Price stability, or financial stability?

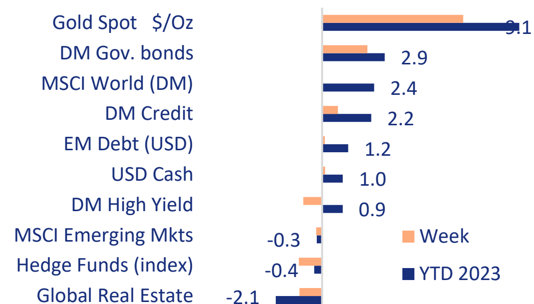
- **The brutal return of stress in the banking sector is a new and urgent conundrum for central banks**
- **Swiss authorities engineered the buy-out of Credit Suisse by UBS, at a cost for stock and bondholders**
- **The Fed’s FOMC meeting this week may be one of the most important ever**

Stress in the banking sector brutally took center stage. After the failure of three banks in the US, the focus switched to Credit Suisse, under immense market pressure. CS was bought by its rival UBS over the weekend. Importantly, the deal includes a material level of “bail-in”: shareholders will receive UBS shares based on a price of CHF3bn, which is materially lower than the latest market capitalization of 8bn. Most crucially, the value of $17bn of contingent convertible, AT1 bonds, will be erased. Preventing failure is the very purpose of these hybrid instruments, though this is still a shock.

Let’s be clear. The situation of global banks is not about an economic crisis triggering defaults which would meet insufficient levels of capital, or about toxic positions in their balance-sheets suddenly exploding. The economy is resilient while capital positions are strong. Still, the rise in interest rates has depressed the value of the investment portfolios of many Western banks. These are supposed to be held to maturity, so their mark to market value doesn’t impact capital. But if they have to sell them – like SVB had to, it’s a different story.

It comes down to liquidity. Central banks won’t choose between price and financial stability. They should fight inflation with higher interest rates (we expect the Fed to hike 25 basis points Wednesday), but at the same time use their balance-sheet to prevent a banking crisis (the Fed should be explicit on this point). This combination of orthodox and unorthodox policy should persist until inflation abates, which should happen as recession risk actually materially increases. At this time, the value of bonds will rise and central banks will anyway be able to be accommodative again. Let’s hope that no black-swan event happens in the meantime, in what our 2023 Outlook called the era of unpredictability.

ASSET CLASSES USD % TOT.RETURN, YTD 2023 & LAST WEEK



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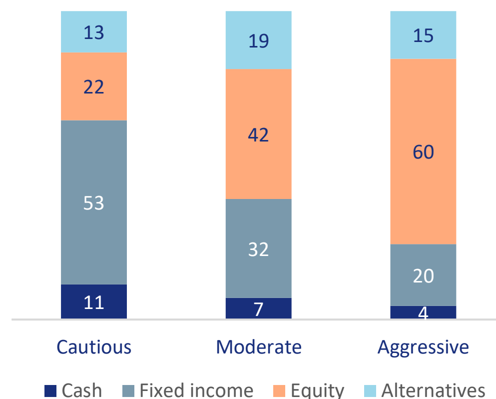
Cross-asset Update

Crises naturally incline investors to focus most on the current events, being the most topical, with all the rest taking a backseat. This banking crisis is no exception, and market participants are now anxiously waiting for measures to be taken by the authorities that will put an end to the turmoil caused by the heightened lack of confidence in the US financial system. And the only answer to restore credibility seems to be, in our view and according to most renowned experts, that the FDIC guarantees all of the US deposits at least for a limited time period, so that the transfer of funds from the local, non-systemically-important banks to the too-big-to-fail ones will cease. Such a step would avert the snowballing of the crisis into a global systemic event, by safeguarding the liquidity positions of banks. That central banks and regulators in the end take the proper action, will not diminish the damage already done by the steep tightening, nor offset the shrinking of bank credit to come and induced by the financial turmoil. So, investors will soon have to come to terms with a deteriorating outlook, irrespective of the appropriateness of the response to the current crisis.

Banks in the United States will have to raise rates on their deposits to be able to attract liquidity and remain competitive against the mid-single-digit attractive yields on treasury securities, even as the impaired government bond holdings hit the asset side of their balance sheets. A second blow to the banking sector will come from the uncertainty about the economic outlook. The Conference Board US Leading Index of 10 Economic Indicators released last Friday, relevant for the economic picture three-to-six months ahead, remains in negative territory for the eighth straight month and points to recessionary conditions, alongside the deeply inverted yield curve. Banks, all the more so regional lenders, under these unfavorable conditions will be tightening lending standards, aggravating the already uncertain outlook. In summary, all the ingredients seem to be there for an inflection lower in the cycle, although only a few weeks ago a no-landing scenario was contemplated by market participants.

We still think investors should err on the cautious side and have a preference for high quality bonds, our long-standing call, as well as for EM equities. Contrary to the past, the current crisis is for now leaving EM assets relatively unscathed. EM equity implied volatility has remained lower versus US equity implied volatility, and selling pressure on US HY credit, according to our metrics, has been higher than for EM HY credit. This is quite a departure from past crises patterns and speaks to the relative resilience of assets in the developing markets, at least until a recession hits. Gold has been the asset class of choice in the growing turmoil, yet we would expect it to pull back as central banks properly manage events in the financial sector. A final gold buying opportunity should be available to investors during a US downturn.

TACTICAL ASSET ALLOCATION: SIMPLIFIED POSITIONING

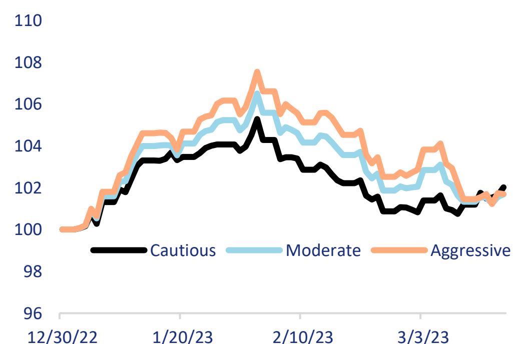


TAA – RELATIVE POSITIONING – MODERATE PROFILE

UW/N/OW:Underweight/Neutral/Overweight

	UW	N	OW
Cash			>>
DM Gov.			>
DM Credit			>>
DM H. Yield	<		
EM Debt	<<		
DM Equity	<<<<		
EM Equity			>>>>
Gold	<		
Hedge Funds		=	
Real Estate	<		

TAA – 2023 INDICATIVE PERFORMANCE



Source: Bloomberg. CIO Office calculation based on TAA applied to market indices, net total return in USD.

Emirates NBD
PRIVATE BANKING

Fixed Income Update

The title of the Oscar-winning movie "Everything Everywhere All At Once" aptly describes the current turbulence. From the previous weekend's policy moves to contain the contagion in the US to the last weekend's scramble in Switzerland to engineer a deal between UBS and CS indicates the pace with which market expectations could pressure weak entities. We had advised last week to reduce exposure to subordinated debt. But we must confess that at that time we did not anticipate the scope of the turmoil the asset class would face over the weekend.

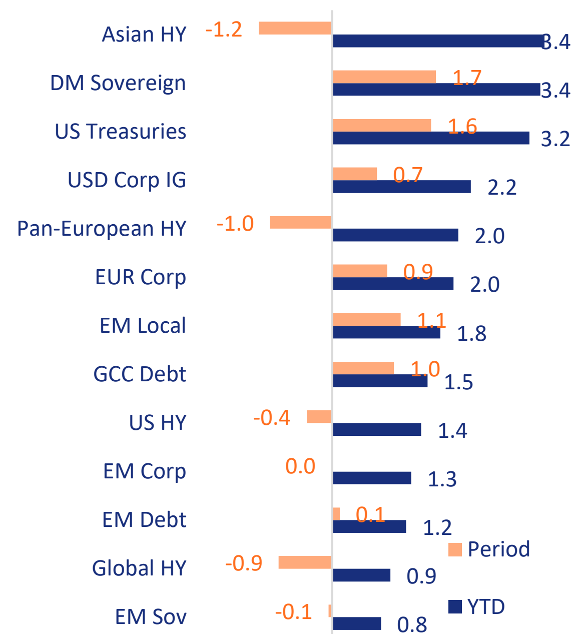
At the outset we would like to reiterate that CS AT1 perps were not part of our recommended list. We only have two senior bonds issued by the HoldCo of CS which should mature at par. The AT1 bondholders of CS were at the receiving end of the deal and Credit Suisse's 16 billion Swiss francs ($17.2 billion) of risky bonds are now worthless after the government-brokered takeover of the lender by UBS. The deal will trigger a "complete write-down" of the AT1s in order to increase core capital, Swiss financial regulator FINMA said in a statement on Sunday. In a typical write-down scenario, shareholders are the first ones to take a hit before AT1 bonds face losses, as Credit Suisse also guided in a presentation to investors recently. This has created a furore among bond holders and could lead to litigations. The clause that enabled the complete write-down is not common in CoCo instruments. Only CS and UBS had such clauses in their prospectus. Even the European Banking Authority weighed in on Monday, saying in a statement that "common equity instruments are the first ones to absorb losses, and only after their full use would Additional Tier One be required to be written down." There are other Tier 2 bonds of the bank which trade in the 50s without any clarity on their treatment yet. The only surety is about the Senior bonds issued by the Group HoldCo which would be honoured by UBS and should mature at par.

There has been some geographical differentiation in the way bank perpetuals have moved. GCC perpetuals have been largely stable losing between 2-4% only. European-bank CoCos have taken the largest beating dropping between 10 to 20 cents on the dollar. Asian bank AT1 securities have lost between 5 to 15%. Though investors may be tempted to buy the dip, the road to recovery is going to be long and we advise against bottom fishing. We would again restate our view to limit exposure to CoCos and use the opportunity offered by the stability in GCC to move up in quality and move to strong champion-bank securities from the weaker bank perpetuals.

FIXED INCOME KEY CONVICTIONS

DEVELOPED MARKETS
OW Quality corporates
OW Government Bonds
UW High Yield
EMERGING MARKETS
Overall UW EM Debt
Favor quality and selectivity
OW Selectively Asia, LatAm

FIXED INCOME SUB ASSET CLASS RETURNS (YTD, LAST WEEK)



Source: Bloomberg

Equity Update

In an absolute maelstrom of bank-related market volatility, global equities surprisingly closed flattish last week, but with large differences in performance across regions and sectors. Equities were volatile, as evidenced by the 2.86% increase in the VIX, trading at 28 on Friday. Recent stress in the financial sector has raised concerns regarding the monetary health of banks. This volatility was driven by concerns regarding the impact of rising rates on the banking sector and exacerbated by extremely low liquidity in the marketplace. Ultimately, in the US, support from the FDIC and stabilization efforts from the large banks and in Europe, the Swiss National Bank brokering a buy over of Credit Suisse by UBS, helped ease concerns about systemic risks The S&P 500 was +1.5% for the week and the Nasdaq +4.4%, with big tech the winner. In Europe, the STOXX 600 and FTSE 100 ended the week lower, at – 3.8% and –5.0%, respectively, driven by liquidity and contagion worries around banks.

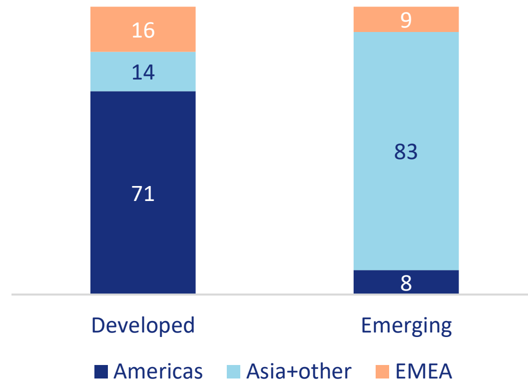
The US banks SVB and Signature don't have anything in common with Credit Suisse and don't pose a 'systemic' problem, yet they have caused concerns around the health of the whole banking sector. Regional bank performance has fared the worst. The KBW Nasdaq Global Bank "GBKX" Index tracks the performance of the banks that have been classified as Globally Systematically Important by the Financial Stability Board (FSB) and Basel Committee on Banking Supervision. These banks are publicly traded and equally weighted in the Index. This had the better performance YTD at -6%, however not immune, losing -17% March to date. All banks, even the better capitalized, have seen a sell off in March. Though the bigger banks could see an increase in capital requirements, but also an inflow of deposits. The Regional 1200 Global Banks "SR12BNK" Index has been the worst performer -37% so far this month as worries about flight of capital and support of central banks has led investors to worry about the future of regional banks, with no guaranteed backstop.

While we expect sentiment to drive markets near term and barring any black swan event or run on any other bank , relative to the Global Financial Crisis, many banks today hold more cash, fewer risky real estate loans, and have lower loan to deposit ratios. In addition, Tier 1 capital ratios, the first line of capital available to absorb losses, are at multidecade highs, providing capital buffers for these banks.

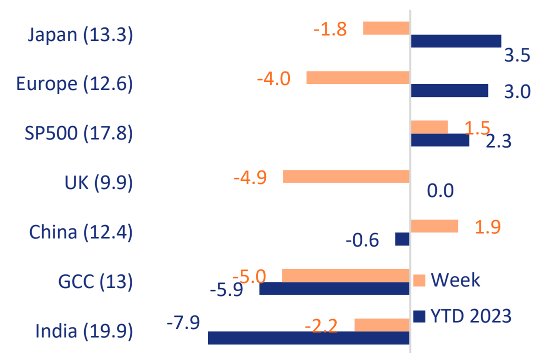
We remain overweight Asia as it provides the higher growth and Asia banks have been relatively, though not completely, immune to the US and European bank liquidity concerns.

At the same time, the technology sector has seen positive returns not only driven by the future of generative AI but the lower Treasury yields seen as a positive for high growth sectors. We would selectively look at the big semiconductor and big tech companies with cash on their books and lower leverage as future outperformers.

EQUITY RECOMMENDED REGIONAL POSITIONING

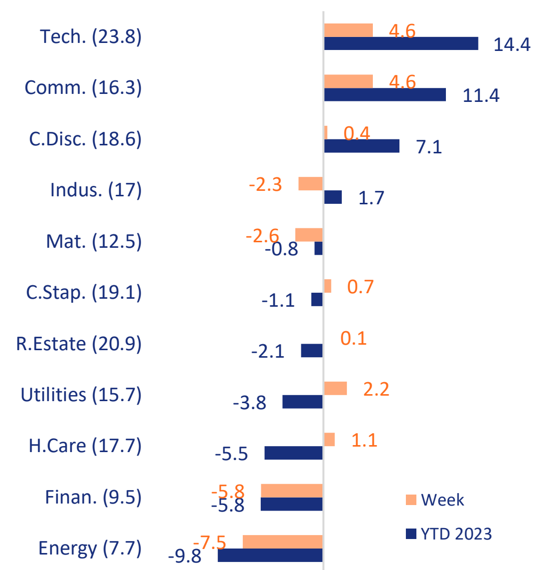


MAJOR INDICES PERFORMANCE (TR, US$) AND 2023PE



Source: Bloomberg consensus. MSCI Indices unless specified.

GLOBAL SECTOR PERFORMANCE (TR, US$) AND 2023PE



Source: Bloomberg consensus. MSCI All Country World sectors US$.

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