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Weekly Market Flash

Has the arrival of a recession been accelerated?

March 19, 2023

It was another intense week for financial markets, with plenty of volatility and market reversals following the news from Europe and the US. Despite the tension and the feeling of an emerging crisis, the MSCI World index closed the week flat, up one basis point (bp)! But the divergence was huge at the sector level, with European and US banks taking a beating with declines of 13.4% and 14.5%, respectively. To better highlight the weekly index trends (in line with our expectation that these divergences will remain strong in the coming months), we have added a column to our financial assets table (Figure 1). Another winning investment theme of the past few months, the energy sector, took a beating, with the index down 6.85% this week, or -11.1% since the beginning of the year. But let's take a closer look at the main events of the week, before making a general comment on the situation.

Highlights

- Following the bank crisis, US banks borrowed USD152.9 billion through the emergency lending program and another USD11.9 billion through the new Bank Term Funding Program.
- The ECB raised its benchmark rate by 50 bps, while the communication clearly highlighted the prevailing risks to the economic and inflation outlook.
- The main liquidity indicators of the interbank system reached crisis levels: the 3-month FRA-OIS spread returned to +57 bps and the 3-month cross-currency basis swap to 38 bps.
- The Swiss National Bank announced a EUR50 billion liquidity facility available to Credit Suisse. The bank will use it to shore up its liquidity and buy back some senior bonds to reduce debt.
- Over the course of the week, USD121 billion flowed into money funds, which is the largest flow since the week of 15 March at the onset of the pandemic.

"Banks borrowed USD152.9 billion and another USD11.9 billion, effectively reversing the Fed's QT..."

Markets & Macro | Has the arrival of a recession been accelerated?

Liquidity indicators reach crisis levels.

In the aftermath of the regional bank crisis (triggered by the bank run on SVB last week), Federal Reserve (Fed) data showed that banks borrowed USD152.9 billion through the emergency lending program and another USD11.9 billion through the new Bank Term Funding Program (BTFP), effectively reversing the Fed's QT (which had reduced the balance sheet by almost USD600 billion over the course of a year). Meanwhile, the European Central Bank (ECB) raised its benchmark rate by 50 bps and gave no indication of the next path of rates. The ECB communication clearly highlighted the prevailing risks to the economic and inflation outlook.

"...while we do not believe in a systemic crisis, the issue of competition for deposits diminishes the profitability of banks, even more so in a recessionary environment."

Figure 1: Year-to-Date Performance of Major Indices

Equity Indices	Last Value	Week	Ytd
MSCI World	2,656.19	0.01%	2.51%
Nasdaq	11,630.51	4.44%	11.36%
S&P 500	3,916.64	1.47%	2.40%
DJ Industrial	31,861.98	-0.11%	-3.35%
Nikkei	27,333.79	-2.88%	4.82%
Eurostoxx	4,064.99	-3.87%	7.53%
Swiss SMI	10,613.55	-0.84%	0.16%
FTSE 100	7,335.40	-5.20%	-0.64%
Canada	19,387.72	-1.83%	0.69%
Shenzen	3,958.82	-0.21%	2.28%
Hong Kong	19,518.59	1.03%	-0.96%
MSCI EM	951.56	-0.26%	-0.21%

Equity Sectors	Last Value	Week	Ytd
S&P value	145.35	0.04%	0.19%
S&P Growth	61.05	2.74%	4.36%
S&P Defensives	1,497.44	2.33%	-2.09%
ARK Fund	38.68	7.38%	23.82%
Fangs	5,764.38	9.08%	29.64%
S&P Banks	78.80	-14.49%	-21.32%
Euro Stoxx Banks	76.97	-13.40%	1.24%
S&P Energy	76.97	-6.85%	-11.09%
Gold Miners	30.58	12.43%	6.70%

Commodities	Last Value	Week	Ytd
BBG Commodities	102.59	-1.87%	-9.05%
BBG Agriculture	67.02	0.08%	-2.63%
Gold	1,989.24	6.48%	9.06%
Silver	22.60	10.04%	-5.65%
BBG Brent Crude TR	916.40	-11.04%	-13.70%
BBG WTI Crude Oil TR	160.02	-12.75%	-16.34%

FX	Last Value	Week	Ytd
DXY Index	1,246.67	-0.55%	0.01%
Bbg JP ASIA	100.87	0.49%	-0.32%
Bbg JP LATAM	39.76	-1.74%	0.05%
EUR/CHF	0.9879	0.78%	-0.17%
GBP Index	629.92	0.94%	1.14%
EM FX Index	1,675.48	0.55%	0.90%
USD/JPY	131.85	-2.36%	0.56%
USD/CNY	6.89	-0.44%	-0.17%
Bitcoin	27,343.03	36.02%	65.32%

Bond Indices	Last Value	Week	Ytd
US Inv Grade	107.99	1.10%	3.11%
US High Yield	73.37	-0.10%	0.73%
Euro Corps	231.51	0.50%	1.69%
JPM Europe Govies	9,764.58	2.08%	5.80%
US Treasuries	2,258.35	1.60%	3.20%
China Aggregate	259.80	1.45%	1.78%
EMBI Global	777.34	0.25%	1.18%
EMBI Local	125.68	-0.42%	1.61%

Source: Bloomberg, as at March 17, 2023. Performance figures in indices' local currencies.

The heavy losses of European banks have increased the stress levels in money markets. The main liquidity indicators of the interbank system reached crisis levels, not comparable to 2008 levels, but still very high. The 3-month FRA-OIS spread returned to +57 bps (from a physiological level of 10-15 bps) and the 3-month cross-currency basis swap to 38 bps (the cross-currency swap represents the additional cost that the interbank market is willing to pay to secure funding in USD using the EUR swap market). It was a key measure of stress both during the 2008 financial crisis and during the onset of the pandemic in March 2020.

The Swiss National Bank announced a EUR50 billion liquidity facility available to Credit Suisse. The bank will use it to shore up its liquidity and buy back some senior bonds to reduce debt. In addition, FINMA and the central bank issued a statement underlining Credit Suisse's capital strength and confirming that the bank complies with all stringent capital soundness rules. Finally, it is likely that a final solution to the bank's crisis will be announced in the next few hours/days, through the acquisition by a solid player (there is talk of UBS) and the disappearance of the Credit Suisse brand.

"Today's picture, despite the constant references by commentato-rs, looks very different from that of 2008."

Over the course of the week, USD121 billion flowed into money funds, which is the largest flow since the week of 15 March at the onset of the pandemic. This flow clearly shows the movement that is taking place, and it is the reason why the banking sector is unlikely to recover in the short term: while we do not believe in a systemic crisis, the issue of competition for deposits diminishes the profitability of banks, even more so in a recessionary environment (with less consumer spending and potential bad loans).

Our view: Today's picture, despite the constant references by commentators, looks very different from that of 2008. The banking system, in aggregate, looks more solid to us. Compared to 2008, there are some major differences: 1) banks' assets are not deteriorating in quality as they did then; 2) banks no longer have to mark-to-market their assets, so that if the market value of assets declines, this does not lead to balance sheet crises; 3) capital requirements have been raised considerably as a result of the crisis and collateral instruments such as the Liquidity Coverage Ratio have been introduced.

From a macro point of view, there are also some big differences between today and 2008: the economic system is highly indebted, as it was then, but the debt burden in 2008 was borne by households (through mortgages, often against very poor quality assets). Today, the highest portion of debt is borne by governments, which have continued to borrow gradually to prolong the recovery cycle after 2008, until the surge following the pandemic and the support programs for citizens and businesses to compensate for the shutdown of economies. Moreover, we are now in a high inflation environment, which on the one hand slowly makes government debt more sustainable, but on the other hand, will make central banks' choices more difficult—as they will have to choose, at some point, between supporting the economy and making the high inflation regime permanent.

"The latest events make it more likely that the recession will arrive soon..."

As a result, our positioning remains extremely defensive on portfolios in view of the coming economic recession. The latest events make it more likely that this will arrive soon: while central banks, starting with the ECB, continue to raise rates (it is quite likely that the Fed will also raise rates, albeit by a quarter percentage point, next week), the banking crisis has the immediate effect of further tightening lending standards for corporate and household credit (a process that has already begun since the end of 2022). Since we believe that central banks will soon have to abandon their hawkishness in order to cope with the problems in the economy, we quickly added a new position to our asset allocation—we bought an ETF on Gold Miners (GDX), which should benefit from the rise of precious metals in this macroeconomic environment. As you can see from Figure 2, gold seems to have broken through important technical levels in both absolute and relative terms (versus the S&P 500 index).

Figure 2: Gold Breaks Through Technical Levels

Source: Bloomberg, as at March 17, 2023.

Equities | Is the tide going out?

Diebold is unlikely to be a single case.

Major equity indexes closed mixed for the week as the probability of a recession rose due to the stresses across the banking sector. Investors sought refuge in the lightly-indebted technology sector, especially the Mega Tech stocks that have ample of cash on the balance sheet and are highly free cash flow generative. Financials and energy shares, with the latter being a crowded traded, suffered the most.

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The banking sectors' woes (SVB, First Republic and Credit Suisse) appeared to divert investor attention away from the inflation reports of the week. Within the industrial sector, Diebold Nixdorf (a highly leveraged manufacturer of ATM machines) saw its share price drop by 58% on Friday after the company cited "near-term pressure on liquidity" as banks tightened lending criteria.

"…we believe we have reached the moment where the tide is going out and we are about to discover who has been swimming naked."

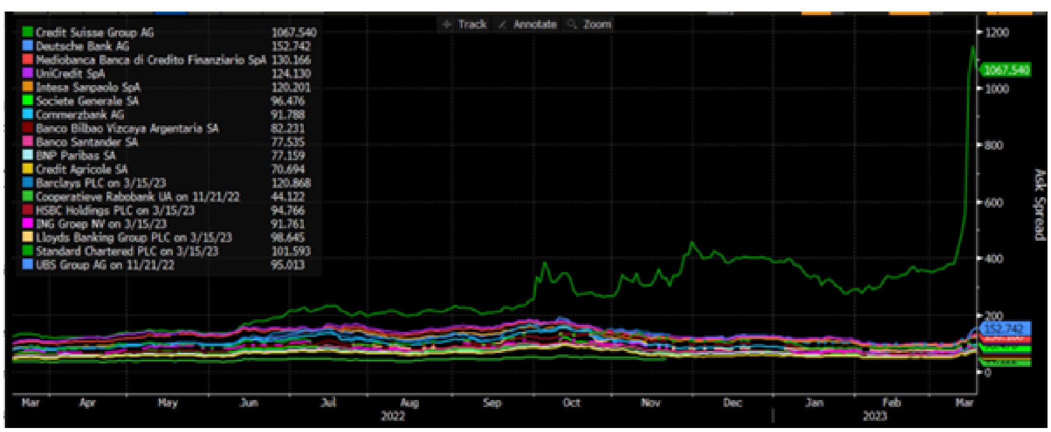
Our view: The fallout of the banking stresses is already having an impact on sectors and companies with high levels of indebtedness. Diebold's high levels of leverage and slow inventory-to-revenue conversion rate is unlikely to be a single case. Years of loose monetary policy caused investors to undervalue management teams with prudent capital allocation skills, and often rewarded those taking excessive balance sheet risk. To paraphrase Warren Buffett, we believe we have reached the moment where the tide is going out and we are about to discover who has been swimming naked.

Fixed Income | Credit Suisse volatility likely to remain elevated

Spreads on sub and senior debt reach widest since December.

The week was a stark reminder of the financial crisis of 2008. As always, there are differences. The problem now is rapidly rising rates, not mortgages—and the problem seems much less systemic. But now, as then, the complacency of investors willing to give money to unprofitable tech startups, cruise lines grappling with a pandemic, or retailers relying on dying malls, is rapidly fading. Moreover, persistently low rates pushed investors to buy long-dated bonds and venture further down the rating spectrum and capital structure. Although investors knew that central banks were raising rates, they hoped that inflation would come back under control with minimal pain for bondholders. Over the past week, these hopes have evaporated. A number of medium-sized US banks had to be bailed out, and Credit Suisse, massacred on the stock market and by CDS vigilantes, had to get help from the Swiss National Bank.

Figure 3: Major European Banks CDS



Source: Bloomberg, as at March 17, 2023.

"Credit Suisse has been an outlier for months, while the rest of the sector is more tightly packed together…"

As noted by Jim Reid from Deutsche Bank, in 5-year CDS terms, Credit Suisse has been an outlier for months, while the rest of the sector is more tightly packed together, and no other European bank has traded beyond its 2022 CDS wides in this selloff. Nevertheless, spreads on US high grade corporate bonds widened to 163 bps, the widest since mid-October (over the last three years, high grade spreads averaged 124 bps, while for the 20 years the average was closer to 157 bps). The gap between spreads on a basket of financial sub debt and senior debt reached its widest since December. US junk bond yields climbed above 9% for the first time this year. With CDS on Credit Suisse still signaling distress, the 2-year German yield is anchored around 2.40% (the black line), down from 3.31% at the start of March.

"...the ECB sent out a message of double confidence about its resolve to quell inflation, while underscoring its confidence in the solidity of the European banking framework."

Figure 4: 2-year Government Bond Yields

Source: Bloomberg, as at March 17, 2023.

Our view: On Thursday, when the ECB raised interest rates, President Christine Lagarde made a clear demarcation between monetary policy and the tools it owns to ensure financial stability. Hoping that this will not be a "Trichet moment", the ECB sent out a message of double confidence about its resolve to quell inflation, while underscoring its confidence in the solidity of the European banking framework. Should the turmoil surrounding Credit Suisse be resolved, German 2-year bonds face considerable downside from here.

According to UBS Research, Credit Suisse announced a cash tender offer for 10 USD-denominated senior Operational Company (OpCo) bonds for an aggregate consideration of up to USD2.5 billion. These are short-dated bonds (maturities 2023-2025) with a notional value of USD13.2 billion. In addition, Credit Suisse announced a separate cash tender offer on four EUR-denominated senior debt securities for an aggregate amount of up to EUR500 million. The EUR buyback covers a notional EUR4.7 billion of senior OpCo bonds. Credit Suisse is offering to buy them back at attractive premiums (say 2-7 points above the close on 15 March). With the buyback, Credit Suisse is looking to restore liquidity on the bid side, optimize interest expenses and take advantage of current trading levels to repurchase debt at attractive prices. Tendering for Holding Company (HoldCo – CS Group) bonds with material lower cash prices would have been more financially beneficial, but it could have been met with regulatory resistance given the instruments fulfil a purpose as bail-in capital.

"Investors need to remain cautious on Credit Suisse's preferred and non-preferred senior bonds..."

Figure 5: HoldCo Loss Versus OpCo

Source: Bloomberg, as at March 17, 2023.

Credit Suisse is currently rated A3 negative / A- stable (Credit Suisse AG) and Baa2 negative / BBB- stable (Credit Suisse Group), and the risk of an average one-notch downgrade for Credit Suisse's holding company can't be ruled out. Therefore, investors need to remain cautious on Credit Suisse's preferred (PS) and non-preferred (NPS) senior bonds and expect headline risk to remain elevated, resulting in elevated price volatility for all outstanding debt.

Against this backdrop, our view remains unchanged and cautious. We stay up in credit quality and prefer investment grade corporates, which in the case of a recession should experience less spread widening. For the moment, we are avoiding the lowest rated bonds (especially below BB-). We are wary of subordinated credit, which tends to be more correlated to equity markets, and they would likely decline in a recessionary environment.

Week Ahead | Key events to watch for

- **There's more central bank action next week with the Fed and the BoE**. Both are expected to hike, likely by 25 bps. The Fed meeting will be extremely critical given the context in which it arrives, and the fact that it coincides with the committee's review of economic forecasts.
- **On the data front, we will see global flash PMIs,** US durable goods orders and sentiment indicators in Europe. In Japan, all eyes will be on the CPI report.
- **On the geopolitical front, Chinese President Xi Jinping** will be in Moscow from Monday to Wednesday.

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