March 19, 2023

Thoughts re: Banking Developments and Exposures

Dear Investor,

In light of the significant developments in the US and European banking industry, I wanted to provide a brief update on our exposures, share some thoughts, and offer some issues to consider.

We have minimal direct exposure to US & European banks.

- Our global portfolios have no exposure to US banks and less than 1% exposure to European banks (BBVA). Remaining bank investments are in Japan (Sumitomo Mitsui Trust), India (HDFC Bank), Brazil (Banco Bradesco), and Korea (KB Financial).
- Our unrestricted international portfolios include two European banks (Lloyds, BBVA) amounting to less than 1.6% exposure. Other bank investments include those in Japan (Sumitomo Mitsui Trust), India (HDFC Bank), Brazil (Banco Bradesco), and Korea (KB Financial, Hana Bank).
- We have meaningful exposure to US and European-based financials, primarily among non-life insurance companies, insurance brokers, and exchanges. These companies do not face the combined capital, liquidity, and asset-liability mismatches that have plagued many banks and some life insurance companies.
- Our dedicated emerging markets portfolios have approximately 13% exposure to banks.
- None of our bank holdings experienced the combination of sharp growth in uninsured deposits, asset duration mismatches that hindered liquidity, large unrealized losses on government securities, and weak capital that contributed to the collapse of SVB and Signature in the US.

The US banking landscape will change forever.

- The deposit guarantee genie is out of the bottle. Now that all depositors, regardless of size, have been rescued, it will be difficult to not make this the de facto policy.
- The top four US banks already have greater than 50% of total deposits. Unless the government wants this to rise to 90%, they will have to increase the regional banks' deposit guarantees – and do so quickly. The US government/FDIC will need to dramatically reshape its deposit guarantee program – far above the $250,000 limit – if it wants regional banks to exist and to stem a major credit crunch.
- Even if these guarantees are extended, regionals are still loaded with risk, particularly tied to the unraveling US commercial real estate (CRE) sector where they are the largest lenders. If trust is not restored, the CRE dominos could fall even sooner as lending conditions continue to tighten.
- All of this comes with a cost. Regulation, increased capital requirements, and increased funding and insurance costs will weigh on ROEs. Banks are investable, but the quality of franchises, management teams, and balance sheets vary greatly. As always, price paid matters.
- We must not forget that all of this is occurring while credit conditions and non-performing loans are subdued – at least for now.
- Who would have thought that the namesake of a landmark reform (Barney Frank of the Dodd-Frank legislation) would serve as a board member of Signature Bank, the third largest US bank to ever go under?

Swiss banking is not quite the pillar of stability it had once been thought to be.

- The Swiss National Bank (SNB) announced a $54 billion lifeline for Credit Suisse, and it appears increasingly likely that the SNB will orchestrate a takeover/"take-under" by UBS. This would be the end of an institution, as a standalone entity, that was founded in 1856 and is one of the 30 systemically important banks in the world.
- Liquidity and credit risk are ongoing concerns among European banks and life insurance companies.
- Confidence should be restored, but further deterioration could reignite TARGET2 flows and talk of EU fragmentation.

Is "private credit" the winner in all of this?

- As banks cut back on credit, there is certainly a void to be filled. However, we are concerned by the prolific growth in these unregulated entities that have never been battle tested at the scale they now operate. We view this area as a greater source of risk rather than opportunity.

We believe an underappreciated issue is the erosion of trust and credibility among developed market central bankers and policymakers.

- Clearly, the banking system is more fragile than generally perceived despite the increased capital requirements, regulations, "stress tests," and assurances of so-called experts.
- Supreme confidence clearly existed when ECB governor Mario Draghi was able to simply utter the words "we will do whatever it takes" and crisis was averted. An unprecedented amount of fiscal and monetary stimulus, including new forms of experimentation, has been exhausted since then. Mountainous debt levels and blunders such as confidently referring to inflationary pressures as "transitory" could cause market participants to increasingly question the credibility of important institutions. We expect this to intensify in the US amidst discussions regarding the debt limit.
- In the US, Fed Chairman Powell has a brutal task ahead as he attempts to ensure financial stability while taming inflation. Tuesday's meeting will be another test; markets' responses will be an indicator of how his credibility is trending.

We have not viewed the recent events as a significant "tactical" opportunity, but rather further evidence of a structural regime change brought on by 1) the end to the orderly decline in interest rates and stimulatory policy experimentation (QE), 2) increased regulation and role of government in our lives, 3) less supportive tax regimes, and 4) increasing competition in previously monopolistic verticals, to name a few. The outcome should be a more normal environment where capital and liquidity are not as cheap or abundant – and one where the price you pay for a business actually matters.

We are being opportunistic but not amidst the ashes of leveraged and lower quality businesses. We are currently seeing some of the most compelling opportunities among industrials that are embracing technology to transform their businesses, non-bank financials, and across industries in emerging markets. We will expand upon these thoughts in our Q2 investor letter and invite you to contact us with your thoughts and questions.

Sincerely,

John

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