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Are More Banking Crises on the Horizon?

Altuğ Ükümen and Jerry Haar

A shroud of pessimism has hung over the U.S. for nearly a decade with on signs of abatement. Politically, economically and cultural—and independent of socioeconomic class, gender, race or geography, a majority of the population lacks a positive outlook on life in general.

Adding to this malaise, on March 16, 2022, the Federal Open Market Committee enacted the first of what would be eight interest rate increases. The result has been pain on both Wall Street and Main Street, with the most recent notable example being the collapse of both Silicon Valley Bank and Signature Bank. (Although it should be noted that for the last two decades there have been approximately two bank failures per month).

As for the current banking crisis, it is one that did not happen overnight but was years in the making. The earthquake in eastern Turkey, the war in Ukraine, and the COVID-19 pandemic were all outcomes of long-term processes. These events were just triggers that brought existing tensions to the surface. Lessons learned from large-scale events with devastating effects have allowed us to curtail the recurrence of such events or at least to significantly diminish their impact. However, introducing new rules to prevent certain types of crises can contain the seeds of other forms of crisis.

The sub-prime turmoil of 2008 triggered a credit-crunch, large-scale bankruptcies, and a global recession along the way. It took massive and coordinated liquidity injections and a major restructuring of the banking sector to pull the world out of this mess. Systemic risks were curbed by deploying all forms of circuit breakers into the system and shoring up the balance sheet of banks.

Recapping recent history, SVB, a bank whose balance sheet looked good, had high concentration in treasury bonds, which was matched by a client base that came mostly from the tech industry. As the pandemic receded, demand for tech dropped, triggering large-scale layoffs and causing customers to withdraw more than usual. At the same time, new account openings dried up, forcing the bank to sell its bond holdings at steep losses. Panic ensued, triggering a classic bank run which necessitated the intervention of the government to avert wider contagion.

Several other smaller banks folded along the way, such as Signature, but the real shock came with the lingering troubles at Credit Suisse, a 167-year-old institution on the too big to fail list. Fear and panic reached fever pitch, forcing the Swiss government to step in to avert a crisis with huge global financial repercussions from materializing. The events exposed some glaring deficiencies in the system and a troubling thought that even well-funded, too big to fail banks were not immune from the effects of irrational mobs.

The global economy appears to be in a transition phase, with conflicting signals indicating steady inflationary pressures and the potential for a looming recession. The Federal Reserve, which had been focused on combating inflation, is now having to deal with the fallout from its aggressive tightening, causing recession fears to show up in bond and currency markets. The US is facing several challenges, including a slowing economy, record deficits leading to political showdowns, and the 2024 presidential election. The growing rift with China and Russia will likely create economic frictions, and a process of partial decoupling of their economies seems inevitable.

Europe is also facing challenges, including a resource-sapping conflict, widening social upheavals, and an ongoing banking crisis. Over the longer term, Europe must secure its energy needs and navigate ideological rifts between east and west. The Biden administration's drive to lessen dependence on China through subsidies is causing friction with Europe.

Volatility is expected to persist in the second half of the year as the world transitions from the post-COVID recovery and inflation phase to a potential recession. Recent gains in gold and bitcoin suggest a lack of confidence in monetary authorities to steer the global recovery out of troubled waters. Bond markets may benefit as yields drop, but the outcome will depend on the banking crisis's evolution.

As for equity markets, these face headwinds, especially if the economic slowdown turns into a major recession, causing layoffs and reducing consumption demand, further squeezing profit margins. This is an environment that warrants a high degree of diversification with a conservative bias, and higher volatility allocations should tilt towards alpha generating solutions.

It is natural to ask: What should be the role of government to alleviate banking crises and prevent future ones? Some argue that more regulation is needed while others argue “let the market sort things out”. Recognizably, there is no panacea and no way for financial institutions to insulate themselves from major macroeconomic and geopolitical “black swans”. The only recourse financial institutions do have within their control is to ensure they are well-capitalized, diversified in their portfolios, adept at managing risk, technologically sophisticated and staffed with the very best people—and that includes their CEO.

Altuğ Ükümen is a Geneva-based investment consultant specializing in portfolio management, asset allocation, and fund selection. Jerry Haar is an international business professor at Florida International University and global fellow of the Woodrow Wilson International Center for Scholars in Washington, D.C.