MyStratWeekly
Market views and strategy

Ostrum ASSET MANAGEMENT

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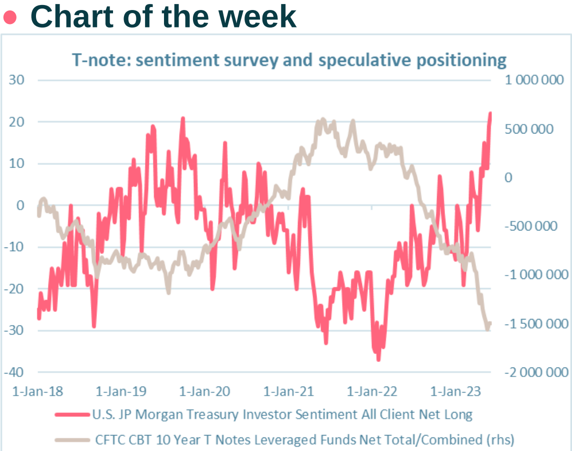
Topic of the week: US banks: health check two months after SVB.

- **Deposit outflows have hit small banks in March and then larger institutions as savers shift holdings into money market funds;**
- **Outflows have slowed recently but aggregate bank deposits are down about 5% year-to-date;**
- **Investors feared a credit crunch would tip the US into recession. Weekly credit data have been rather reassuring;**
- **Banks have used reciproqual deposit schemes to expand the share of deposits insured by the FDIC;**
- **Money market funds have attracted savings by offerring higher returns and banking on high rates at the Fed's reverse repo facility;**
- **The Fed should tweak the RRP to stem risks of bank runs and channel MMF assets back into Treasury bill markets.**

Market review: Fed: pause and active thinking

- **Fed: rates unchanged but restrictive bias;**
- **Euro zone: technical recession between Q4 and Q1;**
- **Risky assets resist the rebound in long rates;**
- **Credit and high yield benefit from the low level of equity volatility.**

Chart of the week



Source: Bloomberg, Ostrum AM

The positioning on the Treasuries market is difficult to read. Sentiment surveys describe a clearly long positioning of investors (at the highest since 2019) which constitutes a bearish signal on the market.

Conversely, hedge funds have unprecedented net short positions. Speculative accounts are thus betting on a rise in long rates. These exposures can also represent credit hedges or strategies playing on the narrowing of bases between securities and derivatives, for example.

Figure of the week

23.5

Source : Ostrum

This is the abyssal exchange rate of the Turkish Lira for one US dollar on Friday. The depreciation has accelerated since the results of the Presidential elections.

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● Topic of the week

US banks: health check two months after SVB

The crisis that wiped out three banks since March has sparked expectations of a full-fledged credit crunch in the US and downward revisions to the growth outlook. Deposit outflows initially concentrated in regional banks but have spread to larger banks more recently. Money market funds have attracted savings held previously with banks. Banks have been active to maximize insurance coverage and reassure savers. The Fed intervened to stem the crisis, but we argue that its reverse repo facility may have exacerbated the crisis.

The deposit shift crisis

Regional banks have made headlines since March. Three large financial institutions failed and a few more are teetering. Silicon Valley Bank (SVB), Signature Bank (SB) and more recently First Republic (FRC) all succumbed to deposit outflows far exceeding their ability to raise liquidity in a timely manner either via asset sales or borrowing from the Fed emergency facilities.

Banks are fragile by design and trust is undoubtedly their most important asset. The banking panic manifested itself in swift deposit outflows chasing safety at larger banks or higher returns offered by money market funds. It is worth mentioning that credit quality was not the issue: default rates remain low across the board.

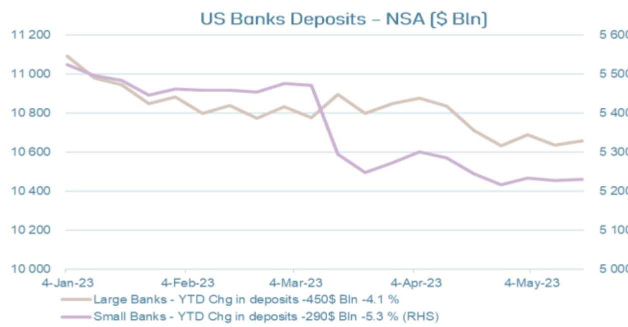
Hence, this crisis raises many questions about the future of banking regulation, the risk assessment of deposit liabilities and the implied price of deposit insurance. But we will leave these important questions aside to focus on the still evolving situation in the US banking sector.

The financial backdrop could be conducive of further banking stress. With the debt ceiling out of the way, the US Treasury will have to raise financing to restore its depleted cash. Bill issuance should amount to between $600-700 billion in the coming weeks. Furthermore, the Fed may not be done raising interest rates after all as core inflation remains stubbornly high. The combination of increased borrowing needs and higher rates could further stress bank balance sheets and reduce their ability to lend. US money market funds should continue to attract inflows to the detriment of bank deposits.

Deposits down for both large and small banks

Deposit liabilities at small banks have fallen suddenly in March. In the case of SVB, the bank run was particularly swift as 42 billion went out the window on its last day of its 40-year existence. Electronic withdrawal and a concentrated client base magnified the panic. There were other factors at play but the speed of that bank run was unusual. As Washington Mutual collapse in 2008, deposit outflows reported totaled $18 billion over a 10-day span. Hence market participants have paid attention to weekly deposit data produced by the Fed. The Federal Reserve groups banks into large and small institutions. It is worth noting that 'small' US banks may have tens of billions in assets.

Bank deposits have fallen to the tune of 5% in aggregate. In March, bank deposits fled small banks, particularly regional institutions. The sharp fall in deposits at small banks coincide with the demise of SVB on March 9th. Initially, deposits with large banks were stable or slightly up as depositors turn to larger institutions for safety. From mid-April however, even large banks have felt the pinch of deposit outflows. So far in 2023, deposits have shrunk by $290 billion at small banks (or -5.3% year-to-date) and $450 billion at large banks (-4.1%).

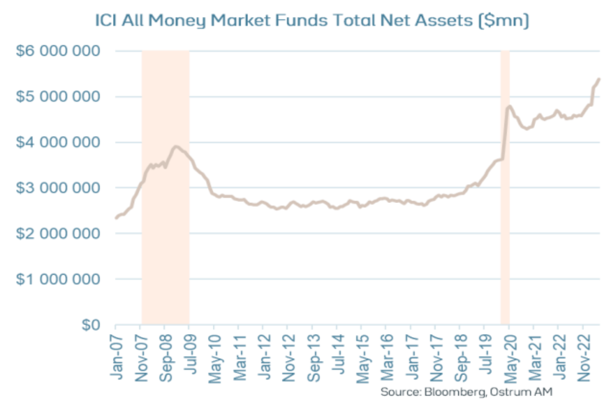


Source: Bloomberg, Ostrum AM

US banks are losing deposits mostly to money market funds (MMF). Deposits and shares in MMF are not perfect substitutes. Deposits can be subject to a guarantee from the FDIC and offer access to bank services (including checking accounts and services). But MMF offer daily liquidity. Both can be subject to runs and liquidity mismatches by the way as the 2007 liquidity crisis showed.

As the Fed started raising rates last year, the market rates offered by Treasury bills climbed. Money funds thus returned more to savers than deposits as banks tend to pass on only a portion of the rate increases (to protect their interest margins). However, when overall excess liquidity starts declining and savers aim at maximizing yields, banks will have to tap markets for short-term funding or raise deposit rates. The rising share of time deposits in bank liabilities suggests that banks have indeed paid up for deposits as long as it helps to stabilize their liabilities.

As can be seen in the next chart, money market funds have attracted bank customer savings lately. MMF inflows always tend to rise in times of recession as investors sell risky and growth-sensitive assets to reduce portfolio risk exposure. This time round, savers piled up holdings in MMF as an alternative to bank deposits. On ICI data, it appears that MMF assets under management have risen by $282 billion since March 22nd, 2023 or about 5% of AuM. Of the $287 billion, institutional money accounts for $179 billion of new inflows whilst households have moved $108 billion since the peak of the crisis.



Swapping deposits to expand insurance coverage

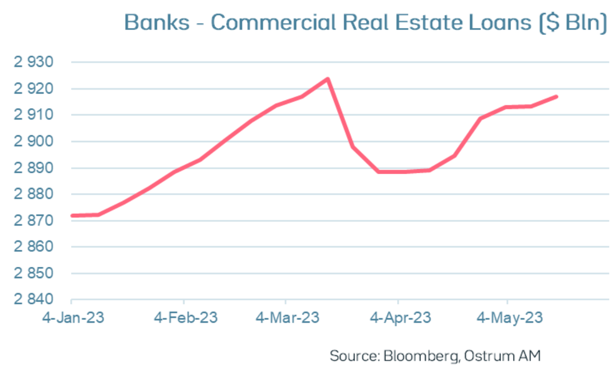
One lesson must be drawn from the SVB meltdown: both household and institutional depositors must be wary of the uninsured part of their deposits. Such need for security must be addressed by banks. Banks are therefore finding ways to expand deposit insurance to reassure savers.

Enhancing insurance entails the use of reciprocal deposits, which funnel a portion of customer cash to other depository institutions, keeping the total amount in each account less than the FDIC-insured $250k cap. In that process, banks enroll customers into reciprocal deposit networks. The biggest of these networks is run by IntraFi, owned by private equity giants Blackstone and Warburg Pincus, and connects about 3,000 banks. Amounts deposited in such reciprocal accounts soared to a new record high of $221 billion at the end of the first quarter, up from $158 billion at the end of 2022. The share of deposits covered by the FDIC is now the highest in more than 10 years at 56%. At first glance, reciprocal deposits should add to financial stability by reducing the risk of a bank run, but it is a form of legit window-dressing spreading operational risk.

Lending impact of stress on deposit liabilities

Deposit outflows from regional banks have raised questions about the lending side. The Fed's quarterly survey of bank lending conditions points to a broad-based tightening in lending standards.

Regional banks play a key role in the financing of commercial property. In the wake of SVB's collapse, there was an immediate shock on CRE loans outstanding. Since mid-April though, commercial banks' CRE lending has resumed rising. Nevertheless, anecdotal evidence indicate that credit is harder to get for SMEs and other borrowers.

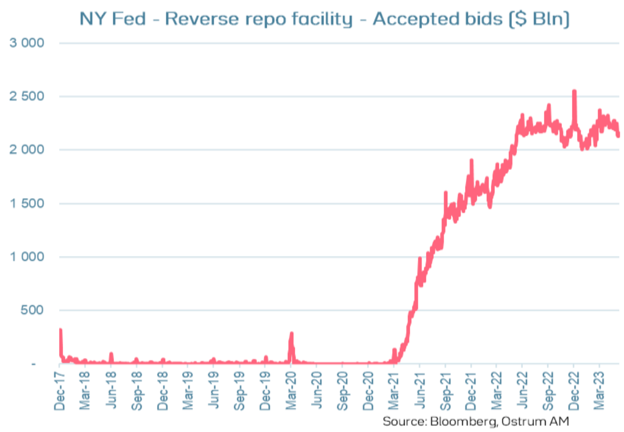


Has the Fed made the problem worse?

An important question is whether the Fed has unintendedly made the deposit outflow problem worse. Of course, the Fed has a range of tools to provide emergency liquidity to banks. But the ample reserve system put in place in the aftermath of the global financial crises (GFC) expanded the Fed's intermediation role in US money markets.

The reverse repo facility allows banks, GSE and other counterparties including money market funds to earn interest on an overnight basis and receive collateral from the Fed's SOMA holdings. The Fed borrows liquidity and lend out securities. The RRP rate has followed the Fed funds rate higher and now stands at 5.05%, near the lower end of the Fed funds range (5-5.25%). The reverse repo facility absorbs $ 2.1 trillion excess cash in the financial system at present. It is estimated that money market funds hold nearly 100% of that total. The safe and high rate earned on the RRP facility mean that money market funds can offer very high returns compared to bank deposits.

On FDIC data, the average national deposit rate was indeed a paltry 0.40% on savings accounts at the end of May and 1.59% on 1-year certificates of deposits. Furthermore, interest rate restrictions limit a less than well capitalized institution from soliciting deposits by offering rates that significantly exceed yields in its prevailing market. In addition, yields on the shortest-term T-bills have been low in the past few months due to the debt ceiling crisis. Direct holdings of bills were no match to the overnight Fed facility either.



In sum, the Fed could arguably help stem outflows from the weaker banks by lowering RRP overnight rates or reduce its counterparty limit which stands at a sizeable $ 160 billion. The Fed's reverse repo rate has been set 5 bps above the lower bound since June 2021. However, the spread between the reverse repo rate and the lower bound of the Fed funds rate was negative in 2019 (5bps below) in response to tensions on repo market rates. Increasing bill issuance could require a cut in the reverse repo rate to smooth market functioning. A reduction in the counterparty limit could also help channel funds towards the US T-bill market.

Conclusion

Two months after the SVB's collapse, deposit outflows from weaker banks have slowed, if not stopped. However, larger banks have suffered from a second wave of outflows. Money market funds have attracted the bulk of bank deposits, forcing banks to find ways to maximize FDIC insurance coverage and reassure customers. On the lending side, credit standards have tightened but even CRE lending is showing signs of life. The Fed could tweak its reverse repo facility to stem the stress on bank liabilities.

Axel Botte

Market review

Fed: pause and active thinking

Equities and credit resist the rise in the T-note towards 3.75% before the meetings of the Central Banks

Bond yield movements during the blackout periods preceding the FOMC meetings are often indicative of the positioning of participants. The uptrend in bond yields, briefly interrupted last week, has resumed so that the US 10-year note is back in the 3.75% area. The Fed is expected to take a pause in June, but a new hike could be on the agenda in July. The recent U-turn from the RBA or the BoC tells us that a pause does not necessarily herald an upcoming rate cut. The ECB is expected to proceed with two rate hikes in June and July. In the United Kingdom, the reluctance of two of its MPC members will not prevent the BoE from taking action against inflation. The Gilt is approaching 4.25%. The rebound in long bond yields was little impediment to risky assets. Credit is well oriented as the low volatility environment favors carry plays. The tightening in swap spreads set the tone, and sovereign, credit and high yield spreads rallied. As for stocks, the S&P 500 has rallied 20% from last fall lows. Technology stocks still dominate the market, but trade-offs are taking place to the benefit of small-cap stocks. The Russell 2000 bounced by 6%. Europe also gave up some performance after a jump in equity prices at the start of the month. The rise in equities still coincides with a somewhat weaker dollar. The euro climbs back above $1.07. The level of the Japanese yen, close to 140 against the US greenback, remains problematic for the Chinese authorities who are seeking to control the slide of the yuan, which is also justified by the desire for domestic monetary easing. The collapse of the Turkish lira (beyond 23 against the dollar) continues despite the alleged willingness of authorities to restore a more conventional policy mix.

The economic situation should lead the Fed to raise its projections for growth and underlying inflation this week. The latest publications confirm the good performance of the labor market and growth in the second quarter should be around 1.5% or even 2%. Key FOMC members appear to be opting for a pause but the hawkish policy bias will persist. The expected fall in inflation is not a sufficient argument to start an easing cycle, especially as the risk of recession recedes and housing, a particularly rate-sensitive sector, recovers. Two central banks were forced to revise their plans. The BoC and the RBA raised rates by 25 bps contrary to market expectations for a status quo. The BoE is probably in a similar situation. In Europe, a technical recession is now confirmed after a first quarter at -0.1%. Disinflation should support consumption, especially as job growth is strong (+0.6% in Q1) and wages are on the rise. The ECB will probably raise rates twice and then most of the monetary tightening effort will come from the reduction of excess liquidity. TLTRO repayments will be substantial in late June (€477 billion) and balance sheet reduction will amount to €148 billion in the second half of 2018.

On the fixed income markets, US investor surveys point to a bullish market sentiment on US Treasuries. Paradoxically, speculative leveraged accounts display a significant short position on the futures market. This apparent disconnect may indicate that 3.75% on 10-year bonds is an acceptable level of yield over time, but that the hedge fund community is not ruling out a final monetary tightening after the surprises in Australia and Canada. Inflation is no longer a long-term issue for the markets. Indeed, 10-year inflation swaps in the United States and Europe have stabilized around 2.5%. The markets seem to rule out the scenario of persistent price pressures. Yield curve inversion continues and could be further accentuated by the upcoming issuance of T-bills and a probable extension of the Treasury debt maturity from the second half of the year. In Europe, the Bund hit a ceiling around 2.50% but the upward risk-free yield movement contributed to a broad-based tightening of swap spreads and sovereigns. The low stock of marketable Greek bonds added to the narrowing trend in spreads below 130 bps. ECB reinvestment data shows that peripheral debt has been spared for two months. ECB holdings of Italian BTP even increased by €2 billion over this period. Questions about the worsening Italian budget balance did not affect the spread (175 bps on 10-year bonds) especially since the Italian government can tap household savings.

The credit market seems correctly valued at around 100 bps against swap on euro investment grade markets. The spread per unit of leverage is in line with its 5-year average. Having said that, renewed tensions on risk-free rates would probably spark some selling pressure, especially since ETFs are capturing the bulk of credit inflows. We should therefore see a homothetic movement in credit spreads in response to the rise in risk-free yields. High yield (466 bps, -31 bps in five days) has become much more expensive, especially the lower rating categories. Despite potential default cases, the environment remains healthy in terms of credit quality at this stage.

The speculative bubble in artificial intelligence stocks in the United States leads us to reconsider relative valuations. Short covering helped the Russell 2000 to rebound 6% last week. In Europe, earnings are being revised upwards as sector rotations in a flat European market last week seem to favor cyclicals.

Axel Botte

Main market indicators

G4 Government Bonds	12-Jun-23	1wk (bp)	1m (bp)	2023 (bp)
EUR Bunds 2y	2.86%	-3	+27	+10
EUR Bunds 10y	2.33%	-5	+5	-24
EUR Bunds 2s10s	-54bp	-2	-22	-33
USD Treasuries 2y	4.56%	+10	+58	+14
USD Treasuries 10y	3.71%	+3	+25	-16
USD Treasuries 2s10s	-85bp	-6	-32	-29
GBP Gilt 10y	4.24%	+4	+47	+57
JPY JGB 10y	0.43%	0	-2	-15
€ Sovereign Spreads (10y)	12-Jun-23	1wk (bp)	1m (bp)	2023 (bp)
France	53bp	-1	-4	-2
Italy	168bp	-8	-12	-46
Spain	96bp	-4	-9	-12
Inflation Break-evens (10y)	12-Jun-23	1wk (bp)	1m (bp)	2023 (bp)
EUR 10y Inflation Swap	2.43%	-8	+6	-12
USD 10y Inflation Swap	2.49%	-3	+2	-4
GBP 10y Inflation Swap	3.8%	+2	+9	-12
EUR Credit Indices	12-Jun-23	1wk (bp)	1m (bp)	2023 (bp)
EUR Corporate Credit OAS	164bp	-5	-4	-3
EUR Agencies OAS	77bp	-3	-4	-2
EUR Securitized - Covered OAS	84bp	-4	-6	+1
EUR Pan-European High Yield OAS	465bp	-20	-47	-47
EUR/USD CDS Indices 5y	12-Jun-23	1wk (bp)	1m (bp)	2023 (bp)
iTraxx IG	77bp	-1	-10	-14
iTraxx Crossover	407bp	-7	-44	-67
CDX IG	71bp	-1	-11	-11
CDX High Yield	441bp	-12	-60	-43
Emerging Markets	12-Jun-23	1wk (bp)	1m (bp)	2023 (bp)
JPM EMBI Global Div. Spread	456bp	-8	-27	+4
Currencies	12-Jun-23	1wk (%)	1m (%)	2023 (%)
EUR/USD	$1.076	0.467	-0.793	0.5
GBP/USD	$1.256	0.949	0.787	3.9
USD/JPY	JPY 139	0.287	-2.500	-5.8
Commodity Futures	12-Jun-23	-1wk ($)	-1m ($)	2023 (%)
Crude Brent	$73.0	-$3.8	-$1.0	-12.8
Gold	$1 962.6	$0.7	-$48.2	7.6
Equity Market Indices	12-Jun-23	-1wk (%)	-1m (%)	2023 (%)
S&P 500	4 299	0.39	4.24	12.0
EuroStoxx 50	4 311	0.42	-0.15	13.6
CAC 40	7 257	0.77	-2.13	12.1
Nikkei 225	32 434	0.67	10.36	24.3
Shanghai Composite	3 229	-0.11	-1.33	4.5
VIX - Implied Volatility Index	14.65	-0.54	-13.98	-32.4

Source: Bloomberg, Ostrum AM

Additional notes

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