October 17th, 2022

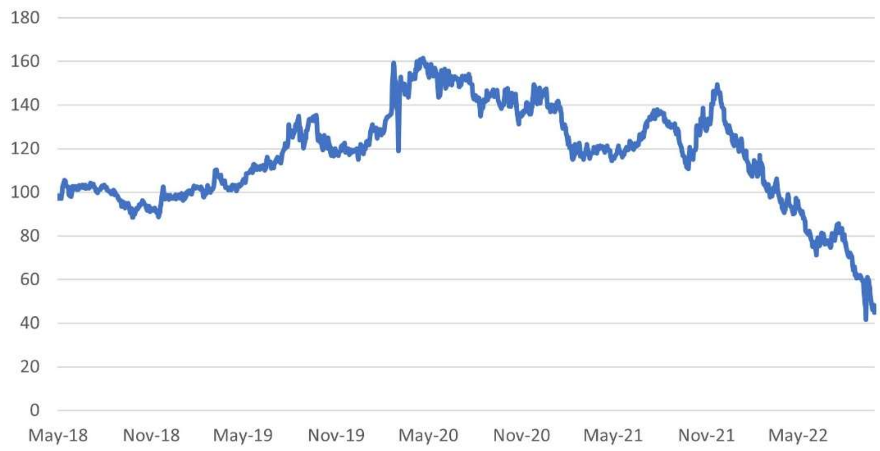
What Breaks Next and What Will They Do?

- **Recent challenges in the UK show that the global economic and political system may struggle to keep trouble at bay**
- **The regime change to inflation as problem rather than an aspiration is catching out institutions and corporates who lack the knowledge of how to react**
- **In the financial system the problems could fall on the secondary banking system which in our view does not have the capacity/liquidity to necessarily cope.**
- **Expected asset class returns still don't look sufficiently large to match the likely risks of coming months**
- **Keep liquidity at hand**

The song "if a picture paints a thousand words…" continues to be a soft rock gem. But we wonder if the songwriter had the chart of a long-dated UK gilt in mind when the popular song was composed. As Chart 1 shows, the very long dated (2071) UK gilt price perfectly paints the myriad of issues plaguing our world at the moment. It's almost reminiscent of an emerging market bond in terms of price action!

1. Inflation is out of control, and policymakers are struggling to establish their credibility.
2. Governments, which try to alleviate the necessary pain that an economy must endure to squash inflation will be run over by investors looking for an exit from the beleaguered currency and bond markets.
3. Those that bought assets at the peak of the good times will suffer potentially catastrophic mark-to-market losses. Investors who purchased this bond may have to wait 49 years to get all their money back!

Chart 1: Long-dated (10/22/2071) UK gilt price (£) collapse



Source: Bloomberg

The UK experience shows just how vulnerable even seasoned policymakers can be to make mistakes under pressure. The consequences in the UK have been severe, so much so that a part of the UK pension industry finds itself on a rather sticky ground. In hindsight, it's clear that the foundation of the UK pension industry's investment culture wasn't sturdy enough to fend off this scale of a setback in asset prices.

The pension funds had, in essence, built up derivative positions on the premise that the UK gilt yields would remain in a reasonable range. The pension funds bought the derivatives to ensure that they had enough liquidity to maintain pay outs to retirees even in an unfavourable interest rates scenario.
The problems in the UK are reverberating worldwide as liquidity-crunched UK pension funds sell other overseas assets to fund their derivative positions. Hence, US and Asian yields have risen sharply.
The political fallout in the UK is profound. The Chancellor lost his job after 38 days in office and the newly appointed prime minister is struggling to hold on to her chair.

A section of the market is of the view that central banks and dovish government policy would come to the rescue if the situation worsened. That's a bit of a wishful thinking. The recent 'experiment' in the UK is a salutary lesson. The new UK prime minister may have thought that she was about to save the country with her new expansive fiscal policy, but the markets saw things differently. The Bank of England's assertion that it could no longer provide tacit support for government profligacy dampened sentiments further. Perhaps, the BoE was (rightly) wary of turning a fiscal disaster into a financial Armageddon. The UK pensions industry, the Chancellor of the Exchequer and probably, in time, the prime minster herself will have ended up being the victims of policymaking that doesn't understand sufficiently that credibility in the eyes of the financial markets remains the measure of success or failure.

There are pressure points across the markets. The scale and pace of the increase in short rates and the fall in asset prices must surely break more actors in the financial markets. Friday's fall in the equity markets reflected investors' nervousness as they didn't know where the next problem would occur.

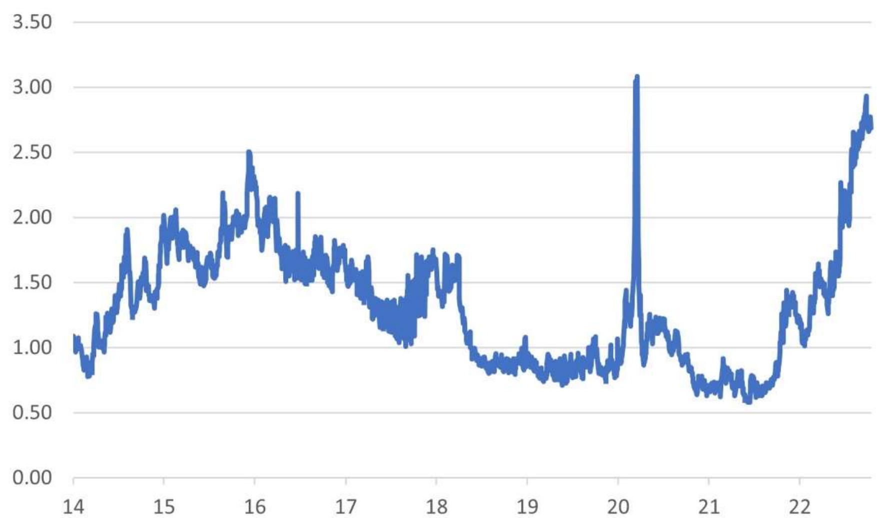
The critical issue for investors is that current challenges in the market are unlike anything seen in a long time. As Axel Weber, the former chairman of UBS and President of the Bundesbank, said recently, "I haven't seen anything like this in 50 years". Essentially, we have a regime change to a market dominated by inflation, not deflation risk. Banks, investors and corporates who lack the experience or corporate framework to deal with current conditions are learning as they go along. The need of the hour is to recalibrate risk models in banks to deal with the current market conditions. Such new learning, although tough, can lead to a marked reduction in risk-taking or complacency through ignorance.

.

The global financial conditions index, measured by Goldman Sachs, has climbed to the highest level since 2009. There are signs of angst in the financial derivative market where credit default swap pricing has increased almost across the board as treasurers seek to take out more insurance against bad news unfolding.

We have noted the challenges in the UK gilt market, but what is also worrying is the significant drop in liquidity even in the US Treasury market. The Bloomberg US Government Liquidity Index is at a stress level above the 2020 pandemic wobble. However, there are no signs of the Fed riding to save the situation.

Chart 2: Bloomberg US Govt Securities Liquidity Index



Source: Bloomberg
Note: The index measures the average yield error across a universe of US Treasury notes. Hence the higher the index the greater the error in the price of Treasuries relative to norms.

Those looking for signs of trouble must first analyse the health of the bank sector given the experience from the 2007-09 global financial crisis. To be fair, the regulations implemented during and in the aftermath of that crisis and the tools created for the central banks should help mitigate some risks. Banks are no longer the hedge-fund-like vehicles they were at that time. However, they are still at the economy's core, and their risk management will be tested as and when the recession hits. By region, it is Europe that worries us the most. European banking regulators have regularly commented in recent months that they thought banks were overly complacent about the challenges. **Fitch recently commented that European banks were in a reasonable state even though Fitch's own analysis showed only four out of the 18 top banks in the green zone on such parameters as capital ratios, profitability and write-downs.**

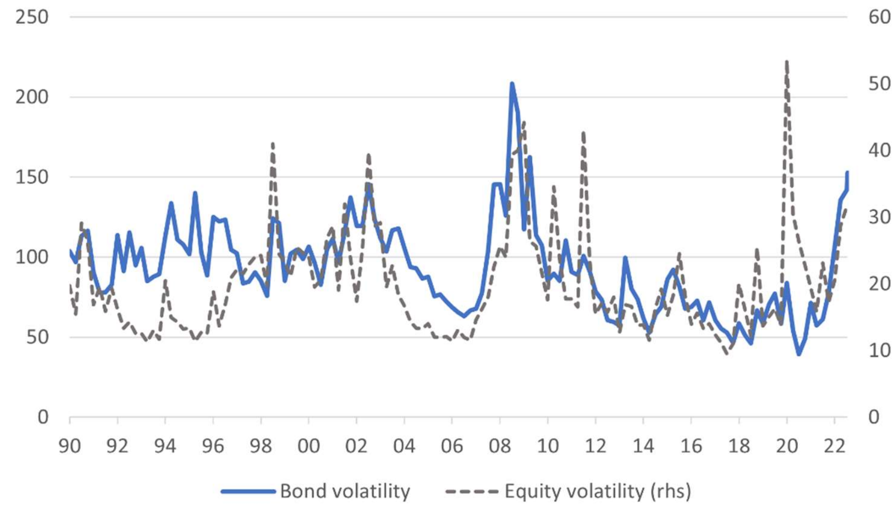
The downside for regulators, such as the Fed, keeping banks safe from trouble is that it keeps them from providing critical support during times of crisis in the economy. The primary relationship between money growth and the economy has diminished as the transmission mechanism between the monetary system and the economy evolved into something that is much less responsive. For years, while there was a great deal of money growth in the economy, there was not a commensurate growth in economic activity. Hence as times get tough, it won't be the banks that will stand ready to support their customers with lending. The burden will be on non-financial institutions that have grown to prominence in the past decade but can't be relied on to provide liquidity when times are tough. They are opportunistic investors.

The secondary banking industry of asset managers and non-financial banking institutions will be the potential weak link on this occasion. As evidenced in the UK gilt market, where a sharp drop in bond prices has brought key investors to their knees, there are hazards ahead that we have not previously thought or fretted about.

We are already seeing more offers of slugs of private equity funds in the market at a 20-30% discount to the most recent NAV as private investors try to raise liquidity. The market has yet to see a mass liquidation event where equity markets fall precipitously.

To the concerns raised above and the stress points, we would add the increased volatility in both bonds and equities. Taken in aggregate, these market conditions are akin to the global financial crisis.

Chart 3: The bond MOVE index and S&P500 VIX index of market volatility



Source: Bloomberg

There's a simple rule of investing: Only invest in the asset where the available return justifies the risk you are taking. Given the elevated market risk, we can see little reason even to be too clever and try to trade the markets.

What will the policymakers do? We don't believe that central bankers and governments have yet thought up the toolbox to bring calm to the markets and ensure the overall financial system's safe running. We hope the recent ham-fisted effort in the UK does not become a trend. The global financial crisis saw central bankers make up an entirely new toolbox of quantitative easing. The Bank of Japan has shown that even buying the equity market is not ruled out when supporting a financial system.
To be honest, we prefer to answer our questions emphatically, but we struggle at this juncture. We and many others don't know how the next couple of quarters will play out. All we can advise is to keep your risk under control and maintain sufficient liquidity to enable you to navigate the upcoming storms.

Gary Dugan
Bill O'Neill (Consultant)