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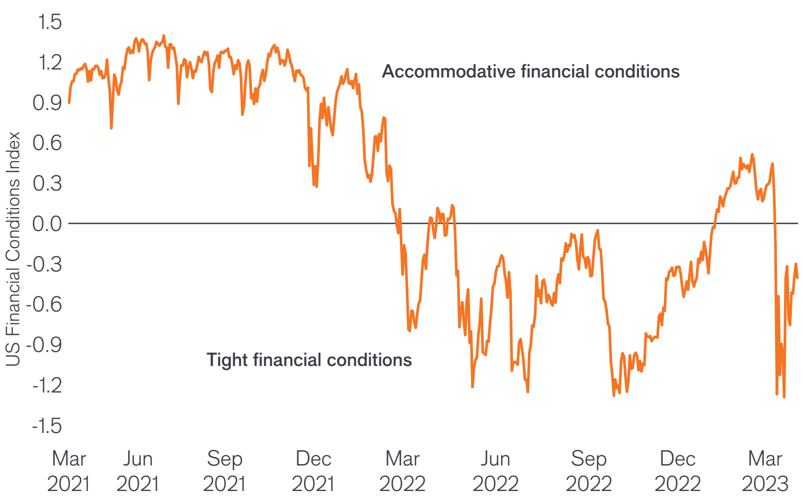
The Fixed Income Investment Strategy Group (ISG) brings together investment professionals from across the global fixed income platform and other Janus Henderson teams, providing a forum for debate around the fixed income asset class and key drivers of the market. The ISG Insight seeks to provide a summary of recent debate within the group.

The focus of debate among participants centred on tighter financial conditions in the economy and how the recent banking crisis was likely to have exacerbated recession risks. This provoked discussion around regulation, vulnerabilities in high yield and what could shape central bank direction.

The wake-up call

A key requisite for central bank policy success was to tighten financial conditions to slow the economy and thus dampen inflation. The market strength earlier in the year was unhelpful to their cause as higher values for risk assets such as equities and tighter credit spreads were offsetting some of the tightening from higher interest rates. The banking crisis in March was a rude awakening for markets, although in shifting behaviour it may have granted central bankers their wish.

Figure 1: Bank crisis restored tightness to financial conditions



Source: Bloomberg, Bloomberg US Financial Conditions Index, 31 March 2021 to 31 March 2023. The index is a Z-score that indicates the number of standard deviations by which current financial conditions deviate from normal (pre-crisis) levels. It tracks stress in money, bond and equity markets to assess availability and cost of credit.

It was widely expected that central banks would need to break things to restore price stability. Bank collapses in March threw an obstacle into the mix by reigniting concerns around financial stability – the Global Financial Crisis (GFC) has cast a long shadow – but what impact might the recent banking stress have on credit and rates?

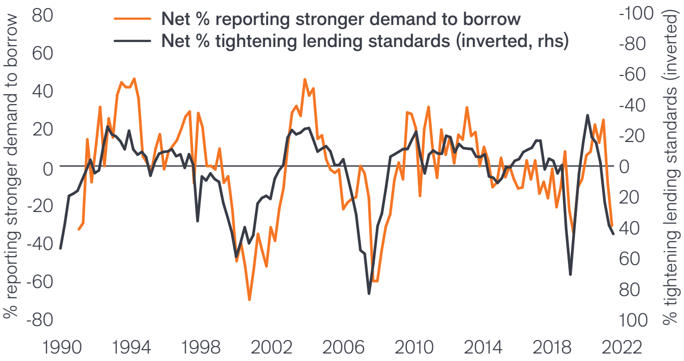
KEY TAKEAWAYS

- Tighter credit conditions were evident on both sides of the Atlantic before troubles erupted in the banking sector – recession remains the most likely outcome.
- The banking crisis is symptomatic of late-cycle flare-ups when market and economic developments become non-linear; this crisis appears contained, however, rather than systemic.
- The trade-off between price stability and financial stability is still weighted towards fighting inflation but yields and spreads can pivot sharply so it is important to stay nimble.

Tighter credit conditions

Debate centred on how banks were likely to react to the crisis, with an expectation that lending standards would tighten further. After all, credit conditions were tightening well before the recent crisis erupted, with banks already tightening lending standards and reporting weaker demand for borrowing through the second half of 2022.

Figure 2: Credit conditions were tightening well before the recent bank woes

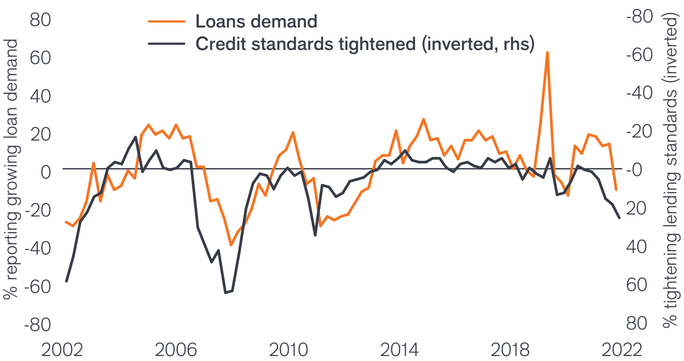


Source: Refinitiv Datastream, Federal Reserve Senior Loan Officer Opinon Survey (US commercial and industrial loans to large and medium firms, net % domestic banks tightening lending standards, net % domestic banks reporting stronger demand for credit), Q4 1990 to Q4 2022.

Worryingly, the trends in the US were evident elsewhere. Europe displayed a similar squeeze, with credit standards heading back into the tight territory seen during the 2011 Eurozone Debt Crisis. Demand for loans had dropped sharply and it would be worth observing if the recent bank trauma caused this to persist.

Figure 3: ECB Bank Lending Survey shows similar credit tightening by banks

Percentage balance of banks reporting growing loan demand and tightening credit standards



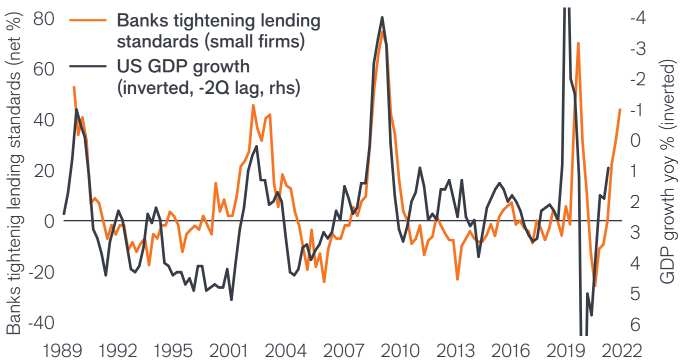
Source: European Central Bank, December 2002 to December 2022.

Several participants raised the point that there had been little to no increase in debt growth among US investment grade (IG) corporates since 2021. This could store up economic trouble ahead since credit creation is a key element in economic expansion. Weaker earnings growth also suggested leverage (debt/earnings) ratios were likely to deteriorate in coming quarters, although interest cover remained high.[1]

Members noted the close positive correlation between tighter lending standards and economic growth, with the latter often following lending standards with a two-quarter lag. In late March, Goldman Sachs estimated that the banking tensions and tighter lending conditions were likely to shave 0.25-0.5% off US gross domestic product (GDP) growth and imply a roughly 0.3% drag on Euro Area GDP.[2] Given the fallout in the US regional banking sector, there was concern that many small firms are reliant on regional banks for capital access so if the relationship shown in Figure 4 holds, it could hasten recession.

Figure 4: Economies are built on credit creation

Tighter lending standards for small firms will slow GDP growth



Source: Refinitiv Datastream, Federal Reserve Senior Loan Officer Opinion Survey (US commercial and industrial loans to small firms, net % domestic banks tightening lending standards), US real gross domestic product growth year-on-year (yoy) % change, Q4 1989 to Q4 2022.

\+ **Total debt growth among US IG corporates has been static** and interest rate cover remains strong.

− **Without credit creation the economy will stall.** Worryingly, a slowdown is evident on both sides of the Atlantic.

[1] Source: Deutsche Bank, Global Credit Chart Book, 9 March 2023.

[2] Source: Goldman Sachs, March 2023. There is no guarantee that past trends will continue, or forecasts will be realised.

Fed – are you listening?

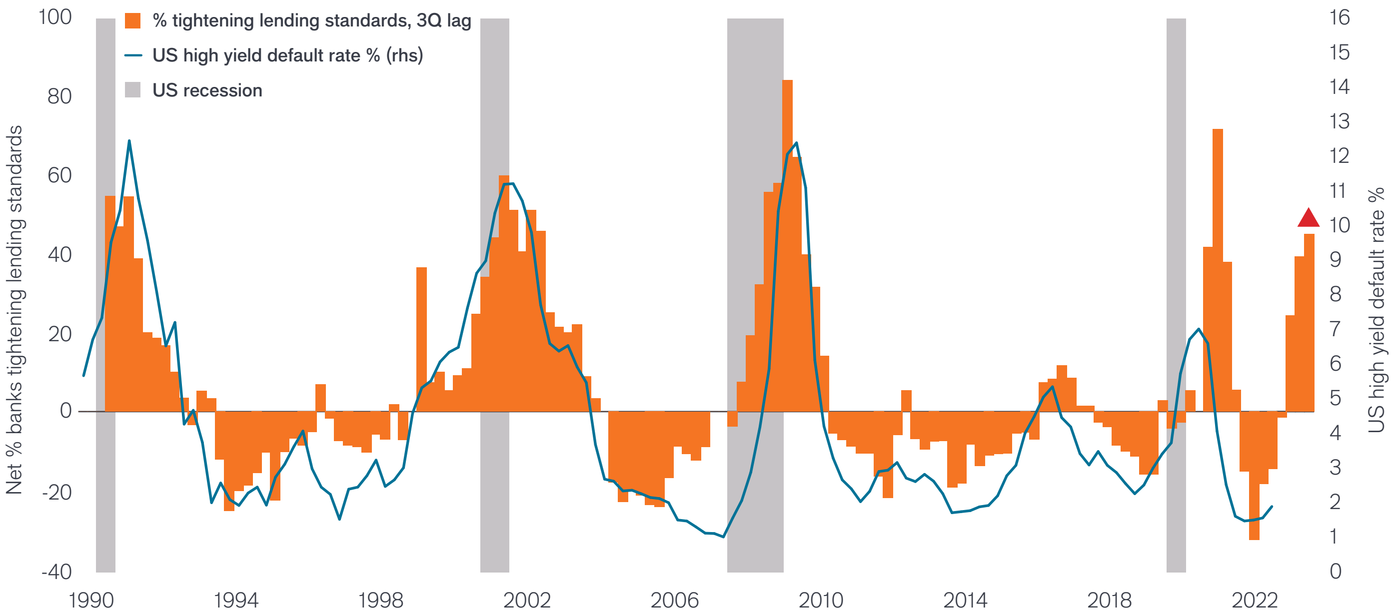
Participants generally agreed that even though economic data had been stronger than anticipated in early 2023, tighter lending standards among commercial banks could substitute for central bank action. Fed Chair Jerome Powell said as much in the press conference following the March Federal Open Market Committee meeting, albeit caveating it with a lack of precision. The presumption in the quote (to the right) is that one rate hike is 25 basis points.

The markets clearly felt the Fed would listen, with futures markets switching rapidly from pricing in several further interest rate hikes in 2023 to pricing in rate cuts in the second half of 2023 and a lower peak rate of 5% (down from 5.6%).[3]

> "Such a tightening of financial conditions would work in the same direction as rate tightening… you can think of it as being the equivalent of a rate hike or perhaps more than that."
>
> **Jerome Powell**

Noting the pattern between bank lending standards and economic growth, portfolio managers observed that there was a similarly tight fit between lending standards and the high yield default rate. Prior to the meeting members approached a number of investment banks for their view on where credit standards might be in the next quarter. Their aggregated response is denoted by the red triangle in Figure 5.

Figure 5: US Commercial and industrial lending standards and US high yield default rate



Source: Deutsche Bank, Janus Henderson Investors, Bloomberg, Federal Reserve Senior Loan Officer Opinion Survey, net % of banks tightening lending standards (large and medium firms), US high yield default rate, 30 June 1990 to 31 December 2022. The red triangle denotes aggregated expectation for lending standards from several investment banks. There is no guarantee that past trends will continue or forecasts will be realised.

Amongst participants there was scepticism that defaults would fully match the tightness of credit standards and get as high as 9-10%. Many high yield borrowers still have strong fundamentals and near-term maturities are modest with refinancing needs only picking up in late 2024. The quality of the high yield bond market had improved, with a much higher weighting in BB rated credits compared with previous downturns. It was generally agreed, however, that 4-5% seemed a reasonable floor for defaults in the next 12 months as it was hard to argue against the pattern fit of this model. Tighter credit conditions affect defaults in two ways:

- Slower economic growth: Less credit leads to slowing demand so revenues and cash flows come under pressure.
- Lack of access to capital: It becomes more expensive or is denied altogether, making refinancing difficult.

\+ **Tighter credit conditions substitute for policy tightening,** potentially hastening the peak in terminal rates and the shift to rate cuts.

– **Credit sensitive areas of the economy are vulnerable** as they are exposed both operationally and financially to a tightening in lending standards.

[3] Source: Bloomberg, shift in US interest rate projections between 7 March 2023 (implied peak policy rate of 5.6% in Q3 2023) and 31 March 2023 (implied peak policy rate of 5% in Q2 2023 and cuts to 4.35% in H2 2023). Data as at 31 March 2023. There is no guarantee that forecasts will be realised.

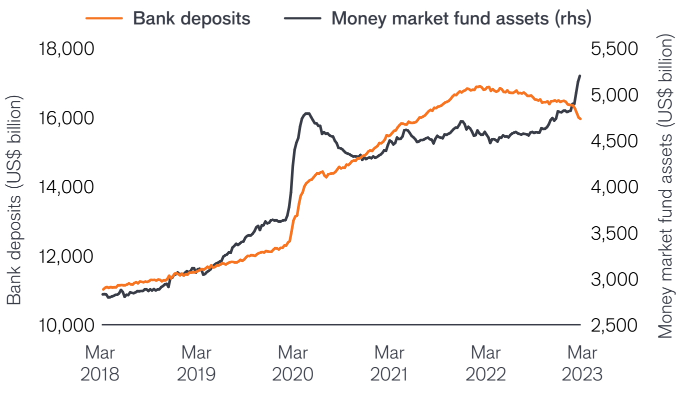
Is banking permanently affected?

Given the failures of Signature Bank and Silicon Valley Bank (SVB) in the US, together with the UBS rescue of Credit Suisse, talk turned to bank deposits. It was generally agreed that there was an implicit deposit guarantee across all US banks even though Treasury Secretary Janet Yellen was loathe to officially commit to this. A blanket deposit guarantee was seen as politically challenging, particularly as the coming months could be tested by Congressional debate around extending the US federal debt ceiling.

Online banking is the norm today so deposits can move at speed – making banks even more vulnerable to a bank run than they were in 2008. Social media arguably fuels any panic. It was acknowledged that deposits were more fluid than regulatory stress tests assumed. Most liquidity capital ratio assumptions anticipate 5-25% deposit outflows over a 30-day stress period – SVB suffered a 25% deposit outflow in half a day, leaving SVB with insufficient time to access its liquidity options at the Federal Home Loan Bank (FHLB) and the Fed, and another 61% of deposits was planned to be withdrawn the next day.[4]

Several members shared the view that there could be a structural shift towards greater use of money market funds as corporate treasurers pay greater attention (if only for reputation) to the safety of cash given the limits on insured deposits. This was likely to bid up the cost of deposits at banks (in the absence of any policy rate cuts), further tightening financial conditions.

Figure 6: Money market funds have replaced deposits in the US



Source: Refinitiv Datastream, Federal Reserve: US domestically chartered commercial bank deposits, seasonally adjusted; Investment Company Institute: US money market fund assets, 28 March 2018 to 29 March 2023.

Liquidity, capital or asset quality?

Discussion moved on to the causes of bank troubles – loss of liquidity, lack of capital, and deteriorating asset quality. Uninsured deposits created a liquidity issue for stressed regional banks, with SVB having a particularly concentrated deposit base among venture capital firms, start-ups and tech firms. With US banks having to hold capital against the total size of their balance sheet, quantitative easing-driven deposit inflows and lack of lending opportunities led banks to look to generate a return on equity on those deposits. This included investing them into low credit-risk government backed securities, including long-duration Treasuries and mortgage-backed securities to try and earn a margin. SVB was an extreme example of this duration mismatch. Negative headlines and uncertainty around the execution of its strategic plan similarly made Credit Suisse a prime target of the bank bond sell-off that followed the unravelling of SVB.

In terms of capital, participants agreed that bank capitalisation was in a much stronger place than 2007 when banks were heading into the GFC: for example, the average common equity tier 1 ratio on European banks was 15.3% in Q4 2022 according to the latest European Banking Authority data, compared with 8.2% back in June 2007. The swift move by the European Central Bank (ECB) and Bank of England (BoE) to reaffirm the order of seniority in the capital structure – equity typically absorbing losses before alternative tier 1 capital – gave some reassurance that the Swiss authorities' inversion of this hierarchy during the Credit Suisse rescue was unique.

Capital was seen as reasonable among US banks and conversations with syndicate banks had revealed that there was currently little appetite to issue fresh capital since most regional banks were keen to signal they were solid. Some members suggested that regional banks may look to reduce returns to shareholders to build capital internally ahead of higher regulatory capital requirements in coming years. At the very least, it was felt that in the US there would be a fresh look at tightening some of the regulations and stringency of stress tests.

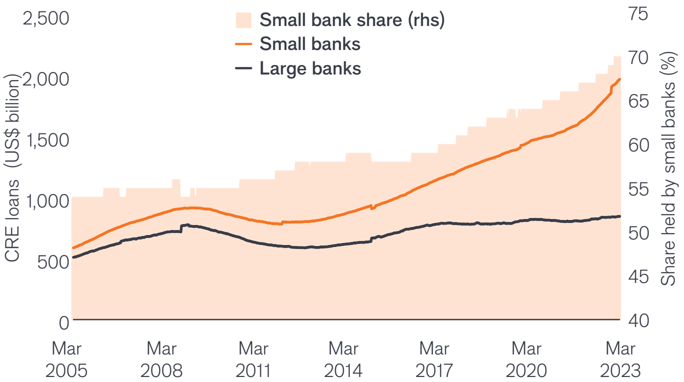
[4] Source: SVB deposit outflow of US$42bn on 9 March 2023 according to California state regulatory filing, and a further US$100bn scheduled the following day. This compares with deposits on SVB's balance sheet of US$165bn at 28 February 2023 according to SVB's Q1'23 mid-quarter update.

Shaky foundations?

Turning to asset quality, commercial real estate loans were flagged as a source of vulnerability for banks. Higher interest rates put downward pressure on capital values of real estate while real estate borrowers face higher financing costs at a time when occupancy levels are already feeling the strain of a softer economy and hybrid working. Smaller regional banks have bigger exposure to commercial real estate than the large global systemically important banks. There was concern that stress could be self-reinforcing, with deposit outflow at regional banks causing them to tighten lending standards on their loan book, making conditions tougher for the local economy and real estate borrowers.

Figure 7: Small domestic banks are more exposed to commercial real estate (CRE) loans

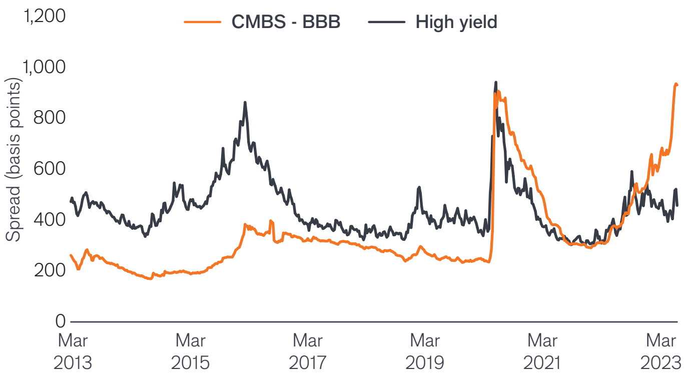
CRE loans outstanding at domestically chartered US banks ($bn) and % share held by small banks



Source: Federal Reserve, H.8. Assets: Commercial real estate loans of small and large domestically chartered banks in the United States, March 2005 to March 2023.

There was already evidence that parts of the fixed income market more vulnerable to problems at regional banks were exhibiting some strain. High yield bonds that are credit sensitive had seen spreads widen since the crisis erupted. The same was true for commercial mortgage-backed securities (CMBS) as investors mapped a potential fallout from regional banks onto this sector.

Figure 8: Spreads over sovereigns show stress in US high yield and CMBS



Source: Bloomberg, ICE BofA BBB US Fixed Rate CMBS Index, ICE BofA US High Yield Index, Govt option adjusted spread. 22 March 2013 to 24 March 2023. Basis point (bp) equals 1/100 of a percentage point. 1 bp = 0.01%, 100 bps = 1%. The ICE BofA BBB US Fixed Rate CMBS Index tracks the performance of US dollar denominated investment grade fixed rate commercial backed securities publicly issued in the US domestic market, rated BBB1 to BBB3 inclusive. The ICE BofA US High Yield Index tracks the performance of US dollar denominated below investment grade corporate debt publicly issued in the US domestic market.

\+ **Idiosyncratic reasons for recent bank failings** but how many failures does it take before something is declared a pattern?

\+ **Tighter regulation is likely to ensue,** which should be good from a credit perspective and stress tests could be more stringent.

\+ **European and US banking systems are well capitalised.**

– **Deposits can move at speed.** Compared with 2008, the world does a lot more banking online, while social media amplifies any panic.

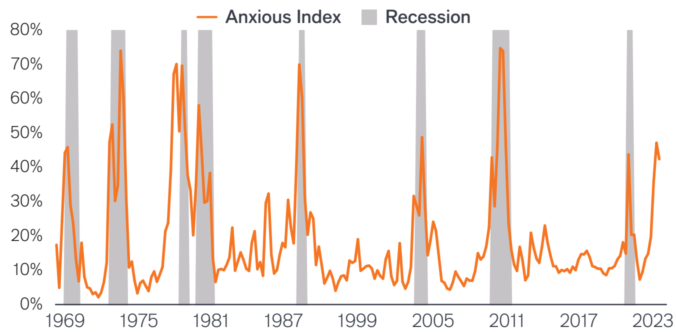
– **Shift towards money market funds may be structural,** bidding up the costs of deposit funding.

– **Path to more regulation likely to be volatile.**

Is recession baked in?

It was difficult to argue against so many leading indicators pointing towards recession. From weakness in housing and consumer sentiment to sub 50 readings (suggesting contraction) on PMI new orders indices, the projected outlook was bleak. This was summed up by the Anxious Index compiled from the Federal Reserve Bank of Philadelphia Survey of Professional Forecasters.

Figure 9: Philadelphia Fed probability of decline in next quarter US GDP



Source: Federal Reserve of Philadelphia Anxious Index, Survey of Professional Forecasters, Q1 1969 to Q1 2023. There is no guarantee that past trends will continue, or forecasts will be realised.

Several members pointed to recent meetings with companies in which they heard clearer anecdotal evidence of an impending economic slowdown. For example, buy-to-let lenders were noticing that performance trends on pre-crisis collateral were showing delinquencies at levels not seen for some time.

Particular attention was paid to yield curve inversions given these have an almost infallible record in predicting recession. Yet, several members pointed out that while recessions typically followed yield curve inversions these were often not immediate. Research (below) showed that since 1969 the time gap between the 3-month/10-year yield curve inverting and a recession starting ranged from five to 16 months. If history were a guide, that could place the beginning of the next US recession anywhere from early Q2 2023 through to Q1 2024. Such a wide range gives plenty of scope for market volatility together with trading opportunities around rate shifts and spread widening and compression. Ominously, a re-steepening of the yield curve from an inverted trough (as happened the week after the SVB collapse) is historically a sign that recession is close.

Figure 10: How long until the recession?

When the 3-month to 10-year yield curve inverts for 10 consecutive trading days

Date of inversion	Consecutive trading days inverted	Date of next recession	Calendar days to next recession
10/01/1969	24	Dec 1969	325
14/06/1973	177	Nov 1973	140
08/12/1978	91	Jan 1980	389
07/11/1980	102	Jul 1981	236
06/06/1989	30	Jul 1990	390
31/07/2000	135	Mar 2001	213
01/08/2006	217	Dec 2007	487
06/06/2019	41	Feb 2020	268
22/11/2022	**???**	**???**	**???**
Average	**111**		**311**

Source: Bianco Research, 3 February 2023.

Yet it was also important to reflect on what could postpone or avoid a recession altogether. A resolution to the war in Ukraine was an obvious candidate to lift markets. Europe was viewed as having potentially stronger economic growth prospects than the US as a decline in energy costs began to make its presence felt and its export markets could benefit from China's economic re-opening. Few felt that China's reopening would lead to an aggressive inflation impulse as it was focused more on the return of general consumption rather than a property and infrastructure boom. Some argued that countries may experience a "rolling recession", in which the economy as a whole crawls along – avoiding a technical recession of two consecutive quarters of negative real gross domestic product growth – but specific sectors or pockets of the economy contract. In such a climate, parts of the credit market could be robust while others suffer (much as the high yield energy sector experienced in 2015).

\+ **A resolution to war in Ukraine** could see a fillip for markets.

\+ **China re-emergence** post Covid lockdown could help offset some of the slowdown in developed markets.

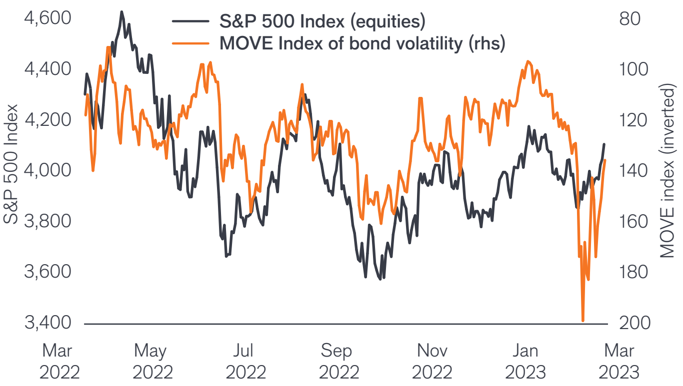
– **Lead indicators are aligned to recession** – to argue against them requires ripping up long-held models.

– **A rolling recession could materialise** – i.e. not economy-wide but rolls through different sectors at different times.

Whole world is a risk premium trade

Given the febrile nature of markets it is important not to be painted into a corner and instead be able to react when markets become oversold or overbought. Figure 11 shows risk assets can move rapidly with shifting sentiment towards interest rate volatility.

Figure 11: US stocks and bond volatility

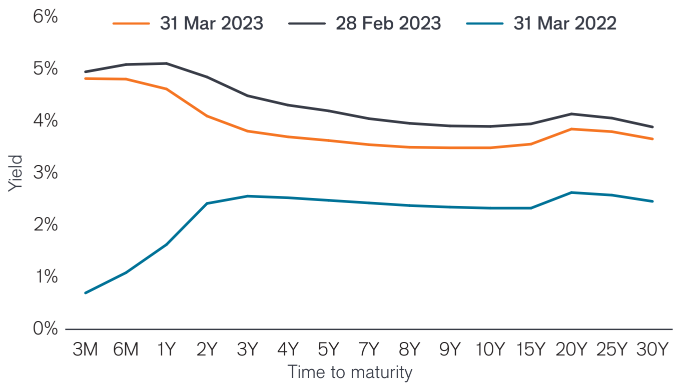


Source: Bloomberg, S&P 500 Index, ICE BofA Move Index, 31 March 2022 to 31 March 2023. The S&P 500 Index is a stock market index tracking the performance of the 500 largest companies publicly traded in the US. The move index is a yield curve weighted index of the normalised implied volatility on 1-month Treasury options which are weighted on 2, 5, 10 and 30-year contracts over the next 30 days. It is a measure of interest rate volatility in US Treasuries.

The banking crisis resurrected fears about fundamentals in the economy. Banking stress is likely to bring forward recession, so the widening in credit spreads in March appeared warranted. Spreads might tighten as initial bank stress fears recede, offering selective near-term trading opportunities within high yield but the more medium-term outlook is one of a potentially higher default rate. In such an environment, investment grade credit, with less credit risk and more sensitivity to rates appears to offer a more attractive risk-adjusted return profile over the medium term.

In terms of rates, markets had reacted violently to the banking crisis, repricing expectations for the interest rate policy path. This was reflected in the downwards shift in yields across the US Treasury curve between the end of February 2023 and the end of March 2023, with the 2-year yield moving 75 basis points lower in a month.

Figure 12: US Treasury yield curve



Source: Bloomberg, US Treasury yield curve, 31 March 2023. Yields may vary and are not guaranteed.

Ultimately, it was agreed that much would rest on the path of inflation, with central bankers alive to the stress in the banking sector but conscious that labour market strength and headline inflation remain elevated. The Fed, the ECB and the BoE had all hiked during the midst of the March banking crisis. For now, it seems financial stability is to be targeted at individual problems; price stability remains the primary goal.

+ **Market volatility offers opportunities,** with recent credit spread widening opening up potential for near-term tightening.

– **Central banks continue to focus on inflation**, as such rates volatility is likely to persist around economic data points.

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