An Inflection Point

SVB FALLOUT | 21 MARCH 2023

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Fallout from volatility across the banking sector following the collapse of Silicon Valley Bank (SVB) and subsequent policy responses from regulators in the U.S. and Europe likely mark **an inflection point in policymakers' current tightening cycle**. However, regulators' inflation-fighting credentials are still very much at risk, with core inflation in the U.S. running at approximately 5.5%, well above the Federal Reserve's (Fed's) 2.0% target. The duality of fighting deflation and inflation at the same time with the same tools leaves Fed officials in a real bind. They're likely to hikes rates one more time this week but may need to pause thereafter. Also, policymakers on both sides of the Atlantic may attempt to lean heavily on forward guidance and balance sheet management going forward to help stabilize markets.

Risk of a recession has risen considerably over the past two weeks as losses in the banking system are likely to lead to tighter credit conditions going forward. This situation coupled with already-tight monetary policy suggests heavy sledding in the real economy. Credit investors repriced credit markets in a violent, but fairly orderly, manner with spreads about 35% wider in 10 days. However, current levels of credit spreads suggest an economic backdrop of sluggish, uninspired growth—but not a recession.

Looking ahead, bond yields should consolidate around current levels but trend lower over time as growth falls and inflation moderates. Credit spreads could come under more pressure, with more segmentation across the market as weak credits are exposed and strong credits thrive. Given the relatively high starting point of yields, returns could be attractive. We've positioned for this outcome and believe our commitment to active management and diversified risk management should help mitigate investment volatility throughout this period. Allspring's active investment process in fixed income rests on making diversified investment decisions across rates; curves; ratings; sectors; and, most importantly, securities.

Global Liquidity Solutions

JEFF WEAVER, CFA
Senior Portfolio Manager
Head of Global Liquidity Solutions

The Fed can simultaneously fight inflation and manage liquidity in the banking system. However, it cannot buffer against capital shortfalls. Additional rate hike(s) should help the Fed preserve its inflation-fighting credentials, while underwriting liquidity provisions (in conjunction with the Treasury and Federal Deposit Insurance Corp.) should help stabilize the banking system.

Allspring's forward-looking view

Despite the market turmoil caused by SVB's failure, we expected the Federal Open Market Committee (FOMC) to raise interest rates by 25 basis points (bps; 100 bps equal 1.00%) on Wednesday, March 22, in an attempt to preserve its inflation-fighting credentials. However, the FOMC may lean heavily on forward guidance and the possibility of more flexible balance sheet management to help restore stability in the financial system.

It's surprising how quickly perceptions can change. In the days before federal regulators shut down SVB on March 10, 2023, investors debated whether data releases during the month of February were concerning enough to merit a 50-bp increase in the federal funds rate. In the 10-day span (as of this writing) since SVB failed and subsequent concerns around First Republic Bank and Credit Suisse bubbled to the surface, rate-hike expectations for the Fed's March 21/22 meeting have been pared back significantly.

Economists frequently say that the Fed tightens policy until something breaks—and after March 10, something broke. The Fed will be sensitive to the instability that has ensued in markets since and will want to observe how the new interest rate environment, which works with long and variable lags, continues to affect the real economy.

Positioning for the future

Liquidity and short-duration portfolios are well positioned for the current market environment, in our view. Beginning last fall, the team held the view that corporate credit spreads did not properly compensate investors for the risk of a slowdown as the Fed continued full tilt on its tightening cycle. Alongside that, the 2-year Treasury yield exceeded 4%—a level not seen since 2007—making Treasuries a viable alternative investment. Portfolios began increasing exposure to Treasuries at the expense of corporate bonds in late 2022. In times of heightened volatility, portfolio managers maintain a steadfast focus on two primary investment objectives: preservation of principal and ample liquidity in portfolios.

The primary market is the most plentiful source of offered side liquidity but has been shuttered due to a recent surge in market volatility, making price discovery in yield-advantaged sectors more challenging. As the primary market reopens, which could happen as early as this week, portfolios will look to take advantage of opportunities. Investors are likely to demand significant compensation for lending money even to the highest-quality issuers. Many companies whose fundamental credit metrics are unblemished by the crisis of confidence in domestic regional banks will be forced to pay elevated interest rates. This is a credit-pickers' market, which favors a disciplined approach to a bottom-up security selection process, such as the process Allspring follows.

Municipal Fixed Income

NICK VENDITTI, CFA
Senior Portfolio Manager
Head of Municipals

We believe municipal debt will likely outperform other asset classes, such as bonds, equities, and even cash, over the next six to nine months. A combination of healthy fundamentals and very strong technicals should support this segment of the bond market during these turbulent times.

Allspring's forward-looking view

At Allspring, we believe munis offer both absolute and relative value. On an absolute basis, yields are much higher today compared with the past decade. When yields go up, the value of the tax exemption of municipal bonds goes up, too. On a relative basis, munis are not in the crosshairs of today's volatility. That is reserved for regional banks; federal debt; and, increasingly, equities. As a result, the price volatility of munis is less than other parts of the market.

Muni fundamentals are in good shape, but munis aren't immune to cyclical trends. If the economy slows down, muni credit spreads will widen. However, muni revenue streams (i.e., taxes) tend to hold up better than the cyclical earnings of companies, at least initially. You know this if you own a house. When your house appreciates, your local assessor is quick on the draw to send you a new and improved tax bill. But when it declines in value, the assessor is much slower to send you a lower tax bill. As an added benefit, the water and sewer systems across America are significantly less affected by geopolitical conflicts, failing regional banks, and supply-chain issues than a typical industrial company is.

Positioning for the future

As previously stated, we're constructive on the outlook for munis. As disciplined risk managers, it's important to make sure we scale our positions prudently. Currently, interest rate volatility is very high. As a result, "duration" as a risk is relatively cheap. To capture this, we're increasing the duration of our portfolios. That said, the yield curve is inverted, so bonds with a maturity of 20 years offer a better risk/reward than bonds 20 years and longer. This allows us to slowly step into duration without overpaying for curve exposure.

On the credit side, many municipalities across America are still basking in the glow of the $5 trillion stimulus check written by the federal government during COVID-19. Much of that money was paid directly to states and municipalities. Looking forward, we expect the benefits of the stimulus to wane, but fundamentals should remain healthy for the foreseeable future. Indeed, even more challenged credits, such as those of Illinois, were upgraded by the rating agencies following the stimulus transfer payments. As a result, many opportunities remain for investors to take credit risk up and down the ratings spectrum. However, we're shifting our credit purchases to those A-rated or higher as higher quality likely pays off in the near term.

Plus Fixed Income

JANET RILLING, CFA
Senior Portfolio Manager
Head of Plus Fixed Income

Taxable-bond investors should benefit from the recent upsurge in volatility as it acts to slow growth and temper inflation. An up-in-quality bias should perform well in this environment as higher-quality cash flows are likely to be more stable and more predictable. Looking farther out, the opportunity to add credit risk will likely emerge, but not quite yet.

Allspring's forward-looking view

We see the events that have transpired since the fall of SVB as indications that the cumulative impact of the historically fast monetary policy tightening over the past year is beginning to affect the real economy and tighten financial conditions. Tighter financial conditions should act as a drag on the economy and help bring down inflation. This is something we've been expecting for the past few months. We believe this indicates that recessionary risks, which were already higher than average coming into 2023, have increased in recent weeks. Valuations have changed substantially since SVB collapsed: Government bond yields have fallen, yield curves have steepened, and credit spreads have widened. At current levels, both the yield curve and credit spreads suggest slow, sluggish growth over the coming quarters—but not quite a recession. As a result, we maintain a defensive bias in our portfolios.

Positioning for the future

Over the past few quarters, we've been positioning our portfolios for a period of high volatility and economic uncertainty. We allowed our exposure to duration to moderate between neutral and modestly long relative to our benchmarks, we positioned for a steeper yield curve, and we brought our exposure to credit down. In credit, we reduced our exposure to U.S. investment-grade and high yield credit (which in some portfolios is at all-time lows) and moved up in quality in the existing allocation. We recycled risk into FX-hedged global government bonds to earn income while avoiding credit risk and building liquidity and optionality into portfolios. We also added to high-quality agency mortgage-backed securities as valuations improved and we closed out our long-standing underweight to that sector.

We're comfortable with our existing allocation at this time given the intense volatility in the market and the fluidity of market developments. However, we remain vigilant in our consideration of relative value and will adjust portfolios accordingly.

For more information

We want to help clients build for successful outcomes, defend portfolios against uncertainty, and create long-term financial well-being. To learn more, investment professionals can contact us.

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