MARCH 13, 2023

PHILEQUITY CORNER

By Wilson Sy

Bank rout

Financial stocks tanked as the SPDR S&P Bank ETF (KBE) tumbled 11.1% in two days. Global equities followed suit as the S&P500 sank 3.3% while the All-Country World Index ETF (ACWI) fell 2.9%. These came on the back of the rapid collapse of Silicon Valley Bank, the biggest US bank failure since the 2008 Global Financial Crisis. This development stoked fears of a contagion brought about by rising interest rates.

Silicon Valley woes

Last Friday, California banking regulators announced the closure and federal takeover of Silicon Valley Bank (SVB), the 16th largest US bank and a top funding source for tech startups and venture capital. SVB's business model of financing tech startups that have a high frontloaded cash burn has become untenable in light of tightening liquidity amid a rising interest rate environment. SVB initially announced that it would undertake a share sale after taking a substantial loss in its fixed income investment portfolio. These announcements sparked fears regarding the financial health of SVB, thus prompting prominent venture capital funds to withdraw their deposits with the bank. The bank run on SVB was too swift that it triggered a takeover by the US Federal Deposit Insurance Corp (FDIC). SVB's listed parent, SVB Financial Group (SIVB), fell 60% last Thursday before its trading was halted last Friday.

Silvergate closes amid crypto crash

Another casualty was Silvergate Capital (SI) which announced its closure last Wednesday. Silvergate was a bank that focused on serving crypto companies. Like SVB, the bank experienced a massive outflow of deposits. It was consequently forced to sell investment securities at a loss to raise funds to cover withdrawals. These, coupled with a more stringent regulatory environment, prompted Silvergate to close down operations and liquidate the bank.

Banks got Powelled

Wells Fargo's bank analyst, Mike Mayo, said that banking stocks got Powelled by the hawkish statements and actions of Powell and the Fed. Mayo stated that hiking interest rates at an unprecedented pace may pummel smaller regional banks. In Powell's testimony to the US Congress last week, he reiterated the Fed's firm hawkish policy stance in light of strong economic data and persistently high inflation. Below are some quotes from Powell's recent testimony which spooked investors and set the stage for the global rout in banking stocks.

- "Although inflation has been moderating in recent months, the process of getting inflation back down to 2% has a long way to go, and is likely to be bumpy."
- "The latest economic data have come in stronger than expected, which suggests that the ultimate level of interest rates is likely to be higher than previously anticipated."
- "If the totality of the data were to indicate that faster tightening is warranted, we would be prepared to increase the pace of rate hikes."

Early casualties

Central banks around the world embarked on a historic pace of monetary tightening to tackle the highest inflation in a generation. The failures of SVB and Silvergate may be signifying deeper stress in the financial system amid the unprecedented global monetary tightening. Bigger banks with stronger funding and larger depositor bases can withstand tighter liquidity. In contrast, smaller regional banks with less stable funding are more vulnerable to tougher liquidity conditions. Considering the recent developments, the Fed and other central banks would have to be more vigilant and circumspect in assessing the far-reaching consequences of their actions.

Philippines feels the pinch

Though the Philippines has a resilient economy and a robust banking system, the country also felt the pinch of elevated inflation and rising interest rates. Domestic inflation remained high despite the pullback in petroleum prices. The country's unemployment and underemployment rates creeped up. The banking sector's NPL ratio moved higher while salary-based personal loans soared 60%. These metrics bear watching as these show the health of the Philippine economy and banking system during the ongoing global monetary tightening.

Unintended consequences

While US banking regulators may not have intended it, the collapse of SVB and Silvergate are consequences of their aggressive monetary tightening and steep policy rate hikes. The sudden closure of these banks would have a seismic impact not only to the financial sector, but also to tech, biotech, and crypto companies globally. Silicon Valley is the pride and glory of the US and is the main hub for tech innovation. The failure of Silicon Valley's top bank would squeeze funding for the tech sector. This can question the business model of tech startups and venture capital, and challenge their status as primary growth engines of the American economy. Meanwhile, depositors would now be more scared or wary of maintaining deposits with smaller regional banks, and this can further exacerbate the latter's troubles.

Contagion fears

The rapid reversal of monetary policy from ultradovish during the pandemic to the current ultrahawkish stance inevitably resulted in the failures of Silicon Valley Bank and SIlvergate. Is this the tip of the iceberg? Will these problems spread to a larger part of the financial system? Will these issues affect tech and startup companies around the world and stifle their growth? Would these concerns hamper the global economic recovery and snowball into a deep recession? In light of the recent bank failures, contagion is a new risk with far-reaching implications that investors and regulators must now study and consider. Markets may suffer in the short-term as investors price-in contagion risk and digest Powell's recent hawkish comments.

Philequity Management is the fund manager of the leading mutual funds in the Philippines. Visit www.philequity.net to learn more about Philequity's managed funds or to view previous articles. For inquiries or to send feedback, please call (02) 8250-8700 or email ask@philequity.net.