Omega Analysis Notes

Market Risk Alert: US Banks 6 November 2023

Some major US Banks are showing the warning signal that preceded the collapse of Lehman Brothers and Royal Bank of Scotland.

The US Banking System is in trouble. Large institutions (and the KBW Index) are giving the same warning signal of 'panic selling' that Lehman Brothers and the Royal Bank of Scotland did in 2008 in the lead-up to the GFC. Bubbles always correct because prices can't go to infinity. Asset prices in Anti-Bubbles *often* correct—but the difference is that prices *can* go to zero.

It is not just regional banks

Last March, when Silicon Valley Bank blew up, many people became aware for the first time of the damage that the rapid rise in interest rates had done to Regional Banks in the U.S. It's not just regional banks that are in trouble. And we're now in the era where "Taxpayers will not have to bear the costs of Wall Street's irresponsibility."[1]

Bail-ins are the new improved bank resolution mechanism with shareholders, bond-holders and uninsured depositors all being bailed-in (apparently without regard to their tax-payer status). At least that's how it was *supposed* to work. Until the decision was made to remove all the depositors at Silicon Valley Bank and Signature Bank from the bail-in list.

As CNBC reported: Treasury Secretary Yellen told the US Senate Finance Committee "Our banking system remains sound and Americans can feel confident that their deposits will be there when they need them." Under questioning, however, Yellen admitted that not all depositors will be protected over the FDIC insurance limits of $250,000 per account as they did for customers of the two failed banks.[2]

That won't work for large banks, even if Secretary Yellen wants to try

The depositor 'rescues' in the regional bank failures were paid for by shifting the burden to the FDIC's Deposit Insurance Fund contributors—the US banks. This will, inevitably, result in increased bank fees to customers—only without headlines about tax-payers bailing out banks. But such a manoeuvre is totally implausible for even a single major bank—and there's more than one that's in trouble right now.

Bubbles

Financial markets provide a 'view' on a traded company's health every day. But there's a long-standing debate about whether and to what extent market prices contain information about 'mis-pricing' such as bubbles in which the company trades at a price far above what it 'ought' to be. There are prominent economists on both sides of this question and in 2014 the Economics Nobel prizes went to Eugene Fama, who says that bubbles can't be identified in advance and Robert Shiller who says he does it all the time.[3]

(continued)

[1] Wall Street Reform: The Dodd Frank Act, White House Press Announcement 2010.

[2] Treasury Secretary Yellen says not all uninsured deposits will be protected in future bank failures. Christina Wilkey and Chelsea Cox CNBC Mar 16 2023 at 11 am EDT.

[3] What the Great Fama-Shiller Debate Has Taught Us. Justin Fox, Harvard Business Review Oct 14 2013.

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In the aftermath of the GFC, we showed that the necessary information is in market returns rather than prices. In particular, we showed that measured risk of loss in returns distributions can be used to identify an asset price bubble and to predict its eventual correction level.

The signal that triggers our 'bubble detector' is a persistent anomaly between measured levels of risk[4] for long and short positions an asset whose price is rising.

Our detector correctly accounts for all the major equity market bubbles from pre-1929 in the US to Japan in the 80s to the banks and global equity markets that collapsed in the GFC.

Anti-Bubbles

Our approach also predicts 'Anti-Bubbles' of panic selling when a price is falling. All the major banks that collapsed or came close to collapse in the GFC were in Anti-Bubbles from late 2007. Like Bubbles, Anti-Bubbles also come with a Correction Level—a level of price increase that will turn off the alarm. But Anti-Bubbles can also end when the price goes to zero. Exactly as it did for Lehman Brothers and the Royal Bank of Scotland. Goldman Sachs was in an Anti-Bubble when they negotiated the capital injection by Warren Buffet that kept them afloat.

Any bank in an Anti-Bubble is a dangerous counter-party

You don't need to be a shareholder of a bank to be endangered by an Anti-Bubble. Or a bond holder. You only need to be a counter-party to be caught up in the new, improved, bank resolution procedures. Just ask the Cypriots how this worked for them [5].

The US banking system is in trouble. Shares of banks in Anti-Bubbles can go to zero—just as they did in 2008. Whether you're a shareholder, bond-holder, counter-party, or short seller, you need to know which US banks are in Anti-Bubbles to successfully steer through what's coming.

A detailed overview of the US equity market conditions outlined above, including background on the statistical technology that supports them is available in forms from a written report, to an expanded presentation over a Zoom call, to bespoke versions with your chosen banks.
Contact : risk@OmegaAnalysis.com

[4] We use the 99% daily Expected Shortfall, the loss conditional on exceeding the 99% VaR as the risk measure.

[5] Bank of Cyprus's Bail-in Blues, Michalis Persianis, Wall Street Journal 29 July 2014 8:03 am ET.

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About Omega Analysis Research

William F. Shadwick is Managing Partner of Omega Analysis. During his previous career in mathematics he was responsible for establishing the Fields Institute for Research in Mathematical Sciences and worked in many prestigious institutions, including the Institute for Advanced Study, Princeton, the Mathematical Sciences Research Institute, Berkeley, IMPA, Brazil and the NASA Ames Research Center.

Ana Cascon, co-founder of Omega Analysis, was a tenured professor of mathematics at the Federal University Fluminense Brazil before moving from academic to industrial research.

Together they have pioneered a fundamentally new approach to the study of probability and statistics. Their revolutionary new tools, coupled with their no-nonsense approach, have yielded extraordinary results.

Since April 2020, these tools have been applied to the response to Covid-19. Thanks to this work it's now possible to make accurate estimates of hospital admissions even at the very beginning of an outbreak. It removes the rationale for panic that led to lockdowns all over the world—it would have correctly predicted demand for hospital beds everywhere from Wuhan onwards.

In what may have been the first time since the pioneering work of Kermack and McKendrick almost 100 years ago, they evaluated epidemic data without preconceptions and created a mathematical model that accurately describes viral dynamics. It correctly predicts critical stages in any viral epidemic such as the peak of infections and the onset of herd immunity. This model is an unprecedented tool for evaluating the effectiveness of interventions.

In 2018, Cascon and Shadwick were the winners in the Best Use of Technology category in Investment Week's Investment Research Awards for "building additional insights through the use of proprietary technology". In 2017, Omega Analysis was shortlisted in two categories, Best Research Report and Best Research Service in the Investment Week Research Awards. In October 2016, Omega Analysis came second, Highly Commended for 'Best Economic Research' in Investment Week's inaugural Research Awards.

Their published research on risk and performance measurement won both the 2010 Edward D. Baker III Journal Award and the 2007 Journalism Award of the Investment Management Consultant's Association.

In 2010, Shadwick was the University of Hawaii Mathematics Department's Distinguished Lecturer.

Omega Analysis Research risk@OmegaAnalysis.com

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