March 21, 2023 | United States

Credit Suisse rescue staves off contagion fears but raises new credit questions

The sale of the venerable bank to UBS brought relief to credit markets, but tighter credit conditions likely mean a faster end to Fed rate hikes and greater economic risks.

Highlights

- UBS's acquisition of Credit Suisse seems to have appeased parts of the market, but the treatment of Additional Tier 1 (AT1) bonds as part of the deal has raised questions about investors' pecking order in the capital structure.
- The events over the last 12 days have increased the cost of capital for banks globally, raising the cost of financing throughout the economy. This should help the Fed's efforts to bring down inflation but makes a mild recession more likely.
- We expect earnings growth to be weaker in the coming quarters, but a lot is still unknown. Reduced access to capital may warrant greater caution toward companies with higher leverage and more cyclical exposure.

The big picture

The banking scare went global last week, taking down a 170-year-old Swiss financial giant. Credit Suisse (CS) had been plagued by management missteps for years, most recently an admission of "material weakness" in their reporting controls. The bank faced increasing liquidity concerns last week, sparking concerns of broader contagion following US regional bank failures. The crisis of confidence deepened after the Saudi National Bank, one of its largest shareholders, announced it would not increase its ownership beyond a 10% threshold, leading to a collapse in the company's stock price and a blowout in credit spreads.

Over the weekend, regulators coordinated a sale of the company to its long-time rival, UBS, for US$3.2 billion, a 60% discount from its Friday close. Markets cheered the quick resolution, relieved that the Swiss bank would not be another "Lehman moment." However, the terms of the agreement raised new questions.

An unexpected twist for AT1 bonds

The Swiss regulator, FINMA, took the step of writing down securities characterized as Additional Tier 1 (AT1) capital — also known as CoCos — wiping out their value, even while preserving some value for holders of common equity. The move put the claims of AT1 holders *below* those of equity holders. The ECB's Single Resolution Board quickly sought to differentiate its stance from that of the Swiss regulator, stating "…common equity instruments are the first ones to absorb losses, and only after their full use would [AT1 bonds] be required to be written down."

Which approach would define a future bank failure? It's hard to say, but the precedent set this weekend has rattled other European AT1 bonds, which traded 7–12 points lower overnight heading into Monday trading. Senior debt has traded firmer, with CS notes nearly recovering to levels before the Saudi National Bank news last week. UBS senior bonds initially widened but have since recovered much of that widening by the day's end.

Economic risks have increased, but still no fundamental imbalances

The quick buyout seems to have averted concerns of an escalating banking crisis — but now come the economic ripple effects. All banks now have a higher cost of capital, which will flow through to all borrowers via tighter lending standards for both companies and consumers. Higher borrowing costs and reduced access to financing should help to moderate inflation and restrict global growth to well below trend, or even to mildly recessionary levels. That said, we do not see fundamental imbalances in either the consumer or corporate sectors, which should help limit the severity and duration of these challenges.

The end (of rate hikes) is nigh

These developments have upended the Federal Reserve's roadmap for rate hikes. Regardless of the Fed's decision this week, we believe the peak in the fed funds rate is at hand. Importantly, last week's 50 bp rate hike by the European Central Bank was partly a reflection of its singular mandate on inflation and price stability. The Fed's dual mandate to maintain both price stability *and* conditions for economic growth gives them flexibility to pause.

Fixed income

Are other AT1 bonds at risk?

Among European banks, we remain comfortable with fundamentals for senior debt, but we are marginally less positive on the AT1 market after this weekend. However, most non-Swiss European AT1 debt is structured for equity conversion or a temporary write-down rather than a permanent write-down. Moreover, AT1 bonds serve an important role in European banking regulation, and we believe regulators have strong motivation to support investor confidence in the AT1 market. We will continue to monitor this market carefully for more developments.

What is the risk to European banks broadly?

We do not view the troubles at CS as widely applicable to other European banks, as there were significant mitigating circumstances. Likewise, in the context of Silicon Valley Bank (SVB), we view the deposit networks of European banks as less vulnerable to flight due to lower concentration. In addition, deposit balances have not grown as quickly in Europe over the last few years as they have in the US, and European banks that issue USD-denominated debt do not generally have large unrealized losses in their securities portfolios.

Risk of rating agency downgrades on banks warrants caution

Potential rating-agency actions and downgrades are hard to call. Last week, both Standard & Poor's and Fitch Ratings took negative ratings action on a number of US regional banks due to concerns over deposit withdrawals. The nature of this pressure continues to be on the liquidity side and not driven by credit issues/losses, which would typically guide the rating agencies actions. The agencies are feeling pressure to reduce ratings, but they are also a source of potential volatility for these names. Based on our concerns that the rating agencies may take negative actions, we continue to prefer higher quality banks.

Equities

Earnings season should provide needed clarity

We believe the events of the past week have increased the likelihood that the long-awaited recession will land in the next few quarters. We expect a lot of noise to drive markets until earnings reports offer more data on the health of each bank. Key questions on our minds include the depth of a potential recession, how much the Fed shifts course, and whether other regional banks will face a run on deposits. In our view, the troubles at Credit Suisse are not indicative of contagion to large banks more broadly, as the issues at the company have been brewing for years.

De-risking equity portfolios on the margin

We expect access to capital will be much harder to come by, which may warrant more caution toward companies with higher leverage and more cyclical exposure. We continue to monitor our portfolios to determine when and how to de-risk on the margin, with the aim of exercising patience as we shift our positioning to be more defensive.

IM2803574 • marketing code • e-ship • 032123