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GLOBAL INSIGHTS • GLOBAL INSIGHTS •

Principal Asset Management℠

# Further concerns, or crisis contagion?

## The latest on global market volatility

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*Select commentary updated as of March 20, 2023, 8:00am ET*

**The Global Insights team at Principal Asset Management, in conjunction with the firm's specialized investment teams, is keenly following the latest market and economic developments during this period of heightened market volatility and stands available to offer additional perspectives. Please reach out to your Principal AM client team with any questions or concerns.

Over the past week, investors have had to digest U.S. banking failures and the threatened collapse of a major European bank. This stress has finally underscored the tensions between global central banks' efforts to tame inflation and growing concerns that further policy tightening will spark a crisis. As we all follow the latest developments, it's important to consider each of them in context. Ultimately, investors need to decide if these individual/idiosyncratic crises add up to growing concerns or mark the start of crisis contagion.

### How did markets and global economies get here?

While the specific nature of the various bank crises has come as a surprise to much of the market, it should not be surprising that the banking system and broader economy are under pressure from central banks' rapid withdrawal of liquidity.

Indeed, the origins of the latest crisis are borne from the sharp rise in policy rates over the past year as central banks scrambled to contain inflation. Recall that, rather than react swiftly when pandemic-induced supply chain issues started driving the Consumer Price Index (CPI) higher, eventually accelerating to multi-decade highs, the U.S. Federal Reserve watched from the sidelines, only starting to hike rates in March of 2022. Since then, in the space of just one year, the Fed has raised policy rates by 450 basis points. Similarly, the European Central Bank (ECB) belatedly starting tightening policy and has raised rates by 300 basis points since its lift-off in July last year.

Every central bank tightening cycle in history has induced some sort of financial strains. Notably, not only is the current Fed hiking cycle the most aggressive in 40 years, it's one of the most aggressive in history. The situation in Europe is equally stark—this is the ECB's most aggressive hiking cycle since its inception in 1999. Until this week, markets had broadly ignored the threats that tightening policy was starting to uncover. The latest turmoil, however, has quickly reminded investors that risk assets simply cannot escape the wrath of monetary tightening.

### Perspectives on each of the global market tensions

*Updated as of March 20, 8:00am ET, indicated by blue highlights*

#### *U.S. banking sector: SVB, SBNY and Silvergate collapse*

U.S. commercial banks' profits have been under pressure from deteriorating asset quality, slowing loan growth and rising deposit rates. Silicon Valley Bank (SVB), Signature Bank (SBNY) and Silvergate, the three banks that have collapsed in the last week, were, however, somewhat unique to the broader banking sector in that their deposit bases were predominantly from the now-struggling technology and crypto sectors. The banks also held an unusually large proportion of customer deposits in fixed income securities which had significantly fallen in value as the U.S. Fed started to push up rates. As market conditions for the banks' clients grew more challenging, they withdrew their deposits en-masse, forcing the banks to realize their fixed income losses.

With these bank failures threatening a loss of confidence in the financial system, on Sunday, March 12, U.S. policymakers announced that all depositors (not just those insured by the FDIC) at SVB and SBNY will have access to all their money. Hopefully, this will prop up confidence among depositors across other U.S. banks, preventing additional bank runs. The Fed also announced a new Bank Term Funding Program which will provide additional funding to banks that run into future liquidity problems, limiting the need for banks to sell underwater securities if deposit declines materialize. If this works successfully, it too should ward off potential future deposit flights.

**FOR MORE INFORMATION READ:**
Silicon Valley Bank collapse: The big picture

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### *Credit Suisse again in the crosshairs*

Financial stresses rapidly shifted to Europe last week, with concerns about Credit Suisse (CS) accelerating sharply and spilling over into the broader market. While the bank's issues differ significantly from those of SVB and Signature, CS's problems were not new to markets or investors. The bank was in the throes of a major restructuring plan, meant to stem major losses and revive operations, both of which have been hampered by a string of scandals over the past decade.

As broad concerns about the health of the global banking system and the potential for unrealized losses grew, the weakest links in the sector have come under significant pressure – with Credit Suisse sitting at the epicenter.

Over the weekend, in response to considerable concerns about the outflows from CS and its global systemic importance, Swiss authorities engineered the merger of UBS and CS. The agreed terms will see UBS purchase Credit Suisse in an all-equity transaction for approximately CHF 3 billion, 40% of its market value at Friday's close and down 99% from the peak pre-GFC. The Swiss authorities provided significant financial and liquidity support as part of the sale, a testament to the importance of ringfencing the risks attached to CS.

An initially concerning feature of the deal was the decision by Swiss regulators to "trigger a complete write-down of the nominal value of all AT1 (Additional Tier 1) shares of Credit Suisse in the amount of around CHF 16 billion." AT1s are a type of bank debt, introduced in the aftermath of the financial crisis as part of regulatory reforms to make the banking system stronger, and are designed to provide additional cushion if a bank's capital ratio falls below a certain level. Typically, AT1s rank above equity holders in the capital structure. As such, the decision to wipe out CS AT1 bondholders ahead of equity holders was surprising, initially triggering additional market turmoil, with serious questions about the broader European regulatory framework.

Importantly, European Union regulators have since reiterated that, for European banks *outside* Switzerland, AT1 bonds only take losses after equity holders have been wiped out. By clearly underlining the contrast between their approach and that of the Swiss authorities, they hope to reassure investors that regulatory norms still hold and thereby avoid a further loss of confidence in the European banking sector.

Broadly speaking, the agreement should reduce systemic risk and help stabilize European and global banks. Recall that the European banking sector actually holds stronger liquidity positions and lower duration risk than their U.S. peers, with valuation multiples meaningfully less stretched than those of U.S. banks. In the near term, the sector will inevitably be more volatile. Liquidity concerns are unlikely to disappear quickly, potentially prompting lenders to further tighten credit availability. At the same time, with rates now meaningfully lower and central banks' tightening paths in question, a key source of upside for Banks' earnings has been removed.

### *Inflation and jobs data*

With central banks' policy efforts to loosen the labor market and tame inflation at the heart of recent market turmoil, investors need to maintain a watchful eye over those economic data points. Last week, the February U.S. employment report delivered another strong gain in payrolls, while the unemployment rate remains historically low, suggesting that wage pressures—and therefore price pressures—remain strong. The CPI inflation report, released March 14, showed a similarly concerning story, with monthly core inflation rising to its fastest pace in five months. The longer it takes for the labor market to loosen and inflation to fade, the greater the dilemma for central banks will be: Price stability vs financial stability.

**FOR MORE INFORMATION READ:**
February CPI: Inflation stays hot
February jobs report: Big picture is one of strength
March ECB meeting: A dilemma solved for now

## Where do markets and investors go from here?

Almost two weeks ago, a materially more hawkish narrative from Fed Chair Jerome Powell at his Congressional Testimony had convinced financial markets that the U.S. Federal Reserve could revert to a 50 basis point hike in March. In Europe, with core inflation hitting a new record high in February, expectations for European Central Bank policy had also shifted, with markets pricing in a peak ECB deposit rate of 4%.

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As financial stresses rapidly shifted over to Europe this week, there were rising expectations that the ECB would slow its rate hiking cycle. Instead, as a result of its considerable inflation concerns, the ECB again raised its three key policy rates by 50 basis points for the third time in a row.

ECB President Lagarde reassured markets they were not undermining financial stability concerns, underscoring the view that despite the recent stress euro area banks are much stronger than during previous crises and stated that "the euro area banking sector is resilient, with strong capital and liquidity positions." In addition to this reassurance, the ECB "stands ready to adjust all of its instruments within its mandate… to preserve the smooth functioning of monetary policy transmission."

Despite the ECB's decision to stand firm in its tightening cycle (which was largely aided by the Swiss National Bank's announcement that Credit Suisse was eligible to borrow up to 50 billion Swiss Francs or $54 billion, and that CS, "meets the capital and liquidity requirements imposed on systemically important banks,"), the ECB (and the Fed) will need to take into ongoing consideration the additional pressures a rate hike could put on the financial system.

## Expectations for the ECB

For the ECB, it seems that inflation concerns are still greater than financial stability concerns. Should investors be reassured by that, or should they be worried that the ECB perhaps has some tunnel vision? Reassurances that the ECB toolkit is fully equipped to provide liquidity support will need to be sufficiently credible and convincing, otherwise the central bank will be facing tough questions about its actions.

Clearly the ECB is stuck between a rock and a hard place, and whatever they chose to do with policy rates would have been met with criticism. Finding a way to effectively separate price stability risks and financial stability risks is no small feat, yet it is absolutely necessary in an environment of elevated inflation and banking crisis concerns.

## Expectations for the Federal Reserve

While recent market events show that the Fed's rate increases have hit segments of the banking system hard, those hikes still haven't had the desired effect on inflation. However, with the past week's bank failures sending the financial sector into disarray, the Fed will likely need to put extra focus on the financial stability side of its mandate at its next meeting. Given that bank lending standards are likely to tighten further, and with rate sensitivity of risk assets elevated, the Fed may, in fact, have the space to re-focus on financial stability.

While a full pause in rate hikes could be interpreted as a sign of panic and may raise further concerns about the inflation outlook, a 25 basis point hike, which infers a continued focus on inflation combined with an appreciation of the financial stability risks, seems like most likely outcome from the FOMC meeting this week.

Ultimately, financial conditions will tighten further—either via additional central bank tightening as they try to tame inflation, or via a deterioration in the current banking crisis.

## › ASSET ALLOCATION VIEWS

Given the sudden realization of risks, investors should ensure their exposures minimize vulnerability to the macro-driven threats. High-quality, defensive assets should be sought out, while diversification will be increasingly important.

**Broad U.S. equity markets will likely remain challenged as the twin concerns of risk aversion and economic weakness come to the fore.**

- Maintaining exposure to segments which have lower exposure to cyclical sectors and have less stretched valuations will be important, as will focusing on corporates that are able to preserve margins and top line growth via pricing-power.

**Within fixed income, U.S. Treasurys and high-quality credit merit portfolio allocation.**

- As is already unfolding, bonds are positioned to provide risk mitigation during periods of volatility and risk.
- The negative correlation between stocks and bonds has reasserted itself, and the diversification benefit of fixed income has been restored.
- By contrast, riskier credit segments will likely see fairly significant spread widening over the coming months.

Ultimately, as investors experienced during the COVID crisis, policymaker intervention can be powerful and can completely change the market landscape. Staying invested and waiting for the situation to stabilize, rather than attempting to time an extremely volatile market, remains the best option for reaching portfolio goals.

**Risk considerations**

Investing involves risk, including possible loss of principal. Past performance is no guarantee of future results. Asset allocation and diversification do not ensure a profit or protect against a loss. Equity investments involve greater risk, including higher volatility, than fixed-income investments. Fixed-income investments are subject to interest rate risk; as interest rates rise their value will decline. Inflation and other economic cycles and conditions are difficult to predict and there Is no guarantee that any inflation mitigation/protection strategy will be successful.

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