EDMOND DE ROTHSCHILD

LETTER FROM THE CIO AM

MARKET ANALYSIS AND PRINCIPAL INVESTMENT THEMES

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IS THERE NOTHING TO FEAR BUT FEAR ITSELF?

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► After the events of the past three weeks in the banking sector, there is nothing to confirm a contagion of the "banking crisis" in the United States, but rather relatively contained tensions for small banks for the time being. The weekly data published by the Federal Reserve on 15 March, and thus the first ones after Silicon Valley Bank (SVB) and Signature Bank went into receivership, show that small banks (i.e. not in the Top 25 in terms of balance sheet) recorded deposit withdrawals of $108 billion (a little less than 2% of their deposits) in a week, including those of Signature Bank, which certainly explains a good portion.

We nevertheless note that the situation of First Republic Bank remains uncertain, but the authorities do not feel the urgency to place it under receivership. As for the large banks, they received $120 billion in deposits. For other countries, we will have to wait for new data to be published to get an idea of the risk of contagion.

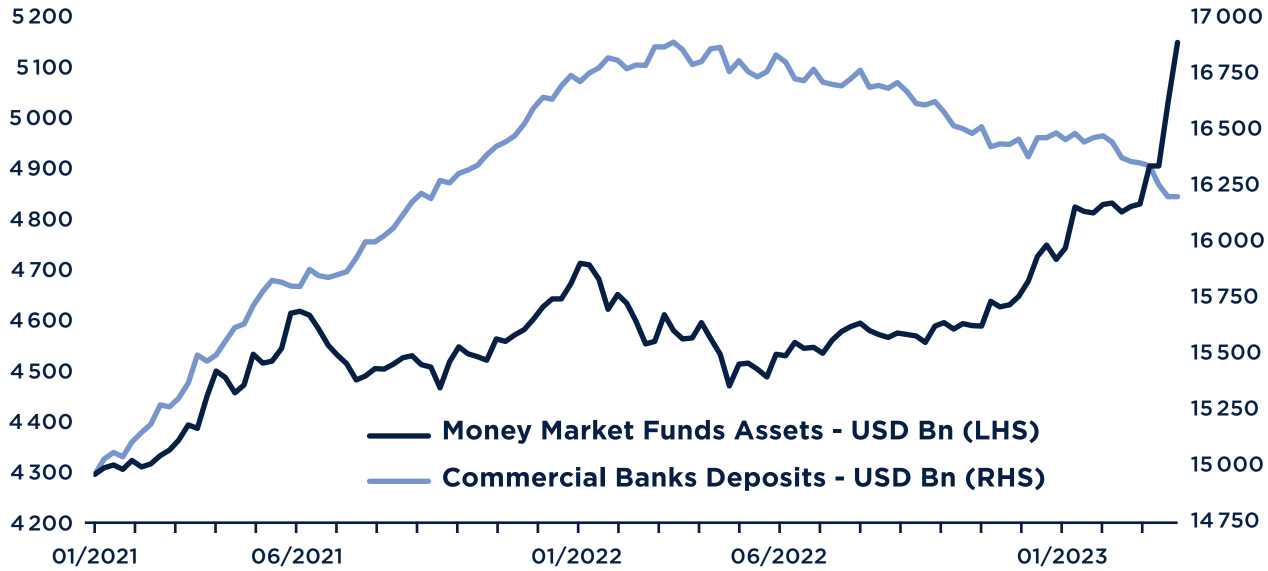
TOWARDS A TIGHTENING OF BANK LENDING

There will be a before and after of the "banking crisis" that has already occurred: as a minimum, the tightening of lending that commercial banks had announced (Fed Loan Survey and ECB lending survey) before this crisis will undoubtedly be implemented afterwards. Either because competition from money market funds in a context of higher rates is accelerating the flight of deposits, or because the episode already experienced, regardless of what will come after, itself calls for a more prudent lending policy.

Competition from money market funds

In the United States, over the past year, deposits with banks have fallen by $700 billion, i.e. almost 4%, largely in favour of money market funds, which have increased by €557 billion, due to the higher returns than deposits combined with very high liquidity and security. Given the recent rise in money market rates, and the lack of urgency maybe felt by large banks to pay significantly more on their deposits, especially as they benefit from transfers of deposits from small banks, it is likely that this trend will continue.

MONEY MARKET FUND ASSETS HAVE INCREASED SIGNIFICANTLY



Source: Bloomberg - data as at 27/03/2023. Past data is not a reliable indicator of future results and may vary over time.

Eroded hierarchy of the bank's capital structure

The full write-down of Credit Suisse's AT1s poses the risk of a decrease in visibility on the subordinated bank debt asset class. It is never easy to explain how a bank which according to the latest news had good solvency and liquidity ratios could see its share capital evaporate in a single weekend with an acceleration in deposit outflows. Furthermore, how could AT1 debt have been "juniorised" compared to equities? It was important and useful for European and UK regulators to recall that the latter option is impossible in their respective jurisdictions. On Friday 24 March, Deutsche Bank was the victim of a speculative attack with no particular origin, even as the bank posted a continued improvement in its fundamentals, but Monday practically erased the drop on Friday. In any case, if banks become more cautious about the extension of their liabilities, they will automatically be the same concerning their assets.

FROM A LIABILITY CRISIS TO AN ASSET CRISIS?

There is no crisis in bank assets. While there are losses on their bond portfolios, which have destabilised banks that have mismanaged duration risk such as SVB, we are in a low default rate environment. The problem today essentially concerns banks' liabilities, with outflows linked to the returns on the money market, or customers' intrinsic perception of the bank risk. The fear is that the foreseeable tightening of lending will be sufficient to generate a form of credit crunch, with a rise in default rates and therefore an asset crisis.

The most striking example is US commercial real estate: small banks finance nearly 80% of bank loans to this sector, which accounts for 29% of their assets. It is still too early to comment on this risk because it is difficult at this stage to know how much banks will tighten lending. This will have to be monitored closely.

CENTRAL BANKS KEEP SOME OPTIONS OPEN

Both the Fed and the ECB maintain a bias towards monetary tightening, but following their last monetary policy committee meetings, they reserve the option to wait. They do not intend to ease monetary policy, especially in a context where inflationary pressure remains high. However, as of June, the market anticipates a cut of 80 basis points in the Fed's key rate up to January. This pricing shows that investors are not counting on a single scenario, but are probabilising the risk of contagion from a banking crisis that would likely lead to further rate cuts. Schematically, either the banking crisis is absorbed and the Federal Reserve has no reason to cut rates in the coming months – it could even increase them a little further – or the crisis spreads and major rate cuts will have to be considered. The volatility of interest rates, which had risen sharply in previous weeks, therefore has all reasons to remain high, as current anticipations do not correspond to any credible equilibrium given the current persistence of inflation.

FINALLY, INTEREST RATE VOLATILITY REDUCES THE VOLATILITY OF THE PERFORMANCES OF CREDIT INVESTMENTS

The very sharp easing of yields on the curve during the banking crisis protected all or part of the negative effect on performance of the widening of credit spreads depending on the type of instrument. The return to a higher level of interest rates therefore offers protection again: if we were to enter a banking crisis, the associated credit crunch would most likely resolve the short-term problem of too high inflation in just a few months. We therefore continue to favour the carry theme in our allocations. We will revise our decision in the event of continued bank contagion or excessively drastic rationing of bank lending.

A BIT MORE CAUTIOUS ON EQUITIES

Even if there was no contagion from the banking crisis, the tightening of lending policies, which is nevertheless likely to follow, increases the risk of recession. We cannot rule out the fact that the very strong monetary tightening of recent quarters has caused other damage than the aforementioned liability crisis. We therefore prefer to be a little more cautious on this asset class. Within the equity markets, we favour China, which despite a slower-than-expected recovery in activity and still unstable geopolitical environment, is benefiting from the support of the authorities and the absence of inflationary pressure. We also favour the healthcare theme, a sector that is distant from the current problems and benefits from relatively attractive valuations and favourable prospects, as well as that of the energy transition.

KEY POINTS

We favour the carry theme in our allocations

On the equity markets, we favour China

We favour healthcare and energy transition themes

	Our convictions*	Changes compared to the previous month
ASSET CLASSES		
Equities	-	→
Fixed Income	=	→
Dollar	☆	↑
Cash	+	→
EQUITIES		
US	-	→
Europe (ex-UK)	-	→
UK	-	→
Japan	-	→
China	+	→
Global Emerging	+	→
Convertibles	=	→
SOVEREIGN BONDS		
US	=	→
Euro Zone	=	→
Emerging Markets	=	→
CORPORATE BONDS		
US Investment Grade	+	→
Euro Investment Grade	+	→
US High Yield	=	↓
Euro High Yield	=	↓

☆ Tactical score

*Range of investment committee ratings on the asset class/geographical zone (from -/- to +/+). Source: Edmond de Rothschild Asset Management (France). Ratings at 20/03/2023.

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