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Weekly Market Flash

Tensions ahead between the markets and the Fed

May 14, 2023

This week ended with a strong recovery on Wall Street, which allowed global indexes to make The week was an uncertain one for global markets, with marginal losses for the major equity indexes. The trend of the single days was often schizophrenic, with continuous changes of market direction depending on the news that came in from the macro front, monetary policy, and US domestic policy—especially as the debt ceiling debate heats up in view of the now imminent June 1 deadline.

Highlights

▪ The US is nearing its debt limit of USD31.4 trillion, and if it defaults by June 1, there could be several negative consequences such as non-payment to entities like Social Security recipients and Treasury securities holders, credit rating downgrades, higher borrowing costs, and a partial government shutdown.

▪ The T-bills curve has become distorted with the T-bills maturing before June 1 trading at a significantly lower yield than the longer-dated issues one. For instance, the T-bill maturing June 1 has seen its yield surge more than 100 bps this month alone to 5.46%.

▪ The US banking index has now lost 27% since the beginning of the year, after 3.5% this week.

▪ There was some confirmation of the slowdown underway, mainly from initial jobless claims, which have been steadily above 250,000 over the last few weeks after being below 200,000 over the last 12 months. The consumer confidence from the University of Michigan was also down six points.

▪ The Bank of England raised its rate to 4.5%, the highest level since 2008, and another hike in June is expected.

▪ In the hedge fund industry, there has been a growing dominance of the multi-strategy managers model. The growth these managers have experienced since 2018 has outpaced the industry.

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The effect of the rate hikes is beginning to be felt.

From a macro point of view, the most relevant data published this week was the US Senior Loan Officers' Opinion Survey on Bank Lending Practices (SLOOS).

Figure 1: Year-to-Date Performance of Major Indices

"…small banks are being forced to liquidate loss-making assets to meet liquidity needs, large banks are simply losing profitability…"

Source: Bloomberg, as at May 12, 2023. Performance figures in indices' local currencies.

In Figure 2, which presents the supply and demand balance of credit for medium/large companies, the headline figure (the blue line) shows the net percentage of banks that tightened lending standards for commercial and industrial (C&I) loans to 46%. The figure is not too bad (worse was feared in the wake of the regional bank crisis), but it is still in line with a GDP contraction. Needless to say, the dynamics were more evident at the smaller banks, consistent with the crisis of the regional banks.

Figure 2: Tightening Lending Standards

"The US consumer has been the prop of the US economy for the past two quarters, supported by the labor market and the savings accumulated during the pandemic."

Source: Bloomberg, as at May 12, 2023.

Evidently, the effect of the rate hikes of the past 18 months on the economy and the banking system is beginning to be felt. There are now many alternatives to bank deposits with attractive yields being offered to borrowers. The consequence is what we are seeing: small banks are being forced to liquidate loss-making assets to meet liquidity needs, large banks are simply losing profitability (central bank funding is extremely expensive, well below the yields offered by long-dated US Treasury bonds), and they have less room to lend anyway. The US banking index has now lost 27% since the beginning of the year, after 3.5% this week.

But the most surprising part of the survey concerns the demand side for loans (the gray line). The US consumer has been the prop of the US economy for the past two quarters, supported by the labor market and the savings accumulated during the pandemic. As can be seen from Figure 2, such low levels of demand for credit have only been seen to coincide with the recessions of 2001 and 2008.