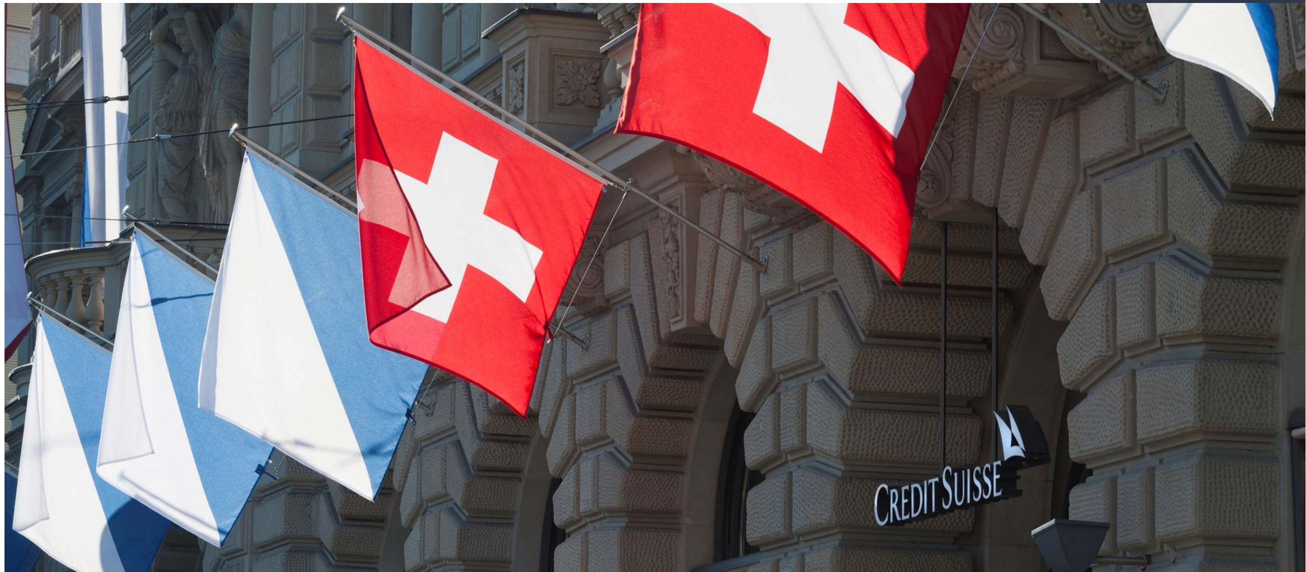
Investec

OUT OF THE ORDINARY

WEEKLY DIGEST | 21 March 2023

Swiss CoCo Pops



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Had Oscar Wilde written the character of Lady Bracknell as a financial commentator, she might well have said something along these lines: “to lose one bank may be regarded as a misfortune; to lose two looks like carelessness”. Credit Suisse (CS), Switzerland’s second largest bank, is the latest to need to be rescued, this time by the country’s largest bank, UBS. This comes hot on the heels of the demise of Silicon Valley Bank (SVB), which we wrote about last week. (There were also two smaller banks in the US that went under, Silvergate and Signature, but not in such a high-profile fashion).

SVB was widely viewed as a relatively isolated special case, owing to the structure of its assets and liabilities as well as the highly concentrated nature of its clients (predominantly immature technology companies). CS is largely viewed in a similar way. It has a much longer history (founded in 1856), but more recently suffered more than its fair share of mishaps and regulatory run-ins. For example, it was heavily involved in the Greensill scandal as well as being badly exposed to Archegos, a highly leveraged family office asset manager that imploded in 2021.

In many ways its demise has not come as a big surprise. Indeed, there have been rumours of it for months, with periodic upward spikes in the cost of Credit Default Swaps which can be bought as insurance against a default on its bonds. The share price was CHF 82.7 at its peak in 2007, but it never reclaimed those heights after the Great Financial Crisis (GFC). It started this year at CHF 2.76 and was down to CHF 1.86 by last Friday's close. The deal with UBS values the equity at CHF 0.80 based on the UBS share price at Monday's market close (CHF 117.40). But, as always, it is the speed at which events like this unfold which can be unsettling.

Last week, we wrote that one unintended consequence of the US Federal Deposit Insurance Corporation putting SVB into bankruptcy was the broader economic risk that might ensue from the fact that it failed to consider that a very high proportion of the bank's depositors were uninsured (that is, had deposits above the $250,000 insurance cap). The situation was quickly remedied over that weekend, although it showed that balls can be dropped when even the supposedly brightest people in the room are attempting to resolve a big problem. Something similar happened in the case of CS.

While, on the surface, the rescue appeared to be good news as it removed the risk of a disorderly bankruptcy, there was one very salient detail of the deal that sent shockwaves through markets. This was the fact that holders of Credit Suisse's CHF16 billion of Additional Tier 1 credit (of which one form is Contingent Convertible Capital, or CoCos) saw the value of their bonds wiped out completely. This is the layer of a bank's capital structure that sits second lowest on the claims ladder, above only equity. CoCos tend to yield more than plain vanilla bonds owing to the risk that they can be converted into equity if the bank's capital falls below pre-agreed thresholds.

But not in the case of CS. Even though equity holders are getting a sliver of a share in UBS for every CS share, the AT1 holders get nothing. Although this does appear to be allowable under some of the terms and conditions buried deep in the prospectus, it also appears that not everyone was aware of the relevant clauses. That was very unsettling to investors in the asset class, who expected equity to be wiped out first. We were happy (and not surprised) to see UK and EU regulators saying later that they would abide by the convention of wiping out equity first in similar circumstances.

Another bit of good news arrived in the form of a joint communique from the world's major central banks on Sunday "announcing a coordinated action to enhance the provision of liquidity via the standing U.S. dollar liquidity swap line arrangements. To improve the swap lines' effectiveness in providing U.S. dollar funding, the central banks currently offering U.S. dollar operations have agreed to increase the frequency of seven-day maturity operations from weekly to daily. These daily operations will commence on Monday March 20, 2023, and will continue at least through the end of April."

We would not expect any less at this stage. As long as banks are solvent, they will have access to liquidity. That's why we keep on saying that this is not the beginning of GFC 2.0. Of course, that prompts the question: "what about solvency?" There are two basic strands to investors' analysis of the financial sector: solvency and liquidity. You could add in trust and confidence, although they are more intangible and thus impossible to model. Even so, we do recognise that a classic "run on the bank" tends to be associated with a loss of confidence. We think the central banks have liquidity covered to our satisfaction. Solvency?

How solvent are the central banks?

The market has been pretty sanguine about the risk of increased loan losses so far for various reasons: they have been minimal to date; banks still have a backstop of unutilised Covid-related loan loss provisions up their sleeves; leverage ratios are low by historical standards; capital positions are very strong; loan-to-deposit ratios are absolutely fine, and so on. However, over the last week there has been increasing concern about, for example, the exposure of US regional banks to commercial real estate. What will happen when current loans mature and are offered for renewal at much higher rates? The terming out of debt has been great for avoiding immediate problems but is potentially storing them up for the future.

Another concern is that the need to pay up more for deposits will constrain banks' profitability and thus make them less willing to increase loans. We are already seeing some evidence of an increased reluctance to lend in various surveys of banks' loan officers, in both the US and Europe. Why do deposit rates need to rise? Because customers are being drawn away to the higher rates available in Money Market Funds and in government bonds (although not as generous as they were a couple of weeks ago). This situation could be exacerbated if regulation is tightened, which we believe is a strong possibility.

What might be the impact on interest rates?

Obviously, things would get much worse in the event of a deep recession, and the market is beginning to bet that the central banks will not allow that to happen. Instead, interest rates will be cut sooner and faster. This shift in the market's expectations for policy rates was underway almost as soon as SVB's troubles emerged, and there has been another nudge down this morning. If we look at peak rate expectations in the US, UK and Europe respectively, they were marked at 5.69% (vs the prevailing 4.75%), 4.87% (4%) and 4.07% (3%). This was on 8 March, the day after Fed Chair Jerome Powell's hawkish Congressional testimony, in which he pledged to keep on tightening policy to squeeze inflation out of the system, and the day before SVB's problems hit the headlines. Those expectations now stand at 4.78%, 4.13% and 3.06%.

That's a huge shift, with the market effectively removing around 1% from its peak rate expectations in just eight trading days. And there have also been some remarkable moves further along the rates curve. For example, the market is now pricing in big cuts by the end of the year in the US, from the current 4.75% to 3.73%. This is not the case in the UK (3.92%) or Europe (2.91%), which might speak to the prior positioning in the US where there were much bigger bets being taken on higher rates.

The market's collective view is that central banks are done raising rates, and that is possible, if not a certainty. Some are taking this as a signal to be piling back into riskier assets, but we remain more circumspect. The reason for lower rate expectations being met would be a much weaker outcome for the economy and for corporate earnings. And while we know that it will probably be right to be buying into an earnings downgrade cycle, at least based on experience, we still feel that there is a bit too much complacency in markets for comfort. We continue to look for a better entry point for risk assets, although also believe that there is no cause for alarm, despite the worrying headlines.

Economic Commentary

FTSE 100 weekly winners

Auto Trader Group PLC	2.0%
Compass Group PLC	1.9%
Polymetal International Plc	1.8%
Admiral Group plc	1.8%
Severn Trent Plc	1.7%
Bunzl plc	1.5%
London Stock Exchange Group plc	1.5%

FTSE 100 weekly losers

Prudential plc	-17.9%
M&G Plc	-17.1%
Standard Chartered PLC	-14.3%
Shell Plc	-13.0%
Shell Plc	-13.0%
BP p.l.c.	-12.6%
Ashtead Group plc	-12.0%

FTSE 100 index, past 12 months

EuroStoxx 600 index, past 12 months

S&P 500 index, past 12 months

All data shown in GBP.

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