logical financial management

Logical Thoughts

THE COLLAPSE OF SILICON VALLEY BANK

What happened to SVB Financial Group?

In a nutshell, Silicon Valley Bank (SVB) took in a surge of deposits from its clients who were largely venture capital funds, as well as tech and healthcare start-ups. SVB saw deposits rise 86% in 2021, to $189 billion by year end. Their deposits hit a peak of $198 billion in the first quarter of 2022.

What did they do with all the deposits?

They invested most of the deposits in U.S. Treasury (UST) and mortgage-backed securities (MBS) at an average yield 1.56% for the MBS portfolios and 1.66% for the UST portfolios.

Unfortunately, what happened next was a surge in inflation followed by the U.S. central bank engaging in a dramatic tightening of monetary policy (increasing interest rates). Short-term interest rates rose as did bond yields (bond yields up and price of the bonds down). This led to a sharp decline in the value (mark to market) of their investment securities (US Treasuries and MBS).

The problem was SVB had to keep increasing the interest rate on their deposits as the Fed raised short-term interest rates. So, if you're paying 4% on deposits and earning 1.6% you have a problem. Although, it is believed SVB was paying only about 2% on its deposits. Still, you have an even bigger problem when largely risk-free 2-year U.S Treasury Bills are offering an income yield of c.5%.

SVB's corporate customers did the logical thing and began to withdraw their deposits. SVB was then forced to sell $21 billion of its investment securities (UST and MBS), from its 'available-for-sale' portfolio, which realised a loss of $1.8 billion.

It also then tried to raise $1.25 billion through the sale of common stock and an additional $500 million of convertible preference shares. This was obviously abandoned as the share price plummeted.

Last Thursday, SVB's clients tried to withdraw $42 billion, which was about one quarter of its total deposits. By Friday U.S. regulators had seen enough and SVB became the second-largest bank failure in U.S. history.

What has been the Government's response?

On Monday, a joint statement by the US Treasury, U.S. Federal Reserve and U.S. Federal Deposit Insurance Corporation announced a blanket, unconditional government guarantee of all US bank deposits, including those larger deposits above the US$250,000 threshold that were---prior to this announcement---"uninsured" and exposed to the possible risk of loss. All depositors at Silicon Valley Bank, including those who were uninsured, were given access to 100% of their cash on Monday. This was a definite surprise to the market on the upside.

The Fed also announced that it will offer unlimited, 1-year funding to any U.S. bank that wants to borrow against its eligible assets at an incredibly cheap cost of just 0.10% above the cash rate, which accordingly provides all US banks with access to extremely low-cost funding.

This is a big deal on many levels for U.S. banks and also creates a profound precedent for all other countries. We saw similar blanket government guarantees of bank deposits rolled out during the global financial crisis. And when one country moves, others are often forced to follow.

In theory, this new US guarantee protects 100% of the value of all U.S. bank deposits, which means that depositors face zero future risk of loss. It should, in practice, remove any risk of a deposit run---that is, a rush for the exits---on the basis of fears that smaller US banks might fail. This has certainly been the experience in the past when blanket deposit guarantees have been introduced. And it's safe to assume that other nations will roll-out similar protections if they are ever required.

Blanket government guarantees of all bank deposits, which are the banks' biggest source of funding (and hence their largest liability), very directly reduces the risk of default and insolvency on all bank liabilities, including their bonds.

Since banks run leveraged mismatches between their assets (long-term loans) and their liabilities (short-term deposits and bonds), they are always at risk of a shortfall of funding if deposits walk out the door.

This is why central banks were set-up in the first place: to provide loans (liquidity) to banks that were subject to temporary funding shocks as a result of a deposit run. It is also why almost all global governments have extended this public back-stop of banks to explicit government-guarantees of deposits (and in the 2008 crisis, government guarantees of their bonds) to prevent any risk of future deposit runs and consequent bank failures.

These measures should prevent any contagion risks and spill over risks in the wider regional banks and America’s largest and systemically important banks. **However, it is important to note that this will protect debt holders and depositors not shareholders.**

What have been the implications for the markets?

Bonds Rally (price up & yields down)

Financial contagion concerns have driven a sharp flight to quality, a rally in U.S. Treasuries as well as the broader developed market sovereign rate.

Last Wednesday, the yield on a 2 Year Treasury climbed to 5.07% - its highest level since before the financial crisis, as Chairman Powell, in congressional testimony, pondered reaccelerating the pace of monetary tightening. By Friday, it had fallen back to 4.6%, partly in response to mild wage readings in the February jobs report, but primarily because of the collapse of SVB.

The 2 Year Treasury is now currently trading at 4.70% and reflects the fact that the bond market has pared back pricing for the peak U.S. Fed Funds Cash Rate to only reach 4.75%, instead of 5.50%. Market pricing for the Reserve Bank of Australia's peak terminal cash rate has similarly contracted from ~4.25% to current estimates around 3.85%, which suggest that the RBA has one more hike to go.

At the same time, fixed-rate bonds have soared in value as yields---and hence interest rate expectations---have slumped. U.S. 10-year government bond yields have dropped from 4.05% to 3.68%, (Aussie 10-year government bond yields have plunged from 3.90% to 3.48%). So, portfolios of long duration bonds have benefited greatly.

Equities down

Following the collapse of the SVB. the US S&P 500 Index fell 4.75% with many U.S. regional banks suffering significant losses. Performance amongst larger U.S. banks was mixed, with many posting smaller losses as they opened new accounts for depositors fleeing smaller banks.

Since the announcement of the U.S. Government guarantee package the market has pared back some of these losses, up 2.9%. In this risk off environment, the Australian share market as measured by the ASX 200 price index has followed the US markets lead and fallen around 4.2%.

It is important to understand that the big Aussie banks are in a much better financial position because they have among the highest risk-weighted capital ratios, and hence lowest leverage, of any peers overseas because of APRA's decision in 2014 to force them to adopt "unquestionably strong" capital ratios.

The four majors have the best capital ratios of any peers globally. As a result, there is no risk that the contagion will spread to Australian major banks.

Implications for clients

• We think the U.S. Regional bank concerns has brought forward the end of the tightening cycle by the Fed and provides further reason to expect just one more rate hike by the RBA, if any. As discussed above markets are already pricing this in to 2 year and 10 year bond yields.

• The U.S. Fed is unlikely to raise interest rates at its March meeting as there is an elevated level of uncertainty around the recent bank failures. There is no doubt the recent financial turmoil of the past few days will certainly affect monetary policy decision making.

• We believe the concern is two-fold, that many banks are sitting on large unrealised losses in their bond portfolios and might not have sufficient buffers if there is fast withdrawals of deposits and the availability of capital may be a constraint on many companies.

• This was demonstrated overnight when Switzerland's second-largest lender, Credit Suisse, saw the share price fell as much as 29% after its largest shareholder, Saudi National Bank, said it could offer no further financial assistance.

• Credit Suisse's problems predate the SVB disaster, clients pulled out $100 billion from Credit Suisse in the fourth quarter 2022 and funding costs and access to capital have become so prohibitive for the bank that their capital adequacy could by under threat.

• As we highlighted in the December 2022 "Logical Thoughts", we expected that the central banks in the U.S. and Australia would stop interest rate hiking mid to late 2023. While the collapse in SVB brought this interest rate cycle event forward, the expected impact on the client portfolios has not changed. This was demonstrated by the movement in the various markets over the last week. Positive for bonds, negative for equities and credit (corporate lending).

• We still believe bonds are attractive at these valuation levels due to last year's poor performance (prices are still trading at large discounts).

• We continue to expect a high level of equity market volatility throughout 2023 and a high probability that the US will still enter a recession at the end of 2023 or beginning of 2024. In this type of environment high quality bonds should generate better risk adjust returns for investors over the next 12-18 months as bonds yields adjust downwards and prices upwards.

• To take advantage of this bond environment, Logical has been implementing the following bond strategy for clients over the last 6 – 9 months:

- Bought additional units by reinvesting the income distributions via purchasing more units in the bond fund, taking advantage of a lower unit price.
- Bought additional bond units by increasing a client's exposure to a bond fund through reducing their cash, credit or growth assets – tactical asset allocation decision.

• We expect equity markets to be challenged over the short term because it is not just the cost of capital that companies will need to be concerned about but the availability of capital, which will be a constraint on many companies. The obvious implications for equities market is that companies which are reliant on credit markets for their business model to function will come under share price volatility.

• We also expect the coming end of the rate tightening cycle in the U.S. which means it should be an interesting time for the AUD. On one hand you would now expect some strength in the AUD against the USD due to our strength in commodities and terms of trade (linked to a recovering China) but on the other hand, due to a risk off environment there may be a flight to quality - the USD and U.S. Treasuries.

• For those living off investment income, say in retirement mode, we continue to expect good levels of gross investment income generated by our portfolios (including franking tax credits).

• For those accumulating for some years prior to needing to rely on personal wealth to support lifestyle, reinvesting your investment income distributions and dividends provides a great opportunity to purchase additional units or shares at potentially lower prices. This means that when the eventual recovery returns, these portfolios recover far quicker in value. We have already seen this strategy in play for 2022 with great success…although capital values fell, portfolio investment income was strong allowing more units to be purchased when reinvested.

And finally.....

Logical has attempted to ensure our client portfolios meet their needs and long-term objectives such as:

- Ensuring we build bespoke portfolios for our clients to meet their specific needs and requirements.
- Ensuring the appropriate time horizons are in place.
- Sufficiently diversified (not over diversified) across asset classes and best of breed investment managers, investment styles and quality investments.
- Not investing in speculative investments or highly leveraged (e.g. Bitcoin or large overweight to Technology Stocks)

The collapse in SVB has proven once again that timing financial markets is fraught with danger, and it is increasingly difficult to achieve. Volatility in markets has been increasing and inflection (or turn around) points in markets are becoming sharper which makes timing entry and exit into a market even more difficult.

As always, we advocate taking a long-term view to successful portfolio outcomes and avoid making knee jerk reactionary changes in the short term which inevitably end poorly.

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UPSIZING BY DOWNSIZING

If you are about to sell your home and are over age 55, a strategy worth considering is making a 'downsizer' contribution to your super. Legislation has now been passed effective from 1 January 2023, reducing the eligibility age for downsizer contributions from 60 to 55.

What are the possible benefits of making a downsizer contribution?

The benefits of making a downsizer contribution vary depending on individual circumstances but may include:

- increasing your retirement savings in a concessionally taxed environment
- no need to meet a work test and can be made regardless of your total super balance
- the contribution is not assessed against any of your other contribution caps
- the amount forms part of the tax-free component which is not taxable when you withdraw it, or after death.

How does it work?

The maximum downsizer contribution that you can make is the lesser of $300,000 or the total proceeds received from the sale. As this is an individual limit, this means that for couples, it may be possible to contribute a combined amount of up to $600,000. Multiple contributions can be made, however, the contributions can only be made from the sale proceeds of one eligible dwelling. This means that if you don't fully utilise your $300,000 downsizer cap, you can't make additional downsizer contributions if you later sell another property which qualifies.

General eligibility

To be eligible to make a downsizer contribution the following must be satisfied:

- You are aged 55 or over at the time the contribution is made;
- The contribution is from the proceeds of the sale of a single eligible property in Australia (and is not a houseboat, caravan or mobile home);
- You have owned the property for at least 10 years prior to the sale;
- You claim the capital gains tax (CGT) main residence exemption on the sale of this property (wholly or partly);
- The contribution is made within 90 days of settlement;
- You complete the required paperwork to elect to treat the contribution as a downsizer contribution and submit the form to your super fund (either before or when the contribution is made);
- You do not claim a tax deduction for this contribution; and
- You have not previously made a downsizer contribution in relation to another sale.

Can I upsize instead of downsize?

What if I don't buy a new property at all?

Although the contribution is called a 'downsizer' contribution, there is no requirement to downsize, or to purchase another property in order to make this contribution.

Important Considerations

- Once you've contributed to super, you won't be able to access your funds until a condition of release is met. If you are 55 to under age 65, conditions of release that you can satisfy include retirement after your preservation age, ceasing an employment arrangement after turning age 60, or reaching age 65.
- If you are at least Age Pension age (or Service Pension age if applicable), or you commence a superannuation income stream, these savings are assessed when determining your Centrelink entitlements, and may reduce your benefits.
- If a downsizer contribution is made and the eligibility criteria are not met, the amount you've contributed is treated as a personal contribution. If a personal contribution can be accepted by the super fund, the amount remains in your super fund and counts towards your non-concessional cap, which may trigger an excess. If the contribution cannot be accepted, the contribution must returned to you.

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Looking for Financial Advice?

In an ever increasingly complex financial and legislative world, our mission is to provide you with clear, concise and tailored strategic advice.

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