Origins Capital

Market Liquidity Risk and Asset Allocation

May 2023

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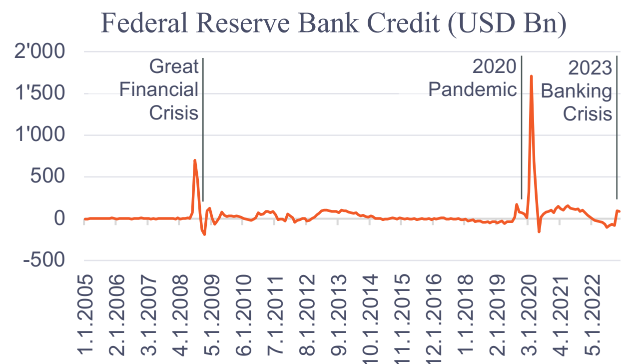
SVB Failure Highlights Systemic Liquidity Risks

The banking industry crisis spurred by rising rates, weak liquidity and financing conditions.

There were five significant events in March 2023 that provided a stark reminder of the Global Financial Crisis (GFC) and its contagion effects. However, the closures of Silicon Valley Bank (SVB) and Signature Bank and the sale of Credit Suisse were all idiosyncratic and a by-product of the liquidity and confidence crisis as compared with the broad-based global systemic issues noted in GFC. Also, there were specific issues related to portfolio concentration, internal financial management and hedging that, coupled with ongoing monetary tightening that led to these collective failures.

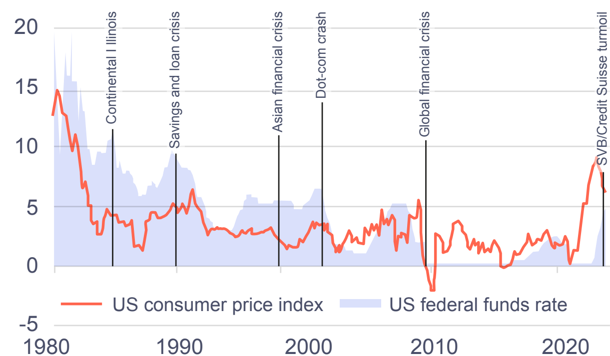
US regulators quickly responded with implicit deposit guarantees and liquidity facilities to backstop the banking system, tapping the Federal Reserve liquidity facilities at record levels amid the collapse that totalled $165Bn much higher than the $112Bn drawn during the GFC. Simultaneously, the Fed, along with five central banks (BoC, BoE, BoJ, ECB and SNB) announced coordinated action to enhance US dollar liquidity. While the systemic banking risks are seemingly under control now, the effects of banking stress on credit conditions have come into focus. Market pricing of rate cuts could imply that tightening from stricter lending standards could substitute for future rate increases.

Federal Reserve Bank Credit (USD Bn)



Source: Federal Reserve

Inflation, Interest Rates and Crisis Correlation



Source: IMF

1H23 - A Timeline of Key Events

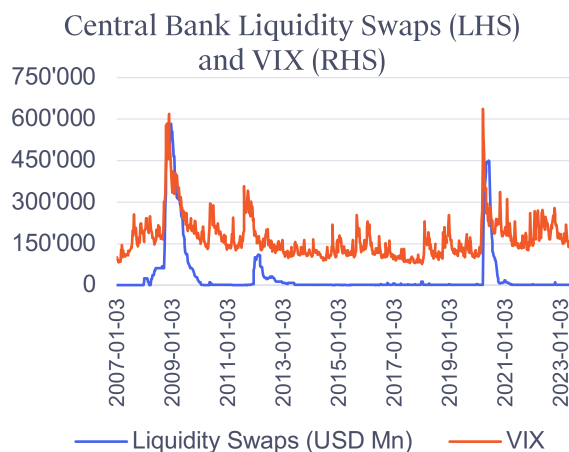
- **March 8: Silvergate Capital ceases operations.** As global crypto market found itself in troubled waters from the massive LUNA collapse in May 2022 due to mismanagement of funds by former FTX CEO Sam Bankman-Fried, Silvergate Bank reports losses of $1Bn in Q422, followed by an announcement of its winddown in early March 2023.
- **March 10: SVB failure is the largest since 2008 financial crisis.** SVB's failure raises questions about the venture startup's ability to ride out the current economic downturn. In March, SVB was shut down abruptly as rapid customer withdrawals ($40Bn in one day) strained the bank's liquidity as regulators rushed to prevent a broader systemic crisis. Its concentrated exposure to tech industry along with exposure to a large uninsured depositor base proved fatal.
- **March 12: Signature Bank's collapse.** As SVB's collapse sent shock waves through the U.S. financial system, Signature Bank failure followed soon. A plunge in crypto prices harmed the bank, especially after crypto-friendly Silvergate Bank wound down in early March. Signature faced a surge in withdrawals and was subsequently forced to shut down by regulators.
- **March 19-20: UBS group merger with Credit Suisse.** The global banking industry saw one of the largest, unexpected mergers of SIFI institutions since the GFC, as contagion fears were stoked by financial troubles at Credit Suisse. In March, the Swiss National Bank provided $100Bn to UBS to facilitate the takeover of Credit Suisse and the Swiss government backstopped some of UBS losses (~$9Bn).
- **April 24: First Republic Bank failure.** Failure of First Republic marks the latest panic-driven fallout. The bank reported that customer deposit withdrawals totaled $100Bn in March leading to a sharp drop in market confidence. The bank was subsequently placed under FDIC receivership on May 1 by regulator.

The Liquidity Conundrum

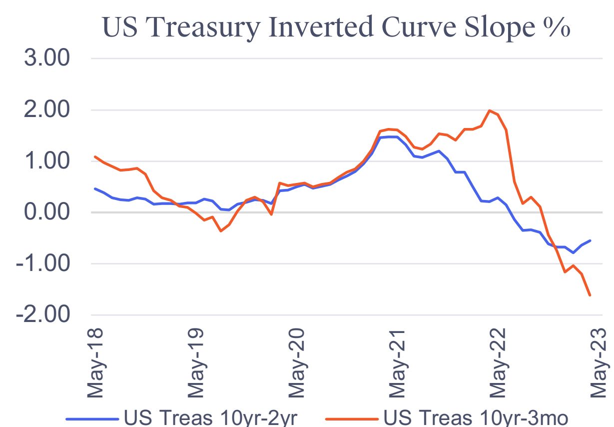
After a decade of abundant market liquidity followed by Covid-19 exogenous shock in 2020 that led to market repricing than quick recovery, year 2022 marked the onset of a period of heightened volatility. Macroeconomic weakness, inflation, rising interest rates and geopolitical risks have left investors/asset managers navigating murky waters. The banking crisis that ensued in the aftermath of the SVB failure has lowered risk appetites and players are closely watching liquidity stress in the financial markets. In the next few years, asset allocators will likely move away from traditional strategies such as liquid/alternative assets play to an integrated risk factor approach where the capital and risk allocation goes to for e.g., credit and then the implementation spans across liquid securities (IG or HY), private placements and infrastructure debt, etc. Lines are blurring when it comes to liquid and illiquid investing.

Investor considerations in the current market scenario

- The largest yield curve inversion since the 1980s has been in place from July 2022.
- Relatively wide credit spreads in lieu of recent strain in the banking system (SVB failure, the takeover of Credit Suisse by UBS and ongoing investigations into tax avoidance at several European banks.
- Aggressive rate hikes by major central banks – The US Federal Reserve (Fed) in its May Federal Open Market Committee (FOMC) meeting increased Fed funds rate by 25bps to 5.25%. Market has not yet priced in a significant chance of further Federal funds rate hikes while rate cuts are factored in.
- Geopolitical risks – The continuation and potential expansion of the banking sector crisis, the Ukraine conflict with a subsequent impact on commodity and energy supply and prices. Ongoing debt ceiling negotiations – Market needs to price in negative spill over if Congress fails to raise the debt ceiling in a timely fashion.
- Persistent inflation – longer-than-anticipated elevated inflation.
- The interplay of public and private lending in today's credit markets – where the decadal switch to higher-for-longer rates with elevated inflation and looming risks of recession could raise defaults, especially in the private markets.



Source: FRED



Source: FRED

Active Asset Allocation, Alternative Investments and directing lending strategies will be top investment themes in the near-term

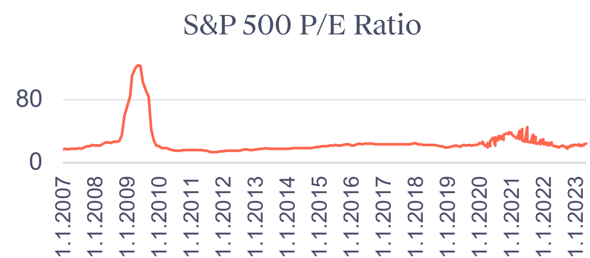
- Active asset allocation will be the preferred choice to navigate cyclical uncertainty, while pursuit of uncorrelated returns will lead to more risk-mitigating strategies. Last year saw both equity and bond markets decline, and the positive correlation turned the equity/bond relationship from risk-mitigating to risk-additive.
- Investors will likely increase their allocations in private equity or private debt given significant dry powder, an appetite for higher yields and lower market volatility. The asset class enjoyed a strong tailwind until 2020, when activity stalled due to the Covid-19 pandemic but has since gained momentum.
- In private debt, direct lending strategies should be preferred, as banks stay away from mid-cap corporate lending.

Embedded Losses Within Various Pockets of Asset Classes

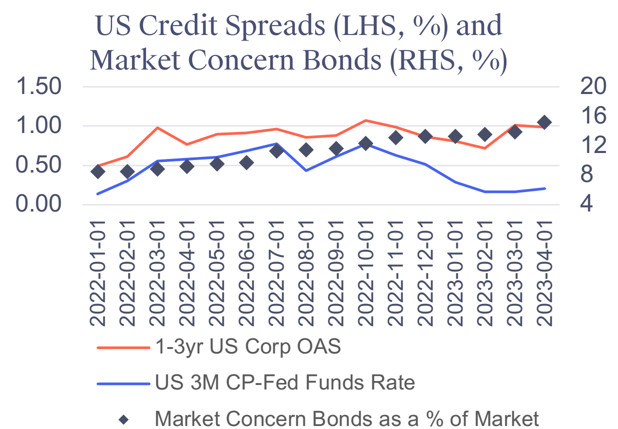
The performance of public equities will likely soften in the coming 12 months: After a downcast 2022, equity markets showed great resilience in 2023 with strong positive returns from the start of the year. The S&P500 is trading at 24x P/E, largely driven by the top 10 stocks. Market turbulence post the collapse of SVB has failed to affect investor optimism, leading to overall gains in the quarter. However, global monetary conditions do not appear to support risk-taking over the next 12 months. Specifically, the global money supply in excess of what the economy can organically absorb is flat—effectively robbing the market of the liquidity it needs to expand. Also, weak data, stoking fears of recession; uncertainty around tighter bank lending; and fed action are major headwinds for public equity.

Public debt anticipates gradual reductions in pricing pressures: With financial stability risks remaining elevated, we believe asset managers would lean towards 'higher quality over higher yields' in fixed income, noting that current yield levels are more than twice a year ago. New issuance continues to be light and planned supply is expected to be low all year. Defaults have stayed below historical averages, but a larger percentage of issuers are trading at distressed levels. With a potential recession in view, spreads should widen further; however, they are likely to remain below the extreme levels seen during the Great Financial Crisis (GFC) and Covid-19.

Leveraged loan markets need closer monitoring: In 2022, total new issuance volume in the syndicated loan market plunged 63% to a 12-year low of $225 bn amid market volatility. As markets normalize, activity will likely gain traction in 2023 with upcoming maturities resulting in higher refinancing volumes. However, high interest rates coupled with weak macro conditions are expected to negatively impact credit, especially in Europe, where opportunities in this spectrum should grow significantly in 2023.

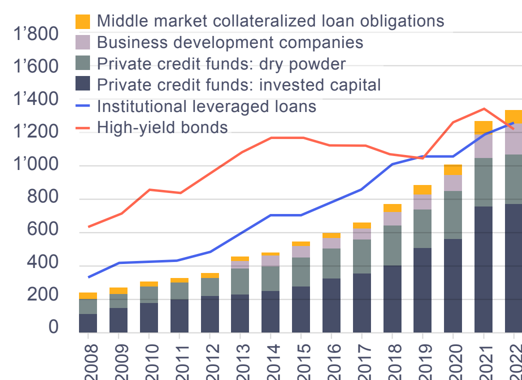


Source: Nasdaq



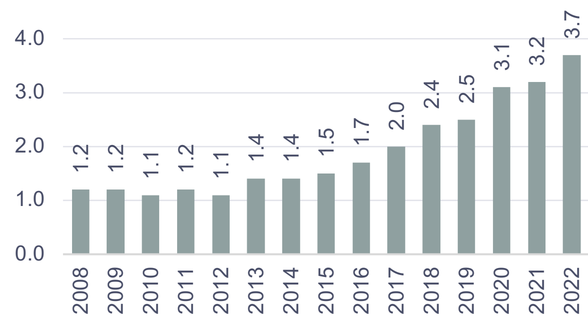
Source: FRED, Fitch Ratings U.S. High Yield Default Index

Private Credit AUM, US Leveraged Loans and HY outstanding loans ($Bn)



Source: IMF Global Financial Stability Report Apr 23

Private equity deal volumes to dwindle: In 2023, we anticipate lower valuations, increased buyout, merger and acquisition activity, and more quality portfolios for sale in the secondary market. The industry ended 2022 with record dry powder of $3.7tn, and the general partners would be eager to deploy. However, macroeconomic weakness will continue to curb deal activity, especially for the largest transactions that require the most leverage. For exits, asset allocators will likely use secondary markets to balance portfolios, seeking attractive pricing today than to avoid selling at a discount in the future.



Source: Statista

Private debt to maintain momentum: Private credit performed robustly in 2022 when compared with conventional fixed-income alternatives. With rate hikes and heightened market volatility, investors were drawn towards private credit as a diversified means for uncorrelated returns. Moreover, the large chunk of dry powder with the GPs acted as a catalyst. With the traditional 60-40 portfolio underperforming in 2022, investors and allocators reconsidered their private credit allocations. The asset class will gain traction in the future. However, implications for credit quality and portfolio risk are yet to be tested in an economic downturn with high inflation continuing to elevate borrowing costs and squeeze margins.

*Note: Market Concern Bonds as defined by Fitch Ratings are HY bonds that are expected to default in the next 2 years