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Amafi

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FEATURE

Crash or correction? Interpreting recent market movements

Equity and bond indexes have plummeted since the start of the year. Are these dramatic falls, which contrast starkly with the post-Covid rebound, a sign of irrationality or a sensible response to previous excess? What role does monetary policy play? The relatively new field of behavioural finance may offer insights on these issues and, crucially, on what comes next.

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EDITORIAL

Stéphane Giordano and Stéphanie Hubert | AMAFI

Commodity prices are under severe pressure due to the Ukraine war and Russia's geopolitically motivated manipulation of trade in grain, oil and gas. The knock-on to agricultural and energy derivatives markets has been massive. Margin calls from central counterparties to clearing members have soared, as have calls from clearing members to end-customers. These demands are being honoured for now, but they are generating liquidity pressures that could spell trouble for industrial firms in the energy sector and, by extension, the financial system.

To address this situation, the European Commission, backed by ESMA, has proposed legislation introducing a set of short-term measures, along with longer-term action as part of the EMIR review. However, these proposals were put together hurriedly. If the resulting initiatives are poorly calibrated, some participants – particularly industrial firms – could be crowded out of the clearing system. Any regulatory amendment needs to be based on robust impact studies that consider all the ramifications of the proposed measures. We need a broader conversation about risk sharing and the contributions that clearing members, end-customers and even governments would have to make in a variety of crisis scenarios.

Whatever the case, it is critical to consider the functioning of energy markets as a whole in order to establish a system that operates consistently along the entire value chain, including trading venues, clearing houses, clearing members and customers. The primary aim is to ensure that a runaway increase in asset prices and the related margin calls does not trigger the collapse of otherwise viable industrial firms. Further discussion is also needed on the conditions for trading suspensions and liquidity stress-testing for non-financial participants exposed to potentially significant margin calls. Public guarantee schemes are another important issue. To ensure that firms can cope with exceptional calls, these schemes must be built on an unprecedented scale and designed to be implemented quickly. AMAFI plans to contribute actively to all of these efforts through its Commodities Committee.

Crash or correction? Interpreting recent market movements

Sandra Sebag

What is happening in financial markets? The indexes that track bond and equity performances around the world have had a torrid year. As of 23 November the EURO STOXX 50, a gauge of eurozone shares, was down about 10% from its 2022 starting point. The S&P 500 of US equities was even worse, having surrendered 15.5%. Fixed income tells a similar story: eurozone sovereign issuers were down 15% as measured by the iBoxx index. Since the year began, and despite periodically rebounding, financial markets in developed economies and across most emerging economies have fallen much farther than during past major crises. Not since Paul Volcker helmed the US Federal Reserve in the early 1980s, when policy rates were hiked from 11% to 20% to ward off rampant stagflation, has the bond market witnessed a correction of this magnitude. Volcker's hikes plunged America's economy into recession and unleashed a full-blown global crisis. Equity markets have experienced other meltdowns since then, but the corrections on fixed income markets have never been as large as they are now. During the 2008 global financial crash, or in 2011/2012, when Europe was rocked by a sovereign debt crisis, financial asset prices collapsed in tandem with major economic upheaval. That makes it hard to draw parallels between this year's market upsets and movements during previous crises. "From a purely factual point of view, today's situation can't be compared to 2008 or 2011," says Angelo Riva, a professor at the European Business School and researcher at the Paris School of Economics. He argues that what we are seeing now has more in common with the oil shocks of the early 1970s, even though financial systems at that time were radically different from today's. In each instance, the common denominator is a supply-side shock triggered by geopolitical pressures that drove up energy prices. In the present case, the initial shock was exacerbated by supply chain problems related to Covid-19.

With the possible exception of the crypto-asset sector, what is happening now is not a true financial crisis, usually characterised by the default of a major institution or an insolvency or liquidity crisis among financial intermediaries. Market rumours and movements show that participants are panicky, but for the time being at least, financial institutions – particularly in the European Union – are not facing major risks, though caution is certainly warranted. Moreover, since financial markets began their slide almost a year ago, they have periodically run into liquidity issues, but these have been dealt with quickly and the shocks have not fed through to the real economy. Macroeconomic indicators and corporate earnings have mostly surprised on the upside.

Trimming past years' excesses?

Since no direct parallels can be drawn, the current behaviour of financial markets is open to multiple explanations. The main culprits include higher energy and commodity prices, the war in Ukraine, post-Covid supply chain disruptions and surging inflation. Combined, these factors are undoubtedly a headache, yet none of them is a single cause that everyone can agree on. In the absence of a major financial crisis or crash, some specialists think that markets are simply shedding the excesses of previous years. AMAFI Chairman Stéphane Giordano argues that a crash cannot be characterised purely by numbers: just because shares have plunged 15% or 20% this year does not mean that markets have crashed. In fact, since the textbook definition of a crash is a sudden and massive swing involving irrational asset depreciation, this year's equity market performances do not fit that description. If anything, valuations have actually become more rational. This is especially true of tech and growth stocks generally, where valuations have been out of step with economic and financial performances for some time. Despite never generating positive earnings, some listed shares have commanded demanding and rising valuations until lately, on the back of low-to-negative interest rates and plentiful liquidity. These are the stocks ▶▶▶

that have seen the sharpest adjustments. According to this reading, the corrections are merely a return to normal, bringing valuations back into alignment with economic performances, as central banks work to tame inflation by hiking interest rates and curbing the amount of liquidity in circulation.

Another explanation for the current behaviour of financial markets lies with the expansionary monetary policies applied in 2008 to prevent the global financial crisis from wreaking havoc on the real economy. Although these policies played a vital role, the procedures used to implement them were sometimes ill-judged. With massive amounts of liquidity made available over a long period, shares and real estate became overvalued as their prices inflated. Until recently, however, the effects on the real economy went unseen because inflation was under control. This situation changed dramatically as the Covid-19 crisis led to unprecedented shortages that caused a resurgence in inflation. Markets were hopeful that the crisis would end quickly, followed, as in previous years, by a sustainable rebound driven by ample liquidity. But the rally fizzled out quickly. Equity markets certainly recorded a big bounce after the first lockdown in 2020. The EURO STOXX 50, for example, was flat between 2017 and 2019, but headed upwards in 2020 and in 2021, while US growth stocks rebounded sharply through to mid-2021. The corrections wiped out much of the gain. Even so, many investors have shrugged off the adjustments, believing that the post-Covid bounces were not fully justified by fundamentals.

Upward adjustment to interest rates

The slide on fixed income markets can also be linked to the shift in central bank monetary policy stances. Higher official rates translate automatically into lower valuations, because bond yields and prices move in opposite directions. Here, too, market participants reckon the corrections are rational. While acknowledging that issuance volumes are down, Stéphane Giordano makes the point that fixed income markets have been resilient and continue to provide liquidity and secondary market prices while adjusting to a new set of circumstances, which include resurgent inflation, a radical shift in central bank interest rate and liquidity strategies, and an extremely worrisome geopolitical situation with the war in Ukraine.

Looking for answers in behavioural finance

The relatively new discipline of behavioural finance may offer clues to current and future market behaviour. A subset of behavioural economics, behavioural finance seeks to explain market movements outside the neoclassical model built on the efficient market hypothesis formulated by Eugene Fama. The basic tenet is that humans (and markets) are irrational, emotional entities swayed by biases and prone to mistakes. They use mental shortcuts and, sometimes, take decisions that are not in their own best interest.

In "Does the Stock Market Overreact?", a paper co-written in 1985 with Werner De Bondt, Richard Thaler, the 2017 Nobel economics laureate, showed that equity markets overreact to good news and underreact to bad news because of the behavioural biases of market participants. Specifically, people tend to suffer from optimism bias, overconfidence bias, as well as a disposition effect that means they often hold onto losers and sell winners. In a now-famous study conducted in 2000, behavioural finance researchers Sheena Iyengar and Mark Lepper wanted to see what happened when people were given a wide array of choice. They set up a tasting booth in a supermarket and offered passers-by either six or 24 flavours of jam to try. They found that while more people stopped to sample products when a larger number of flavours was offered (60% vs. 40%), only 3% of people

actually made a purchase, compared with 30% for the smaller selection. Their findings suggested that people become overwhelmed and confused when presented with too many options.

Daniel Haguet, who teaches finance at EDHEC Business School and co-chairs the Behavioural Finance Committee of the French Society of Financial Analysts (SFAF), believes that behavioural finance and the biases it identifies can help to understand current market trends. He points out that finance is all about taking decisions amid uncertainty. Today's environment is a prime example, featuring severe geopolitical uncertainty over which financial markets have no control, including the Ukraine conflict, simmering tensions between the United States and China, and strained relations between North and South Korea. These factors make it extremely difficult to forecast what will happen three or six months down the line. Compounding this, most market participants have never experienced an environment of high interest rates and rising inflation and are unsure how to respond. At the same time, with multiple information channels keeping up an intense barrage of news, companies reporting more frequently than before, and news circulating instantly on social media, market participants are constantly under pressure to do something, a situation that behavioural finance calls action bias. Taken together, these factors may account for the market overreaction and the current extreme volatility.

When asked whether markets could slide into a deeper crisis, Haguet suggests that geopolitics or poorly considered policy decisions are the most likely catalyst. He cautions that an escalation or stalemate in Ukraine or the emergence of a new conflict zone could trigger a market incident. Another key factor could be anchoring bias, which affects investors as whole, but especially retail investors, by stopping them from recognising changes in the macroeconomic regime and their effects on assets. Investors need to consider switching assets, particularly within life insurance investment contracts. These changes could have a major impact on the finance industry.

> *"Recent corrections have wiped out the post-Covid rebound on equity markets"*

Whatever the case, specialists have not ruled out the possibility of a financial crisis in the coming months or weeks amid softening growth and a resulting rise in business failures. Energy prices are likely to remain high for the foreseeable future, the supply side shock looks set to last, and higher interest rates will complicate financing for businesses and individuals alike. The International Monetary Fund is much gloomier in its economic forecasts for 2023 than for 2022. In October, it foresaw global growth of 3.2% for 2022 but downgraded its estimate for 2023 to just 2.3%, from 2.9% in July, and warned that the worst is yet to come. With the outlook uncertain, current corrections could quickly turn into a full-blown financial crisis. All eyes will therefore be on interest rate movements. For the time being, corporate earnings are holding up and economic indicators are surprising positively, but real interest rates could act as the tipping point because if they enter positive territory, financing costs will exert significant drag on households and companies. A recession would then be inevitable, bringing with it further financial market corrections and significant challenges for financial participants.

INTERNATIONAL

ICSA

Interim Meeting, London, 17 November 2022

The International Council of Securities Associations held its interim meeting in London on 17 November. Beyond discussing ICSA's own operation, members also had the opportunity to talk with Dietrich Domanski, Secretary General of the Financial Stability Board, about systemic threats, which are at their most intense since the financial crisis of 2008.

Mr Domanski spoke about the elevated level of inflation and increased interest rates, which are causing financing conditions to tighten even as households, corporates and governments are grappling with worryingly high debt levels.

He pointed out the liquidity issues for non-bank financial institutions and the resulting impact on financial stability due to their greater role in financing the economy. He also highlighted the need for a balanced regulatory framework for crypto-assets, not only to capture the risks more effectively, but also to promote the development of these assets, given the potential benefits. Mr Domanski additionally spoke about the FSB's work to support a global approach to disclosure of the financial risks associated with global warming.

Arnaud Eard

EUROPE

EFSA

Brussels meeting, 8 and 9 November 2022

The Belgian Association of Stock Exchange Members (BASE) welcomed its sister organisations from the European Forum of Securities Associations (EFSA) as it hosted a meeting in Brussels on 8 and 9 November. AMAFI was represented by Chief Executive Stéphanie Hubert and Director of European and International Affairs Arnaud Eard.

Picking up where they left off at the July meeting in Stockholm, members reached agreement on the EFSA's core tasks and governance arrangements, with a view to reinvigorating the forum and revitalising its joint initiatives. AMAFI welcomed this support for the common framework, which seeks to raise the profile of EFSA's positions and defend the interests of Europe's sell-side industry in Brussels.

Participants also approved a joint position paper on the MiFIR Review *(AMAFI / 22-82)*. The paper will provide a basis for joint talks with European MPs and authorities.

The next EFSA meeting will take place in Stockholm on 24 and 25 April 2023, on the sidelines of the Eurofi Forum gathering.

Arnaud Eard

MIFID II

Investor protection

Retail Investment Strategy

The European Commission published on 26 September a questionnaire on new provisions that it is considering as part of its retail investment strategy, with a view to enhancing the appropriateness and suitability regimes. An open hearing was held on the draft on 28 September. AMAFI took part and stressed the need to maintain two separate regimes, since not all clients want to be advised on their investments.

After telling the Commission that its questions could not be answered in such a short timeframe, France's professional associations are currently working on a shared position paper that they will shortly submit to the Commission.

AMAFI, along with Germany's derivatives association DDV and the French Treasury, held a meeting on 24 October to discuss the two associations' shared priorities for the retail investment strategy *(AMAFI / 22-78)*. Among the topics broached were alternatives to a potential ban on inducements, with a particular focus on the value for money of marketed financial instruments and improved transparency and delivery procedures for investment services targeting retail customers.

Product governance

AMAFI submitted numerous observations *(AMAFI / 22-69)* to the consultation launched in early July by ESMA on updating its guidance on product governance requirements to reflect the integration of ESG criteria in MiFID II. The association called for flexibility in the methodologies that could be used to define sustainability criteria for financial instruments, including with regard to the types of ESG data used. This flexibility is needed throughout the period during which the data disclosable under Europe's new sustainable finance legislation (particularly CSRD) will be unavailable because the legislation will not yet have come into effect.

Impact of inflation on MiFID II implementation

ESMA released a statement on 27 September concerning the impact of inflation on the provision of investment services. It reminded firms to consider inflation and inflationary risks when providing investment services to retail customers and to pay particular attention to the provision of information and to suitability and product governance requirements. AMAFI is working with the members of its Compliance Committees to draft an interpretative note clarifying some of the operational impacts of ESMA's statement.

Catherine Balençon

MARKET OUTAGES

Communication protocols

In September 2021, as part of the draft revision of MiFID II, ESMA set out a number of proposals in *a report on algorithmic trading.* One of the proposals was to provide guidance on how trading venues should communicate with market participants in the event of a market outage.

ESMA therefore consulted on how National Competent Authorities (NCAs) should ensure that trading platforms have established appropriate protocols to communicate with participants and the public if a market an outage occurs. Although the consultation was aimed primarily at NCAs and venues, AMAFI provided feedback in which it stressed the need to harmonise communication protocols across the European Union to ensure greater consistency in rules and prevent venues from exploiting regulatory differences to gain a competitive advantage over other trading platforms.

Emmanuel de Fournoux, Mathilde Le Roy

MIFIR REVIEW

AMAFI-Portuguese Finance Ministry meeting, 14 November

With negotiations underway within the European Council on the MiFIR review, AMAFI Chairman Stéphane Giordano and Director of European and International Affairs Arnaud Eard met with representatives of the Portuguese Finance Ministry to discuss the compromise text prepared by the Council's Czech presidency.

AMAFI spoke about the importance of enhancing the competitiveness of European businesses and making Europe's regulatory framework more attractive. It welcomed the Czech proposals on equity and non-equity transparency regimes, aimed at preventing a regulatory gap with the United Kingdom which could trigger a transfer of liquidity. Portugal's representatives expressed overall support for the proposals on the non-equity transparency regime. However, they were more cautious on the proposed amendments to the equity transparency regime, which they felt were too similar to those mooted by UK authorities.

On the topic of a pre-trade consolidated tape for equities, AMAFI and the Portuguese representatives expressed disappointment at the turn taken by negotiations within the European Council, which appear to be tilting towards establishing only a post-trade tape.

As regards payment for order flow (PFOF), which is critical to achieving an agreement under the Czech presidency, AMAFI insisted that if a ban were introduced, it must be restricted to equities and should not extend to other products such as warrants, whose price discovery mechanism is not order-linked. Portugal's representatives said they were not in favour of a ban and supported better regulation of PFOF-related practices.

AMAFI-European Parliament meeting, 17 November

As part of talks underway within the European Parliament's ECON Committee, an AMAFI delegation led by the Chairman met with MEP Danuta Hübner, the rapporteur for the MiFIR review, to discuss the proposed amendments submitted by MEPs. AMAFI had provided its own draft amendments in mid-October, which addressed the creation of a pre-trade consolidated tape for equities as well as attractive equity and non-equity transparency regimes (AMAFI / 22-70).

While the rapporteur was fairly upbeat on the likelihood that the final report would include a proposal to create an ambitious pre-trade consolidated tape for equities, she was more doubtful on reforming the equity transparency regime to incorporate questions of EU actors competitiveness. AMAFI once again reiterated the need to take account of the reforms currently under consideration in the UK and ensure that trading volumes do not migrate to Britain because Europe's equity and bond markets are insufficiently attractive and competitive.

On the question of PFOF and a possible ban, Ms Hübner pointed out that this was the most divisive topic and that negotiations would be delicate.

Arnaud Eard

INVESTMENT FIRMS REGIME

Pillar 2

After numerous discussions with the French Treasury and the ACPR on Class 1 investment firms and their authorisation applications, discussions are continuing on Class 2 investment firms (smaller, non-systemic institutions), with particular focus on the integration of Pillar 2 requirements, namely the additional equity that might be required by the supervisory authority as part of a standardised process.

AMAFI obtained clarification from the ACPR about how Pillar 2 will work and especially about the internal capital-adequacy assessment process and the prudential supervision and assessment process *(AMAFI / 22-81)*.

Emmanuel de Fournoux, Mathilde Le Roy

SUSTAINABLE FINANCE

Derivatives and Sustainable Finance

AMAFI is continuing its discussions with members of the Derivatives and Sustainable Finance Group on a methodology to include derivatives in reporting under the Taxonomy Regulation, and more specifically in the green asset ratio (GAR) that tracks the share of banking book assets associated with activities classified under the regulation as environmentally friendly.

This work is taking place within a broader context, and the approach adopted for the GAR could be replicated in other regulations that deal with sustainable finance, particularly SFDR and MiFID II, which have yet to determine how derivatives are to be treated but to which European authorities are now turning their attention.

AMAFI hopes not only to contribute to the conversation within the Paris market community on this issue but also to provide input to the discussions being held by the European Commission and European Supervisory Authorities.

Lina Jouker, Stéphanie Hubert

AML/CTF

AML Questionnaire

The ACPR presented on 3 October 2022 a draft streamlined annual AML Questionnaire to members of the AML/CTF Consultative Commission, on which AMAFI sits. AMAFI had called for the new draft during the consultation on the review of the general AML Questionnaire *(AMAFI / 22-51)*.

AMAFI *(AMAFI / 22-71*) stressed the lack of clarity of some of the proposed filter questions, highlighted the need to extend streamlining measures to reporting entities that engage in "pure" third-party order execution, and insisted on the need to do away with the customer-based eligibility requirement – currently restricted to institutional EU or EEA customers – for activities giving entitlement to streamline requirements .

Having made these points, AMAFI welcomed the authority's efforts to reword the filter questions. However, it expressed disappointment that no action had been taken on its comments regarding the need to offer streamline requirements to entities that do not provide account-keeping services and whose business is confined to order reception-transmission and/or order execution for third parties, irrespective of the type of customer served.

Julie Dugourgeot, Catherine Balençon

INITIAL PUBLIC OFFERINGS

Meeting with the AMF

Working through its Corporate Finance Committee (CFC), AMAFI reviewed Paris Europlace's recommendation on making it optional to reserve a tranche of shares for retail investors during initial public offerings. The CFC and the AMF then addressed the topic at a meeting on 22 September.

During the meeting, CFC members said that it was more important to shorten the offer period from six to three days than to make the retail tranche optional, although they were not opposed to that idea. Shortening the period would require an amendment to European law, which could be incorporated in the future proposal for a Listing Act announced by the European Commission for the end of the year.

Given the fruitful discussions that resulted from the meeting with the AMF, it was agreed that the CFC would meet with the securities authority at least once a year.

Thiebald Cremers, Clara Le Du, Léa Verucchi

AMAFI

APPOINTMENT

Aimée Camilli was appointed chair of AMAFI's Private Banking Compliance Committee on 9 November to replace Pierre Emmanuel Charrette, who has resigned. Aimée Camilli is Head of Risk Management at UBS France, with particular responsibility for compliance, AML/CTF and permanent control.

AMAFI wishes Ms Camilli every success in her role and thanks Pierre Emmanuel Charrette for his hard work on behalf of the committee.

Catherine Balençon

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AMAFI documents quoted in this Newsletter and flagged with a reference number are on our website at

www.amafi.fr

Most of them, notably AMAFI's responses to public consultations, are freely available, but some are restricted to members only.

FRENCH FINANCIAL MARKETS ASSOCIATION

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