PGIM FIXED INCOME

All the Credit® Episode 37

Transcript

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Female Voice: You're listening to *All the Credit*, a monthly podcast series brought to you by PGIM Fixed Income, an active global fixed income investment manager. And now your host senior portfolio manager, Mike Collins.

Mike Collins, CFA, Host and Senior Portfolio Manager, Multi-sector Strategies: Hello and welcome to Episode 37 of *All the Credit*, PGIM Fixed Income's monthly podcast. I'm Mike Collins, just one of the many investment professionals at PGIM Fixed Income and your host of *All the Credit*. I'll be joined today by a cohost, my long-standing colleague, Lindsay Rosner. Now, most of you listeners will remember Lindsay from last August where we discussed areas of opportunities across the fixed income market. And as many of you know, Lindsay and I have worked side by side for the past decade or so, as co-portfolio managers on many of the multisector fixed income strategies here at PGIM Fixed Income. So, Lindsay, welcome back to *All the Credit* and to your inaugural hosting role.

Lindsay Rosner, Multi-Sector Portfolio Manager: Thank you. Ready to step up to the plate. And it is an honor.

Mike: Well, your timing is great too because this episode will without a doubt be one of the most important and topical ones in the history of *All the Credit* between everything going on in the banking sector and across global central banks. Wow, there is a lot to cover.

Lindsay: Yes, we are going to review the latest edition of the global banking crisis, how we got to this point and offer an outlook on the potential for more bank runs, potential regulatory responses and the impacts on bank earnings and credit fundamentals. We'll also discuss the broader economic policy and market implications of this new bout of uncertainty and volatility. We'll unpack the recent huge sways in interest rates and central bank policy expectations. We'll review the results of the latest round of central bank meetings and the likely future path of monetary policy. And we'll also attempt to estimate the impact on the economy of inflation of tighter conditions as a result of the banking crisis. Finally, we'll summarize our portfolio positioning at PGIM Fixed Income, particularly regarding the financial sector and recession risks in general.

Mike: Yeah. So, we have a very full episode for you guys, our listeners today and here to help us sort through all of the details. We're really lucky to have David Jiang and Mick Meyler join us as our guests. David Jiang is a Senior Credit Research Analyst at PGIM Fixed Income covering the banking sector. Prior to joining us about 15 years ago, Mr. Jiang held stints at Barclays, BNY, Bear Stearns and even JP Morgan Chase. So, David has certainly lived and breathed the good, the bad and the ugly of the banking sector for his entire career. David received a bachelor's degree in International Relations and Economics from Boston University and an MBA from the University of Virginia's Darden School of Business. And Mick Meyler who's been a guest on this show in the past, he's a Senior Portfolio Manager and the Head of our Developed Rates team at PGIM Fixed Income. Prior to joining us in 2017, Mick was a prop trader at Nomura Asset Management and

Citi, and even worked at Lehman Brothers back in the day. So, Mick is also no stranger to banking crises. Mr. Meyler received an economics degree from New Jersey's own, Rutgers University and an MBA in Quantitative Finance from the University of Chicago's Booth School of Business. David, Mick, Lindsay and I are here to give you all the credit. Welcome, guys. And you all have something in common. You all worked at either Lehman or Barclays back in around 2007, '08 and '09. So, this is kind of back to the future for you guys.

Mick Meyler, Head of Developed Market Rates: Yeah, really interesting times. Mike and Lindsay, thank you so much for having me on the episode. I appreciate the opportunity to talk to you all.

David Jiang, U.S. Investment Grade Credit Research Analyst: Thanks again, guys. Appreciate it.

Mike: Yeah. And Mick and I, you also have something in common and interesting tidbit, right? Mick's mother, Frau Meyler, was my son's high school German teacher in Voorhees High School in Hunterdon County, New Jersey. So, that's pretty wild. And we realized that after working together for a few years. So anyway, let's get started and dive in. So, David, you are in the middle of this, right? This banking crisis is alive and well. It's a gift that keeps giving and the markets keep focusing on different banks and different countries. Just, why don't you to recap for the listeners quickly of the latest banking crisis and where we are at least as of this recording.

David: Sure. So, a lot going on. The latest banking crisis began somewhat suddenly on Wednesday, March 8th, with a bank run on Silicon Valley Bank, which is a large 200 billion plus regional bank based in California that's focused primarily on the venture capital community. They have a concentrated deposit base with over 90% uninsured deposits from the FDIC, meaning that only 10% of their deposit base was insured. And subsequently, a bank run took place the following day on Thursday and the bank was seized by the regulators on Friday, March 10th. Concurrently the same week, two other banks failed, Silvergate Capital and Signature Bank. Both banks involved in a crypto deposit industry that also suffered a deposit run after the failure of FTX. So the Fed, FDIC and Treasury moved quickly over the weekend to respond to the contagion risk with two important actions. One, they guaranteed the uninsured deposits, remember deposits under 250k, are covered by FDIC insurance so anything above that are uninsured. And secondly, the bank term funding program was created which was the liquidity program that allow banks to pledge their government securities at par without a haircut at market rates. The floor was put into the U.S. banking system for the time being. However, the following week, the contagion spread across the pond to Europe to Credit Suisse, a Swiss globally systemic bank which has been repairing its balance sheet after a series of missteps and losses in its investment banking business. So, as depositor flight took place, dramatically that following weekend, Swiss regulators orchestrated the acquisition of Credit Suisse by their rival UBS, which was a healthy bank, also based in Switzerland. And now, that's where we are. The focus is back on the U.S. And there are again several regionals that are under tremendous pressure like First Republic Bank which has been currently in the news and others that we don't know about yet.

Lindsay: So, David, should investors be worried and let's say our listeners as well, should they worried about another 2008 style global financial crisis? You just mentioned some that we don't know about. What don't we know? What may be coming?

David: I would say every banking crisis is unique, OK. And unfortunately, we're always fighting the last war. The 2008 global financial crisis was different and so far, way worse than the current banking crisis that we are currently experiencing. 2008 was a solvency crisis driven by subprime mortgages and other toxic instruments like CDOs and CDO-squared securities that were burning huge holes in the balance sheets of large systemically important Wall Street banks, and also non-banks that were ultimately converted to banks like Goldman Sachs and Morgan Stanley. Sure, there was collateral damage around some of the large thrifts like Washington Mutual and IndyMac that failed, but contagion risk engulfed mainly the largest banks in the U.S. and globally. The current banking crisis is more of a classic liquidity crisis driven by asset liability of mismatches on bank balance sheets as the Fed hike rates from zero bound to 5% in a year. We know very well the asset values on the balance sheet unlike '08. These are treasuries and mostly agency MBS that are sitting with unrealized losses due to the rate hikes. But we don't know the duration of liabilities on the other side of the sheet matching the assets. And so, the crisis of confidence started with the not so small regional bank, Silicon Valley Bank, that had a super concentrated deposit base in the VC community who all lost confidence in the viability of the bank. And the bank experienced a classic bank deposit run with $42 billion of deposit withdrawals requests the day before they were seized by the FDIC. We believe the current crisis and contagion is more of a mainstream banking crisis, hopefully a liquidity crisis that do not run its course and turn into a solvency crisis like in 2008.

Lindsay: Thank you for explaining that. That's really helpful in conceptualizing. Maybe to follow up on that about it being potentially a mainstream crisis, for mainstream people, one thing they may be thinking about is FDIC insurance that only covers $250,000 worth of a deposit or in a single account. Are they supposed to think about if they have more than $250,000 at a given bank, are they supposed to try to spread that out?

David: I think the initial reaction was to reevaluate the safety and security of their deposits, especially the uninsured deposits. But I do believe that the Fed actions over the weekend of March 12th did put a floor on the bank run that was happening over the course of that week. I think depositors should, both retail and commercial, should feel very safe keeping their deposits in our banking system, especially with these actions, especially since the FDIC has made it clear that all depositors are covered even if the bank fails. And the liquidity facilities are there to make sure that banks can manage their contingent liquidity risk with ample reserves.

Lindsay: Thank you. That is a relief. Mick let's turn to you. How have central banks and policymakers responded to this crisis thus far?

Mick: So, I think really good question that ties into what David was saying because when we talk about central banks, almost all the time, we're saying, "OK, what's inflation doing? And in the U.S. with the dual mandate, what's employment doing?" And when you get into a situation like the one that we're in now with a stability issue, a financial stability issue, everything goes to the backburners for central banks. And they have to address that issue as the immediate issue that requires attention. And I think David mentioned a little bit about the bank term funding program. Certainly, the central banks are reacting. So, you see it in the U.S. with programs like that. You see it in Switzerland with the Swiss National Bank and what happened between UBS and Credit Suisse. But I think even at a higher level, so what's happened since the banking crisis started and how have central banks responded? I think one of the big things that central banks have tried to do is say, "We are not going to let this become a stability issue. And we're going to continue on the path that we had laid out before. We're focused on inflation. We're focused on growth. We're focused on employment." And so, in recent meetings, you look at what the ECB did. They hiked. You look at the Fed, they hiked. You look at the Bank of England and they hiked. Now, in that context, you'd be like, "OK, well, potential financial crisis and stability risk here." But I think central banks have made it a priority to signal to the market things are under control and that stability is our focus, we're going to manage it. And it's not so bad that we can't continue to address the broader financial issues.

Mike: Yeah, that's a great point. I always think the central banks have two main tenants, right? Stable prices and full employment. But overarching all of that, they have to ensure the banking system is intact and the financial markets are functioning. And then certainly, they've looked at trying to convince the markets. They have multiple tools and they can actually manage these different competing interests independently. We'll see how that goes. And David, your point on this crisis being more of a liquidity crisis than the solvency is really important, right? We haven't really seen any asset quality deterioration to speak up at all so far. So, that's really the good news at this point. So, David, how are the banks responding? I mean, what are they doing to ensure that their depositors don't flee? What are they doing to ensure they have the liquidity they need?

David: So, I think U.S. banks are in a bunker mode right now, especially the regional banks. After the initial shock of the SVB bank run, banks have activated their liquidity contingency plans. The latest Fed data has shown that they have amply utilized the Fed discount window as well as the new BTFP facility, as well as their traditional federal home loan borrowings to effectively liquefy their balance sheet and be ready to accommodate deposit outflows. Unfortunately, the downside is banks are likely to pull back on riskier types of exposures and conserve their balance sheet. The large U.S. money center banks are under less pressure as they will be beneficiaries of the deposit flight from the rest of the banking system. However, they have a vested interest in making sure the crisis is contained which is given that it will probably lead, as you say, to asset quality issues, it's not contained. So, as one example of that, on Thursday, March 16th, a consortium, the 11 largest banks in the U.S. came together to shore up the deposit of one of the banks that's currently under a lot of pressure, tremendous pressure actually, First Republic Bank which is a California-based regional that has seen their stock price decline by 90%. However, after the initial action, the equity continues to drift lower. So, it would seem that more has to be done.

Lindsay: So, David, that's what banks have done. How about what has the market done in terms of how it is now valuing both the debt and the equity of large money center banks and regional banks? And maybe break apart the two because I think they're being treated differently?

David: Absolutely. On the equity side, the banks in question, some of the regionals, they're under pressure. They've unfortunately become, in a sense, un-investable because there's an information vacuum around what type of liabilities are flowing out and what type of costs they have to maintain in order to keep those liabilities, those deposits. And the liquidity facilities are quite expensive at market rates. And banks are generally not constructed to handle this type of a funding profile. The BKX index which is KBW's broad bank equity index is down about 23% since the beginning of the year. A lot of that came about over the last few weeks. The select regionals that are under the greatest pressure are down anywhere from 20 to 90%, in First Republic's case since the beginning of the year, with the average decline of this subgroup around 50% lower in equities. So, quite a dramatic move. On the debt side which we track closely, I would split it up into two groups. The U.S. money center banks are about 15 to 25 basis points wider in the 10-year part of the curve which has meant that they have been a safe haven during this crisis. While the large regionals, names like U.S. Bancorp, PNC and Truist Financial, they are about 40 to 50 basis points wider since March 1st. And the smaller mid-sized regionals such as KeyCorp, Fifth Third and M&T Bank are 130 basis points wider. And that's not including some of the outlier banks, smaller regionals that could be quoted 175 to 200 basis points wider, although there's not much trading going on. So, there's absolutely risk off across the entire regional space currently with the money centers faring much better than their peers.

Mike: David, obviously, the additional Tier 1 capital are the deeply subordinated bonds of some of the European banks and certainly Credit Suisse. They've really, really taken it on the chin. I think those additional Tier 1 capital bonds of Credit Suisse have been basically wiped out. Is that right?

David: Effectively. As part of the liquidity injection and the support of the Swiss government in the merger of UBS and Credit Suisse, the Credit Suisse additional Tier 1 bonds have been effectively wiped out. Then the U.S.-style Preferreds which are lower in the cap structure are also down as well on sentiment. And the ones that are at the regional banks are down substantially.

Lindsay: Those are some pretty tremendous moves. I'm wondering if we're seeing similar kind of reaction in the bond market. Mick, loaded question because I kind of know the answer. Tell us about it.

Mick: Yeah, Lindsay. Yeah, definitely seeing a high vol period, right? And so, I think what's important to do is not only say, "OK, is it a high vol period and is the depth of the Treasury market like less robust than where it was before we had the high vol period?" That is absolutely the case. But if you take a little bit more of a historical perspective and say, "When else have we experienced really high levels of volatility? And how does this compare to distress that we saw in those other high vol periods," right? So, just going back to like the Flash Rally that we had and then the September 19 repo crisis, and then the onset of the pandemic in March of 2020. During those periods, I would say the Treasury market stress was higher than what it is now. So, if I were to describe the current market condition, a lot of the market is still functioning very well. The repo market has been incredibly resilient and showing no signs of stress and probably because of things that were put in place by central banks to support those markets like the reverse repo facility. And when you look at banks and their excess reserves now, there's no shortage of cash in the system. So, the funding markets are all doing well. Volatility is higher. Bid offer is wider. But even deeper off the runs are still trading. And so, this is not a period of extreme stress like we saw in March of 2020. It's more normal in the context of when there's high volatility and there certainly is high volatility now as you know, you're going to have wider bid offer and you're going to have a less step.

Lindsay: Mick, can you translate that for us? For example, what's happened to two-year Treasury yields? What's gone on there? So, you talked about volatility, translate into numbers for some of us.

Mick: Yeah. So really, an incredibly large range of the two-year as people respond to really what the central banks and David has been talking about financial stability is a front and center issue. And when that becomes front and center, you're going to look for protection against it. And we've seen that happen in the frontend of the curve. So, two-year yields repricing and a Fed that was going to hike maybe another 25 or 50 basis points as recently as a month ago. And now, it's taking the other side of that and saying we might be in a world where we have to see a Fed cut rates at some point in the not very distant future. And as that happens, volatility really picks up. And the range on twos, as you mentioned, has been really enormous.

Mike: Those Fed rate hike expectations have turned into pretty aggressive Fed rate cuts just over the last couple of weeks really which is pretty amazing. We'll see that game of chicken between the Fed and the markets lay out. And Mick, in terms of flows and obviously we're talking about deposits and people taking their money maybe out of banks which aren't providing enough yield on deposits and moving it into other things, into ETFs and money market funds. What are you seeing in regard to the flows in the Treasury market?

Mick: Yeah, Mike, really exactly what you're talking about. Like as people are pulling deposits from some regional banks and trying to find safety, I think they are moving into money funds. And you're seeing that in the data. So, there is a shift of deposits to money funds. But there's also an interesting dynamic going through the market now where just in general, buying of fixed income has been happening at a higher level. And you can see that through the ETF data. So, ETF flows have been robust. People are looking to treasuries here. I think the yields at these levels are from a 10-year or 15-year perspective, very attractive. And if people are concerned about equity performance, it is an asset class that provides a reasonable yield and hopefully offers some protection. And so, we are seeing those flows take place both in the frontend, but even in the belly of the curve and longer end with retail buying it looks like in ETF space.

Mike: Yeah. And for what it's worth, when we see 10-year rates kind of getting into the fours, we've been generally advising our clients, "Hey, add duration." We certainly put out on a lot of thought leadership this year saying bonds are back, and yield is destiny. And the yields we see in the bond market and a lot of the different strategies we manage are pretty attractive arguably even relative to equities, potentially. So, David, let's shift back to you. I know this is really tough, crystal balls are a little murky. I mean, what would be your best guess on how this current banking crisis will play out let's say over the course of 2023?

David: So, I think we're still in the early innings of this banking crisis. There are reverberations that are occurring throughout the U.S. banking system and spreading across over to Europe as we speak. Silicon Valley Bank was the first big domino to fall in the U.S. and a floor was put in subsequently afterwards. And Credit Suisse was the second large domino in Europe that almost fell. Thanks to regulators stepping in at the last minute. I would say that our banking regulators have been incredibly responsive in putting out these fires, invoking their systemic risk powers. But there are still a lot of smoldering ashes that can turn into a large fire at any moment in time. We have to remember there are 4,000 banks in this country. And despite the emergency actions, the banking system and then some of the smaller banks are still under a lot of pressure. And unfortunately, there is an information vacuum until the bank reporting earnings season for first quarter of 2023 which should be released in mid-April. So, how it plays out? I mean, I think there's currently a structural shift of deposit outflows from the smaller banks to larger banks. It's mainly across commercial and corporate clients who have a business to operating accounts, and a fiduciary duty to consider the uninsured deposits and where they reside and the business relationship they have with their bank. I think that larger issue is the crisis of confidence and the regulator's ability to contain the contagion risk. The spillover to Europe has taken place. The initial collapse of the three U.S. regional banks have also taken place. But since then, there has been no further bank failures post these emergency actions. Although I do mention, there's a lot of other regional banks under tremendous pressure and in some cases reaching the point of commercial non-viability. My best guess is the Fed will have to step in ultimately and create some sort of a temporary guarantee on all bank deposits, potentially with a series of regulatory reforms to close some of the regulatory gaps and loopholes that allow some of this asset liability mismatch and liquidity stress testing to be more stringent. And one of the issues is the losses, unrealized losses that's sitting on the balance sheet of these government securities that have gone down in value. So, I think all of that has to be addressed by regulators. Beyond the regulatory response, we believe there will again be further bank consolidation across the industry, not the G-SIBs, the money centers, they are at their caps, it will not be allowed to get bigger. But there are plenty of large regionals that can certainly consolidate. And we had a wave of consolidation in the '90s and 2000s. And this very well could be another effort at reducing the population of banks in our economy. Unfortunately, I think the second crisis will have a longer tail. There is issues around bank credit contraction and tightening financial conditions that will ultimately come out of all this. But hopefully with these coordinated global regulatory actions, bank M&A and consolidation and some type of a deposit backstop, we can get through the banking crisis and merge with stronger banks in our economy.

Lindsay: So, Mick, David just talked about potentially tightening financial conditions. And tightening financial conditions often lead to changes in outcomes for growth and inflation expectations, but they're very much priced in by the interest rate market. So, what have you seen happening in the interest rate market, kind of on the back of what David just shared with us?

Mick: Yeah, Lindsay, another really good question and it's something that our economics team has been working on a fair amount. So, when we talk about PGIM's economic outlook and how much is the credit contraction that David's talking about going to affect the macro environment, we're looking at like a 1% hit to our GDP forecast as a result of it. And so, in that type of environment, if that plays out that way then, yeah, interest rates are closely linked to central bank policies and maybe they can even be forward looking in terms of what the central bank policies are going to be. And right now, what the markets are telling you is maybe the Fed is a little bit too restrictive at current levels and eases could be coming down the road. Now, that doesn't mean they cut to zero like they did in 2020 or in 2008 but an adjustment lower. If conditions are affected by what's going on in the banking system, it doesn't seem like an unreasonable outcome for the end of this year or maybe into early next year.

Mike: Yeah. For what it's worth, our internal economics team GDP forecast at least for the U.S., I think it was something like 1% for 2023. And if you take a hit on this credit contraction, as a lot of these regional banks generally provide a lot of credits certainly in the local economy and the real estate market, so you're already seeing tightening conditions across the real estate sector. So, that will take our GDP base case closer to zero really for this year, for what that's worth. We'll see what the impact is on inflation. But generally, these banking crises and tighter credit conditions tend to be disinflationary but we've been fighting that battle for a couple of years now. So, David, let's get to where the rubber meets the road. Really, how we're positioned, how our clients who are listening to this podcast are being affected. Generally, when we have these crises and big economic problems, we tend to shine our credit research teams, and folks like you tend to be pretty good at anticipating deteriorations and credits and avoiding some of those. I think we've generally done a great job and kudos to you and the team and the portfolio managers on the investment grade corporate side for generally steering us through this I think in a pretty good fashion. So, how are the fundamentals of our positions? And generally, we have overweight in the big money center banks and we generally have not had positions in some of the subordinated debt and these contingent convertibles and additional Tier 1 capital and so how does this impact the fundamentals of the positions we have in your mind?

David: Sure, we're in good shape. I think we're predominantly in the senior parts of the cap structure, not the subordinated parts of the cap structure. And we are still constructive on the credit fundamentals of the large money center banks. They are officially called Global Systemically Important Banks, G-SIBs. And they're strictly regulated with enhanced prudential standards under the Fed. These are annual stress testing under the Dodd-Frank Act which results in two additional layers of protection to investors. One is a stress capital buffer that they have to maintain as well as a G-SIB capital surcharge. So, we think they are very strong from a solvency perspective. Liquidity requirements are also very stringent relative to the non-G-SIB banks as they are the only banks to have to fully adhere to the liquidity coverage ratio under Basel III. So, we are confident that they can manage their liquidity prudently through this crisis. And lastly, their diversified earnings power which we view as future capital remains intact, likely lower given the current macro headwinds but the credit and market risk is very diversified across the large banks. And the exposure to vulnerable spots like office commercial real estate remains much lower than the regionals. We are watching the large regionals banks carefully for investment opportunities as they will be winners and losers from the current crisis.

Mike: And hopefully are opportunities. I know we've been looking at the selloff in some of these really high-quality money center banks where their spreads have widened. And you mentioned they haven't widened a lot. But there have been pockets of opportunities maybe to even add some exposure in those. That's something we're certainly looking at. So, Lindsay, why don't you summarize in addition to our general positioning in banks across the multisector portfolios, our general exposure to this growing recession risk.

Lindsay: So, just big picture, when we started the year, we were assessing the macro backdrop and recognize it's a very, very dynamic environment. And that caused us to look at really the different probabilities of economic outcomes. And what we were finding is that there are kind of the few camps with about a third of the probability of occurring. A third really in the soft-landing camp that the Fed would be able to really thread the needle and take care of inflation but not break the back of the economy. Then basically a third of a probability weighted in a garden-variety recession. To be clear, back to my question the beginning, not a 2008 style, a very mild garden-variety recession. And then another third probabilities and slightly worse scenarios like stagflation and slightly even better scenarios of a booming economy that got inflation under control. And when we took all the probabilities together, that made us think that this is not an average type of economic outcome. And when we looked at spread levels, so the spread you're compensated to go into the investment grade or go into the high yield market, we were seeing very average spread levels when you think about it from a historical perspective. That just didn't sync up for us. And that left us wanting to be very cautious on risk usage. So, we're on the lower end of the risk spectrum in our portfolios. And as you can see with what we've experienced in the past few weeks, that was the right place to be. We had a feeling that something could happen. Couldn’t necessarily have told you that it was what did transpire, but now, we're in a really good position, as we mentioned, to take advantage of the opportunities. And when we saw, for example, our favorite position in the U.S. money center banks, banks that we feel very confident in from the work that David and others are doing, very regulated, have a ton of capital in really good positions. Net beneficiaries actually from those crises, well, they widened not as much as regionals as we talked about of lowering the cap structure abroad, for example, paper. When we saw this great high quality, U.S. money center things widened over the past few weeks, we were buyers on that widening. And in fact, that paper has rallied in as well. So, we've been on the lower end of our risk spectrum, that's kind of the right place to be given this economic backdrop. And we have the dry powder to go take advantage of the opportunities in the market. U.S. money center banks, a favorite position of ours, and very clear in their performance in the past few weeks why that is so.

Mike: Yeah, I've been telling our clients all year, Lindsay, that they will have better outcomes if we have a risk-off environment. If spreads widen, because of that dry power and that limited risk budget usage on the credit side that we have now the capacity to take advantage of some of these dislocations. I'm actually excited about the opportunity set as it unfolds here. So, let's wrap up there. Thank you so much, David Jiang and Mick Meyler, for all those thoughtful insights on state of the banking sector, on impact on interest rates and the economy. And thank you, Lindsay, for cohosting with me today.

Lindsay: My pleasure.

Mike: Yeah. And for all the listeners, please look at all of our thought leadership on pgimfixedincome.com. We have a blog called the Bond Blog. It's really easy to find. And until then, we'll talk to you next time.

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