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Japan,
Centre for Risk Management Strategy at Deloitte Touche Tohmatsu LLC.

Global Risk Watch Newsletter

Unrest in the Financial Assets Market

Global Risk Watch Vol.2
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1.Overview Macroeconomic and Financial Risks (Trends & Topics)

◆Unrest in the Financial Assets Market (Tsuyoshi Oyama, Partner/Head of Centre for Risk Management Strategy at Deloitte Touche Tohmatsu LLC.)

Since the second half of last year, we have observed a little strange synchronization of bond and equity markets, both of which have been overheated thanks to two market prerequisites that (1) single resilient US economy would lead the world economy, and: (2) Quantitative easing (QE) due to long-standing disinflation in EU and Japan would continue for a while. Inherently, the movement of both markets should be in an inverse relationship – the timing of collapse of this fragile equilibrium, and questions must rise for these two prerequisites stated above.

The past one month's world economic/financial trends can be described as 'wavelet' created by 'minor' question marks of these two prerequisites. Three question marks to be addressed. The first is the resilience of US economy. As stated in the previous e-Newsletter, March US employment was significantly below the forecast. The April figures (published in the beginning of May) reached the forecast level, but wages increase remained at a lower level. In addition, Q1 GDP growth rate was at 0.2%, and is likely to fall below the negative territory after the figures will be revised. Thus, the soft patch in the US economy became more apparent.

The second question mark is the long-standing disinflation trend in Europe. EU Harmonized Indices of Consumer Prices (HICP) fell by close to 1% year on year a few months ago. Thereafter, however, EU economy enjoyed a steady recovery and HICP has now returned to the same level as previous year. ECB (European Central Bank) is expected to continue QE for a while, but the 'excessive' low level of interest rate can be naturally normalized in the market if the deflationary risk is lessened.

The third question mark is the long-standing disinflation trend in among many countries including Japan and EU. The cause factor is certainly due to rebound of crude oil price. Crude oil price has once plunged to around 40 dollar per

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barrel at one point, but recently recovered to around 60 dollar level. Considering that disinflation had been accelerated by declining crude oil price in the past months, the rebound effects should also be very clear to us.

The ‘two prerequisites’ bear the overheated asset market (bonds and equities) in major countries, added with these minor question marks stated in the above – as the extent of overheating was strong up until now, thus, a major rebound occurred (especially in the bonds market). However, as ‘minor’ is expressed here for these question marks, the two prerequisites have not yet collapsed. The likelihood of resilient US economy and the disinflation in EU/ Japan remain strong. Therefore, the corrections in asset market are limited to an extent. Moving forward, the focal point is not the risk of both prerequisites collapse simultaneously, but rather which one of this conventionally contradicting factor will collapse first.

2.Overview of Development in Financial Regulations (Trends & Topics)

◆Excessive and Insufficient Regulations (Koichi Iwai, Senior Manager, Centre for Risk Management Strategy at Deloitte Touche Tohmatsu LLC.)

US have been playing leading role to strengthen financial regulations since the Global Financial Crisis, as shown in the implementation of Dodd-Frank Act. However, discussions to loosen regulatory burden have surfaced just recently in US. A prominent example is the movement in the Senate Committee on Banking, Housing, and Urban Affairs. The Chairman of this committee is considered to have a profound influence on financial regulatory reforms. Following the election last year, Senator Shelby inaugurated as the Chairman this year, and is aiming for deregulation. In particular, Chairman Shelby is pursuing to adopt ‘The Financial Regulatory Improvement Act of 2015’ including the revision of Dodd-Frank Act. The draft bill has a few objectives, one of those is to loosen the criteria for ‘Systemically Important Financial Institution (SIFI)’. Under current law, bank holding companies with total assets over 50 billion USD are automatically designated as systemically important and must comply with stricter regulations and supervisory requirements. Chairman Shelby is proposing to increase the threshold to 50 billion USD, which could allow mid-size banks to enjoy lesser regulation and supervision and promote bank lending in order to underpin the economic growth.

On the other hand, there are heated discussions over insufficient regulations in other areas. The notable example is the regulatory measures against cyber-attacks and trading glitches. Some industry bodies composed of US financial institutions urge the Congress and the government to encourage widely information sharing on cyber security information. Moreover, the debate to strengthen Reg SCI, the recently adopted regulation to restore resilience in trading system, becomes stronger. In the US, major trading failures continue to occur since the ‘Flash and Crash’ in 2010. In recent years, the disorders during Facebook IPO and Knight Capital erroneous transaction have gained concerns from regulators and market participants, and breakdown of Bloomberg terminals in April caused UK government to delay bonds issuing.

The opinions to strengthen cyber security and trading infrastructure are not limited in the US. For example, the Senior Supervisors Group, a regulatory body of supervisory authorities from 11 countries/regions, issued a report in April on the risks from algorithmic trading and the necessity of greater risk management. In addition, the International Organization of Securities Commissions (IOSCO) also published a paper in the beginning of April requesting trading venues and financial intermediaries to strengthen risk management, crisis management as well as the countermeasures in the time of market turmoil. These developments seem to reflect growing concerns over possible systemic risks triggered by an 'accident' in financial markets while cyber-attacks and trading glitches are occurring on a daily basis.

Perhaps, the forthcoming trends of regulatory reforms include loosening of excessive prudential regulations and strengthening of insufficient market regulations. Japan also faces increasing trends of algorithmic trading and high frequency trading. Moreover, the Japanese Financial Services Agency is intent to finalize regulations related to 'Domestic Systemically Important Bank' within this year. The focal point moving forward could be to observe the impacts of regulatory reform 'trends' on rule making and supervisory administrations in Japan.