standard chartered
Wealth Management Chief Investment Office
20 March 2023

Market Watch

Big Bang approach

Summary

- UBS's acquisition of Credit Suisse for CHF 3bn has been approved by Swiss regulators. The agreed share price is well below Friday's close and the deal would trigger a complete write-down of CHF 16bn of Credit Suisse bonds.
- Separately, the Fed and 5 other central banks proposed to boost USD liquidity through existing swap agreements.
- The aim is to dramatically reduce systemic risk from the global financial sector. Initial reaction to the deal has been positive, with US stock futures and US government bond yields up and the USD and gold weakening slightly.
- It is too early to say we are out of the woods. We are monitoring potential unintended consequences of the deal on financial markets and the banking sector. The relative treatment of investors in Credit Suisse bonds and equities risks legal action, which may need to be addressed.

A big deal

UBS, Credit Suisse and regulators hammered out a takeover deal during the weekend. UBS will acquire Credit Suisse for CHF 3bn (USD 3.3bn), or around CHF 0.76 per share, which compares to a closing price on Friday of CHF 1.86. Meanwhile, CHF 16bn of junior Credit Suisse debt [Additional Tier 1 capital (AT1) bonds*] will be written down to zero – the largest write-down of AT1s in their short history as an asset class. In 2017, Banco Popular shareholders and AT1 holders were both wiped out in a government-managed takeover by Banco Santander.

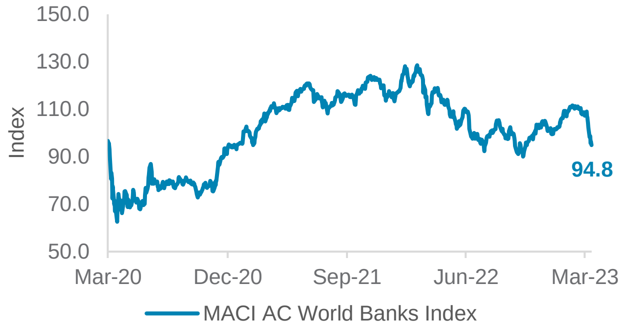
The latest deal includes the Swiss National Bank offering a CHF 100bn liquidity line for UBS and a loss guarantee of CHF 9bn from the government, although UBS would be on the hook for the first CHF 5bn of losses.

Meanwhile, six central banks (Fed, ECB, BOE, BOJ, BOC and SNB) said they would switch to daily auctions (from weekly) of US dollar liquidity to ease strains in global funding markets. This is in response to some concerns that the Credit Suisse deal could increase stress on bank liquidity in the days ahead.

Finally, the People's Bank of China cut the bank reserve requirement ratio by 25bps on Friday in order to inject liquidity into the financial system and support growth.

Banking sector still under pressure

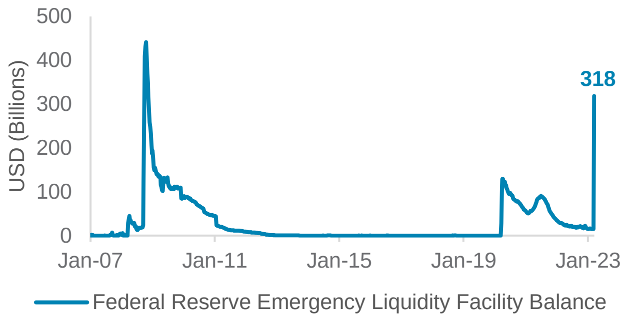
MSCI all-country World Banks index



Source: Bloomberg, Standard Chartered
*See explanatory note on page 9

US banks availed of the Fed's emergency liquidity funding last week. The global central banks' swaps facility should ease global US Dollar liquidity concerns

Fed emergency liquidity facility balance



Source: Bloomberg, Standard Chartered

US government bond yields testing key support

US 10-year government bond yield

Source: Bloomberg, Standard Chartered

Are we there yet?

The action taken over the weekend is clearly very significant. The hope is it will massively reduce systemic banking risks and allow the financial system to function smoothly once again.

However, we think it is too early to declare victory. The UBS-Credit Suisse deal is likely to face legal challenges. Shareholders are unlikely to be happy with the big markdown in valuation (relative to Friday's close), while AT1 bondholders are likely to be upset that they get nothing while shareholders get something. In theory, AT1 bondholders should have a priority claim on the bank's assets over shareholders.

Of course, it is possible that the terms of the deal are modified in some way to counter these arguments, but investors are likely to look at the world slightly differently today and this could lead to a repricing of risk across different asset classes.

Meanwhile, the situation for US regional banks remains fluid and the focus is increasingly shifting to their exposure to commercial real estate, especially the office sector. Commercial real estate prices fell in Q4 as funding costs rose sharply. As we highlighted last week, bond market volatility has risen sharply in the past few days, adding to uncertainty for the real estate sector, and could increase concerns about the solvency of some of the regional banks.

Therefore, while we doubt this will escalate into a full-blown crisis, as the authorities are very focused on avoiding such an outcome and have the experience of 2007-9 to lean on, we do not think we are out of the woods yet.

Gold looking over-extended

Gold price per ounce

Source: Bloomberg, Standard Chartered

Asset class implications – Add to income

- We continue to be defensively positioned, preferring bonds over equities, investment grade over high yield bonds and Asia over Developed Markets (both bonds and equities).
- The preferential treatment of Credit Suisse equity holders over AT1 holders is likely to lead to a reassessment of the risks surrounding the USD 275bn asset class. We are watching pricing of AT1 bonds closely, especially in Europe. AT1 prices in Asia have fallen sharply after the unprecedented treatment of Credit Suisse AT1 holders.
- We would not be chasing gold higher now after the recent strong rally seen; we expect it to fall back in the near term.
- We would look to sell into any USD rally.
- Watch out for the FOMC meeting on 22 March. Our central scenario is for a 25bps hike, but there is significant uncertainty around this. If markets become calmer, a 50bps risk is a possibility, whereas rising banking sector concerns could encourage the Fed to pause its hiking cycle.

— **Steve Brice**
Group Chief Investment Officer

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