GLOBAL ECONOMICS UPDATE

Answering your questions about our new FCIs

- **We held an online Drop-In yesterday to present our new financial conditions indices and discuss how conditions have evolved in the wake of SVB's collapse. (See a recording here). This *Update* addresses some of the questions we received, a couple of which we did not have time to answer during the event.**

- **Your FCIs suggest financial conditions are very tight. What are the implications for central bank policy?** So far, central banks have done a good job of separating financial stability from inflation risks in conducting policy. Indeed, they have offered liquidity support where necessary to maintain market functioning, while hiking interest rates to quell inflation. Now that financial conditions are so tight, and so the downside risks to growth so elevated, we think that DM tightening cycles have either concluded or are near to completion. As activity and subsequently underlying inflation weaken in the coming quarters, this will allow central banks to cut rates back towards neutral settings, reducing financial stability risks in the process.

- **How can we use the FCIs to identify the origins of financial instability?** In the first instance, by tracking the subcomponents of the FCIs alongside side our aggregate FCIs on our CE Advance Dashboard. While the new FCIs are robust, we are aware that, as with any aggregate indicator, they can hide developments in a couple of areas that turn out to be consequential for the macroeconomy. Hence we provide a holistic overview of financial variables on our financial conditions dashboard, which we will update on a regular basis. In conjunction with our FCIs, our Global Markets service publish a *Stress Monitor*, which provides a more granular, qualitative analysis of financial market strains, including assessing the sources of instability.

- **How concerning are bank deposit outflows in the US and Europe?** While there has been a fall in instant-access bank deposits, that seems to be more of a rational response to rising interest rates than a sign that depositors are losing confidence in the banking system. Indeed, in the euro-zone, a lot of the bank deposits that non-bank financial institutions have withdrawn has flowed into bonds issued by the banks themselves. And in the US, deposits have been flowing into money market mutual funds (MMFs), which currently offer higher cash returns than bank accounts. That said, the situation in the US does warrant concern. For starters, the outflows have accelerated in the wake of SVB's collapse. Even if higher interest rates have been the primary cause of US deposit outflows, that could still be destabilising for banks with precarious balance sheets, or at least reduce their appetite to lend. And even if the outflow doesn't topple more regional US banks, it is still contributing to tighter financial conditions given that the MMFs are parking much of the funds in the Fed's repo facilities instead of recycling the money back into credit markets.

- **Shouldn't you use real, rather than nominal, interest rates in the FCIs?** Decisions about prospective costs and returns should take inflation into account. But the question is inflation over what period? If a household is contemplating the real servicing costs of taking out a mortgage, or a firm of issuing a bond, the relevant inflation rate is the average over the life of the debt, which could be many years. Given that long-term expected inflation doesn't vary much, nominal rates are the key driver of economically important real rates. So, in practice, we are not convinced that looking at interest rates in real terms is worth the complication.

- **How are the "cost" and "stress" components of the FCIs weighted?** About 50:50, on average, estimated using pre-pandemic data. Within the 'cost' component, 'borrowing costs' (such as interest rates on mortgages, consumer loans, and corporate bonds) account for the bulk, while risk-free rates and collateral measures (house prices and market cap.) make up the rest. On the 'stress' side, credit and money market spreads account for less than a third of the overall FCIs, which is much less than in other big-name FCIs.

(Continued overleaf.)

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- **If financial conditions are broadly as tight as in 2008, what does this mean for UK housing?** The tightness of UK financial conditions is derived mainly from higher risk-free rates rather than financial market stress. Higher mortgage rates have priced many would-be buyers out of the market, causing mortgage approvals to slump by 40% y/y to a similar level as in 2008. Admittedly, sentiment and cash buyer demand have been more robust so far. But with mortgage rates unlikely to fall further, tight financial conditions more generally likely to tip the economy into recession, and many Buy-to-Let investors likely to be forced to sell, we expect house prices to fall further. We forecast a 10% drop in prices in total, most of which yet to come.

- **Who needs risk assets when you get 5% on cash?** We discussed this in a recent *Asset Allocation Update*. The short answer is that historically, equities and other risky assets have tended to underperform both cash and long-term government bonds in an environment of high short-term interest rates. We expect that to prove the case this time around as well. We think that major equity markets will come under renewed pressure later this year, falling by 10-15% in most cases, and that long-term bond yields will fall back a bit.

- **What is the best application of this indicator for asset allocation decisions?** Our FCIs are primarily aimed at helping us, and clients, assess the outlook for economic activity. A view about the likely path of growth and corporate earnings are, in our view, essential inputs to forecasting financial market variables and formulating opinions about asset allocation. For example, our forecast (informed by our FCIs) that the major advanced economies will fall into recession later this year drives our view that equity markets will fall over the coming months. Two other potential uses of the stress component of our FCIs is as an aggregate indicator of risk premia discounted in financial markets, and to judge the likelihood of policymakers stepping in to address strains in core money markets. Both of these uses are relevant to decisions about asset allocation.

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