POST-EVENT REPORT

European Markets Insight

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Eurozone braced for new era of battle against inflation

From left to right: Laurie McAughtry, Managing Editor (The TRADE), Jean-François Cirelli, Chairman and Senior Advisor (BlackRock France, Belgium and Luxembourg), Declan Costello, Deputy Director-General (European Commission, DG ECFIN) and Imène Rahmouni-Rousseau (Director General Market Operations (European Central Bank)

Market participants started 2023 with some optimism that central bankers' rate hiking would start to ease after a brutal 2022. However, policymakers speaking at the Euronext Markets Insight Conference were adamant that they will maintain tight policies until inflation has been stamped down to their 2% targets, setting the stage for a realignment of the investment landscape.

The first signs of disinflation in G7 economies have excited many investors after a brutal 2022. Most asset classes have been hammered as central banks pared back bond buying programmes and hiked interest rates. This reversed a near decade characterised by sustained periods of low volatility and rapid recovery from market sell-offs.

Talking at the Euronext Markets Insight Conference in Paris, both current and past European policymakers warned that the region, and global economy, are not out of the woods when it comes to combatting inflation.

Predicting the future path of inflation is highly challenging, given the multiple factors that have caused its rise, which Jean-Claude Trichet, former president of the European Central Bank and now chairman of the French Academy of Moral and Political Sciences for 2023 noted in remarks at the event.

Jean-Claude Trichet, Chairman of the French Academy of Moral and Political Sciences for 2023, and former President of the European Central Bank

These include the economic recovery from Covid-19, central bank models that did not anticipate the rapid changes in inflation and led to authorities delaying their response to initial indicators and the war in Ukraine. These factors have created an extremely uncertain environment, with the ebbs and flows of geopolitical tensions in particular being both highly present and very hard to predict.

For market participants this has created a broadly negative impact on confidence.

For central banks the resulting inflation has changed the post-2008 rulebook of lowered rates and bond market intervention.

This in turn, has brought to an end the partnership between fiscal and monetary policy that stimulated demand during the Covid-19 pandemic.

Times have changed in the interaction between monetary and fiscal policies. During Covid, while remaining independent, monetary and fiscal policies were pretty much aligned and mutually reinforcing. As long as inflation remained low, policy rates remained accommodative, reducing the costs of expansionary fiscal policies.

This is over, basically. In the new post-pandemic world, this alignment is no longer there and every increase in central bank policy rates is gradually transmitted to the cost of debt issued or reissued by sovereigns.

IMÈNE RAHMOUNI-ROUSSEAU
Director General Market Operations at the ECB

Going forward, this is set to result in eurozone budget tightening and much more targeted fiscal policy that pulls back the broad stimulus measures of the pandemic. It will also be crucial to link reforms to investment, as Declan Costello, Deputy Director-General, European Commission DG ECFIN, was keen to emphasise.

Costello noted that this was already happening in countries such as Italy, which was now implementing justice reforms as it received disbursements from the 18-month-old EU Recovery and Resilience Facility.

Taking stock from 2022

Last year was not an easy one for investors, with many hammered by the volatility caused by central bank tightening.

"2022 has not been a great year, to say the least," said Jean-François Cirelli, Chairman and Senior Advisor, BlackRock France, Belgium and Luxembourg and former CEO of Gaz de France and GDF Suez.

Repeated inflation surprises have sent bond yields soaring, crushing equities and fixed income in 2022.

"It was a perfect storm on the market and there was clearly no safe haven for savings in 2022," added Cirelli.

Going into 2023, recession is foretold as central banks try to bring inflation back down to policy targets. BlackRock Investment Institute, the asset manager's research unit, says in its 2023 outlook that the ultimate economic damage depends on how far central banks go to get inflation down. BII took an underweight position on developed markets equities and an overweight position on global investment grade credit and inflation linked bonds.

Cirelli added that it was also cautious on private markets and reducing its holdings of long-term government bonds **"as they are not playing their role of stabilisers in the portfolio".**

This chimed with the view from European policymakers. Rahmouni-Rousseau emphasised that rates needed to come down below the neutral rate and be sufficiently restrictive to have a dampening effect on demand. She added that 50bp rises should be expected from the ECB in 2023.

This chimed with the view from European policymakers. Rahmouni-Rousseau emphasised that interest rates will still have to rise significantly at a steady pace. This means that additional 50bp increments should be expected in the next months, as indicated by ECB President Christine Lagarde in the December press conference. She added that interest rates will need to go beyond the neutral rate and reach restrictive territory, so to dampen demand and contain the risk of an upward shift in inflation expectations.

Cirelli agreed with the view that markets were unlikely to revert to their pre-inflation patterns in the near term. Instead, he said that investors are entering into an epoch when geopolitics drive macroeconomics, instead of the other way round. The period of great moderation, where mostly stable economic activity dovetailed with low inflation, has come to an end.

We are now, said Cirelli, **"entering in a new regime characterised by clearly more volatility on the markets and the macroeconomics. This calls for a new investment playbook and all of the recipes of the past will not necessarily be the same again. Clearly, we need to review the portfolio construction in this new environment."**

Resilient Eurozone

Costello and Rahmouni-Rousseau were keen to stress that despite the challenges facing the EU, the jurisdiction had also shown impressive resilience through the pandemic. Costello said that the region was reaping the benefits of reforms in the banking sector and the move away from widespread indexation in labour markets, which has prevented a wage price spiral from stoking further inflationary pressures.

"If I think of the scale of the shock of Covid and now the terms of trade shock on energy, coming so close together, and still the third quarter comes out positive, still robust growth, employment still very high – record levels," added Costello.

"Yes, there will be a technical recession but what really surprises me is actually just the resilience of the economy."

Both Costello and Rahmouni-Rousseau pointed to the low sensitivity of eurozone spreads to increases in risk-free rates as a sign of health in the region's markets.

Costello noted that the announcement of the €750bn Recovery and Resilience Facility in combination with the ECB's Pandemic Emergency Purchase Programme had reversed the rise in spreads sparked by Covid-19's outbreak and set the stage for continued reform and investments in the EU. He added that agreement on the EU's Stability and growth pact would be a key part of this effort going forward.

Navigating 2023

While conscious that tighter monetary conditions are set to remain next year, Cirelli said that 2023 would be a better year for investors than 2022, as long as they recognised the changed rules of the game.

That may still take time to sink into some corners of the market, with many still buying into a view where rate cutting begins this year.

"There is this tug of war with markets," said Rahmouni-Rousseau. **"If you look at financial market prices they actually expect, not only for the ECB but also for the Fed, that we reach a peak in the summer and shortly after we start cutting rates. The Fed has been very clear in their minutes that they don't see this, the same goes for the ECB - we don't think this is the playbook for markets."**

Q&A

with **Michele Finocchi Ghersi,**
Senior Options Sales Trader,
Susquehanna International Group

Susquehanna recently sponsored the Euronext Markets Insight Conference, how do you work with the exchange?

SIG has a very good relationship with Euronext. We work with them on numerous projects and initiatives.

SIG is currently ranked number 1 in terms of volume traded in options listed on Euronext. We act as market makers on 217 underlying securities, which equates to a total of 512 products (including weeklies, European options, etc). We also cover LIT markets in 280 stocks in cash equities, and act as liquidity providers on 88 ETFs. Moreover, we are also very active trading with institutional clients, where we actively provide prices via RFQs directly.

We generally see Exchange relationships as a two-way street where we can both use our respective unique strengths to deliver constant improvements to the market. SIG is fully committed to helping the markets become a more competitive space, to the ultimate benefit of the investment community.

As members, we cooperate with the exchanges on the development and launch of new products, which we support by providing our opinions and by actively making markets on and off screen, giving investors better access to the right set of products and liquidity.

Sponsoring the Euronext Markets Insight Conference shows SIG's continued effort to work with the exchanges as the unique point of contact between us as market makers and the buy side investment community.

Over the last 10 years, we have grown a large Institutional Sales Trading team that offers institutional clients direct pricing on all the instruments we cover.

Using our consolidated know-how and technology, SIG's options sales trading desk currently provides liquidity on roughly 800 symbols in Europe, between single names, index and fixed income options. This is an area where we have committed our investments for the long run and have experienced constant growth. We currently feel in the perfect position to help clients in Europe and beyond.

What current trends are you paying attention to in your business?

SIG has been at the forefront of electronic market making for over 35 years now. We have been leading the evolution and innovation of the financial markets ever since, with the goal of making the marketplace a more competitive and liquid environment.

We constantly work to expand our coverage. For example, in recent years we have built a very strong fixed income team, which allow us to help our clients on a broader set of asset classes and products.

As a company, we are looking carefully at the gradual shift from OTC to listed derivatives trading. We consider this a change that will positively affect both the liquidity and the transparency of the market.

We believe that products such as weekly and flexible contracts, which we actively quote, are very good at bridging the gap between trading listed and OTC.

It is also worth mentioning the growing demand for ESG products. Asset managers are increasingly trading these products, as a result of their specific mandates and/or regulatory requirements. Consequently, we have added a long list of ESG derivatives to our coverage, in order to align ourselves with what our clients are looking to trade.

We are able to provide much more liquidity on such products than what is normally represented on the electronic market in terms of spread and size, therefore this is another instance where a direct connection with an Independent Market Maker (IMM) like SIG would be beneficial for an institutional client.

Do you see any changes in the role electronic market makers will play in the future?

Generally speaking, we see a growing role for IMMs going forward.

Trends suggest that asset managers are increasingly looking at diversifying counterparties in their broker lists.

One of the key drivers for them is to improve their access to liquidity in key areas of the market by connecting directly with specialist players such as SIG.

Studies have shown that a direct connection with IMMs helps reduce execution costs and obtain tighter pricing. This has proved to be the case, especially in volatile times, as experienced in recent years during the global pandemic.

Our strong know-how and our ability to successfully work with volatility put us in the right position to step up and keep providing consistent pricing across the board, especially in stressed markets where investors might struggle to find liquidity.

We believe the asset management community, in particular, is gradually realising the role IMMs can play in their efforts to improve their trading efficiency, a role SIG is confidently willing to take on.

European dividend derivatives upbeat amid uncertainity

From left to right: Charlotte Alliot, Group Head of Institutional Derivatives (Euronext), Cédric Baron, Head of Multi Asset Strategies (Generali Investments), Benjamin Clerget, Portfolio Manager (Hudson Bay Capital) and Gabriel Messika, Head of Index Forward Trading Europe (JP Morgan)

After the shock of the 2020 European dividend ban, the market for dividend derivatives has recovered and is now evolving. Products and trading strategies have expanded to capture the new parameters created by pandemic politics. Market participants can now trade dividend exposures in Europe, Asia and the US, and rely on increasingly deep liquidity in a variety of contracts. As the asset class's unique return profile attract new investors beyond the market's original base, the future for dividend derivatives is promising.

Dividend derivatives began life as a solid but fairly niche market. Banks and other structured product issuers that needed to hedge dividend exposures mainly sold that risk to hedge funds. In its early days, this activity was conducted in an OTC swaps market. But trading rapidly moved onto screen with the successful launch of dividend futures on exchanges like Euronext. The universe has since expanded to include options contracts and use equity collateral for financing.

The market suffered its greatest challenge in 2020 as a new form of political risk hit the asset class and threatened to derail activity against the backdrop of the Covid-19 outbreak. The first shock came as companies cancelled already announced dividend payments. This was swiftly followed by an ECB ban on bank divided payments until late 2021.

This upended the risk calculus that futures traders had used to take positions in the market. But instead of stymying activity, the market has recovered, rebounded and is now poised to grow further as its participants expand and diversify.

"The range of investors trading dividends is a lot wider than it was in the past. These can be active fund managers, passive managers, insurance compan ies and retail investors that are looking to trade dividends now," said Gabriel Messika, Head Of Index Forward Trading Europe at JP Morgan.

"What is different trading dividends compared to any other asset class is that it offers investors the opportunity to take a view and have direct exposure to the specific earnings of companies. It is very unique to dividend trading to be able to take this specific view on a period of time and on earnings that it is more difficult to get when investing in just equities."

For investors that build focused research lines for companies and their dividend histories (especially in Europe, where dividend payments are calculated on past earnings), the market can actually provide more predictable positioning than an equity investment, which can be more volatile.

This has been highlighted after a year when double-digit declines hit many of the world's major equity indices. Meanwhile, expectations for dividend payments in 2023 for European companies are actually up by 10%. This has opened a rare chance for investors to create alpha after such an annus horribilis in most asset classes, with accounts able to invest in contracts at a range of maturities.

"For a multi-asset, long only portfolio such as the ones we manage at Generali, we use this product to get access to the equity market in a diversified way compared to traditional indices and with a lower equity sensitivity," said Cédric Baron, Head Of Multi-Asset Strategies at Generali Investments. **"Indeed, when we invest in dividends, the equity beta, especially for shorter term maturities, is lower than one.**

With dividend futures, you get a pure access to corporate earnings while your sensitivity to interest rates is much lower than the equity index one. Therefore, it's particularly interesting in the current environment and explains most of last year's outperformance of this product compared to equity markets.

Those products, due to their natural equity Beta, are part of the equity component of our portfolios. However, due to the way it's priced (it accrues until maturity to the terminal value of the dividends paid on an index over a specific year) it can be compared, in a way, to a bond. As such, we consider it as a carry element of our equity buckets."

Banking and energy prospects **boost bullishness**

This positivity is partly driven by the predominance of the banking and energy sectors in the European dividend market. Both offer higher yielding opportunities compared to other sectors.

This sectoral concentration, particularly in banking, partly reflects its predominance in European structured product exposures. In the current environment of rising interest rates and energy price inflation this should be positive for harvesting returns from the asset class. Banks' profits have been supported by rising interest income, while energy price inflation has boosted the sector's earnings and by turn, dividends. In this way, the product can also serve as an inflation hedge.

This bullish case is tempered by political risk though, especially for energy names. Political attention is already focused on energy companies' large profits during a cost-of living crisis, with windfall taxes a common part of the discourse in many jurisdictions.

For banks, the picture looks more benign.

"We were all traumatised by the dividend ban back in 2020 but I would say that today the banking sector is very different," said Benjamin Clerget, Portfolio Manager at Hudson Bay Capital. **"It has very strong balance sheets. Like in the US, the sector does a lot of buybacks now, so they can cut these before the dividend. And it is one of the very few sectors to improve its profitability with higher rates, with the direct channel between higher rates and profits for banks.**

So it should be a very rosy outcome for distributions to shareholders in banks."

Options market grows

One effect of the realisation of political risk that stunned the market in 2020 has been the growth and shifting dynamics of the dividend options market. This remains a younger sibling to the futures market. But demand for contracts is growing, in part because of participants' desire to hedge against political risk.

Markets participants have seen a rise in demand for puts that some investors are using to protect against future dividend bans. This in turn has fuelled other new trading strategies, with some longer-term investors buying call options to gain exposure to the dividend market and financing that by selling put options (due to the risk of dividend cancellation in the market, buyers are willing to pay a higher premium for downside protection).

This all points to a deepening and expanding market and one which is well suited to helping investors navigate the new world of heightened inflation and volatility.

I am anticipating much more need for hedges and investment using the dividend market. This market offers a better way to hedge inflation than holding shares, it can help investors to fix their long-term revenues coming from equities. So there are many new opportunities and new players that we expect to come into the market with the new challenges that we are facing.

GABRIEL MESSIKA
Head of Index Forward Trading Europe at JP Morgan

Q&A

with **Jean-Pierre Aubin,**
Co-Global Head of BGC Partners Group

What impact did the volatility of 2022 have on BGC and your clients?

The Russian invasion of Ukraine, the economic consequences associated to the change in monetary policies, soaring inflation and rising interest rates entwined to create significant volatility for clients. As a leading interdealer broker, BGC is well positioned in volatile markets and continued to work closely with its clients.

What were the key trends in fixed income trading in 2022?

For more than a decade, interest rates were at zero or even negative, this changed significantly in 2022 with the return of interest rates and active trading in fixed income, especially bond products.

What impact is the electronification of fixed income markets having on BGC?

BGC invests over $100m in technology every year with its electronic Fenics business now representing over a quarter of total revenues. Fenics is expected to become an even larger part of BGC's overall business going forward.

How has BGC responded to Brexit?

BGC already had a strong presence in the EU before Brexit, especially in Paris with offices in Milan, Madrid, Frankfurt and now Copenhagen and Dublin. We worked with regulators and implemented the mandatory requirements.

What does 2023 have in store for markets and for BGC?

With the return of interest rates, increasing trading volumes and wider spreads, we believe 2023 will be a great year for fixed Income products, government and credit bonds, and derivatives related products. As the number 1 fixed income broker, BGC is well placed for 2023.

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