CORE Comments

ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

March 20, 2023

"There's Never Just One Cockroach in the Kitchen"

A large scale banking crisis is underway in America and Europe. The steps taken so far by federal agencies, including the Swiss Central Bank, have been insufficient to staunch the bleeding . In America, depositors are pulling their money from small and mid-sized banks.

We will soon be reading about more bank rescues.

By

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Warren Buffett is said to have made this remark in 2017 in discussing the travails and misdeeds of Wells Fargo in 2017. It is applicable to the present banking crisis in America and Europe. On Friday, March 10, Silicon Valley Bank failed and was closed by the California Department of Financial Protection, which appointed the Federal Deposit Insurance Corporation (the FDIC) as receiver. On Sunday of last weekend, the FDIC, the Treasury Department and the Federal Reserve Board (the Fed) announced that all depositors of the bank would be made whole. On the same day, Signature Bank also failed and was taken over by the FDIC.

The announcement that all depositors would be made whole did not end the banking problems. Several other regional banks came into the cross hairs of the markets, including First Republic Bank, the stock of which fell by some 83% in two weeks, before the federal government persuaded twelve large US banks to deposit $30 billion in First Republic. But even after the huge deposits, stock in First Republic falls further. Meanwhile Credit Suisse, the huge Swiss Bank, troubled by several years of management problems, needed a $54 billion rescue by the Swiss central bank last week.

Came this weekend, another working weekend for governments and bankers, especially for the Swiss. The $54 billion for Credit Suisse was not enough. The Swiss Central Bank, Credit Suisse and the Union Bank of Switzerland (UBS) negotiated the takeover of Credit Suisse by UBS, announcement of which was made late Sunday evening Swiss time. If you wish more detail on these events and the market effects of them, a good account was published on Friday by Bloomberg columnist John Authers. You may read it here: https://www.bloomberg.com/opinion/articles/2023-03-17/first-republic-svb-credit-suisse-crisis-signals-growing-recession-odds. Mr. Authers' piece overnight on the Credit Suisse and UBS matter is here: https://www.bloomberg.com/opinion/articles/2023-03-20/ubs-credit-suisse-and-the-super-sizing-era-of-banking-monopolies?srnd=opinion&leadSource=uverify%20wall.

The announcement by the Fed, the Treasury and the FDIC and President Biden's televised comments before US markets opened on March 13 were not enough to put the banking problem to rest. The Swiss announcement yesterday evening of the UBS takeover of Credit Suisse and concurrent announcements by the Fed and other major central banks of expansive actions to provide liquidity will probably not be enough either. (In today's early trading in Europe, UBS and other European banks are selling off.) There are more cockroaches in the kitchen, more troubled banks of which we will be reading in the weeks ahead.

One extraordinary effect of the banking ructions of these last two weeks is the

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very sharp decline in interest rates on Treasury bills, notes and bonds. On March 8, the yield on two-year Treasuries was 5.05%. The widespread expectation was that these yields would rise further as the Fed continued to raise rates to combat inflation. However, as the banking crisis spread in the last week and a half, yields on these securities posted an epic decline. As markets opened this morning in Asia and Europe, the yield has fallen to 3.66%. The swiftness and depth of the decline themselves have caused problems for many financial institutions. For example, Goldman Sachs is said to have lost $200 million in this last week and one half. This sharp decline will probably have hurt other banks, as well.

For more than a decade, until last March, the major central banks held short-term interest rates near zero; this kept long-term interest rates very low also. Beginning in March 2022, the Fed began to raise the rates it directly controls at a very rapid pace, such that by its most recent meeting six weeks ago, Fed funds were set at a range of 4.50% to 4.75%. The expectation, before banks began to fail, was that Fed funds would likely go up by another one percent or more and stay high throughout this year and in to 2024. Both the very sharp decline in two-year Treasuries in the last two weeks and the steady increase in short- and long-term rates over the last year have contributed to problems at the teetering banks. Another quite apt Warren Buffett comment might describe the effect on banks of the interest rate increases: "only when the tide goes out do you discover who has been swimming naked."

The tide has, indeed, gone out and we will discover more banks that have been swimming naked.

It has been said that the Fed would keep raising rates until 'something broke.' We have had breakage. What will the Fed do when it meets later this week?

It has been said more than once in the last year that the Fed would keep raising rates until something broke. Well, something has broken. The Fed's Open Market Committee meets on Tuesday and Wednesday of this week to determine whether, in its battle with inflation, to continue raising rates and further tighten monetary policy. This will be a very difficult decision. It is certain that the banking problems will have tightened credit conditions markedly in the last week. Need the Fed raise rates again? Will it pause its tightening to evaluate just how bad things will get? Might it, indeed, cut short-term rates to alleviate pressure on banks and the economy? The risks of a pause or a rate cut are well known by the example of Paul Volcker's Fed in the early 1980s. At that time when inflation was very high, the Fed raised rates until a recession unfolded. Then it began to cut rates. But inflation kept rising and, shortly thereafter, the Fed had to raise rates again to extremely high levels. This gave rise to yet another recession, but it began the long process of declining inflation. To raise rates on Wednesday may well cause further damage to an already struggling economy and banking system. This will not be an easy week for the Fed.

The investment effects of the ongoing banking crisis will include lower stock prices and higher Treasury bond prices. In the recent scary and very volatile two weeks, Core's accounts have appreciated in value. Our holdings in long-term Treasury bonds and gold have both appreciated. The modest short positions in the stock market have risen. We retain large cash positions in these risky times. We have had reason to be cautious in our investments for more than a year. Caution remains the watchword.

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