Main Events

Azimut Global Network

- Milan
- Abu Dhabi
- Austin
- Cairo
- Dubai
- Dublin
- Hong Kong
- Estoril
- Istanbul
- Lugano
- Luxembourg
- Mexico City
- Miami
- Monaco
- New York
- Santiago
- São Paulo
- Shanghai
- Singapore
- St Louis
- Sydney
- Taipei

22.03	24.03	28.03	31.03
FOMC MEETING	**JAPAN CPI**	**US HOME PRICES**	**EU CPI**
Will the ongoing banking crisis force the Fed to prematurely halt its rate hike cycle?	Japanese inflation is already expected to slow. If confirmed, a change in Japanese monetary policy may become less compelling	Interest rate increases over the past year are expected to continue driving down real estate prices	If core inflation in Europe does not begin to moderate, the ECB will be in a very difficult position

BANK MAYHEM

- **For the first time since 2008, fears of a banking crisis have come to the fore again in the past two weeks**
- **The failure of Silicon Valley Bank forced the Federal Reserve and FDIC to take extraordinary measures to prevent contagion to the entire U.S. banking system**
- **The Credit Suisse crisis compelled Swiss authorities to push through a takeover by UBS, causing severe losses to investors and violating the rule of law**

Over the past two weeks, an issue that had been forgotten about for almost 15 years has resurfaced as unexpectedly and overbearingly: a banking crisis.

To understand what happened and whether the situation is actually severe or not, let us first explain a basic concept for assessing the riskiness of a bank: the need to maintain an alignment between the duration of assets and liabilities.

We give a couple of examples to explain the concept. Assume that a bank bought a 30-year MBS and financed it by issuing a 30-year bond (obviously at a lower rate, thus crystallizing for 30 years the spread in its favor). If interest rates rise, the bank is unaffected: the value of its assets (MBS) goes down by as much as its liabilities (the price of the bond it issued also went down). The impact is therefore zero. If there are no redemptions, the bank can keep both the MBS (asset) and the issued bond (liability) on its balance sheet safely and without jeopardizing its solvency. Obviously the bank will report an "unrealized loss" on its balance sheet for the MBS, but this is not in itself a risk situation for the bank.

If the bank had instead bought a 30-year MBS by funding it with sight deposits, there would be a potential risk. When rates increase, the price of the MBS collapses, but the value of bank deposits remains unchanged. If the bank does not receive withdrawal requests, this risk situation can remain latent and never become an actual problem.

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If, instead, depositors become concerned and start withdrawing money, the bank is forced to sell MBS on the market to pay depositors, thereby consolidating a loss and making only a portion of the money needed. Realized losses on investments can completely wipe out the bank's capital if repayment claims are large and/or rate increases are severe.

Therefore, unrealized losses are not a problem per se, regardless of their magnitude. They become a problem when 1) there is a maturity mismatch between assets and liabilities (condition) and 2) there are significant customer withdrawal requests at the same time (catalyst).

What happened to Silicon Valley Bank (SVB) is an example of the latter: in recent years characterized by very low rates, SVB invested its assets in bonds with rather long maturities, such as MBS. Its liabilities, on the other hand, had remained with shorter maturities. As a result of the mismatch between the duration of its assets and liabilities, SVB found itself to be "long duration" at the same time as the sharpest increase in rates in 40 years. This situation was public and widely known, so much so that in recent months SVB's spreads and CDS continued to rise, signaling the problem and prompting some of the shrewdest investors to redeem their money. When the issue became widely known, the situation deteriorated, resulting in a bank run, and the losses realized were so significant that they wiped out the bank's capital, forcing SVB to declare bankruptcy.

Aside from SVB, how serious is the problem of unrealized losses? As previously stated, a condition (mismatch between assets and liabilities) and a catalyst are required for it to be an actual problem (abnormal withdrawal requests). Normally, there should be no significant duration mismatch for medium and large banks. Perhaps some of the smaller banks might have some problems, but for small banks the problem is easily manageable. That said, the Federal Deposit Insurance Corporation ("FDIC," the U.S. deposit insurance authority) has reported that by the end of 2022 the U.S. banking system had $620 billion in unrealized losses.

Even in the absence of a duration mismatch, such a high absolute level of unrealized losses still poses a latent risk to the financial system. To prevent the catalyst (withdrawal requests) from occurring, it was announced that all SVB deposits will be guaranteed. Previously, the FDIC only insured current accounts up to a maximum of $250,000, and if a bank failed, the depositor would lose anything above that limit. Because the FDIC guaranteed all SVB deposits, it could be argued that in the future, the FDIC would guarantee all deposits from any bank and in any amount. Individuals, therefore, would no longer have any incentive to withdraw money from their bank, since every bank is guaranteed by the state through the FDIC.

In addition, the Fed, the government and the FDIC have launched a new program, the Bank Term Funding Program (BTFP) which aims to provide banks with a stable resource of funding to meet customer withdrawal requests, if any. The BTFP will provide loans to banks in exchange for Treasury and MBS, valued at par. In other words, if a bank receives unusual redemption requests despite the fact that all deposits are now FDIC-guaranteed, instead of liquidating the securities on the market at a loss, the bank can use them as collateral at the Fed. In exchange for the securities, the Fed will lend the bank an amount equal to the face value (100, "valued at par"), not the market value of the security, which is potentially even lower than 100.

With these two programs, therefore, the Fed has done everything it could to stop the banking crisis by making sure that unrealized losses do not turn into real losses (the condition) and by not giving customers reasons to withdraw their money from banks (the catalyst), since their deposits are fully insured by the FDIC, regardless of the balance.

Let us now turn to Credit Suisse ("CS"). For months the CDS of CS had been trading between 300 and 400, an unusually high level in the absence of serious problems. Although there is no direct link between CS's problems and the issues of unrealized losses or SVB's bankruptcy, the wave of risk aversion caused by these events caused CS's CDS to skyrocket, even surpassing the 1000 mark, a level only reached by companies that are on the verge of bankruptcy.

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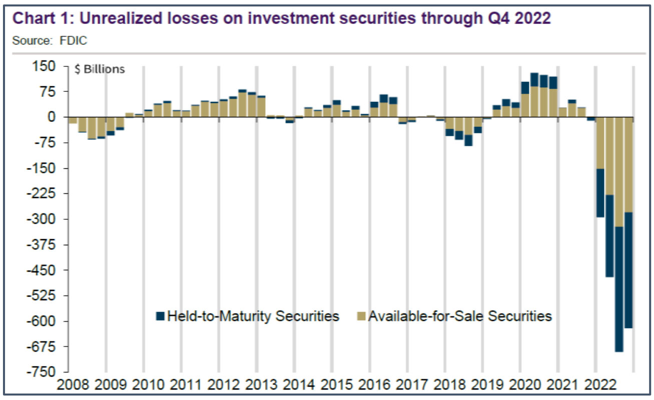
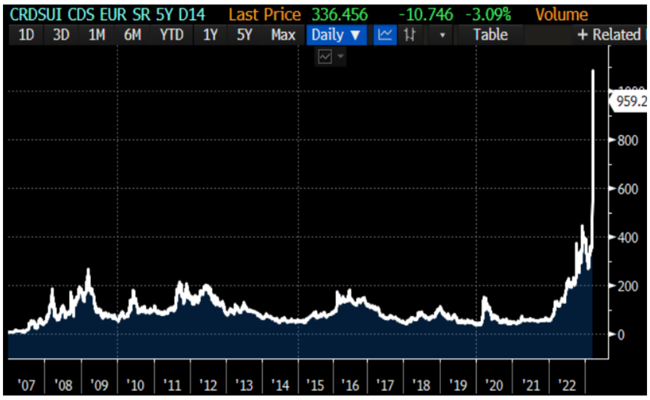


Source: NatWest Markets Plc, FDIC



Source: Bloomberg

Despite this evidence, FINMA and SNB issued a joint statement (https://www.finma.ch/en/news/2023/03/20230315-mm-statement/) on March 15 stating: "FINMA confirms that Credit Suisse meets the higher capital and liquidity requirements applicable to systemically important banks." Well, fast forward four days later, on Sunday, March 19, it was announced that CS had been acquired by UBS. Market rumors stress that apparently this was not a voluntary deal, but rather one that was strongly pushed by supervisors.

CS was acquired for CHF 3 billion, which is 4.5 billion less than the bank's capitalization last Friday, thus resulting in significant losses for shareholders. In addition, CHF 16 billion of Additional Tier 1 (AT1) bonds were wiped out, in what turns out to be the largest default in the history of Contingent Convertible bonds (CoCo bonds, created in Europe after the global financial crisis to act as shock absorbers when banks are in danger of bankruptcy). Furthermore, the Swiss government had to pledge up to 9 billion Swiss francs in losses, if UBS' losses exceeded 5 billion francs. Finally, as a condition for closing the deal, the central bank had to grant UBS a credit line of up to CHF 100 billion. Luckily, the SNB and FINMA had stated that CS was in very good shape! We wonder what would have happened if they had said CS had a problem?

The CS case is sending shockwaves through the entire financial system. The AT1s of all European banks were the first to be affected. For many years, investors saw these bonds as providing a higher interest rate while posing no additional risks. Unfortunately, investors have learned that there is no such thing as a free lunch.

UBS's CDS, which was trading at 65 ten days ago and 133 last Friday, has now reached 160 at the time of writing (Monday, March 20). It's difficult to predict what will happen in the medium term, partly because it's unclear how serious CS's situation is. If UBS can quickly resolve CS's legacy problems, then the problem may remain confined. If not, then in a few months UBS's CDS will also begin to rise, and then Switzerland (and the entire world) will have to face an even bigger problem.

However, one cannot sleep peacefully. Resolutions were made in violation of Swiss laws in effect at the time in order to avoid bigger problems if a deal was not reached by the weekend.

In cases where a deal would result in serious losses for shareholders, the transaction should first have been ratified by an extraordinary meeting of shareholders. This did not occur in the CS transaction. Furthermore, because bondholders are normally senior to shareholders, the company's share capital should have been reduced to zero before the value of the AT1s is wiped out.

For some AT1s, conversion into shares or their write-off (even without wiping out the shareholders first) is only possible if the bank's capital falls below regulatory thresholds. However, given that FINMA and the SNB stated in their March 15 statement that the bank was adequately capitalized, why did they decide to write off the value of the AT1s?

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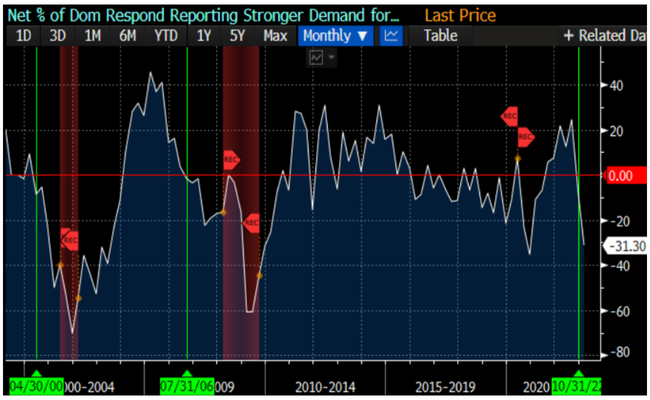
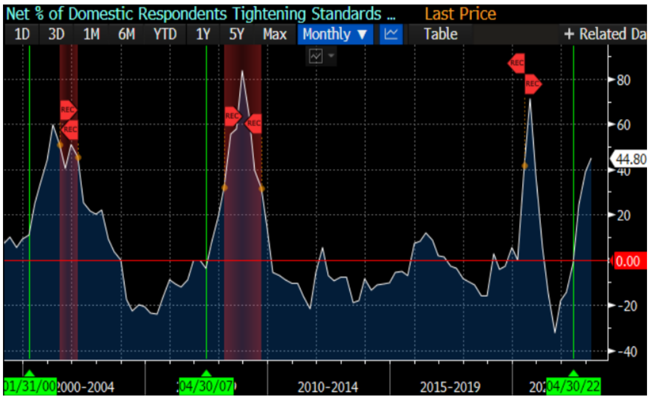


Source: NatWest Markets Plc, FDIC



Source: Bloomberg

Both decisions (imposing a deal that severely harms shareholders without an extraordinary meeting and resetting AT1s to zero in the absence of any evidence that regulatory capital has fallen below legal thresholds) open the door to lawsuits, which could also call the legitimacy of the transaction into question. This uncertainty will linger for a long time, and if ever one or both decisions are overturned, the market’s consequences could be dire.

In addition to this, what happened to SVB and CS will likely lead to a significant increase in the probability of a recession. Even before these events, banks in both Europe and the United States were imposing tighter lending criteria, and loan demand was falling. When we've seen these dynamics in the past, we've always seen a recession within the next 9 to 18 months.

Markets may soar in the short term by focusing solely on the possibility that these events will cause central banks to end the rate hike cycle sooner than previously anticipated. In the medium term, however, markets must consider the fact that the economic outlook is much worse today than it was just a few days ago.

We also remind that whenever there has been a major crisis, the first adverse developments have always appeared to be easily digestible by the financial system. However, as a research by NatWest Markets Plc recalls, “Home prices peaked in late 2006. New Century, an American real estate investment trust specializing in subprime lending and securitization, went bust in April 2, 2007. In August of 2007, American Home Mortgage declared bankruptcy, and several hedge funds saw liquidity evaporate and investors were gated. September 2007 was the run on Northern Rock … all of these were a full year before the failure of AIG, Bear, and Lehman, as well as the breaking of the buck by several US money market funds, etc. The lesson here is to be cautious about assuming that the breaking of SVB [*and the acquisition of CS, note by Azimut*] marks the end of “things breaking.”

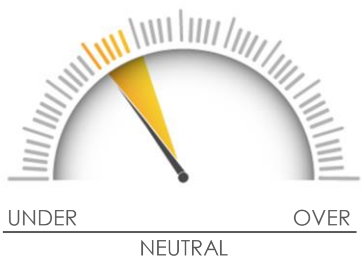
Asset Allocation View

	−	=	+
Equity			
Developed Markets	Downgrade		
Emerging Markets	Downgrade		
Fixed Income			
Developed Markets Sovereign		■	
Developed Markets Corporate	Downgrade		
Emerging Markets	■		
Commodities			Upgrade
Currencies		*Commentary below*	

− UNDER = NEUTRAL + OVER

Equity

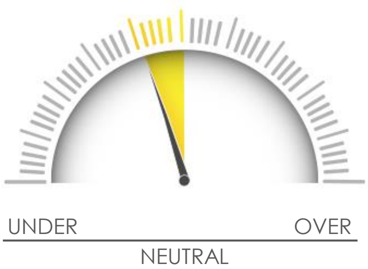
Developed Markets



We downgraded our recommendation on Developed Markets Equities to **Underweight**. The sudden outbreak of the banking crisis in both the United States and Europe will inevitably have implications for economic growth, making the risk of recession much more concrete and imminent. In the short term, the market could bounce back if it focuses solely on the possibility that these negative developments will force central banks to end the rate hike cycle sooner than expected. Should the rally materialize, it is advisable to take advantage of it to reduce portfolio exposures.

US	=	**Europe**	=	**Japan**	=

Emerging Markets

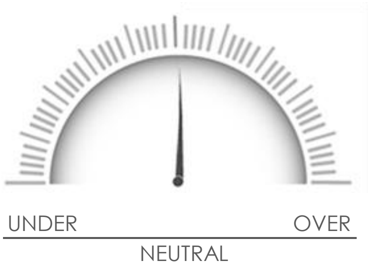


We changed our recommendation on Emerging Markets Equities to **Slightly Underweight**. The reasons for the downgrade are the same as those articulated for developed markets

Asia ex-Japan	=	**EEMEA**	−	**LATAM**	=

Fixed Income

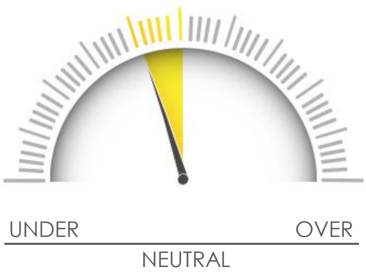
Developed Markets Sovereign



We maintained our **Neutral** recommendation on Developed Markets Sovereign Bonds. In the short term, interest rates may continue to fluctuate sharply as they have over the past two weeks. We recommend maintaining a neutral exposure to the asset class until there is more clarity on the medium-term outlook in the absence of adequate visibility on the developments in the banking crisis and given the uncertainty surrounding the Federal Reserve's stance.

EU Core	=	EU Periphery	=	US Treasury	=	Japanese JGB	=

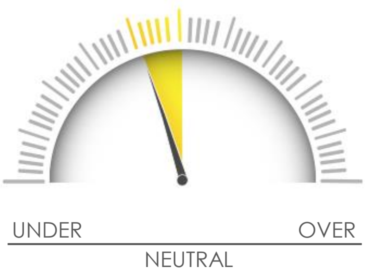
Developed Markets Corporate



We have changed our recommendation on Developed Markets Corporates to **Slightly Underweight**. The ongoing banking crisis will inevitably widen spreads, not only on financial bonds, but also on all other corporate bonds, given that access to banking credit will be more difficult in the coming months due to tightening lending standards. We continue to see high yield as the segment with the worst prospects.

IG Europe	+	IG US	+	HY Europe	-	HY US	-

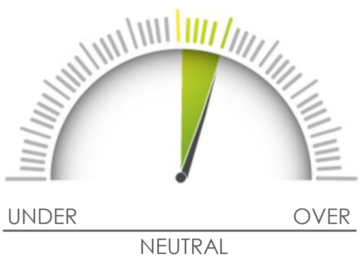
Emerging Markets



We kept our recommendation on Emerging Market bonds as **Slightly Underweight**. The crisis of the banking system in developed countries will inevitably lead to widening spreads for emerging countries as well.

Local Currency	+	Hard Currency IG	-	Hard Currency HY	-

Commodities



We increased our recommendation on Commodities to **Slightly Overweight**. Fears unleashed by the banking crisis in the U.S. and Europe, coupled with expectations that this will lead to a premature end to the rate hiking cycle, are both driving forces for the price of precious metals. Furthermore, we believe there is room for a rebound after other commodities experienced a sharp correction due to fears of an impending recession.

Precious	+	Energy	=	Industrial	=	Agricultural	=

Currencies

The Committee confirmed its **Neutral** view on the US Dollar pending the March Fed meeting, from which clarity is expected on whether developments in the banking sector warrant a premature end to the rate hike cycle.

The Euro is still viewed as Neutral. Concerns about the soundness of the European banking system, particularly the effective riskiness of CoCo bonds following the Credit Suisse wipeout of its AT1, may outweigh the fact that interest rates in Europe may now have more room to rise than in the United States.

The view on the **Chinese Renminbi** and on **other emerging market currencies** is also confirmed **Neutral**.

Euro	=	USD	=	CNY	=	Other EM	=