Beneath the Surface

Snap Comment – 17 October 2022

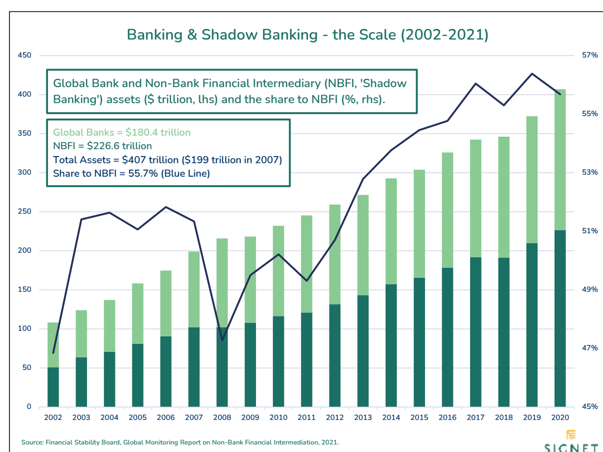
SIGNET

From out of the Shadows

- The global financial crisis (GFC) of 2008 revealed the nature of the markets' vulnerability to financial contagion, and it also exposed the fragility of the global financial system's regulatory supervision. The regular banks endured the blame. However, the GFC also highlighted the potential build-up of systemic risk arising from increased credit intermediation involving entities outside the regular banking system. These entities, collectively known as 'Shadow Banks' (formally Non-Bank Financial Intermediaries or NBFI), are significantly entwined within the 'plumbing' of the global financial ecosystem, and it can be a challenge accounting for their scale and influence. Their operations directly, or indirectly, impact the provision and transformation of liquidity, credit, collateral and risk, and they can therefore undermine, distort or amplify the consequences of monetary policy implementation.

- Shadow banking is often associated with the money-market (short-term) funding of capital market (long-term) investing and, implicit within that, it is therefore highly vulnerable to a market-based refinancing risk. With ample reserves and short-term funding derived from the zero-bound since 2009, all had been fine. Now, with base liquidity being drained, and rates being hiked aggressively, we appear to be witnessing a sudden escalation of systemic risk, derived from a disproportionately large number of these NBFI entities (and sub-industries) structuring their profit models and balance sheets around the same core assumptions of suppressed inflation, abundant cheap credit, asymmetric monetary policy, the Fed 'Put' and one-way asset prices.

- The UK's BoE was recently forced into an emergency Gilt buying programme to support the pension fund industry and its Liability Driven Investment schemes. There are reports of $160bn of losses within the $1.9tn UK DB pension fund industry as their interest rate hedging policies, liability matching policies, and collateral pools experienced 'unexpected' stress. In the US, there may be similar strains within the private markets. McKinsey report that global private markets now control over $9.8tn of assets, up 33% in a year, with venture capital accounting for $1.8tn of these assets. North American investment represents 53% of the total. Private investment has grown increasingly popular with institutional investors looking to avoid the transparent reality being offered within the public markets. But private markets are prone to overvaluation, optimistic assumptions, aggressive accounting and high leverage. The private markets' greatest attributes may be obscure valuations and illiquidity, which disguise volatility, but the industry may struggle to conceal the exuberant investment practices that have been pursued in recent years.



- The IMF have just released their Global Financial Stability Report: "The global economic outlook has deteriorated materially since April 2022." A leading chapter is dedicated to a potentially fragile component of the shadow banking complex: open-end investment funds. Fund-structured investment plays a key role in the financial markets, but funds offering daily or monthly redemptions while holding illiquid assets can amplify the effects of adverse shocks: by raising the likelihood of investor panic, herd-like selling and cross-investment contagion as selling begets selling. As an example, we monitor a well-known investment group with a relatively new $70bn US private real estate income fund, offering monthly liquidity to retail investors and underpinned by a leveraged portfolio including 55% in US rental housing.

- The chart above, using FSB data, highlights the size of global shadow banking – at $226.6 trillion it is more significant than ever before (up from $102 trillion in 2007). In 1992, Hyman Minsky warned us of unstable financing regimes borne out of periods of stable and prolonged prosperity. That warning is highly relevant today.

Therefore:

- Remain defensively positioned. Fixed Income: there are opportunities to target quality and liquidity. Equities: wait.

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