29 March 2023

Investment Institute Macroeconomics

Accelerated monetary tightening pass-through

Key points

- Even if the financial stability risks can be quickly mitigated, the banking stress is likely to exacerbate a tightening in lending standards which will weigh on the real economy.
- Central banks are ready to be more prudent with their next moves, but their current ambition remains clear: they don't want to capitulate while inflationary pressure remains largely untamed.
- In terms of how this leaves investor sentiment, we consider the following:
  - Cash is king for now
  - Credit promises solid returns
  - Downside risk remains on earnings

The potential significant macro ramifications of the stress in banking

Central banks and governments have responded swiftly to the turmoil in banking triggered by the demise of two regional banks in the US and Credit Suisse. Liquidity provision has come quickly and with generous terms. Resolution decisions have also been made rapidly in both the US and Switzerland, commensurate to the acceleration in deposit movements which is now permitted by technology and fuelled by access to instant information. Still, even if financial stability risks are mitigated, it's probably illusory to believe the real economy will be immune to an unavoidable change in banks' attitude to lending.

The Federal Reserve (Fed) released the asset and liabilities data for large and small domestically chartered US banks for 15 March, offering a first quantification of the impact of the turmoil. As expected, large banks in general reported an inflow of deposits (USD67bn) while small banks lost USD120bn. Yet, both large and small banks have adopted a precautionary behaviour, borrowing heavily from the Fed to raise cash holdings. The overall picture of the US banking system is now typical of crisis mode. This is hardly a configuration conducive to a relaxed attitude to lending to the non-financial sector.

Deposit migration from smaller to larger banks would not be neutral from a macroeconomic point of view. Small banks exhibit in general a much higher loan to deposit ratio than their larger competitors, and they play a crucial role in a sector – real estate – which is already under significant pressure. While small banks account for only 30% of total bank assets in the US, they have originated 70% of commercial real estate loans.

A regulatory backlash is probably looming in the US which may also impair credit origination over the medium-term. Indeed, reversing the relaxation observed under the Trump administration, we expect more stringent rules to be applied on the recognition of potential losses into capital ratios. Reducing the supply of loans to corporations and households is a way for banks to downsize their total Risk Weighted Assets, thus boosting their capital ratios without raising new equity at a time when investors would probably be demanding a hefty risk premium.

Higher banks' funding costs everywhere, and not just in the US – if the risk premium drifts higher – would be another transmission channel – we find quite a tight correlation between banks' refinancing gaps and their lending standards to firms. The decision of the Swiss authorities to "bail-in" holders of Credit Suisse's Additional Tier 1 bonds (AT1) while offering some protection to shareholders has not helped, even if the European Central Bank (ECB) and the Bank of England have been prompt to re-affirm the normal seniority ladder.

Banks are in addition facing another headwind: competition from money market funds. Large banks deposit inflows did not fully match outflows from smaller ones in the US. Non-financial agents are diverting a growing share of their liquid assets towards money market funds. The erosion in the deposit base of the banking sector as a whole is not going to help spur a rebound in lending.

Central banks unwilling to alter their stance

We were already concerned with the decline of the credit impulse in both the US and the Euro area before the banking turmoil started. We saw it as the first tangible sign that the monetary tightening had started working its way through the economy. The ongoing banking stress is precipitating and magnifying these developments, but this was always going to be a painful, but probably unavoidable step towards taming inflation. This is why the central banks are for now holding firmly onto the "separation principle" and are unwilling to reverse their policy stance. They are ready to tread more carefully, now that market conditions are doing a part of their work, but the direction of travel remains clear.

True, the ECB removed all trace of forward guidance in the prepared statement of the March Governing Council meeting after hiking by 50bps. Yet, Christine Lagarde made it plain in the Q&A that rates would have to rise higher ("*we know we have more ground to cover*") *if* its baseline for the macro outlook – established before the banking turmoil emerged – were to materialise despite the banking turmoil. Inflation is simply still too high. Upon hiking by 25bps the Fed chose to maintain an explicit, albeit weak, tightening bias, in the prepared statement ("*some additional policy firming may be appropriate*"). The impact of the banking turmoil on tighter credit conditions, weighing on the economy and ultimately on inflation was duly noted, but the concluding sentence in this paragraph ("*The Committee remains highly attentive to inflation risks*") acted as a reminder of where the central bank's priorities lie.

Investors react with rising caution

Growing uncertainties surround the macroeconomic outlook. This has created a "cash-is-king" preference in financial markets. So far, central banks have stuck to their guns in terms of focusing on the battle against inflation. Short-term interest rates have remained high as a result, with safe, low-duration assets like Treasury bills appealing to investors that don't want to hold money in low interest paying bank accounts and are fearful of taking on duration, credit or equity risk. The flows are evident in the US with money market funds benefitting from deposit drawdowns at banks, particularly smaller regional banks.

Taking a snapshot of financial markets, it is not surprising that short-term cash is proving to be attractive. Yields on US$ or Euro denominated Treasury bills are close to overnight interest rates which reflect the stance of monetary policy. Yield curves are negatively sloped across major currencies which means government bonds offer increasingly lower yields the longer the maturity gets. Investors in government bonds suffered negative returns in 2022. Although returns have been positive so far this year, volatility has been elevated and sentiment fragile. If recent concerns about the banking system and financial stability recede, and central banks stick to their hawkish stance, there is a risk that government bond yields reverse some of their recent declines and generate another wave of negative returns. At the time of writing, 10-year benchmark government bond yields were towards the bottom of the trading-ranges they have occupied since October.

Risks around corporate bonds have also increased recently. As the environment has become more difficult for banks, overall credit conditions are likely to tighten. This has been evident for some time in the US, as suggested by the Federal Reserve's monthly survey of lending conditions. For small, regional banks, the cost of funding is likely to increase as they raise interest rates to maintain deposits. Net interest income could be undermined as a result. Tighter credit conditions will hit the availability and cost of funds to the corporate sector. Small and mid-sized companies are likely to be the most impacted. Sectors like commercial real estate, where loan growth has been strong in the last couple of year, could also suffer a credit squeeze at the same time as higher interest rates could affect asset valuations.

We note that growth risks have increased in the wake of the banking crisis on both sides of the Atlantic. Given the recent resilience of US economic data, the change in fortunes is more abrupt there. Slower growth is likely to feed into further downgrades for the earnings of US companies in the next couple of quarters. The technology sector already seen lower earnings forecasts and is likely to be joined by the banking and energy sectors. In our view this leaves US equities vulnerable to weaker sentiment on the earnings side given that, in aggregate, earnings-per-share levels remain markedly above the long-term growth level.

Cash won't always be king

Government bonds, credit – including high yield fixed income – and equities have inherently more volatile returns than cash. Investors are wrestling with the near-term outlook for inflation, the stance of monetary policy and the growth outlook. This means expectations on volatility will remain high. However, the relative attraction of holding cash-like assets may not last so long. First, central banks could, under some conditions, pivot away from further increases in rates. More likely, on a medium-term view a rate cutting cycle will begin, reducing cash interest rates. Markets may well be premature in pricing in rate cuts by the Fed before the middle of the year, but if a recession does materialise in the US in the second half of 2023, then lower interest rates next year make sense, especially if inflation declines become more meaningful. Cash returns may be attractive today but a rolling 1-month or 3-month re-investment strategy could see returns tail-off quickly over a one-to-two-year period.

Investors in riskier assets are navigating negative macro drivers of expected returns, against valuations that suggest positive returns over the medium term. This is most obvious in fixed income markets where credit spreads have widened again recently, delivering all in yields that are higher than short-term risk-free rates. The spread between yields on corporate and government bonds is approaching levels typically marking a cyclical peak. This is the case in the US dollar and Euro markets as well as in high yield as well as better credit quality investment grade bonds.

Of course, there are concerns about credit. Bank debt has come under pressure recently and credit impairments are likely to rise. However, borrowers tend to have relatively strong fundamentals, at least in comparison to previous credit cycles. Taking a through-the cycle perspective, today's yields on corporate debt will provide superior returns to cash, benefitting from both the credit risk premium but also the pull-to-par on fixed income assets that continue to trade or price levels that were dictated by last year's market performance.

Market timing is difficult. The fundamental outlook is particularly clouded as the global economy transitions from an inflation shock to a potential growth or financial stability shock. This is when time horizon plays a key role in the investment decision. History suggests that today's entry levels in corporate credit markets will reward investors for taking credit risk over the medium-term. A similar argument can be made for equities. Outside of the United States, equity markets trade on prospective 12-month earnings multiples that sit below their 10-year averages. Slower growth could also impact on earnings expectations globally, but in Asia and Europe, the downside does not seem to be as clear as in the US. According to consensus estimates for the S&P500 universe of stocks, this year's expected USD218 per share is still very close to the peak level of earnings registered in the 12-month period for September 2022.

Looking forward, the case for equities could strengthen. Global GDP growth should be firmer in 2024 and 2025 which will provide a basis for some recovery in earnings in sectors such as technology and industrials. Investment spending spurred by the US Administration's industrial policy will also help, spurring competitive policies to attract investment in other countries. The recent performance of quality growth stocks partly reflects these expectations. In addition, the relative value of equities compared to bonds should improve as the interest rate cycle turns over. However, there is some way to go. The implied spread between the current earnings yield and the 10-year risk free rate in the US is just 2.3%. This is meagre compensation for the earnings risk and looks low relative to almost 6% for the Euro Stoxx universe and over 7.5% for Japan.

Steps taken to reassure investors over the stability of banks in the US and Europe should underpin confidence. Any sign from central banks that the most recent move in rates was the last, or at least close to the last, would also be positive for sentiment. Fixed income markets would be the most obvious beneficiary of a move lower in global rates. For equities, it really depends on the growth hit that appears to be underway.

Download the full slide deck of our March Investment Strategy

Key market calls

Our Directional views across assets in key market (3-month horizon)

CURRENCIES	weaker	neutral	stronger
Euro			●
Yen		●	
GBPEUR		●	

CURRENCIES

Banking troubles clouding central bank inflation fighting. Cyclical advantage in Europe & US centric banking concerns suggest EUR upside near term. Less so in JPY on BoJ inaction. Sterling caught between inflation pressures and growth concerns.

EQUITY	lower	neutral	higher
US equity	●		
EU equity		●	
EM equity		●	

EQUITY

More constructive on Europe, due to growth resilience and appealing valuation, while we see an uptick in growth downside in the US. Profit margin pressures ahead point to further downside in profits' momentum. Not the best mix for stocks.

RATES	higher	neutral	lower
US rates short	●		
US rates long		●	
EU rates short	●		
EU rates long	●		

RATES

Market moves in rates remain extraordinary. Bar a full blown banking crisis, short end yield moves appear excessive. Long end yields better anchored by drop in peak policy rates and higher growth downside. Short end yields likely to rebound higher.

CREDIT	wider	neutral	tighter
US IG		●	
EU IG			●
US HY		●	
EU HY			●

Source: AXA IM Core Investment Research, as of 27 March 2023

CREDIT

Spreads are caught in no man's land. Wider on banking troubles but not wide enough to compensate for recession risk. Banking risks more systemic in the US than in Europe. Tail risk for spreads more broadly is towards widening.

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Macro forecast summary

Real GDP growth (%)	2022*		2023*		2024*	
	AXA IM	*Consensus*	AXA IM	*Consensus*	AXA IM	*Consensus*
World	3.5		2.7		2.7	
Advanced economies	2.7		1.0		0.7	
US	**2.1**	1.9	**1.0**	0.7	**0.3**	1.1
Euro area	**3.5**	3.2	**0.7**	0.4	**0.6**	1.2
Germany	**1.9**	1.7	**0.2**	-0.1	**0.6**	1.4
France	**2.6**	2.5	**0.6**	0.4	**0.6**	1.2
Italy	**3.8**	3.7	**0.6**	0.4	**0.5**	1.0
Spain	**5.5**	4.5	**1.3**	1.2	**0.9**	1.9
Japan	**1.6**	1.5	**1.7**	1.1	**1.3**	1.1
UK	**4.0**	4.4	**-0.3**	-0.8	**0.5**	0.7
Switzerland	**2.3**	2.1	**0.6**	0.6	**1.3**	1.6
Canada	**3.5**	3.4	**1.0**	0.6	**0.8**	1.5
Emerging economies	3.9		3.7		3.8	
Asia	4.2		5.0		4.6	
China	**3.0**	3.1	**5.3**	5.2	**5.0**	5.1
South Korea	**2.6**	2.6	**1.5**	1.2	**2.0**	2.2
Rest of EM Asia	5.7		5.0		4.4	
LatAm	3.9		1.5		2.1	
Brazil	**3.0**	2.9	**1.0**	1.0	**1.5**	1.8
Mexico	**3.1**	2.9	**1.2**	1.1	**1.8**	1.8
EM Europe	1.6		0.0		2.2	
Russia	**-2.1**		**-3.8**		**2.0**	1.2
Poland	**5.0**	4.9	**0.1**	0.8	**2.4**	3.0
Turkey	**5.6**	5.1	**0.5**	2.2	**1.4**	2.4
Other EMs	4.8		3.0		3.4	

Source: Datastream, IMF and AXA IM Macro Research – As of 27 March 2023
**Forecast*

CPI Inflation (%)	2022*		2023*		2024*	
	AXA IM	*Consensus*	AXA IM	*Consensus*	AXA IM	*Consensus*
Advanced economies	7.3		4.7		2.8	
US	**8.0**	8.1	**4.5**	3.9	**3.2**	2.5
Euro area	**8.3**	8.5	**5.8**	5.5	**2.8**	2.4
China	**2.1**	2.1	**2.3**	2.4	**2.5**	2.3
Japan	**2.5**	2.4	**2.7**	2.1	**1.3**	1.2
UK	**9.1**	9.0	**5.8**	6.7	**2.2**	2.9
Switzerland	**2.8**	2.9	**2.0**	2.2	**1.3**	1.2
Canada	**6.8**	6.8	**3.8**	3.7	**2.7**	2.3

Source: Datastream, IMF and AXA IM Macro Research – As of 27 March 2023
**Forecast*

These projections are not necessarily reliable indicators of future results

Forecast summary

Central bank policy Meeting dates and expected changes (Rates in bp / QE in bn)		Current	Q2-23	Q3-23	Q4-23
United States - Fed	Dates	5	2-3 May 13-14 Jun	25-26 Jul 19-20 Sep	31-1 Oct/Nov 12-13 Dec
	Rates		+0.5 (5.25)	unch (5.25)	unch (5.25)
Euro area - ECB	Dates	3.00	4 May 15 Jun	27 Jul 14 Sep	26 Oct 14 Dec
	Rates		+0.5 (3.5)	+0.25 (3.75)	unch (3.75)
Japan - BoJ	Dates	-0.10	27-28 Apr 15-16 Jun	27-28 Jul 21-22 Sep	30-31 Oct 18-19 Dec
	Rates		unch (-0.10)	unch (-0.10)	unch (-0.10)
UK - BoE	Dates	4.25	11 May 22 Jun	3 Aug 21 Sep	2 Nov 14 Dec
	Rates		+0.25 (4.50)	unch (4.50)	-0.25 (4.25)

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Our Research is available on line: www.axa-im.com/investment-institute

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