Video Transcript: Banking Crisis Roils Credit Markets, Unveiling Opportunities
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Katie Klingensmith [00:00:05] Welcome, everybody, to today's conversation at Brandywine Global. I'm Katie Klingensmith, and I'm delighted to be joined by two of our portfolio managers, Brian Kloss, who focuses on multi-sector strategies, and Bill Zox, who focuses on corporate credit and high yield. There's been so much going on in the banking sector and in credit markets and the economy the last week. I'm very pleased to get both of their perspective. I'll just start out with Bill. Where are we? What has happened over the last week? Do you think we're in the middle of a banking crisis, or do you think we can start talking about looking at opportunities and looking at what's next at this period in the economic cycle?

Bill Zox [00:00:40] Thanks, Katie. And that's a good question. But before I answer that, I want to turn it back on you, because you're right in the epicenter of this banking crisis. And I just want to get your perspective.

Katie Klingensmith [00:00:52] That's right. I'm in San Francisco. And I actually think one of the themes right now is that we're talking about regional banks, regional banking, regional economies, and how that can have ultimately systemic implications. It's really interesting in San Francisco, there's been so much conversation around the stability of various banks. A lot of concern. I'm very aware of the psychology of concern around banks that might not otherwise have had any problems with their credit worthiness. I'm also very aware from just the conversations on the street and in the local news coverage, the implications for the real economy when a bank goes down. When local companies can't access their own working capital, their own cash accounts, can't pay their employees, that's immediately felt by people in my area.

Bill Zox [00:01:39] I think you've really sort of answered the question more broadly that our banking system, both in the US and globally, is entirely dependent on confidence, and that is an issue right now. The government is on it in the US, but I don't think they've done everything that they will need to do to restore that confidence. And that while there are concerns about the banking system, you're going to feel that in the real economy. Now in the financial markets to this point, it has been relatively contained to the banking sector. If you look at investment grade credit or high yield credit, you've not seen dramatic moves. Spreads have widened in both markets. In the case of investment grade market-wide, that spread widening has been more than offset by the decline in Treasury yields. So you've seen positive total returns over the last week. High yield, even more significant spread widening market-wide. But some meaningful portion of that move from a total return standpoint has been offset by the decline in Treasury yields. So, so far it's been relatively well contained. But every day that goes by when confidence has not been restored, it becomes more of an issue for the broader economy and the broader financial markets.

Katie Klingensmith [00:02:59] Absolutely. And Brian, I know you and I have talked about the importance of psychology for the stability of individual depository institutions. How much do you think of what's going on right now is around confidence and psychology and how much are we really seeing the implications of higher interest rates?

Brian Kloss [00:03:16] Thank you, Katie. When we look at this question and think about confidence and how it ties together, these two are really tied together, and it is about confidence and it's about the policies that we're talking about. Structurally, if you think about the construct of fractional banking system, or fractional reserve banking I should say. No bank actually sits there with 100 cents on the dollar for every deposit that they have. So, we really have to think about it from a perspective of how confident are we in that underlying bank, that they do have the ability to function as a bank? And that's what was called into question. I think when we talk about the crisis that we're talking about that began last week, as we think about that though, it also stems from policies. So, these two are really tied together. And that's in response to both fiscal and monetary policies that we've seen over the past, whether it's decade, or maybe the tightening monetary policy over the past 12 months or so. Those are really what I think are the triggers. So, when you really ask us to dig in and ask the question, which one is the true driver? I think they're both hand-in-hand. It's the proverbial chicken and the egg. Which one is more important? I think they're both equally as important. And as Bill said, we really need to have that confidence as we move forward, and we're looking for what solution is going to be. And that's going to have to come from both the regulators, so whether it's the Treasury, whether it's the Federal Reserve and the other regulators, as well as market participants supporting it. I think that's where we're going to find the solution as we go into the balance of this year.

Katie Klingensmith [00:04:53] One of the issues related to higher rates was individual banks recognizing losses on securities that are not typically marked to market. And I think what we've been looking at the last week has been around the safest securities having to be marked to market. What does that mean? And what about other securities, especially in private markets, private lending, private credit--securities that aren't typically marked to market? Are there other risks here? I'd like to ask Bill that question.

Bill Zox [00:05:22] Yes, Katie. Absolutely. That was a major part of the issue with the banks, combined with the stability of the funding on the bank side. In the private credit market, at private equity market, you have the lack of mark to market, which is a significant issue. In there, the funding might be more stable, but in many cases the debt is floating rate. So, you have leveraged companies, and you have higher interest costs as interest rates have increased, and an absence of mark to market on the asset side. I think that's an area of very real concern.

Katie Klingensmith [00:06:07] Brian, I understand your team specifically has been analyzing mortgage-backed securities, commercial mortgage-backed securities. And that's come into the limelight over the last week or two as those are often held by regional banks. Any view on housing and what mortgage-backed securities might do going forward?

Brian Kloss [00:06:25] Absolutely. It's an asset class that is very important to investors. It's one that all investors should be looking at. You should look across CMBS. You should look across RMBS. You should look across agency and non-agency. I think in the short term, if we get a little bit more Treasury, maybe a little bit calmer Treasury market, you should see some spread compression in that agency part of the market. Be very leery in the short term. There's some volatility that might be exacerbated around maybe the lower quality end of the housing market as well as the commercial market, given just some of the nuances that happen when you see some stress in the banking system. And that stress can come from banks having to sell assets into a market as the Fed is reducing their balance sheets. So remember, we saw the Fed that's reducing their MBS portfolio as well as other players that may be looking for liquidity given some of the events that have transpired over the past week or so, and potentially maybe looking for some capital as we move forward. So that's going to create opportunities for investors. And we would suggest it's a place that investors should look at. But let's think about what could happen, though, if we do have potential earnings recession down the road. That could be a little bit more weakness in the commercial space for the shorter term before you start to see a recovery into this is probably the second half of 2014.

Katie Klingensmith [00:07:56] Well, commercial real estate is just one topic among many that seems to be connected to regional banks right now. Bill, how do you see the outlook for regional banks in the US?

Bill Zox [00:08:08] I think that regional banks are an important part of our banking system. And I think that there are several ways to address their issues. One is by merger. So, they would become larger banks than they are now, but still not as big as our very largest money center banks. Another way is to find a way for them to once again have access to capital. But I do know that the problem will be fixed. The government is on it. The government fixes this problem every time when it comes to a financial panic or a threatened collapse of the banking system. The government fixes it every time--every government, every party, every country, every time. And it's going to happen this time. So, it's creating, I believe, a good opportunity in the credit of regional banks. That is not a huge market by any stretch. But if you can take advantage of that, they're quickly pricing every regional bank credit as if the bank is going to be taken over and the bonds have a very high probability of being wiped out. And I think that is not the case. If you have a diversified exposure to that, you know, prudence is still warranted, but if you have diversified exposure to regional bank credit, I think you're going to do very well from these levels.

Katie Klingensmith [00:09:40] And what about you, Brian? Not just regional banks, but you, in a multi-sector approach, are really thinking about risk everywhere. Do you feel like the worst is behind us, or are you thinking about mitigating particular or broad risks across all of the different allocations?

Brian Kloss [00:09:56] Great question, because this is what we're assessing every day is risk. Let's build off of Bill's answer that we just heard from him a second ago. It's really about these banks and the policy response from the regulators. It's from the Treasury. It's from the Federal Reserve and their counterparts in Europe as well. But has this crisis been averted? It will be. The question is going to be when will it be and how will it be averted? One of the things that we do have to think about, and I know we're trying to be forward-looking with these and think about this, but to some extent, one of the challenges that you have is this is psychologically driven. When you wake up and the first thing you see on your phone overnight is that there's a risk within a bank somewhere. You text that to a friend and your friend texts that to somebody else. We've got to some extent a little bit of an issue in that maybe we're even over-talking about this, and everybody knows about that. And it makes the regulators job as well as the Treasury and the Fed's job a little bit harder because they need to counterbalance something that they're not traditionally used to having to deal with. It's a new issue for our age in this digital age. So, the crisis hasn't been averted yet. It's in the process of being averted. They're taking the steps just like we saw in the financial crisis. There was a methodology that played out, and that's what we're going to see again. Again, we just don't know exactly how much we have to do or where it's going to be. But I think, as Bill highlighted, it's going to be something along the lines of maybe the mergers, which could be very interesting, and a little bit more of some support from some of those parties that I just mentioned a second ago.

Katie Klingensmith [00:11:49] So, Brian, I want to stay with you. It feels like some of these, the risks that have materialized recently are idiosyncratic or about specific institutions. But is it, by chance, more interesting to think about exposures outside of the US than in the US, given the risks within the US right now?

Brian Kloss [00:12:06] Maybe, only because there might be other risks outside of the US at this point in time. And once you see one percolating up, you might see another percolate up. And so, Europe may not be out of the woods yet. And does that have any type of contagion to other areas of the world? But I think generally your concept and idea is right. It's just we have to make sure that there aren't those risks as we look to those other regions. As you think about those types of regions, maybe Asia might be one of those areas that could be attractive. And then we have to assess what the relationship is and how tight it is if you think about Latam and South America to the US. Is there a knock-on effect? Is there that proverbial "If the US sneezes, the rest of the world catches cold"? So does that impact Latam and Central America? Those are the issues that we're going to be looking at and thinking about as we go through this. But I would actually argue, yes, we should be looking everywhere and where those opportunities are if we have that type of risk appetite in our mandates.

Katie Klingensmith [00:13:06] Thank you. And I just want to pull this all together with Bill. We're talking about idiosyncratic risks. We're talking about psychology. Just going forward, are you seeing opportunities? What do you think will come next?

Bill Zox [00:13:16] We're absolutely seeing opportunities. And when you do a podcast like this, that's typically a good sign that there's a lot of opportunities in the marketplace. But you have to be careful. I mean, you know, the most important thing is to live to play another day. And if you think back to the 2008 example. If you survived as an investor in financials into November of 2008, you were going to do incredibly well from that point forward, especially if you're talking about investing higher up in the capital structure than the equity. And I think more broadly speaking, as debt investors, I would say the same thing today. We are creating a number of fantastic opportunities. You just need to be prudent in dealing with liquidity, in dealing with mark to markets. And then you should be in a very good position to generate returns from here until we resolve these issues.

Katie Klingensmith [00:14:23] Well, thank you so much for that perspective, Brian Kloss and Bill Zox from Brandywine Global. We appreciate everyone for participating today.