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Alfred Escher, around 1875
Founder of the Schweizer Kreditanstalt

Zurich, March 20, 2023

IC No. 32 – Déjà-vu?

The sale of Credit Suisse to UBS by emergency law on Sunday, March 19, 2023, marks the end of the 166-year history of Switzerland's second-largest bank. A tragic end for CS. What began on the other side of the world with the insolvency of the Silicon Valley Bank on March 10, intensified by the ill-considered words of CS's major Saudi investors, ends at Paradeplatz in Zurich: Credit Suisse is history.

Searching for clues

In our role as an asset manager, we have to ask ourselves how this could have happened. In the case of the insolvent Silicon Valley Bank, our interpretation is that there was a mismanagement of maturity transformation: In the course of the ultra-loose monetary policy, huge amounts of liquidity flowed into the bank in recent years. The bank invested this liquidity primarily in supposedly safe long-term US government bonds. However, the rapid rise in interest rates over the last 12 months had devastating consequences: The book value of the long-term bonds lost a lot of value and the bonds held at fair value had to be booked at market prices. When the first rumours of distress began to circulate in the market and investors withdrew their money in droves, the Silicon Valley Bank was done for. A classic bank run.

The problems of Credit Suisse, on the other hand, are different and have a lot to do with the corporate culture and a lack of risk diversification. High fines for unfair business practices coupled with gigantic losses from high-risk transactions were the beginning of the end.

The accentuating loss of trust and rapid outflows of client funds could then no longer be stopped. In our view, the known problems at the management level were only an expression of a larger problem: the lack of responsibility, solidarity and proximity of the owners. By this we do not mean the many loyal shareholders, most of whom had a savings account with SKA (the predecessor organisation of CS) when they were young; rather, we are referring to sovereign wealth funds from the desert or large asset managers from the USA, for whom CS represents only a decimal point in their balance sheets.

At the end of the day, the banks mentioned have failed because of inadequate business models and bad entrepreneurial decisions - and that is how it should be. Much more important for us is the question of whether we are at the beginning of a profound systemic crisis. A déjà vu of the financial market crisis of 2008/2009?

Déjà-vu?

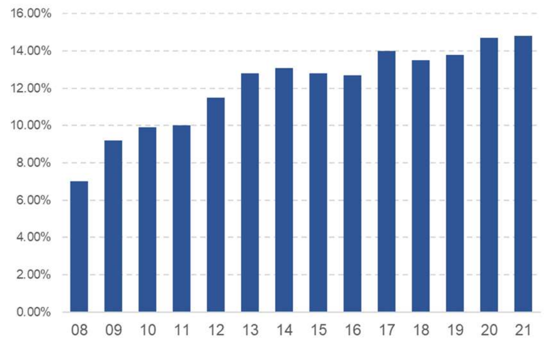
The search for an answer to this question directs us towards the central banks and their monetary and interest rate policies. Interest rates, which have been kept too low for too long, have been raised at a historically unprecedented pace. Who would have ever thought that such a "strategy" could lead to difficulties? Cheap money leads to excesses and misallocations of capital. This is not new. Combined with a historically remarkable pace of interest rate hikes, the whole thing becomes a crash-test experiment where one can only hope that the chassis is built solidly enough.

Crash test experiment of central banks?
Global development of key interest rates, in %

Source: Bloomberg, Prio Partners

In order to make the financial system more resilient, politicians and central banks increased the capital requirements for banks after the financial market crisis. The extensive revisions of systemically important banks were also intended to ensure stability. Accordingly, the banking sector as a whole has implemented higher capital and liquidity ratios.

Equity ratios increased. But is that enough?
Ø Core capital ratio of European banks, in %

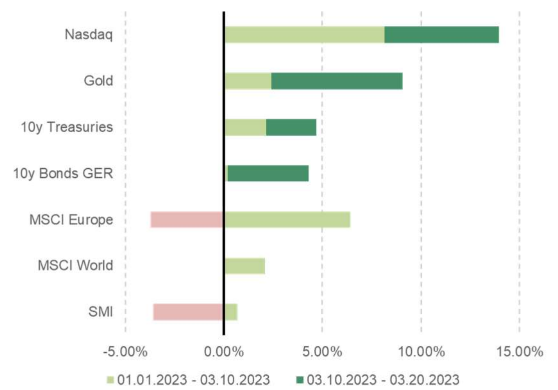


Source: Deutsche Bank Research, Prio Partners

What we see as distinctly different from the financial crisis of 2008/2009 is the determination with which policymakers and central banks have confronted uncertainties in the financial system right from the start. No hesitation; no Lehman moment; where bankers run out of the bank that went bust overnight with boxes; no panic. In the past, we used to talk about the central bank put, meaning that in case of emergency the central banks would prop up the economy and the markets with cheap money. Today we would speak of the state put, because the politicians seem willing to intervene in the markets and especially in the banking system when trouble looms. Accordingly, we see clear differences to the financial market crisis of 2008/2009. However, we advise caution in interest-sensitive and highly leveraged sectors of the economy, such as the real estate sector or private equity, which benefited from cheap money for years.

Turning point
There always are turning points in the market: The case of Silicon Valley Bank and Credit Suisse is one such point. Investor behaviour also changes at turning points. Therefore, we are particularly interested in how the various asset classes and sectors have developed since the beginning of the year and before and after March 10 in order to draw conclusions for market behaviour. We have highlighted the most striking movements in the charts below. The light green bars show the development from the beginning of the year until March 10, the dark green bars and the red bars show the development from March 10 until today.

Asset classes since the beginning of the year
Before and after March 10, in %

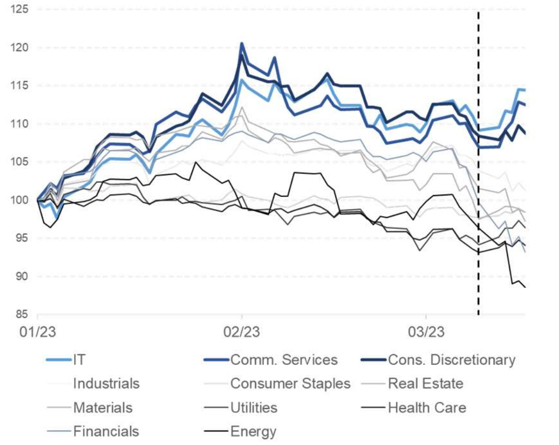


Source: Bloomberg, Prio Partners

It stands out that technology stocks are being sought as a safe haven. This may also be related to the sharp drop in expectations of further interest rate hikes. Gold has (unsurprisingly) performed very well, especially since March 10. Bonds have also done well, with the rise in risk aversion clearly seen in 10-year German government bonds. On the equity side, the stock markets in Europe and Switzerland in particular have fallen sharply since March 10.

On the equity side, the picture is more differentiated when evaluating performance on a sector level. The following chart shows the development.

Sector development since the start of the year
Before and after March 10, indexed, in %



Source: Bloomberg, Prio Partners

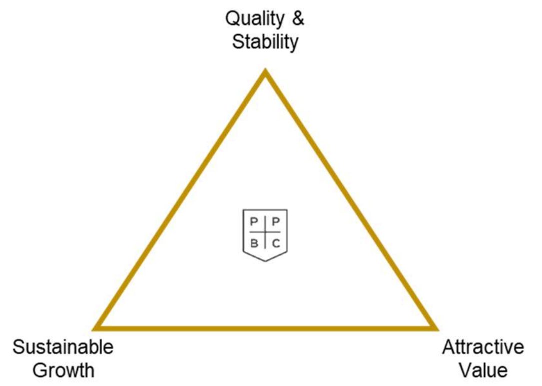
Technology stocks and companies in the communication services sector have been able to escape the negative trend of the other sectors not only since the beginning of the year, but especially since March 10. Consumer discretionary also developed positively. All other sectors have had a harder time since the beginning of the year and since March 10.

These observations are also the basis for our portfolio positioning, which we have been adhering to for a long time.

Our portfolio positioning
We like gold as the ultimate systemic insurance, see short-term government bonds as a tactically sensible addition, rate medium to long-term bonds as relatively attractive and prefer tech stocks and consumer staples.

Once again, we favour companies with good balance sheets and stable business models. As a guiding framework, we recommend Prio Partners' Golden Triangle with the dimensions Quality & Stability, Sustainable Growth and Attractive Value.

The Golden Triangle of Prio Partners



Source: Prio Partners

Beyond the day-to-day business
We would like to see more actual accountability from those who are in charge in large corporations. We also question excessive remuneration systems that can no longer be justified to the general public. Here, the shareholders as owners of the companies are also responsible. Let us take care of our free economic system, which must exist in harmony with society.

Dr. Patrick Cettier