Central banks back to fighting inflation

Deepak Mehra
Head of Investment Products and Chief Economist
Treasury, Asset Management and Global Markets

The month of March was characterized by an extreme level of volatility in the bonds market due to banking crises across both sides of the Atlantic and surprisingly sanguine and calm equity markets. Having ringfenced the banking crises with a firm resolve, central banks across the developed markets brought their focus back to their number one battle: to bring inflation back to their target levels.

ECONOMIC AND MARKET UPDATE

Hawkish Fed: March 2023 started off with a particularly hawkish commentary by Fed Chair J. Powell during his testimony to the Senate Banking Committee where he highlighted the need to raise rates to levels much higher than anticipated earlier. Markets quickly priced in a new peak rate above 5.5% and no rate cuts in 2023.

US banking crisis: However, just a day after his comments, the implosion of Silicon Valley Bank, the 16th largest bank in the US, changed the interest rate outlook very quickly. Along with a number of other smaller, niche banks, the turmoil started spreading but was met by swift action from the authorities. The Federal Reserve and Federal Deposit Insurance Corporation stepped in to guarantee all depositors of the troubled banks, irrespective of the size of deposit, and also opened a discount window to offer liquidity to banks in need. In the process, the Fed that was in the process of cutting down its balance sheet, has once again expanded it by nearly $400 billion.

Fed expanded balance sheet by
~$400 billion

Swiss banking crisis: Just as things started to settle in the US, news about Credit Suisse, the second largest Swiss bank started hitting the headlines. When $54 billion of credit line to the bank from the Swiss National Bank failed to calm the nerves, the Swiss authorities hurriedly concluded a deal for their largest bank, UBS, to buy Credit Suisse at a deeply discounted value while giving a full write-down to the holders of its Additional Tier 1 or Contingent Convertible (CoCo) perpetuals.

This unprecedented arrangement changed the generally accepted capital structure of banks (refer to the box following this paragraph) and brought into question CoCos issued by banks all across Europe, leading to the sell off of bank bonds, of all types. Over the following week even larger European banks came under selling pressure as investors evaluated risks associated with holding bank securities.

What are AT1 / CoCos and how are they different from bonds?

It is important to note that CoCos and senior bonds of banks are very different types of securities. CoCos came into existence after the Global Financial Crisis in 2008 as part of the regulatory effort to create mandatory buffer capital and to absorb losses in case common equity was insufficient to protect depositors and senior bond holders, due to any crisis. As a result, banks have issued CoCos paying high level of coupons to make it attractive for risk-taking investors to hold them. It is also important to note that CoCos may behave like fixed income securities but they are not bonds; in the capital structure they fall under preferred equity.

Investment Risk / Return	Bank Capital Structure	Priority on insolvency
LOW	Senior Secured	HIGH
	Deposits	
	Senior Unsecured Bonds	
	Tier 2 Capital (Subordinated bonds)	
	Additional Tier 1 Capital (CoCos /Perps/ Pref Equity)	
HIGH	Tier 1 Capital (common equity)	LOW

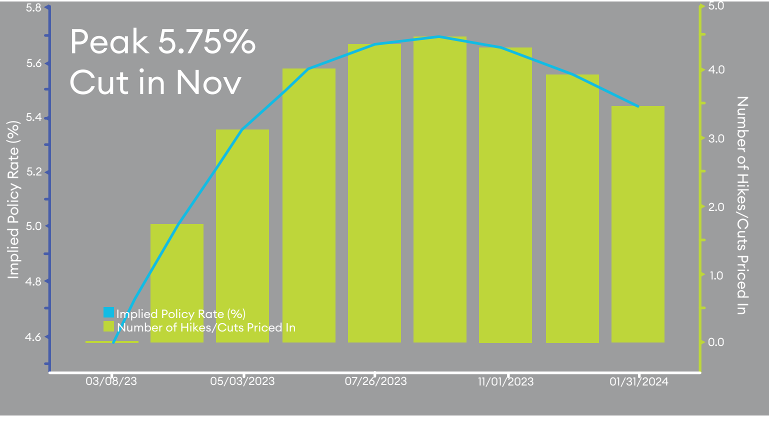
Central banks stick to plan: After a swift and resolute response to the banking crisis, central banks turned their attention back to their primary job of fighting inflation. Despite many analysts calling for the Fed to pause interest rate hikes, the Federal Reserve went ahead with the expected 0.25% increase in rates on the 22nd of March, taking the rates to the 4.75-5.0% range. The European Central Bank raised the rate by 0.50%, taking it to 3%, stating that the banking system was resilient and pledging support if needed. The Bank of England increased the interest rate by 0.25%, taking it to 4.25% as inflation in the UK surprisingly increased to 10.4% y-o-y. Even the Swiss National Bank increased the rate by 0.50% taking it to 1.50%.

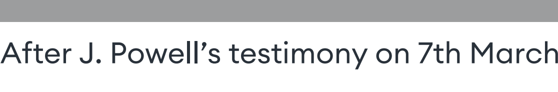
Fed Fund rate increased to **4.75-5.00%**

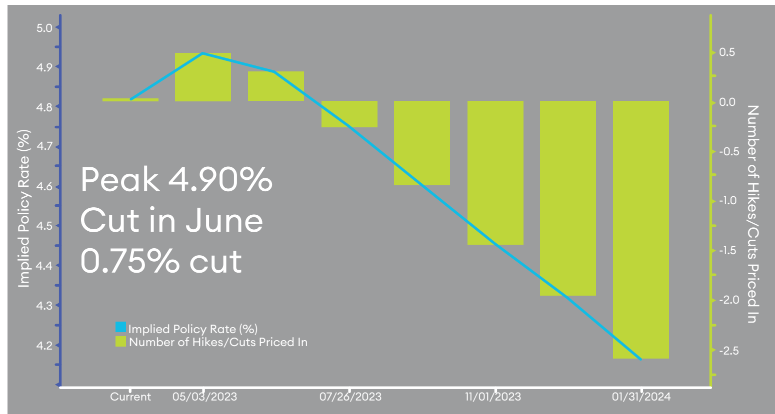
Interest rate outlook flips: Following the banking crisis, the market implied interest rate outlook, as measured by Bloomberg, flipped from overly hawkish after J. Powell's testimony to extremely dovish. At this time, the market is expecting one more rate hike by the Fed in May followed by a series of rate cuts starting in June, with a total reduction of about 0.75% by year-end.

Rate cut of about **0.75%** expected by year-end

Market-implied Fed Fund rates:




After J. Powell's testimony on 7th March



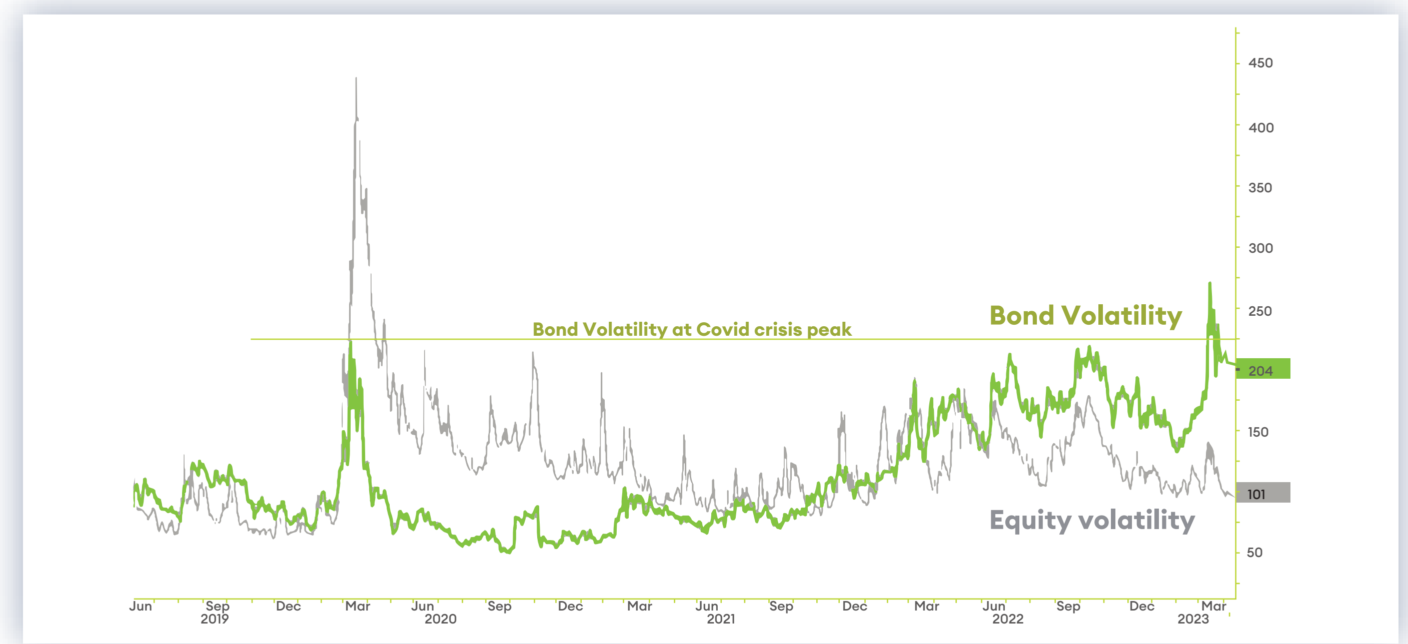
End of March

Inflation moving in the right direction: The US consumer price index (CPI) data for February showed continued improvement in overall inflationary pressures (headline inflation declined to 6.0%) even though the improvement in core inflation (after stripping off volatile energy and food) was less than expected at 5.50%. However, key and sticky components of inflation, housing rents and labor cost, are also cooling down. Private data shows that rental inflation has slowed down significantly while the increase in labor participation rate points to easing of labor supply issues. Clearly, the interest rate increase of over 4.50% in just 13 months is having an impact in slowing down the economy, although with a lag, and inflation is expected to slow down rapidly in the second half of the year.

US inflation down to

6%

Volatility in bonds: The hawkish Fed followed by the crisis in the banking industry led to wild gyration in bond yields. The 2 year Treasury yield most sensitive to short term rate expectations first crossed the level of 5%, a 16-year high, and then dramatically fell to 3.85%, the steepest drop in the last 35 years. Bonds are trying to price in the possibility of a pause or cuts in interest rates while also worrying about an economic recession following very aggressive monetary tightening which will continue to work with a lag. The MOVE Index, a measure of bond volatility, has shot up to levels not even seen during the 2020 Covid-19 crisis. By comparison, the VIX Index that measures volatility in equities has been quite calm.



INVESTMENT OUTLOOK

Rates outlook: It is estimated that the banking crisis among smaller and regional banks in the US and the resultant tightening of credit conditions is equivalent to about 1% of interest rate increase. As discussed earlier in this month's update, aggressive rate hikes so far are already working their way through the system with more evidence of slowdown likely to show up by the middle of the year. The Fed Chair has sounded dovish after the recent meeting saying "some additional policy firming may be appropriate" rather than the previous language of "ongoing increases" in rates. The Federal Reserve is likely to be dependent upon data to decide the future course of action. If the glide path to its 2% inflation target is visible, the Fed is likely to pause in June and start cutting rates before the end of the year. If an economic slowdown or recession becomes a worry, the Fed may actually start cutting rates much earlier, as shown in the market implied outlook.

Fixed income outlook: As we have mentioned in our previous months updates, bonds have become attractive again, after many years of low interest rates: "income is back in fixed income." From the current indications, inflation in the US will come under control much before Europe or the UK. Hence, the Fed is likely to be the first central bank to pivot. In this case, the current level of attractive yields available on investment grade bonds and sukuks may not last for long. The recent volatility in bond prices has opened up opportunities in good quality bonds. Investors with the appropriate risk appetite and available time horizon have an opportunity to lock in high levels of yields on high quality paper for the medium to long term.

Equity outlook: Equity markets, with the exception of bank stocks, have been surprisingly calm during this period of turmoil in the month of March. Equity investors are drawing comfort from a variety of factors that include: a) the economy has been able to absorb one of the steepest rate hikes on record thanks to the strength of personal and corporate balance sheets and may end up avoiding a hard landing; b) inflation is moving in the right direction and by the second half of 2023 a clear path to lower levels will be more evident; c) the Fed could be near peak rates and reduction in rates is also imminent after a period of pause.

Short term volatility is likely until clarity emerges on all the above-mentioned factors but for long term investors, this seems to be a good level to start accumulating a portfolio of diversified high quality stocks. Dollar-cost-averaging approach of investing regularly is likely to yield the best results overtime.

MARKET DATA

Global Equities	Last price	YTD 2023
MSCI World	2791.44	7.25%
Dow Jones Ind.	33274.15	0.38%
S&P 500	4109.31	7.03%
NASDAQ COMP	12221.91	16.77%
EUROSTOXX 600	457.84	7.75%
FTSE 100	7631.74	2.42%
India Nifty50	17359.75	-4.12%
Nikkei 225	28166.67	7.94%
Shanghai Comp	3272.86	5.94%

Currencies	Last price	YTD 2023
Dollar Index	102.86	-0.63%
Euro	1.081	0.98%
GBP	1.2298	1.78%
JPY	132.99	-1.41%
CHF	0.9171	0.81%
AUD	0.6667	-2.14%
CNH	6.8823	0.58%
INR	82.1825	0.67%
SGD	1.3332	0.47%

Regional Equities	Last price	YTD 2023
Dubai DFM	3406.72	2.12%
Abu Dhabi ADX	9430.25	-7.65%
Saudi Tadawul	10,590.10	1.07%

Commodities	Last	YTD 2023
WTI Crude	80.31	0.06%
Brent Crude	84.75	-1.35%
Nat Gas	2.083	-53.45%
Gold	1963.51	7.65%
Silver	23.92	-0.12%
Copper	408.2	7.13%
Corn	665	-1.98%

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MULTI-ASSET	• Income distributing mutual funds, from leading fund managers in the world, investing in equities and fixed income
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ALTERNATIVES	• Mutual funds investing in US senior secured loans delivering regular income

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