Banking Crisis

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Trading Strategy

Thesis

We believe that the bank crisis will continue and this will negatively impact regional banks while benefiting large banks. We have created a trading strategy to capitalize on these short-term issues that will likely further disturb the banking industry.

Recommendation

- Put options for PACW & HMST & OVLY
- Buy stocks for JPM & BAC
- Buy 6 month treasury bonds as hedge

Market Overview

Market conditions have been volatile in the recent weeks as a result of central bank policies and turmoil in the banking sector. A few months ago Silicon Valley Bank, a financial institution with around $177 billion in deposits, filed for bankruptcy after the company suffered a bank run. This was followed by Signature Bank's bankruptcy as well. Despite the FDIC covering the deposits of both banks, the bankruptcies have led to increased tensions and contagion fears at other banks around the world with Credit Suisse as the next domino to fall, as the troubled company was bought by UBS for ~$3 billion after a $54 billion emergency loan from Switzerland National Bank failed to slow the large withdrawals made from the bank. These recent developments and uncertainties in the banking industry have led to a volatile stock market as investors worry about a worse than expected recession and as the economy digests a 25 basis point rate hike. More recently, the overall markets have been buoyed by renewed optimism in the economy; however, we believe that there is more negative news to come out for the banking sector.

High Inflation

Currently, the year-over-year US inflation rate is 4.93% based on most recent CPI numbers, which is slightly higher than the long term average of 3.28%. This rate is still higher than the 2% inflation target that has been a historic target for the Federal Reserve for generations. There continues to be signs that the inflation rate may be above 2% for a longer duration of time than what the market is expecting. Such a persistent and high inflation rate could lead to a recession and exacerbate the banking crisis. That is because during times of high inflation, the Federal Reserve will create tighter monetary conditions by raising interest rates and removing liquidity from the markets. Tighter monetary conditions lead to less cash in circulation which can severely harm companies, lead more people and corporations to default on their loans, and increase liquidity risk for businesses. Additionally, this liquidity risk will raise the likelihood of another situation where startups and businesses attempt to pull money out of banks, and therefore destabilize, or at worst, cause more regional banks to collapse.

Looming Recession

Many economists and institutions forecast a recession to come to the economy, and this has been accelerated by the recent trouble in the banking sector. The recession could potentially lead to further troubles in the bank sector, as consumption slows down, and more debtors default on their loans. Rising unemployment in combination with reduced consumer spending would lead to decreasing value for money. Loan losses will increase in a recession, and further worsen the recession as a result, causing more risks and failures in the banking sector.

Further Bank Troubles

One particular bank that is currently experiencing trouble as of now is Pacific West Bank, which tumbled more than 35% in early May due to news that there were an overwhelming amount of withdrawals. PacWest Bank haS been down 72% since the beginning of the year, and the recent bank closure of Silicon Valley bank and First Republic bank have all put pressure upon regional banks in California like PacWest. PacWest currently has over $41 billion in deposits, but most of it is invested and not available immediately. This means that if the bank were to see a large amount of withdrawals, PacWest will be unable to provide the money to everyone and therefore increase the likelihood of a bank failure and/or default. These scenarios are similar to the previous failures of regional banks and indicate that PacWest Bank may fall as well. This would also further validate the ongoing trend of banks falling one after the other like dominoes, and greatly weaken confidence in regional banks.

Trading Strategy

I believe that the bank crisis will continue to worsen and unfold over the next few months.In the process, other small and regional banks will see shareholder value plummet. Similar to the recent crises, damage in the regional banking sector will lead to a greater share of the banking industry for large banks. Based on these predictions, I will invest in large banks like BAC and JPM while shorting regional banks such as ARBV, HMST, and PACW. I chose these two banks because both are regional banks located in California, both with a relatively low market cap for banks, which makes them more at risk.

Action Plan Based on $200k Allocation

My action plan involves a conservative allocation of spending $25k to have exposure to large bank equity and another $25k to purchase medium-term put options on regional banks. These allocations are consistent with my thesis that the regional banking sector will see a downturn, and large banks will benefit in the long run from such a downturn. In this hypothetical portfolio, I will allocate another $150k on treasury bonds as a hedge as the bonds will provide high yield due to the high interest rate environment (1Y hovering at ~5.0%). In the event of an economic crisis, this portfolio's value will likely increase as bond prices will rise as investors flee to safety and as the market will expect further rate cuts.

Risks

The biggest risk for this strategy is that the bank crisis may be over exaggerated, and PacWest bank might not fall. This would undermine our belief that regional banks will fail, and as a result our strategy will not work. Although this is a possibility, the ongoing recession, in addition to the high inflation and rising unemployment all point towards a weakening economy, which indicate that the chances of bank failures are very likely, meaning that while the risks are high, they are also very unlikely to become true.

Summary

In summary, I believe that the banking crisis will continue, and in the process more regional banks will fall while benefiting large banks as a result. Based on this assumption, I have designed a strategy to purchase put options on regional banks and buy stocks for large banks while buying short term treasury bonds as a dependable hedge.

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