Markets outlook – what next?

March 2023

From Silicon Valley to Switzerland, banking stress has tested policymakers and unnerved markets, stirring memories of the global financial crisis. But are these isolated incidents or a symptom of deeper problems? Our global Chief Investment Officers (CIOs) offer their take – and indicate what investors should consider next.

Key takeaways

- Recent events are the latest reminder of financial fallouts that might occur because of the shift to a higher interest rate regime.
- Policymakers, already grappling with managing high inflation, may now also focus on tightening regulation to contain financial risks.
- Volatility is set to persist, particularly in equity markets as investors scrutinise the resilience of banking and technology companies.
- Focus on quality: favourable opportunities are likely to emerge for stock pickers in quality value and growth names.

Navigating higher capital costs

Virginie Maisonneuve
Global CIO, Equity

"Money has a cost again" – we are seeing the pressures created by higher interest rates come into sharp focus again in recent days. Over the past year, we have experienced not just the fastest increase but also the largest tightening of policy rates since 1980[1] – rates are up 450 basis points (bps) since March 2022. Money supply, as measured by M2, is growing more slowly than nominal Gross Domestic Product (GDP), meaning less money for financial assets. Until recently, the world was awash with liquidity – a situation accentuated by the Covid-19 pandemic where governments provided additional support for economies. This has helped stoke inflationary pressures, including wage pressure. In developed economies like the US, wages can represent up to 70% of costs.

The tightening of monetary conditions can lead to potential flash points, as we have seen with Silicon Valley Bank (SVB). While not a systemically important bank, SVB grew very rapidly and was a victim of concentration risk, with its focus on the technology industry, combined with some unwise risk management.

Like water, higher capital costs are permeating the system and finding the "lowest" or the weakest points in the system. When this occurs at a time of slower economic growth, it can highlight the weaker segments and trigger intense reactions. When risk is distributed across many banks

1. Source: Refinitv Datastream as of December 1, 2022. Past performance does not predict future returns.

Navigating Rates

Allianz Global Investors

Navigating higher capital costs *(continued)*

or players under a strong supervision framework, the system can handle it. The current robustness of the financial system is supported by the tighter regulation we have seen since the global financial crisis, especially in Europe. We believe it is highly likely that the latest events could lead to a tightening of regulations in the US.

What to consider now

Market events continue to support our focus on quality. We favour a carefully constructed portfolio of high-conviction positions. We consider anchoring portfolios around low-volatility multi-factor strategies that provide a possible bedrock of stability on which to build. Second, we believe the current environment has created potentially favourable opportunities for stock pickers in quality value and growth names, as well as income. Finally, we retain high conviction around long-term thematics.

All things considered, we think that rising rates should be positive for the financial sector, as they support margins, and buying opportunities may emerge in the coming months. But key considerations include the impact of latest events on confidence and the cost of deposits, and the impact of higher rates on final demand and hence on earnings power. Overall, we believe investors can take some comfort from the fact that the financial system appears to be overall stronger than it was previously. In our view, it needs to be, as with "money having a cost again", it will likely be tested further.

Seeking safe havens from market unease

Greg MA Hirt
Global CIO,
Multi Asset

In many ways, the collapse of Silicon Valley Bank (SVB) was an idiosyncratic event, caused by some poor risk management choices. But we might classify it as one of a series of recent "accidents" that can at least in part be attributed to the sharp rise in interest rates. Investors will want to know where the stresses caused by this abrupt regime change might surface next.

It's reassuring to the market that Credit Suisse has secured financing that provides an immediate lifeline. Breaking it apart would be complex. The banking sector is, by nature, built on the trust of depositors and counterparties, and we may see strong intervention from regulators and central banks to support confidence in the sector.

Indeed, the US Federal Reserve (Fed) and the European Central Bank (ECB) will be on high alert and we think recent events could be the trigger for markets to move to what we qualify as a "risk off, liquidity off" scenario associated with financial accident. Overall, this environment is not a constructive one for risky assets (to say the least) and safe havens like the US dollar and US Treasuries should benefit.

Central banks face a dilemma: do they pivot from their medium-term goal of fighting inflation to a more short-term priority of preventing a bank run or contagion? We already had an answer from the ECB, which chose to stick with its expected 0.5 percentage-point rise in rates at its meeting on 16 March, but crucially the central bank removed reference to future rate rises.

What to consider now

By addressing the SVB incident quickly, the Fed may also have bought itself time to continue to focus on its core target – to bring core inflation under control by raising leading rates.

This could trigger further weakness in the economy and a softening of core inflationary pressures, which is the goal of the Fed, especially considering the recent strong labour market data.

We could be due a weaker phase in US equities, especially as valuations remain on the high side and margins deteriorate. We recently reduced US equities in multi-asset portfolios, while shifting to a more positive stance on US Treasuries, at least tactically. We are a bit more constructive in some areas, like emerging markets that offer attractive valuations and are supported by the reopening of China. Similarly, the Japanese yen, with now-positive yields, also offers strong safe-haven potential. With little visibility about the coming period, caution should be the watchword.

Seeing opportunities for active positioning on the yield curve

Franck Dixmier
Global CIO
Fixed Income

It all started in Silicon Valley with a relatively unknown bank facing record outflows of more than USD 40 billion in just one day. Within a week, the European banking sector lost more than 10% of its market value. Credit default swaps (CDSs) widened by around 40bps on senior unsecured debt and 70bps on subordinated, respectively. This contagion makes no sense for banking analysts: we stand by our conviction that European banks are not in crisis.

Even so, we must adjust to this new reality, especially as the banking sector is based on confidence. We are selecting the most resilient names thanks to our bottom-up investment process based on thorough analysis of fundamentals.

Generally, liquidity is not a problem for large US and European banks, which are mostly compliant with regulatory liquidity minimums by a wide margin. And we are confident central banks would act vigorously to prevent a systemic liquidity crisis if needed.

Recent events have caused a major adjustment of yield curves in the US and euro zone, with a drastic revision of central banks' rate-hike expectations. In February, investors seemed to capitulate by lifting expectations by more than 100 basis points (bps) for the Fed terminal rate and 80bps for the ECB terminal rate between the beginning and end of the month. The banking stress has reduced expectations for interest rate rises to almost zero for the Fed and considerably reduced the ECB's terminal rate outlook. This downward correction on rates was concentrated on the short and intermediate part of the curves, but also affected long-term rates.

In our view, these revisions seem excessive. As indicated by the ECB, central banks have specific tools to deal with a potential liquidity crisis. The strength of core inflation should not make them relax their efforts to fight inflation. We still expect central banks to raise rates. But the extent of the hikes will be determined by their success in containing the stress on the banking sector and by the path of core inflation.

What to consider now

We think this very high volatility in the bond markets could create opportunities for active positioning on the yield curve by underweighting the short end, which we think should correct upwards. We consider taking advantage of the recent tensions in credit spreads to overweight allocations, particularly in banks whose spreads have widened by contagion and in an undetermined manner.

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