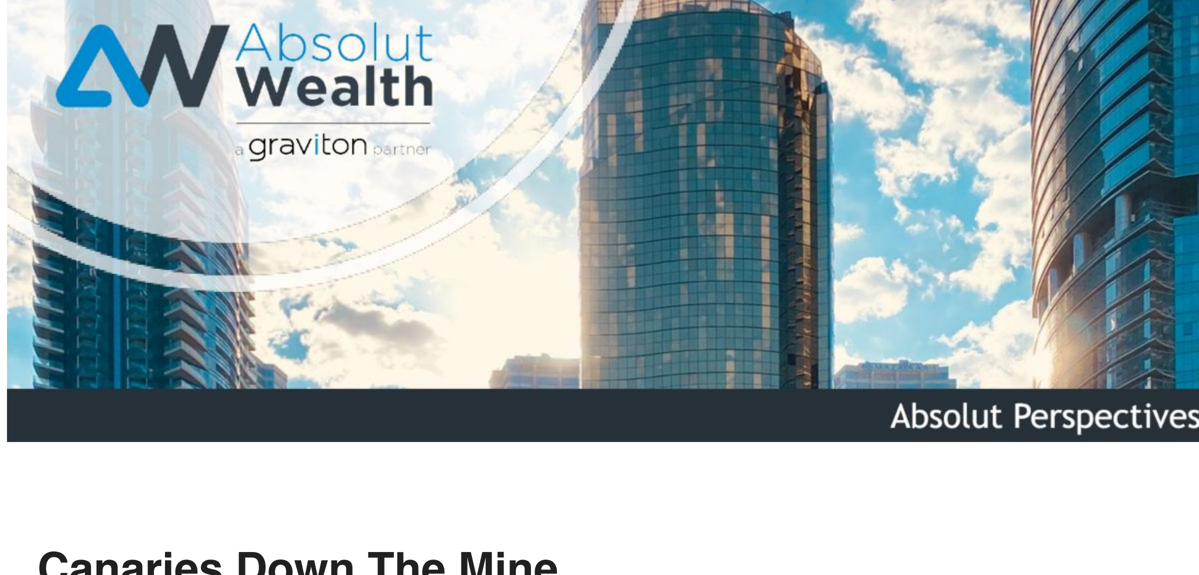


Canaries Down The Mine

Richard Harris | March 2023

Over the past year, as a result of some of the most aggressive monetary tightening ever implemented, we have remained vocal that "cracks" would start forming in the global financial system.

The transition from a post COVID environment (where credit was essentially interest-free) to a regime where interest rates have become material was inevitably going to catch up with businesses and consumers as the rules of the game changed.

We have discussed these changes in previous newsletters, but I'll highlight some implications of higher interest rates below:

- Higher costs of borrowing for consumers and Governments
- Higher mortgage, vehicle, and credit repayments
- Higher interest rates on savings
- Asset prices usually decline, as it is more expensive to borrow
- A stronger Dollar affects multinational companies that report in the US.

It was always going to be difficult to predict the exact industry or moment that would be the proverbial "canary down the mine" but we are starting to see signs of structural weakness globally, especially in businesses that have not been prudent to the nature of this new, higher interest regime, and as a result, have not hedged their risks appropriately. The likelihood of this potential demise, however, would inherently be linked to the credit system of businesses that rely on interest rate spreads to make profits.

Over the past few weeks, we have seen certain "cracks" starting to emerge in smaller banks globally, caused as a direct result of recent monetary tightening.

The Global Banking System

Banks can profit in a variety of ways, but typically make money by borrowing at low interest rates and lending at high interest rates. This is done by taking the deposits that clients have placed in their accounts (i.e., savings) and lending those deposits out to other consumers in need of credit (i.e., vehicle, mortgage, credit loans, etc).

This lending is sometimes done using leverage and providing riskier loans (especially amongst smaller banks) as these banks try their best to increase the interest rate spread between deposits and loans in order to maximise profits.

It is essential for said banks to ensure that these assets and liabilities remain balanced, and that money lent out is paid back effectively, whilst ensuring that those customers with bank deposits have timeous access to their funds should they need.

Recent Banking Issues

The banking system in the United States works somewhat differently to the rest of the World. In the US, you have:

(1) National Banks, which operate much like the banks we know and function nationally/internationally. They are the largest and most well-known banks with assets above $1Tn.

(2) Regional Banks - Smaller banks with assets between $10Bn and $250Bn in assets.

(3) Community Banks - Assets under $10Bn.

In the past month, the world has awoken to potential stresses in smaller regional and community banks as well as in many European banks and their practices.

It started with Silicon Valley Bank (SVB) in early March when news broke that SVB was raising additional capital by selling stock. This created panic across markets and other smaller banks such as Signature Bank and First Republic, as investors started digging deeper into the financials of these companies, uncovering risky lending practices and a lack of hedging that would ultimately lead to business instability and insolvency.

Naturally, consumers with deposits in many small banks started to panic as they realised that their money (deposits) could be at risk. This led to what is known as a "bank run", as deposits were withdrawn at astronomical levels and reinvested into what they perceived as safer banks and US treasuries.

As the deposit base of these smaller banks diminished, so did their credibility and solvency, as they no longer had the collateral to sufficiently fund their higher rate loans. The share prices of many of these small banks tanked as a result with many investors comparing the situation to the 2008 Global Financial Crisis, jumping over one another to sell their stock.

As contagion spread across the sector, the solvency of major banks, such as Credit Suisse in Europe (who has been notorious for bad practice and unstable debt over the last decade), were now also brought into question.

Step in the Authorities

With this impending crisis and a large scale "run on Global banks" becoming more and more likely, authorities stepped in and announced measures that they hoped would reassure deposit holders and reduce systemic risk. The US Treasury Department, Federal Reserve, and FDIC (Federal Deposit Insurance Corporation) announced protection to depositors as well as an emergency lending program to prevent further contagion. Other major banks, such as JP Morgan, also stepped in to fund struggling banks like First Republic.

A week later, a reluctant UBS in a Government-brokered deal, was obligated to buy a struggling Credit Suisse to avoid similar panic in Europe, with the Swiss National Bank granting a massive guarantee on potential losses that may arise from the takeover.

Since recent action from global authorities, the banking sector and respective share prices have remained somewhat stable. However, it must be noted that with smoke, there is usually fire, and with global authorities taking such drastic action in a matter of days, investors will question the stability of the banking system in the short term.

The last mention on the topic of smaller banks, especially those in the US (which is often a barometer for global economic strength), relates to the riskiness of the loans made by these banks in order to profit. 50-70 percent of commercial real estate and small business bank loans in the US come from these smaller banks and as economic conditions and asset valuations deteriorate, these banks will be the first to lose if said risky lenders default. It will be important to watch how authorities respond to this.

How does this impact an already fragile outlook?

The recent banking crisis and potential contagion thereof has added increased pressure on Global Central Banks to pause their rate hiking cycle, or dare we say, start cutting rates. This is very difficult, however, as inflation is still running hot globally and Central Banks have continually expressed their intention of bringing it down at all costs.

The longer rates remain elevated, further "cracks" will start to surface and this will ultimately have adverse effects on Macroeconomic data and company profits. We have already seen company layoffs being initiated with general guidance becoming somewhat more conservative each quarter.

Recent intervention on small banks will eventually be tied to stricter regulation on lending going forward and this will filter into the economy as consumer and business credit will be tightened.

Rising unemployment, reduced consumer spending, and a likely global recession during the course of 2023 is undoubtably going to impact company earnings and their valuations. This will have the greatest impact on overvalued markets such as the United States, but will also create huge opportunities in markets and share prices of companies that already reflect a poor environment.

This deterioration of economic conditions will likely be deflationary and as a result, inflation should drop drastically if the above comes true. This will allow Central Banks to, at some point, start cutting rates and stimulate economies once again. The question will then be based around the extent of the economic damage created by recent monetary tightening and how long it will take economies to recover.

As many current market participants and decision makers have become accustomed to markets moving higher with Quantitative Easing (QE) and other support measures by Central Banks, markets will likely rally with any new information on "bailouts", stimulus, or aid. At some point, however, sanity will have to prevail, and the world will have to find its new equilibrium, where a new normalcy will be established. Something that we have also highlighted, is that monetary tightening usually has delayed effects, and when Central Banks start cutting rates and stimulating the economy again, it is usually because they foresee difficult financial times ahead.

Market Update

March saw volatility once again creep into markets, globally, as the abovementioned stresses started showing in certain businesses and sectors. Despite this volatility and concern, we saw general market strength as investors turned their focus to an earlier Federal Reserve "Pivot" and security that Central Banks had once again come to the rescue.

The NASDAQ100 (US Technology) soared 7% as US Bond yields decreased and investors started piling into companies with longer duration earnings. Hong Kong's Hang Seng and the S&P500 followed with gains of 3 and 2.3%, respectively. One the other end of the scale, UK's FTSE index lost 4%.

Back in South Africa, the JSE Top40 recovered to small losses (-1%) after being down as much as 7% at one point. The Rand continued to whipsaw but stayed below the NB R18.50/$ technical level to close below R18/$ at month end. The South African Reserve Bank continued to follow US rate hikes by hiking once more by 0.50% on Thursday to increase our Repo Rate to 7.75%.

Gold, Silver, and Bitcoin remained on the front foot in March as investors started questioning the strength of the current financial system and searched for asset class hedges to protect them against any potential risks.

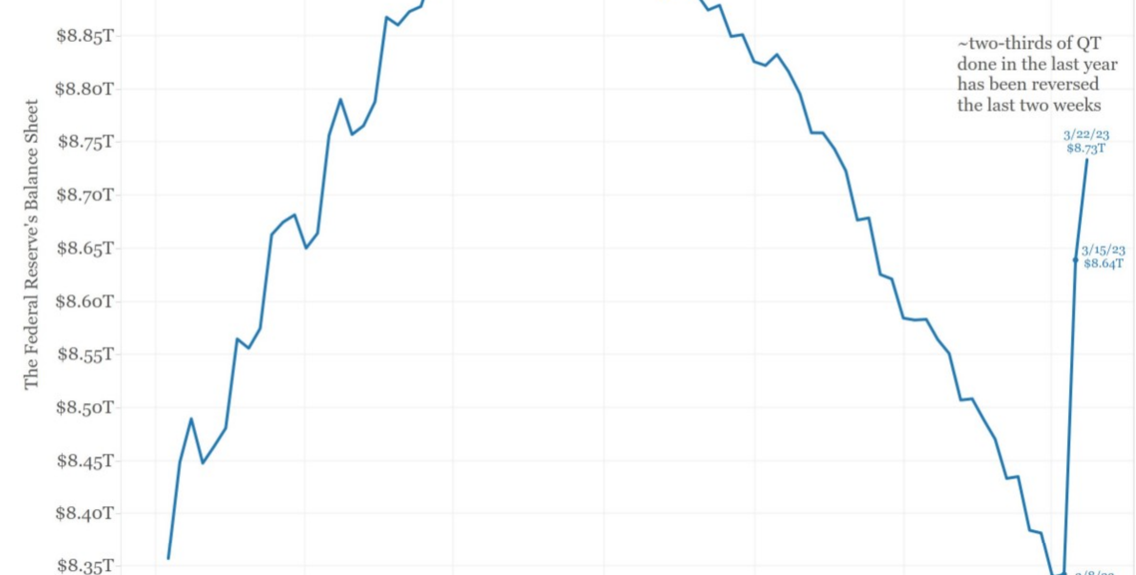
Other hard commodities remain fairly subdued this month; however, those energy related ended the month significantly lower with investors pricing in a slowdown in global growth (and energy consumption as a result).

Our market outlook, both locally and offshore, continues to remain cautious as we continue to monitor ongoing developments and commentary from Central Banks. We remain defensively positioned with maximum offshore exposure and relatively high levels of cash and defensive allocations among our portfolios. We will look to deploy into higher return (alpha) generating investments that offer adequate risk-adjusted returns at favourable entry points in the near future.

Charts of the month:

The chart below shows the size of the US Federal Reserve's Balance Sheet. (The higher the size of the balance sheet, the larger the amount of stimulus in the system). Since mid-2022, the Fed has been actively trying to reduce this debt in an attempt to take money out of the system and slow spending and inflation as a result.

Since the banking issues in March, the Fed's balance sheet has given back 2/3s of their quantitative tightening efforts in the space of weeks, as destressed regional banks have requested loans to remain in business (almost $500Bn).



"Successful investing is about managing risk, not avoiding it" - Benjamin Graham