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Market views and strategy

Ostrum ASSET MANAGEMENT

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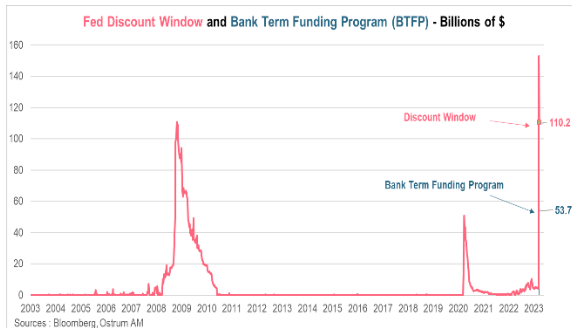
Topic of the week: How to monitor bank liquidity risk

- **The SVB and Credit Suisse cases have awakened old and bad memories, but we think the situation is solid;**
- **Below is a list of indicators that can be used to estimate whether there is a liquidity crisis in the European banking system;**
- **The data we have is more than reassuring about the possibility of a systemic crisis. For the moment there is almost no sign of abnormal stress. To be continued.**

Market review: The risk of financial dominance

- **The Fed keeps guidance for higher rates;**
- **Fed balance sheet up $ 400 Bn in past two weeks;**
- **Bank stocks under pressure amid confidence crisis;**
- **Fed injects $165 Bn.**

Chart of the week



For the 2nd week in a row, commercial banks massively requested the Fed's loan facilities and this for a total amount of $163.9 billion, the week ending March 22, an amount almost identical to the previous week (164.8 billion).

Banks' recourse to the Fed's Discount Window moderated, after reaching an amount well above the 2008 peak, to remain very high (110.2 billion). Banks, on the other hand, made more use of the loan facility created on March 12, following the bankruptcy of SVB and Signature Bank. The Bank Term Funding Program was requested to the tune of 53.7 billion, against 11.9 billion the previous week.

Figure of the week

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Source : Ostrum AM

The European Union plans to produce 40% of its “clean” technology needs by 2030, such as heat pumps, wind turbines, solar panels, renewable hydrogen and CO_2 storage. It is a response to the American Inflation Reduction Act.

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Topic of the week

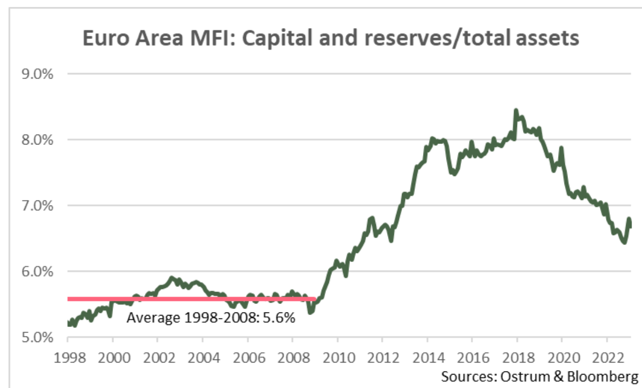
How to monitor bank liquidity risk

The SVB case and Credit Suisse have awakened old and bad memories. However, the situation seems sound to us. Below is a list of indicators that can be used to estimate whether there is a liquidity crisis in the European banking system. So far, flat electroencephalogram, no obvious signs of stress.

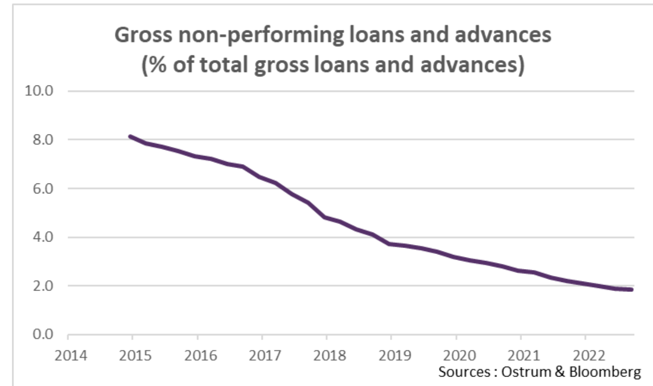
Introduction: the fundamentals

Before focusing on liquidity indicators, it is interesting to briefly review some of the fundamentals.

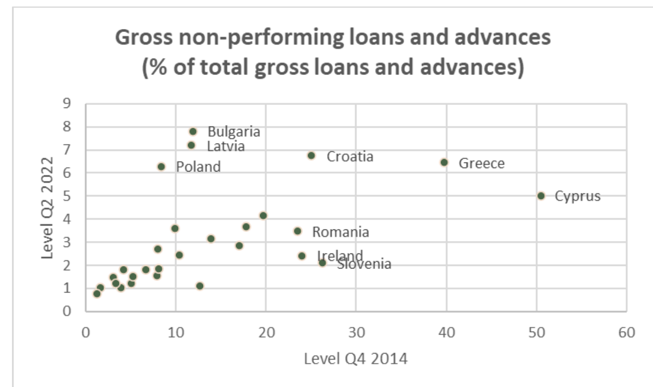
First, by looking at the aggregated accounts provided by the ECB on euro area financial institutions, a capital ratio can be calculated. The graph below shows that the level at the beginning of this year is much higher than it was before the great financial crisis of the last decade. The regulator has imposed much more restrictive prudential ratios and this can be seen in the composition of banks' liabilities.



Another point on asset quality: the legacy of the last crisis in terms of non-performing loans. Here again, the ECB provided figures, they show that doubtful accounts accounted for 8.1% of the portfolio in Q4 2014 (the first data available), but only a small 1.8% in Q3 2022.



The findings are even more impressive at the country level. For example, the rate went from 39.8% in Greece to 6.4%, from 17.0% to 2.9% in Italy, from 17.8% to 3.7% in Portugal, from 8.0% to 2.7% in Spain, etc.



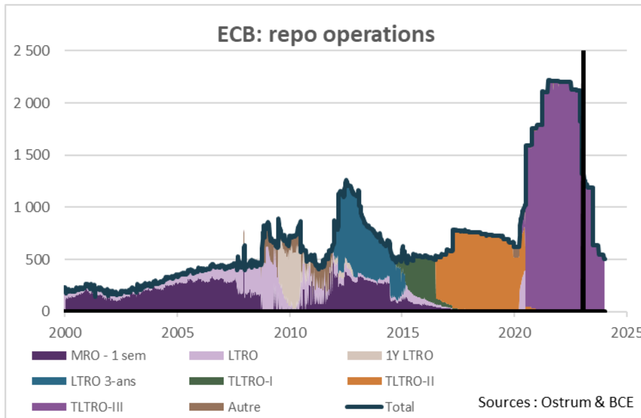
The purpose of this paper is not to make an expertise on banks, our credit team is much more competent. But the few figures and examples shown above aim to emphasize that the situation of European banks seems healthy to us and that it would be wrong to make a simple copy -paste of the previous crisis.

What to look at?

There are essentially two approaches to identifying a liquidity problem: volumes and prices.

Volumes

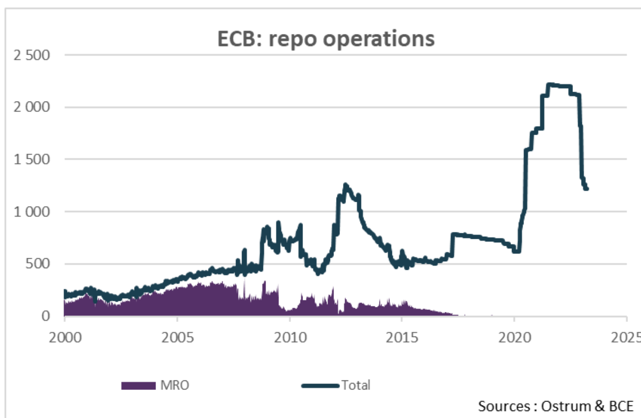
We have to go back to the instruments available to the ECB to provide liquidity to banks. The following graph gives an exhaustive history of the range of repo operations that have been implemented since the beginning of the ECB. The stacking of different programs over the last decade is quite impressive.



The ECB's latest weekly balance sheet shows that it has provided €1.221 billion in liquidity to banks through its various repo operations. The peak was reached shortly after the Covid crisis at $2.217 billion. This liquidity is mainly provided through TLTROs, long-term repo operations. These transactions were implemented in 2020 and 2021 and are no longer accessible. A bank that needs liquidity cannot therefore apply for a new TLTRO.

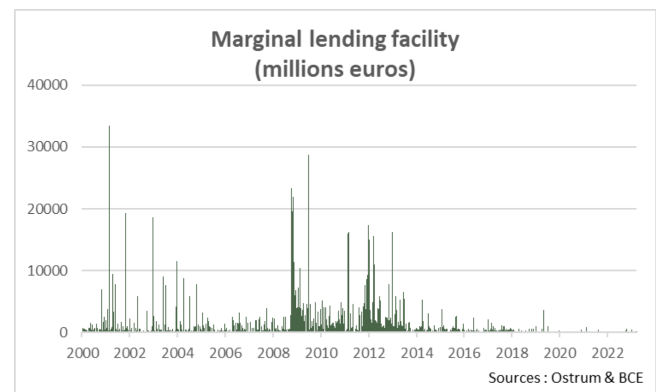
In contrast, the ECB maintained the Main Refinancing Operation (MRO). We must go back to the good old days, before the great crisis of the previous decade. The main source of liquidity for banks was the MRO, a weekly repo operation, every Tuesday, with a 7-day term. So the banks were funding for a week and renewing that every Tuesday.

The graph below, a simplification of the previous one, shows that until 2008, these MROs were indeed, by far, the main source of liquidity for banks. A bank that is currently experiencing liquidity stress would therefore seek funds from the MRO. The last transaction, dated March 22, shows that the banks went to get 974 million (millions not billions!). It's marginal. No signs of stress here.



We still have to get into the plumbing of the ECB. If a bank needs liquidity, should it wait for the next MRO? No, there is another option, the "marginal lending facility". This facility allows a bank to conduct a 24-hour repo transaction with the ECB. The difference with the MRO is the rate: it is the repo rate that applies to the MRO, 3.50% at present, while the lending facility is at a rate of 3.75%. The idea is that the ECB wants to encourage banks not to manage their liquidity on a day-to-day basis. The loan facility is an emergency instrument to avoid an accident. Access to this facility is therefore an emergency measure for a bank that cannot balance its balance sheet and find liquidity over a day.

This is really a measure of unexpected stress, since the bank is forced to borrow at a rate higher than the repo. The latest figures show that the banks asked for €57 million. A totally marginal number in relation to money market volumes.



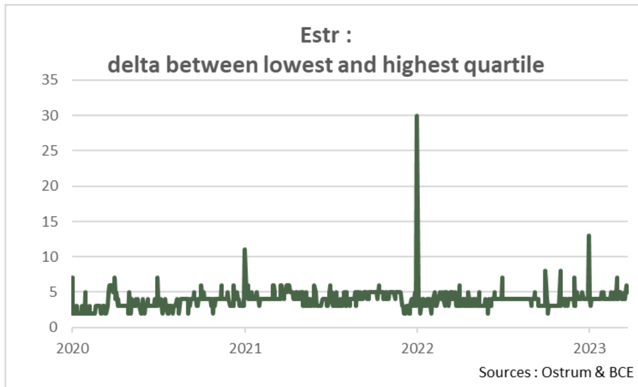
These indicators therefore suggest that liquidity problems remain very limited.

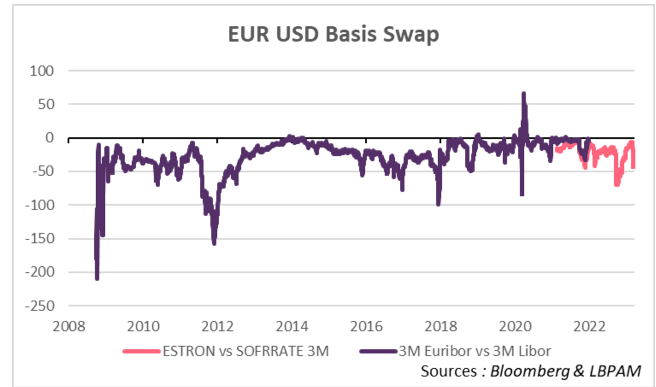
Price

Another way to look at the stress level is to look at interbank rates.

Starting with the €STR, the "euro short-term rate" (€STR) is published daily from interbank transactions. Information on the dispersion of the STR is also available. High dispersion means that some banks borrow at a much higher rate than others. This is a sign of fragmentation.

The chart below shows the difference between the first and last quartiles remains limited, only 6 bps. Again, no obvious signs of stress.





Another indicator is the "basis swap". It is a swap with two floating legs that consists of making a payment from one index and receiving a payment in another index. In our case, basis swaps involve two currencies. They can therefore be seen as the risk premium that an American investor requires to take a position on the European money market. To complicate things, the reference in Europe has changed with the introduction of the €STR and we therefore use two series, normally close, to be able to give a history dating back to 2008.

As a result, the basis swaps are currently at 23 bps, versus an average of 20 bps since the €STR was used as a benchmark. And far, far away, from the peaks of 2008 or 2011. Once again, no signs of stress, but rather business as usual.

Conclusion

It is important to keep a close eye on the banking sector. A crisis is always possible. At the very least, recent events will have a minimal impact on banks' credit granting decisions. As is often the case in economics, the question is where do we put the risk? The data we have is more than reassuring about the possibility of a systemic crisis. For the moment there is almost no sign of abnormal stress. To be continued.

Stéphane Déo

Market review

The risk of financial dominance

The market ignores Powell's message and demands rate cuts.

The troubled financial situation at the end of the first quarter calls for some comments. The difficulties of the banks indeed hide stellar returns in the 1st quarter (+8% on European equities amid a revenge of the 60/40 portfolio after 2022). Some asset valuations make no sense. The low 1-month volatility of equities (V2X, VIX) contrasts with that of interest rates and implied volatilities on 0DTE products (0-day to expriy options) which account for the lions share's of option trading volumes. The liquidation of risky positions on oil futures took the consensus betting on the Chinese recovery and the risk of cutback in Russian oil production wrong-footed. The flight-to-quality bid totally ignores the message from the central banks regarding inflation risks. A 2-year bond about 3.6% can only be justified by assigning a very high probability to a hard landing for the US economy. As always, markets beg for asset price reflation as the cure for all ills. The search for safety and security perhaps reflects a certain distrust of the complexity of banks' liabilities. The rescue of Credit Suisse ignoring the priority of payments sets a dangerous precedent, whatever the EBA may argue. It is striking to note that the crisis of confidence in the US banking system comes at a time when payment defaults are practically at their historic lows. As a result, assets backed by commercial real estate (CMBS) are in free fall.

Contrary to the ambient financial malaise, economic signals point to annualized growth of around 3% in the 1st quarter in the United States. Residential construction is showing signs of improvement (with a rise in housing starts) after a sharp upturn in transactions. Unemployment claims (<200k) have never reflected the layoff announcements (in the technology sector notably) made during the last earnings season. Job openings are plentiful so that individuals can easily come back to work. However, the Fed lowered its GDP growth projections to 0.4%Y (-0.1pp) in 4Q 2023 and 1.2% in 4Q 2024, citing the recessionary impact of the tightening of bank credit conditions. Inflation will nevertheless be a little higher in 2023 than forecast in December, but the drop in oil prices is a helpful development. The interest rate policy guidance is practically unchanged for 2023. There is a strong consensus within the FOMC for a final 25 bp hike before an extended status quo and then cuts worth about 150 bps next year. The breath of FOMC participants' views is much wider for 2024, with Fed funds projections ranging from 3.50 to 5.75%. The path of interest rates essentially depends on the severity of future credit rationing. The provision of liquidity I the past two weeks has reached $400 billion through the discount window ($117 billion), loans to the FDIC (~$40 billion), BTFP ($53 billion) and repos with foreign institutions (60 $ billion). In the euro area, surveys describe a strong recovery in activity in services (55.6 in March).

Current rate volatility is comparable to 2008 levels. Since the start of the confidence crisis, daily movements in 2-year bonds have averaged around 25bp. The money market seemingly ignores the Fed's dual mandate and prices in 75 bps of cuts this year. Flows to money market funds are increasing with the flight of deposits from regional banks and arbitrage justified by the level of short rates. The outstanding amount of money market funds totals more than 5 trillion dollars. These flows may nevertheless end up on the Fed's reverse repo facility as money funds' deposits increased. In short, all roads lead back to the Federal Reserve. The inversion of the yield curve has also eased. The 2-10 year spread is at -30 bps after hitting a low at -110 bps. The T-note yield is practically at its 2023 lows around 3.30%. In the euro area, Schatz yields are approaching 2.30% after trading 100bp higher at the start of this month. The volatility of the 10-year Bund yield is barely lower. On the other hand, sovereign spreads have proven resilient. The French OAT trades between 50 and 60 bp spreads on 10-year maturities. Italian bond spreads remained within 200 bps. The difference between volatilities on risk-free assets and that on spreads is striking. The credit market is nevertheless under some pressure. Spreads on the euro IG fluctuate around 190 bps against Bund. Financials are underperforming. The primary market is practically closed for now. The start of the QT has, so far, had little consequences on the ability of large companies to refinance. That said, the tightening of bank lending conditions may feed back into tougher market conditions at some point. High yield is repricing wider. The iTraxx Crossover is trading around 500 bps. But, comparatively, tensions on the US CMBS are truly mind-blowing, as AAA CMBS tranches trade at 150-bp spreads to Treasuries with BBB in excess of 900 bps. The important role of regional banks in this commercial real estate sector raises fears of refinancing difficulties, amid higher rates and questionable availability of capital.

European equity markets are weakening under the weight of banking stocks, which erased all of their gains in 2023. But the resilience of broad market indices is truly remarkable. The Euro Stoxx 50 shows 8% performance in 2023. The Nasdaq is up 11%, thanks to lower interest rates offsetting the difficulties in the technology sector. Just bear in mind that this market equilibrium rests on expectations of monetary easing.

The Japanese yen has regained its role as a safe haven, with the low volatility of JGBs also attracting inflows from non-resident bond investors. The draw on the Fed's FIMA repo facility led to a rebound in the dollar. That said, the cross-currency bases are still not trading at crisis levels (-30 bps at 1-year maturities).

Axel Botte
Global strategist

Main market indicators

G4 Government Bonds	27-Mar-23	1wk (bp)	1m (bp)	2022 (bp)
EUR Bunds 2y	2.56%	+20	-52	-20
EUR Bunds 10y	2.26%	+14	-32	-31
EUR Bunds 2s10s	-30.6bp	-6	+19	-10
USD Treasuries 2y	3.96%	-2	-82	-47
USD Treasuries 10y	3.49%	+1	-42	-38
USD Treasuries 2s10s	-47.1bp	+3	+40	+9
GBP Gilt 10y	3.43%	+12	-37	-24
JPY JGB 10y	0.32%	+7	-6	+2
€ Sovereign Spreads (10y)	27-Mar-23	1wk (bp)	1m (bp)	2022 (bp)
France	51.09bp	-4	+4	-3
Italy	183.54bp	-3	+1	-30
Spain	103.1bp	-4	+8	-5
Inflation Break-evens (10y)	27-Mar-23	1wk (bp)	1m (bp)	2022 (bp)
EUR 10y Inflation Swap	2.44%	+10	-9	-11
USD 10y Inflation Swap	2.51%	+9	-8	-1
GBP 10y Inflation Swap	3.77%	+8	-7	-14
EUR Credit Indices	27-Mar-23	1wk (bp)	1m (bp)	2022 (bp)
EUR Corporate Credit OAS	184bp	-5	+37	+17
EUR Agencies OAS	82bp	+1	+11	+3
EUR Securitized - Covered OAS	95bp	+2	+16	+12
EUR Pan-European High Yield OAS	537bp	+2	+100	+25
EUR/USD CDS Indices 5y	27-Mar-23	1wk (bp)	1m (bp)	2022 (bp)
iTraxx IG	94bp	-5	+15	+4
iTraxx Crossover	484bp	-23	+72	+10
CDX IG	83bp	-5	+7	+1
CDX High Yield	496bp	-26	+37	+12
Emerging Markets	27-Mar-23	1wk (bp)	1m (bp)	2022 (bp)
JPM EMBI Global Div. Spread	503bp	-6	+58	+51
Currencies	27-Mar-23	1wk (%)	1m (%)	2022 (%)
EUR/USD	$1.079	0.681	1.744	0.8
GBP/USD	$1.226	-0.139	1.633	1.5
USD/JPY	JPY 132	-0.205	3.496	-0.4
Commodity Futures	27-Mar-23	-1wk ($)	-1m ($)	2022 (%)
Crude Brent	$76.1	$2.3	-$5.9	-10.75
Gold	$1 948.7	-$30.2	$131.5	6.83
Equity Market Indices	27-Mar-23	-1wk (%)	-1m (%)	2022 (%)
S&P 500	3 971	0.49	-0.28	3.4
EuroStoxx 50	4 173	1.29	-1.78	10.0
CAC 40	7 092	1.12	-2.79	9.5
Nikkei 225	27 477	0.52	0.11	5.3
Shanghai Composite	3 251	0.51	-0.86	5.2
VIX - Implied Volatility Index	21.40	-11.39	2.15	-1.2

Source: Bloomberg, Ostrum AM

Additional notes

Ostrum Asset Management

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