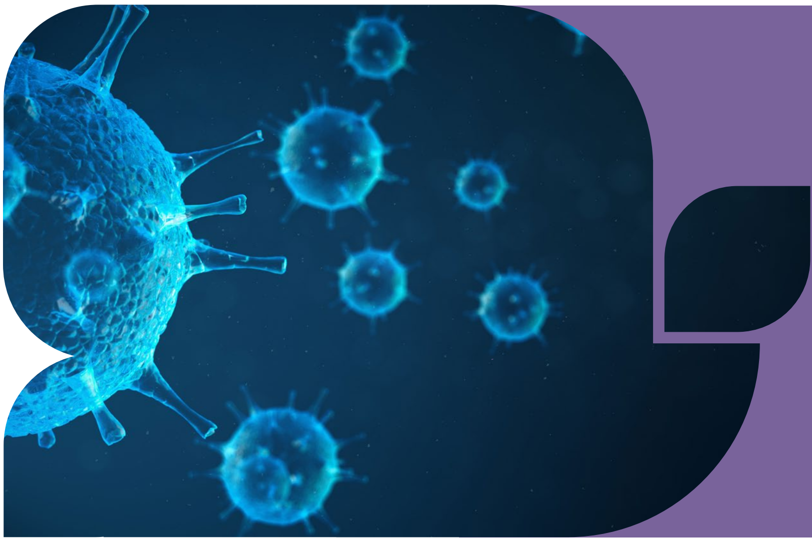

Rathbones
Look forward

Review of the week

27 March 2023

The fear bug strikes again

Strong gains for Europe's banks last week were reversed by Friday's close. With the fear bug spreading, can we be confident it won't strike again?

Last week ended on an unnerving note. Peak panic in the health of the global banking system seemed to be easing after the collapse of three regional banks in the US and the forced takeover of Swiss banking giant Credit Suisse.

But, on Friday, Europe's banks took a further pounding, with Deutsche Bank (Germany's biggest bank by far) caught in the eye of the storm. Deutsche Bank's shares were down by as much as 14% at one point on Friday, while the cost of insuring its debt against default soared to a four-year high. (Its share price is now recovering.)

There were precious few rational reasons driving Friday's moves. Deutsche Bank isn't another Credit Suisse. It's much more profitable. It reported a EUR1.8 billion ($1.98 bn) net profit in the fourth quarter of 2022, compared with Credit Suisse's fourth-quarter loss of 1.4 billion Swiss francs ($1.5 billion) which brought the Swiss bank to a full-year loss of 7.3 billion Swiss francs. Deutsche Bank has certainly had its problems. For many years, it was viewed as a lumbering behemoth that was too slow to change. But, after years of lacklustre performance, it's completed an ambitious restructuring plan and aggressively reshaped itself to reduce costs and improve profitability. By contrast, Credit Suisse was only six months into a shaky turnaround plan at the time of its demise.

Unlike Credit Suisse, which had experienced huge deposit outflows in the fourth quarter of last year, Deutsche Bank's deposits have risen significantly since 2020. It had only a very small outflow in the final quarter of last year, in line with most banks as they lost a bit of market share to money market funds that pass on higher interest rates more quickly.

All this suggests that the most recent turbulence is a confidence crisis, without a clear or obvious trigger for the panic as was the case at the time of the global financial crisis (GFC) when the world's banks had a bunch of toxic assets sitting on their balance sheets. Back then, it took a long time for banks to offload their troubled assets. This marks a stark contrast to the announcement over the weekend that North Carolina-based First Citizens Bank has already agreed to purchase a large chunk of the assets of Silicon Valley Bank (SVB), the largest of the US banks to fold, at relatively modest discounts to their market value.

The largest banks globally are much better capitalised now than they were ahead of the GFC, giving them much greater capacity to absorb losses. Their liquidity - the cash they have on hand - is also much stronger. And we don't see evidence of widespread risky lending to borrowers with poor credit quality, as was the case before the GFC.

Although we may see more smaller, regional US lenders get into trouble, we do believe that the systemically important banks are isolated from the issues that some banks have faced over the last couple of weeks. Policymakers on both sides of the pond seem to have the willingness and the tools to try to stop the contagion stemming from this crisis of confidence.

But, as we explained last week, it's confidence that keeps the banking sector afloat. All the legislation and support from governments and central banks in the world can't completely guarantee a panic-proof banking system.

Social media helps spread rumours like wildfire. And technology may have made life easier for bank customers, but it's brought new challenges for the banks themselves. No one has to queue up to get their money out of a bank anymore. Digital banking means we can move our money in seconds.

This can trigger liquidity problems very, very quickly. In what's been described as the first ever Twitter-led bank run, customers at SVB pulled a staggering $42 billion (£34.1bn) in deposits out of the bank in single day.

In the meantime, investors in the stocks and bonds of banks seem likely to keep sifting away on the lookoutfor more potential trouble spots. The smaller regional US banks may prove particularly vulnerable - in retrospect, the easing of the regulation governing these banks was probably a misstep. Looking across Europe, it's hard to spot obvious weakest links. But investors will be watching out for the wobbliest balance sheets and any evidence of over-exposure to trades that have been blown out of the water by higher interest rates.

The natural response to all this is that banks seem likely to do their utmost to appear as conservative and reliable as they can. Lenders around the world are likely to turn more cautious. Banks started tightening their lending standards significantly late last year. That trend is now likely to intensify further, making it tougher for households and businesses to borrow. And, as we explain in our recent InvestmentUpdate, this raises the (already significant) risk of a global economic recession.

UK inflation confounds again

It was only a couple of weeks ago that Chancellor Jeremy Hunt delivered his spring Budget and forecast that inflation would be 2.9% by the end of the year. That prediction is already looking optimistic, with UK inflation rising again to 10.4%.

A lot of the press coverage on this latest inflation print has focused on food prices, which aren't following the drop in agricultural commodity prices as had been expected. But it isn't just high food prices that have been driving up inflation: there were month-on-month gains across a broad swathe of goods and services in the inflation basket, reminiscent of last year's inflation spikes that prompted aggressive monetary policy tightening.

Nearly half of the scores of categories included the Consumer Price Index (CPI) basket rose by over 1% month-on-month - we haven't seen that since the middle of last year. That's up from a fifth of the categories registering such gains in December, which is more or less the norm.

The "persistence" of higher costs in consumer prices was cited as one of the reasons why the Bank of England (BoE) raised interest rates by another 0.25% last Thursday. BoE Governor Andrew Bailey has urged businesses not to raise prices further, in a bid to break the inflationary cycle. None of this creates huge confidence that inflation is going to get back to 2.9% any time soon.

The UK now has its highest mortgage rates and fuel and food prices for a decade. Even if the UK ends up avoiding a technical recession (and we don't think it will, though we would expect it to be moderate), all this is going to mean that it will continue to feel like one.

This makes trying to forecast when UK interest rate are going to peak particularly challenging. The BoE is presiding over a weak economy, while also contending with one of the world's highest rates of inflation. This suggests there are significant risks that UK inflation could get uncomfortably stuck somewhere between its current rate and the Chancellor's target.

The pound has been weak and this contributes, over time, to high consumer prices. In addition, the huge and continued rise in the number of people out of work in the UK due to long-term sickness (in stark contrast to every other advanced economy since the end of the pandemic), is a particular problem when it comes to wage pressures.

You can read more about some of the measures announced in the Budget to address key challenges facing the UK economy here.

If you want to hear more about the banking sector wobbles, the outlook for inflation and interest rates, along with a review of China, you can register for our 12 April Investment Insights webinar here.

If you have any questions or comments, or if there's anything you would like to see covered, please get in touch by emailing review@rathbones.com. We'd love to hear from you.

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