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Elston Insights

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Tracking the tremors

- Banking sector problems are firm-specific
- Higher rates and stickier inflation are biting
- Financial conditions are tightening

It's not just SVB…

The collapse of California's Silicon Valley Bank a little over a week ago has been followed by the emergency acquisition of Credit Suisse by its bigger national rival, UBS. At its peak in 2007, Credit Suisse was valued at US$330bn. UBS just paid US$3.3bn for it. SVB's downfall is not connected to the demise of Credit Suisse, which has been in trouble for some time, but in the context of higher-for-longer interest rates, it's becoming clear where risk controls are working, and where they aren't. The corollary of high interest rates and a high rate of inflation mean that a) it is harder for banks to borrow cheaply in the short term and b) the bonds in which banks would traditionally invest their assets have taken a significant hit to performance, making mark-to-market risk calculations a challenge: good risk management is key.

Taxpayer-funded bail-outs no longer acceptable

The widespread opprobrium brought about by the government's use of tax-payer funds to bail out failing financial institutions in the 2008 financial crisis has left policymakers having to find alternative solutions to support financial stability now. Understanding that the banking system is almost entirely reliant on public confidence, it was fellow banks that raised US$30bn to provide the ailing First Republic bank with vital liquidity two days after the SVB collapse. Information (and misinformation) flows fast and free via social media channels and deposits can be transferred digitally at the touch of a button rendering the whole system considerably more vulnerable in this information age, particularly in times of stress.

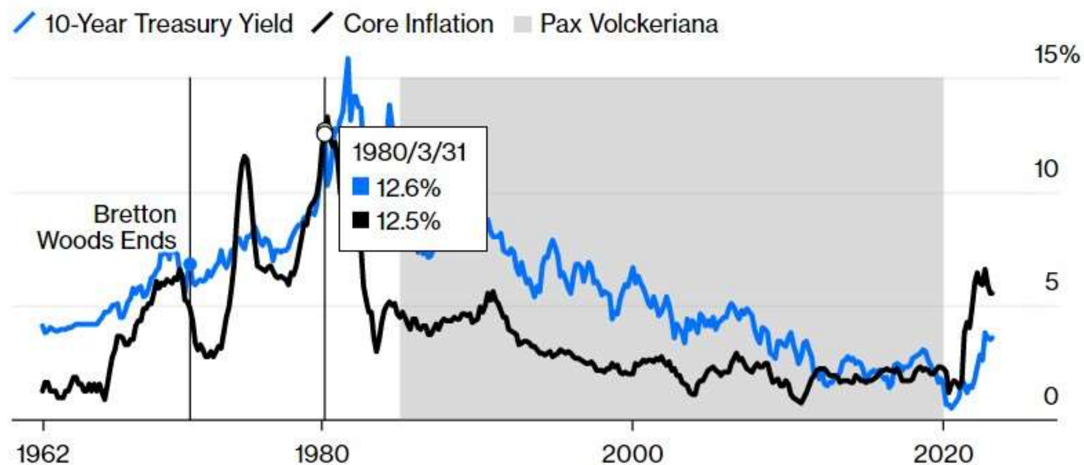
Suppressing moral hazard

There is also the issue of moral hazard. This means that if market actors know that big bets gone wrong will be underwritten by the likes of the Federal Reserve in order to preserve market stability, then attitude to risk becomes skewed. There has been an outcry over the Swiss government's decision to allow US$16bn of AT1 debt to go to the wall in the UBS/Credit Suisse deal but its

motivation will no doubt have been to send a sharp reminder to investors of the risk/reward trade-off.

The end of QE and normalisation of interest rates

Paul Volcker's aggressive monetary tightening in the 1980s put an end to an inflationary spiral that plagued the US in the 1970s. His actions, although painful for the economy in the short run, ushered the world into an era of growth and declining inflation (disinflation) that lasted from the mid-80s to 2021. Large-scale Quantitative Easing ("QE") was unleashed in the wake of the financial crisis of 2008 which drove rates down further to stimulate the flagging economy. The move was repeated during the Covid-19 lockdowns as countries battled to keep their economies stable during the pandemic. Beyond QE, countries all around the world had to deliver a massive fiscal stimulus in the form of tax cuts, furlough schemes and individual and corporate loans worth thousands of dollars deposited into bank accounts almost as 'free' money. The payback for this largesse is now QE in reverse (known as Quantitative Tightening "QT"), and the normalisation of interest rates away from near-zero-interest rate policy that has been in place since the financial crisis. This is a fundamentally different market context that has been dislocating markets as they adapt to this paradigm shift.



With central banks wielding quantitative tightening and interest rate normalisation as severely as they have, markets on both sides of the Atlantic have been punished in the past year. A key tenet underpinning central bank decision-making is the objective of bringing inflation under control with rate hikes without compromising financial stability. Thus the support measures that will be taken to address possible contagion in the banking sector will not necessarily stimulate the economy. This is the main difference between their intervention now and the intervention in 2008.

Pause before pivot

The macro data – which would normally have been the central focus of the business news were it not for the dramatic events in the financial sector – suggest another rate hike is viable, and thereafter the Fed may hold rates at these higher levels to appraise the full effect on inflation, which takes time to feed through. The Fed – and other central banks – are likely to pause rate hikes for the rest of 2023, before potentially pivoting in early 2024, or whenever inflation is visibly in check.

Could the tremors spread further than the banking sector?

The banking sector in general has fared poorly since the 2008 financial crisis. Bank shares have fallen continuously relative to the rest of the market and valuations remain less than half their pre-crisis peak.

The Humbling of the Banks

Since the GFC, financials have never regained their strength

MSCI World Banks, Price-to-Book

MSCI World Banks Relative to MSCI World

Source: Bloomberg

Higher interest rates should translate to higher net interest margins. But wrongly managed, they are vulnerable to the effects of high interest rates and high inflation and the pain will potentially travel further into other parts of the market liable to suffer in these new, more constrained conditions. Commercial real estate, private equity and private credit look vulnerable over the medium term with higher-for-longer interest rates.

The banking sector has been the most visible indicator of the paradigm shift in interest rate policy: adapting to the new normal of stickier inflation and a normalised interest rate regime is proving to be disruptive, but necessary in the fight against inflation.

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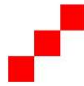

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