Maybank

Macro | FX Research and Strategy

Global

FX Insight

The Impact of Bank Contagion Risks on FX

Background

Two US banks, Silicon Valley Bank (SVB, assets: US$209b) and Signature Bank (assets: US$118b) were shut down by US regulators over the weekend. In terms of assets at the time of failure, these were the 2nd and 3rd largest bank failures in US history, with the failure of Washington Mutual (assets: US$307b) in the 2008 financial crisis remaining the single largest bank failure in the US.

The bank run on SVB was triggered after Moody's downgraded SVB to "outlook negative". SVB then announced its intention to raise capital by selling new shares, which then resulted in Peter Thiel's Founders Fund, among others, advising its depositors (mainly venture funds) to pull their deposits with SVB. There were also fears that venture-funded start-ups and cryptocurrencies could be affected by SVB going under, as SVB was an important lender for the tech and venture capital sector.

Given the risk of contagion on the wider financial system, the Fed, FDIC and US Treasury issued a joint statement to stem the possibility of contagion early on Monday (SG/KL time) that depositors of both SVB and Signature Bank would have full access to their deposits with no cost to the taxpayer. In addition, shareholders and certain unsecured debtholders would not be protected.

Since news on SVB broke last Thursday, shorter-dated US yields have fallen (2Y UST: -74bps) on expectations that the Fed would moderate the pace of rate hikes. The USD has been pressured lower on such expectations, with the DXY today reaching levels as low as -1.91% from its Thursday peak. Fed funds futures have also been pricing both a lower terminal rate of about 5% and a lower likelihood for rate hikes moving forward. The probability of a hike at the next meeting in March 22 has been slashed to about 80% for a 25bps hike. This is a stark contrast to the terminal rate of about 5.75% and 71.2% probability for a 50bps hike (100% for 25bps, 71.2% for 50bps) at the March 22 meeting that was being priced last Wednesday, before the SVB news broke.

Aim

We look to episodes of bank runs and failures through history to determine what the likely impact of bank contagion risks on FX would be. In addition, we examine the various scenarios for contagion, estimate their likelihoods, and suggest FX strategies for each particular scenario.

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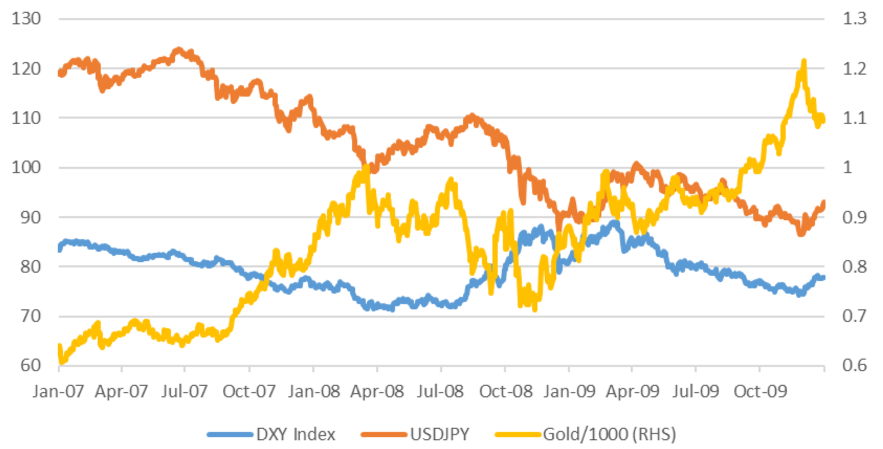
Historical Episodes of Bank Runs and Bank Contagion Risks

We look to the most recent episode of fear, uncertainty and doubt in banking which was the Global Financial Crisis from between 2007 to 2009. In this case, we see that the USD initially depreciated from 1Q2007 to 2Q2008 (Figure 1). This was the period of time when the Fed discount window provided cheaper liquidity to the banks as a backstop. In addition, the problem was thought to be largely confined to the US and was not a global issue. We then see a rebound in the USD from 2Q2008 to 1Q2009 as it became apparent that the problem was not confined to just the US alone.

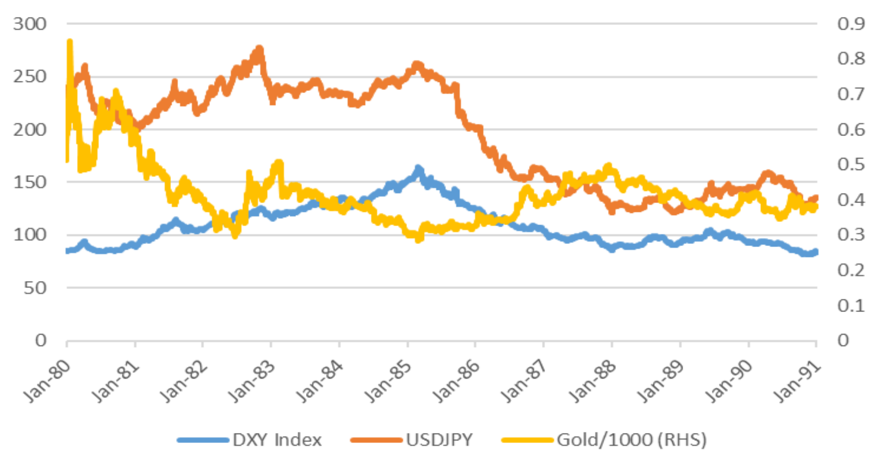
Figure 1: Global Financial Crisis (2007 to 2008)



Source: Bloomberg, Maybank FX Research and Strategy

Instead, the global financial system as a whole was under threat of a broader contagion from a collapse in the financial system in the US. Also, we observe that Gold and the JPY broadly gained (Figure 1) over this period of time.

Figure 2: Savings and Loan Crisis (1980 to 1991)



Source: Bloomberg, Maybank FX Research and Strategy

Looking at an even older episode, the savings and loan (S&L) crisis, where about one-third of savings and loans associations collapsed in the US, we see that the USD started to depreciate from 1985 (Figure 2), when the failure of the associations started to make the news. This was considered a slow-moving financial crisis that was considered the biggest failure of the US banking system post Great Depression. A key reason for the crisis was a mismatch of regulations to market conditions. Moral hazard was also a problem because of a combination of guarantees and deregulation, which led to lending standards which exposed banks to far too much risk when compared to the capital that they had on hand. While we observe that JPY broadly strengthened over this period, gold initially sold off and only appreciated as the USD depreciated (Figure 2).

Looking at episodes of fear, uncertainty and doubt in banking even further in the past, the Great Depression of 1929 to 1939 and the Knickerbocker crisis of 1907 also saw a broad sell-off in the USD. We are unable to provide charts from these times, as reliable real-time exchange rate data from these two periods does not exist and the depreciation in the USD was chronicled by historians. We are however cognizant that these were very different times and the world was much less connected than it is now. The world has drastically changed in terms of how quickly information is transmitted, and the pace at which SVB and Signature Bank have failed attests to that.

Based on historical events, we surmise that episodes of fear, uncertainty and doubt that lead to bank runs and bank contagion risks are **negative for the USD should the problems be confined to the US and affect the US economy alone**. **Traditional safe-havens (JPY, CHF and gold) should be big beneficiaries in such a scenario. Should the problem spillover and become a global issue, then the USD should also then rally alongside the other safe-havens in a global risk-off scenario.**

Various Scenarios and Outlook for FX

With regards to the current episode of fear, uncertainty and doubt that markets are faced with at the moment, we highlight three possible scenarios in order of decreasing likelihood.

Scenario 1 (most likely): The actions of the US government and regulatory authorities quells fear, uncertainty and doubt in markets. The provision of a liquidity backstop and guarantee of the deposits stems the problem and the issue is resolved. There is no further contagion in either the US or to other countries. In this case we see a more dovish Fed that slows down on the pace of rate hikes to not unnecessarily stress the financial system. In this scenario, we maintain our current view for the USD to gradually weaken over the course of the year against most currencies. We expect the biggest beneficiary to be the JPY (short USDJPY) and we also look for other Asian currencies to remain well supported by China’s reopening. We also expect the EUR to perform well, given the ECB remains hawkish on the problem of inflation. The risk to this view would be the return of hawkish Fed in the future (three to six months), especially if inflation and labour market data continue to surprise to the upside.

Scenario 2 (less likely): The actions of the US government and regulatory authorities does not completely quell fear, uncertainty and doubt in markets. The issue is not completely resolved and there is further contagion that is restricted to the US banking system and this negatively affects the US economy. In this case, we see an even higher likelihood that the Fed is dovish and slows down on the pace of rate hikes to not unnecessarily stress the financial system. In this scenario, we look for a quicker pace of depreciation for the USD, with the traditional safe-havens JPY, CHF and gold the most likely big beneficiaries. The EUR should also perform well if the ECB remains hawkish on inflation. We would be more cautious on the more risk-sensitive currencies such as the AUD and the MYR, IDR, PHP and THB. The SGD should remain relatively resilient in this scenario as a regional safe-haven.

Scenario 3 (least likely): Fear, uncertainty and doubt spiral out of control as the liquidity backstop and guarantee offered by the US government and regulatory authorities does not carry any weight. There are further bank failures in the US and this translates to some global contagion. There is a strong risk-off sentiment that arises from this and the USD benefits from the risk-off in spite of a more dovish and supportive Fed. In a worst case scenario, market participants may choose to hoard USD or refuse to lend USD to each other, risking a USD liquidity crunch. Other beneficiaries remain the safe-havens of the JPY, CHF and gold. The outlook for the EUR turns negative, given that the ECB will likely dial back on hawkishness in this scenario. Risk sensitive currencies such as the AUD and the Asean currencies (MYR, IDR, PHP, THB) will be the worst performers in this scenario. The SGD should still remain relatively resilient as a regional safe-haven.

Other Risks

A key risk that still exists is the risk that other small US banks fail. This is because they likely have less reserves than the larger banks and their depositor base is also more likely to consist a larger proportion of chunky deposits which when combined implies that a bank run will be more likely in the case of a small bank than that of a larger bank. A case of more banks failing could perpetuate or exacerbate fear, uncertainty and doubt and increase the likelihood of both Scenario 2 and 3.

The other key risk is that the guarantee provided by the US Treasury, Federal Reserve and FDIC to depositors could create an unnecessary moral hazard in the banking system in the US. This could result in a repeat of the Savings and Loan Crisis or Global Financial Crisis if not properly managed. We see in this case that authorities have clearly articulated that equity holders are not protected and this should prevent moral hazard if equity holders are able to dictate how a bank is run. A crisis would be beneficial to the JPY and other safe-havens.

The resolution of the two fallen entities, SVB and Signature Bank is something that we should closely watch for further developments on. In particular, the two banks have assets on their balance sheets that will need to be sold. The two banks were not particularly large and as such we do not expect that the sale of their assets will cause unnecessary volatility in financial markets. Should the resolution go smoothly, we expect that Scenario 1 would become even more likely.

Table 1: Limited Exposure of Regional Banks to US Banks

Country	Claims on US banks (millions of USD)	Liabilities to US banks (millions of USD)	Net exposure to US banks (claims less liabilities)
Australia	60,377	157,793	-97,416
Taiwan	36,156	5668	30,488
Hong Kong	100,683	58,035	42,648
Japan	320,694	305,675	15,019
Korea	32,142	50,800	-18,658
Macau	1135	43	1092
Philippines	7035	4410	2625
Total	558,222	582,424	-24,202

Source: Bank for International Settlements, Maybank FX Research and Strategy
Note: Data is sourced from BIS to which some regional countries do not report bank exposures

Outlook for the Yuan

The Yuan strengthened around 1% vs. the USD over the past two sessions of trading, in tandem with most of the Asian peers. The broad USD decline was triggered at first by the US labour data which was mixed, paring back bets on a 50bps hike for Mar. The news of Silicon Valley Bank and Signature Bank entering receivership swung the bets on Fed towards a +25bps hike for Mar and spurred a further decline in the USD. Thus far, regional exposure to SVB has been limited (Table 1). Shanghai Pudong Bank has a joint venture with SVB, but the joint venture has also issued a memo that their dealings are on a separate balance sheet. Yuan has thus far been a beneficiary of the saga vs the USD, supported by the prospect of a monetary policy convergence between the Fed and the PBoC. As long as the crisis remains contained within the US, the USD is more likely to decline against peers, including the Yuan. Should there be signs of credit/liquidity stress beyond globally (least likely scenario), we may expect USD to strengthen materially. In that case, we can expect yuan to display resilience on a trade-weighted basis given that the yuan is still perceived to be controlled and guided by PBoC and as such, more insulated to external market events/forces.

Conclusion

We think that this episode of fear, uncertainty and doubt is likely to be sufficiently contained by the guarantee provided by the US Government and regulatory authorities. We see that the most likely beneficiary moving forward is the JPY (likely to benefit across all three scenarios) and recommend going long on the JPY by selling USDJPY, given that yield differentials between the US and Japan are most likely going to shrink moving forward.

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