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OUT OF THE ORDINARY

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They think it's all over...

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It was very pleasant to wake up on a Monday morning not facing the bankruptcy or rescue of a bank for the first time since March 6th. Even so, there were moments on Friday when people were beginning to wonder whether we were in for a third weekend of fraught government and central bank negotiations. Deutsche Bank was served up as the bears' next sacrificial lamb as the price of insuring its debt against default shot up and its share price fell more than 10% intra-day. But calmer heads prevailed in the end.

Indeed, as if to bookend the events of the last few weeks, the weekend saw First Citizens Bank (FCB) of North Carolina taking both the assets and liabilities of Silicon Valley Bank's US business off the hands of the Federal Deposit Insurance Corporation (FDIC). But it's a measure of the run suffered by SVB that FCB is only assuming $56bn of customer deposits against the roughly $180bn that were in SVB before it started to unravel. The FDIC estimates the cost of SVB's failure to be in the region of $20bn, which doesn't seem to be an unreasonable sum for maintaining equilibrium in the global financial system.

For now, then, it does appear as though all four of the banks that are no longer with us (SVB, Silvergate, Sovereign NY and Credit Suisse) were victims of circumstances peculiar to themselves, with deposit outflows being the prime catalyst of their ultimate demise. Call it a duration mismatch between liabilities and assets, or a loss of faith in the competent management of the business (very much the case at Credit Suisse), but there is still little to suggest that we are on the cusp of a classic solvency-driven banking crisis during which borrowers are unable to make good on either their interest payments or loan repayments.

Commercial real estate risks rise

However, there are still many who maintain that the next leg of the bear market is going to play out that way. Deutsche Bank notwithstanding, US regional banks remain the main area in the spotlight for further trouble, with the primary, but not only, concern being around commercial real estate lending. According to data from Nomura, small and medium banks in the US (ie those below the Top 25 by size of loan book) account for the following percentages of lending in various categories: total share of loans is 38%, of which: Credit Cards 27%; Industrial & Commercial 28%; Residential Loans 37%; Other Consumer 48%; Autos 50%; and the one that they are most concerned about - Commercial Real Estate (CRE) 67%.

Within CRE, offices are under particular scrutiny, with West Coast technology a sub-sector under meaningful pressure. This is down to several factors. The shift to more flexible working patterns has been a risk for a while in terms of the requirements for space, and in future, one can add the need to make buildings more compliant with sustainability and environmental requirements. On top of that, cost savings are being forced upon companies as equity backers in both private and public markets ask them to prioritise profitability over hell-for-leather growth. Shrinking office space is an option.

Goldman Sachs believes that as much as 30% of existing office stock in the US could be obsolete by the end of the decade. We have already witnessed some tick up in CRE loan defaults, but not yet at an alarming rate. To put that into context, the current CRE default rate in the US is around 2.5% against 11% during the Great Financial Crisis in 2007/8.

Going back to all those outstanding loans made by regional banks, most of them will be to private entities, not publicly quoted ones, and certainly not to the large and mega-caps. JP Morgan provides the following data: 90% of debt for companies in the S&P500 Index is fixed and just 10% is floating. A lot of it will be well termed out too. There is limited refinancing risk here. In the mid-cap S&P400 the ratio is 65%/35%, and in the small cap S&P600 it's 60%/40%.

But outstanding debt is going to be lot more skewed to floating interest rates the further down the market capitalisation scale you go, and especially into the unquoted economy. Bearing that in mind, it's worth remembering that the size of the leveraged loan market (which is floating rate notes) is $1.6 trillion, which is bigger than the more often referenced high yield market, which is $1.4 tn. JP Morgan reckons that only around 20% of this debt is hedged, and so there is a refinancing time-bomb ticking away in the background.

How might this impact interest rates?

From an interest rate perspective, refinancing is something that generally has not been a great burden for the last forty years. Indeed, an interesting statistic I came across recently was that since 1980, there have, until now, only been five months when the yield on a 10-year Treasury bond was higher than it was ten years previously. That probably needs some further fact-checking, but it does ring true in terms of the huge tailwind investors have enjoyed for equity valuations during the period. It also underlines how much easier it has made it to finance burgeoning government deficits, and it might well be the risk of fiscal rather than corporate constraints that ends up putting the ultimate cap on policy rates and bond yields.

Even so, most of the economics community still expects at least one more round of interest rate increases in the US, even if the futures market is not so inclined. A standard line of argument is that both consumption and capital expenditure remain relatively robust, with excess savings accumulated during the pandemic and fiscal incentives covering both the energy transition and the reshoring of manufacturing supporting activity. With inflation refusing to abate as much as central banks would like, they will keep tightening conditions until the medicine works (or until something else breaks – it looks as though SVB was not big enough a casualty, nor Credit Suisse).

But there remains a disconnect between the stated intentions of the Federal Reserve and what markets are pricing in. At last week's meeting, the Fed reiterated its "higher for longer" approach to interest rate policy. This remained evident in the "dot plot" of members' estimates of future rates. They are forecasting, on average, a peak rate of 5.1%, whereas futures markets are stuck at 4.92% (data as of midday Monday 27th). That's almost one meeting's worth of a 25bp increase difference. And the gap becomes a chasm when it comes to the year-end projections. The Fed sees the rate as unchanged from that peak by December's meeting, but markets are pricing in a full percentage point of cuts (with the implied rate at 4.13%).

The market outlook

We keep thinking that markets are trying to have their cake and eat it. If the economy (and therefore profits) remain resilient, the market is going to have to price out those rate cuts. It's had to do that a couple of times already in this bear market, with negative consequences for the valuation of equities on each occasion. The alternative is that the economy does slow down sharply and profit forecasts are reduced too. While lower rates might be more supportive for valuations, the earnings themselves will be lower.

All of this points to a choppy environment for equities, with the elusive "immaculate disinflation" outcome really being the only one where we think we could be caught out to the upside. But we think that this is the lowest probability outcome too. Indeed, more like wishful thinking.

And so, there is still a waiting game to play from a market perspective, which might well involve periods of rotation between cyclical and defensive plays. Investors are currently positioning themselves in the safer havens, with mega-cap technology in the US being a particular beneficiary, thanks also to falling real bond yields. The MAGMAN cohort (Microsoft, Apple, Google [Alphabet], Meta, Amazon, Nvidia) collectively added around $620bn of market cap from when the regional bank issues began, up to the closing bell last Friday, which compares to around $950bn of collective market cap lost by the remaining 494 companies in the S&P 500. And another interesting factoid: Microsoft and Apple alone now comprise more than 13% of that index. No two names have been this dominant since AT&T and IBM back in 1978.

But we don't want to get carried away with this short-term trend either. Even technology companies are cyclical, let's not forget. And so, while most investors must remain invested somewhere in the market, there still has to be an eye on value.

Economic Commentary

FTSE 100 weekly winners

BAE Systems plc	7.4%
Melrose Industries PLC	7.2%
Ocado Group PLC	5.6%
Reckitt Benckiser Group plc	5.1%
Antofagasta plc	5.1%
Admiral Group plc	4.3%
3i Group plc	4.0%

FTSE 100 weekly losers

Standard Chartered PLC	-6.7%
British Land Company PLC	-6.5%
Just Eat Takeaway.com N.V.	-5.6%
Kingfisher Plc	-5.0%
Land Securities Group PLC	-4.7%
Barclays PLC	-4.1%
Polymetal International Plc	-3.6%

FTSE 100 index, past 12 months

EuroStoxx 600 index, past 12 months

S&P 500 index, past 12 months

All data shown in GBP.

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