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The Archegos Crash Reveals Risks in the Shadow Banking System

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ANALYST INSIGHT

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Background

The interconnectivity of the global banking system and financial markets was made painfully clear over a decade ago in the Global Financial Crisis (GFC). This was observed as the failure of Lehman Brothers and Bear Stearns, and the near-collapse of AIG shook the entire global economy. Since then, modern and robust banking and financial sector regulations have been introduced, including Basel III, Dodd-Frank and other related regulatory reforms. Now, while the world has moved beyond this challenge, another, though less apparent, has surfaced in the form of shadow banks. Broadly speaking, these are entities that are unregulated but tend to offer 'similar' financial services and products as the regulated banking system. Since they aren't subject to traditional banking regulations, in the event of a crisis or emergency, they can't borrow from a central bank for liquidity purposes, which increases the likelihood of failure. Depending on the size of the entity and its indirect or direct interconnectivity to the overall financial system, its failure could have ripple effects that could shock the whole system.

A Crack in the System – Family Offices

Among shadow banks, Family Offices, represent one of the least regulated and can present a significant risk to markets and potentially, the wider financial system. Family Offices are 'investment vehicles' whose operations are typically funded using the personal wealth of ultra-high net worth individuals. Recently, once such family office, Archegos Capital Management, managed by an American investor, Bill Hwang, had a total meltdown that had a ripple effect on the wider market. To summarize the recent meltdown, Archegos held US$ 10 billion of its own money in assets, but the family office's exposure to equities was 5x more, at US$50 billion. How was this possible? Well, large portions of Archegos' equity exposures were facilitated through complex derivatives known as total return swaps. In short, using these swaps, Wall Street banks allowed Archegos to buy massive amounts of equity with limited up-front capital – thereby borrowing the excess from the banks. In addition to increasing the leverage and risk, these swaps allowed Archegos' equity positions to remain anonymous, though it held more than 10% in some companies, an exposure that would typically need to be reported to regulators.

Archegos's Implosion and Implications

Archegos' long position in ViacomCBS started to backfire as shares started to decline, putting strain on the family office as well as the banks that funded the leverage. To mitigate losses, margin calls were enforced by the banks and Archegos started to reduce exposure to several of its holdings. Of course, this only increased the selling pressure and drove stock prices down further. As a result, to cover their losses, the banks also began selling in massive blocks; thereby creating a chain reaction for several of Archegos' equity holdings while amassing losses for the banks. JP Morgan has assessed the conundrum and indicated that the losses to banks like Credit Suisse Group AG, Nomura Holding and several other banks could be as much as US$ 10 billion.

Lessons and Implications

The Archegos Capital Management debacle is simply a drop in the bucket of what can materialize if shadow banks are allowed to remain unregulated with no oversight. Additionally, it has shone a light on the hidden risk of the lucrative but opaque equity derivative business of large banks, that lever-up these shadow banking entities. Importantly, the regulations of the banking industry are significantly more robust than 2007/2008; creating a foothold of capital and liquidity to buttress fallouts and stem the potential ripple effects across the broader market. However, what remains unclear is just how massive and interconnected some of these shadow banks may be and in turn, the fall-out that could ensue if enough of them fail simultaneously. At present, however, the liquidity provided by the Federal Reserve, heightened optimism about the economic rebound and earnings growth continue to drive markets. The confluence of these could be masking potential risks, particularly surrounding derivative products that get very limited regulatory disclosures. The implication points to greater regulatory oversight which is already being touted by Elizabeth Warren and Treasury Secretary, Janet Yellen.

Concluding Thoughts

Importantly, Jamaica doesn't have these shadow banks that are completely obscured from regulators. The closest we've come has been the microfinance industry and the new Microcredit Act, 2021, is a positive regulatory step towards mitigating potential risks through mandated disclosures and regulatory oversight. With that said, the main risk continues to stem from overseas exposures and the shadow banking industry's connection to the wider system. This just means we must remain vigilant as the global shadow banking industry is massive, accounting for 48% of total financial assets at the end of 2018 according to Bank for International Settlements. Finally, this Archegos debacle merely underscores the importance of proper due diligence and proper asset selection, whether bonds or equities, at this stage of the cycle.

LOCAL EQUITIES MARKET

For the week ended Thursday, our local stock market improved week-over-week. The JSE Combined Index increased by 0.54%, the Main Market Index improved by 0.56%, the JSE All Jamaican Composite Index rose by 0.61%, the JSE Junior Market Index improved by 0.40%, and the JSE USD Equities Index increased by 3.44%.

During the week, 138 Student Living Jamaica Limited Variable Preference was the largest gainer, rising by 25.93% to close at J$5.44. The biggest loser was K.L.E. Group Limited which fell by 17.74% to close at J$1.02

As at the end of March, we continue to see Junior Market Equities outpacing their Main Market counterparts, as indicated in the table below.

As at Thursday April 1st, Overall Market activity resulted from trading in 102 stocks of which 47 advanced, 46 declined and 9 traded firm. Market volume amounted to 99,355,709 units valued at over $584,272,931.88. Mayberry Jamaican Equities Limited was the volume leader with 19,635,532 units (19.76%) followed by Transjamaican Highway Limited with 15,798,891 units (15.90%) and Derrimon Trading Company Limited with 11,512,742 units (11.59%).

Revisiting relevant news during the week:

Gross value added for the Jamaican economy declined by 8.3 per cent in the fourth quarter of 2020 when compared to the similar quarter of 2019. This was largely due to a decline in the services industries of 11.1 per cent.

That was one of the findings contained in the quarterly report done by the Statistical Institute of Jamaica (STATIN).
https://www.jamaicaobserver.com/business-report-front-page/quarterly-gross-domestic-product-down-8-3-_218384?profile=1056

While Latin America and the Caribbean (LAC) suffered more health and economic damage from the novel coronavirus pandemic than any other region, there is the potential for significant transformation in key sectors as the region begins to rebound, says the World Bank.

According to a new report by the bank, because of the pandemic, gross domestic product (GDP) in the Latin America and Caribbean region — excluding Venezuela — fell 6.7 per cent in 2020. While a return to growth of 4.4 per cent is expected in 2021, which compares to the bank's late 2020 forecast of a 7.9 per cent GDP decline in 2020, and four per cent expansion in 2021.

https://www.jamaicaobserver.com/business-report/recovery-offers-chance-to-build-back-better-in-latin-america-and-the-caribbean-says-world-bank_218238?profile=1056

Jamaica's central bank announced at the start of this week that it will continue to hold its policy rate at 0.50 per cent per annum in an effort to stimulate economic growth and aid recovery from the crushing effects of the novel coronavirus pandemic.

The BOJ, in a news statement this week, said that its decision to keep the policy rate at this level was aimed at facilitating speedy economic recovery and jump-start greater economic activities in the pandemic's aftermath. The bank further said that while the country's economic outlook remains uncertain, there was cautious optimism as vaccination programmes commence.

https://www.jamaicaobserver.com/business-observer-corporate-listing/boj-policy-rate-remains-unchanged-at-0-50-per-cent_218236?profile=1056

Index	01/04/2021	26/03/2021	31/12/2020	Week/Week	Year-to-Date
JSE Main Market	397,354.26	395,153.87	395,614.93	0.56%	0.44%
JSE Junior Market	2,996.49	2,984.70	2,643.38	0.40%	13.36%
JSE Combined Market	397,812.53	395,662.24	392,435.92	0.54%	1.37%
JSE USD Equities Market	210.27	203.28	186.3	3.44%	12.87%

INTERNATIONAL DEVELOPMENTS

The U.S. Centers for Disease Control and Prevention on Friday said fully vaccinated people can safely travel at "low risk" after the agency had held off for weeks on revising guidance that discouraged all non-essential trips.

The announcement lifting the agency's guidance that all Americans should avoid non-essential travel should assist the U.S. travel industry which is still significantly struggling since the Covid-19 crisis began in early 2020. The new CDC guidance specifically greenlights vaccinated grandparents getting on airplanes to see grandchildren.

https://www.cnbc.com/2021/04/02/fully-vaccinated-people-can-resume-travel-at-low-risk-cdc-says.html

Job growth boomed in March at the fastest pace since last summer, as stronger economic growth and an aggressive vaccination effort contributed to a surge in hospitality and construction jobs, the Labor Department reported Friday.

Nonfarm payrolls increased by 916,000 for the month while the unemployment rate fell to 6%.

Economists surveyed by Dow Jones had been looking for an increase of 675,000 and an unemployment rate of 6%. The total was the highest since the 1.58 million added in August 2020.

https://www.cnbc.com/2021/04/02/us-jobs-report-march-2021.html

March brought the strongest manufacturing growth in more than 37 years, and with it increasing indications about inflation pressures in the months ahead.

The Institute for Supply Management's monthly manufacturing survey registered a 64.7% reading, representing the level of companies reporting expansion against contraction. That translated to a 3.9 percentage point increase from February, and the highest level since December 1983.

Moreover, responses to various subcategories within the readings, as well as the written summations from survey participants, showed how tight conditions are in the sector.

https://www.cnbc.com/2021/04/01/manufacturing-boom-brings-more-signs-that-inflation-is-building-rapidly.html

A measure of U.S. manufacturing activity soared to its highest level in more than 37 years in March, driven by strong growth in new orders, the clearest sign yet that a much anticipated economic boom was probably underway.

The Institute for Supply Management (ISM) said on Thursday its index of national factory activity jumped to a reading of 64.7 last month from 60.8 in February. That was the highest level since December 1983.

A reading above 50 indicates expansion in manufacturing, which accounts for 11.9% of the U.S. economy. Economists polled by Reuters had forecast the index rising to 61.3 in March. The year-long Covid-19 pandemic has boosted demand for goods.
https://www.cnbc.com/2021/04/01/ism-manufacturing-march-2021.html

Index	02/03/2021	26/03/2021	31/12/2020	Week/Week	Year-to-Date
Dow Jones	33,153.21	33,072.88	30,606.48	1.64%	8.32%
S&P 500	4.019.87	3,974.54	3,756.07	2.82%	7.02%
NASDAQ 100	13,329.51	12,979.12	12,888.28	4.30%	3.42%
FTSE 100	6,737.30	6,740.59	6,460.52	0.94%	4.28%
Euro Stoxx 50	3,945.96	3,866.68	3,552.64	2.96%	11.07%

Local Economic Conditions

Local Foreign Exchange Market

- Our local currency appreciated by 0.15% against the U.S. Dollar week on week to settle at $146.42 as at close of trade Friday, relative to $146.19 per US$1.00 at the end of the prior week. Year to date, the Jamaican dollar has depreciated by approximately -2.42%.

Interest Rates and Inflation

- Since the onset of the pandemic in March 2020, market volatility has declined significantly. Notwithstanding, the BOJ maintains its position; supportive of the wider economy and continues to hold the policy rate at 0.50%.

- At this rate, based on its assessment, the BOJ notes that inflation will generally continue to remain within the target of 4.0% to 6.0% over the next two years.

- As at February 2021, point-to-point was recorded at 3.8%

- Barita's Collective Investment Schemes ("CIS") offer the opportunity for investors to remain invested in the market at this delicate stage of the market cycle; moreover, there is a diversification benefit and opportunity to have a professional portfolio manager make the best-in-class professional judgements on your behalf.

- The F.X. Growth Fund, which is benchmarked against the S&P 500, has decreased by 1.73% year to date.

- As at March 29th, 2021, the Capital Growth Fund has delivered a return of 2.53% relative to the JSE Combined and Main Indices which posted a returns of 1.37% and 0.44%, respectively.

- The FX Bond Portfolio remains an attractive fixed-income portfolio, particularly when viewed within the context of global interest rates which have declined significantly as central banks maintain low policy rates to drive the economic recovery.

Currency Pair	01/03/21	26/03/21	31/12/20	Wk/Wk	Year-to-Date
JMD: USD	146.8625	146.1942	142.6493	-0.46%	-2.95%
JMD:CAD	117.7642	117.0514	111.4117	-0.61%	-5.70%
JMD:GBP	202.4103	202.4294	193.6657	0.01%	-4.52%

Unit Trust Performance

- Year to Date, The Money Market Fund has increased by 0.60%, the FX Bond Portfolio has decreased by 0.63%, the F.X. Growth Portfolio decreased by 1.73%, the Real Estate Portfolio has increased by 1.55% and the Capital Growth Fund grown by 2.53%.

"The individual investor should act consistently as an investor and not as a speculator."

— Ben Graham

Unit Trust

Unit Trust Fund	29/03/2021	22/03/2021	Week/Week Return	Year-to-Date Return	1 Year Return	Yield
Capital Growth	87.0146	85.5060	1.76%	2.53%	14.83%	-
Money Market	14.8641	14.9227	-0.39%	0.60%	3.20%	1.69%
Income Portfolio	100.0000	100.0000	0.00%	-	-	2.27%
FX Bond Portfolio (US$)	1.3477	1.3446	0.23%	-0.63%	8.89%	2.06%
Real Estate Portfolio	5,925.6461	5,877.6126	0.82%	1.55%	1.47%	-
FX Growth Portfolio	0.9812	0.9921	-1.10%	-1.73%	20.48%	-

"There are at least three significant reasons we resist contemplating our personal financial goals: it can be stress-inducing, we dislike numbers, it is socially taboo, and we are slaves to "right now."

– Daniel Crosby, Personal Benchmark: Integrating Behavioral Finance and Investment Management

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Investment Playbook

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Equities

Stock Ticket	Stock Information (As at April 1st, 2021)	Analyst Outlook
WISYNCO Wisynco Group Ltd	P/E: 22.61x P/B: 3.95x Price: J$15.34 Div Yield: 1.17%	**OVERWEIGHT** The local fiscal support to both households and businesses was instrumental in maintaining individuals' consumption capacity, particularly those furloughed and made redundant, which supported the demand for consumer staples distributed by manufacturers and distributors Wisynco. We expect that with continued fiscal support through either direct household support or government spend on projects to stimulate employment, Wisynco's business will thrive in this environment.
LASM Lasco Manufacturing	P/E: 15.30x P/B: 2.50x Price: J$4.54 Div Yield: 1.34%	**OVERWEIGHT** The local fiscal support to both households and businesses was instrumental in maintaining individuals' consumption capacity, particularly those furloughed and made redundant, which supported the demand for consumer staples distributed by manufacturers and distributors LASM. We expect that with continued fiscal support through either direct household support or government spend on projects to stimulate employment, LASM's business will thrive in this environment. Given that more restrictive curtailment measures do not seem likely, LASM is likely to perform better than in the April - June quarter. The national curfew measures were particularly restrictive and, therefore, negatively impacted LASM's revenue growth.
LASD Lasco Distributors	P/E: 15.61x P/B: 2.22x Price: J$4.10 Div Yield: 1.24%	**OVERWEIGHT** The local fiscal support to both households and businesses was instrumental in maintaining individuals' consumption capacity, particularly those who were furloughed and made redundant, which supported the demand for consumer staples distributed by manufacturers and distributors as LASD. We expect that with continued fiscal support through either direct household support or government spend on projects to stimulate employment, LASD's business will thrive in this environment.

Ratings Definitions

OVERWEIGHT/BUY
Exposure to this asset should be between 5% and 10% of your total portfolio

MARKETWEIGHT/HOLD
Exposure to the asset should be equal to 5% of your total portfolio

UNDERWEIGHT
Reduce exposure in your portfolio to less than 5% for this particular asset

SELL
Reduce exposure in your portfolio to zero

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SEP Seprod Limited	P/E: 18.63x P/B: 3.17x Price: J$73.01 Div Yield: 0.41%	**OVERWEIGHT** Seprod has undergone significant structural changes within the last 5-years aimed at improving the underlying performance of the company. Within this period, particular emphasis has been placed on optimizing the distribution, warehousing and logistics capabilities of the company. This gradual, multi-year, improvement was accomplished through reinvestment within the organization coupled with strategic acquisitions aimed at increasing the distribution reach and quality of the company. Another major change was the closure of the Group's loss-making sugar division; a move that enhanced shareholder value. These changes have positioned Seprod to deliver robust growth through an expansive product mix and access to consumer markets both locally and regionally.
PROVENJMD Proven Investments Limited	P/E: 17.21x P/B: 1.10x Price: $34.45 Div Yield: 3.59%	**OVERWEIGHT** Given the current economic environment, characterized by low interest rates and increased uncertainty, PIL has shifted from the carry trade business to more private equity and real estate ventures, thereby allowing for diversification benefits to be realized - particularly as it relates to the "spreading" of risk. Given the business model of PIL wherein capital is used to acquire strategic assets, this APO is expected and should make the stock accessible to a wider pool of investors. At present, only a small subset of listed companies pursue private equity investments which makes PIL an attractive security for investors who want the liquidity the stock market provides as well as exposure to non-listed companies that can provide value.

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PROVENUS Proven Investments Limited	P/E: 18.04x P/B: 1.15x Price: US$0.25 Div Yield: 3.11%	**OVERWEIGHT** Given the current economic environment, characterized by low interest rates and increased uncertainty, PIL has shifted from the carry trade business to more private equity and real estate ventures, thereby allowing for diversification benefits to be realized - particularly as it relates to the "spreading" of risk. Given the business model of PIL wherein capital is used to acquire strategic assets, this APO is expected and should make the stock accessible to a wider pool of investors. At present, only a small subset of listed companies pursue private equity investments which makes PIL an attractive security for investors who want the liquidity the stock market provides as well as exposure to non-listed companies that can provide value.
SCIJMD Sygnus Credit Investments	P/E: 22.50x P/B: 0.49x Price: J$14.58 Div Yield: 2.46%	**OVERWEIGHT** Sygnus provides funding to Mid-Size firms within the lending market, which is considered to have a higher risk and generally overlooked by providers of traditional financing forms. This provides a largely untapped/under-tapped niche market within the Caribbean lending space for Sygnus, a few direct competitors. The flexibility in the financing terms offered by the Company is a clear advantage to borrowers, and it allows SCI to manage its credit risk to generate double-digit risk-adjusted returns on investments, which, consequently, bolsters shareholder value.
SCIUSD Sygnus Credit Investments	P/E: 26.67x P/B: 0.52x Price: US$0.12 Div Yield: 2.08%	**OVERWEIGHT** Sygnus provides funding to Mid-Size firms within the lending market, which is considered to have a higher risk and generally overlooked by providers of traditional financing forms. This provides a largely untapped/under-tapped niche market within the Caribbean lending space for Sygnus, a few direct competitors. The flexibility in the financing terms offered by the Company is a clear advantage to borrowers, and it allows SCI to manage its credit risk to generate double-digit risk-adjusted returns on investments, which, consequently, bolsters shareholder value.

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CCC Caribbean Cement Company	P/E: 18.64x P/B: 5.17x Price: J$70.10 Div Yield: 0.00%	**Overweight** Throughout the COVID-19 pandemic, all industries have been affected by what has been a significant downturn in aggregate demand as the pandemic has created a need for persons to reduce travelling and physical interaction. Despite this setback which predominantly materialized in Q2 of 2020, the construction industry has rebounded significantly (7.0% in Q3 2020 and 6.2% in Q4 2020), ahead of many other industries and well ahead of the overall economy. This strong growth over the last two reported quarters has been a significant tailwind for Caribbean Cement and the company has consequently seen a significant increase in the demand for its product, well in excess of previous years. On the heels of what has been a great year for the company, management expects demand to increase further, fuelled by upcoming government projects that will require substantial cement deposits. The recent government budget lends to this expectation as one of the main components of the government's SERVE Programme is infrastructure development. With that said, the company is positioning itself to meet this demand while maintaining its more efficient cost structure which was displayed in 2020, chief among these was the reduction of debt, which in turn reduced the company's cost of debt.

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