The Credit Suisse Take-Under

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As books get written about Credit Suisse's demise, fundamental questions will have to be asked: was the bank condemned once Switzerland gave up its bank secrecy laws five years ago? Did the negative yield curve that prevailed in Switzerland for over a decade push the bank into taking excessive risk and accepting rotten deals (Greensill, Archegos, Wirecard)? Was its management just poor compared to other banks? Are private banks and investment banks condemned to be poor bedfellows? Whatever the reasons, it is hard to see a storied institution disappear and not feel a degree of compassion. As with many readers, we at Gavekal have friends, ex-colleagues, counterparties and clients who work at Credit Suisse. For them, today will be a very sad day.

Two key precedents were created by the "rescue" of Credit Suisse

But taking a step back, Credit Suisse may not be the only thing that died today. For amid the Swiss bank's weekend "rescue", the notion that the Swiss can be counted on to be both punctilious and the ultimate "rule followers" has also been blown out of the water. Indeed, the episode creates two precedents:

Minority shareholders in systemically important banks have no real rights

1) A bank can merge with another bank without shareholder approval being granted. The logic runs that if a bank is systemically important, minority shareholder rights have to be overrun in the name of the "greater good". This is an important precedent that minority shareholders in all systemically important banks will no doubt take notice of.

The so-called CoCo market can now be considered a busted flush

2) Even as the "take-under" of Credit Suisse leaves equityholders with cents on the dollar, contingent convertible bond holders (known as CoCos or AT1 bonds) are being wiped out. This is an arresting development, given that even unsecured bondholders usually rank above equityholders in the capital structure. So for equityholders to get "something" and CoCo bond holders to get "nothing" raises serious questions about the real value of CoCo bonds. This is important since CoCo bonds were widely used by European banks to bolster their balance sheets after the 2008 mortgage crisis and 2011-13 eurozone crisis. To cut a long story short, the terms of the Credit Suisse take-under is likely to kill the CoCo market.

Checking The Boxes

Our short take on the latest news

Fact	Consensus belief	Our reaction
US industrial production was flat MoM in Feb, from 0.3% in Jan	Below 0.2% expected; YoY, IP fell -0.2%, from 0.5%	US mfg sector is contracting; US banks are hurting; can services hold up the US economy?
US consumer sentiment fell to 63.4 in Mar, from 67 in Feb	Below 67 expected	Inflation expectations (1y and 5y ahead) also fell; not a good sign for consumer demand
Eurozone labor costs rose 5.7% YoY in 4Q22, from 3.7% in 3Q	N/A	As labor costs rose firms raised selling prices to protect profits, sustaining higher inflation
UK BoE/IPSOS inflation survey for next 12-months fell to 3.9% in Feb, from 4.8%	N/A	Falling inflation expectations makes it more likely BoE will keep rates on hold on Thursday

Imagine being the Saudi National Bank, which in October invested US$1.5bn for a 9.9% stake in Credit Suisse, no doubt on the premise that Switzerland is one of the safest jurisdictions for foreign investors. Yet in less than six months, the Saudi bank's investment has been merged into UBS, crystallizing a loss of some 80%, without a vote being offered on the matter. How likely are Saudi institutions to invest more in Switzerland, or perhaps even in the wider Western world? This situation brings me to two of my longstanding themes:

The western economies have again undermined one of their key comparative advantages: individual rights

Firstly, that Western economies keep on undermining their main comparative advantage, namely, the rule of law and sacrosanct property rights. After all, when China was accepted into the World Trade Organization in 2001, the hope was that as trade grew, China would become more rules-based, democratic and civic rights-minded. Instead, the reverse has occurred, with Western countries following China to permit less free speech and impose more government interventions that include directed bank lending policies. The West embraced stupid Covid restrictions, imposed vaccine mandates and repressed demonstrations of dissent (see **Who Is Copying Who? Part II?** & **What Freezing Russia's Reserves Means**). In the battle between "individual rights" and the "common good", the West could usually be relied on to strongly favor "individual rights". But can one believe that today? The Credit Suisse take-under shows that, given a chance, policymakers will trample all over "individual rights" in the name of promoting the "common good".

This is probably doubly true if the individuals in question are both foreign and from non-democratic countries. Since most current account surpluses accumulate in countries like China, Saudi Arabia and Qatar and most of the world's twin deficits occur in democracies like the US, France and Britain, a difficult question arises: if Western economies no longer treat property rights as sacrosanct, why should capital keep flowing from the "greater South" into the "unified West", as it has since the late 1990s Asian Crisis?

Today's social media-driven culture is weakening rights and making the West a less attractive investment destination

Secondly, Western policymakers seem ready to sacrifice "individual rights" on the altar of the "common good" due to a bad brew stemming from the 2008 crisis, social media's development and our current cultural predilection for virtue signaling (see **The Guiding Principle Of Our Time** & **CYA As A Guiding Principle (2022)**). All of this has shortened policy time horizons to the "here and now". Hence, the more involved a population is with social media, the more the policy time frame shortens, with the "common good" tending to prevail over "individual rights". So more individual freedoms expressed on social media seems to lead to weaker individual rights!

Putting it all together, the unfolding Credit Suisse debacle and the Swiss government's policy responses lead to the following conclusions:

1) The effect of government interference is to raise regulatory uncertainty and so again make the broader financial industry uninvestible.

2) Breaking the CoCo bond market means that in the next crisis banks will have to fund themselves in new ways, or shareholders will simply face massive dilution.

3) Emerging market savings will increasingly stay at home. I exaggerate for effect, but if I was a Saudi banker today, I might feel that, like the Russians last year, my assets had just been seized.

4) Policymaking in the Western world remains a shambles. This means that emerging market bonds will continue to outperform developed market bonds, and gold is likely to continue outperforming both.