Another volatile day for financial markets

Tensions that may ultimately help bring down inflation

IN A NUTSHELL

- The previous day's calm was followed by another day of violent fluctuations on the markets
- Expectations for further rate hikes have been almost completely priced out by markets, current valuations now imply rate cuts before the end of the year
- Compared with the period before the financial crisis, systemic risks are significantly lower, however, some bumps in the road can still be expected

Markets reel but keep working

On the fourth day of trading since the announcement of the insolvency of Silicon Valley Bank (SVB), the mood in capital markets worsened. Those who assumed, given Tuesday's recovery, that the in some cases record-high market movements of Monday (see below) merely reflected a shock, low trading liquidity and hasty liquidations of positions, were proven wrong.

Instead, tensions rose, especially in Europe, after a major European financial institution came under investor scrutiny. Europe's equities lost another 1.5% from Monday (Stoxx 600), high-yield corporate bond risk premiums in Europe and the U.S. widened again[1] and in the U.S. the regional bank index[2] closed on a lower level than on Monday. Once again, however, it was the bond markets that showed the biggest movements. 2-year Bunds were yielding 2.39% at the close of trading (Monday: 2.67%), 2-year U.S. Treasuries slipped below four percent again, while 10-years slipped below the 3.5% mark for the first time since early February. The market now no longer expects a single further interest rate rise from the Federal Reserve (Fed), but three rate cuts by the end of the year. Viewed in isolation, this sends the same signal as the commodities market: the expectation has become that there will be a significant decline in economic activity this year. Brent crude has lost nine dollars within three days and is now trading at 74 dollars a barrel.

But, despite all this turmoil, many areas of the market continued to function well. The typical hedging instruments did their job from a portfolio perspective: Government bonds, gold, and, at least in the U.S. equity market, three defensive sectors ended in positive territory, as did the dollar, which had been weakening on Monday.

Systemic risk should not be the issue

Indeed, despite all the short-term extreme volatility, we think it's important not to lose sight of the somewhat more reassuring bigger picture. Central banks want to get a grip on inflation and need to cool down the economy to do so. It is probable that they have moved a lot closer to their goal over the past few difficult days. For example, inflation expectations for the Eurozone

[1] Bloomberg U.S. High Yield OAS and Bloomberg EUR High Yield OAS, Source: Bloomberg Finance L.P. as of 3/15/23
[2] KBW Regional Banking Index

over the next 10 years, derived from inflation-indexed bonds, fell to 2.27%, 0.4 percentage points below the peak seen at the beginning of the month.
However, the ferocity of this week's market reaction suggests that investors are concerned about systemic risks. But we maintain our view that there are more differences than similarities between the 2008 financial crisis and today. The following should be noted:

- Every pronounced Fed rate-hike cycle has its victims: the crash of 1987[3] the Tequila Crisis in 1994[4], the bursting of the dot-com bubble in 2000 and the housing bubble in 2007, all the way to the volatility crash of 2018. But the Fed's current hiking cycle is the sharpest in decades and comes when the post-Covid global economy is still out of balance.
- Yet, until the events of the last few days, this rate-hike cycle has been surprisingly smooth and orderly. At first glance this seems encouraging but it has also made central banks' inflation fight more difficult. The hopes many in the markets have cherished, that inflation could be controlled without major blows to the real economy, may have been finally disappointed this month. For now, however, we do not expect a real recession, either in Europe or the United States.
- This confidence is ultimately fed by the differences from the 2007/08 crisis. Regulators and central banks have learned their lessons: Banks were forced to strengthen their capital base, reducing their leverage and increasing their capacity to absorb losses. In addition, liquidity parameters were imposed on financial institutions to prevent short-term payment problems. SVB escaped some of this regulation because of its relatively small size. Other important differences are that: the interbank market now plays hardly any role in short-term bank refinancing; derivatives trading is largely handled by clearing houses; and, above all, banks hold significantly fewer problematic assets on their books.
- In addition, compared with 2008, central banks, regulators and other public institutions have a much broader arsenal of instruments to respond to problems rapidly. As last night showed, European regulators, central banks and other institutions are also standing by to respond promptly and proactively. For example, a major Swiss bank in focus is receiving liquidity assistance of 50 billion Swiss francs from the SNB.
- Of course, indicators that signal systemic stress in the financial system have reacted. But the stress they are showing is only moderately higher so far. Examples include the Composite Indicator of Systemic Stress (for the Eurozone) and the Office of Financial Research (OFR) Financial Stress Index (for the U.S.).

Given the violent market movements, it nevertheless cannot be ruled out that individual market participants may become distressed.

What's next?

Whether making interest-rate decisions in the midst of such volatility is a help or a hindrance for a central bank is probably something that can only be judged in retrospect. The Fed has a chance to learn from any European Central Bank (ECB) mistakes, since the ECB announces its decisions today, while the Fed will not do so until next Wednesday. At this point we still expect the ECB to raise rates by 50 basis points (bps), and the Fed by 25 bps. Keeping rates steady could be misunderstood by the markets, fueling rumors that central bankers know more, and that their further knowledge is not reassuring.

Apart from that, of course, it is still vital to get inflation under control. Tuesday's U.S. core inflation print, 5.5% percent year-on-year, only 0.1 percentage points lower than the January figure, certainly did not sound the all-clear. Verbally, however, the central banks are likely to go to great lengths to convince the markets that they have emergency weapons and are ready to use them. We think the central bankers will only get really nervous if the market turmoil leads to a broader credit crunch. But the tensions of the past few days could make banks more cautious in their lending and keen to cut back on risky commitments. That would be very much in line with what the central banks want.

[3] On October 19, 1987, also referred to as "Black Monday", stock markets globally crashed in response to a general feeling of overvaluation in markets after a combination of news triggered market participants to start selling.
[4] In 1994, the Mexican peso almost collapsed as a currency peg to the dollar, high amounts of debt issued in U.S. dollars and rising interest rates in the U.S. caused foreign reserves to dwindle

Glossary

One basis point equals 1/100 of a percentage point.

Brent crude is a grade of crude oil dominant in the European market.

In financial markets, a clearing house acts as an intermediary between buyers and sellers, ensuring that both will honor their contractual obligations.

Core government bonds are debt securities issued by especially credit-worthy governments both within the Eurozone and in other developed markets.

Core inflation excludes items which can be susceptible to volatile price movements, e.g. food and energy.

A corporate bond is a bond issued by a corporation in order finance their business.

Defensive stocks are stocks from companies whose sales are expected to fluctuate less than the market average as the demand for their products are less tied to business cycles.

The derivatives market is the financial market for derivatives.

The European Central Bank (ECB) is the central bank for the Eurozone.

The Eurozone is formed of 19 European Union member states that have adopted the euro as their common currency and sole legal tender.

A hedge is an investment to reduce the risk of adverse price movements in an asset.

Inflation is the rate at which the general level of prices for goods and services is rising and, subsequently, purchasing power is falling.

Leverage attempts to boost gains when investing through the use of borrowing to purchase assets.

Liquidity refers to the degree to which an asset or security can be bought or sold in the market without affecting the asset's price and to the ability to convert an asset to cash quickly.

The risk premium is the expected return on an investment minus the return that would be earned on a risk-free investment.

The Swiss National Bank (SNB) is the Swiss central bank.

The Stoxx Europe 600 is an index representing the performance of 600 listed companies across 18 European countries.

Treasuries are fixed-interest U.S. government debt securities with different maturities: Treasury bills (1 year maximum), Treasury notes (2 to 10 years), Treasury bonds (20 to 30 years) and Treasury Inflation Protected Securities (TIPS) (5, 10 and 30 years).

The U.S. dollar (USD) is the official currency of the United States and its overseas territories.

The U.S. Federal Reserve, often referred to as "the Fed," is the central bank of the United States.

Volatility is the degree of variation of a trading-price series over time. It can be used as a measure of an asset's risk.

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as of 3/15/23; 095052_1 (03/2023)

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as of 3/15/23; 095053_1 (03/2023)