Banks: the winners and losers

Financial markets ended Friday in some turmoil, due to the dilemma over the strength of bank lending.

In a rapidly appreciating interest rate environment, banks are usually the core winners as interest spreads and ongoing interest loan differentials cause bank profit margins to rise. Great news for banks which until Friday have been a core appreciating sector in markets globally. No mistake, rising interest rates are good for bank profits, until, that is, concerns about default rates - the ability of borrowers to cover interest payments or indeed repay loans - also begin to rise.

Interest rates rising is inherently bank positive... raise them too far too quickly, however, and delinquencies on borrowings start to increase.

So, what has kicked off the present round of fear versus the jubilation we have witnessed during the past few months? As usual, it just takes one weakness in the system to set the hares running.

SVB, a tech led bank and lender in Silicon Valley, came under enormous pressure on Friday as clients threaten to pull cash (remember Northern Rock) from the lender. Its need to bolster its balance sheet by issuing $2.5bn of new shares has set the skids under the banking sector - specifically as its investment book has suffered significant losses and its regulatory capital needs strengthening. Debt delinquency is an issue for this tech led bank. The contagion risk is of course what the markets fear and the question is, 'who next?'.

We believe there is no need to fear an industry wide banking crisis, so let's not worry too much. The crash of 2008 resulted in regulators requiring the banking majors to substantially reinforce their capital ratios and this has ensured strength in depth across the banking industry. What the current market action will do is throw some doubt on the solidity of small or specialist banks - probably unfairly so. These specialists could be in for a very rough ride in the short term.

Looking more directly at the impact on portfolios, TAM had expected some form of increased level of debt delinquency and contrary to many market participants had not moved into the high yield debt market where the battleground is likely to unfold.

The spillover to small banking entities may dominate the press for the next few weeks, but should strong banks and AAA rated debts weaken in this environment, it becomes a very positive place to be considered for long-term portfolio holdings. Fear is probably much greater than fact in this case, and in our humble opinion, while the banking market is distinguished by many idiosyncrasies, this is a focused problem in a single banking area with specific exposures. HSBC have not bought an entirely lost cause.

In conclusion, we would be a buyer on weakness of high yielding AAA debt for portfolios.

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