

## Market turmoil: Making sure you don't make a drama out of a crisis... yet

Turmoil in the global banking industry, and the consequence of aggressive monetary tightening, have led people to question whether we're on the verge of yet another financial crisis. We don't think we are. Major stresses remain, however. So what's really going on in global markets? And where are we headed now? We have some answers



The Fed's Jay Powell announced another US interest rate rise on Wednesday

### ☐ The impact on the wider US and European banking sector and what's coming next

The global banking sector has been hit by deep concerns over the impact of aggressive monetary policy tightening on the sector. And, depending on the day, we're still seeing volatile swings in various markets. In the US, we have seen smaller regional lenders exhibit substantial deposit outflows which, combined with the unrealised losses on their securities holdings, have resulted in banks burning through their liquid assets at a very fast pace. These events have led to the demise of three regional banks so far. All (including uninsured) depositors of Silicon Valley Bank and Signature Bank were fully protected, while shareholders and certain debtholders were not.

The message from US Treasury Secretary Janet Yellen has been seen as rather conflicting on the potential treatment of uninsured non-systemic bank deposits, creating substantial uncertainty among depositors and in financial markets. In Europe, Credit Suisse was forced to merge with its stronger domestic rival, UBS. We consider that the problems of Credit Suisse are more company specific and started long before the US events. Its position considerably deteriorated in the fourth quarter of last year, when it suffered from substantial client fund and deposit outflows, which gained more speed after the general market sentiment weakened.

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Most European banks are impacted by these events mainly via the more cautious market sentiment. Debt risk premiums have widened, and the sharp swings in financial markets have guaranteed that the primary bond markets have remained steadily closed so far. The wider spreads make it more expensive for banks to fund their operations, the impact of which will come through only slowly as banks advance with their funding programmes.

The decision of the Swiss authorities to wipe out the Credit Suisse AT1 debtholders resulted in the AT1 market being severely hit. It is doubtful that banks will be able to issue new AT1 anytime soon, increasing the likelihood of outstanding AT1 notes being extended. We consider that the recent events in the banking sector have resulted in substantially increased uncertainty, which is likely to continue to be reflected as substantial short-term volatility in credit markets. We expect bank spreads to be negatively impacted in general and also in the longer term, whether in bank capital or in bank senior debt, as bank investors factor in more uncertainty regarding resolution practices.

## **? Is this Lehman 2.0 or rather a rerun of the 1980s Savings and Loan crisis?**

It is neither. So far, the problems have been concentrated in US regional banks and one specific weaker entity in Europe. The European issue has been more or less addressed by prompt interventions by the Swiss government and central bank. In the US, the problems are concentrated in non-systemic banks, while larger banks may actually have benefitted from new deposit inflows and business attracted by their systemic status. This makes a likelihood of a wide systemic crisis quite limited. We consider that stabilisation of deposit developments in the US would be key for a more pronounced stabilisation in bank credit spreads too. So far, no institution under pressure has played a similar role in the global banking industry as Lehman Brothers did. While it cannot be excluded that other institutions are suffering from the same symptoms as those under pressure in recent weeks, a cascading effect as experienced during the 2007-09 crisis does not look likely.

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We're still in the very early stage, so the range of possibilities along with further developments is wide. In the US, even if the problem seems to have been contained so far, the full impact of recent

events is still to unfold. Banks were already tightening lending standards markedly (adjusting terms of borrowing, covenants, size of credit lines, maximum maturity lengths, etc., as highlighted by the Federal Reserve's Senior Loan Officer survey). The risk now is that lending conditions will tighten even further as small and regional banks see their deposit base shrink and regulators recognise that they need to take a more proactive approach, making banks even more wary.

Small banks (less than \$250bn of assets) account for 43% of all commercial bank lending in the States, up from 30% in 2008, so they have become more important for the US economy. If they pull back, it is doubtful that large banks can completely fill the void. Moreover, small banks account for more than two-thirds of all outstanding commercial real estate lending and more than a third of all outstanding residential real estate lending. Should price falls for these assets accelerate, the balance sheet position of the small and regional banks could look even more strained and intensify the turmoil.

## ? How concerned should we be about Europe?

Since the financial crisis and the euro crisis, large European banks have been subject to much stricter regulation than before. The Single Supervision Mechanism, together with national financial supervisors, has clearly improved transparency, stress tests and supervision. Also, the Single Resolution Mechanism should help break the doom loop between sovereigns and banks that played such a prominent role during the euro crisis.

More generally speaking, the European banking system is supported by strong capital and loss-absorption buffers. These offer banks room to absorb the impact of the weakening of credit quality. Banks are also required to meet stringent requirements on liquidity (LCR) and longer-term funding (NSFR). These factors make the system generally well protected against negative shocks.

European banks have raised a record-breaking amount of debt across covered bonds to unsecured debt from capital markets this year, that is before the latest chain of negative events started to unfold. This makes banks better positioned to weather the closure of primary debt markets for now. That being said, the bulk of the funding that the European Central Bank has offered to banks via its TLTRO-III programme matures in only three months' time in June. Also, the collateral relief measures offered to banks during the Covid-19 crisis are set to tighten further in tandem. If we experience further disturbances in bank funding markets, the ECB may choose to offer banks access to additional liquidity, potentially restarting (T)LTROs and/or lowering collateral requirements again.

## ? How much are lending standards likely to tighten?

In the eurozone, financial stress has only increased moderately so far. The ECB's own index of systemic stress has grown in recent days, but only to levels last seen around the turn of the year. The war in Ukraine and the start of the hiking cycle caused stress to jump significantly more than what we've seen so far.

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Before the events of the past couple of weeks, credit conditions were already being tightened on the back of recessionary concerns and higher rates. The ECB's bank lending survey also suggested that banks were expecting to further tighten standards in the months ahead, on top of which comes the impact of the current banking turmoil. With CDS spreads for banks widening, funding costs will increase and could eventually lead to even tighter lending conditions.

For the US, the Senior Loan Officer survey from the Federal Reserve is the most obvious indicator to follow, but there are other data points, such as The National Federation of Independent Businesses' Small Business Optimism Index. It has a sub-component titled "availability of loans versus 3M ago" and "expected credit conditions over next 3M". This is starting to tentatively deteriorate. There is also monthly data regarding lending to commercial and industrial companies and it fell month-on-month in January, the first monthly decline since the third quarter of 2021. That said, it is still up 12% Year-on-Year and by 20% on 2019 levels, but this is something we will be keeping a very close eye on.

The combination of higher rates, less credit availability and weakening business sentiment suggests the risks are to the downside. On the consumer side, we know mortgage applications for home purchases have more than halved. Consumer credit numbers are still coming in reasonably hot, but the rising default rates on car loans are a signal that all is not well. The latest consumer sentiment data suggests the appetite to buy 'big ticket items' such as cars, houses and household appliances is waning, so we would expect consumer borrowing to slow, especially if households get spooked that their savings aren't safe.

## □ ING's base case for the economy and how much things have changed

Our existing base case was already more cautious than consensus and factored in the adverse impact of the rapid monetary policy tightening so far. It was clear that at some point, something would break, be it something in the real economy or in financial stability. In any case, recent developments have strengthened our base case scenario of a recession in the US and subdued growth in the eurozone. Where previously the risks were clearly skewed to more resilient growth and higher central bank rates, it's now more symmetric.

Until last month, the main drivers of the different scenarios had been energy prices and monetary policy, while now it's credit conditions or lending standards as well as the health of corporate balance sheets which determine the different scenarios.

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*The prospects of a technical recession in the eurozone has increased on the back of even tighter credit conditions*

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The prospects of a technical recession have increased again in the eurozone on the back of even tighter credit conditions. While risk-free interest rates have actually dropped, bank lending rates are likely to increase further, potentially hampering investment. Corporates tapping bond or equity markets could be an alternative for bank funding, but given the eurozone's high reliance on banks, this is still unlikely to be a big game-changer. Some financial stress could actually help bring down inflation faster than expected but too much financial stress would push the eurozone into

recession. Up to now, risks of a return of the euro crisis have remained muted. However, in the case of longer-lasting financial stress, the likelihood of yet another euro crisis clearly increases.

In the US, higher borrowing costs and reduced access to credit mean a greater chance of a hard landing for the US economy. This will help to get inflation lower more quickly than would otherwise have happened. Rate cuts, which we have long predicted, are likely to be the key theme for the second half of 2023, and we are favouring 75bp of easing in the fourth quarter of this year.

## □ Central banks and their stability and monetary conundrums

Central banks have pretty much unanimously adopted the mantra that financial stability and monetary policy can be treated independently and that policymakers have different tools for different problems. It's true that the likes of the Federal Reserve and European Central Bank have become more nimble in creating and implementing tools to unblock specific areas of the financial system, exemplified in March 2020, where they eased challenges facing money market funds; also in the UK late last year by the temporary buying of government bonds to stabilise LDI pension funds. Central banks, chiefly the Fed, have already been quick off the mark with new schemes addressing the current market issues. But the difference between now and previous episodes of market stress is that the primary cause is the higher interest rate environment itself. And that ultimately makes it hard to disentangle the financial stability issues from future monetary policy decisions.

As Fed Chairman Powell mentioned after this week's Fed rate decision, tighter credit conditions and declining bank lending would have a similar impact as rate hikes would. Essentially, this means that central banks will be monitoring closely whether tighter financial conditions are already being achieved thanks to banks becoming more cautious due to the current turmoil. If that is the case, central bank peak rates may be reached earlier as commercial banks are doing the work for them.

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If nothing else, it's now clear that rate hikes are having an impact and that policy is generally fairly restrictive. While central bank doves were initially slow to move away from "transitory" inflation predictions during Covid-19, something similar may be true of the inflation hawks today. Recent events are likely to see policymakers become more vocal about the increasingly two-sided risks to growth as interest rates ratchet higher.

For the Fed, we expect a final 25bp hike in May, leaving the Fed funds range at 5-5.25%. The feedback loop from financial stresses onto the broader economy is significant via both higher borrowing costs and less credit availability. With the risk of a hard landing increasing, which should weigh on inflation, we expect the Fed to cut rates by perhaps 75bp in the fourth quarter. This would take the Fed funds target rate range to 4.25-4.5%. We then expect rates to head to 3% in 2024.

For the ECB, the latest financial stresses also mark the start of the final phase of rate hikes. Things would have to get worse for the ECB not to hike again in May, but this time a 25bp rate hike looks

like the most plausible option. After a final rate hike by another 25bp in June, Europe's central bank is likely to move into a 'wait-and-see' stance. With core inflation still stubbornly high, we cannot see the ECB cutting rates before the second half of 2024.

## □ Our new base case for rates

One of the simplest models for long-tenor rates is to look at the futures strip as far out as it goes (with reasonable liquidity) and add a moderate premium to this (maybe 20bp). Employing that, we find that by mid-2024, the implied Fed funds rate is 3.5%. That's where the current US 10yr yield is today. The fed funds strip can, of course, shift lower, and we think it will, ending up at 3%.

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That 3% level is key for us, as it provides a target for the 10yr yield to aim for. Evidence of stress in the banking sector and tightening in credit conditions is likely to push us in that direction in the coming months or maybe even sooner. However, any break below 3% should prove short-lived, as even the move down to 3% should be classed as an overshoot to the downside.

Employing a similar methodology, we find that the Euribor futures strip also heads down to the 3% area by the end of 2024 and goes below 3% in 2025. So again, the 3% level is a key one here too. And note that the 10yr German yield currently trades some 40bp below Euribor, which brings the 2.5% area into focus for the 10yr German yield. Currently, the German 10yr is at 2.25%, and the base case can see this heading to the 2% area. But it really should not get below 2%. And ultimately, the 10yr German yield should move back to the 2.5% area once that downside test is complete in the coming months. Also, our view argues that the ECB will not be cutting in 2023. One upshot from this is a further convergence between US market rates and eurozone ones.

## □ Our new base case for fx

The dollar has been the big loser since the banking turmoil started. To some, that may sound a bit surprising; after all, financial turmoil is often associated with demand for safe-haven assets like the greenback. However, this crisis has been quite unique since markets have rapidly moved to price out Fed rate hikes and price in rate cuts for this year, which put some limit to the downside first and fuelled a recovery in global risks assets then. The combination of lower Fed rate expectations and improved risk sentiment is quintessentially negative for the dollar.

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*The dollar has been the big loser since the banking turmoil started*

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Moreover, the balance of concerns about the banking sector has increasingly shifted towards America as opposed to Europe; the US regional bank crisis remains unresolved, while the UBS-Credit Suisse deal has fuelled a steadier improvement in investor sentiment in Europe. This has favoured European currencies versus the dollar.



Looking ahead, there is a possibility that we'll see a scenario in line with current market conditions, where the US banking situation remains troublesome but doesn't turn into a fully-fledged systemic crisis, and the Fed sticks to some ambiguous communication until a tighter financial environment hits the economy and forces large cuts. In this scenario, further dollar depreciation seems inevitable, and if the EU banking sector remains broadly shielded, stickier inflation in the eurozone should force more hikes by the ECB and ultimately a contraction in the USD-EUR rate differentials. Ultimately, EUR/USD should easily break above 1.10, and be on track to touch 1.15 by year-end.

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