FRIDAY, MARCH 24, 2023

Well, hello and welcome to the Dividend Cafe. We are getting ready to go into another weekend, and that's sort of what I'm talking about today is the last couple of weekends and this general era of Sunday drama of Sundays being kind of hijacked by some distress event, some announcements, some alert in financial markets. And so I first of all will say to those of you who have no idea what I'm talking about, congratulations. You have successfully pulled it off. There is no reason for you to know what I'm talking about. The types of things that I'm referring to are major substantive, and in our world, that are world changing events. I'll explain it all in a second, but if somebody has their capital stewarded and managed by someone else they trust and they're spending their Sundays going to church and being with their family or watching the afternoon game or whatever and not even aware of these types of things, then I think that's kind of for the best.

It's not really an option all the time in our world, but of course we really are talking about the exception, not the rule. And it was 2008 where this idea of kind of a Sunday interruptive moment was happening very frequently. And the time period at which Fannie Mae and Freddie Mac in early September of '08 were put into conservatorship was the first kind of weekend enhancing moment. I remember that one vividly. It was my seven year wedding anniversary. I was away with my wife. And then it was just one week later that, and this one may have caught up into Main Street even more, maybe not because I don't know, but the Lehman Brothers bankruptcy on the following Sunday evening was another just moment of it was a little less techy back then. I think social media existed, but it was more text and television and things like that email. But the alerts and the beeps and the tweets and the popups kind of has intensified with technological expansion and ongoing digital mediums since 2008. But the Lehman weekend, there was a weekend where it looked like the deal for Morgan Stanley to sell a big piece of it to Mitsubishi and raised the equity capital necessary to kind of save the company, that one was near and dear to me because I was a managing director at the firm then and there was a whole lot of economic ramifications for me personally. And we went into that weekend, Friday thinking the deal was dead. And Sunday we kind of realized it was back to life. And Monday everything closed. Well, there were other moments too. Citigroup almost was dead again over a weekend. And there was a Sunday night where the Feds kind of announced a whole new level of backstop and that changed things. So anyways, I don't want to talk about oh eight forever, but those are just periods where was an individual Sundays where I could tell you where I was and what I was doing. And yeah, it definitely took over an entire Sunday afternoon or Sunday evening or whatever it was. And for it doesn't happen often and there's a reason Sundays, it's something where there's an intent for policymakers to kind of wrap something up or a deal to come together after the markets have closed on a Friday and before the markets have closed on a Monday and it's a little hard to do these things in the middle of the market they're in, they end up having an impact in equity markets or interest rates, bond markets, sometimes currencies. And so getting a little period of respite from when markets are open is often what will happen and Sundays fits the bill.

I don't know, I think that the other aspect is the globalization of markets, that there's also a desire to get it closed Sunday before Sunday night because Sunday night in America is really Monday morning in Asia, and then you do have a market opening dynamic, albeit a different part of the clock, a different part of the globe. All that to say that we, two Sundays ago from when I'm talking, I believe it would've been March the 12th, I had gone down to a coffee shop near my house at the beach here in Newport and was going to work on a book I'm writing for like five, six hours, just kind of sit and write and I didn't write a word and I had set up my kind of station and this and that and was ready to get into it. And then these beeps and popups and alerts and emails, and I'm in correspondence with other friends of mine, different analysts, hedge funds, colleagues, and there's dialogue and one minute they're announcing a new rumor and the next minute, and on that particular Sunday, it was about three in the afternoon by the time an official announcement came, it had been 6, 7, 8, 9 hours of back and forth and speculation and whatnot.

But by, I think it was three in the afternoon, the FDIC announced they were back stopping the uninsured deposit levels for depositors at Silicon Valley Bank and Signature Bank in New York. And I was taking my son to the Laker game that night. And then all of a sudden I kind of had to go through all this stuff we had a little time for before we were going up for the game. And it's a major deal. You have unlimited deposit insurance being announced above and beyond the legal limits and the Fed Treasury and FDIC co announcing together the rationale being to control systemic risk and the futures went up. It didn't last. The next day ended up not being good, but it looked as if that was going to soothe the markets for a little bit. And it kind of forced a rewrite of a lot of things they'd been working on that day for the next day's commentary. And then now, just this last Sunday, just one week later, and again, I had just gotten back the night before from a couple days in Vegas with some friends watching basketball, and I was up very early Sunday morning to get my daughter out to an all day volleyball tournament. And when I got there, I knew I was going to be there like nine hours, but she's only playing two or three times. And so I'm setting up the computer, I have all this catch up work to do from being out on that Friday and Saturday and I had writing projects, reading just my normal stuff. And now I've set up kind of obnoxiously at this volleyball tournament, there's over a thousand people there, my iPad and my laptop and my phone and it look like I have kind of a full office deal. And then again, can't really get into that rhythm of all the work and the inbox and the projects because you start hearing reports that UBS has made an offer that Suisse are not accepting the offer. Credit Suisse wants this, UBS is doing that. And then I have the AirPods in. I'm listening to Bloomberg live, and next thing I know, I recognize the voice of Cole Kellerher, who was the CFO at Morgan Stanley when I was there, and he is the chairman of UBS now announcing that indeed UBS was doing a sort of rescue acquisition of Credit Suisse. And there's a whole lot of ramifications out of that. Now, markets responded favorably to that throughout this last week, even though there's been some up, down and whatnot, you've had a lot of big updates including Monday and Tuesday.

I don't mean to spend so much time talking about this setup, but this is in a way not just kind of oh, nice reminiscing and interesting calendar interventions to volleyball tournaments and book writing and coffee shops and whatnot there you don't have major announcements and 50 tweets and texts and alerts and popups, whatever else, when everything is kind of hunky dory, like this is a reflection of a tremendous amount of financial distress that's coming to the marketplace. And I think that this Credit Suisse deal with UBS is a very big deal, and it actually has not gotten all the attention this week. In a normal week, it would be the biggest story of the year. And you're have 167 year old bank, 530 billion of assets, 490 billion of debt. And we think of for good reason Swiss banking as kind of this gold standard of solid, reliable, impenetrable stability. And now you have a bank that was on the verge of insolvency being bought at a 96% discount to its equity value high. And we don't really know how bad things would've gotten had they opened up, I think 245 billion of their liabilities were customer bank deposits. It was 150 to 160 billion of long-term debt. So there was a systemically high level of counterparty exposure and credit exposure.

And this is kind of the first thing I want to say that is more relevant and not backward looking or nostalgia or context sharing just as a basic takeaway. Understand that all their PR deficiencies and political headaches and challenges in a democratic society not withstanding these bailouts and these rescue moves or whatever else they get called or loaded with or what have you, sometimes fairly, sometimes not usually more nuanced, meaning both they are bailouts of creditors and depositors. And it's one of the most historically fascinating things about the TARP moment in 2008 is in a lot of ways, I think it the Fed, the Occupy Wall Street, the Bernie Sanders angst to the Left, it really fed into some of the right wing populism as well that led to the Tea Party movement eventually led to the Trump movement. And yet there was just this incredible incapability of branding it as what it really was, which was a creditor bailout, a depositor bailout. The equity of Lehman Brothers was wiped away. The equity of AIG and Citi was basically wiped away and a few companies lived to find another day and maybe in a technical bankruptcy they wouldn't have. But the reason for it is creditors that we have a very leveraged financial system and the contagion effect when one troubled entity doesn't pay someone it owes money to, and that entity then by not getting paid, can't pay another entity it owes money to. And that web of complexity and potential insolvency and certainly illiquidity is too unbearable to think about and it would never stop at the first company. And so it's all kind of complicated. And I don't know that a president or a treasury secretary is able to give a speech. It's going to lay it all out. But I do know that that's what these guys are thinking. I don't think any of 'em care one iota about the equity holders of any of these companies. I think that they're essentially trying to keep the contagion effect from spreading worse. And the reason is because of the sheer horror of contagion itself and what a financial panic looks like. But also going forward, if you're going to have a credit driven economy, and this is a global statement, not merely domestic, if you're going to have a credit dependent economy, you're not able to have creditors if creditors are constantly worried about being wiped out or if creditors demand the risk premium that they should when they've seen real credit impairment. But when creditors are bailed out, it puts in a moral hazard that allows debt to trade at a lower price. It allows debt to happen, it'll lower price, the lower cost of capital, I think it's distorted. I think there may be problems with it, but it is right now the way the world works and there, if there's a protected class in American capital markets, it is primarily been debt holders. And the reason is not because they like those debt holders on that debt deal with that debt company. It's generally because the next day and the next week and the next month, we need more creditors. Whether it's selling municipal bond offerings or buying the sovereign wealth of United States or any other number of countries. The way that which we raise money is so leverage dependent in our society that creditors have really been kind of at the ground zero of these various events. And I wish that we could explain that better. This is not for me to say, well, I think it's all good. I'm glad it works this way. I'm not, but I have another takeaway as to where the real heart of the matter lies.

Now what happens? You say, okay, well UBS's balance sheet has now got a backstop. The liquidity issues, maybe even the solvency issues at Credit Suisse. That's pretty true except for they got a hundred billion dollar credit line from the Swiss National Bank. And there is now with UBS, before this transaction, Credit Suisse had a 530 billion assets on their balance sheet. UBS had over a trillion. Credit Suisse had, what was it, a 480 billion of debt. UBS had 600, 700 billion. They didn't have anywhere near. The leverage is a lot more equity on the balance sheet with UBS. But my point, and that's how they're able to do this transaction, but my point is too big to fail existed for Credit Suisse on its own and for UBS on its own. And now the two put together, just trust me, this thing is too big to fail and the Swiss National Bank is now on that backstop and maybe won't be necessary. And they do. They work through the Credit Suisse assets and UBS protects its own interest. And we'll see, I don't have any opinion about that. It's not my point to talk about those two particular companies. It's to give you the context as to what caused this moment was the desire and need to protect depositors and creditors in a massive organization. And you could argue that it's all for the best, that the systemic risk would've been worse to not go coordinate a arrangement like this. And I don't necessarily disagree, but I will not sit here and say that it was the right thing to do with no downside or there's no negatives or no trade offs. And this is a very important point to me in the way I teach economics that if you believe there's no free lunch, you have to look at what the tradeoff is in a situation. And this case, I think there's a trade off, albeit indirect to us because I don't think any of us wanted to wake up to global financial contagion under an insolvency event for Credit Suisse, but it doesn't seem like it's directly connected to us across the pond and not being holders of UBS or Credit Suisse. But here's where there is a connection in the trade off going forward.

First of all, I've been fond lately of my friend Louie Gave of Gavekal Research talking about the West trading away some of it's most important differentiators that it's unique value proposition in a global economy being private property and a high regard for the rule of law that we have in the West in particularly United States, and they force this transaction through without a shareholder vote. Now, was that all things being equal? Was that for the best? It may have been have been the contagion risk of doing that versus something else? I I'm open to that argument. It's usually non-falsifiable and non-verifiable. So it's kind of intellectually dishonest, even go there, but we'll pretend. However, I won't pretend that it can happen without a trade off. I think that denying a shareholder vote there, these things, you may have heard about the news, it was only about 16 or 17 billion of what are called Coco's contingent convertible bonds that were technically alternative tier one capital. So they're supposed to get paid before equity but after senior debt. But there are different nebulous conditions that could kind of cause them to have an impairment not get paid. And in this case, they wiped it out, these holders of this debt. Again, it's a smaller amount in the grand scheme of their total balance sheet, but that money is not going to be paid back. They're liquidating that debt at a hundred percent loss. And yet the largest bond holder of this was PIMCO here in Newport Beach owned like 750 million of it. I mean, it's not that much, but is there a trade off? Are there people now or some of these other hybrid types of capital structures that believe they're at risk of a cramdown, the suspension of law of some situation where the rule of law will not function the way it's supposed to be and the way it's supposed to function. And so private property and the rule law are not highly regarded generally on the margins during financial panics and during Sunday afternoon interruptions. It's usually something is going to happen that works against what conventional rule law and trade and private property rights would be. And I don't like it doesn't mean, I think all the circumstances don't sometimes warn it, but this idea that it can happen without a tradeoff is absurd.

Another thing on this credit Suisse deal, by the way, is the Saudis had just put in one and a half billion dollars of equity capital for a 10% interest in the company. So they were valuing it at 15 billion. It had been worth about 88 billion at its high in 2008/2007. And then going into the weekend it was still valued about 9 billion. And then of course this deal, UBS did valued it when all was said and done at a little over 3 billion. So the Saudis are taking a massive loss on their one and a half billion dollar investment. Well, are they okay with that? Is this going to make them more likely to be an economic actor with the West? Is there vulnerability already in the relationship between Saudi and the United States and Western allies, NATO block countries, European Union members? I think there that risk, that vulnerabilities has already been there, this probably doesn't help.

So you have a few things related to rule of law related to prior property related to the way this obscure hybrid debt securities treated relative to capital structure relative to expectation. You have the Saudi consideration. So this is all I'm trying to say is that there are negatives, there are trade-offs even as there is a positive avoiding contagion risk. And where does this necessity of trade-off come from? Where does this necessity of basically having to swallow a decline of distinctly western values, rule of law and private property,? It comes from the boom bust cycle that creates these problems to begin with. And that boom bust cycle is in my mind largely at the hands of the Federal Reserve. Now in this case, we're talking about a global event, so I'm not going to sit here and just only blame the Fed. You have global central banks, call it BOJ, call it Bank of Europe call, excuse me, European Central Bank, call it Bank of England. You have various global monetary authorities and they're all in it together exacerbating a Boom Bust cycle. And what happens when the central banks exacerbated Boom Bust cycle is you get Sunday afternoons filled with financial interruption, tweets, beeps, blogs, and alerts. That's where it comes from. The negative repercussions, a threat of rule law, threat of private property that comes for the ramifications of the Bomm Bust cycle, doing what it does. It creates a credit Suisse problem, a Silicon Valley bank problem, something I've talked about before. And then we sit around and want say, look, in this moment, there's nothing we can do. We have to put the fire out. And I don't disagree in theory. I think generally speaking, you do want to put the fire out, but I do think that when you put a fire out, it's always helpful to go back and talk about what caused the fire to begin with. And we just don't do that. And that's where there's a financial vulnerability in the system. That's where there's a need for financial quality in a portfolio for decision making that transcends the merely speculative, and that transcends the hopeful assumption that what has worked well in the past will continue working well in the future.

We want better than that. That's why we invest money the way we do it, the Bahnsen Group. But it's also why I want you to sort of understand the nature of the real financial system that we have, not just for what it can do on Sundays, but what it can do every day of the week. Thank you for listening to Dividend Cafe. Thank you for watching. Thank you for reading, and please share with us any questions. You have questions@thebahnsengroup.com, and please support us by rating us writing a review and sharing this with those you think could benefit from it. Thanks again for your weekly role with the Dividend Cafe. I look forward to talking to you again next week.
