



October 10, 2022

## POCKETS OF VULNERABILITIES

Quincy Krosby, Ph.D. *Chief Global Strategist, LPL Financial*  
George Smith, CFA, CAIA, CIPM, *Portfolio Strategist, LPL Financial*

As Federal Reserve (Fed) officials continue to emphasize the Fed's commitment towards restoring price stability, the dollar marches ever higher. Markets are currently pricing in another 75-basis point rate hike at the November 2 Fed meeting as calls for the Fed to halt its aggressive campaign are mounting. Worries persist that tightening financial conditions, underpinned by a stronger dollar, will lead to deeper cracks within the global financial system.

Officials at the recent United Nations Conference on Trade and Development (UNCTAD) offered its views on Fed policy, stressing that it is "hurting the most vulnerable, especially developing countries," and it "risks tipping the world into a global recession." A wider range of informed critics also view the Fed's assertive stance as unabating until something "breaks," and point to the bond-related blowup in the U.K. and even the issues faced by Credit Suisse as examples of pockets of vulnerability that could be magnified more perilously as monetary policy becomes increasingly restrictive.

### CREDIT SUISSE FACES A DIFFICULT FUTURE

In markets that are focused on what can go wrong when monetary policy moves into restrictive territory, as it is now with global central banks raising interest rates to curtail stubbornly high inflation, the health of the banking system is always a top concern. Memories of 2008-2009 are still vivid even though global banks, overall, are in much healthier shape due to stringent regulations put in place following the crisis.

Credit Suisse's financial and leadership problems have been in the headlines as it struggles to convince investors that its balance sheet remains strong and liquid. The price of the bank's credit default swaps (insurance that the holder will be paid if there is a bond default) has been climbing. To counter investor concerns, the bank announced a repurchase plan to buy \$3.03 billion of debt securities. In addition, a major structural re-organization is in the planning stages that will involve sales of assets and spinning off parts of the international business.

Comparisons with the now-infamous "Lehman" moment have been rife in the press, but analysts stress that the bank is in much stronger shape financially than when Lehman Brothers declared bankruptcy in September 2008.

Still, when clients are pulling away out of concern for Credit Suisse's financial stability, as recent reports have suggested, it can exacerbate fears that the bank is on the brink of insolvency, although by all accounts Credit Suisse remains in good financial condition.

Where there is legitimate concern, however, is that amid a more challenging market backdrop, the firm will have a difficult job raising capital at attractive rates.

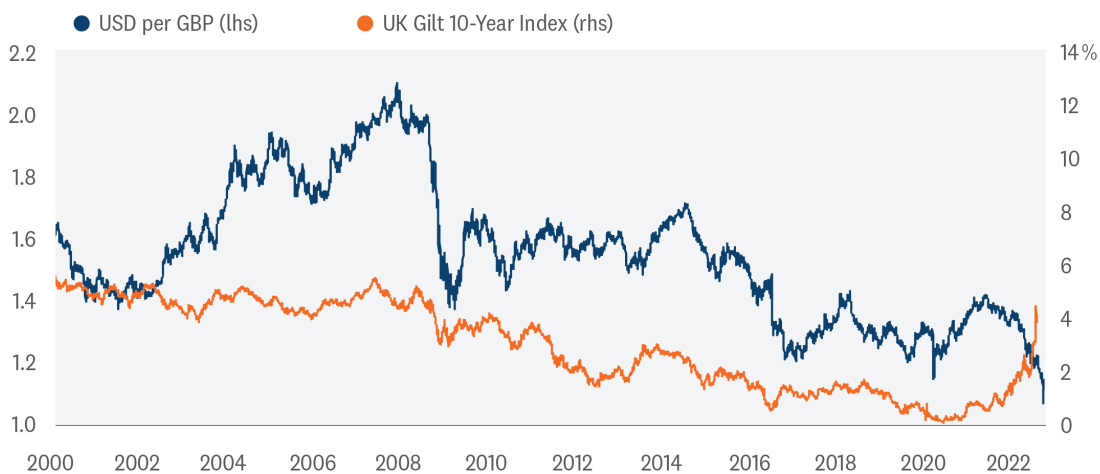
### STERLING GETS POUNDED

Ramifications of the coordinated global move higher in interest rates and that currency is acting as a pressure release valve, have been felt nowhere more strongly than the United Kingdom (U.K.). The British pound had been weakening for some time amid a backdrop of dollar strength and a poor economic outlook as the U.K. has been wracked by rising energy costs. A stimulus packed government 'mini budget' announcement that included significant unfunded tax cuts sent sterling spiraling to an all-time low of \$1.035 per pound, see **Figure 1**, as currency markets panicked about the U.K.'s rising current account deficit.

The Bank of England (BoE) is projected to continue raising interest rates to slow inflation. A weak pound exacerbates inflation as imports become more expensive, which puts fiscal and monetary policies at odds with each other. This is worth highlighting because fiscal policy and monetary policy should go hand in hand. If an economy needs to see inflation easing, it makes little sense to stimulate the economy through tax cuts while tightening monetary policy by raising interest rates.

#### 1 BRITISH POUND AND U.K. 10-YEAR GILTS MOVING FAST IN OPPOSING DIRECTIONS

Markets React Sharply to New Government Policies



Source: LPL Research, Bloomberg, 10/06/22

Forecasts may not develop as predicted. Past performance is no guarantee of future results.

### BANK OF ENGLAND FORCED TO STEP IN TO SAVE PENSION FUNDS

This incoherence of policy also led to highly volatile moves in yields on the U.K.'s government debt, or gilts as they are known locally, with the yield on the 10-year gilt increasing 1% in just three days to its highest level since 2008, see **Figure 1** again. This in turn almost caused a meltdown in the U.K financial system. Many pension funds in the U.K operate Liability Driven Investment (LDI) programs whereby they use derivatives to gain leveraged exposure to, supposedly safe, gilts.

This left pension funds susceptible to rapid moves higher in gilt yields that almost led to a “doom selling” scenario where pension funds would be forced to liquidate gilts to meet margin calls, further forcing gilt yields up and triggering more margin calls. With multiple pension funds hours from collapse, the BoE was forced to step in and promise to purchase up to GBP 65 billion (\$73 billion) of long-dated gilts to stabilize markets. Yields declined after the BoE announcement (and the U.K. government backtracking on some of the tax cuts) but have been edging up again in the past few days.

### CONCLUSION

While Fed Chairman Jerome Powell has acknowledged that the pace of interest rate hikes could cause “pain”, at this point, there is no indication that the Fed is prepared to slow down its mission to restore price stability. Powell has repeated, in what has become his mantra, that without price stability we cannot have a strong economy or a strong labor market.

Investors are concerned that restrictive monetary policy, that is, tighter financial conditions, could lead to the kind of financial accident that dries up liquidity and delivers more harm to the global economy.

As the Fed embarks on a \$95 billion per month “Quantitative Tightening (QT)” schedule in an attempt to unwind its nearly \$8.9 trillion balance sheet, conditions will tighten further.

Lael Brainard, the Federal Reserve Vice-Chair, commented in a speech at the end of September that “as monetary policy tightens globally to combat high inflation, it is important to consider how cross-border spillovers and spillbacks might interact with financial vulnerabilities,” and that the Fed remains “attentive” to these vulnerabilities.

Markets have become more volatile as “uncertainty” intensifies. Unfortunately, that the Fed has become more “attentive” does little to assuage investor concerns as to whether the Federal Reserve has a profound understanding of the ramifications of its policies beyond just fighting inflation.

Market participants now wait to hear from corporations as the third quarter earnings season begins. There should be considerably more understandable clarity from what corporate leaders tell us about the economic and financial environment than what Fed officials are able to offer. If interest rates rise at the current pace though, pockets of vulnerabilities could continue to deepen.

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The PE ratio (price-to-earnings ratio) is a measure of the price paid for a share relative to the annual net income or profit earned by the firm per share. It is a financial ratio used for valuation: a higher PE ratio means that investors are paying more for each unit of net income, so the stock is more expensive compared to one with lower PE ratio.

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All index data from FactSet.

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