# CIO View

CIO Flash

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Marketing material

# UBS to take over Credit Suisse

Immediate concerns alleviated, new concerns arise

## IN A NUTSHELL

- The Swiss authorities have brokered a deal that should take Credit Suisse out of markets' line of fire for now
- Investors are likely to struggle however with the way bond holders (AT1) were treated. The cost of capital for this sector is likely to increase, especially as we still don't believe major central banks will cut rates this year.
- On a longer-term horizon we remain confident that current events could help to get inflation under control, while creating short-term volatilities.

## UBS-CS merger arranged by authorities

With generous support from the Swiss National Bank (SNB) and under its guidance and that of the financial regulator, Finma, UBS announced on Sunday that it was taking over Credit Suisse. It will pay CHF 3bn or CHF 0.76 per share compared to Friday's closing price of CHF 1.86. The government will cover the first CHF 9bn of losses and SNB will provide up to CHF 100bn in liquidity. Potentially the biggest shock to markets may be the fact that CHF 16bn worth of AT1 bonds will be completely wiped out. Also on Sunday, the Federal Reserve (Fed) said that it would increase the frequency of its swap auctions from weekly to daily in order to alleviate global dollar funding concerns.

Assuming that we are spared a full-blown crisis, there is a good chance that in a year's time we will look back and find that these and other developments in March 2023 were healthy. A few weak players will have gone out of business, the risk of runaway inflation would have been averted, and the economic damage from the inflation battle would have been contained. And that, in turn, could make for a solid start to a healthy new economic cycle. But this remains, for now, a nervous period for the markets.

## Short-term gain, long-term pain, nervous markets

The immediate market reactions to the weekend's actions have been mixed. The yen strengthened further, European equities were down in early-morning Monday trading by 2% and 2-year Bund yields fell by over 20 basis points. We believe that relief over the immediate handling of the most urgent concerns has been overshadowed by the handling of the AT1 bonds. Wiping these out while shareholders still receive something will make many banks and investors re-evaluate this asset class. However, markets recovered somewhat in the course of the day, with equities turning positive and sovereign yields reversing most of their initial losses. European corporate bond spreads were still wider in the afternoon, however. Commodity markets might suggest that investors have grown more nervous about a recession as Brent crude has lost USD 17 per barrel from its peak two weeks ago, touching USD 70 per barrel this morning. Gold, seen as a safe haven, briefly surpassed USD 2000 per ounce.

We will keep comparisons to 2007/08 to a minimum. We are dealing, at least till now, with mark-to-market losses, while in 2007/08 the underlying assets were seriously impaired. In this cycle, inflation has soared and central banks have raised interest rates at a pace not seen in decades, causing heavy price losses on fixed-income investments. In our opinion, the big difference to 2008 is that high quality fixed-income investments, in sharp contrast to the financial crisis, are likely to be repaid at 100% at maturity. Anyone who has bought such securities with the intention of holding them until maturity should face no problems in this regard and should be spared from any write downs (when accounted for as "held-to-maturity").

At the same time, however, there are also similarities to 2007/08: in particular, the urgent need to find a solution once a major financial institution's health is questioned by the markets, and the speed at which things have unraveled within a couple of days. As we have outlined in previous views, however, we believe that both the financial institutions and the regulation have changed fundamentally compared to 2008. We would argue that U.S. financial regulation in certain areas has some catch up potential compared to European regulation. But in our opinion, in both continents there is no guarantee that a new set of problems will not occur, giving regulators and market participants unexpected issues to resolve.

# Market and policy implications

The tightening of financial conditions that is currently underway is exactly what central banks were aiming for in order to slow down the economy and bring inflation rates back to more reasonable levels. Pain is inevitable. In our view, UBS's agreement to buy Credit Suisse on Sunday night has been a good outcome for global financial markets, although breaking with market conventions by ranking shareholders above AT1 bond holders will create some lasting confusion among investors (ECB and BoE were quick to point out that they still see all bonds as senior to equity[1]). It might therefore take time before markets feel that confidence in the European banking system has been fully restored. The coordinated action by global central banks to improve access to dollar liquidity shows that financial conditions have tightened significantly across the globe and decisive action is needed to avoid contagion from the banking sector into other areas of the economy. The next thing we're watching closely now is the further development of lending - the oxygen of the economy. For now, we do not see a need to change our global GDP forecasts for this year (Eurozone 0.8%, USA 0.7%). But we certainly see downward risks should lending activity deteriorate more than we currently anticipate.

# Asset-class implications

## Fixed income and currencies

Sovereign yields fell substantially this month, despite the ECB's rather hawkish meeting last week. All eyes will now be on the Fed's statement on Wednesday. We still believe the Fed will hike by 25 basis points. We don't believe it will make major adjustments to its economic forecasts; it will stress that it stands ready to implement necessary measures in case of market stress. It is far too early to adjust our 12-month Treasury and Bund forecasts, as everything will now depend on how quickly financial conditions tighten, how long the tightening lasts, and the degree to which inflation and labor market pressures are alleviated. Once the CS problem has been dealt with, we will be more confident about European Investment Grade bonds, whose spreads have shown some of the fiercest short-term widening in their history in the past week.

We think, for currencies "risk on and risk off" is currently the main driver. However, the USD wasn't able to profit from safe-haven demand due to the sharp correction in rate hike expectations in the US. The JPY is currently functioning as an anti-USD safe-haven currency. Volatility in the currency market is remaining remarkably low and there is so far no strong evidence of rising USD funding costs for foreign investors. The newly announced dollar liquidity measures at the weekend will further

[1] Furthermore, in Europe, no other banks besides Credit Suisse and UBS have provisions that would allow for the full writedown of AT1s, while maintaining some value for equity investors. A Swiss exception.

ease the concerns. Current interest rate differentials and the stress in the US banking sector point to a lower USD, but stabilization of risk sentiment is necessary to remove the risk premia in the market and bring currencies more into line with interest rate differentials. Depending on how the market interprets the deal, the Swiss Franc could come under pressure. So far CHF has been pretty stable and has lost only about 1% vs the Euro. We expect the market to be relatively quiet as risk appetite is low.

## Equities

In equity markets, however, we believe that volatility is likely to remain elevated until confidence in the financial system is fully restored. Some scars will persist. The immediate market turmoil has various effects on equities. On the negative side we will most likely have to deal with higher funding costs for banks that they will pass on to their customers. Markets' growth expectations for revenues and profits have certainly deteriorated. Furthermore, support from corporates themselves through stock buy-backs might take a hit. At the same time lower interest yields are beneficial for equities, which was one of the reasons why tech stocks have shown relative strength over the past days.

We expect sectors dependent on regular refinancing activities to be the focus of investors now. We would continue to avoid companies with weak balance sheets. In this environment it seems that European financials might have an advantage over their U.S. peers. The three most urgent problems we see in the U.S. are: 1. The lack of regulation (also concerning liquidity rules) for "small" institutions with assets of below USD 250bn. 2. The mismatch between funding and lending margins that the Fed is unlikely to ease with lower interest rates given the inflation outlook. And finally, 3., little potential for market consolidation as the four biggest institutions are barred from substantial takeovers, and smaller institutions have yet to digest recent acquisitions or are having to deal with other issues. A revealing comparison is that the European bank index has lost almost 20% month-to-date but is only down 1.6% year to date. The equivalent figures for the U.S. are -13% MTD and -15% YTD.

## Glossary

Additional Tier 1 bonds, or AT1s for short, are part of a family of bank capital securities. They are bonds issued by banks that contribute to the total level of capital they are required to hold by regulators.

The Bank of Japan (BoJ) is the central bank of Japan.

One basis point equals 1/100 of a percentage point.

Bunds is a commonly used term for bonds issued by the German federal government with a maturity of 10 years.

The European Central Bank (ECB) is the central bank for the Eurozone.

The Eurozone is formed of 19 European Union member states that have adopted the euro as their common currency and sole legal tender.

The gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

Inflation is the rate at which the general level of prices for goods and services is rising and, subsequently, purchasing power is falling.

Investment grade (IG) refers to a credit rating from a rating agency that indicates that a bond has a relatively low risk of default.

The Japanese yen (JPY) is the official currency of Japan.

The final payment date of a financial instrument is its maturity.

A safe-haven investment is an investment that is expected to retain or even increase its value in times of market turbulence.

A share buyback involves a company buying back its own shares.

Sovereign bonds are bonds issued by governments.

The spread is the difference between the quoted rates of return on two different investments, usually of different credit quality.

A swap, a type of derivative, is an agreement between two parties to exchange sequences of cash flows for a set period of time.

The Swiss National Bank (SNB) is the Swiss central bank.

The U.S. Federal Reserve, often referred to as "the Fed," is the central bank of the United States.

Volatility is the degree of variation of a trading-price series over time. It can be used as a measure of an asset's risk.

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