Financial Markets Have Recovered from 2018 Losses

Markets sold off in 2018, but have generally recouped their losses so far this year

Returns by Asset Class
(Percent)
Risk Assets Have Reflected the Ebb and Flow of Trade Tensions

Trade tensions weighed on equity and credit markets

Relative Equity Performance of Trade-sensitive Firms
(relative to benchmark, index to March 2018)

EM sovereign and Global High Yield Corporate Spreads
(basis points)

Note: 1. US initiated national security investigation into autos; 2. US announced 25% tariff on $50 bn Chinese goods; 3. US implemented 10% tariff on $200 bn of Chinese goods; 4. US tariff on $200 bn of Chinese goods hiked to 25%; 5. June FOMC meeting when policy rate expectations were revised lower; 6. G20 meeting.
EM Capital Flows Have Been Volatile

Growth and trade concerns have weighed on EM portfolio flows in recent months

EM Portfolio Flows by Investor Type
(USD billions; three-month rolling sum)

Bond flows to China have been strong after index inclusion

Index-Inclusion Related Flows to China
(RMB billions)

-60 -40 -20 0 20 40 60 80 100 120
Jan-17 Jul-17 Jan-18 Jul-18 Jan-19

MSCI announcement
First phase of MSCI inclusion
First phase of Global Agg Inclusion

Change in foreign holdings of Policy Bank Bonds
Change in foreign holdings of Treasury Bonds
Stock Connect Northbound equity purchases

Renminbi devaluation
Taper tantrum
U.S. election
EM Sell-off
Stock Connect Northbound equity purchases
Market Conditions for Frontier Issuers Remain Favorable

Issuance is expected to reach new highs in 2019...

Frontier Market Sovereign Issuance: Volume
(USD billions)

Frontier Market Sovereign Issuance: Price
(Percent; Basis points)

... on favorable market conditions
Financial Conditions Have Eased

Financial conditions have eased in the US and euro area ... as market interest rates have fallen

Financial Conditions Indices
(Standard deviations from mean)

United States: Contributions to Financial Conditions
(Standard deviations from mean)
Market expectations of inflation have declined… along odds of high inflation.

**Market Expectations of Inflation**
(Percent)

- **5-year breakeven**
- **5-year-5-year forward inflation swaps**
  - US
  - Euro area

**Market Implied Probability of High Inflation**
(Probability of CPI > 3% for 1 year in 5 years, percent)
Investors Expect Monetary Policy Easing

**Further monetary policy easing is priced-in for AEs…**

**… as well as many EMs**

**Advanced Economy Policy Rates**

(Percent)

**Emerging Market Policy Rates**

Expected 1-year change in policy rate (bps)

Current policy rate (percent)
Global Bond Yields Have Declined Further

Global yields have fallen on expectations of policy easing ... ... leading to a rise in negative-yielding bonds

Government Bond Yield Curves

Global Bonds with Negative Yields
The tail of the distribution moves to the left when the yield curve is included.

**US Forecast Distribution:**
Conditional 1-year Ahead Real GDP Growth (Percent)

- Including the slope of the yield curve
- No financial conditions

5th percentile

**Downside risk is higher ahead of recessions**

**US Downside Risks to GDP Growth (Percent)**

Note: The slope is measured as the difference between 3-month and 10-year Treasury yields. This slope is used in the estimation instead of the financial conditions index.
Investors Expect Risks to be Contained in the Short-term

Equity investors believe downside risks are contained... …and market volatility remains compressed

**US Equity Skew Index**
(Standard deviations from historical average)

US Equity and Bond Volatility
(Standard deviations from historical average)
Easy Conditions Are Encouraging Corporate Financial Risk Taking

Debt-funded payouts by US firms have risen further …

S&P500 Nonfinancial Firms: Debt-Funded Payouts
(Percent of assets; annualized)

… and leverage continues to rise

US Leveraged Loan Market
(USD billions; Debt/EBITDA in multiples)

Note: annualized 2019 number based on data till May.
An "Unusual" US Monetary Policy Cycle

Financial conditions have eased during the most recent monetary tightening cycle in the US

US Financial Conditions Index (FCI) During Tightening Cycles

Financial conditions index

-1.0 -0.5 0.0 0.5 1.0 1.5 2.0

Cumulative rate hikes (bps)


Note: Based on GFSR FCI from 1995. Pre-1995 FCI is spliced using the Chicago adjusted FCI.

US Financial Conditions Index (FCI) During Easing Cycles

Financial conditions index

-1.0 -0.5 0.0 0.5 1.0 1.5 2.0

Cumulative rate cuts (bps)


2019

5.7
Unconventional Monetary Policies in the Next Recession?

How much policy space is available?

Central Bank Balance Sheet
(Percent of GDP)

2008 vs. 2019

BOJ  PBOC  ECB  BOE  Riskbank  Fed

2008 2019

Riskbank

Fed
Where Are We Headed…?

S&P Index Returns through Tightening Cycles

Treasury 10-year Yields through Tightening Cycles