Letter n°77

A 3rd black swan in 3 years. What impact will it have on growth and markets?

" The sickly belief that the world in which we live is more easily understandable and explainable, and therefore more predictable than it actually is." Nassim Taleb.

Nassim Taleb, in his famous book ***"The Black Swan,"*** gave unpredictability its full importance in the evolution of stock markets.

The black swan phenomenon is supposed to be rare, but in the last three years, there have been three of them. First, the pandemic, then the first invasion war in Europe since 1945, and finally some bank failures, which have resurrected the specter of a systemic crisis.

So many imponderables, so many events likely to break the bullish dynamic of the markets recorded since 2009. The shock of Covid gave way to the stock market frenzy of 2020 and 2021. The war in Ukraine and its impact on commodity prices broke the optimism, and the euphoria gave way to gloom.

The year 2023 had started with euphoria until the occurrence of a third swan, that of a possible financial crisis. We remember that in the United States, following the monetary tightening imposed by Paul Volcker at the head of the Fed between 1980 and 1994, nearly 3,000 small banks had disappeared. What will happen today? A few weeks after the bankruptcy of SVB, the market seems reassured.

Central banks have been on a difficult-to-manage tightrope for several weeks, subject to contradictory injunctions: the fight against inflation and the avoidance of a systemic banking crisis which, as in 2008, could break the dynamics of credit and growth.

In the past, crises were deep and rebounds were significant. Since 2008, government rescue plans have increased state budgets but have also cushioned crises.

Many are concerned about a possible recession, but it is necessary to recognize the low unemployment rates, the continuation of job creation, the maintenance or recovery of confidence, and the beginning of disinflation.

What to think? What is the risk of a systemic crisis? What is the impact on economic growth and markets? What is the impact on the evolution of credit? What influence on the Fed's rate hike policy? These are the questions of this Letter 77 and to answer them, we will analyze the causes and consequences of these embryonic crises.

The 6 causes of the financial crisis:

- ***Permissive factors***:

In the United States, medium-sized banks with less than $250 billion in total assets are no longer subject to regulation, following a decision by Trump.

- ***The consequence of the monetary policies of the last fifteen years***:

A decade of liquidity injections and zero interest rates has weakened the system, allowed weak actors to prosper, and encouraged banks to seek returns in risky assets.

- ***The prelude to the crisis***:

The recent beginning of a contraction in the balance sheets of the Fed and then the ECB, and the sharp rise in interest rates have weakened borrowers and financial institutions in managing their asset-liability.

In 2022, bubbles burst: the bond markets saw a 14% decline for the year, the cryptocurrency market capitalization fell from $3 trillion to $800 billion, and SPAC bubbles burst.

One bubble is still threatening, that of "private equity," which has grown more than tenfold since 2000 to reach $10 trillion in assets. With the end of low interest rates, part of the "private equity" business model, low-interest debt, no longer works, which jeopardizes profit realization. Combined with often high prices paid before the economic downturn, there should be many disappointments.

- ***Hidden losses***:

Bank losses related to the difference between the market value of bonds and their value at maturity can be significant but hidden because last year, banks in the United States massively reclassified their bonds as maturing bonds.

According to the FDIC, the fund insurance agency of US banks, JP Morgan reclassified $78 billion, Charles Schwab $188 billion, Wells Fargo $50 billion, and US Bancorp $45 billion.

As long as depositors' confidence in these banks persists, there is no problem, but if, like SVB customers, there is a rush of depositors then banks could have difficulties.

At the end of 2022, the potential losses for the tenth-largest US bank, Charles Schwab, amounted to $14 billion, nearly 40% of its equity. For Wells Fargo, they amounted to $41 billion, or 23% of equity, and for US Bancorp, $11 billion, or 16% of equity.

Such figures are obviously fluctuating and have decreased significantly in the past two weeks with the decline in the US 10-year rate from 4.05% to 3.28%.

- ***A loss of confidence:***

Many deposits in these large banks are guaranteed by the FDIC, which was not the case for SVB.

The difficulties recently experienced by banks, for example, SVB, the second-largest bank failure in American history, did not result from excessive indebtedness, as during the subprime crisis, or the bursting of a bubble. They are the result of inadequate asset-liability management, loss of confidence, and a withdrawal, according to the Fed, of $42 billion in deposits in one day and potentially, if there had been no federal intervention, $100 billion in two days because undoubtedly, the availability of e-banking favors faster movements.

- ***Insufficient liquidity***:

Small and regional banks started the year with only 7% liquidity, half the percentage of large banks. SVB was even at $12 billion, or 6%, and First Republic at 2%.

These banks thus benefited from deregulation, gained from the transformation of liquidity into longer-term investments, but at the same time, they weakened themselves. A rush of depositors was enough to cause the bankruptcy of some of them.

The 7 consequences:

- ***The risk***:

It is the loss of confidence, it is the "bank run," it is the domino effect. Fortunately, the authorities reacted quickly, facilitating the takeover of SVB by First Citizens Bank, a $72 billion acquisition of assets with a discount of just over 20% and the assumption of $56 billion in deposits, with the rest placed under FDIC guarantee. In the case of SVB, deposit insurance was necessary because the clientele consisted of Silicon Valley businesses, often startups or private equity funds, with nearly 90% of deposits over $250,000 and California's GDP accounting for 15% of the US GDP.

Looking ahead, we can expect a tightening of prudential regulations to require medium-sized banks to increase their equity to better cover long-term debt risk. Stress tests must obviously calculate the impact of the rise in long-term rates.

- ***The development of money market funds***:

The US Treasury guaranteed SVB's deposits but refused to generalize this provision to all American deposits. As a result, savers placed $340 billion in money market funds over the past two weeks, and the assets under management of these funds increased from $4.8 trillion to over $5.1 trillion. The remuneration of deposits at 4 months is attractive, 4.9% compared to 3.4% for 10-year rates.

- ***A continuation of transfers of deposits from small banks***:

Before the recent crisis, banks with less than $250 billion in assets controlled one-third of US business and individual deposits. Since then, according to the Fed, small banks have lost $120 billion in deposits in just the week of March 15, while large banks have recovered $66 billion.

This could lead to the possible disappearance of many medium-sized banks and, for the US economy, a risk of contraction in the volume of credit, and therefore slower growth.

- ***Mergers and acquisitions***:

Mergers between banks, like in other sectors, are often difficult as they cause cultural shocks. We remember the merger between Bank of America and Merrill Lynch in 2008, i.e., a deposit bank with a broker.

- ***A drying up of mortgage loans***:

A partial consequence of the rise in rates, business loan volumes have slowed over the past 5 months. The real estate credit sector is potentially the most affected. Two reasons: the Fed stopped buying mortgage debt a few months ago, and regional banks account for 80% of commercial real estate loans and 60% of residential real estate loans.

The gap between 10-year bonds and 30-year rates in the US has worsened, going from 0.50% at the beginning of 2022 to 1.60% today.

- ***The disappearance of Credit Suisse***:

Weakened by CHF12 billion in losses in 2022, a decrease in assets under management from CHF1.6 trillion to less than CHF1.3 trillion in 2022, the loss of CHF5 billion in the Archegos fund, and the loss of CHF10 billion in the Greensill bankruptcy, Credit Suisse had no solvency problems but was the weakest link in European finance.

The speed of the solution reassured the market, but the terms of the takeover of Credit Suisse, CHF3 billion paid by UBS representing a 60% discount from the last price, are highly criticized, whether it concerns the write-off of AT1 and CoCo bonds, the CHF9 billion guarantee offered by the government to UBS to cover potential losses of Credit Suisse, the CHF100 billion facility granted by the SNB to Credit Suisse, or the CHF100 billion liquidity line granted by the SNB to UBS. Shareholders were able to sell their shares, while holders of the 16 billion convertible bonds lost everything. However, in the hierarchy of risks, equity came

before CoCos, and European monetary authorities clearly recalled this to avoid unduly worrying AT1 holders, a market worth $270 billion.

As a consequence of the merger, UBS should potentially have CHF5 trillion under management (unless clients leave after the merger) and be the world's number one, holding 30% of the Swiss market but eliminating over 35,000 jobs worldwide, including 11,000 in Switzerland.

For the Swiss economy, a potential UBS bankruptcy would be a problem since the assets of the new group will represent more than twice Switzerland's GDP, but the banking sector, which accounts for 6% of Switzerland's GDP, is, contrary to beliefs, less decisive for the country's economy than it has been in the past, and the positive fundamentals of the Swiss economy, such as a low unemployment rate of 2% and a positive trade balance of 10% of GDP despite a strong currency, attest to the country's competitiveness.

- ***Lower rate hikes***:

At the end of March, the Fed and the Bank of England limited their rate hikes to 0.25% instead of the anticipated 0.50% increase before the difficulties faced by US banks. Only the ECB and the Swiss National Bank raised rates by 0.50%.

In Europe, two rate hikes of 0.25% each are still being considered, which would bring the official rate to 3.5%. In the United States, with the prospect of less rate hikes, 10-year rates have dropped by 0.8%, 2-year rates by 1.25 points, and the yield curve is now only slightly inverted at 0.45%.

Conclusion in 7 points:

- ***From an economic point of view***:

In 2008, there was concern about the bankruptcy of large banks, today, the market is realizing the risk of a systemic crisis caused by the bankruptcy of small banks and Jamie Dimon, CEO of JP Morgan, fears lasting consequences.

However, the last financial crisis where a year had elapsed between the first tremors of the credit market in 2007 and the bankruptcy of Lehman Brothers in 2008 seems far away. The reactivity of monetary authorities has been rapid and appropriate, the Fed quickly increased its injections and therefore its balance sheet again. In the era of e-banking, and thus the potential rush of depositors, it cannot be different.

Nevertheless, this crisis will result in lower credit growth and therefore lower GDP.

- ***From a monetary point of view***:

Undoubtedly, QE is at the origin of distortions in interest rates, but it has also made it possible to support fiscal policies constrained by public debt levels and it has prevented in 2009 a deeper recession with all the imaginable social or political consequences.

It is difficult to blame recent restrictive monetary policies because fighting inflation is a necessity, and the rise in rates, however brutal, did not cause a recession.

Now that calm has returned, the fight against inflation will become the priority of central banks again. While overall inflation (including energy prices) will continue to decrease rapidly, "core" inflation, which stands at 5.5% in the United States and 5.7% in Europe, will be more challenging to control due to the rise in wages and the desire of companies to preserve their margins.

Given the expected credit contraction, the market considers the rise in US rates to be over and anticipates a first cut by the end of the year, but we still predict a rise. In Europe, two hikes are likely.

- ***From a banking perspective***:

One way to extinguish banking risk would be to extend US federal insurance to all deposits, rather than limiting it to $250,000 as it is today, but this would be too expensive and eliminate "moral hazard." Therefore, it is unlikely, and thus the concentration of US banks will continue.

US banks have a Tier 1 capital ratio of nearly 14%, much higher than the 8% in 2008, but the scope of bank regulation must include all banks that could be defended in the event of a financial crisis. Therefore, the Biden administration is considering extending supervision to banks with more than $100 billion in assets. This should have been the case for SVB.

In Europe, thanks to Basel IV, banks are better capitalized than in the United States, have ample liquidity, and are stronger. Therefore, we do not fear a systemic crisis and are positive on the sector's attractive stocks on the stock market.

- ***From an insurance perspective***:

Credit Default Swaps (CDS), which are supposed to be insurance against defaults, are often speculative instruments, often illiquid and always amplifiers of a trend. This was observed on Credit Suisse and then on Deutsche Bank.

- ***From a financial point of view***:

Bond issuances were stopped for a week, but since then, they have resumed, and in the face of a slowdown in growth and inflation, long-term bonds remain attractive.

Traditionally, American companies rely less on credit than European companies, but European banks are stronger. In the United States, as in Europe, caution will be maintained on high-yield bonds, and sovereign bonds will be preferred.

In England, the Bank of England is warning of the risks posed by shadow finance, losses in the private credit market with leverage or high yield.

- ***From a political perspective***:

If the crisis were to escalate in the United States, China would know how to take advantage of the alternative it represents. In order to consolidate its nascent recovery, the Bank of China has lowered the required reserve ratio by 0.25%.

- ***From a stock market perspective***:

As in 2022, the initial reaction was a parallel decline in bonds and equities, especially financial ones. Nevertheless, the VIX index has fallen below 20, CDS have fallen again, and bank stocks, especially the largest ones, have recovered half of their losses from March. Thus, in the face of this volatility and the unforeseen events mentioned in the introduction, it seems necessary to approach stock markets with the eyes of ***Stefan Zweig*** who wrote, ***"the feeling that everything was merely temporary dominated my life in some secret fashion".***

Geneva, 6th April 2023

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