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WEEKLY MARKET RECAP

20 March 2023

Summary for the week ending on Friday, 17 March 2023

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ECONOMIC AND POLITICAL BACKDROP

The US

Worries that the previous Friday's failure of Silicon Valley Bank (SVB) would set off a wave of new collapses eased over the previous weekend, despite the closure on Sunday of another large regional bank, New York's Signature Bank, which had heavy exposure to cryptocurrency markets. The Federal Reserve (Fed), the Federal Deposit Insurance Corporation (FDIC) and the Treasury Department announced on Sunday, 12 March, that all SVB depositors would have full access to funds on Monday morning, while the Fed made additional funding available to banks to safeguard deposits and prepared to address any potential liquidity pressures. The Fed also announced that it was launching an internal review of its supervision and regulation of SVB, which was overseen by its San Francisco branch.

Absent a series of further bank failures, T. Rowe Price Washington analyst Michael Pinkerton does not expect significant new banking legislation to come out of the recent turmoil. Instead, he anticipates that regulators will propose increased capital requirements for regional banks, perhaps as early as this summer. He notes that most Republicans and some Democrats are sceptical that lax regulation was to blame for the collapses of SVB and Signature. Furthermore, legislation of any sort is especially difficult to pass when one party does not control all three branches of the federal government.

Hopes that the Fed might also adjust its monetary policy in response to events seemed to drive a stock market rally on Tuesday. Concerns that policymakers would reaccelerate the pace of rate hikes from 25 basis points (bp) to 50bp suddenly seemed off the table. By the end of the week, futures markets were pricing in zero likelihood of a 50bp hike compared with a 40% chance of one the week before, according to CME Group data. Markets were also placing a roughly 39% chance on the Fed keeping rates steady at its upcoming meeting on 21-22 March and a nearly 99% probability that the federal funds target rate would end the year lower than its current range of 4.50% to 4.75%.

News on Wednesday that European banking giant Credit Suisse (CS) was also experiencing problems sent equity markets sharply lower again, although many observers pointed out that the Swiss bank's problems were different in nature. Reports that the Swiss National Bank (SNB) was planning to stabilise CS fostered a stock market rally on Thursday afternoon.

Domestically, the struggles of First Republic Bank, which had a focus on the tech sector similar to SVB's – if not as extreme – also weighed on sentiment. After some initial uncertainty, investors appeared relieved by news on Thursday that major banks had deposited USD 30 billion with First Republic in an effort to calm fears about its balance sheet.

The bank's shares tumbled again on Friday, however, perhaps partly due to a report in The Wall Street Journal that some of its top executives – including its chief risk officer – had sold off shares in recent weeks. Friday was also a quarterly "triple witching" day, with three types of options and futures contracts expiring simultaneously, contributing to volatility to end the week.

The turmoil in the banking sector appeared to turn investors' eyes away from economic data, including inflation reports, for the first time in several weeks. On Tuesday, the Labour Department reported that headline consumer inflation had moderated in February in line with expectations to 6.0% on a year-over-year basis, its slowest pace since September 2021. Thursday brought surprise news that producer prices had declined 0.1%, due in part to a sharp decrease in transport and warehousing costs.

Europe

The European Central Bank (ECB) said that it raised its deposit rate by 0.50% to 3.0% as part of its ongoing effort to curb elevated inflation. The ECB reiterated that future decisions would be data dependent but gave no forward guidance. It also said that it was monitoring current market tensions closely and that "the euro area banking sector is resilient, with strong capital and liquidity positions."

The central bank's projections put average inflation at 5.3% in 2023 and down to 2.1% in 2025, while the forecast for growth this year was revised higher to 1.0%, reflecting lower energy prices and the economy's resilience amid the challenges faced thus far. Staff estimates peg economic growth at 1.6% in 2024 and 2025. The ECB cautioned that its forecasts were subject to greater uncertainty than usual because they were drawn up before 1 March and did not incorporate the latest developments.

The UK

The UK jobless rate was unchanged near a record low of 3.7% in the three months through January compared with the previous three months, the Office for National Statistics (ONS) said. Total pay growth in the period slowed to 5.7% from 6.0%.

The total number of working days lost due to strikes fell to 220,000 in January, the ONS said. Meanwhile, more than 400,000 workers – including junior doctors in the National Health Service (NHS), teachers, civil servants, rail workers and BBC staff – went on strike this past week.

UK finance minister Jeremy Hunt included larger-than-expected spending of about GBP 20 billion in the budget. Measures included a 100% tax break on business investment, an extension of the energy price cap to help households, and the expansion of free child-care and other reforms to get people back to work. Hunt offered no new tax cuts; however, the corporate tax will still rise to 25%.

Japan

Japan's government stated that it will coordinate closely with the Bank of Japan (BoJ) to ensure an appropriate response to recent market volatility caused by concerns about US and European banks. It also said that the Japanese banking system was stable as a whole, with Prime Minister Fumio Kishida asserting that domestic banks had adequate liquidity and capital.

Many observers agree that Japanese banks appear to have limited funding and liquidity risks due to their balance sheets and the interest rate environment, but worries appear to have grown about the global market turmoil's impact on BoJ monetary policy. The central bank's April meeting will be the first chaired by incoming Governor Kazuo Ueda and is likely to be closely watched for any pivot from the current ultra-loose stance.

Japan's annual "shunto" spring wage negotiations, held between businesses, major industrial unions and government leaders, wrapped up during the week. Many large Japanese companies, including some leading equipment manufacturers and automakers, agreed to the biggest pay rises in decades – a hike of more than 3%, according to the Japanese Trade Union Confederation (RENGO).

Prime Minister Kishida has repeatedly called for businesses to raise wages to compensate for the impact on households of rising living costs and to support the government's "new capitalism" agenda, which aims to ensure a fairer distribution of income and stronger growth.

China

The People's Bank of China (PBOC) said it would cut the reserve requirement ratio (RRR) for most banks by 25bp for the first time this year in a bid to ensure liquidity and boost the economy. The central bank last cut the RRR in December by the same magnitude. Separately, the PBOC injected a greater-than-expected RMB 481 billion into its financial system via its one-year medium-term lending facility, compared with RMB 200 billion in maturing loans. The central bank left the medium-term lending rate unchanged, as expected.

The moves follow PBOC Governor Yi Gang's surprise reappointment for another term after he was widely expected to retire. Yi's retention appeared to have a calming effect on markets following the revamp of central government institutions under the State Council, China's cabinet, in the prior week. Some analysts viewed Yi's reappointment as a desire to maintain financial stability as China prioritises supporting the economy amid rising growth headwinds.

New home prices in 70 of China's largest cities rose 0.3% in February, above the 0.1% gain in January and marking the fastest increase since July 2021, according to the National Bureau of Statistics. China's real estate market has been in a downturn in recent years as cash-strapped property developers have struggled with slowing sales and high debt levels. However, the sector has recovered significantly in recent months, bolstered by Beijing's dismantlement of its zero-COVID policy in December.

In other economic news, new bank loans reached a higher-than-expected RMB 1.81 trillion in February compared with January's record RMB 4.9 trillion. Though credit expansion typically slows in February, China's accommodative policy and post-COVID recovery led to a pickup in economic activity last month.

Australia

Australia employment rose by 65,000 in February, beating market consensus of 50,000 and more than reversing the job declines in December and January. The unemployment rate fell to 3.5% from 3.7%, even after accounting for the increase in participation rate. The job growth was entirely driven by full-time work, which helped drive a sharp climb of 3.9% month-on-month in hours worked. The underemployment rate fell from 6.2% to 5.8%. While this print shows labour market resilience, forward labour market indicators have continued to turn lower in recent months.

EQUITY MARKETS

Last week, the MSCI All Country World Index (MSCI ACWI) was broadly flat (2.2% YTD).

In the US, the S&P 500 closed 1.5% higher (2.4% YTD), reflecting the crosscurrents of stresses in the banking sector, worries that a steeper slowdown in the economy would follow, and hopes that the Fed would now be forced to moderate or even pause in its rate-hiking cycle. Relatedly, sector returns within the S&P 500 Index varied widely, with communication services and technology shares recording strong gains, while financials and energy shares suffered significant losses. The mega-cap tech shares that generate significant free cash flow and have minimal exposure to the regional banks performed especially well, and large-cap growth stocks outperformed their value counterparts by about 5.8%, according to Russell indexes. Small-caps underperformed large-caps. Over the week, Russell 1000 Growth Index returned 4.1% (8.9% YTD), Russell 1000 Value Index -1.6% (-3.9% YTD) and Russell 2000 Index -2.6% (-1.7% YTD). The technology-heavy Nasdaq Composite recorded a large gain of 4.4% (11.4% YTD).

In Europe, the MSCI Europe ex the UK Index tumbled -3.4% (4.2% YTD) on fears sparked by strains in the financial system. Major stock indexes retreated. Germany's DAX Index fell -4.3% (6.1% YTD), France's CAC 40 decreased -4.1% (7.1% YTD) and Italy's FTSE MIB dropped -6.6% (8.0% YTD). Switzerland's SMI lost -0.8% (0.2% YTD). The euro appreciated versus the US dollar, ending the week at USD 1.07 for EUR, up from 1.06.

Within the MSCI Europe ex the UK Index, the banking sector declined the most, reflecting concerns that Credit Suisse's challenges could create counterparty risk in the financial system. Shares of the Switzerland-based financial giant, which

last fall had unveiled an ambitious restructuring plan, sold off after the chair of Saudi National Bank announced that it would not invest further capital in the company. This development followed on the heels of Credit Suisse delaying the release of its annual report due to “material weakness” in its financial reporting controls. News that the Swiss National Bank had offered to provide Credit Suisse with liquidity and that the company had sought to strengthen itself “pre-emptively” by borrowing more than USD 50 billion from the Swiss National Bank gave the stock a lift on Thursday. Nevertheless, media speculation continued that further action eventually could be needed.

In the UK, the FTSE 100 was down -5.2% (-0.6% YTD), its biggest weekly drop since early June 2020, and the FTSE 250 declined -4.5% (-1.6% YTD). The British pound strengthened versus the US dollar, ending the week at USD 1.22 for GBP, up from 1.20.

Despite limited direct impact on Japan’s financial system from the turmoil in the global banking sector, the accompanying dip in investor sentiment helped sending Japanese equities sharply lower. The Nikkei 225 Index shed -2.9% (4.8% YTD), the broader TOPIX Index retreated -3.5% (3.6% YTD) and the TOPIX Small Index decreased -3.8% (3.9% YTD). Losses were, to a degree, cushioned by speculation that major central banks, in light of the week’s developments and concerns about broader weakness in the global economy, could adopt a less aggressive approach to monetary policy tightening.

As growing risk aversion prompted investors to seek out assets perceived as safer, the yield on the 10-year Japanese government bond fell to 0.28% from 0.40% at the end of the prior week. The yen strengthened to JPY 131.9 against the US dollar from JPY 135.0 the previous week, also on the flight to safety.

In Australia, the S&P ASX 200 lost -2.1% (1.3% YTD) as the SVB and Credit Suisse turmoil pushed investors to a risk-off mode. Australian shorter-term government bond yields moved notably lower as investors moderated their expectation of the terminal rate of the Reserve Bank of Australia (RBA) due to early signs of worsening financial conditions. The Australian dollar, on the other hand, strengthened against the US dollar as US Treasury yields plunged even more.

Emerging markets and other markets

MSCI Emerging Markets Index closed -0.3% lower last week (-0.2% YTD), with a mixed contribution to performance from the stock market of China and a negative contribution to performance from those of Taiwan, India and Brazil.

Chinese stocks ended a volatile week on a mixed note as global banking woes offset optimism about an economic recovery and further monetary support from Beijing. The Shanghai Stock Exchange Index added 0.6% (5.2% YTD) and the blue-chip CSI 300 Index shed -0.2% (2.3% YTD). In Hong Kong, the benchmark Hang Seng Index gained 1.0% (-1.0% YTD).

In South Africa, the equity market continued to feel the impact of the country’s energy crisis, while also suffering from the general downturn in emerging markets due to the turmoil in the American and European banking systems. South Africa’s citizens and companies have been struggling with a series of rolling energy blackouts due to aging coal-fired plants. Executives at state-owned electric utility monopoly Eskom have also blamed widespread corruption and thefts of coal and parts by crime syndicates.

T. Rowe Price sovereign credit analyst Roy Adkins notes that a surprisingly large contraction in the economy in the final quarter of 2022 was due in part to weakness in power-intensive sectors, such as mining, manufacturing and trade. Moreover, he expects that problems from so-called loadshedding will be exacerbated in the coming months, when the Southern Hemisphere moves into fall and winter. While a good deal of private generation is in the pipeline, it is unlikely to arrive in the immediate term.

In Argentina, the S&P MERVAL Index fell -6.2% (9.7% YTD) as the country continued to wrestle with some of the highest inflation in the world. Bloomberg reported that the central bank was considering its first rate hike since November after data showed that consumer prices rose 102.5% over the 12 months ended in February, a pace not seen since 1991.

In South Korea, the KOSPI ended the week roughly flat (7.1% YTD), after late gains in heavily weighted Samsung compensated for weakness on news of stresses in the US and European banking systems. On Thursday, the leaders of South Korea and Japan met formally for the first time since 2011 and announced the end of Japan’s controls of some

technology exports to South Korea, which have impacted Samsung and other firms. Dow Jones reported on Wednesday that Samsung was planning on investing USD 228 billion over the next two decades in building the world's largest chipmaking facility in the country.

FIXED INCOME MARKETS

Last week, the Bloomberg Global Aggregate Index (hedged to USD) returned 1.4% (3.0% YTD), Bloomberg Global High Yield Index (hedged to USD) -0.8% (1.1% YTD) and Bloomberg Emerging Markets Hard Currency Index 0.1% (1.2% YTD).

Lower growth expectations and higher risk aversion led to a sharp drop in longer-term US Treasury yields, with the yield on the benchmark 10-year note touching an intraday low of 3.37% on Thursday, its lowest level since the beginning of February. Over the week, the 10-year Treasury yield decreased -27bp, down from 3.70% to 3.43% (down -45bp YTD). The 2-year Treasury yield decreased -75bp, from 4.59% to 3.84% (down -59bp YTD). The 2-10-year yield curve remained inverted – often seen as a harbinger of recession.

The German 10-year bund yield decreased -40bp, down from 2.50% to 2.10% (down -46bp YTD).

Yield on 10-year UK gilts decreased -36bp, down from 3.64% to 3.28% (down -38bp YTD).

The fallout of the banking stresses made its way into credit markets. US investment-grade credit spreads widened to a four-month high, while shorter-duration bonds and bonds issued by regional banks experienced some of the largest fluctuations. No new deals reached the market during the week as volatility side-lined potential issuers. The high yield market was also mostly quiet.

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