Could rising banking risk change the Fed's trajectory?

- **Silicon Valley Bank collapsed last week: its funding crunch was directly linked to the rise in interest rates**
- **On Sunday, the Fed set up an emergency lending program to secure needs of the depositors**
- **Still, rising risks in the banking system clearly support more moderation in terms of rate hikes**

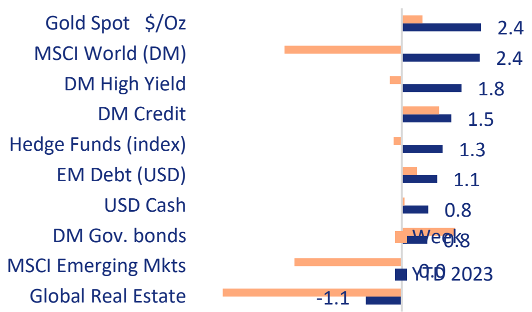
Just a week ago, following Powell's hawkish testimony to the US Congress, markets were painfully adjusting their forecast, with a high probability being given to another jumbo 50-bps hike in interest rates in March.

It quickly changed, in another illustration of the current unpredictability. On March 8th, Silicon Valley Bank, then US 16th largest, announced it had sold $21bn of securities from its portfolio at a loss of $1.8 billion and that it seeked $2.25bn of fresh capital through a share offering. Its stock collapsed, and clients rushed to withdraw their deposits. Two days later, the bank officially failed, put under the authority of the US Federal Deposit Insurance Corp. SVB is deeply active in the startup world: this on one hand makes its problem specific, with a high risk concentration in companies which naturally "burn cash", which means declining deposits. On the other, the failure would have repercussions in the entire tech and private equity world, especially VCs and their investors. Finally but crucially, the portfolio loss is directly linked to the rise in interest rates: SVB had massively invested in long-dated treasuries at a time when inflation was seen as only temporary: only losses to take when cash is required.

US authorities have quickly acted to protect depositors. Still, this is a wakeup call: higher interest rates do not just slow consumption and jobs (so far, with mixed results), but they exacerbate financial risks. Beyond specific tools for banking stress, the Fed's policy could also be impacted: a 25 basis points hike, or even, no hike at all in March FOMC, as Goldman Sachs suggests.

We keep on favoring high quality bonds over riskiest ones, and EM stocks over DM. Volatility will without a doubt remain extreme in the year of unpredictability.

ASSET CLASSES USD % TOT.RETURN, YTD 2023 & LAST WEEK



MAURICE GRAVIER
Chief Investment Officer
MauriceG@EmiratesNBD.com

ANITA GUPTA
Head of Equity Strategy
AnitaG@EmiratesNBD.com

GIORGIO BORELLI
Head of Asset Allocation
GiorgioB@EmitatesNBD.com

SATYAJIT SINGH, CFA
Head of Fixed Income Strategy
SatyajitSI@EmiratesNBD.com

Cross-asset Update

The message from three US bank failures in one week is that investors are now incentivized to take less risk and, given the compounding of systemic and macroeconomic issues, the outlook will be starting to visibly deteriorate. If on the one hand the regulator is going to put enough safeguards in place to guarantee the viability of the financial system, on the other they cannot do anything to prevent further negative impacts from past Fed's tightening. In other words, the end of the asset cycle, whereby markets did rise and private balance sheets did expand, has reached crunch time and is now going to be followed by a credit crunch and then most likely by an economic contraction.

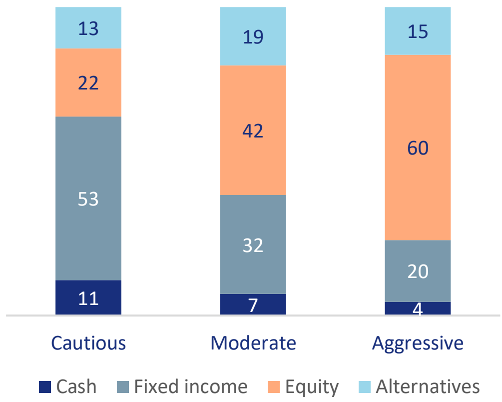
This view is reflected in different leading indicators signalling no rebound in economic activity before year-end or the very beginning of next year. Markets may well be discounting the inflection higher in the business cycle in advance, yet it is inevitable that first the Fed will have to stop raising rates and then proceed again to the easing of policy, before markets get the all-clear to rise sustainably. All of this will take time, hence the base-case scenario that sees more damage to the economy and markets before the bull phase resumes. Investors rushed to discount less than two rate hikes by year end from seeing none, and they currently see the Fed funds rate peak at 5% by June this year. Rate cuts may well follow, yet if the Fed perceives that systemic risk can be averted, they are likely to continue the tightening, though at a moderate pace, in order to avert an unbearable inflation risk down the road. The US government is overleveraged, and the inability to curb inflation would entail the loss of control of the economy, that in turn would see the status of the United States as primary superpower come under scrutiny. What happened to China in 2020-2021 following repeated bouts of regulatory crackdowns is a case in point. Given the circumstances, we believe that the Fed will be treading cautiously, balancing the systemic and the inflation risks carefully, rather than throwing money at the system as it was customary to do in the past.

Under the current conditions we see quality outperforming across asset classes. We have advocated for higher-quality bonds and higher-dividend-yielding stocks for a while. We continue to be cautious both on DM equities and weaker credit issuers, broadly the HY space. We see the EM equity setback as temporary, as systemic effects of the SVB event are not there for the emerging countries, in particular for China.

Last week price pressures surprised to the downside in China, unlike in the US and Europe, giving leeway to the central bank to maintain a supportive policy stance. And more importantly China's credit, as measured by aggregate financing, expanded above projections, offsetting concerns about the pace of economic recovery.

More economic and systemic risk in the Western markets is counterbalanced by expansive policies in China and the EM recovery where we remain overweight.

TACTICAL ASSET ALLOCATION: SIMPLIFIED POSITIONING

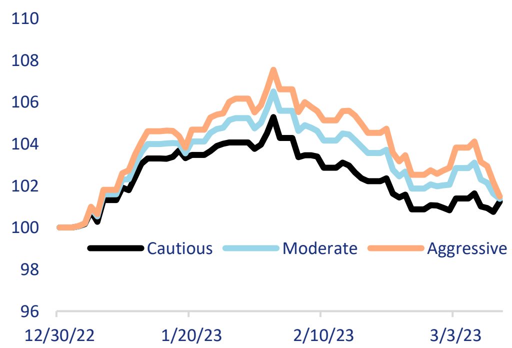


TAA – RELATIVE POSITIONING – MODERATE PROFILE

UW/N/OW:Underweight/Neutral/Overweight

	UW	N	OW
Cash			>>
DM Gov.			>
DM Credit			>>
DM H. Yield	<		
EM Debt	<<		
DM Equity	<<<<		
EM Equity			>>>>
Gold	<		
Hedge Funds		=	
Real Estate	<		

TAA – 2023 INDICATIVE PERFORMANCE



Source: Bloomberg. CIO Office calculation based on TAA applied to market indices, net total return in USD.

Fixed Income Update

Fans of the fantasy novel series “The Wheel of Time” would recognize the following words “Almost down yesterday, maybe down tomorrow, but alive and gloriously up today.” This would aptly describe the happenings in the credit markets post the SVB bailout. We had repeatedly mentioned that increasing rates faster exposes hidden risks in the system. Volatility returned to the markets after a hiatus. If Silver gate had scared the markets, SVB spooked them. Unlike the GFC, the Fed and the US Government moved fast to stem investor concerns and prevent a broader contagion.

It took a week for the market to do an about-turn. A U-Turn happened in a couple of days from pricing at the high of 5.6% peak rate to just above 5% peak rate and from no rate cuts to at least one rate cut. What happened to the US Treasury yield curve is nothing short of spectacular. The yield curve bull-steepened. Term premium increased. But as we had mentioned last week in one of the daily notes, it was more due to the front-end coming down sharply (2-year dropped by 80 bps) than the long-end rising. The 10-year fell by 45 bps, and investors with long-dated treasuries in their portfolios would have been happy. We reiterate our call for adding long-dated treasuries as hedges. Money market funds or T-Bills will not give those benefits.

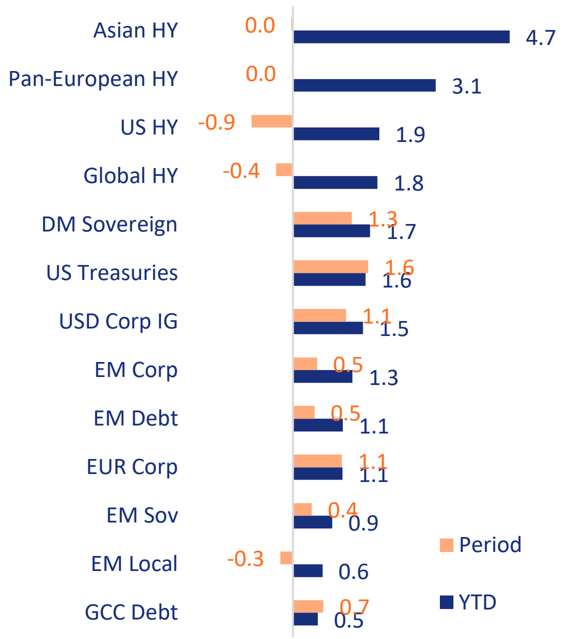
All the segment spreads widened and, in fact, wiped off the spread compression that had happened YTD. But spreads have not widened as much as the recent jump in rate volatility implies. This indicates the pace with which credit can move and the rationale behind our overweight in Quality. Even within Quality, the govies are a notch above IG credit. But still, the MOVE index is up 33% since February 1st, and IG spreads have been only 9 bps wider since then. Credit is outperforming what the Rates volatility would otherwise suggest. This is due to the higher yield provided by the IG bonds.

Despite the quick action to stem the fallout, sentiment remains fragile, and the worst affected segments would be the subordinated financial securities. We advise against adding to this particular segment until the dust settles and removing any tactical overweight in the client portfolios. If the allocation is within the maximum HY allocation limits, we can ride out the storm. But would strongly advise to cut any overweight positions to HY in FI portfolios. Credits such as Soft Bank would also be negatively affected due to their exposure to the start-up ecosystem, and investors should be careful about bottom-fishing in these securities.

FIXED INCOME KEY CONVICTIONS

DEVELOPED MARKETS
OW Quality corporates
OW Government Bonds
UW High Yield
EMERGING MARKETS
Overall UW EM Debt
Favor quality and selectivity
OW Selectively Asia, LatAm

FIXED INCOME SUB ASSET CLASS RETURNS (YTD, LAST WEEK)



Source: Bloomberg

Equity Update

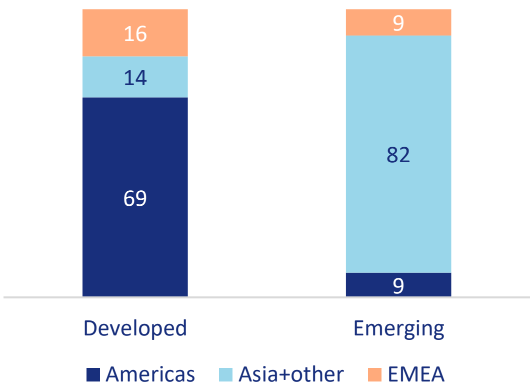
Equity markets are holding onto small year to date gains, after last weeks broad-based sell off which affected most global regions except Japan, the UAE and India. Rates and the effect on bank assets in the forefront. Global equities fell 3.5%, with the US S&P 500 at -4.5%. Worst off were China equities at -7.3% and the MSCI China now negative year to date. The National People's Congress disappointed, real estate will be supported, though only reputed developers. Consumption was a focus and innovation, which we see as positive catalysts for a market rebound. UAE markets were close to flat last week. Capital market raising in full swing with 2 IPOs on offer currently: Al Ansari Exchange and Presight AI Holding PLC which follow ADNOC Gas successful placement last week. Diversification is in play with no Money Exchange, AI or Gas company currently listed on the DFM or AD bourses. Dividend yields remain an important metric for investors and ADNOC GAS opened for trading this morning at an almost 20% premium. The KSA Index was up almost 2% last week and Saudi Aramco results yesterday, with $161bn in net profit and a dividend raise support further market upside.

We held our Asset allocation committee last week and on the broader equity allocation there was no change in tactical positioning, with an overweight to EM equities and Underweight DM equities continuing. Within DM we took US equities to neutral and Japan to Overweight. Within EM, we maintain a preference for EM Asia and the UAE and an Underweight positioning for Eastern Europe.

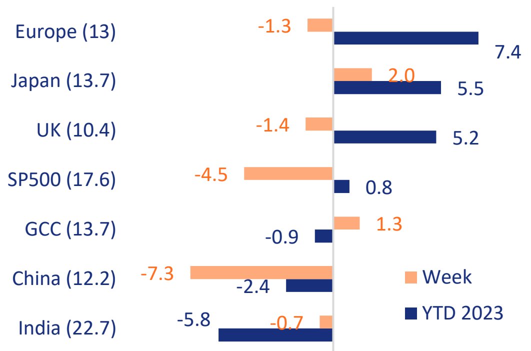
Last week began with Fed Chair Powell signaling a higher terminal rate and reopening the door for 50 bps hikes. The Fed is worried about the upside inflation risk from stronger economic and job data -the labour market remains too hot for the Fed and this implies a further tightening of FCI to slow growth and inflation. The week ended with the first major bank failure since the Global Financial Crisis and this may cause the Fed to rethink its tightening plans. Liquidity concerns are in the fore. It's too early to predict the impact on equity markets, but the FDIC assuring availability of 100% of deposits was comforting for other regional bank depositors. SVB is the 16th US largest bank, which at the end of last year, had more than $175 bn in deposits — the vast majority of which are uninsured — and $209 bn in total assets. The run on deposits from its large base of tech startups led to the FDIC taking it into receivership. SVB works with almost 50% of US VC tech and life science firms. While the risks from SVB seemed idiosyncratic and not systemic, unrealized losses on Hold To Maturity Securities on account of higher rates are an industry wide challenge. Whilst US banks shares i.e. the KBW index fell 16% last week, (some US regional banks like First Republic fell 34%), global financials were not spared and fell 5.5% with the global real estate sector in sync.

Quality remains the fore of this year's investing and strong balance sheets and cash flows key to equity upside. We are in an environment of higher rates, with consumer demand a target of Central banks and only corporates with resilient cash flows will weather this scenario successfully.

EQUITY RECOMMENDED REGIONAL POSITIONING

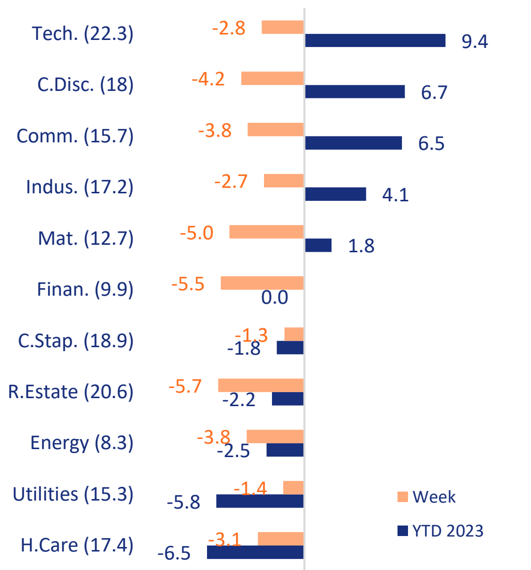


MAJOR INDICES PERFORMANCE (TR, US$) AND 2023PE



Source: Bloomberg consensus. MSCI Indices unless specified.

GLOBAL SECTOR PERFORMANCE (TR, US$) AND 2023PE



Source: Bloomberg consensus. MSCI All Country World sectors US$.

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