

A week that shook the markets... again

Is the worst of the market turbulence behind us after the forced merger of Credit Suisse and UBS? That's what we were asking at the start of the week. Not quite. Catch up on where we are right now, watch Carsten Brzeski give his take on the market moves, listen to our experts on this week's rate rises and read our analysis on the central banks' actions

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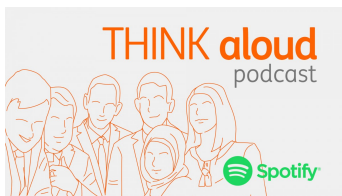
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The Fed's Jay Powell announced another US interest rate rise on Wednesday

□ 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.

Most European banks are impacted by these events mainly via the more cautious market sentiment

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.

The likelihood of a wide systemic crisis is quite limited

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.

Credit conditions were already being tightened on the back of recessionary concerns and higher rates

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.

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

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.

It's now clear that rate hikes are having an impact and that policy is generally fairly restrictive

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%.

The 3% level is key for us

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.

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

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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Carsten on a crisis avoided, at least for now

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Market turmoil: a crisis avoided, at least for now

Watch ING's Carsten Brzeski's take on the recent market turbulence as he explains where we might be headed next

[Watch video](#)

Three scenarios for the global economy

Scenario #1 (base case): Banking crisis eases but prompts central bank reality check

Banking sector

Economic slowdown reflects negatively on bank earnings and capital. Deposit flows stabilize, supporting liquidity positions of smaller lenders. As financial markets volatility eases somewhat, bond spreads stabilize but on higher levels to reflect higher bank risk.

Impact on corporates

Higher policy interest rates find their way to the real economy and are cyclically slowing down bank lending and consequently corporate investments.

Economic Impact

Tighter lending standards and already-weak business confidence leads to US recession through the middle of 2023. Unemployment rises. Europe narrowly avoids recession but the rebound is slow.

Wider market impact

Downward pressure on market rates dominates, with a tendency for curves to re-steepen, and for EU rates to converge on US ones.

Central banks

Federal Reserve hikes in May, but cuts rates by 75bp by year-end. ECB hikes by 25bp in May and June but signals no cuts in 2023.

Central bank – peak rate

5.25% Fed 4.0% ECB

Markets: End-2023 forecasts

1.15 EUR/USD 3.00% US 10-year

Source: ING

Scenario #2: Crisis eases quickly and central banks re-focus on inflation as medium-term risks build

Banking sector

The improving market sentiment supports volumes as lending and other activity picks up. Central bank rate hikes reflect as higher revenues, outpacing the increase in credit costs. Bank funding markets are wide open and secondary bank bond spreads perform.

Impact on corporates

Corporates can further tap financial markets for financing, supporting investments in energy transition, digitalisation and infrastructure.

Economic Impact

The US avoids recession, aided by resilient corporate balance sheets. Core inflation takes longer to fall as a result. Eurozone is more resilient than expected and inflation becomes a real demand-side problem.

Wider market impact

The upside pressure for market rates re-asserts, with curves re-inverting. Still convergence of EU to US rates, but less dramatic.

Central banks

Policy rates go another leg higher, and no major central bank cuts rates in 2023. But a deeper recession as result of monetary tightening prompts widespread easing in H2 2024.

Central bank – peak rate

5.75% Fed 4.5% ECB

Markets: End-2023 forecasts

1.10 EUR/USD 3.25% US 10-year

Source: ING

Scenario #3: Deepening crisis prompts recession and earlier rate cuts

Banking sector

Banks hit the breaks in lending and lower volumes pressure revenue development. Weak economy pushes up credit costs. Bank earnings and capital ratios take a dive. Bank funding markets face disturbances and spreads are pushed wider.

Impact on corporates

Bank lending channel is increasingly clogged, first affecting SMEs in the US but also Europe. Fully-fledged credit crunch and market uncertainty outweigh any additional market funding for corporates.

Economic Impact

A sharp tightening in credit conditions results in a swift rise in unemployment across the developed world. Recession is the base case, helping to bring inflation back to target more quickly.

Wider market impact

Market rates shoot to the downside and credit spreads widen as a deep recession elevates default risk significantly. Rates correlate lower.

Central banks

Rate hikes plans in May/June are mothballed. Rates cuts in US and Europe come before year-end to first restore financial stability and to then fight recession.

Central bank – peak rate

5.0% Fed 3.5% ECB

Markets: End-2023 forecasts

1.00 EUR/USD 2.50% US 10-year

Source: ING

Author

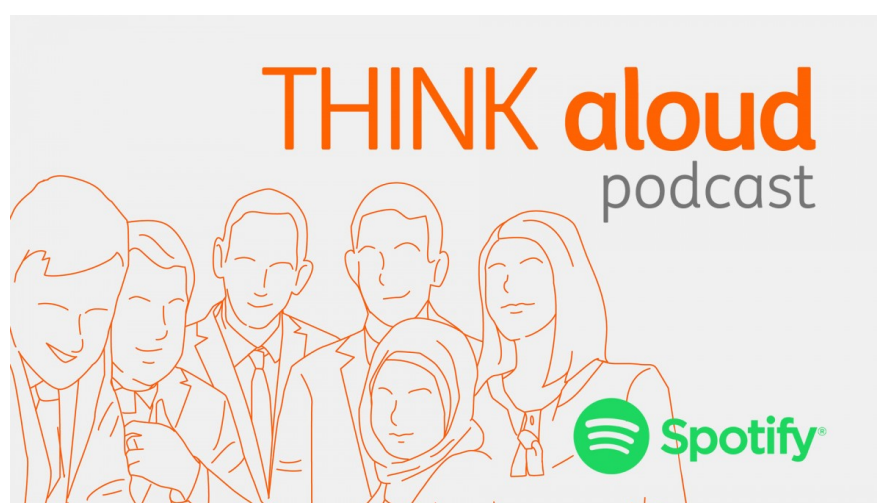
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Listen: Price stability vs financial stability

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Less than two weeks after the collapse of Silicon Valley Bank, which sent shockwaves through the US banking system, the Federal Reserve raised interest rates again, noting that the banking sector is "sound and resilient". The move follows a decision by the European Central Bank this month to hike rates by 50bp, despite concern over huge outflows at Credit Suisse, which ultimately led to a government-backed UBS takeover. [In this podcast](#), ING's Senior Editor Rebecca Byrne asks Padhraic Garvey and Antoine Bouvet to reflect on the news and what it could mean for market interest rates in the US and Europe.

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Credit chaos: is the worst behind us?

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Spread widening and curve flattening across the board

Increased uncertainty in the global banking system and violent swings in rates markets have led to weakness in credit. Statistically, spreads are looking cheap, but we argue that risks remain high and market direction is still uncertain. Additionally, there may be more 'hunting for weakness'. So, here's a warning: don't try to catch any falling knives.

- EUR corporate spreads are 12bp wider since the tights on Friday 10th
- EUR financial spreads are 46bp wider since the tights on Friday 10th
- USD corporate spreads are 23bp wider since the tights on Thursday 9th
- USD financial spreads are 58bp wider since the tights on Thursday 9th

Furthermore, the short end of (both EUR and USD) credit curves have been underperforming, drastically pushing curves much flatter.

The AT1 market fell drastically

Chaos continued yesterday in bank-subordinated bond markets. Subordinated debtholders should

be prepared to face losses in times of trouble; the complete wipeout of Credit Suisse's AT1 layer as part of the emergency rescue deal orchestrated with UBS came, however, as a shock to many. The Swiss authorities didn't respect the normal creditor 'waterfall'.

While AT1 bonds will be wiped out, shareholders get to walk away with CHF3bn. Other European bank regulators rushed to confirm that the Swiss way should not be seen as the blueprint for future bank trouble in Europe as a whole. This has calmed the AT1 markets somewhat but is unlikely to remove all the uncertainty hanging over these markets for now.

Spillover into credit

The rescue of Credit Suisse and, subsequently, the debacle in the AT1 market has, of course, sent shockwaves across other areas of credit. Corporate credit has felt the pinch as the bearish run continues. Initially, the rest of the banking liability structure widened rather notably, but there was a turn in spread direction on Monday afternoon. The high-yield credit space was also under a lot more pressure, widening by 146bp since the tights seen on 6 March. Corporate hybrids have also been under pressure, widening by 44bp in the past two weeks.

Concerns on regional banks in the US

Another drag on bank risk comes from the US regional banks. After three banks failed in the past couple of weeks, US regional banks have remained under strain. Silicon Valley Bank and Signature Bank were labelled earlier as systemic on-the-go to allow for support for their complete deposit bases. In contrast to her earlier remarks, the US Treasury Secretary Janet Yellen notes in a speech today, Tuesday, that if deposit runs of smaller banks pose the risk of contagion, similar actions could be warranted again.

The US officials are also said to study ways to extend the FDIC deposit coverage on a temporary basis, according to media sources. If extended, these types of measures should help alleviate bank risk and provide more stability for (uninsured) deposits. Large deposit shifts increase the risk of liquidity-driven bank collapses. Yellen earlier spooked the markets by indicating that the government is willing to step in only for the uninsured depositors of banks that pose systemic risk to the financial system. The more limited size of regional banks means that it is less straightforward to assume they would then be extended this support. This would create pressure for uninsured depositors to move from smaller non-systemic banks to larger systemic ones.

Tighter lending standards will widen spreads long term

Lending standards have been tightening in both Europe and the US. This will have a negative credit effect on credit spreads. As the availability of liquidity lowers, the demand for a higher spread will follow. As such new issue premiums on newly issued bonds will increase, and ultimately spreads will need to be priced wider long term. This will particularly be the case for the high-yield market. This isn't necessarily driving spreads right now but does add an additional negative factor in a secondary effect.

Primary markets remain closed

The large turbulence in the rates and credit markets has left primary markets shut for the past week. Supply is still sitting rather high on a YTD basis, with:

- EUR corporate supply sitting at €81bn, up on €65bn last year,
- EUR financial supply at €108bn, up on €76bn last year,
- EUR covered bond supply at €76bn, up on €69bn last year,
- USD corporate supply at US\$207bn, up on US\$156bn last year and
- USD financial supply at US\$107bn, down on last year's US\$176bn.

The funding environment has been more conducive for issuance in January and February, as spreads were stuck around much tighter levels. However, the cost of debt has yet again jumped higher with volatile rates and wider spreads. There are indeed some issuers side-lined for now, waiting for the primary markets to re-open, but as long as rates remain volatile and spreads widen, primary markets will remain shut for now.

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Fed hikes interest rates by 25bp, but acknowledges we are close to the peak

The Federal Reserve has raised the policy rate by 25bp, but signalled it 'may' only hike once more. This is a little more dovish than anticipated,...



Federal Reserve Chairman Jerome Powell

25bp hike, but we are close to the peak

The Federal Reserve has hiked the fed funds target rate range 25bp to 4.75-5% as largely expected by the markets and economists. This was a unanimous decision with the committee backing the view that “some additional policy firming *may* be appropriate”. This is a slight language shift having previously said that “ongoing increases in the target range *will* be appropriate” (our emphasis).

Its dot plot chart shows that its end-2023 Fed funds median forecast is 5.1%, which is the same as it was in December, whereas surveys of economists suggested an expectation that it would have raised that to 5.4%. So again it does appear to be a little more dovish than expected.

Federal Reserve economic projections

	2023	2024	2025	Longer run
Change in real GDP (Mar Fed forecast)	0.4	1.2	1.9	1.8
Previous Fed projection (Dec)	0.5	1.6	1.8	1.8
Unemployment rate (Mar Fed forecast)	4.5	4.6	4.6	4.0
Previous Fed projection (Dec)	4.6	4.6	4.5	4.0
Core PCE inflation (Mar Fed forecast)	3.6	2.6	2.1	-
Previous Fed projection (Dec)	3.5	2.5	2.1	-
Federal funds rate (Mar Fed forecast)	5.1	4.3	3.1	2.5
Previous Fed projection (Dec)	5.1	4.1	3.1	2.5

Source: Federal Reserve, ING

Nonetheless, the Fed appears quietly confident that the economy won't be heavily disrupted by recent banking sector woes. It argues that the "US banking system is sound and resilient" so its fourth quarter year-on-year GDP forecast for 2023 has only been cut from 0.5% to 0.4% while 2024 is now 1.2% versus the 1.6% expected three months ago. The unemployment and inflation expectations are little changed. Moreover, the Fed is now looking for only 75bp of rate cuts in 2024 rather than 100bp of cuts that it had projected back in December. Chair Jerome Powell used the press conference to separate the Fed's price stability role and financial stability role, saying that it has the tools to deal with both, echoing comments from ECB President Christine Lagarde last week.

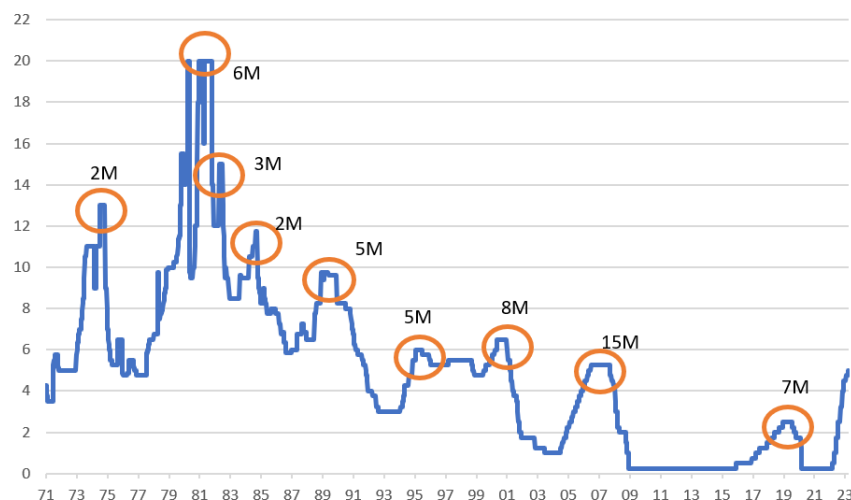
We are more nervous about the economic threat from the banking stresses

We are a little more pessimistic, having been on the more dovish end of expectations for interest rate moves in 2023 for quite some time. Our concern was that this has been the most aggressive monetary policy tightening cycle for 40 years and by going harder and faster into restrictive territory you naturally have less control over the outcome. This heightens the chances of economic and financial stress and that is what we have seen over the past couple of weeks.

Even before the recent banking woes, borrowing costs have been rising rapidly, but significantly, the economy has also experienced a tightening in lending conditions, which we felt would increasingly weigh on credit flow to the detriment of economic growth.

It's our view that the recent events will make banks more nervous about who they lend to, how much they lend and at what interest rate. With regulators also likely sensing a need to be more proactive, this could intensify risk aversion and make banks tighten lending standards even more. This will hamper credit flows, weigh on the economy and allow inflation to fall even more quickly. The Fed does acknowledge this stating "recent developments are likely to result in tighter credit conditions... and weigh on economic activity, hiring and inflation". We are therefore a little confused as to why it didn't adjust its economic projections more than it did, although Powell did acknowledge that it is difficult for the central bank to assess the impact of recent events because it is so recent, adding that a "pathway still exists" for a soft landing but recent events don't make this more likely.

The Federal Reserve never leaves it long between the last hike in a cycle and the first rate cut



Source: Macrobond, ING

Rate cuts in the second half of 2023 remains our call

Just over two weeks ago the expectation was that the Fed could be looking to get the Fed funds rate up to 5.5-5.75%, with some commentators talking about 6%. Markets are now barely pricing one further rate rise (around 15bp at the May meeting currently) and are looking for cuts later this year (somewhere between 50bp and 75bp from the peak).

We agree that we could get one final 25bp hike in May, leaving the Fed funds range at 5-5.25%. But higher borrowing costs and reduced access to credit mean a greater chance of a hard landing for the economy. 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. As the chart above shows, it is important to remember that the Fed never leaves it long between hiking and cutting rates. Historically, it has been just six months between the last hike and the first rate cut.

The Fed lets its facilities do their work, betting for resumed status quo, and system stability

The impact effect has been for lower market rates, in particular on the front end as the market takes on board a Fed that seems to be almost done. One theme that we think continues is the disinversion of the curve, and we've seen another material move in that direction as a response to the Fed's decision.

Market rates had been edging higher as we headed into the Federal Open Market Committee meeting, which no doubt helped to embolden the Fed to deliver the 25bp hike that the market had (practically) discounted. The market will also be comforted by the fact that the Fed decided to go ahead and hike when the alternative could have been to hold and nod toward bank angst as the rationale. There is enough in that combination for market rates to re-nudge higher in the weeks ahead, at least until we get to a point where the disinflation story has become more compelling, notwithstanding the impact effect towards lower market rates.

Market technicals are in an interesting place right now. The Fed's balance sheet increased by \$140bn last week as a consequence of support being provided to some banks, including Silicon Valley Bank, Signature Bank and First Republic Bank. And indeed the regional Fed breakout of support confirms that the bulk of additional liquidity went through the New York Fed and the San Francisco Fed.

The consequence of this from a balance sheet perspective is to push against the quantitative tightening policy where \$95bn is being allowed to roll off from the Fed's bond holdings on a monthly basis. This, the Fed argues, is the various mechanisms doing their work. The same logic obtains for the reverse facility, which continued to mop up excess liquidity and has popped higher in the past week in part reflection of that. No new angle on this from the Fed today.

Dollar to come under more pressure

Looking at the negative dollar reaction after the announcement, the FX market had clearly anticipated a good deal of the rate hike, leaving the surprise being driven almost entirely by the new dot plot projections. With markets perceiving the unchanged 2023 median projections at 5.1% as moderately dovish and the general investors' sentiment on the banking crisis having gradually improved in the past couple of days, the dollar was left without a floor.

Before the Fed meeting, we had flagged risks of a small EUR/USD correction on a potential hawkish surprise, but the road for a break above 1.0800 appeared paved barring another major shock to the banking sector. The next key handle for EUR/USD is 1.1000: that is an important benchmark level that may see some significant resistance unless markets feel substantially confident that the worst of the banking shock – especially in Europe – is over.

But even with the Fed pushing ahead with tightening today, its rhetoric compared to the ECB is appearing more dovish, particularly when it comes to rate cuts. All this points to a supported EUR/USD for the remainder of this year and we target 1.15 in the second half of 2023.

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SNB stands firm in the face of market turbulence with 50bp rate hike

Despite the events related to Credit Suisse, the Swiss National Bank (SNB) has not flinched and decided to raise its interest rate by 50 basis points to 1.5%



SNB Chairman Thomas Jordan speaks during a media briefing in Zurich, Switzerland, 23 March 2023

Inflation is too high

Given the inflationary environment, this decision was expected. Compared to other developed economies, inflation in Switzerland has been relatively low, reaching a maximum of 3.4%. Nevertheless, the recent upward trend has not been good. After stabilising in the summer of 2022 and falling at the end of last year, inflation has been rising again since the beginning of the year, and faster than expected. In February 2023, headline inflation reached 3.4% and core inflation 2.4%, its highest-ever level. This is well above the SNB's objective of having inflation between 0 and 2%, which justifies the rate hike.

Moreover, the SNB is unique in that it only meets every quarter, which is much less often than the other major central banks. As a result, today marked only the fourth rate hike for the SNB, increasing by a total of 225 basis points, compared to 350bp for the ECB and 500bp for the Fed.

Foreign currency selling

In addition to the interest rate hikes, the SNB says it continues to be active in the foreign exchange market, mainly by selling currencies. After years of buying currencies to limit the appreciation of the Swiss franc, the SNB is now selling foreign currencies to strengthen the Swiss franc and limit imported inflation. The SNB says it sold about 27 billion Swiss francs worth of foreign currency in the fourth quarter of 2022, and it plans to continue doing so in the coming months. Its currency sales are therefore the second instrument of the SNB's monetary policy in its fight against inflation.

No trade off?

The SNB seems to consider that the events linked to Credit Suisse and the threats to financial stability can be managed with other instruments than interest rates, such as liquidity provision. It believes that the decisions taken last weekend "have put a halt to the crisis", so there is nothing to stop it from focusing on inflation again. Like the ECB, the SNB is therefore trying to convince the markets that there is no trade-off between the price stability mandate and the financial stability mandate. If this can be seen as a sign, the exceptional interest from the markets and the press in today's SNB decision probably shows that not everyone is (yet) convinced.

In our view, the two mandates can indeed be managed with different instruments, but only to a certain extent. Furthermore, there is little doubt that fears about financial stability will have an impact on the availability of credit and thus on the economic situation and the inflation environment in the coming months, which will ultimately influence the path of interest rates.

Higher inflation forecasts

The SNB's inflation forecast was revised upwards in March. It now expects average inflation to be 2.6% in 2023 (compared to the December forecast of 2.4%) and 2.0% in 2024 and 2025 (compared to the December forecast of 1.8% for 2024). Inflation is thus expected to be 2% or more over the entire forecast horizon. Moreover, the SNB expects inflation to rise to 2.1% by the end of 2025, a figure higher than its target. Its forecast sends a rather hawkish signal, suggesting that further rate hikes are in store for the SNB. It says "it cannot be ruled out that additional rises in the SNB policy rate will be necessary to ensure price stability over the medium term".

We believe that a further rate hike is likely in June, but given the economic slowdown, which is likely to be exacerbated by concerns about the banking system, this hike is likely to be limited to 25bp to 1.75% and will probably be the last. After that, the interest rate is likely to remain at this level for a long period.

FX: Franc gains likely to emerge versus the dollar

The Swiss franc rose after the SNB hike, with EUR/CHF briefly touching 0.9940 before bouncing back to the 0.9970 level at the time of writing. As highlighted above, the SNB actively favours a stronger CHF to limit imported inflation, but the ECB-SNB policy differential and an improvement in European sentiment are tilting the bias towards a stronger EUR/CHF at the moment, where a stabilisation above parity seems likely in light of recent developments. The channel where we could see the SNB hawkishness play in favour of CHF is probably through USD/CHF, where we may see a break below the 0.9080 early-February lows, also aided by the generalised USD weakness.

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Bank of England tightening likely done as it hikes by 25bp

The BoE has kept its options open this month amid financial market turmoil. But assuming the tentatively encouraging trends we've seen in price...



The Bank of England

Bank of England keeps its options open on future hikes

The Bank of England has increased interest rates by 25 basis points, a move that may well be its last. Bank Rate now stands at 4.25%.

We only get a statement this time around (no press conference), and an initial flick-through shows that it reads as fairly balanced. Growth and employment look stronger, it says, but services inflation - which has been volatile so far this year - is seen as in line with expectations, and nominal wage growth weaker.

In short, the Bank is keeping its options open. Like last month, it has indicated it could hike again if inflation is continuing to show signs of “persistence”. Our read of that phrasing is that officials are less beholden to month-to-month swings in the data than perhaps the Federal Reserve/European Central Bank and are trying to take a more top-level look at pricing-setting behaviour. It's this that will determine whether the Bank hikes again in May - and for now we think it won't, though another 25bp move is possible if the inflation data turns more hawkish.

If improvements in broad inflation picture continue, expect a May pause

Indeed, recent trends in inflation have looked more encouraging. The Bank's own survey of businesses suggests price-setting behaviour is becoming less aggressive, while as the BoE acknowledges, wage growth tentatively appears to have peaked on a three-month annualised basis. Services inflation should start to come down in time, with lower gas prices. When asked about recent price hikes by the ONS, service-sector firms more commonly cited energy prices than labour costs as the driver of these changes - and the same should be true in reverse.

Assuming these trends continue then we think a pause in May is likely. That's also partly dependent on banking sector stability and like its peers overseas, the BoE will keep reiterating that it has separate tools that are better suited to maintaining financial stability.

We're also likely to see the committee become more divided. There were no massive fireworks in the vote split on this latest decision - seven members voted for the 25bp hike, and as at the past two meetings, Silvana Tenreyro and Swati Dhingra voted for no change. Both have, however, hinted it might not be long before they consider voting for cuts.

Gilts in the long pause

Gilts, like other bond markets, now have to reflect a new phase of this cycle where central banks are at, or near, their policy rate peak. Two conclusions should ensue. Firstly, stability in policy rates means lower volatility in front-end yields, if the BoE can stick to its message of patience.

Progressively, this volatility will be displaced to the longer end, especially if a resilient economy pushes the inflation premium higher.

The second conclusion is that the yield curve now stands a better chance of re-steepening, as the front-end upside is now limited and as the inflation premium is no longer suppressed by a hiking central bank. We continue to think yields are skewed lower with 10Y headed to 3% by year-end. This is unlikely to be in a straight line however, and we have growing confidence in our call for a steeper curve.

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