

# Episode 2: Recent Market Tumult and Impact to Asset Owners

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## **Anders Reinertsen**

Hi, I'm Anders Reinertsen, and I lead the Asset Owner Business in the Americas at BNY Mellon.

BNY Mellon Rapid Insights is a series of short podcasts aimed at providing exclusive industry views and perspectives on the most pressing topics impacting asset owners to help you turn insights into opportunity and prepare for the future.

Today is September 30, 2022, and I'm joined by Danny Tenengauzer, Head of Strategy at BNY Mellon Markets, and John Templeton, Head of Securities Finance, Sales and Relationship Management. And today, we're going to discuss current market conditions, recent volatility in the markets, and a couple of important considerations for asset owners. Welcome, Danny and John.

## **Daniel Tenengauzer**

Thank you for having me, Anders.

## **Anders Reinertsen**

So, Danny, what's the latest from Central Banks and the Federal Reserve on rates? And where are we going from here?

## **Daniel Tenengauzer**

So, let me start from the end. Inflation is really high. I know this is very much of an obvious statement, but it's actually quite important to stress that the market, main street, and Wall Street are still adjusting to higher inflation around the world. And just to give you one example. This morning, European estimated for September inflation data came up 10% year-on-year. It was higher than expected. The reading for the market expected was 9.7%. Also, sticky inflation – so that's the kind of inflation that is not expected to go away anytime soon – also came in higher than expected.

Now, why am I going through this rant? Well, because, Central Banks will need to be hiking interest rates by a lot, which basically means that we're going to stay with bond yields quite high for a long time. That's really the critical part to this. And if I was to actually go back to the turmoil that we're seeing in

markets, it's really about diverging policies between Central Banks.

If I go back to last Wednesday, the Central Bank came across – the Central Bank in the U.S. came across quite hawkish. They hiked interest rates 75 basis points, and they also adjusted the median projection for 2022 by 100 basis points, while also adjusting all the median projections for the years to come, including introducing a media projection for 2025 that is 40 basis points above what they believe to be the neutral rate.

So, the message here is very clear. They want to be hawkish and they will stay hawkish for a long time.

Now, on top of that, the following day we had, essentially, three or four Central Banks that came across quite dovish. It's not that they didn't hike interest rates, they did hike, but they didn't sound as hawkish as the Fed. And that's the critical part. That kind of behavior triggers market dislocations and volatility. The following day, we had the BoJ (The Bank of Japan) coming across and pre-committing itself of 25 points, pegging 10-year JGB (Japanese Government Bond) yields for the years to come. That's a very dovish statement. On top of that, what confusion to what the markets were seeing, the BoJ intervened in markets and sold dollars.

So, you basically have two policies that are almost exactly the opposite. You're trying to keep your currency from weakening, while also keeping your yields unchanged at 25 basis points. One is dovish, the other one comes across as hawkish causing a lot of confusion. The yen appreciated a lot, but because of the confusion, eventually, it weakened right after that.

Last but not least, on Friday, the UK – and this is probably the most talked about story in the markets right now – released a very, very, very dovish expansionary fiscal adjustment. Now, that also followed the BoE (The Bank of England) hiking interest rates by 50 basis points, which was more or less in the price, with the statement that was neutral to dovish.

So, again, diverging policies. The fiscal coming across very expansionary. Monetary policy hiking interest rates, but not hiking as significant as some of the other Central Banks, particularly the U.S., and that triggers all the volatility that we saw subsequently.

### **Anders Reinertsen**

So, Danny, thinking about that and from what you see, are you seeing a terminal rate in the U.S. or around the world that we're expecting to have for an extended period of time?

### **Daniel Tenengauzer**

Correct. So, basically, we are currently working with 5% for the Fed next year, which is somewhat more than what's in the price. But the message there is that the Fed is probably following a pretty well-known-in-advance script. Just to give you a point, overnight rates six months forward in the U.S. are at just over 4.5%. So, the market is reasonably priced for rate hikes.

In the meantime, if you actually go to the Eurozone, the market is priced for 1.9% for the end of this year, and then about 2.5, 2.6% six months out, with inflation in Europe just 0.10%, right?

So, again, you will need to see more hawkish, marginally – significantly more hawkish policy stances coming from countries outside the United States.

## Anders Reinertsen

So, digging in on that a bit. As you mentioned, there's some diverging Central Bank policies throughout the world. How's that playing on currencies and flows? And how are investors reacting?

## Daniel Tenengauzer

So, we use the framework called iFlow in the bank, and basically, what iFlow does, it collects all the transactions through a business day across asset classes. So, we look at foreign exchange, we look at swaps, forwards, U.S. Treasuries, government bonds around the world, corporate bonds, and equities. And we do a crisscross to try to understand where are the flows and what's going on.

To use that framework and try to give you some idea of what we're seeing out of those flows – and again, this is a collection of flows that goes through US\$43 trillion of assets under custody that we have at BNY Mellon, so it's a pretty extensive and deep database.

We are right now – when it comes to euro holdings – we're probably at the shortest or near the shortest we've seen for the data. The market right now is as short euros as it was during the great sovereign debt crisis back in 2011/2012. So, the positioning here is quite short with markets actually being quite bearish.

Pretty much all currencies out there around the world, with the exception of emerging markets, which warrants a separate discussion, because they have been ahead of everybody else when it comes to rate hikes. When it comes to G10, the positioning – particularly when it comes to euros and now the British pound – it has been deteriorated, with the most significant shorts being in euros.

Now, the next thing which is quite interesting that we're seeing in the flows is all of this volatility is actually driving investors out of U.S. equities, interestingly enough. So, we're seeing actually pretty significant unwinding of U.S. equities, which I'm sure that John will be addressing a little bit later because there is a lot going on in that space on shorting of U.S. equities. But also, we're seeing a pretty significant unwinding and selling of European debt, which is quite interesting.

On the other side of the ledger, we're seeing some demand for emerging markets, which is also in line with what we're seeing in both the currencies in emerging markets, but also equities in those markets.

## Anders Reinertsen

Thanks, Danny. So, John, turning to you for a minute. With securities lending such a large part of asset owners' strategies, on the back of everything Danny has just said about rates and Central Bank policies and flows, what are the impacts to asset owners that you're seeing?

## John Templeton

Thanks, Anders. We've certainly come a long way in a short period of time. If you look back even just a year ago, we were in a totally different environment. On the equities side, we were seeing massive interest in being long equities, and that was coming through in the securities lending market in really specific ways where we had demand for equity financing trades where borrowers would come to us looking to deliver us equities, and be able to borrow more liquid assets like treasuries and U.S. dollar cash.

And in the U.S. Treasury market, it was hard to find any issues that were borrowing out that you would pay more than 10 basis points higher than GC rates to borrow anything in the U.S. Treasury market. That shifted towards the end of last year, and it really accelerated in February.

In the equity market – from the period of February through the summer – what we saw was a real increase in focused demand to be short specific stocks. And so, for our asset owners that were invested in those stocks, that was a great natural hedge, it may have had some price depreciation in those issues, but they earned returns in the demand that the borrowers had in those positions.

And in the U.S. Treasury market, what we saw was that with the advent of inflation, we saw the return to short demand in the U.S. Treasury market for the first time in several years. And so, that was a great opportunity for clients to be able to increase returns in those markets as well.

Now, that shifted again over the course of the past couple of weeks. We've seen an increased amount of short covering in the U.S. equity market. And so, delivering back to us those specific stocks that borrowers were short, and in return, borrowing against the market, borrowing to short the market in general.

So, if you look at the last few weeks, equity markets are down, say, 8%, but our notional volumes are up. And to account for that increase in notional volumes, the amount of borrowing activity that we're seeing is up 15 to 20% in the U.S. equity market, and that's coming through in the form of borrowing GC assets in general, and ETFs in specific to be short the market, in general.

The same thing is true in the U.S. Treasury market. There's some dislocation in specific issues, and so that demand to be able to borrow specific issues that the U.S. Treasury market has been really focused over the past few weeks, and we've been able to mobilize those assets out on loan to the borrowing community at really attractive rates for our client base.

### **Anders Reinertsen**

So, John, it sounds like securities lending is a valuable tool for asset owners to be able to earn some yield during a tumultuous market.

### **John Templeton**

Anders, that's exactly right. And it's not only that, it's part of a solution set that we focus on for our clients. So, for any clients right now who are challenged to hedge currency risk, deploy liquidity, or raise liquidity, we have a variety of different solutions in our business where we act either as agent or as principal to be able to help them meet their goals. We welcome our clients to engage in those conversations with us, we're here to help.

### **Anders Reinertsen**

Great. Danny and John, thank you for your insights today into the recent market volatility and impact to our asset owner community. This is an interesting time for asset owners and BNY Mellon. Look forward to continuing to support our clients' need as they navigate this market condition.

And on that note, thanks again for joining. I hope you enjoyed the conversation.

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