EUROPEAN CENTRAL BANK

BANKING SUPERVISION



Financial market risks: Too many fault-lines?

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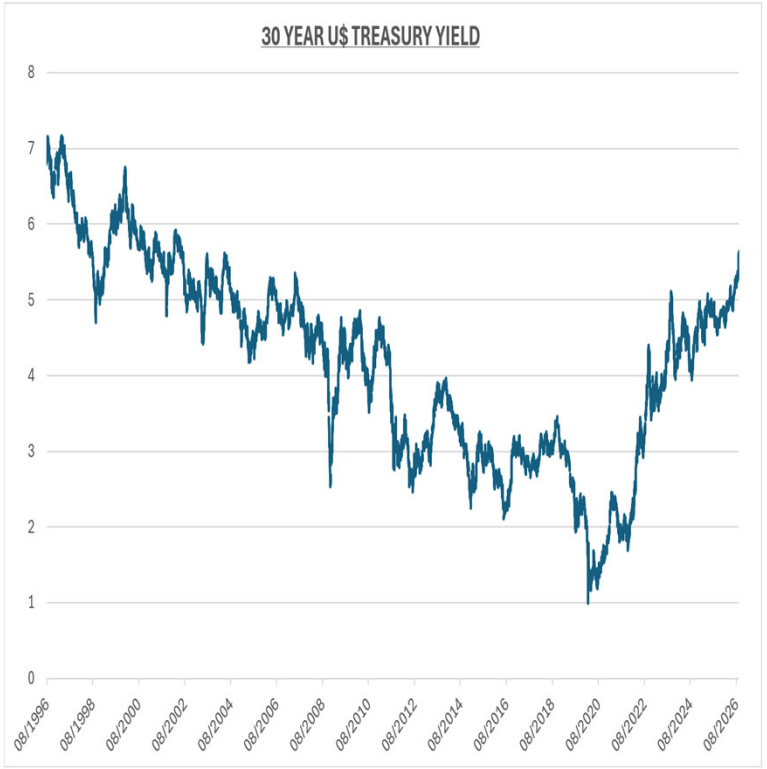
The current market environment: High fragility

- Starting point: Unique combination of financial, structural and (geo-) political risks
- **Fixed-income segment tackling two "tsunamis"**: Simultaneous jump in Government and AI debt issuance - > Sharp rise in yields
- **Equity market**: "Irrational exuberance" in AI/ tech sector?
- Changes in market structure: Non-Bank Financial Institutions (NBFIs) are the new systemic actors, but major banks still heavily involved -> **Fiscal-Financial Stability nexus (BIS)**

Rising risks in government bond market: Price vs Quantity

Falling price of government debt

- High inflation in US & Europe & jump in oil price
- **Shrinking safety component** in bond yields
- Weaker “Flight to safety” mechanism; Correlation of bond & stock price now positive (No market risk hedging)
- Huge sovereign and private **issuance** (AI boom)



Fragile quantity of government debt

- **Fragmented trading** on many platforms run by (Bank) Dealers –> vulnerable to dislocation (unlike equity market)
- **Price-sensitive participants** dominant: Arbitrage traders as major holders (more than ~ US$ 1 trn); Trading Firms as new Dealers; Reserve / SWF managers exiting (cf. gold price)

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Zooming in on pressure in U$T market

- **US fiscal policy**: US public debt > $40 trn > 120% of GDP
- So far, no dislocation, but sharp rise in dealer flows (Volume $ 750 BN) => intermediation capacity (heavily **dependent on NBFIs**) approaching limit?
- **Focus on 30Y "off the runs"**: Rarely traded, buy-back paid with T-bills
- Issuance of T-Bills increasing **-> Keep long yields down**
- Fed runs "reserve management purchases" of T-Bills (paused now) but new policy regime and major discussion about shrinking Fed balance sheet
- Yen intervention via EUR **-> Keep long yields down**
- Various geopolitical risks
- **Huge private-sector issuance** in debt markets (hyper-scalers borrowing $5 trn for AI, also in EUR)

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Plenty of risks in the private sector and stock prices

- **Is stock price boom driven by AI valuation a "*casino*"?**
  - Will firms realise the revenue required to justify equity valuation and cover costs of debt?
  - Anthropic IPO aiming for stock market valuation of $ 2,000 BN
  - Almost half of S&P 500 growth in 2026 Earnings per Share comes from AI investment
  - Vulnerability to high interest rates (discount factor, rotation etc)?
  - Who wins the global AI model race: Quality of model vs price vs adoption?
  - Circular investment relationships and complex network around Nvidia
  - Very high leverage (Korean retail investors and Situational Awareness Hedge Fund)
- **Private credit**: "*Déjà vu all over again*"?
  - Sharp growth in low-rate environment ($2.3 trn); Some parallels to subprime before 2007 (opacity, complexity of instruments)

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"*Dancing until the music stops*": Three themes for today

- **Analysis of stress scenario**: Global repricing of fiscal / credit / market risk -> *"Things fall apart"* in cash bonds, repos, FX, equity and swaps
  - Doubts about fiscal sustainability => Volatility, margin calls and "dash for cash"
  - Doubts about golden future of AI => leverage multiplies losses
  - Banks still on the dancefloor (backstop for funding & market liquidity plus Financial Market Infrastructure as Clearing Members and prime brokers)
- **Risk management of this stress scenario: What can e.g. banks do?**
- **Policy measures for this stress scenario: What can / should central banks do?**

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