Private Client Letter

Publisher: Private Client Bank AG, Zurich | T +41 44 253 73 00 | info@privateclientbank.ch | privateclientbank.ch 1 April 2023 | Q2/23

On a ridge

Nowadays, bank runs occur as digital earthquakes beneath the surface. After the failure of Credit Suisse and several US banks, the focus is on financial stability. Investors should follow a few simple rules.

"Oh my God, no! Credit Suisse is not going bankrupt. That's like asking whether Kim Kardashian will go broke – it's unlikely. ... So, don't panic, people!» That was ChatGPT's answer to the question «Is Credit Suisse going bankrupt?» shortly after nine o'clock in the morning on Sunday 19 March 2023. Admittedly, the request had been for a humorous response, but the analytical version also mentioned «unlikely», while the metaphorical version was of «a ship on a stormy sea», equipped with enough resources and experience to survive. Twelve hours later, it was clear that while Switzerland's second largest bank might not be bankrupt, it was still somehow broke, being absorbed into UBS with a large dose of state aid.

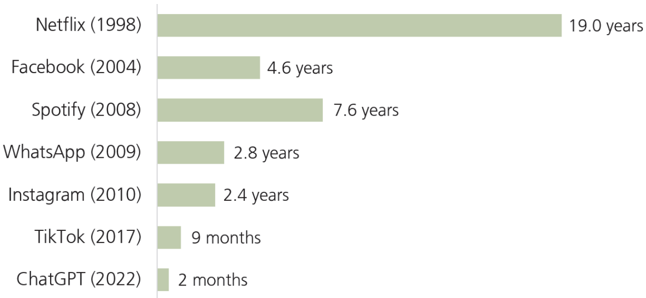
Despite some questions that remain unanswered, the result of the hasty action on that historic weekend was probably the least bad of several bad options. Yet for all the surprise at the chaos, speed and timing of events, the outcome should not astonish attentive observers of the banking scene. In autumn 2022, for example, the bank had found itself in such a precarious position that cautious account holders – yes, including us – took measures to reduce the Credit Suisse share of balance sheet risk to a minimum (mostly: close to the deposit guarantee) without withdrawing the assets that would be protected in the event of a potential bankruptcy. This, and the diversification of banks and custody accounts inherent in our business model, meant that the operational agitation in the days before and after the financial quake was limited for us and our clients. And last but not least, our assumption that the state would stage a «rescue» in extreme cases was proven correct, if you like it or not. In the short term, the situation seems to have calmed down, but in the medium and longer term an uneasy feeling lingers – more on that later.

Digital eruptions

In these times of digital revolution, information and products can travel the globe within a very short time. A good example is the novel «ChatGPT» bot cited above, developed by the US company OpenAI that was founded in 2015. The software is based on machine learning and can write texts as if it were a human being. It is already being used widely at schools and universities to complete assignments and write essays. In parliaments, politicians are giving the first speeches formulated by ChatGPT. According to Wikipedia, the latest version, GPT-4, can process images, answer tax questions and pass exams with distinction. The model's performance is impressive, even if the language algorithm is far from flawless and sometimes «hallucinates» by delivering absurd answers to simple questions. The chatbot cannot process forecasts, extreme events or the very latest topics because it is based on texts from the past and statistical probabilities. Nevertheless, here looms a new phase of the digital revolution. Tech giant Microsoft has recognised this and invested another ten billion US dollars in OpenAI in January 2023. The goal is to integrate ChatGPT into the Bing search engine and thus challenge Google. With over 90% of all search queries, the latter has dominated this extremely lucrative market on the internet for years, and is developing its own chatbot called Bard. Meanwhile, the share prices of the tech giants are already reacting to news from the world of chatbots.

TIME REQUIRED TO REACH 100 MILLION USERS

Around the World in 60 Days



Source: UBS Global Research (2023) and our own analysis. The year of global market introduction is listed next to each product.

ChatGPT was made available to the public on 30 November 2022 and, according to OpenAI, had already reached one million users within five days. By the end of January 2023, there were already over 100 million users, and the trend is rising rapidly. As our chart shows, this makes ChatGPT the fastest-growing internet application in history.

Against this backdrop, it does not take much imagination to picture what happened in recent weeks at some US banks (Silicon Valley Bank, Signature, First Republic and others) and at Credit Suisse: a «blitz bank run» via online banking on mobile phones, tablets and PCs. Bank failures no longer occur via queues at bank counters and ATMs, but quietly via the internet; unnoticed by radio and television, in a kind of digital earthquake beneath the surface. Once the domino of lost confidence has fallen, an appropriate response by politicians, authorities and central banks becomes highly challenging, if not impossible. So the actors must have been under enormous pressure on the weekend of 19 March.

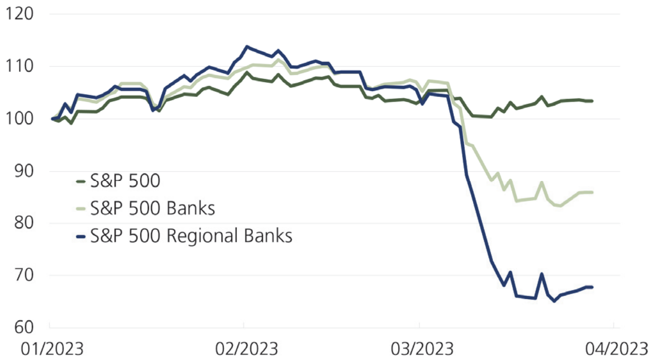
Focus on financial stability

In such an environment, it is not surprising that the «too big to fail» regulations built up over years at great expense to prevent state intervention and disorderly bankruptcies of systemically important banks have not taken hold. The international banking system is too interconnected; in times of digital eruptions, major risks cannot simply be «regulated away». That is why the newly created «UB-Suisse» in Switzerland arouses an uneasy feeling. This bank is twice as large as the entire Swiss economy and thus definitely «too big to rescue» for Berne – or, as the NZZ so aptly put it: «A zombie is gone, but a monster is emerging.» The new bank is already walking a tightrope between politics, efficiency and stability. It is safe for the moment, but should a rescue be necessary one day, it would only be possible in an internationally concerted action with much greater risk.

The developments in the banking sector are also worrying for other reasons. In our «Letter» of summer 2022, we compared the emerging cycle of interest rate hikes with dynamite fishing, in which big fish only appear «belly up» on the surface after some time. There is much to suggest that we have entered a delicate phase of this cycle. This applies not least to banks in the USA, which are the hub for the international financial world and thus potential epicentres for major crises. There are many effects of interest rate increases for banks: they can lead to higher earnings in the interest business, but at the same time they can also create large gaps in the balance sheet – for example, if borrowers can no longer bear the higher interest rates or if balance sheet investments lose value due to market corrections. The latter was the bane of the Silicon Valley Bank at the beginning of March, when customers withdrew money en masse but the bank's assets could only be sold at great loss. If we consider that of the aggregate USD 19 trillion or so in customer deposits at US banks at the end of 2022, about half were protected by a deposit guarantee, while the immediately available liquidity was USD 3.4 trillion, then it is understandable that customers are beginning to pay closer attention to their banks' balance sheet structures. If confidence is lost, the «blitz bank run» cannot be not far away – something no bank can withstand unless the central bank provides it with unlimited liquidity (which did not happen in the case of the allegedly solvent Credit Suisse, for reasons that are as yet unclear).

S&P 500 AND BANK INDICES IN THE USA 2023

NO CONTAGION YET



Source: Bloomberg. 1 January 2023 = 100.

While central banks have so far «only» concentrated on inflation and the economy, since the beginning of March they have also focused on financial stability. It seems as if they are pumping the brakes with interest rate hikes, and at the same time stepping on the gas with cash injections for banks. But due to high inflation, everything is different now from what it was during the last crisis in 2008. The initially broader path for interest rate hikes has become a narrow ridge. For now, only the banking sector seems to be affected, especially since the broad US stock index S&P 500 has held up well so far (see chart). It is unclear whether the spark will start a fire and perhaps also infect the real economy.

Complex and uncertain

So what happens next? When asked «Is a financial and banking crisis imminent and what is the outlook until the end of 2023?», GPT-4 answered at the end of March: «As an AI model, I cannot make accurate predictions. Until the end of 2023, factors such as high debt, geopolitical tensions and currency risks may favour a crisis, while sound fundamentals, regulation and international cooperation mitigate the risk. The situation is complex and uncertain.» This sounds suspiciously like a disclaimer from your average banking publication. But it is not wrong, although the issues that are central from our point of view – inflation, interest rate hikes and financial stability – remain unmentioned.

Be that as it may – given the situation, it is worth remembering a few simple rules:

(1) By the time a crisis is evident, it is often too late for an appropriate response, especially for larger fortunes. Structural issues such as the distribution of accounts and deposits among different institutions should be planned and implemented calmly. Diversification and the avoidance of cluster risks are also key here.

(2) Liquidity has value. In a crisis, waiting even a few months until repayment of a time deposit can seem like an eternity. It may be worthwhile to forego squeezing the last bit of interest and instead retain flexibility, room for manoeuvre and options.

(3) Complex and hybrid investments can react unexpectedly in extreme scenarios. Who would have thought that Credit Suisse's AT-1 bonds could suddenly become worthless in the event of government intervention due to small print in the prospectus? With simple, classic instruments such as bonds or equities, these risks are significantly lower, although not zero.

Asset management is primarily about avoiding mistakes – and often it is simple rules that let you sleep well. The goal is to avoid having to say in the next crisis: «Oh my God...!»

—

IA, 31.03.2022

IN CAPITALISM *ONE* IS ULTIMATELY RESPONSIBLE

Once again the knives are out for bankers. This is understandable when a major bank like Credit Suisse disappears from the scene at the drop of a hat. The resulting destruction of capital is massive: more than 50 billion Swiss francs. In the preceding years, the bank suffered from consumption. Since the turn of the millennium, in many different ways, countless billions in capital have been «burnt» in spurts. During this time, the responsible managers pocketed salaries and bonuses in the multi-digit millions. Per person. That is shocking, even absurd.

The ultimate failure, by no means only in the Credit Suisse case, lies with the general assembly. The tools would have been available, but the uprising of those ultimately responsible never occurred. Where are the genuinely critical shareholders who revolt?

In my opinion, however, a manhunt is of little use. Just as "success has many fathers" and, accordingly, the bonus culture focused on specific individuals is misplaced, it is equally wrong to causally link such a clearly recognisable, long-lasting failure to a few individuals. Certainly, they enjoyed their role at the top of the hierarchy. But blame? Solely? Not by a long chalk.

The problem of the big bank in question was rather the choice of its strategy and the inability to deviate from it, or at least to correct it. According to Swiss law, there is a clearly defined group responsible for strategic decisions of a company: the board of directors. Over the years, it has failed to read and understand the signs of the times, the profit and loss account and other indicators and to draw the necessary consequences. The C-suite members and their strategy should have been changed.

But what if the board of directors acts too late or not at all because they are too lazy, too corrupt or too ignorant? Then there would still be the electoral body, namely the general meeting, and there would be the stock market to procure voting rights there – at ever lower prices. The ultimate failure, by no means only in the Credit Suisse case, lies there and nowhere else. The tools would have been available, but the uprising of those ultimately responsible never occurred. What use are legions of financial analysts if they only stare at bonus-relevant key figures instead of looking at which board of directors is finally ready to be dismissed? Where are the genuinely critical shareholders who are rallying to revolt? Where are the hedge funds that could make money – risky but well-deserved – with such machinations?

Capitalism can only survive if people assume responsibility once again. Otherwise, it will cede the field to the technocrats and regulators and will survive nominally due to dysfunctionality, but will soon be dead in terms of content.

—

KH, 31.03.2023

Private Client Bank AG
Alte Börse
Bleicherweg 5 – Postfach
8034 Zurich – Switzerland

T +41 44 253 73 00
F +41 44 253 73 20
info@privateclientbank.ch
privateclientbank.ch