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ASSET MANAGEMENT

Bank failures – Lehman revisited or buying opportunity?

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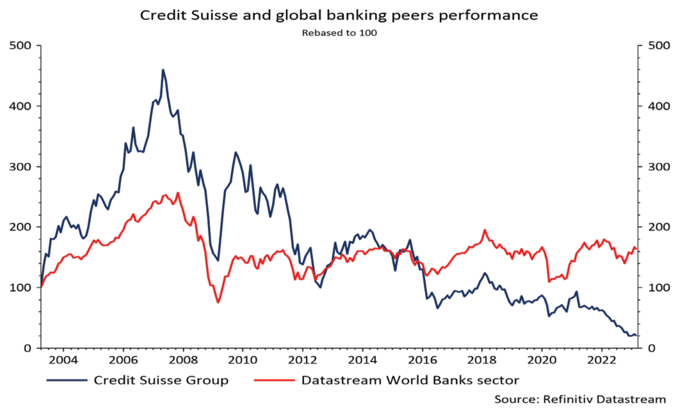
The forced takeover of Credit Suisse by UBS over the weekend for CHF3 billion, down from a CHF116 billion peak valuation in 2007, put financial markets on newspaper front pages and brought back memories of the 2007-08 global financial crisis.

Banks have been in the spotlight since the failure of Silicon Valley Bank (SVB) in the US on 10 March. SVB is one of three US banks to fail in the first half of March alongside Silvergate Bank and Signature Bank. All had significant exposures to high-risk technology sector start-ups and ailing crypto-currencies.

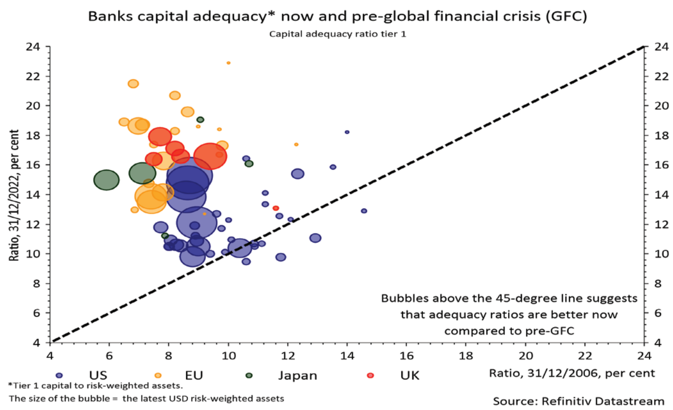
The problems at Credit Suisse, Switzerland's second-largest bank, are of a different ilk and have been building for years. As the chart below shows, Credit Suisse shares have lagged its global peers since the global financial crisis.



Credit Suisse has suffered a run of fines and losses. In 2014, it pleaded guilty to allowing US clients to evade taxes. In 2019, its chief executive resigned after revelations of corporate espionage. In 2021, it made heavy losses following the failures of Archegos Capital, a hedge fund, and Greensill Capital, a controversial supply-chain financier. This February, the bank reported the largest operating loss since the global financial crisis.

Central bankers, politicians and market regulators responded swiftly to the problems at the four banks to protect depositors and minimise the impact on the wider banking system although shareholders and some debtholders will suffer losses. In the US, Janet Yellen, the treasury secretary, Jerome Powell, the Federal Reserve chairman, and Martin Gruenberg, the Federal Deposit Insurance Corporation (FDIC) chairman, issued a joint statement saying no SVB depositors would suffer losses including those not covered by FDIC insurance. In the UK, the Bank of England and the Treasury said depositors' money with SVB's UK subsidiary was "safe and secure" following the forced sale of SVB's UK subsidiary to HSBC. In Switzerland, the Swiss National Bank extended a CHF100 billion facility to UBS and Credit Suisse to facilitate the rescue takeover.

Central bankers and regulators are trying to avoid the failure of a systemically-important bank on a par with the Lehman Brothers collapse, seen by many as the defining moment of the 2007-08 crisis. Today, banks are better capitalised and regulated than they were when Lehman failed. Reforms such as the Basel III international regulatory framework have increased the capital adequacy and liquidity of the banking system. The chart below shows the capital adequacy of banks today is much higher than in 2007-08.



The accountability of senior executives has also increased, with measures such as the UK's Senior

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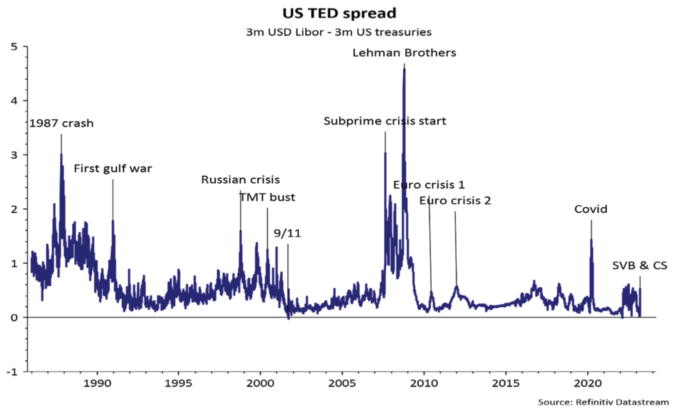
Managers Regime designed to deter irresponsible risk-taking and a reliance on state bailouts.

Despite the recent banking failures, the Brompton Asset Management investment team does not at present see signs of widespread distress in the banking system. The willingness of banks to lend to each other is a key measure of confidence. This is measured by the so-called "TED spread". This is the difference between interbank loan interest rates and the interest rate on short-term US government debt. As the chart below shows, the TED spread has risen but is not indicating the levels of stress seen in the financial crises of the last 40 years.



Monetary policy tightening exposed the weaknesses in these four banks whether these were caused by a narrow reliance on specific sectors such as technology start-ups and cryptocurrencies or poor business decisions resulting in fines and losses. Interest rates have increased rapidly over a comparatively short period of time and at a time of slowing economic growth. The Fed raised interest rates from 0-0.25% in February 2022 to 4.5-4.75% in February 2023 to combat inflation and the full effect of these rises is yet to be seen because of the lagged impact of monetary tightening on the economy. From its cyclical peak of 9.1% last June, US inflation has fallen every month to reach 6.0% in February. This suggests official interest rates may be close to their peak for this cycle, not least because the bank failures will add to pressure on central banks to adopt more accommodative monetary policies.

Heightened uncertainty in markets shows the value of investing via a portfolio diversified across global asset classes. In the first 17 days of March, global equities fell 2.16% in sterling and there was a rotation away from more cyclical, value-oriented equities towards growth-oriented equities. Gold equities, gold and global bonds, however, benefited from expectations that interest rate cuts might be on the horizon, gaining 9.93%, 7.33% and 2.49% respectively in sterling. The prospects for equities and longer-dated sovereign bonds should remain positive as investors anticipate easier monetary policy. At the same time, diversification can be provided by investments in gold and gold equities, which typically act as safe havens during periods of market turmoil.

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