OVERBERG MARKET REPORT

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Global Report

Nick Downing

UK gilt riot may signal Federal Reserve pivot

Newly appointed Chancellor of the Exchequer, Jeremy Hunt, the fourth in as many months, has brought stability to UK financial markets. The pound has steadied, and UK gilt yields have come down from their recent peak. It has been a calamitous three weeks for Bank of England Governor Andrew Bailey as he sought to address the rapid increase in gilt yields. As gilt yields rose prices plummeted, leading to huge margin calls at UK pension funds. Pension funds have increasingly used their gilt holdings as collateral to earn higher income rates. So-called “liability-driven investments” have grown rapidly in popularity from less than half £500 billion to just under £2 trillion in less than 10 years. The rapid surge in gilt yields was on the verge of creating a UK financial crisis, before the BOE stepped in with unlimited purchases of UK gilts and the new Chancellor reversed Kwasi Kwarteng’s misguided budget.

However, deeper problems remain. The zero-interest rate environment which ensued in the decade following the 2008/09 Global Financial Crisis (GFC) and continued during the Covid pandemic, has led to excessive household leverage and the creation of a housing bubble. UK mortgage debt is higher now than it was in the US on the eve of the sub-prime mortgage implosion, which heralded the GFC. Ever rising home prices were affordable because mortgage rates were close to zero. However, mortgage rates are surging in line with rising gilt yields. Mortgage rates, which used to be close to zero are now above 5%.

The UK is not alone. Canada, Australia, and New Zealand also suffer from domestic housing and credit bubbles, which are in danger of sudden corrections from the fastest increase in interest rates in 40 years. Sweden and Norway suffer from similar vulnerabilities, but this did not deter the Riksbank in Stockholm from raising its policy rate by a full 100 basis points at its last meeting. Interest rates across these countries will need to be gradual but this may not be possible while inflation keeps surging. At its last policy meeting, the Bank of England raised the base rate by 50 bps to 2.25%. Interest rate futures predict the base rate will rise to 5.25% by next May, despite the budget U-turn.

By contrast, the US spent the years following the GFC repairing its household balance sheets. The credit binge which led to the sub-prime crisis has reversed. As a result, debt, and debt financing costs, as percentages of household disposable income are at multi decade lows, which suggests households will be able to cope with rising interest rates. At the same time there are no signs of a housing bubble. This means house prices are unlikely to drop and create stresses at household level or at the financial institutions holding the mortgage debt. Moreover, bank balance sheets are in rude health. The Eurozone, like the US, is equally able to cope with rising interest rates. While the energy crisis is particularly close to Eurozone countries, savings rates, household indebtedness, and home prices are all at their healthiest levels in decades. There are exceptions. Italy and Spain suffer from excessive government debt and elevated budget deficits. However, the Eurozone is generally free from structural imbalances.

With the US better able to withstand rising interest rates, the Federal Reserve may be less inclined to slow its pace of monetary tightening. However, its actions are causing global dollar liquidity to shrink at an alarming rate, at its fastest pace since 1938. The strong dollar is compounding the liquidity drain. Even Paul Volker, who presided over the Fed's attack on inflation in the early 1980s with a peak fed funds rate of 22%, kept money supply growing at a minimum 3-month annualised rate of 4.8%. It is currently dropping at an annualised rate of 2.8%. As liquidity is withdrawn, the risk of a liquidity or solvency crisis increases. The risk increases in a non-linear fashion and could therefore strike with little warning.

The IMF warned last week in its twice-yearly Global Financial Stability Report that the stability of the global financial system has "materially worsened". Tobias Adrian, head of monetary and capital markets at the IMF warned that "There certainly are many vulnerabilities out there… When interest rates increase very rapidly, these vulnerabilities are exposed." Fractures have already started appearing. Credit default swaps, used to insure against Credit Suisse liabilities, have surged. The ECB in July launched the Transmission Protection Instrument to prop up sovereign bond markets of vulnerable member states. Italy's bond yield spread over German bunds has surged over the past fortnight.

The biggest fracture so far has been the gilt market riot in the UK that began on 23rd September. Although the UK's problems are home grown, Fed policy could be the catalyst for a disorderly solvency crisis. A crisis in the UK or any of the other vulnerable economies, which MRB Research describes as the "weak links", could ignite global contagion. The Fed's mandate is primarily maintaining price stability, which means keeping inflation under control. However, it is also mandated to target full employment and to maintain financial stability.

The near financial accident in the UK may be enough to convince the Fed that it has to tread more cautiously with its hawkish policy stance. Perhaps it is the UK gilt riot that prompted global financial markets to rise sharply last week despite far worse than expected inflation data, if it means Fed chairman Jay Powell is tempted to call it a day on reducing money supply. Even in the robust US economy, stresses are growing. The US Treasury's Office of Financial Research Financial Stress Index is near a two year high. The Bank of America's credit market stress index is close to its critical level.

Local Report

Robert Wantenaar

Grey listing

With the end of October hurtling towards us like an out-of-control freight train, so too does the potential grey listing by the Financial Action Task Force (FATF) which ominously hangs over our heads risking our freedom as South Africans to trade effortlessly with the rest of the world.

Who are the FATF and what do they want with us? The Financial Action Task Force is the global watchdog fighting against and preventing money laundering. The intergovernmental body aims to prevent illegal financial activities by setting the international standards which governments should adhere to. FATF currently comprises 37 member states and two regional organizations with South Africa having been a member since 2003.

The FATF has long warned that we (South Africa) are at risk of being added to the grey list, but we have failed to heed this warning. A ruling will now be made later in October as to whether we will be added to the list with two options which may follow. The ruling can have one of two outcomes: (1) If the FATF is not satisfied with our progress we will be added to the grey list immediately. (2) The FATF is impressed with the steps taken to fight corruption at a governmental level and we are given a 6-month extension after which they will reassess the situation.

South Africa has long suffered at the hands of the ruling party with funds being syphoned off, used for personal gain rather than the purposes for which they were intended. Let us not forget the price we continue to pay for the damage inflicted between 2009 and 2019 at the hands of our former president and the Gupta brothers. Not to mention the insurmountable amount of corruption which happens at a lower level which we are not even aware of… therefore the FATF has identified us as a potential grey lister. Coincidently, we have recently seen an uptick in the number of financial cases being heard in the courts. Whether this is enough to delay or avoid being placed on the grey list, only time will tell.

History of grey listing: It may come as no surprise that Mauritius was added to the FATF grey list in February 2020 due to a lack of correct procedures in place to ensure proper anti-money laundering measures. Due to a high-level governmental undertaking, Mauritius strengthened its procedures to the satisfaction of the FATF and was removed from the grey list within 18 months. International business immediately rebounded upon its removal from the grey list.

What may come as a surprise to many is that Malta, traditionally accepted as a trustworthy financial jurisdiction, was added to the grey list for concealing the ultimate beneficial owner of a structure that aided tax evasion. They too were removed after improving the way they share data with authorities.

What are the effects of grey listing? By being placed on the FATF grey list enhanced due diligence becomes standard practice when individuals wish to transact internationally. Further reaching effects are that existing, long standing accounts are reviewed, higher fees are levied, and, in some instances, account holders are informed that their accounts will be shut on a prescribed date. At a national level, the economy is affected to a potentially greater extent than a credit rating downgrade. The local currency devalues due to disinvestment from the country, the International Monetary Fund (IMF) will not grant loans should they be applied for, and international investors will not want to consider future investment into the country until all issues are resolved.

What do we do next: Act now! If you are unable to take action immediately, do not be discouraged by the process that needs to be followed to open international accounts. Institutions will require more information from you, they may ask for the most trivial information as a result of their enhanced due diligence but ultimately once the account is opened and the source of funds has been cleared, international transactions will become far easier to fulfil. Here we can help. Contact one of our highly qualified and friendly consultants.

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