Weekly Market Flash

Some Signals Amid the Noise

March 24, 2023

This has been a strange week. It started – as now seems to be the norm – on Sunday with a trio of Swiss financial authorities announcing the takeover of Credit Suisse by UBS. That arrangement looked less like a polished deal brokered by well-tailored financial elites, and more like a backcountry shotgun wedding. Then came Wednesday, which was supposed to be Fed day until Janet Yellen stole the spotlight with her comments to a Senate appropriations committee about the banking system. Bond yields, share prices and all manner of other assets have been all over the place. It's been a cacophony of noise, but there are at least a few signals that seem to be coming through.

Organic Monetary Policy

Let's start with the Fed, because Jay Powell was probably the most clear-spoken individual this week in communicating what we can expect to see from his organization in the weeks ahead. If your bingo card had "the banking system is sound" on it going into the Wednesday afternoon press conference then you were not disappointed – that was literally the first phrase out of Powell's mouth as the event began. As expected, the FOMC voted to raise the target Fed funds rate by 0.25 percent to a range of 4.75 to 5.0 percent. Also, in what should not have been a surprise, Powell stated that the central bank has no intention in its base case scenario of cutting rates any time in 2023. We remain utterly baffled by the determination of both the stock market and the bond market to live in a pretend world where the Fed takes us right back to the zero interest rate world of the 2010s, no matter how many times Powell and his colleagues tell them otherwise.

The key takeaway – and the clearest signal for how the Fed sees the next few months unfolding, is that the recent unrest in the banking system is likely to result in a naturally tightening financial environment. In other words, banks are going to curtail their lending activity and focus on strengthening their liquidity and capital reserves. This – which we call "organic monetary policy" – will take some of the burden off the Fed in needing to raise rates much further. What we heard from Powell was that one more rate hike of 0.25 percent is probably all the Fed needs to do. The more cautious pace of activity in the banking sector will do the rest in helping bring inflation back down.

Janet Yellen's Star Turn

Normally, Fed week is all about the FOMC press release, the "dot plots" showing where committee members expect interest rates to be, and of course the press conference where reporters try to trap Powell into a "gotcha" moment that will give them a prominent byline and maybe move markets. But this week it was Treasury Secretary Janet Yellen who created more midweek buzz as she told a Senate appropriations committee that the administration was not intending to go it alone in regard to taking off caps on deposit insurance. In other words, the government was not giving blanket coverage to the full quantity of $19.2 trillion worth of deposits in the US banking system. Yellen's remarks seemed to be the main catalyst for the late selloff in stocks on Wednesday afternoon.

But did she really mean it? Yellen would take to the microphone three more times in the course of the week to clarify, or re-clarify, or re-direct, what she meant such that at this point nobody really knows what the official policy is regarding potential further weakness in the sector. It seems for now that situations will be dealt with on a case-by-case basis. That will probably be fine if conditions stabilize – which at least for now seems to be the case. Our main concern, though, is that the absence of a clear policy will result in more nervous depositors pulling their money out of small and midsize banks, which if it happens will turn a small problem into a big problem. There is some talk in Washington about potential room for agreement among legislators to come up with a bipartisan policy for deposit insurance. We are a bit skeptical of any conversation that includes the word "bipartisan" but hope there is some substance to those rumors. We need clarity around a policy, not just case-by-case decisions on whether to intervene or not, and if so how.

About That Swiss Bank

With everything else going on in the financial world this week you would be excused for not paying too much attention to a thing called "Alternative Tier 1 Bonds," or AT1s. But this may be the single piece of that warped UBS takeover of Credit Suisse that casts a longer-term shadow over securities markets.

Credit Suisse had about $17 billion worth of these bonds, which are considered to be a hybrid type of debt instrument for the purposes of giving banks greater flexibility to manage their capital in the event of crisis situations. The bonds tend to pay out a relatively high rate of interest due to their riskiness, which riskiness is clearly stated in contractual language that the value of said bonds can be wiped out completely in the case of "extraordinary events." And wiped out they were. Every investor holding Credit Suisse AT1 bonds got zero point zero on every dollar of exposure.

Here's what makes the situation strange, and explains why the jilted AT1 bondholders are in the process of suing the Swiss financial authorities who gave them the axe. There is a thing in finance called the capital structure, which is essentially a ladder of risk from the riskiest to the most secure types of capital. The bottom rung of that ladder is common equity – the riskiest – and from there it goes up through preferred stock, junior (subordinated) bonds all the way up to senior secured debt. That's the capital structure as everybody learns in Finance 101 and is the assumed impermeable order of things when evaluating the potential risk and return of alternative financial instruments.

In the Credit Suisse case, though, the capital structure was turned on its head by the financial regulators who authored the deal. Holders of common stock in Credit Suisse got paid $3.25 billion collectively by UBS as it acquired the bank, while the AT1 bondholders, as noted above, lost everything. Yes – legally, according to the bonds' covenant language, the bondholders should have known they stood the chance of losing everything. But a bondholder could make a valid argument (whether or not a legally actionable argument) that in any such "extraordinary event" it would go without saying that the common shareholders would be the first ones kicked out the door. We'll see how this plays out in court (probably not to the benefit of the bondholders, we would imagine). But the idea of financial regulators summarily deciding that the politics of a deal justify overriding the normal rules of capital structure – that's not a good look (especially given that the profiles of some of the shareholders involved are, to be blunt, political). It may be around to haunt markets for some time to come.

Masood Vojdani
President & CEO

Katrina Lamb, CFA
Head of Investment Strategy & Research

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