MARKET UPDATE

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STREET PARTNERS

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The fall of Credit Suisse: Should we fear a credit crunch?

The collapse of Credit Suisse, an institution which has stood for nearly 120 years, will have understandably caused real concern amongst all investors. The bank has been bought by rival UBS. Shareholders in the bank are set to receive a small amount of money but it is likely to be just a fraction of their initial investment. Some owners of risky bonds invested in Credit Suisse have also lost their money. Here we address some of the key questions our clients might have.

Are we heading for a new banking crisis?

Over the past two weeks we have seen the collapse of a small bank on the west coast of the United States, Silicon Valley Bank (SVB) and Credit Suisse. We have also seen clear evidence that some of the other small banks in the United States are in some difficulty.

On the face of it these events are separate and have occurred for idiosyncratic reasons. SVB had not acted to properly manage the risk of interest rates rising and because it was small had not been forced to by the US government. In Switzerland the Credit Suisse problems are much longer running and associated with a level of mis-management that has not affected other banks.

However, these problems are coming to the fore together because of higher interest rates. Higher interest rates lead some of a bank's assets to fall in value such as its short-term bonds. As money becomes more expensive this puts pressure on the whole financial system and we find out the weaker points of it. This process is not yet over. It is highly likely that if interest rates stay at this level for a prolonged period of time other gremlins will emerge from the financial system.

Yet there are sound reasons for believing this is unlikely to lead to a significant financial crisis or credit crunch. Firstly, unlike in 2008-2009 governments are moving rapidly to contain the problem.

This includes offering big facilities to banks to provide liquidity and to swap their bonds that may have temporarily fallen in value for cash. Secondly, banks are far better capitalized than they were in the Global Financial Crisis. Indeed it is notable that so far the larger banks in the United States have been stumping up the money themselves to support the smaller ones. Thirdly, there is not yet any evidence that the actual assets held by banks are themselves in real trouble. In this sense banks today have a problem with liquidity. In the earlier financial crisis they had a problem with solvency. That is because the assets they held simply did not have a value – a problem that institutions have worked for more than a decade to tackle for just such an eventuality as this.

This final point though is the one to watch. As long as banks are only struggling because of the temporary fall in value of their government bonds this is a problem that central banks and governments can solve. However, if companies begun to default on their debts a bigger problem will emerge. At the moment we consider this unlikely as we believe that inflation will fall rapidly from here enabling the central banks to move interest rates lower. This does not mean that the next few weeks will be calm for markets. In this situation the stock market acts like a sniffer dog searching every bag on the carousel of the global economy for the one which contains a problem. Such an environment is likely to be associated with higher volatility temporarily.

What does this mean for interest rates?

In the space of two weeks expectations of interest rates have fallen sharply with the market now predicting that by the end of 2023 interest rates will have fallen by as much as 0.5% in the United States. This is because the market believes that central banks will not want to push rates much higher now it is clear that it is causing significant stress on the financial system. It is also however because the banking problems in themselves are likely to slow lending by banks. This will effectively have the effect on the economy of an interest rate rise and lead to a slowdown in growth. It is likely that this week the US Federal Reserve will increase interest rates by a further 0.25% to tackle inflation because it believes it has done enough to contain the financial problems. However, we may also get some kinder language emphasizing the need to wait and see how much affect the rises that have already taken place have had. It is also likely that UK interest rates will now peak a bit lower than people had predicted.

Conclusion

We are aware that all investors are fatigued after what has felt like a succession of crises: the Brexit debacle, the pandemic, the war in the Ukraine, the cost of living crisis and rising interest rates. Now a banking crisis just feels like the cherry on the cake. However, in investment it is generally the most patient that prevail. One of history's most successful investors, Warren Buffett, once quipped: 'the stock market is a device for taking money from the impatient and giving it to the patient.' We believe this saying has never been more true. With careful management but a conviction that ultimately it pays to be a rational optimist. We believe that portfolios can recover well from these problems, benefitting from the higher expected returns that now exist in stock markets.