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PHILEQUITY CORNER

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To the rescue

Equities experienced heightened volatility in the past two weeks, led by the continued drop of banking stocks globally. Overall confidence in the financial system was damaged following the failure of Silicon Valley Bank (SVB), Silvergate Capital, and Signature Bank. It became evident that there are cracks in the system, as seen in the troubles and eventual rescues of Credit Suisse and First Republic Bank. Regulators and peers of the distressed banks moved decisively in offering financial lifelines to prevent more bank failures and avert a potential financial crisis.

Swiss mess

Last Wednesday, Credit Suisse fell as much as 30% and reached an intraday all-time low of 1.75. This came with the statement of Saudi National Bank that it would not boost its stake in Credit Suisse past the 10% regulatory threshold. This followed the disclosure that Credit Suisse had material weaknesses in its financial reporting and internal controls. Moreover, the bank bared that it expects to post another net loss after suffering from massive client outflows last year.

Lifelines

Sensing imminent danger, Credit Suisse opened a $52b credit line with the Swiss National Bank to preemptively shore up its liquidity position. In doing so, it became the first major financial institution to tap a regulatory lifeline since the 2008 Global Financial Crisis. There are now government-initiated talks for UBS to acquire all or parts of Credit Suisse.

After the closures of SVB, Silvergate, and Signature, the Fed has put up backstop facilities that banks can utilize for their liquidity needs. So far, US banks have borrowed $165b from the Fed's backstop liquidity facilities, thereby highlighting the urgent need for funding in an environment with nervous investors and fearful depositors.

Rescue without bailout

Regional US banks continued to languish with the closure of crypto-focused Signature Bank and the problems of First Republic Bank (FRC). FRC teetered on the brink of collapse as it experienced an exodus of funds due to depositor panic. FRC's share price plunged 72% last week. With the suggestion of Treasury Secretary Janet Yellen, a consortium of 11 major American banks (including JP Morgan, Bank of America, Wells Fargo, and Citigroup) afforded FRC a critical lifeline. To provide much-needed liquidity, the group of US banks pledged to maintain $30b of their deposits with FRC.

Aside from putting up backstop liquidity facilities, the US Federal Deposit Insurance Corp (FDIC) created a deposit insurance bank to protect all the depositors of SVB. In doing so, banking regulators were able to safeguard deposits and prevent major business disruptions among SVB clients without providing direct bailouts to holders of bank equity and debt.

“Ipis” theory

The recent spate of bank failures and rescues shows that there are cracks in the financial system. Though troubled banks may have specific reasons behind their downfall, the overall outlook for the sector is challenging due to the impact of higher interest rates and tighter liquidity conditions. It is therefore likely that more banks are experiencing similar problems that plagued recent bank failures.

In our book “Opportunity of a Lifetime (see Chapter 4, page 96) and in a past article (see *IPIS Theory*, February 22, 2010), we used the example of cockroaches to illustrate how financial contagions work. We said that when a person sees an “ipis” in the open, he is likely to encounter more, as there are probably more cockroaches hiding nearby. We believe that the same phenomenon applies to contagions that take place in a difficult macroeconomic environment. In this light, the recent wave of bank failures should not be taken just as isolated events but as warning signs of systemic risk and a potential crisis.

Pause or dial back

Rate hike expectations and bond yields receded sharply following the rout in banking stocks. Consensus forecasts for the Fed terminal rate fell below 5% from 6% previously. Before the banking drama ensued, the market was expecting the Fed to hike rates by another 50 basis points due to persistently high inflation and stronger-than-expected economic growth. After the bank rout, investors now expect the Fed to pause or dial back its prospective rate hike to 25 basis points. Meanwhile, the yield on the 2-year US Treasury plunged by 124 basis points from its recent high earlier this month. This was the biggest drop in the 2-year US Treasury yield since the 2008 Global Financial Crisis and the start of the pandemic in 2020. The sudden collapse in bond yields signify investor anxiety regarding a possible recession or hard landing. Investors now fear that recent bank failures which were caused by the unprecedented pace of monetary tightening would be the trigger for the next global recession or financial crisis.

Uncertainty lingers

The rescues of Credit Suisse and First Republic are steps in the right direction which are meant to prevent more bank failures and avoid a full-blown financial contagion. However, the stock market has remained volatile, thus signaling that investor concerns still linger and that the recent rescues may not be enough to solve underlying problems. Questions and concerns arose regarding the business model, health, and profitability of banks. Smaller banks with less stable funding would still encounter difficulties raising deposits, and their margins and revenues would be eroded by soaring funding costs. Moreover, fears of a financial contagion persist. There may be more troubled banks in hiding and this may lead to more bank failures. Confidence in the financial system has been dented, and it will likely take time and more convincing actions to rebuild a strong trust in smaller and more vulnerable banks.

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