TRV Risk Monitor — key insights

ESMA Report on Trends, Risks and Vulnerabilities, No. 1, 2023
ESMA Economics, Financial Stability and Risk Department
Overview – TRV RM No. 1, 2023

1.1 Risk overview

1.2 Risk assessment by market segments
### Status: Relative stability amid high volatility and episodes of acute local stress

- **Markets**: Securities markets stable despite high volatility in 2H22 esp. in bond and energy derivatives markets; acute stress in GBP markets related to leveraged entities in September; FTX collapse and crypto-asset valuation decline

- **Risks**: Contagion and operational risks very high; market and liquidity risks remain very high; credit risks stay high with deteriorating outlook; environmental risks elevated

### Outlook: Macrofinancial tailwinds, potential for corrections

- **Risk drivers**: Global tightening of financial conditions, inflation and slowdown of economic activity, with stagflation scenario now less likely; rise in already high public and private indebtedness; continuing geopolitical risks

- **Risk outlook**: Fragile EU market environment; high risk of corrections amid fragile market liquidity; sustained decline in valuations; delays in transition to green economy; crypto markets tested for ability to fix fundamental flaws

### ESMA risk assessment: High risks, fragile markets

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1.1 TRV RM: Risk overview

ESMA risk assessment: High risks, fragile markets

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ESMA
1.2 TRV RM: Macrofinancial environment

Deteriorating outlook amid tighter financial conditions

Stagflation risks had increased

![Chart showing inflation and GDP growth from Jan-22 to Oct-22]

Deterioration of macrofinancial environment

- **Growth:** Economic slowdown expected in 2023; recession now anticipated to be narrowly avoided as economic sentiment is becoming more positive

- **Inflation:** Expected to remain very high in 2023; headline inflation starting to decline, core measures still increasing

- **Rates:** Further expected hikes across central banks

Rate hikes tighten financial conditions

- **Yields:** Corporate bonds at highest levels since 09, driven by increase of risk free rate (IG) and bond credit premia (HY)

- **Real estate:** Decline of commercial real estate prices; underperformance of bonds and equities related to real estate; ESRB warning

- **Commodities:** After sharp tensions end-Aug, energy prices and volatility down to pre-war levels

Note: Median GDP growth and inflation forecasts for the euro area for 2023, by vintage month, in %.
Sources: Refinitiv EIKON, ESMA.

Sharp tightening of financial conditions

![Chart showing bond yields from Jan-22 to Dec-22]

Note: Decomposition of bond yields of Bank of America Merrill Lynch Global Corporate Index, in basis points.
Sources: Refinitiv Datastream, ESMA.
Commodities, energy: Prices down, tensions stay

Commodities: Relaxation in 2H22

- **Composite**: Aggregates of commodity prices normalising
- **Components**: Agri and metals stable; remaining volatility driven by energy

Energy: Massive drop from peak, but nervousness prevails

- **Prices**: Spike in prices end-Aug., followed by sharp drop (import substitution, EU storages to 88% vs 53% in 21, conducive weather)
- **Volatility**: Power and gas volatilities remain 2-3 times higher than historical, illustrating high nervousness in markets
- **Outlook**: Investors remain subject to large price swings, incl. extreme valuations of energy-related assets

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**Note**: Commodity price indices rebased at 1/1/2022=100. S&P GSCI indices for global commodities, agricultural products and metals, ICE Dutch TTF futures for natural gas and EEX Phelix futures for power.

Sources: Refinitiv EIKON, Datastream, ESMA.

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**Note**: Commodity price realised volatility (annualised 20D volatility) in %. German Phelix futures for power, Dutch TTF for gas, Brent for oil, S&P GSCI industrial metals index and Euronext wheat futures.

Sources: Refinitiv Datastream, ESMA.
1.2 TRV RM: Risk assessment by market segment

Securities markets: Fragile liquidity

Decline in liquidity across bond markets
- **Sovereign**: Broad liquidity drop in bonds
- **Corporate bonds**: Increase in bid-ask spread
- **Drivers**: Rate hikes; fixed-income volatility

Stress related to leveraged funds using Liability-Driven Strategies (LDI) shows how leverage risks can crystallize
- **Scope**: Majority of UK-owned LDI funds are EU AIFs (EUR 250bn, >80% of pooled funds)
- **Risks**: LDI funds obtain leverage through GBP repo funding, short positions on interest rate derivatives
- **Trigger**: Sharp increase in GBP yields following UK mini-budget end-Sep 22
- **Consequences**: Large collateral and margin requests faced by (EU) GBP LDI funds; redemptions from EU GBP money market funds; substantial pressures on GBP sovereign markets due to forced sales amid low liquidity
1.2 TRV RM: Risk assessment by market segment

Asset management: Funds resilient, but risks rising

Decline in assets under management (AuM)

- **AuM**: -6% to EUR 16trn, largest drop since Global Financial Crisis of 2007-2008
- **Drivers**: Mainly valuation effects
- **Flows**: Most fund types with outflows; high MMF inflows, esp. GBP after Sep 22 BoE intervention related to LDI stress
- **Liquidity**: Funds met redemption requests without resorting to use of LMTs

Higher risks for bonds funds

- **Interest-rate risk**: Funds reduced their maturity transformation; but duration remains close to 7Y for Investment Grade (IG), 3.5Y for High Yield (HY)
- **Credit risk**: Deterioration of credit quality for HY funds; materialisation of credit risks more likely amid high and rising rates
- **Liquidity**: Decline in cash holdings by corporate bond funds
1.2 TRV RM: Risk assessment by market segment

**Consumers: Sentiment, savings, fund flows fall**

**Consumer sentiment remains negative**
- **Consumer sentiment:** Some improvement but remains below zero
- **Complaints:** Close to average levels in 3Q22

**Market participation declines as savings and investment flows fall**
- **Household savings:** Fall from the record highs during pandemic
- **Investment flows:** Flows into UCITS bond and equity funds collapsed as performance worsened

**Large reduction in real and nominal returns**
- **Performance:** Nominal returns close to zero and negative real returns more than 100bps below LT averages

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**Despite pick-up confidence stays low**

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**Retail UCITS fund returns plummet**

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**Note:** Sentix Sentiment Indicators for the EA retail and institutional investors on a ten-year horizon. The zero benchmark is a risk-neutral position.
**Sources:** Refinitiv Datastream, ESMA.

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**Note:** Evolution of net annual performance (net of ongoing costs (TER), subscription and redemption fees) of EU27 UCITS, retail investors only, by asset class, in %.
**Sources:** Refinitiv Lipper, ESMA.
1.2 TRV RM: Risk assessment by market segment

Infrastructures: IRD margins up, OTC rising

Trading venues: Trading stable
- **Trading**: Equity trading volumes stable in 2H22
- **Circuit breakers**: Incidences decline with lower equity volatility

Central clearing: Margins up for interest rate derivatives (IRDs), further migration to over the counter (OTC) derivatives for energy
- **Initial margins**: Margins collected by EU CCPs for IRDs rose, while those for commodity declined significantly in 4Q22, reflecting market conditions
- **Energy derivatives**: Migration from exchange-traded derivatives to OTC continues, with OTC exposures increasing to 40% for NFCs (compared to 25% in Aug 22)

Credit rating agencies (CRAs): Credit outlook turning negative
- **Assessment**: Overall credit outlook by CRAs weakened in 2H22, turning negative for corporates
1.2 TRV RM: Risk assessment by market segments

Innovation: Crypto in crisis, growing viability concerns

Falling crypto valuations

FTX: Leading crypto-exchange collapses

- **Drivers:** Misconduct; management failure; absence of robust internal controls; inherent conflicts of interest

- **Consequences:** Misuse of and large losses on customer assets; crypto valuations shed another 20%, but no contagion to traditional markets

**Crypto markets set to stay in crisis**

- **Market cap:** Crypto markets lost two-thirds in value over the course of 2022

- **Entities:** Series of collapses among crypto intermediaries; growing concerns over sustainability of business models

- **Onward risks:** Extreme market, valuation risks; strong contagion among crypto markets; very high operational issues

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**Crypto risk summary**

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**Note:** Market capitalisation of Bitcoin, Ethereum, Tether and other crypto-assets, in EUR bn.
1.2 TRV RM: Risk assessment by market segment

Financing: Net issuance negative, greenwashing

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### Market finance: Issuance drops

- **Market environment**: Uncertainty, higher financing costs and tighter credit standards weighed on funding opportunities
- **Financing**: Turned negative in 2022 as initial public offering plummeted (-60% compared to 2021) and bond issuance dropped (-40% compared to three previous years)
- **Other deals**: Subdued activity for securitisation in 22Q3 (-18% compared to a year ago), decline in collateralised loan obligation issuance in 2H22 (-48% compared to 2021)

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### Sustainable finance: Risks are rising

- **Greenwashing risks**:
  - Enforcement actions in the US, UK and EU against financial institutions
  - Potential risks to investors from the use of SFDR disclosure as proxy-labels for communication purposes
- **ESG markets**: ESG bond issuance positive in 2H22 but driven by public issuance while corporate issuance turned negative, in line with broader corporate bond market developments