Credit, Liquidity, Contagion, and Opportunity

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After the fall of SVB can investors find new opportunities in high yield?

The fundamentals are still very good in high yield markets compared to where they have been historically. A lot of the weaker credits have moved into private debt markets. Even in this volatile period of bank collapses and rate hikes, there are buyers of high quality looking to lock in yield.

The market is comprised mainly of public companies that have issued high yield debt, so it is very transparent. The investor base of high yield is generally made up of long-term investors, such as pension funds or insurance companies. Because of that, there is a lot of stability in high yield from a technical perspective.

Why should advisors now be considering floating rate bank loans?

We believe floating rate remains one of the best options out there for investors that want to be able to play any potential upside in terms of interest rates and inflation staying persistently high. That hasn't changed in the fallout from the collapse of SVB. Clearly, there is a temporal crisis in the market right now, but people need to reflect on what has really changed?

When the Fed was at its most hawkish last year in terms of hiking short-term interest rates, many people convinced themselves that a recession was imminent and the Fed would pivot to rate cuts, only to have that not materialize.

Even now, in the aftermath of SVB, we are a long way from seeing the Fed truly pivot. The most recent rate hike confirms that taming inflation is their top priority. They will pivot to pause hiking rates, not to cut them.

However, the Fed remains caught between a rock and a hard place. There is still a degree of systemic concern with regional banks. But, by the same token, the inflation and the economic data we are all seeing supports the fact that the Fed still may not be in a position to cut interest rates anytime soon.

In this environment, where so many scenarios could play out, diversified portfolios make more sense than at any other time in the last few years. For the time being, the SVB crisis feels compartmentalized. How much could the fallout change the fundamental view? The more rates fall, the more investors have to be worried about the headwinds that this poses for longer duration strategies.

Through all of that, the potential benefit that investors can enjoy in the floating rate asset class still looks compelling.

With inflation stubbornly high, why is high yield such an important consideration?

Short duration high yield can be viewed as a sweet spot between equities and fixed income with lower volatility because it does not have the same interest rate risk that longer dated portfolios have. Bond prices go down when interest rates go up, and interest rates go up when inflation goes up. With a shorter duration, high yield bonds are less sensitive to a move in interest rates.

There is always exposure to the economy and market volatility, to which advisors and investors are alert. But in terms of sentiment, it remains very steady. On the institutional side, a lot of pension plans are naturally drawn to high yield allocation, because they can plug in 8% which fits their actuarial models. We are also seeing pension plans looking to lower their equity beta, without taking on duration risk, moving into high yield.

Is SVB's collapse a one-off or the start of a contagion?

Contagion is certainly something to worry about. Most recall the financial emergency of 2008, but the speed of information and the ease of deposit withdrawals is so much different today than it was during the last crisis. SVB was the first bank run in the era of social media and digital banking and played out in less than two days.

In the fallout from SVB, the ratings agencies downgraded the outlook for the whole US banking system to negative. However, the subsequent rate hike does send a clear signal that the Fed continues to see inflation as a bigger threat than the repercussions of any uncertainty about the banking system. The collapse of any bank is worrying, but there is also recognition that SVB was an idiosyncratic enterprise with highly concentrated deposit bases. This was not a solvency or credit issue, but a liquidity one.

With the Fed moving quickly to resolve any wider liquidity risks in a way that is also very stimulative to the economy, we don't see this as the beginning of another systemic financial crisis.

However, there are other reasons to be worried. Inflation is still here. The Fed has a lot to work out. There is still a lot of stimulus in the system, and no easy way out of the stimulus trap.

What are the implications of the market response to the Fed's rate hike and the collapse of SVB?

The way the markets hung on the words of Fed chairman Jerome Powell in the immediate aftermath of what was an anticipated small rate hike is indicative of short-term thinking. Investors are feeling jittery over the health of the banking sector and the quarter point rate rise as they weigh the odds of the Fed's intent to pause any further hikes. But that sentiment will be short term. The bigger, longer-term issue of how we get inflation down to 2% persists.

The good news after the collapse of SVB is that deposit outflows have stabilized. Fed data revealed banks sought record amounts of liquidity from the Reserve in the wake of SVB. However, while the borrowing amounts were large, what we saw in the data is consistent with the idea that this is just an idiosyncratic issue at a small number of banks.

The liquidity support is clearly working and there's no reason to fear the events of last week are symptomatic of a bigger system-wide problem.

We also expect a short-term backlog in high yield issuance. Before SVB, there was a lot of M&A in the pipeline. That's on hold on right now. Boardroom confidence has been dented by market volatility. Stability is needed to restore that confidence. But we expect activity to pick up quickly. The impact of any kind of banking crisis on broader M&A activity will be contained, as few of the regional banks are advisers or lenders on deals.

To an extent, we are already seeing a flight to quality based on the Fed's actions, but above that we're seeing a flight to yield. Locking in yield is a good idea right now. The case for active management is also especially strong. Again, from an investment and portfolio perspective, it creates a compelling argument for disciplined, diversified high yield strategies that mitigate downside risk.

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