Silicon Valley Bank and 7IM Portfolios

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AUTHOR
Ben Kumar
Head of Equity Strategy

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It's been impossible to ignore the noise from America over the past few days. The failure of Silicon Valley Bank made headlines around the world, and resulted in a second bank (Signature Bank – heavily involved in the recently deflated crypto-bubble) also failing over the weekend.

We've been following the situation carefully, and with a *little* of the dust now settling, thought it might be worth a quick review of where we are – and the outlook for portfolios.

Short-term: Quick and decisive bailouts
Without digging too much into the technical detail – which is still being squabbled over in the financial Twittersphere – governments around the world have shown their willingness to intervene early and intervene in a way which removes any doubt about the ability of the bank customers to access their money. The lesson learned from 2008 was *not* to let things linger.

Of course, any public failure in the banking industry causes nervousness. Consumers and companies become nervous about their own banks, and more protective of their money. Investors, caught by surprise by one failure, start seeing potential disasters everywhere.

As ever, we think it's important to remain calm. We don't see a significant chance of broad contagion from the Silicon Valley Bank news. SVB was a pretty unique bank specialising in lending to early-stage technology companies, almost all of which are facing the same economic pressures. It also appears to have had a fairly ... idiosyncratic ... approach to risk management.

The large commercial banks in the USA and Europe have a far more diverse spread of customers – from ordinary people all the way up to multinational energy and food companies. And their risk management has been pored over by regulators for the past fifteen years, ever since they were defined as systemically important.

Despite the global headlines, this remains a localised and contained bank failure. That may change, but investors shouldn't overreact.

Medium term: Something always breaks when rates rise
As we've been saying for a while, the point of interest rate rises is to slow the economy, and hence reduce inflation. In a perfect world (one that only exists in academic models), that slowing would take place gently and easily. In the real world, *something always breaks.* And the timing of the breakages is always uncertain.

No matter how carefully the Federal Reserve or Bank of England or ECB analyse the impact of a rate increase, the modern market is too complex to be straightforward. The early rate hikes caused carnage in the crypto industry. And now we're seeing other niches of financial markets feel the strain. At some point, another industry will struggle, as refinancing costs start to bite, or demand dries up. The trick for the central banks is to work out *when* there's been enough pain. Most of the time, historically, a recession will already be underway by then. That's been our view over the past year or so. SVB is just another spring popping as the economic brakes are applied.

What does it mean for 7IM portfolios
We have very limited exposure to the actual equity or bonds of SVB – which barely featured in the major indices, and which our portfolios diversify away from anyway.

Although we have positions in financial-related areas like European bank debt, the impact from SVB should be fairly muted, once the initial market volatility subsides. Of all the sectors in all the world, European banks have probably been under the most scrutiny since 2009.

Balance sheets are extremely robust – one of the reasons we like the debt so much. Despite recent falls, European banks have been one of the strongest performing sectors so far this year, and equity prices are up around 45% in the last four months and 110% since November 2020.

More broadly, our portfolios are well positioned for the moves we've seen. W**e're underweight equity risk and overweight fixed income,** so are positioned for the more "traditional" sell off we've seen in the last couple of days, with bonds protecting as equities fall.

We also have material allocations to alternatives that continue to bring further diversification to portfolios. These positions were taken with an eye on the fact that higher rates would create stresses that would be a drag on specific sectors, particularly the most expensive ones. To that end, US tech, at the centre of this story, has been one of our key equity underweights.