

The beginning or end of the debacle?

On Thursday March 9, The New York Times titled that “More Snow and Rain Raise Flooding Risk in California” and described the local winter storm as an “unparalleled weather event not experienced in several decades”. Little did the author know that this pathetic fallacy of sorts, would culminate in the coincidental SVB financial storm, and surprise global finance with a scare to reminds us of the Great Financial Crisis. Wary depositors lined up that weekend in front of the main branches of regional Californian banks, unphased by the cold rain but fearful of their financial future. A major breach of trust in the US financial system was at play.

With evident panic in the US capital, the Fed, Wall Street, and the White House all stepped in to put out the fire. Biden, Yellen, Blinken all became vocal. Prominent investors such as Bill Ackman or Warren Buffett, gave or were asked about, their opinions. It is never good news when the Sage of Omaha is consulted. There was no doubt in anybody’s mind that the regulator should step in, and so it did – The bush fire was put out with liquidity, once more. The problem with liquid dollars is that they put out the fire at first but burn brighter, sometime later.

Will this be enough, and for how long? What will this achieve, and where will it fail? What should we make of the SVB event, and how will it impact our own Gulf markets? How is CS related, and how does all this make sense? First, let’s look at a timeline of events.

Timeline of events: Debacle quick and controlled

The timeline of events is quite precipitous and the whole SVB-Signature-CS debacle was wrapped up in less than two weeks. This is the amount of time it took to wipe out some USD 35bn in market capitalizations and to fret over half a trillion in banking deposits. From where we stand now, SVB, Signature, and Credit Suisse have been folded. While some money has been lost, most depositors have been made whole. The system is safe, and confidence has been restored – For now.

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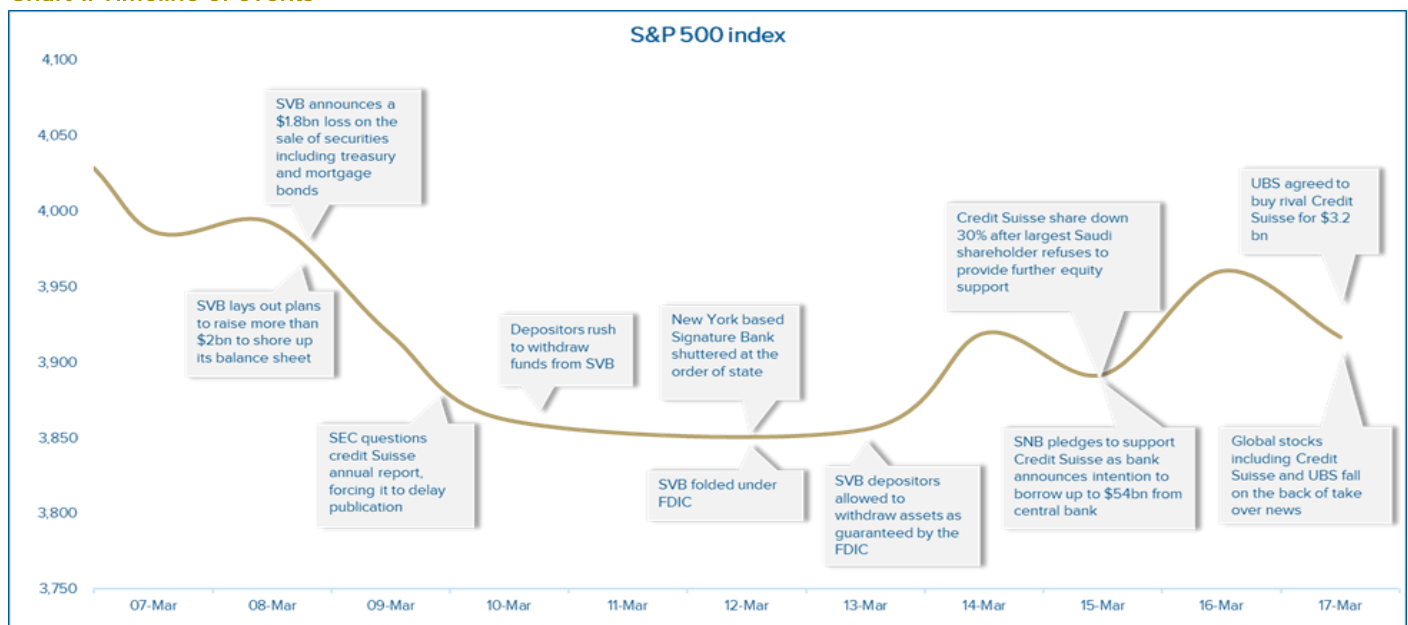
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Chart 1: Timeline of events



Source: Al Ramz Investment Research, Bloomberg

The real problem of abundant liquidity is still unsolved

In many ways, the issues at Credit Suisse and SVB are the same – Not mechanically, but fundamentally. When there is too much money going around, poor decisions are made.

SVB: Greed without fear

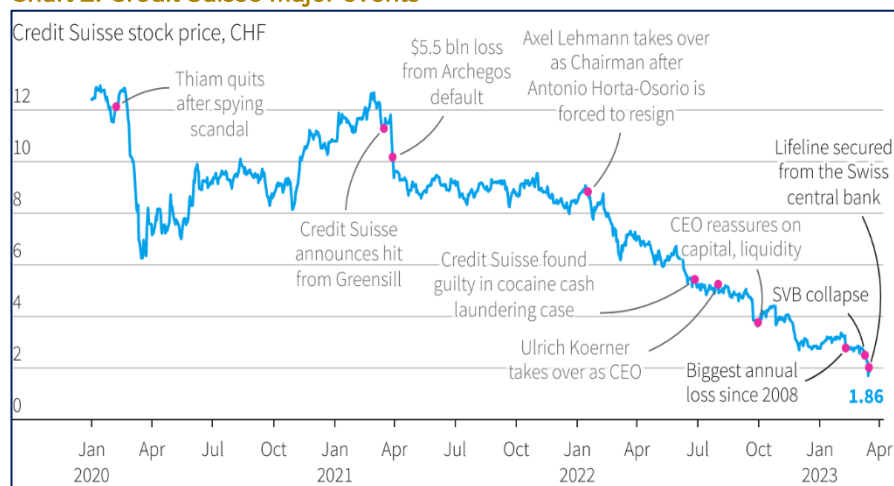
SVB was propelled during the pandemic by the Tech ecosystem, one which was thriving while other sectors were mostly flat-lining. This localized and sector-focused bubble sent the deposits of SVB sky-rocketing to \$200bn from just \$50bn before the pandemic. A hurried investment in long-term Mortgage-Backed-Securities followed in the face of short-term deposits. When Fed rates went up, the sizable, mismatched, balance-sheet blew up.

Nearly 95% of SVB deposits exceeded the \$250k Federal Deposit Insurance Corporation guarantee limit (FDIC), which meant that most deposits were not back-stopped. The mis-management of this balance-sheet would potentially dilute the credibility of the entire US banking system if depositors lost their savings, to the point of provoking a bank run. The FDIC stepped-in hurriedly to prevent such a dramatic event. The SVB failure was contained but could have repercussions.

Credit Suisse: A hellish descent

“A string of scandals over many years, top management changes, multi-billion-dollar losses and an uninspiring strategy can be blamed for the mess that the 167-year-old Swiss lender now finds itself in.” This short and efficient summary by Refinitiv says it all. More than just mis-management, CS had it all, a perfect storm.

Chart 2: Credit Suisse major events



Source: Refinitiv

The same systemic fears to the system as we had with SVB came to haunt the Swiss regulator and European Central Bank. Finance Ministers of France and Switzerland consulted with one another, the ECB was likely brought into the discussion, and the UBS withe-knight conveniently appeared at the eleventh hour.

UBS Saves the day

Multiple scenarios emerged until the final offer from UBS saw the light of day. The larger rival offers the following:

- Buys 100% of its competitor in shares equivalent to CHF 3bn
- This equates to CHF 0.76 per share

- It constitutes a 72% haircut to the closing price of CHF 2.69 on March 8
- A total of CHF 16bn should be permanently lost to Credit Suisse bond holders
- The Swiss National Bank brings CHF 100bn of liquidity assistance to UBS
- The Swiss government grants a CHF 9bn guarantee for potential losses from assets taken over by UBS

Massive liquidity injection

In total, the equity lost from the recent disappearance of the three banks (SVB, Signature, CS) is about \$35bn, if we measure the difference in market capitalization lost pre and post March 8. Not a big deal, in the grand scheme of things.

The bigger deal are the deposits of these three banks, which total about \$500bn. We consider that these deposits were at risk and have now – directly or indirectly – been guaranteed by their respective governments.

In other words, governments and central banks have pumped in the liquidity, yet again, to salvage the system. This is in the context of the Fed and ECB trying to fight inflationary pressures by reducing liquidity (increasing rates). All in all, the volatility of the banking system is coming in the way, and should complicate things for the Fed.

The rate conundrum: One step forward, one step back

The Great Financial Crisis and the pandemic brought endless liquidity to global financial markets. Any, and all problems, have been fixed with liquidity – Ever-more liquidity. The Fed's conundrum of having to shrink its balance sheet at some point without hurting markets or the economy, has been an ever-lasting question for the market. The consequences of less liquidity have been feared, but never yet realized.

Inflation changed the picture dramatically. It was deemed temporary at first, but progressively became well-entrenched. It was blamed by central banks on many, minor, and exceptional events, but never on the result of their liquidity injections. The market capitalization of the S&P500 alone increased by some \$25tn since the GFC. So much liquidity for so long is bound to create structural inflation. It seems obvious today that rising rates to tame inflation, and a subsequent liquidity crunch, are a question of when, not if.

SVB and Credit Suisse and the others are a manifestation of the upcoming, expected liquidity crunch. With rising rates, poor investments blow up first. At SVB, an asset-liability mismatch brought the bank down, as poor management mis-invested excessive liquidity. At Credit Suisse, the confidence breach from SVB and the US regional banking crisis, added to pre-existing interest rate tensions, brought down for good an already weak bank.

What happens to interest rates from here is an interesting question. Inflation has been tamed, to some extent, and the interest rate path has become understandably more benign. The banking crisis has brought more liquidity in a non-standard, synthetic form, akin to interest rate decreases. The tilting pendulum between hawkishness and dovishness is in full swing. Latest statistics depending on the source, are for a 25% to 40% chance of unchanged Fed rates this week, with 60% to 75% expecting +25bps. Beyond the macro, there will be the tone and the politics – The market will seek systemic reassurance, and to see Powell in control.

Looking at the ECB for cues, we find that the recent 50bps hike was mostly a political act. The ECB is sending a signal that it is unphased by the CS event, and that the fight for inflation remains its central purpose. In other words, Christine Lagarde tells us that CS does not threaten the European banking system. To a large extent, with indices rallying today, the market buys the story and is reassured – We are back to normal.

Impact for GCC banks

There are two types of implications that GCC banks might have to deal with, in the context of the recent global bank failures and any subsequent ones.

Firstly, any direct investment by local lenders, in the equity or fixed income of any failed bank, might lose some or all its value. Secondly, any global contagion would play against local lenders as well. Of course, in the event of negative stock market impact, and in the absence of global financial contamination, there may also be an opportunity to pick up some regional GCC lenders at a better price for longer term investment.

For now, we see an immediate yet marginal impact on Saudi National Bank and the Qatar Investment Authority, as they write off their losses on their respective CS equity stakes (10% and 7%). Any bond investments in any of the failed banks from any regional lender would also eventually be impaired, but those should remain undisclosed, and guessing their existence is second to impossible.

Otherwise, we see no immediate impact apart from stock market volatility. UAE banks remain solid and sheltered from a macro perspective, and we believe they have very little exposure (if any) to the failed banks. We spoke to main banks here in the UAE and find that they all remain constructive on the macro and seem far removed from what is happening on the global scene.

This is reassuring for now, and in line with our constructive scenario on local banks. However, we highlight that, as we have seen these past weeks, sentiment and stock prices can turn very abruptly and without notice.

Conclusion: Little harm done, but questions remain

This recent SVB/CS crisis is mostly part of the great liquidity unwind, which has been long expected and is finally taking place. We are progressively paying the price of years of excesses.

So far, the price paid has been reasonable considering the accumulated reward. However, the FDIC revealed on March 6 the amount of 'unrealized losses' across U.S. banks, which amounted to \$620bn at the end of 2022 and are attributable to the recent interest rate hikes.

Further isolated events are likely, and a major event is possible but not necessarily granted. SVB was contained, but such containment added liquidity where the Fed has been trying to remove it. Consequently, the rates are now all over the place and gold through the roof, as the market seeks haven. The Fed meeting this week will be awaited with high anticipation.

Our conviction is that 50bps should be too aggressive after what happened, and no change would spell fear by the Fed at the recent near-systematic events. 25bps it should be, then, which could be well digested by the market.

Recession still in the cards

Some economists, such as Nobel prize winner Joseph Stiglitz, talk about further bankruptcies to come. Flight to safety has been further visible in the renewed fall of the 10-yr yield and the compression of the 2-10 spread. Jeff Gundlach, the new bond king, believes that this compression after such a long and deep reversal is a confirmation of the recession to come. David

Rosenberg, another visible macro guru and former long-time Chief Economist at Merrill Lynch, puts the time frame of this recession 2 to 4 months out from now.

Stay defensive, focus on visible value

From our perspective here in the UAE, the main change in the past two weeks has been the oil price, now down below the critical \$80 per barrel. Our macro picture remains solid nonetheless, with earnings healthy, and the top-down structural changes brought about by local governments bound to be positive game changers.

The latest Abu Dhabi IPO (Presight AI) is subscribed more than 50 times, and our pipeline looks solid otherwise – If not outright exciting. AI Ansari Exchange, which is coming to market this week, is a local and global leader as it commands the largest share of the second-largest global remittance outflow market after the United States and achieves higher margins than any global competitor.

With these cues, the UAE is bound to continue to perform well, if not on an absolute nominal basis, at least relative to other less stable parts of the world.

— By Amer Halawi, Head of Research

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