Special Market Update

Recent Events in the U.S. Banking System

As at March 14, 2023

In this Special Market Update TD Asset Management[1] ("TDAM") discusses the recent events in the U.S. Banking system following the collapse of Silicon Valley Bank ("SVB") and the ensuing Federal Reserve ("Fed") actions. We also provide some information about how TDAM strategies across asset classes are affected in this turbulent market environment.

What Happened to the U.S. Banking System?

On March 10th the American authorities shuttered Silicon Valley Bank, the sixteenth largest bank in the United States with a loan book concentrated to the technology startup sector. On March 12th, two days following the collapse of SVB, the State regulators closed New York based Signature Bank ("SBNY"), making it the third largest failure in U.S. banking history.

The rapid rise in interest rates to fight inflationary pressures has claimed victims, but U.S. authorities have taken extraordinary steps to calm markets. Under the systematic risk exception, the Federal Deposit Insurance Corporation ("FDIC") has been instructed to make whole all depositors.

In addition, the federal reserve is introducing the Bank Term Lending Program, a new lending facility to make loans of up to 12 months to banks, credit unions and other type of depository institutions. Most notably, the collateral used by banks for those loans will be valued at par rather than market value. This is important to note because accepting collateral at par rather than marking to market means that the banks accumulated losses on their holding of treasury securities are no longer an immediate issue and this will allow them to ride out the current economic environment. The purpose of these measure is to prevent a contagion.

Fixed Income

Our investment guiding principles start with extensive independent credit research which has driven us to invest in banks that have multiple sources of revenue, who are market leaders with a strong risk management culture.

Our active fixed income portfolios are not exposed to SVB, SBNY or to other regional deposit taking institutions who were materially impacted by the recent sell off. Our banking sector exposures are mainly in Global Systematic Important Banks (GSIBs) who benefit from greater regulatory oversight. While sizable with over $200 billion of assets, SVB still fell below the threshold of around $250 billion for banks that are required to be stress-tested by the Fed. While this may not have prevented SVB's failure, it should have highlighted weaknesses quicker.

Given the recent confidence shock, market turbulence is not yet behind us, and the risk of another financial accident is still present. Our credit research team is currently assessing the stability of deposits of all banks on our approved list.

[1] The Fixed Income Business of Epoch Investment Partners, Inc. operates as TD Asset Management

We are also analyzing the sensitivity of certain banks to increases in interest rates and the bank's asset liability management structures.

Over the last year we have been materially reducing our corporate credit exposure to build up dry powder in our active portfolios. The recent credit widening was a slight detractor to relative performance, but this was offset by the positive value added created by our duration and curve positioning. Given recent market events, we are reassessing our interest rate sensitivities and have established a profit taking strategy based on the level of interest rates. We also believe that credit buying opportunities are likely to arise if upcoming inflation data surprises to the upside and/or we see further steepening in the 2s10s portion of the yield curve, which would be a sign that a recession is well underway and priced in.

It is unlikely international banks outside of the U.S. would have meaningful exposure to SVB or SBNY. Some Canadian banks who operate in the U.S. do have deposit exposure but given the FDIC's guarantee on deposits, we do not expect a wider bank run to materialize. In addition, the U.S. subsidiaries of Canadian banks have more diversified deposit and funding base and have not seen a surge in deposits in the COVID-19 period.

One clear message from President Joe Biden is to expect tighter regulations on the banking sector going forward. While all global regulators significantly tightened up regulations after the Global Financial Crisis of 2008, the U.S. has gradually rolled back of the rules in the last few years during the Donald Trump administration. Market expectations for the March Fed rate hike and peak Fed Fund rate have rapidly repriced based on this event.

Source: TDAM, Bloomberg LP., as of March 14, 2023.