Exchanges at Goldman Sachs

What the banking turmoil means for investors' portfolios

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Allison Nathan: Since the failure of Silicon Valley Bank and Signature Bank, the financial sector has been under stress as investors and corporations question the impacts on the health of the broader economy. With First Republic Bank and Credit Suisse now in the spotlight, policymakers are looking at what levers they can pull to shore up market and consumer confidence.

So, has the fallout been contained? Are markets over or under reacting at this point? And what does this all mean

for investors' portfolios?

Brett Nelson: Investors, obviously, dislike uncertainty and prefer environments where one can have high conviction and know exactly how to position your portfolio. But, unfortunately, we just don't think we're in one of those environments today.

Allison Nathan: Let's get to the interview now.

[MUSIC INTRO]

John Detrixhe: I'm John Detrixhe, filling in for Allison Nathan this week. To give you the latest updates on the banking sector and breakdown the investing implications, I'm sitting down with Richard Ramsden, who leads the coverage of the banking sector, Chris Hallam, who covers the banking sector in EMEA, and Brett Nelson, head of tactical asset allocation for the Asset & Wealth Management Investment Strategy group of Goldman Sachs. Richard, Brett, Chris, thanks for joining us.

During last week's podcast, we discussed the implications of the collapse of Silicon Valley Bank and Signature Bank.

But this is a fast-moving crisis. And since then, First Republic Bank and Credit Suisse have also entered the turmoil. Now, UBS is planning to acquire Credit Suisse with support from the authorities there. Take us through the news. Chris, what's the state of play?

Chris Hallam: So, as you mentioned, last week Credit Suisse came under sustained market pressure in response to growing capital and liquidity concerns. And, ultimately, this resulted in a resolution process over the weekend, which given Credit Suisse's status as a global, systemically important bank, was key to preserving the stability of the financial system. So, the key parts of the deals are as follows. UBS is acquiring Credit Suisse and CS shareholders will receive one share in UBS for roughly every 22 shares they own in Credit Suisse valuing the CS equity at around 3 billion Swiss francs. And the aim is to close the deal before the end of this year.

Now, in the intervening period, given the turbulence we've seen in financial markets in recent days and weeks, the Swiss National Bank has extended additional liquidity facilities, which essentially means that Credit Suisse now has access to up to 200 billion Swiss francs in central bank

liquidity.

Interestingly, as part of the resolution process, the Swiss regulator FINMA, decided to write down the international tier one capital instruments, the AT1s, to zero. AT1s are a key part of the European funding market and of bank capital. And I think it's fair to say this decision has had some [UNINTEL] on confidence in the broader AT1 market.

But today we've seen statements from both the Bank of England and the European Central Bank, which I think serves to underpin the market's preexisting views of where AT1s sit in the capital structure.

Now, a decision to write down the AT1s essentially frees up around 16 billion dollars of capital for UBS. Which alongside a 9 billion dollar government guarantee gives the acquirer 25 billion dollars in protection against marks, purchase price adjustments, and restructuring costs. And so, now post closing, UBS will begin to restructure Credit Suisse with a view to the traction, eventually becoming earnings accretive in around three to four years.

John Detrixhe: Chris, what is the significance of UBS

acquiring Credit Suisse?

Chris Hallam: I think there is clearly a lot of overlap between these two businesses. UBS will likely be the world's second largest wealth manager with around 3.2 trillion dollars in client assets. And it'll be the third largest asset manager in Europe with around 1.5 trillion dollars in AUMs. And Switzerland's UBS will be the market leader in personal and corporate banking. And with loans and deposits around 50 percent higher than the closest peer.

Interestingly, in North America, UBS is already intended to further invest in their banking and research platforms in order to support further growth in wealth management. The latest view from UBS management is that they should now be able to achieve some of that scale enhancement inorganically through this acquisition of Credit Suisse.

John Detrixhe: And building on what you just outlined, how do you expect this to ripple through the economy? And does this measure, as you've just outlined, draw a line under these banking stresses? Or do we still need more time to see that?

Chris Hallam: I think the key thing here to consider is essentially tighter bank lending conditions. Banks are observing a stressed market and a more uncertain macro outlook are, at the margin, more likely to tighten lending conditions, try to conserve liquidity, and look to improve the capital positions.

Now, importantly, because the starting point in terms of capital and liquidity is so strong, we don't really expect to see a sharp and sudden adjustment to bank behavior as was observed in the global financial crisis or the Euro area sovereign crisis. This time around, it's expected to be a much more limited effect.

Now, our economists have published some work looking to quantify what this could mean at the European level. Their view is that the recent tightening financial conditions could tighten lending standards by around 10 percentage points. That would be roughly a 30 basis point drag on Euro area growth. And this cooling effect is what led them to reduce their May hike expectation for the ECB from 50 basis points to 25 basis points.

John Detrixhe: And let's continue with that pivot to the

US. Richard, shortly after Silicon Valley Bank's failure, First Republic Bank was also swept in the turbulence. What happened there?

Richard Ramsden: So, you're right. Obviously, you saw Silicon Valley initially get into trouble. They went into receivership about a week ago on Friday. Then Signature Bank went into receivership two days later on Sunday. And then over the course of the last week, First Republic has been the latest bank in the US to see significant deposit outflows that has needed a response, both from the private and from the public sector to try and stem some of those deposit outflows.

I think part of the issue is that First Republic is a bank that, on average, caters to higher net worth clients. So, they have larger deposits. And they have a higher percentage of deposits that are not government guaranteed than the average bank. So, this, as you said, has been the latest bank in the US to see deposit outflows. And it's obviously been an important focus of markets in terms of understanding what the resolution is going to be.

John Detrixhe: And also late last week, 11 banks,

including Goldman Sachs, placed a collective $30 billion in deposits of their own funds into the bank to help with the bank's liquidity issues. How does this plan for First Republic work?

Richard Ramsden: So this, in my mind, was a pretty creative by the private markets to the deposit outflows that First Republic were seeing. As you mentioned, 11 banks deposited $30 billion with First Republic. And I think that significantly improved the liquidity position of this bank to meet deposit outflows.

I think the interpretation of this is really twofold. The first is that the largest institutions feel comfortable with their own liquidity and capital position, which I think underscores that in a post global financial crisis regulatory regime, that the largest banks can actually act as a stabilizing influence. But I think the second thing is that it does buy First Republic time to really pursue other strategic options which could include shrinkage their balance sheet or looking to sell themselves to an acquirer.

So, I think the view was that this was a creative approach by the private market that should help in terms of

stabilizing the situation that didn't need government support.

John Detrixhe: Do you think policy is necessary for the deposit outflows to stop among small and medium sized banks? Or do you think that it can stop organically?

Richard Ramsden: I think we've already already seen a policy response. And the policy response is that the FDIC, effectively, came out and said, "Look, we cannot give you an explicit deposit guarantee because that is beyond our legal authority. But we can give you an implicit guarantee." And the implicit guarantee is that if you look at the two banks that were taken into receivership, Silicon Valley and Signature Bank, they made whole the depositors in their entirety, whether they were insured or not.

And the reason that they did that is they said the cost of not reimbursing those deposit holders was higher than the cost of reimbursing them. I.e., if we do not remembers non-insured depositors, there will be other bank runs that will result in further bankruptcies, which will cost the FDIC more than us guaranteeing depositors and institutions that have failed.

And I think that's actually just very important to understand. Could we get an explicit guarantee? I think it's possible. It does require an act of Congress. And it's not clear that the votes are there yet. But I do think it is something that could happen if we do see further deposit runs over ensuing weeks and months.

John Detrixhe: So, bank runs aren't a new phenomena. What is new about this episode? And what does it tell us about bank stress in the 21st century?

Richard Ramsden: I think what is new is the interplay between social media and technology. So, if you look at what happened both with Silicon Valley Bank, but also with First Republic, both of those banks lost somewhere between 30 to 40 percent of their deposits in a very short period of time. And I think what is happening is that depositors can move their cash much more quickly than in the past.

In the past, you would have to, perhaps, go to a branch. Physically withdraw the money. Go and open an account somewhere else. Today, you can move cash seamlessly and

almost instantaneously between institutions. And there really is not a lot of friction in terms of doing that.

I think also what's happening is concerns about some of these banks are getting amplified in ways that we just haven't seen in the past via social media. And that is obviously resulting in these much, much more pronounced deposit runs than we saw even in the global financial crisis in 2008. And I think that is something that both banks and regulators are going to have to think about when they think about the appropriate regulatory response to what we have seen over the last week or two.

John Detrixhe: And Richard, most market participants don't seem to see much of the link between what happened with Credit Suisse and the regional bank stress in the US. But if mid-sized US banks come under even more pressure and have even bigger problems, at what point does that start to impact European financial institutions? And is this already a global issue? Or is it still too soon to call it that?

Richard Ramsden: I think it's important to realize that the situation in the US is very different to the situation in Europe. So, just to explain what happens to the US

banking system over the last few years, when COVID hit, the Federal Reserve looked to pump significant amounts of liquidity into the economy to try and stabilize the market initially, but also to stabilize the economy as well. That resulted in just a lot of deposit creation as the Federal Reserve expanded their own balance sheet. And those deposits showed up in the banking system at a time that there wasn't a lot of loan growth.

So, if you look at deposit growth over the COVID period, so, between 2020 and, let's call it the end of '22, you saw 30 to 40 percent deposit growth at a lot of banking institutions. Most of those banks took that liquidity and they went out and they bought securities at a time that interest rates were low. So, they bought treasuries and they bought mortgage backed securities because there just wasn't a lot of loan depend at that point in time.

What happened over the last 12 months is that interest rates in the US went up very rapidly. The Fed looked to tighten financial conditions sharply to bring inflation under control. And that results in two things happening concurrently. The first is deposits started to fall quite rapidly in the US banking system. So, from the peak, we

estimate the deposits today are down around 10 percent. But it also resulted in significant unrealized losses on some of the securities portfolios that these banks had.

If you look at Europe, deposits are still growing and the banks do not have significant losses on their securities portfolios. So, really a very different backdrop between the two regions.

I think the second thing is that if you go back and look at the global financial crisis, you would get a problem in one region, say the US, and it would immediately result in problems in other parts of the world. And the reason that that happened was really because of the interbank market.

Again, you go back 15 years, banks would lend to each other on a short duration basis in a very significant way. Now, when one bank got into trouble, they would pull back on liquidity. And that would force another bank to have a problem because their liquidity would be withdrawn from the bank that started having a problem. This time round, the interbank market is a tiny fraction of what it was. There is not a lot of interbank lending today. Most banks are sitting on a lot more liquidity than in the past. And they

have to think about how they manage liquidity very differently to the past as well.

John Detrixhe: Last week, Richard, you talked about how banks have already been tightening lending standards and we're likely to see banks further tighten from here. Are there any particular sectors where you expect this to show up first in the economy?

Richard Ramsden: So, I think the area that we are the most focused on is commercial real estate lending. And I think the reason we're most focused on that is there were concerns around commercial real estate heading into this episode.

So, you have not seen a full recovery in terms of commercial real estate valuations, especially in sectors like office and retail. And there are still lingering concerns around the demand for commercial real estate, especially as I said, office and retail, on a go forward basis because of just changes in behavior as a result of COVID.

So, I do think you will see banks pull back on commercial real estate commitments more rapidly in a world that

they're more focused on liquidity. And I do think that is going to be something that will be important to watch over the coming months and quarters.

John Detrixhe: And more broadly, Brett, how do you see this banking stress affecting the outlook for economic growth in the US?

Brett Nelson: Well, Richard alluded to the fact that commercial real estate is one of the areas in the crosshairs. But I was actually surprised because when we looked at this recent GIR research piece that had come out regarding just how important small and mid-sized banks are to credit formation in the US, it's pretty stark in that they represent about half of US commercial and industrial lending. About 60 percent of residential real estate lending. 80 percent of commercial real estate lending. And 45 percent of consumer lending. So, clearly, when we have a tightening of lending standards in this very important group for credit formation, it's going to result in a slow down in economic growth.

And so, while we might have seen the forced order effects of tighter financial conditions play out in the equity markets

and the credit markets, etcetera, we still haven't seen the real impact on the economy. And that's going to come through the impact on economic growth lending standards in consumer confidence.

Now, obviously, it's very difficult to dimension exactly what that drag will look like. But as was mentioned earlier, our colleagues in research have taken a stab at this and they estimated that the tightening and lending standards that they're expecting is on the order so thing like 50 basis points of GDP growth this year. And maybe the equivalent of one to two Fed hikes.

Now, estimates across the street, obviously, vary significantly because there are a lot of uncertainty and degrees of freedom in doing these types of scenario analyses. But I think the punch line in our view would be that it's clearly going to be a drag on growth.

John Detrixhe: Speaking of which, earlier this year, the investment strategy group had a 45 percent to 55 percent probability of recession in the US over the next year. Has that changed?

Brett Nelson: It's funny because clients occasionally ask us why we give a range of probabilities versus a point forecast. But I think the developments this year are exactly why we do that in that year to date developments have pulled recession odds in opposite directions.

So, you might recall earlier this year we had more resilient than expected economic data. We had strong retail sales. Strong payrolls. Consumer confidence measures. Etcetera. And that resulted in many forecasters, including GIR, reducing their recession odds. Now, of course, more recently, we've had tighter financial conditions on the back of the bank stress. And that's obviously pushed those recession odds higher.

So, in our view, the recent events have pulled recession odds from the low end of our range towards the upper end of that range. But we still see the arguments in favor a recession being about as compelling as those against one. And therefore, continue to think about even odds for recession this year.

John Detrixhe: Do you think financial markets have reacted in line with the information that's available? Or do

you think there's been an overreaction in a certain direction?

Brett Nelson: I think it's always really difficult to know exactly what the markets are discounting at any given time. But it seems like if we think about the market shifts we've seen to date to far at least in this, they seem consistent with the developments that we've seen in that the banks are under the most stress given that they were really at the epicenter of the crisis.

And when we look at things like broader S&P 500 equities, for example, they're down about 2 to 3 percent. Which also makes sense given the relatively modest GDP drag that I mentioned earlier of, let's say, 50 basis points or so of real GDP growth.

Now, where we have seen a more exuberant reaction is within short rates. And so, you went from in the two year treasury, for example, pricing 100 basis points of additional hikes to now pricing in 100 basis points of cuts by the end of this year. So, if we think about that 200 basis point swing in expectations for, let's say, the Fed hiking, that's pretty significant in and of itself by historical

standards. But 100 basis points of cuts by the end of this year would also be consistent with a growth outcome, which is probably more negative than what is embedded in the S&P 500 as an example.

The jury is still out as to whether the fixed income markets have moved too quickly or equities have moved to slowly. But we do think that there are a couple extenuating circumstances. So, first, we know that people were very short bonds expecting higher yields and therefore CTAs and other market participants were caught in this recent move. And that could have exacerbated the extent of the move. We've also seen some metrics, such as the fact that within the financials, for example, that the S&P 500 financial sector was about 7 to 8 percent weaker than moves in macro assets alone would justify.

So, we think we have seen some of these overshoots in various pockets of the market. But in general, we would say that the moves have been fairly consistent with the emerging stress that we've seen at this point.

John Detrixhe: Brett, how do you position a portfolio at a time like this?

Brett Nelson: I think very carefully would be the short answer. But investors, obviously, dislike uncertainty and prefer environments where one can have high conviction and know exactly how to position your portfolio. But, unfortunately, we just don't think we're in one of those environments today.

And given these kind of binary outcomes where will we have a recession, we will/we won't, there's obviously a lot of uncertainty in general. And so, we have been advising clients not to position their portfolio for any one outcome exclusively. But instead, to stay invested at their strategic asset allocation targets, which are broadly diversified by design.

John Detrixhe: Are there any lessons from previous crises that you think are useful to be mindful of?

Richard Ramsden: Yes, I think there is a very important lesson, which is that every crisis has a beginning and it has an end. Every crisis does come to an end at some point. And I know when you're in the middle of a crisis, it sometimes feels that there is no end in sight. But usually,

it comes about become of a combination of two things. The first is the strongest institutions step in and buy the weakest institutions. And I think what happened with UBS and Credit Suisse is an example of that. And then secondly, there's usually some sort of government backstop, either around deposit guarantees, ring fencing losses that give the market some certainty about their ability to price downside in terms of bank equities. So, I think those are two important points to keep in mind.

John Detrixhe: And the final question for you all, when will confidence in the banking sector start to rebound?

Richard Ramsden: I think from a banking system standpoint, investors want to get some visibility around what has happened to funding basis. So, we've seen two things happen concurrently. The first is deposits have left some of the smallest institutions and gone to the largest institutions as depositors think about counterparty risk. But also, deposits have just left the system. Deposits have been transferred into treasuries and money market funds as those are treated differently in bankruptcy relative to a deposit at a bank.

And I think before confidence comes back, investors want to get some sense as to what has happened. How much liquidity has been drained from the regional banking system? How is that going to change funding costs for the banks in aggregate? And what is going to be the regulatory response? And what is that going to do to shareholder returns on a go forward basis?

Brett Nelson: Yeah. And I would just add to that that, I forget who said it, but I think it's a great quote in that markets stop panicking when policymakers start panicking. And I think we've definitely seen that kind of abrupt policy response come together. And that's starting to reach fruition. So, that's obviously a key condition to stabilizing and confidence returning, because, ultimately, investors need to know that there is a policy backstop.

And then the second thing, and Richard mentioned this earlier, is that you just need time. You need time for investors to see that more firms aren't failing. You need time for these deposit runs to subside. And then also for people to gauge the fundamental fallout and to make sure that's contained. So, I think some combination of policy actions by, as Richard said, both the private and the public

sector in terms of addressing these short falls. And then just time.

John Detrixhe: And Chris, do you have thoughts on this from a European perspective?

Chris Hallam: Yes, so, I think while it may sound counter-intuitive given everything that we've seen happening in Europe in the last three or four days, I think based on our conversations with clients as of today, incrementally from here, the most important data point for an improvement in the outlook in the European banking system is actually an improvement in the outlook for the US financial system.

I think observers are closely watching developments on the other side of the Atlantic to start to see some of those points that Richard mentioned.

John Detrixhe: Richard, Brett, Chris, thanks so much for joining us.

Allison Nathan: Thanks for joining us for another episode of Exchanges at Goldman Sachs recorded on Monday,

March 20th, 2023. We hope you follow on your platform of choice and tune in next week for another episode.

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