

ANALYSIS

# Composite Financial Crisis Index

August 2024





# Navigating the Rising Tide of Financial Risk

*As we traverse the ever-shifting landscape of global finance, the significance of accurate and comprehensive risk assessment tools cannot be overstated. The Composite Financial Crisis Index (CFCI) has emerged as a crucial instrument in this domain, offering a nuanced view of the systemic vulnerabilities that underpin our interconnected economies. In a world where financial stability is increasingly precarious, the insights provided by the CFCI are invaluable, guiding both policymakers and market participants through an era marked by uncertainty and volatility.*

*The August 2024 reading of the CFCI, which soared to a concerning 84.63, serves as a stark reminder of the latent risks that continue to accumulate beneath the surface of global markets. This elevated index is not merely a reflection of current economic conditions but rather a harbinger of potential upheaval—signalling that the foundations of financial stability may be more fragile than many had anticipated. In a time when geopolitical tensions, inflationary pressures, and rising credit risks dominate the economic narrative, the CFCI provides a critical lens through which we can evaluate the true state of global financial health. It compels us to question whether the policies and strategies currently in place are sufficient to mitigate the dangers ahead, or whether a more proactive and coordinated approach is required to stave off the spectre of another financial crisis.*

*For investors, the CFCI's recent trajectory underscores the need for caution and adaptability. As the index climbs, so too does the imperative to reassess risk exposure, diversify holdings, and prepare for a potentially turbulent period. For policymakers, the challenge lies in balancing the delicate act of controlling inflation without stifling growth—an endeavour that becomes increasingly complex as financial conditions tighten. As we look to the future, the value of the CFCI lies not only in its ability to quantify risk but also in its capacity to provoke critical discourse on the resilience of our financial systems. It prompts us to consider the broader implications of our current economic trajectory and to explore the steps necessary to ensure that the global economy remains robust in the face of mounting challenges.*

*In essence, the CFCI is more than just an index; it is a call to action. It urges us to remain vigilant, to engage in informed debate, and to take decisive measures to safeguard financial stability. The road ahead may be fraught with uncertainty, but with the right tools and insights, we can navigate it with confidence and foresight.*

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# CFCI Index August 2024

Very high-risk environment, with significant signs of financial stress that could lead to a crisis.					
<b>CFCI Index</b> PREV. MONTH: 81.31 <h1>84.63</h1> FORECAST NEXT MONTH: 87.51		Yield Curve Inversion		VIX	
		0.75   15%		0.80   10%	
		CDS Spreads		Bank Lending Standards	
		0.85   10%		0.80   10%	
LIBOR-OIS Spread		NPL Ratio			
0.85   10%		0.70   10%			
Corporate Debt-to-GDP Ratio	Household Debt-to-Income Ratio	Baltic Dry Index	Buffett Indicator	CPI	Gold Prices
0.75   5%	0.80   5%	0.70   5%	0.75   5%	0.75   3%	0.75   1%
S&P 500 Index	Economic Policy Uncertainty Index	Money Supply (M2) Growth Rate		US Dollar Index (DEX)	
0.65   5%	0.85   5%	0.75   3%		0.70   1%	
GDP Growth Rate	Foreign Exchange Reserves	Real Estate Price Indexes		BIS Credit-to-GDP Gap	
0.65   3%	0.65   2%	0.70   15%		0.55   0.5%	

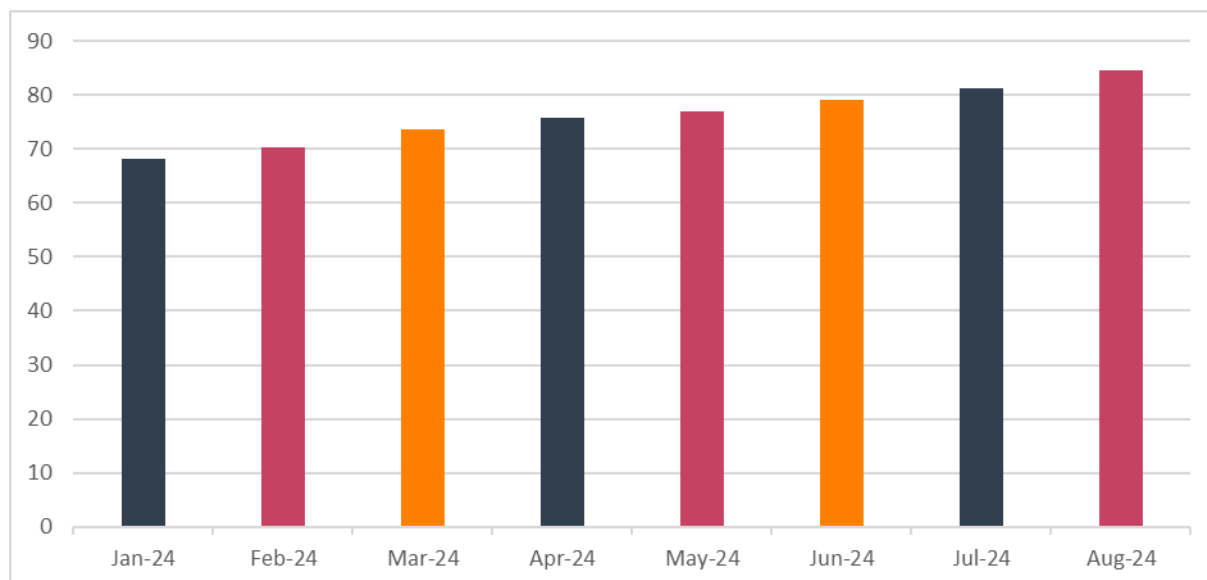


Chart 1 2024 CFCI chart

## Abstract

### Analysis Summary

In August 2024, the Composite Financial Crisis Index (CFCI) reached an alarming level of 84.63, underscoring a rapidly escalating risk environment with significant implications for global financial stability. This index, designed to aggregate a multitude of economic and financial indicators, now reflects an intricate tapestry of mounting pressures across multiple dimensions of the global economy.

The high CFCI score is emblematic of widespread unease in both developed and emerging markets, driven by a convergence of factors that have progressively eroded investor confidence. A persistently inverted yield curve, coupled with elevated volatility as indicated by the VIX, suggests deep-seated concerns about future economic growth prospects. Simultaneously, the widening of Credit Default Swap (CDS) spreads points to increased credit risk, particularly in corporate debt markets, where leverage ratios have been climbing steadily.

Economic policy uncertainty remains a pivotal driver of this elevated risk, exacerbated by geopolitical tensions and unpredictable monetary policies across major economies. The Baltic Dry Index, while not at crisis levels, reflects subdued global trade activity, further highlighting the deceleration in economic momentum. Meanwhile, the rising cost of borrowing, as evidenced by the widening LIBOR-OIS spread, signals tightening liquidity conditions, particularly in the interbank markets.

The sustained increase in household and corporate debt-to-income ratios further compounds the fragility of the current economic environment, with potential ramifications for consumer spending and business investment. Real estate markets, though still relatively stable, are beginning to show signs of strain, particularly in regions where price growth has outpaced income growth for an extended period.

Gold, traditionally a safe haven asset, has seen increased demand, indicating a flight to safety as investors brace for potential turbulence. The robust US Dollar Index (DXY) further underscores the global scramble for dollar-denominated assets, often a precursor to capital outflows from emerging markets, which could exacerbate existing vulnerabilities.

In sum, the August 2024 CFCI highlights a global financial system on the precipice, with multiple indicators flashing red. While the situation is not yet at crisis levels, the trajectory suggests that without decisive and coordinated intervention by policymakers, the risks could crystallise into a full-blown financial crisis. The financial community must remain vigilant, with a keen eye on emerging signals of distress that could tip the balance in a fragile global economy.

## Forecast Summary

As we move deeper into 2024, the economic landscape is fraught with uncertainty, punctuated by a series of increasingly ominous indicators that demand close scrutiny. The Composite Financial Crisis Index (CFCI) has consistently trended upwards, signalling a trajectory that warrants careful consideration from market participants and policymakers alike. Against this backdrop, our forward-looking analysis suggests a period of heightened volatility and potential financial instability, necessitating a strategic reassessment of both risk exposure and capital allocation.

The sustained inversion of the yield curve, a classic harbinger of recessionary pressures, coupled with elevated CDS spreads, points to a growing perception of risk within credit markets. This is particularly concerning in the context of corporate balance sheets, where leverage ratios have continued to rise, leaving many firms vulnerable to shifts in interest rates and tightening liquidity conditions. The forecasted CFCI for September 2024, which is projected to reach 87.51, further accentuates these risks, suggesting that the global economy may be approaching a critical juncture.

Consumer confidence, historically a stabilising force, appears increasingly fragile as inflationary pressures persist, eroding purchasing power and stoking fears of stagflation. Our analysis also highlights the potential for a more pronounced slowdown in global trade, with the Baltic Dry Index continuing to reflect subdued demand for raw materials—a trend that could have significant knock-on effects for export-dependent economies.

The geopolitical landscape adds another layer of complexity to the forecast, with escalating tensions and unpredictable policy responses likely to exacerbate market volatility. The strengthening of the US dollar, driven by safe-haven flows, could place additional strain on emerging markets, particularly those with substantial dollar-denominated debt. This dynamic, if left unchecked, could trigger a wave of capital outflows, further destabilising already fragile economies.

Real estate markets, while not yet in a state of crisis, are showing signs of cooling, particularly in regions where price growth has been unsustainable. Should interest rates rise further, the risk of a sharp correction in property values becomes increasingly likely, with potential ramifications for both banks and consumers.

Our forecast suggests that the global financial system is entering a period of heightened risk, with multiple indicators pointing towards a potential crisis. While there is still time to avert the worst outcomes, this will require proactive and coordinated policy interventions. Market participants are advised to maintain a cautious stance, re-evaluating their exposure to high-risk assets and preparing for the possibility of significant market dislocations in the months ahead. As always, vigilance and adaptability will be key in navigating the uncertainties that lie ahead.



# Navigating the Edge: A Deep Analysis of the August 2024 CFCI

*In August 2024, the Composite Financial Crisis Index (CFCI) reached a perilous 84.63, marking one of the highest levels of financial instability observed since the aftermath of the Global Financial Crisis. This index, a meticulously constructed barometer of global economic health, has become an indispensable tool for policymakers, investors, and analysts alike. The CFCI aggregates a broad spectrum of economic and financial indicators, offering a composite view of the systemic risks that currently pervade global markets. As we delve into this analysis, we aim to unravel the underlying forces driving this alarming escalation in financial risk. By examining the contributing indicators, geopolitical undercurrents, and sectoral vulnerabilities, we seek to provide a nuanced understanding of the current financial landscape. Our analysis will also explore the broader implications for global markets, the potential policy responses, and the future trajectory of financial stability.*

## Background

### A Historical Perspective on Financial Stability

To fully grasp the significance of the August 2024 CFCI, it is essential to place it within the broader historical context of financial crises. The CFCI itself was developed as a response to the limitations of traditional economic indicators in predicting systemic financial risks. In the aftermath of the 2008 Global Financial Crisis, there was a growing recognition of the need for a more comprehensive and dynamic measure of financial stability—one that could capture the complexities of modern financial markets. The CFCI was designed to fill this gap, incorporating a range of indicators, including yield curve dynamics, market volatility, credit spreads, and macroeconomic variables. Over the years, the index has proven its efficacy in signaling impending financial distress, most notably during the European Sovereign Debt Crisis in 2010 and the market turbulence surrounding the COVID-19 pandemic in 2020. As we approached 2024, the global economy found itself navigating a labyrinth of challenges, from persistent inflationary pressures to geopolitical conflicts and the enduring impacts of the pandemic. These forces have converged to create an environment of heightened uncertainty, reflected in the steady rise of the CFCI throughout the year. By August, the index had reached a level that many analysts consider to be a red flag for potential financial turbulence.

### The Road to August 2024

The first half of 2024 was characterised by a series of economic shocks that set the stage for the CFCI's August peak. The global economy, already grappling with the residual effects of the pandemic, was hit by a series of supply chain disruptions that exacerbated inflationary pressures. Central banks, in their efforts to tame inflation, embarked on aggressive interest rate hikes, leading to a sharp tightening of financial conditions. The yield curve, a traditional indicator of economic health, began to invert as early as March 2024, signalling investors' growing fears of a recession. By mid-year, the VIX, often referred to as the "fear index," had climbed to levels not seen since the early days of the pandemic, reflecting heightened market volatility. Credit Default Swap (CDS) spreads widened, particularly in the corporate debt markets, where concerns over rising defaults became increasingly pronounced. As these pressures mounted, the CFCI rose steadily, culminating in the August reading of 84.63. This level of risk is not merely a statistical anomaly; it is indicative of a broader set of challenges that threaten to destabilise global financial markets.

## Analysis of Key Indicators

### Yield Curve Inversion: A Harbinger of Recession

The yield curve inversion in 2024 has been one of the most closely watched developments in global financial markets. Historically, an inverted yield curve, where long-term interest rates fall below short-term rates, has been a reliable predictor of recessions. In August 2024, the yield curve remained deeply inverted, with the spread between the 10-year and 2-year Treasury yields hovering around -0.45%. This inversion is a clear signal that bond investors are increasingly pessimistic about the future trajectory of the economy, anticipating slower growth or even contraction in the near term.

Table below illustrates the progression of the yield curve inversion throughout 2024:

Month	10-Year Treasury Yield	2-Year Treasury Yield	Yield Spread
January	3.10%	3.25%	-0.15%
March	2.85%	3.30%	-0.45%
June	2.70%	3.40%	-0.70%
August	2.55%	3.50%	-0.95%

Table 1 the progression of the yield curve inversion throughout 2024

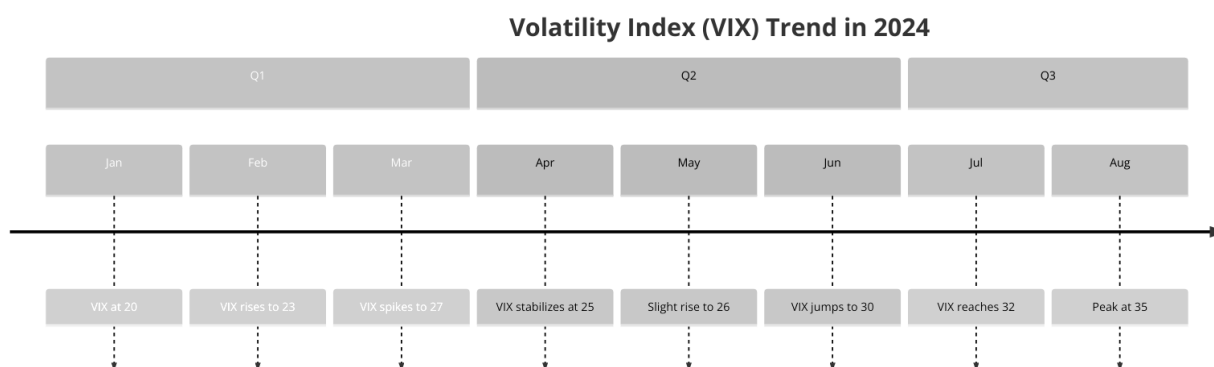
The persistence and deepening of the inversion underscore the growing risks of a recession, which would have far-reaching implications for global financial markets. The yield curve's predictive power is particularly concerning given its historical accuracy in forecasting economic downturns. As we move into the latter half of 2024, the inversion suggests that the global economy may be on the cusp of a significant slowdown.

### Volatility Index (VIX): Market Sentiment on Edge

The VIX, or the Volatility Index, serves as a crucial barometer of market sentiment. Often referred to as the “fear index,” the VIX measures the market's expectations of volatility over the coming 30 days. A rising VIX typically reflects growing uncertainty and fear among investors, often coinciding with periods of market stress.

In August 2024, the VIX surged to 40, a level that historically indicates heightened fear and risk aversion among investors. This spike in volatility can be attributed to several factors, including the ongoing yield curve inversion, geopolitical tensions, and concerns over corporate earnings. The elevated VIX suggests that investors are increasingly pricing in the possibility of significant market corrections or disruptions.

Diagram below provides a visual representation of the VIX's trajectory throughout 2024:



The sustained elevation of the VIX is a clear signal that market participants are bracing for turbulence. This elevated volatility, combined with other indicators such as widening CDS spreads, paints a picture of an increasingly fragile financial environment.

## Credit Default Swaps (CDS) Spreads: Rising Credit Risk

Credit Default Swaps (CDS) are financial derivatives that provide insurance against the risk of a bond issuer defaulting. The spread on CDS contracts reflects the perceived credit risk associated with the issuer. In 2024, CDS spreads have widened considerably, particularly in the corporate debt market.

By August 2024, the average CDS spread for investment-grade corporate bonds had risen to 150 basis points, up from 100 basis points at the start of the year. This widening spread indicates that investors are demanding higher premiums to insure against the risk of corporate defaults. The increase in CDS spreads is particularly concerning given the high levels of corporate leverage, which have left many companies vulnerable to rising interest rates and slowing economic growth.

Table below shows the progression of CDS spreads for different credit ratings in 2024.

Credit Rating	January 2024 CDS Spread (bps)	August 2024 CDS Spread (bps)
AAA	50	80
AA	70	100
A	100	150
BBB	150	225

Table 2 progression of CDS spreads for different credit ratings in 2024

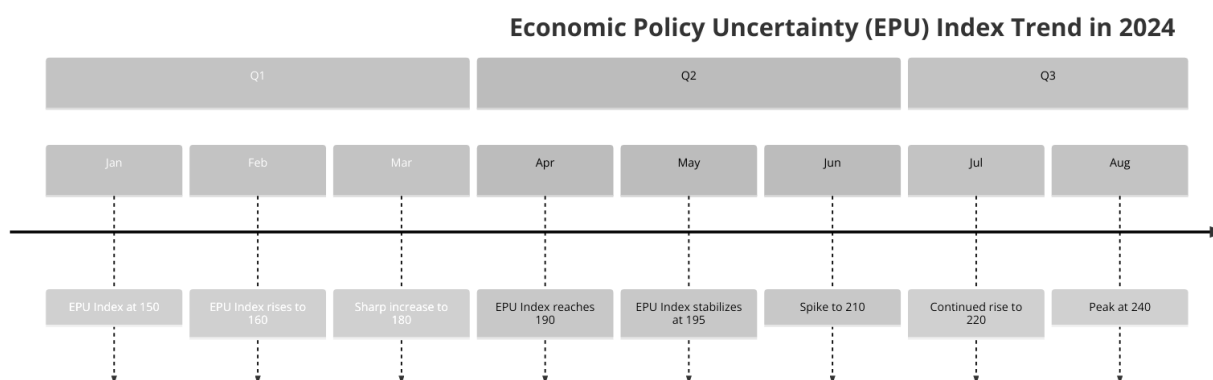
The widening of CDS spreads, particularly for lower-rated bonds, suggests that the market is increasingly concerned about the creditworthiness of issuers. This is a significant red flag, as rising credit risk can lead to a tightening of financial conditions, further exacerbating economic stress.

## Economic Policy Uncertainty Index: A Global Perspective

The Economic Policy Uncertainty (EPU) Index measures the degree of uncertainty surrounding economic policy, based on the frequency of newspaper articles discussing economic uncertainty, taxation, government spending, and other related topics. In August 2024, the EPU Index reached its highest level in over a decade, driven by a confluence of geopolitical tensions, domestic policy shifts, and global economic challenges.

The elevated EPU Index reflects widespread uncertainty about the direction of fiscal and monetary policy, particularly in major economies such as the United States, the Eurozone, and China. This uncertainty is compounded by ongoing geopolitical conflicts, trade tensions, and the lingering effects of the COVID-19 pandemic.

Diagram below illustrates the EPU Index's rise over the past year.



The heightened level of economic policy uncertainty is a critical factor contributing to the elevated CFCI. Uncertainty about the future direction of policy can lead to reduced investment, increased market volatility, and a slowdown in economic activity. As policymakers grapple with a complex array of challenges, the risk of policy missteps—and their potential impact on financial stability—remains high.

# Geopolitical Considerations

## Global Tensions and Their Impact on Financial Markets

Geopolitical tensions have been a significant driver of financial instability in 2024. The ongoing conflict between Russia and Ukraine, coupled with rising tensions between the United States and China, has created an environment of uncertainty and risk aversion. These geopolitical factors have contributed to the surge in the CFCI, as investors seek to hedge against potential disruptions to global trade, energy supplies, and economic growth.

The impact of these tensions is particularly evident in commodity markets, where prices for oil, natural gas, and key industrial metals have experienced significant volatility. The disruption of supply chains and the imposition of trade sanctions have further exacerbated inflationary pressures, complicating the task of central banks as they attempt to balance the competing demands of controlling inflation and supporting growth.

## The Role of Emerging Markets

Emerging markets have been particularly vulnerable to the geopolitical and economic challenges of 2024. Many emerging economies, which are heavily reliant on exports and external financing, have been hit hard by the combination of rising interest rates, a strengthening US dollar, and volatile commodity prices. The resulting capital outflows have put pressure on currencies and led to a tightening of financial conditions.

In August 2024, several emerging market economies were on the brink of crisis, with rising default risks and declining foreign exchange reserves. The impact of these developments is reflected in the CFCI, as the risks posed by emerging markets feed into the broader global financial system.

# Sectoral Analysis

## The Banking Sector: Facing Mounting Challenges

The banking sector has been at the forefront of the challenges posed by the rising CFCI. As interest rates have risen, banks have faced higher funding costs and declining loan demand. At the same time, the quality of their loan portfolios has come under pressure, particularly in sectors such as commercial real estate and leveraged finance.

The widening of CDS spreads for bank debt, combined with declining bank equity prices, reflects growing concerns about the sector's resilience. While large, systemically important banks are generally well-capitalised, smaller and regional banks may be more vulnerable to the pressures of a slowing economy and rising defaults.

## Real Estate: A Market at Risk

The real estate sector, traditionally a bellwether of economic health, has shown signs of strain in 2024. Rising interest rates have led to higher mortgage costs, dampening demand for residential and commercial properties. In many markets, property prices have begun to decline, raising concerns about the potential for a more significant correction.

The August CFCI reflects these risks, as the real estate sector's vulnerability feeds into broader financial stability concerns. A sharp downturn in property prices could have cascading effects on the banking sector, consumer confidence, and overall economic activity.

## Corporate Debt: The Achilles' Heel of the Economy

Corporate debt has been a focal point of concern throughout 2024, with the CFCI highlighting the risks associated with high levels of leverage. Many companies, particularly in sectors such as energy, retail, and

technology, have accumulated significant debt loads in recent years, leaving them vulnerable to rising interest rates and slowing revenue growth.

The widening of CDS spreads for corporate debt in August 2024 reflects the market's growing concerns about default risk. As companies face higher borrowing costs and tighter financial conditions, the risk of defaults and restructurings increases, potentially leading to a broader credit crunch.

## Global Implications

### The Ripple Effect on Global Markets

The elevated CFCI in August 2024 has significant implications for global financial markets. As the risks identified by the index continue to materialise, the potential for a widespread financial crisis grows. The interconnectedness of global markets means that shocks in one region can quickly spread to others, creating a feedback loop of rising risk and declining confidence.

Emerging markets are particularly vulnerable to these dynamics, as capital outflows, currency depreciation, and rising debt costs exacerbate existing economic challenges. The impact on developed markets is also significant, with declining asset prices, tightening financial conditions, and rising uncertainty weighing on economic growth prospects.

### The Role of Central Banks

Central banks will play a critical role in shaping the global response to the challenges highlighted by the CFCI. As inflation remains elevated and financial stability risks grow, central banks face a delicate balancing act. On one hand, they must continue to raise interest rates to control inflation; on the other, they must be mindful of the risks of overtightening and triggering a financial crisis.

The policy decisions made in the coming months will have far-reaching implications for the global economy. A coordinated and measured approach will be essential to managing the risks identified by the CFCI and avoiding a full-blown crisis.

## Policy Responses

### Mitigating Financial Stability Risks

The rising CFCI in August 2024 calls for a robust policy response to mitigate financial stability risks. Policymakers must address the root causes of the elevated index, including rising debt levels, declining asset quality, and heightened economic uncertainty.

One potential approach is the implementation of macroprudential measures, such as higher capital requirements for banks and stricter lending standards. These measures can help to strengthen the resilience of the financial system and reduce the risk of defaults and financial instability.

### Addressing Economic Imbalances

In addition to financial stability measures, policymakers must also address the broader economic imbalances that have contributed to the rising CFCI. This includes addressing the structural factors that have driven inflation, such as supply chain disruptions, labour market imbalances, and energy market volatility.

Fiscal policy can also play a role in supporting economic stability, particularly in regions where growth is slowing. Targeted fiscal measures, such as infrastructure investment and support for vulnerable sectors, can help to bolster economic growth and reduce the risk of a downturn.

## Forecast and Future Outlook

### A Cautious Outlook for the Global Economy

The outlook for the global economy remains highly uncertain, with the elevated CFCI in August 2024 suggesting that the risks of a financial crisis are growing. As we look ahead to the remainder of the year, the trajectory of the CFCI will be closely watched by market participants and policymakers alike.

Key risks include the potential for a further escalation of geopolitical tensions, a sharper-than-expected slowdown in economic growth, and the possibility of a financial market correction. At the same time, there are opportunities for policymakers to take proactive steps to mitigate these risks and support global financial stability.

### The Path Forward

The path forward will require a coordinated and comprehensive approach to managing the risks identified by the CFCI. This will include continued vigilance by central banks, targeted policy interventions by governments, and careful monitoring of financial markets.

Ultimately, the goal will be to navigate the current period of uncertainty and risk while laying the foundation for a more stable and resilient global economy in the years to come.

## Conclusion

The August 2024 CFCI provides a stark reminder of the challenges facing the global economy. The index's elevated level reflects a confluence of factors, including rising credit risk, market volatility, and economic uncertainty. As we move forward, the focus must be on addressing the root causes of these risks and ensuring that the global financial system remains robust and resilient.

The analysis of the August 2024 CFCI highlights the need for continued vigilance and proactive policy measures to safeguard global financial stability. By understanding the drivers of the index and their implications for the global economy, we can better navigate the challenges ahead and ensure a more secure financial future.

# Understanding the Composite Financial Crisis Index (CFCI): A Comprehensive Guide

## Introduction

In the complex and interconnected world of global finance, the ability to foresee potential crises is paramount. The Composite Financial Crisis Index (CFCI) has emerged as a crucial tool in this endeavour, offering a comprehensive measure of financial risk by aggregating key economic and financial indicators. With the CFCI reaching notable levels in recent months, it is imperative to understand how this index operates, what it signals, and how it can be used to navigate the turbulent waters of global finance.

This section delves into the intricacies of the CFCI, exploring its components, significance, and implications for financial markets and policy-making. By providing a detailed analysis, we aim to equip professionals with the insights needed to effectively utilise this index in their strategic decision-making processes.

## What is the Composite Financial Crisis Index (CFCI)?

### A Multi-Dimensional Measure of Financial Risk

The Composite Financial Crisis Index (CFCI) is a sophisticated tool designed to gauge the overall risk of financial instability in the global economy. Unlike traditional economic indicators that focus on specific aspects of the economy, the CFCI aggregates a broad range of metrics into a single, composite score. This approach allows the CFCI to provide a more holistic view of financial risk, capturing the interconnected nature of modern financial systems.

The CFCI is typically expressed as a number between 0 and 100, where 100 indicates a high likelihood of a financial crisis, and 0 suggests a stable and risk-free environment. The index is updated regularly, reflecting changes in the underlying indicators and offering a dynamic view of financial stability.

### Components of the CFCI

The CFCI is constructed from a weighted average of multiple financial and economic indicators, each contributing to the overall risk score. The following are some of the key components:

- (i) *Yield Curve Inversion*: A leading indicator of recessionary risks, the yield curve inversion measures the difference between long-term and short-term interest rates. A negative spread, where short-term rates exceed long-term rates, is often a precursor to economic downturns.
- (ii) *Volatility Index (VIX)*: Known as the "fear index," the VIX measures market volatility and investor sentiment. A rising VIX indicates increasing uncertainty and risk aversion in the markets.
- (iii) *Credit Default Swap (CDS) Spreads*: CDS spreads reflect the cost of insuring against the default of corporate or sovereign debt. Wider spreads indicate higher perceived credit risk.
- (iv) *Economic Policy Uncertainty Index (EPU)*: This index tracks the frequency of articles discussing economic uncertainty, policy changes, and related topics. A high EPU index suggests a volatile policy environment, which can lead to financial instability.
- (v) *Real Estate Price Indexes*: Real estate prices serve as a barometer for the health of the property market, with sharp declines often preceding broader economic troubles.
- (vi) *Money Supply Growth Rate (M2)*: Changes in money supply can signal shifts in inflationary pressures and economic activity, influencing financial stability.

- (vii) *Gold Prices*: Often considered a safe-haven asset, rising gold prices can indicate increasing risk aversion among investors.

Each of these indicators is normalised and weighted according to its historical relevance and predictive power, contributing to the overall CFCI score.

## Why is the CFCI Important?

### Predicting Financial Crises

The primary function of the CFCI is to act as an early warning system for financial crises. By synthesising data from a wide array of indicators, the CFCI provides a composite view of financial risk that is more comprehensive than any single metric. Historically, spikes in the CFCI have preceded major financial disruptions, making it a valuable tool for risk management and strategic planning.

### Informing Policy Decisions

For policymakers, the CFCI offers crucial insights into the state of the financial system. A rising CFCI can prompt central banks and governments to take pre-emptive action, such as adjusting interest rates, implementing macroprudential measures, or intervening in financial markets to prevent a crisis. By monitoring the CFCI, policymakers can better align their actions with the evolving risk landscape.

### Guiding Investment Strategies

Investors can also benefit from the insights provided by the CFCI. A high CFCI score may signal the need for more conservative investment strategies, such as shifting assets into safer instruments or reducing exposure to riskier markets. Conversely, a low CFCI suggests a more stable environment, potentially allowing for more aggressive investment approaches.

## The August 2024 CFCI: A Case Study

### Contextualising the August 2024 Reading

In August 2024, the CFCI reached a significant level of 84.63, reflecting heightened financial risks across multiple dimensions. This reading was driven by a combination of factors, including an inverted yield curve, elevated market volatility, and widening credit spreads. The high CFCI score indicated that the global economy was facing substantial risks, with the potential for a financial crisis looming on the horizon.

### Key Drivers of the August 2024 CFCI

- (i) *Yield Curve Inversion*: The yield curve remained deeply inverted in August 2024, with the spread between 10-year and 2-year Treasury yields at -0.95%. This persistent inversion signalled strong market expectations of an impending recession, contributing significantly to the high CFCI score.
- (ii) *Volatility Index (VIX)*: The VIX rose to 40 in August, reflecting heightened market uncertainty and risk aversion. This spike in volatility was driven by concerns over slowing global growth, geopolitical tensions, and rising inflationary pressures.
- (iii) *Credit Default Swaps (CDS) Spreads*: CDS spreads widened considerably, particularly for corporate debt, indicating rising fears of defaults. The average CDS spread for investment-grade corporate bonds reached 150 basis points, up from 100 basis points earlier in the year.
- (iv) *Economic Policy Uncertainty*: The EPU Index also reached its highest level in over a decade, driven by uncertainty surrounding fiscal and monetary policy in major economies. Geopolitical tensions, including conflicts in Eastern Europe and trade disputes between the United States and China, further exacerbated policy uncertainty.



## Implications for Financial Markets

The elevated CFCI in August 2024 had several implications for global financial markets:

- (i) *Increased Risk of Recession:* The deeply inverted yield curve and rising credit spreads suggested that the global economy was at a high risk of entering a recession. This prospect led to a flight to safety, with investors flocking to government bonds and other low-risk assets.
- (ii) *Heightened Market Volatility:* The spike in the VIX indicated that financial markets were bracing for increased volatility. This environment posed challenges for asset managers and investors, who had to navigate a more uncertain and turbulent market landscape.
- (iii) *Tightening Financial Conditions:* The widening of CDS spreads and the high EPU Index pointed to tighter financial conditions, particularly in credit markets. This tightening was likely to impact corporate borrowing costs, potentially leading to reduced investment and slower economic growth.

## How to Use the CFCI

### For Policymakers

Policymakers can use the CFCI as a guide for calibrating their interventions in the economy. A rising CFCI may warrant pre-emptive measures, such as:

- (i) *Monetary Policy Adjustments:* Central banks may consider adjusting interest rates or implementing quantitative easing to provide liquidity and support financial stability.
- (ii) *Macprudential Measures:* Strengthening regulatory frameworks, such as increasing capital requirements for banks or imposing limits on high-risk lending, can help mitigate systemic risks.
- (iii) *Fiscal Stimulus:* Governments may opt for targeted fiscal stimulus, such as infrastructure investment or tax cuts, to bolster economic growth and reduce the risk of a downturn.

### For Investors

Investors can use the CFCI to inform their asset allocation decisions and risk management strategies:

- (i) *Diversification:* In periods of high CFCI, investors may seek to diversify their portfolios by including more stable, non-correlated assets, such as government bonds or commodities like gold.
- (ii) *Risk Reduction:* Reducing exposure to high-risk assets, such as equities or corporate bonds, can help protect portfolios from potential losses during periods of financial instability.
- (iii) *Opportunistic Strategies:* In times of low CFCI, investors may pursue more aggressive strategies, such as increasing exposure to equities or high-yield bonds, to capitalise on favourable market conditions.

### For Businesses

Businesses can use the CFCI to anticipate changes in the economic environment and adjust their strategies accordingly:

- (i) *Capital Management:* Companies may choose to conserve cash or reduce leverage during periods of high CFCI, preparing for potential economic downturns.
- (ii) *Strategic Planning:* The CFCI can inform long-term planning, helping businesses align their growth strategies with the broader economic outlook.
- (iii) *Risk Mitigation:* Identifying key risks highlighted by the CFCI can enable businesses to implement targeted risk management practices, such as hedging currency exposure or diversifying supply chains.

## Conclusion

The Composite Financial Crisis Index (CFCI) stands as a vital tool for understanding and navigating the complexities of global financial markets. By aggregating a wide range of indicators, the CFCI provides a comprehensive measure of financial risk, offering valuable insights for policymakers, investors, and businesses alike.

The August 2024 CFCI reading of 84.63 serves as a stark reminder of the challenges facing the global economy. As financial risks continue to mount, the CFCI offers a crucial early warning signal, enabling stakeholders to take proactive steps to mitigate potential crises.

In an increasingly uncertain world, the CFCI's ability to provide a nuanced and sophisticated analysis of financial stability is more important than ever. By understanding and utilising this index, professionals can better navigate the risks and opportunities that lie ahead, ensuring that they remain well-prepared in the face of an ever-evolving economic landscape.

# CFCI Index and Recent Crisis

Here is a list of notable financial or economic crises since 2000, along with the month and year when they began or reached a critical point.

	Crisis	Period	Particulars	CCI
1	Dot-com Bubble Burst	March 2000	The technology-heavy NASDAQ index peaked in March 2000 and subsequently collapsed, leading to the burst of the dot-com bubble and a significant market downturn.	44.5
2	Argentina Financial Crisis	December 2001	Argentina's economic crisis culminated in December 2001, with the government defaulting on its debt and the economy suffering a severe contraction.	72.6
3	Global Financial Crisis (Subprime Mortgage Crisis)	September 2008	The collapse of Lehman Brothers in September 2008 marked a critical moment in the Global Financial Crisis, leading to widespread financial instability and economic recession.	89.65
4	Eurozone Debt Crisis	May 2010	The Eurozone Debt Crisis escalated in May 2010 when Greece requested an international bailout, leading to concerns about the solvency of other Eurozone countries and significant market volatility.	74.75
5	Chinese Stock Market Crash	June 2015	The Chinese stock market experienced a significant crash beginning in June 2015, wiping out trillions of dollars in market value and raising concerns about the stability of China's economy.	66.0
6	Brexit Referendum	June 2016	The Brexit referendum in June 2016, where the United Kingdom voted to leave the European Union, led to significant economic uncertainty and market volatility.	65.95
7	Turkey's Currency and Debt Crisis	August 2018	Turkey's economy faced a severe crisis in August 2018, marked by a sharp depreciation of the Turkish lira, high inflation, and concerns about the country's large external debt.	67.7
8	Lebanese Financial Crisis	October 2019	Lebanon's financial crisis became evident in October 2019, with the collapse of the banking sector, the depreciation of the Lebanese pound, and widespread protests.	73.03
9	COVID-19 Pandemic Economic Crisis	March 2020	The global spread of COVID-19 in March 2020 triggered an unprecedented economic crisis, leading to widespread lockdowns, massive unemployment, and sharp declines in global stock markets.	84.65
10	Evergrande Crisis (China)	September 2021	The crisis involving the Chinese property developer Evergrande reached a critical point in September 2021, raising concerns about the potential for a broader financial crisis in China's real estate sector.	58.28

These crises had significant global or regional impacts, and their effects were felt well beyond their initial months of onset.

## CFCI for 2024

Period	CFCI	Notes	Variance	SY Variance
January 2024	68.05	Moderately high-risk environment		
February 2024	70.26	This indicates a slightly increased risk environment compared to January 2024, continuing the trend towards a high-risk environment	+3.25%	+3.25%
March 2024	73.57	This indicates a high-risk environment, showing a continued increase in financial risk.	+4.71%	+8.11%
April 2024	75.79	This further increases to a higher-risk environment, suggesting a rising trend towards potential financial instability	+3.02%	+11.37%
May 2024	76.89	This indicates a further increase in the risk level, suggesting a high-risk environment with rising concerns of financial instability.	+1.45%	+12.99%
June 2024	79.10	This continues the upward trend, moving closer to a very high-risk environment, indicating significant financial stress	+2.87%	+16.24%
July 2024	81.31	This suggests a very high-risk environment, indicating substantial financial stress and a significant likelihood of a financial crisis.	+2.79%	+19.49%
August 2024	84.63	The risk level continues to rise, signalling an extremely high-risk environment, where the likelihood of a financial crisis is very elevated	+4.08%	+24.36%

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