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Pulse Rate – Tuesday, 21st March 2023

Banking crises 2.0?

What a week on the financial markets. With the bankruptcy of the Silicon Valley Bank, Signature Bank, Silvergate, and the loss of investors' confidence in Credit Suisse brought back bad memories of the financial crisis.

The stock markets initially fell in value and yields on the bond markets dipped sharply once again. Thanks to the rapid intervention of the authorities and central banks, the situation has since stabilized and, on balance, the US equity markets actually gained on the week. In Europe and Japan, however, prices pointed clearly downward. As lenders of last resort, central banks will take further measures to stabilize the financial system in the event of an emergency. From today's perspective, there is no threat of a global financial crisis. However, experience teaches that concerns about the stability of the financial system will not disappear overnight.

After all, central banks have indeed massively tightened monetary policy in the last twelve months, making many carry trades that worked well for years unprofitable. Buying longer-term bonds with higher yields and financing them with short-term funds worked excellently in the period of cheap money that we experienced in the last ten years and especially during the corona pandemic.

What's next as central banks' priority remains fighting inflation? Inflation risks have not been averted, and recent developments have increased concerns about the stability of the financial system and the economy. Market expectations of central banks have therefore taken a dramatic turn this week. 10 days ago, the FED was expected to possibly raise the key interest rate by 50 basis points this week and subsequently to up to 5.5% to 5.75%. Admittedly, the assessment of the further course of monetary policy is much more difficult than it was a few days ago. The financial markets expect from the FED for just one more interest rate increase and are already expecting interest rate cuts in summer. For most analysts, the fight against inflation remains the top priority for the central banks, which is why we expect a further interest rate hike of 25 the FED this week.

We are convinced that the takeover of Credit Suisse by UBS is proceeding in an orderly manner. The FED and the ECB expressed their initial support for the merger of the two major Swiss banks. They are also in close contact with international partners to support the implementation. ECB President Christine Lagarde also said the ECB welcomes the swift action and decisions of the Swiss authorities. These are crucial for restoring orderly market conditions and to ensure financial stability.

The stock markets should calm down in the next few days. Especially when we have certainty from the FED regarding its interest rate decision. We currently see no action required and remain neutral in equities.

Tactical Asset Allocation

Liquidity	Neutral
Rates	Overweight
Credit	Neutral
Equities	Neutral
Alternative Investments	Neutral

Bonds or shares of banks?

In the aftermath of the deal between UBS and Credit Suisse, it came quite clear that whether shareholders nor subordinated bondholders are protected. Swiss authorities decided to fully write down the Credit Suisse AT1. This came as a surprise and may have set a precedent for the future especially as shareholders were left with at least some recovery value. From the European banks only the Swiss banks UBS and Credit Suisse had a permanent write-down feature whereas almost any other European bank AT1 have temporary write-down or equity conversion. This would have left the investors in higher ranking to equities.

Senior bonds recovered significantly from Credit Suisse as well as the saver's assets are protected. The 10bn outflow per day in Assets under Management held at CS should therefore be stopped thanks to the buffers granted by the Swiss National Bank. UBS shares closed even Monday on a higher note than Friday showing the negotiation skills of the bank's management. Also the broader bank index Stoxx 600 Banks measuring European bank shares closed higher.

Most of the CDS (Credit Default Swap rates = premium to insure against a counterparty risk) were widening. UBS widened by 20bp - less than most market participants expected after the weekend. Most of the subordinated or additional Tier 1 (AT1) bonds further corrected as market participants are uncertain about further actions of the authorities. We would therefore concentrate on the systemic relevant banks as well as smaller conservative institutes.

US regional banks

The debate over SVB collapse is still ongoing. Whether it is the accounting rules on the recognition process of the security holdings to blame or the FED policy tightening. It's traditional to blame policymakers when something breaks, and it was inevitable that hiking rates would break something eventually. But maybe the global low-interest rates stayed for way too long, so the odds of the steep rebound in interest rates were way too down, and this is exactly what happened.

Nevertheless, financial crises have rarely led to positive economic outcomes, and the main question now is whether the turmoil is finished or how far the domino effect can fall. In fact, the contagion effect can be much stronger and longer than politicians and regulators might say, and any bank can fall if the depositors withdraw all their money at once. No surprise, that in periods of stress, when most of the attention should be paid to the cash flows and strength of the companies' balance sheet. But the entire business model of the banks is predicted on confidence. So even if every investor adjusts the balance sheet of financial institutions for their fair values, trust and reputation are what keeps any bank operating and once it lost its almost impossible to regain.

No doubt, authorities are better equipped nowadays to deal with panic, that is how the new Bank Term Funding Programme (BTFP) was invented. It allows banks to raise term funding by pledging eligible collateral (such as treasuries) at par value, even if they are trading below par. This means that banks do not need to sell securities to fund deposit outflows and recognize losses on them. Recall that financial instruments that supposed to be held till maturity are recognizable at the amortized cost rather than fair value, because those assets are supposed to be held till maturity as their name suggests. Though it is a fair value you liquidate for in response to an early liquidation of held-to-maturity security holdings, one of the reasons that led SVB to sudden collapse.

Even though, banks are more experienced and less leveraged than it was in 2008, there is never only one issue, every time you think it's all done, something else is coming out and sticky Inflation might complicate the potential response to new breaks. The broader banking system, however, looks sound and the systematic contagion risk is limited but tight lending can hit further the GDP growth.

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