Market update

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Summary

The past week has seen **some significant events in markets** as the **US banking crisis spilled over into Europe**. In this update, **Kevin Quinn, Chief Investment Strategist**:

- Explains what happened to Credit Suisse and looks at the resulting UBS takeover.
- Provides an update on US bank closures.
- Looks at consumer inflation, energy prices and interest rates.

Credit Suisse rescue

Credit Suisse dominated headlines mid-week:

- Its **annual report** revealed **material weakness** in its **internal financial reporting controls**.
- This was followed by the **refusal of its largest shareholder**, Saudi National Bank, to **add fresh capital**.
- Its **share price collapsed** and Credit Suisse's **Credit Default Swap (CDS)[1] soared to distressed levels**.

On Wednesday (15.03.23), **Swiss authorities issued a statement** indicating that it was **confident Credit Suisse had sufficient capital and liquidity** and, in a confidence boosting measure, indicated that it **would provide liquidity to the lender** if required. **Shares recovered about 20% on Thursday** (16.03.23) although the CDS has remained elevated.

Over the weekend **rumours began of a merger**, with **UBS offering $1 billion** to buy Credit Suisse. However, the deal held some material adverse clauses that made it unworkable. Late on Sunday (19.03.23), **UBS agreed to buy Credit Suisse at a price of around $3.25 billion**, less than half of the closing price on Friday (17.03.23).

- The **Swiss National Bank has provided liquidity to UBS of $100 billion** as part of the deal
- The Swiss **government is granting a 9 billion franc ($9.70 billion) guarantee in the case of losses** from Credit Suisse assets.
- To ensure global financial stability, the US **Federal Reserve (Fed) and European Central Bank (ECB)**, plus the **central banks of Canada, the UK, Japan and Switzerland**, announced **coordinated action to boost liquidity** in US dollar swap arrangements[2].

The **initial market reaction in Asia was quite mild** but news that the Credit Suisse **AT1 bonds were facing a wipe out** (valued around $17 billion) **triggered a sell off of similar debt in Asia**, and there has been a **drop in financial shares around the world**. AT1 bonds in Europe have been sold off with about a 10% drops in value in a number of larger banks. Treasuries and other safe haven assets have been sought out and yields continue to drop.

Source: Bloomberg, 20.03.23

[1] CDS is an agreement that allows an investor to swap or offset their credit risk with that of another investor.

[2] US dollar swaps allow other central banks to borrow dollars in exchange for their own local currencies. Foreign central banks can then supply dollars locally to ease any strains.

US banking closures

Signature Bank

The Federal Deposit Insurance Corporation (FDIC) announced that a **subsidiary of New York Community Bancorp agreed to acquire key elements of New York-based Signature Bank**, which was closed by state financial regulators a week ago and placed in FDIC receivership.

Silicon Valley Bank (SVB)

Over the weekend the **FDIC indicated that it may sell SVB in parts** after failing to find a buyer for the entire business.

First Republic

First Republic Bank was **downgraded by S&P Global Ratings** for a second time on Sunday (19.03.23) after being cut to junk just days ago. This came even after the **bank received $30 billion from 11 US banks** to stave off a potential collapse. The deal, co-authored by US Treasury Secretary Janet Yellen and JPMorgan CEO Jamie Dimon, appears not to have been enough to quell investor concerns.

Source: Bloomberg, 20.03.23

Inflation looking sticky although energy prices fall further

- The US Consumer Price Index (CPI)[3] came in at 6% in February, in line with expectations. Core inflation came in at 5.5% per year, and the monthly increase was 0.5% (which was ahead of expectations).
- French CPI came in at 6.3% per year, up from 6% in January and higher than expected.
- Italian inflation rose by 9.1% per year, down from 10% in January and below estimates.
- Irish CPI came in at 8.5% per year, up from 7.8% in January.

Energy prices have dropped considerably. Oil prices dropped to a 15-month low after three days of heavy selling due to the US banking crisis and options covering[4], while European gas prices fell significantly also.

Source: Bloomberg, 20.03.23

[3] CPI is the price of a weighted average market basket of consumer goods and services purchased by households.

[4] Options covering is a trading strategy that allows an investor to profit from anticipated price rises.

ECB sticks with 0.5% rate rise

The ECB **raised rates by 0.5% on Thursday**, in line with their previous guidance but somewhat at odds with market expectations given the unfolding Credit Suisse situation. President Christine Lagarde indicated that they are going to continue fighting inflation for as long as they see underlying pressures going up. She added, “We are seeing some slight improvement, in certain areas but frankly not a lot”. There was an absence of guidance on future rate increases, defaulting instead to being data dependent. In the immediate aftermath of the move, interest rate expectations have flattened out, indicating no further changes.

Next up is the **Fed meeting on 22.03.23**, with expectations in the market that they will stick with a 0.25% rate rise in the face of strains in the financial system.

Source: Bloomberg, 20.03.23

Interest rate expectations change significantly

Interest rate expectations have **shifted significantly** as a result of the banking crisis.

As of Monday (20.03.23) the high in US interest rates is now expected to be 4.8% by May, with rate cuts to follow by June, bringing rates back to about 3.6% by start 2024.

European rate expectations also fell back with an expected high of 3.1% by July.

Source: Bloomberg, 20.03.23

Outlook

There is no doubt that the **banking crisis in the US and in Switzerland has changed market conditions in the near term**. As financial conditions tighten as a consequence, it makes **recessionary conditions more likely**.

To balance this, it also means that its **likely interest rates rises will be moderate and may even reverse more quickly** than had been anticipated. As of Monday morning (20.03.23), expectations stand at four interest rate cuts in the US before year-end.

There have been **some gains for conservatively minded investors** and **bonds and other safe havens have been sought out**.

It appears that **regulators have been very swift in the response** to the emerging crisis conditions and **may have fire-walled the problems** to a small number of US regional banks and to Credit Suisse. The price that this has involved includes more quantitative easing and a build-up of central bank balance sheets once again.

Late Monday morning (20.03.23) **equities were bouncing back** as regulators around the world **shored up confidence**. **UBS**, which had faced selling pressure early Monday morning, **rebounded** and the rush to safety seemed to be easing back somewhat.

Source: Bloomberg, 20.03.23

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