What's Next For Investors After Silicon Valley Bank

By Vineer Bhansali| March 12, 2023

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Whenever the yield curve inverts as much as it has inverted in recent days, things break. First crypto, then the UK financial system (and prime minister), and now a large regional bank with outsized influence. The dominoes seem to be falling on cue and there is probably more to come.

Beyond all the statistical "proofs" to the contrary, there is a reason for why finance does not work in a world of negative carry which results when yield curves are inverted and where there is no incentive to lend long by borrowing short. Just as in physics where one can concoct all kinds of experiments to demonstrate the failure of gravity, it still makes more sense to heed gravity than to bet on it not having its way.

Financial markets depend on yield curve "carry" to function: this is one important thing I learnt working with Bill Gross at PIMCO for many years. An inverted yield curve sucks the air out of the markets, and starts to expose who is running a lot of naked leverage. An inverted curve is literally sand in the gears of the engine of the modern financial system. And today there is more sand in the machine, thanks to the Fed, than any other time in the last forty-plus years.

Banks depend on yield curve "arbitrage" for most of their profits. Unless one has been keeping their money under a mattress for the last three years, it is obvious that banks have been enjoying the benefit of not paying much on their deposits. They basically took all the money the Fed printed, and all the money the Federal government sent via helicopter checks to the public, and deposited the windfall into Treasurys and other Fed-created interest-bearing accounts. For some banks, this led to massive risk-free profits indeed. The natural reaction was: If you could borrow from the depositing public at essentially 0%, and earn say 3% or more at the Fed even in short-term assets, why wouldn't you do it in a levered manner and amplify the returns, albeit at higher mark to market risk (but no hold to maturity risk)?

The problem is that you can fool some of the people some of the time, but not all of the people all of the time. As I have written before (see here and here), the public has gotten wise and started to move money out of low-yielding deposits. I have been telling my friends that I buy Treasurys Direct (see here) because I don't have to pay a broker or a bank anything for getting essentially the same yield I would get on a bank CD. And as venture funding dried up, tech startups actually had to start spending the money that they had deposited at banks like SVB.

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Let us do some simple math. Suppose you were a bank and paid nothing on deposits. Let us say you "invested" this money at an average yield of 2% on a bond with duration of 2 years. So you would be making 2% of "income" per year. Now 2022 happens, and two-year yields rise to say 4% over a year. A 200 basis point jump in yield results in a roughly 4% price loss (two times two equals four) minus the 2% yield you earned for the year to leave you with a net 2% loss. No big deal: since you are thinking if you hold the bond to maturity you will get your principal back and no one will know or care about the interim mark-to-market loss.

Now let us say you had levered up the same position by five times. So now you are looking at a loss of 10% on a mark-to-market basis on the holdings if yields rise by the same amount. If you are a typical bank and running a 10-to-1 leverage on your operations, this is enough to make you insolvent on a mark-to-market basis! If you had bought longer duration bonds, or mortgage backed securities whose duration extends as rates rise, or TIPS at negative yields, you don't even need leverage to cause pain as yields rise sharply. The massive penalty from long duration creates a deep mark to market loss. But again, it seems there is no harm done, because if you can hold the position to maturity, you will be able to redeem the bonds at par. But only as long as your depositors don't inconveniently cut you off by demanding their money back.

So the problem with this "free-money" levered carry strategy is that when you are over-levered, you don't have the luxury of holding positions to maturity. Your lenders decide how long you get to hold the positions, and if they ask for their money back earlier you get a "bank run". And there is nothing wrong with a lender getting scared and asking to be made whole so they don't suffer permanent loss of capital. In the case of Silicon Valley Bank, sudden death came because depositors large and small decided they needed the money – and when it became obvious the deposits could not support the leverage, the bank was forced to sell their bond holdings and lock in losses, and basically put the nail in the coffin for the bank. What was "latent insolvency" became all too real.

There is evidence that folks in general have run out of the COVID money they received, and are now going back into hock to meet the high cost of living. So even if they don't move money from the banks to the Treasury market, the amount of low yielding deposits that banks can enjoy is likely to vanish rapidly.

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So what can we do as investors?

Let me repeat my conclusion from the first article referenced above:

"What all of this means is that the impending signs of the Fed's pivot will likely show up first in the price of bank stocks. Banks profited enormously front-running the Fed when it was buying assets (because the banks naturally marked them up and sold them to the Fed), and banks will likely get a whiff of changing Fed winds before the common public does because in the academic halls of the Fed, banks are the main medium through which money flows through the system."

My conclusion was simple: when the banks cry uncle, be ready for the Fed pivot. No wonder that last Friday the 2 year Treasury had one of its largest rallies since the 2008 financial crisis (source: Bloomberg).

Having observed this type of de-leveraging dynamic now for three decades, I would advise investors against catching a falling knife. Yes, banks might look "cheap", but note they still own trillions of dollars of bonds, and there still has not been an en-masse exodus out of bank deposits and bank stocks.

The situation is even more dire for European banks who were forced by the ECB to inhale negatively yielding bonds, and for Japanese banks, who have been forced by the BOJ to eat the same. Meanwhile the Fed, ECB and BOJ have also gorged on bonds (see here) and have barely started to get rid of them. In other words, everyone is suffering from bond overeating syndrome.

As long as inflation remains elevated, it would be tough for the Fed to pivot and start easing; but if the breakage starts to migrate inward to the larger commercial banks that are central to the Fed's model of how the financial system works, all bets are off. Keep a close eye on bank stock prices and default swap spreads.

If the banking sector comes under more stress, the Fed will simply have to throw out the 2% inflation target and agree on a compromise between tolerable inflation (3%-4%) and financial stability. And in this environment, investors would likely do well by holding short term Treasury Bills and T-Notes and short term TIPS and having enough protection against their risky assets like stocks so that they don't have to force sell assets at the wrong time and at the wrong price. Better to let that falling knife hit the ground.

Important Disclosures

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