Invesco

Investment Insights | Invesco Global Liquidity

Global Liquidity Snapshot

An at-a-glance look at what's happening in short-term liquidity markets around the world

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1Q highlights

US

The first quarter of 2023 proved to be very volatile, with market price movements seemingly driven by varying themes each month. January was recession fears, February was concerns over overheated economic growth and inflation, and March saw investors fixated on global banking fears.

Despite market volatility, the Federal Open Market Committee (FOMC) hiked rates twice during the quarter. The magnitude of hikes slowed compared to 2022, with a 25 basis point hike in February and another one in March, bringing the federal funds rate range to 4.75%−5.00%. Inflation and employment data have remained stronger than the market expected, resulting in a sustained response from the Federal Reserve (Fed).[1]

Short-term markets flip-flopped from confident to unruly, as the market reacted to the varying themes while trying to price near-term monetary policy moves. Early March was particularly challenging, as prime money market funds protected their liquidity positions and pulled back from extending purchases beyond one-week maturities. Short duration bank security spreads widened significantly, especially for US regional bank credits, as demand waned. By the end of the first quarter, liquidity had returned to the market, although at wider spreads.

UK

The Bank of England (BoE) voted to increase the Bank Rate by 25 basis points in March to 4.25%. This followed a 50 basis point increase at the February meeting as the UK has now hiked rates eleven consecutive times. The BoE struck an optimistic tone, saying it expected wage pressures to ease and inflation to come down. In its central forecast, the Monetary Policy Committee (MPC) sees inflation falling well below the 2% target two years from now, and further below target at the three-year horizon, though there is a large upside skew to the inflation forecast. Forward guidance was weakened, with the removal of the statement suggesting that most members think further increases in the Bank Rate might be necessary, as well as the one that they would react "forcefully" if inflationary pressure were to prove more persistent than expected. In the press conference, Governor Bailey hinted that, if the data develop in line with their forecasts, then the bank rate may have peaked. But the bias is to tighten again if data on price and wage pressures indicate signs of more persistence.[2]

The IMF sharply revised down its 2023 growth forecast for the UK. The IMF expects the UK to suffer a year of declining GDP and be the only major economy to shrink in 2023.

Europe

Volatility spiked across the banking sector with the failure and break-up of Silicon Valley Bank (SIVB) in the US, the takeover of Credit Suisse by UBS and ongoing investigations into tax avoidance at several European banks. Credit spreads widened before reversing somewhat at the end of the quarter.

The European Central Bank (ECB) hiked interest rates twice during the quarter, with a 50 basis point hike in February and a 50 basis point hike in March, taking the Deposit Facility rate to 3%, in line with market expectations. Core inflation has continued to surprise to the upside, as cost shocks have proven large and persistent and accelerating wages have added new pressures.[3]

The ECB went out of its way at its most recent policy meeting to signal that it is alert to the potential headwinds. It stated that even if the turmoil dies down or remains sufficiently contained, the potential for further rate hikes should not be underestimated amid resilient underlying inflation and accelerating wage growth.

1. Source: Federal Reserve, as of 3/31/23
2. Source: Bank of England, as of 3/31/23
3. Source: European Central Bank, as of 3/31/23

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We believe [financial conditions] are in a critical period, as banks are expected to tighten lending standard, which could have a dramatic effect on the economy.

Key areas to watch

US

- **Changes in economic data:** US economic data releases will likely be scrutinized as markets continue to anticipate and price the Fed’s next move. We will be watching for any signs of economic growth − or potential weakness.
- **Financial conditions:** We believe we are in a critical period, as banks are expected to tighten lending standards, which could have a dramatic effect on the economy.
- **Contagion risks and banking flows:** We will also be watching for unexpected contagion related to the failure of Silicon Valley Bank and Signature Bank, or additional deposit flows from, or within, the banking sector.

UK

- **Inflation:** Inflation fell to 10.5% in December and 10.1% in January but rose to 10.4% in February, surprising the market to the upside. Services Inflation has been marginally weaker than was predicted at the time of the February report, while food price inflation and core goods price inflation have been significantly stronger than projected.[4]
- **General market credit conditions:** After a period of difficulties in the banking sector, and a roller coaster ride for markets, there has been no new negative news on banks but concerns around the wider banking sector linger.
- **MPC member comments:** BoE Governor Bailey said the economy was showing encouraging signs for growth and avoiding recession, and that inflation looked on track to fall in the coming months. He also acknowledged that the BoE was prepared to raise rates further should inflation remain embedded, and that industry should remain especially mindful in the interim, a very non-committal tone with respect to the outlook for policy, emphasizing continued data dependence.

Europe

- **Economy resilient:** While the European growth outlook has remained challenging, the eurozone economy has been resilient so far this year and is now predicted to avoid recession. European economic data have been solid overall in recent months and labor markets remained strong.
- **ECB commentary:** Markets will likely carefully monitor future comments by ECB members, after a more moderate stance at the March meeting, along with GDP, PMI and inflation prints for signs that the eurozone economy is cooling and inflation levels are normalizing.
- **Contagion risks:** Given the volatility driven by the recent banking crisis, we are watching for any further contagion or related market events.

Investment implications

US

- **Near a policy pivot:** The market has not yet priced in a significant chance of further increases in the federal funds rate, although it has begun to price rate cuts beginning in the fall.
- **Volatility risk around debt ceiling:** We expect rate volatility to continue amid ongoing debt ceiling negotiations in Washington. Markets remain vigilant for any negative spill over if Congress fails to raise the debt ceiling in a timely fashion.

UK

- **One more hike:** Current market expectations suggest the Bank Rate could be increased by a further 25 basis points at the May meeting, and possibly kept on hold after that, leading to a potential Bank Rate around 4.5% by the end of Q2 2023. At time of writing, the markets predict the Bank Rate to be 4.5% in one years’ time. This level has been volatile throughout the quarter, ranging between 4% and 4.75%.[5]

4. Source: UK Office for National Statistics, as of 3/22/23

5. Source: Bloomberg LP, Bank of England, as of 3/31/23

> The US may be near a policy pivot while UK markets are only expecting one more policy hike. European markets see rate hikes coming to an end after two more ECB moves.

Investment implications

UK

- **Deliberate shorter maturity:** Short-term yields have risen as the recent rate increase by the BoE feeds into new investments. Our current strategy is deliberately to continue reducing the weighted average maturity of money market portfolios, to enable rate rises to feed into the yield. Investments are currently being kept very shorted-dated, until market volatility calms.

Europe

- **Rate hikes coming to an end:** Market expectations point to a 25 basis point hike in the ECB Deposit Rate by June and a possible 25 basis point hike by Q3 2023, taking rates to 3.50%. Cuts are expected beyond this with forecasts pointing to lower inflation levels. This scenario is in line with our expectations.[6]
- **Short-term yields elevated:** Short-term yields have improved as ECB rate hikes have fed through to the market. We expect to maintain a deliberate strategy to keep the weighted average maturity of portfolios to moderate levels, enabling interest rate rises to feed into the yield. Investments are being kept short− to medium− term until market volatility calms down.

Outlook

US

Base case

- **Moderation:** Inflation should moderate through the rest of the year, although it will likely remain higher than the Fed's 2% target. Employment growth should moderate as well, but not become overly weak.
- **Tighter financial conditions:** Bank lending standards will probably tighten and act as a headwind to economic growth.
- **Volatility risks persist:** Market volatility will likely continue due to the many economic and political uncertainties still on the horizon.

Risks:

- **Banking contagion:** Protracted tensions in the banking sector and their impact on financial conditions and market sentiment.
- **Protracted conflict:** The continuation and potential expansion of the Ukraine conflict with a subsequent impact on commodity and energy supply and prices.
- **Stickier inflation:** Longer than anticipated elevated inflation.

UK

Base case

- **Near a pause:** The BoE is probably close to a pause in its hiking cycle, which should limit the potential scope for a sharp move higher in yields. In addition, there is increasing evidence of a nascent peak in underlying inflation pressures. However, given that inflation is starting well above target and growth remains surprisingly resilient, it is hard to expect significantly lower yields, without a meaningful deterioration in the macro data and/or a tightening of financial conditions beyond that engineered by the BoE.
- **Price stability with risks:** The MPC's remit is clear that the inflation target always applies, reflecting the primacy of price stability in the UK monetary policy framework. The framework recognizes that there will be occasions when inflation will depart from the target because of shocks and disturbances. The economy has been subject to a sequence of very large and overlapping shocks.

6. Source: Bloomberg LP, European Central Bank, as of 3/31/23

Outlook

UK

Risks

- **Inflation:** In the MPC's February Monetary Policy Report projections, consumer price inflation was projected to fall sharply by the end of 2023 reflecting a rapid decline in global price pressures and a greater than expected fall in the contribution of household energy prices. However, domestic inflationary pressures are likely to remain strong over the next few quarters.
- **Pound valuation:** Lower energy prices and somewhat better UK growth data are tailwinds for the pound. However, it remains hard to see how the pound will significantly outperform both the US dollar and the euro, as many of the positive factors that support it are also evident in Europe, and therefore also lifting euro valuations. Indeed, given that the BoE remains far more dovish than the ECB, pressures on EUR/GBP remain tilted to the upside, in our view, even if GBP/USD can stabilize at current levels.

Europe

Base case

- **Inflation to moderate:** The ECB forecasts inflation to average 5.3% in 2023, 2.9% in 2024 and 2.1% in 2025, according to its most recent predictions. These numbers are an improvement over the last projection due to sharp adjustments in energy markets, which have led to a significant decline in price pressures.[7]
- **Improved outlook:** Despite the protracted war in Ukraine, business and consumer confidence improved in the last quarter, though moderately, and we expect the eurozone to avoid recession in 2023.
- **Eventual ECB policy reversal:** On the back of recent market volatility and ECB member comments, markets appear to have lowered their expectations for ECB rates. They are now closer to our expectations of a drop in the ECB policy rate to below 3%, and possibly closer to 2.5% after one year.[8]

Risks

- **Banking sector risk:** Protracted tensions within the banking sector, with a lasting impact on financial conditions and market sentiment.
- **Prolonged Ukraine conflict:** A continuation and expansion of the Ukraine conflict, with a subsequent impact on commodity and energy supplies and prices.
- **Persistent inflation:** Longer-than-anticipated elevated inflation, including persistent wage inflation and inflated production costs.

7. Source: European Central Bank, as of 3/16/23

8. Source: Bloomberg LP, as of 3/31/23

Data spotlight

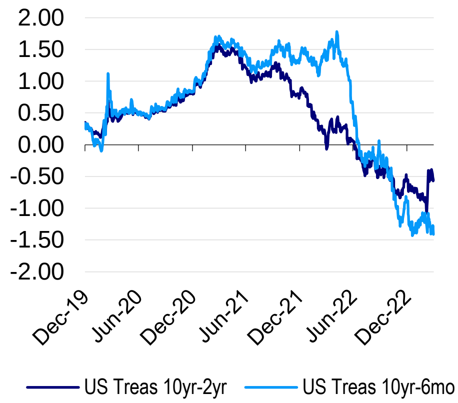
Cracks on the horizon?

The largest yield curve inversion since the 1980s has been in place since July 2022.

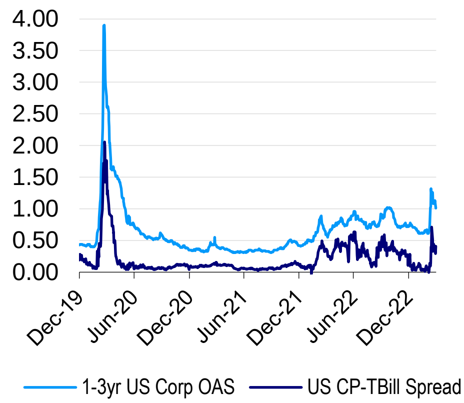
First quarter 2023 banking sector issues forced credit spreads wider as financial conditions tightened, but not to the extent witnessed during the Covid pandemic.

Investors sought refuge in money market funds.

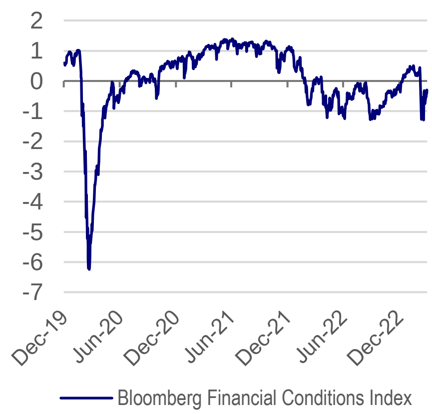
US Treasury curve slope (%)



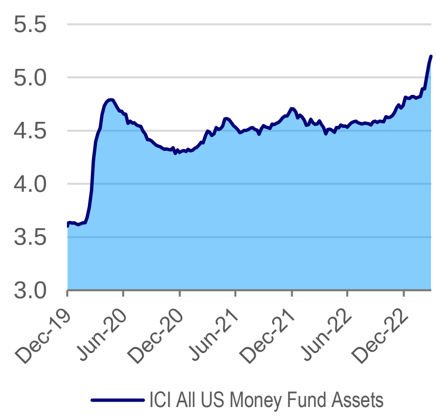
US credit spreads (%)



US financial conditions



US money fund assets ($ trillion)

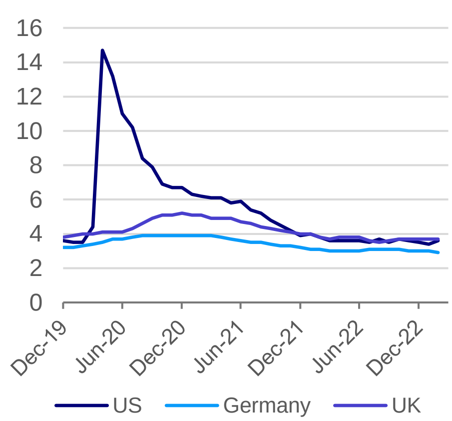


Employment still strong

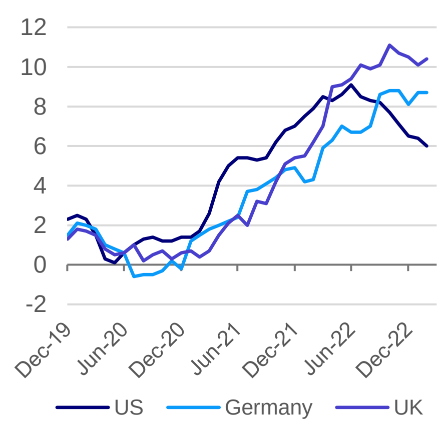
It's hard to imagine a deep recession with this level of employment.

However, key employment measures have likely yet seen the impact from tighter financial conditions, tighter global central bank policies, elevated inflation and the recent banking crisis.

Unemployment (%)



YoY Inflation (%)



Sources: Bloomberg LP, Bloomberg Bond Indices, Investment Company Institute (ICI), as of 3/31/23

Employment and YoY inflation: US Bureau of Labor Statistics, Eurostat, UK Office for National Statistics, monthly as of 02/28/23

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For additional liquidity insights or to learn more about Invesco Global Liquidity solutions, please call (800) 659-1005 or visit invesco.com/cash.

Invesco Global Liquidity

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