

Fed and Treasury won't come to the rescue

The Fed stuck to its inflation-fighting script yesterday, pointing to other tools available for fighting market stress. Markets didn't really appreciate it – but it does suit our script.

IN A NUTSHELL

- A 25bps hike with a view of further hikes and no rate cuts in the cards was the Fed's message.
 - Also, no need for immediate further rescue packages for the U.S. banking sector. The Treasury agreed.
 - Markets did not appreciate these statements, fearing further banking troubles and eventually a recession. We are more sanguine.
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Two weeks into troubled markets

Completing the second week of market routs evoked by banks in trouble, a quick take would be: 1. While the U.S. Federal Reserve (Fed) almost exactly copied what the European Central Bank (ECB) did last week, the market responded much more friendly to the ECB than to the Fed. 2. European banking troubles seem to have peaked for now as UBS's takeover of Credit Suisse is considered a success, at least from a market perspective¹. In the U.S., however, problems of (regional) banks (shrinking deposits, the cheapest form of funding) seem anything but fixed. Half of the banks from the KBW Bank index are down by more than 25% for the month.

While the Fed's 25 basis points (bps) rate hike came in as expected by most, we believe it was a toxic mix of other ingredients that unnerved markets yesterday: 1. Treasury Secretary Janet Yellen's refusal to provide "blanket" deposit insurance to U.S. banks. 2. Fed chair Jerome Powell's refusal to pre-commit to any measures that would help ease the pain for regional banks, stressing the need to prioritize inflation-fighting. 3. The realization that any Fed rate cut may be a long way off, while economic cooling might come faster and more violent than hoped for. That's at least what U.S. markets said by the end of trading: the S&P 500 down by 1.65% and 10y U.S. Treasury yields down 18bps.

We stick to our 12-month forecasts as we know (and knew when we made these forecasts) from history that stark rate-hiking cycles could lead to financial casualties. However, there might be some downside risk to our U.S. 2023 gross-domestic-product (GDP) growth forecast of 0.7% given the structural problems facing U.S. regional banks and given their importance in providing financing to local business, real estate and households alike.

¹ UBS's shares trade "only" 10% below pre-crisis levels while credit protection has recovered from a peak of 244 to now 148. Source: Bloomberg Finance L.P. as of 3/22/23

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Fed meeting: not giving in to markets' wish list

As we expected, the Fed raised interest rates by another 25 basis points despite the lingering uncertainties surrounding financial stability. Nonetheless, it indicated that the rate-hike cycle might come to an end any time soon, stating "some additional policy firming" may be appropriate instead of "ongoing increases." Fed members also did not increase their median expectations of the terminal rate in 2023 but indicated to keep rates higher for longer. Members still judge the inflation risk to be on the upside despite the expectations of somewhat lower growth in 2023. The labor market's increased resilience might explain this. For 2025, however, central bankers seem to be confident to be able to tame inflation.

In the press conference, Powell explicitly pointed to the effectiveness of their recent actions to support troubled banks. Just like the ECB, he made the distinction between macroprudential measures and interest rates. He also clarified that "some additional policy firming" was referring to their monetary policy tools and not to external factors like an escalation of financial stress. Nonetheless he admitted that credit tightening "in a way substitutes for rate hikes."

Overall, it seems that the Fed is happy that financial conditions are finally acting on their behalf. To what extent remains to be seen. Despite this uncertainty, we think it is safe to assume that inflation remains the most prominent factor in the Fed's reaction function. As Powell stated that further rate hikes will be very data dependent, we expect market participants to closely watch inflation and credit standards when assessing the most likely path of monetary policy. Our expectation is for the Fed to deliver another 25bps hike in May and maybe another one in June. The markets, however, expect three rate cuts before the end of this year already. We therefore leave the final word to Powell: "Rate cuts are not in our base case."

Markets no longer in panic, but not bullish either

While U.S. markets didn't really like what they heard yesterday, they are not in panic mode. Most equities are still up for the year to date and equity volatility (Vix) has come down over the past two days. But while the S&P 500 has only lost 1.4% so far this month, there was a lot more going on below the surface. Financials are down 12% for the month, followed by real estate equities (-9%), while tech is up 6% on average². With financials now only accounting for 10% of the market cap of the S&P 500, compared to 20% twenty years ago, tech stocks were able to save the month. In Europe, real estate is the loss leader of the month (-14%) followed by banks (-13%), while tech is only up 1%. Gold is off its month's high, but only slightly, while Brent oil, trading at 76\$/b (down 8\$/b for the month), also doesn't show much confidence in GDP growth.

Asset-class implications

We stick to the general economic picture of GDP growth slowing in Europe and reversing in the U.S. before starting a mild recovery sometime in the second half of the year. We also stick to our constructive view on most asset classes on a strategic 12-month's view. We are aware of the threats to our core scenario as it is still not foreseeable what kind of negative dynamic the U.S. banking sector might still develop – and what other risks are looming on the horizon (Ukraine, Taiwan).

Fixed Income & Currencies:

After the ECB and the Fed delivered in line with our expectations, we stick to our view that **sovereign-bond yields** still have some room to rise this year. More on the longer end than on the shorter end, leading to a steepening of the yield curve. We have become more positive on European corporate **investment-grade (IG)** bonds after the UBS takeover of Credit Suisse took the heat out of the market. **High-yield (HY)** bonds, however, might remain volatile for a while as investors are reassessing

² GICS sectors communication services and IT, Source: Bloomberg Finance L.P. as of 3/22/23

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their default expectations in case of growing recession fears. On a total-return basis, we still consider this to be an attractive asset class in the longer term.

The **dollar** has, to the surprise of some, not been a winner of the recent market turmoil, while the **Japanese yen** proved to be the go-to currency in risk-off times. We do not expect this pattern to change, while it might moderate somewhat.

Equities:

Increasing recession fears and increasing cost of capital for some are weighing on stocks, as are peak margins and the investment alternative in the form of fixed income. Our key equity calls from the last CIO Day³ (early March) remain unchanged, however. Our index targets offer some 7% total return from here on average over the next 12 months while we expect volatility to stay with us. We stick to our preference for 1) **Europe**, especially small and mid-caps, 2) **Emerging Markets** and 3) the **communication services** sector.

From a shorter-term perspective we are avoiding undercapitalized companies. As for **financials**, we believe the outperformance of the European sector is set to continue. In the U.S., we think **small banks** will remain challenged with big profitability pressures. For any bank, the fair cost of debt and equity is very uncertain right now. Still, we are confident that the biggest of the U.S. banks will be able to strengthen their market share.

Alternatives:

Small banks are important players in **real-estate** financing and development. Should recent events lead to decreased lending activity in this space, it could lead to lower supply and therefore increased real-estate valuations. On the other hand, if startups were to go out of business this could create more supply of commercial real estate.

Given markets' lower expectations on global GDP, we expect the **oil** complex to remain under pressure. There has been little production response to the lowered oil price thus far, so we think that markets will focus on the reaction of OPEC+R for further directional guidance in the near term.

Base metals were lower and **precious metals**, especially **gold**, were higher as macro investors focused on the negative impact from credit tightening due to the banking concerns. In our view, metals will likely remain volatile as they digest the possibility of a weaker growth outlook during significant uncertainty given the interaction of path-dependent fundamentals with government and central-bank reaction functions.

³ The meeting in which we define our 12-month economic and market outlook

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Glossary

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

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

The **CBOE Volatility Index (Vix)** is a trademarked ticker symbol for the Chicago Board Options Exchange Market Volatility Index. It is a popular measure of the volatility of the S&P 500 as implied in the short-term option prices on the index.

In business administration, the **cost of capital** is the cost incurred by a company in using equity capital for investments or in obtaining debt capital for them.

Emerging markets (EM) are economies not yet fully developed in terms of, amongst others, market efficiency and liquidity.

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

The **gross domestic product (GDP)** is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

High-yield bonds are issued by below-investment-grade-rated issuers and usually offer a relatively high yield.

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

Investment grade (IG) refers to a credit rating from a rating agency that indicates that a bond has a relatively low risk of default.

The **Japanese yen (JPY)** is the official currency of Japan.

The **KBW Bank Index** is a benchmark stock index of the banking sector, representing large U.S. national money center banks, regional banks, and thrift institutions.

Margin describes borrowed money that is used to purchase securities.

Market capitalization, in the context of an individual firm, is the number of shares issued multiplied by the value of the shares.

Monetary policy focuses on controlling the supply of money with the ulterior motive of price stability, reducing unemployment, boosting growth, etc. (depending on the central bank's mandate).

OPEC+ is an informal alliance of OPEC members and other oil-producing countries, led by Russia, aiming to coordinate their production strategies.

A **recession** is, technically, when an economy contracts for two successive quarters but is often used in a looser way to indicate declining output.

The **S&P 500** is an index that includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

Sovereign bonds are bonds issued by governments.

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.

Yield is the income return on an investment referring to the interest or dividends received from a security and is usually expressed annually as a percentage based on the investment's cost, its current market value or its face value.

A **yield curve** shows the annualized yields of fixed-income securities across different contract periods as a curve. When it is inverted, bonds with longer maturities have lower yields than those with shorter maturities.

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