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Is the BIS sounding the alarm on financial stability?

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- The Bank for International Settlements (BIS) is one of the oldest institutions promoting international monetary cooperation.
- Its Annual Economic Report is a highly regarded research publication that is closely scrutinised by many market observers.
- The 2025 publication was overshadowed by the tariff shock and contained a rather gloomy outlook for the global economy. We therefore asked ourselves to what extent investors should be concerned about the risks highlighted by the BIS.
- Employing artificial intelligence, we analysed all reports published since 1997 and developed two quantitative sentiment indices, whose performance we compared with the leading and lagging performance of the stock market.

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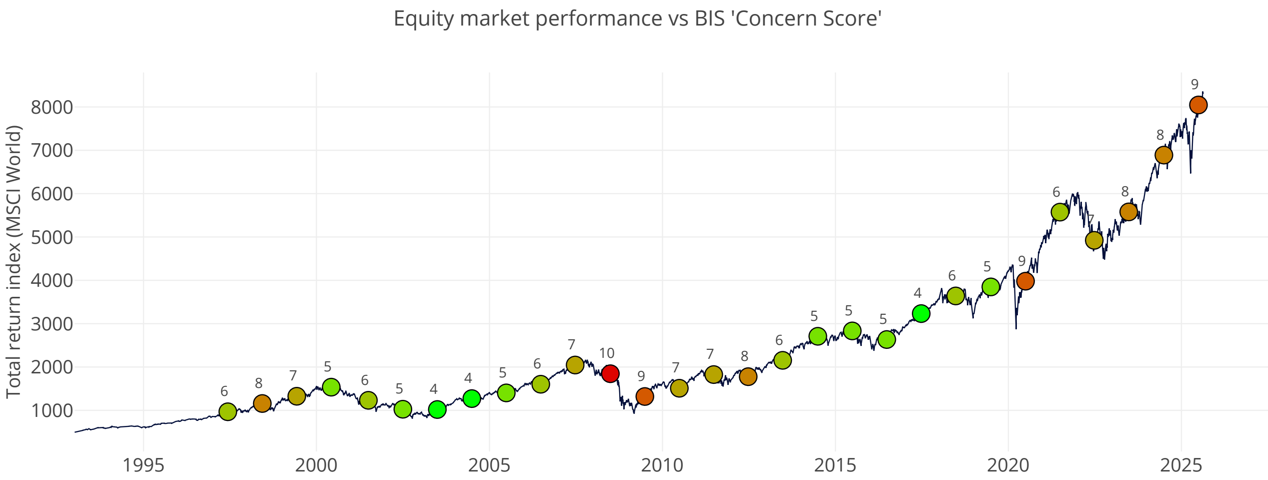
The Bank for International Settlements (BIS) Annual Economic Report probably counts among the most widely read publications on the state of the global economy and the financial stability risks it is facing. Published in June, the institution's flagship publication undertakes a 360-degree assessment of the global economic outlook, financial stability, and monetary policy. This year, market observers have been alarmed by the reports' stark warning of trade fragmentation, inflation pressure, high public debt paired with geopolitical conflicts and the rise in non-bank financial intermediaries. But how does this sobering assessment compare to past readings of the state of the economy?

1 On the role of one of the oldest international monetary institutions

The Bank for International Settlements (BIS) is popularly referred to as the "bank for central banks". It is likely lesser known that the institution, founded in 1930, is one of the oldest organisations facilitating international monetary cooperation. Following the First World War, ideas were floated to establish a continuous international collaboration between the banks and central banks involved in credit origination and monitoring. Eventually, the realisation of the project was triggered by another factor: the need to establish an international body responsible for the settlement of German reparation payments[1]. While the BIS's name still serves as a reminder of this initial task, its activities have obviously evolved. Nowadays, the BIS is firmly embedded in the international monetary system, which also includes institutions like the International Monetary Fund (IMF) and the World Bank. However, unlike the IMF, which was formed by and supports governments, the BIS is backed by 63 member central banks and thus focuses primarily on the conduct of monetary policy[2]. This includes providing a forum for exchange among central bankers and assisting with research and analysis. At the same time, however, the BIS also holds and invests between 10% and 15% of the member central bank's monetary reserves and has the capacity to engage in short-term financial assistance. The latter role gave rise to the aforementioned name of the central bank's banker, even though this may overstate the institution's hard power. In practice, the BIS's role as a collaboration hub, including its hosting of high-profile gatherings such as the committee that sets the Basel banking standards, has turned it into a highly respected institution, whose research and observations carry weight in the community.

It's thus advisable to pay some attention to it. Looking at the 2025 Global Economic Report published in June, it is not surprising that it is heavily shaped by the tariff shock that occurred just months before, which not only triggered an outburst of financial market volatility but also forced economists to rapidly cut their growth expectations. Although by the time the report had been written the US government had, pressured by financial



Source: *BIS, Bloomberg, DeepSeek, Amadeus Capital*

Figure 1

markets and in some cases stopped by courts, rolled-back its most aggressive tariffs and even though risk assets had rebounded, the potential disruptions caused by this unprecedented open-heart surgery in the international trade system was clearly the BIS's number one concern and triggered a sharp shift in the assessment of the near-term economic outlook. It is noteworthy to remember that the previous year's publication was characterised by a pretty optimistic tone, as inflation levels were expected to converge to target alongside moderate economic growth, primarily in the US and China, and a normalisation in labour market activity, accompanied by wage growth still above pre-pandemic levels[3]. The BIS also noted the smooth trajectory of the central bank's balance sheet reduction. These factors, underpinned by strong stock market performance and only slightly overshadowed by a worrying rally in gold and weakness in emerging markets, fuelled hopes for a soft landing for the global economy following the long aftermath of the pandemic. So far, so familiar; what did the economists at the BIS make out of these points? While we, like all market participants, follow a plethora of developments daily, it is interesting to take a closer look at the analytical framework the BIS uses to analyse these events.

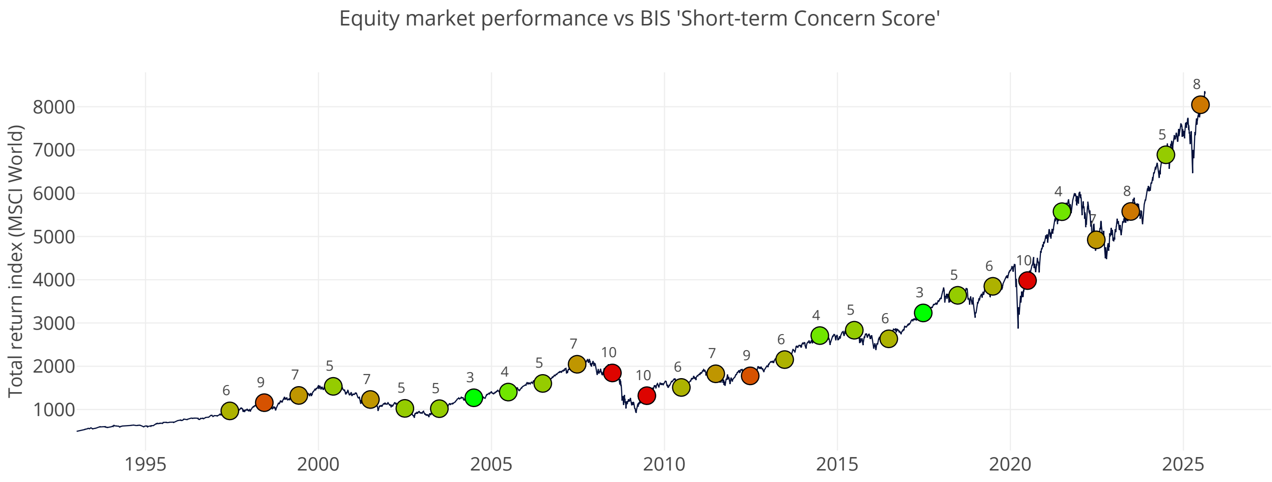
2 Three key vulnerabilities

2.1 Real vulnerabilities

In its 2025 report[4], the BIS currently distinguishes three categories of risk, namely real vulnerabilities, fiscal vulnerabilities, and macro-financial vulnerabilities. The first concentrates on the real economy. Here, the focus is on the danger of the aggressive tariff policy in a world already fragile due to decades of sluggish productivity growth. As humanity is ageing and the benefits of technological advancements seem to be diminishing, the slowdown in growth has spread from advanced nations to developing economies post-2009. The more recent rise in protectionist industrial policies and non-tariff trade barriers exacerbated the problem for emerging markets by contributing to a collapse in foreign direct investment (FDI) that previously drove their expansion. Lastly, the pandemic-era has brought back inflation concerns and is likely to have scarred private households for the longer term, increasing volatility in inflation expectations and the risk of demand-side shocks. Evidently, the introduction of new trade barriers against this already complicated backdrop has increased uncertainty. However, the BIS acknowledged that the effects were not yet visible in the hard data, which continued to show resilience, and that it was difficult to identify precisely the channels through which they would ultimately manifest itself. At this stage, we would argue that the hard data continues to point to a resilient global economy.

2.2 Fiscal vulnerabilities

The second major source of economic vulnerability highlighted by the economist is the significantly increased level of government debt, primarily in advanced economies. Undoubtedly, pandemic-era stimulus measures alongside escalating demands on the health care and pension systems (which almost broke the German coalition[5]) have put a strain on public finances. On top of that, urgently required infrastructure and defence investments are adding to spending needs. The consequences have been felt by governments, notably in the UK and France, where interest rates surged following elections. Elevated debt levels obviously reduce fiscal leeway in the event of another crisis. It is noteworthy, though, that interest expenses as a percentage of GDP, while on the rise, are not elevated by historical standards. Furthermore, the reduction in



Source: *BIS, Bloomberg, DeepSeek, Amadeus Capital*

Figure 2

central banks' government debt holdings (quantitative tightening) has so far been implemented without major accidents. Moreover, in the US, quantitative tightening happened as Treasury holdings by foreign entities fell to a multi-decade low. While the BIS voiced concern about the increasingly important role of levered hedge funds in the Treasury market (more on this under the next point), we consider the private sector's ability to step in and absorb an unprecedented amount of government debt issuance to be rather positive.

2.3 Macro-financial vulnerabilities

The third vulnerability identified by the institution concerns changes in the financial system's structure. This includes the transition from bank lending towards private credit in parts of the corporate sector, the rise of arbitrage strategies in government bonds and the emergence of stablecoins as a sizable buyer of public debt. Two factors have driven the rapid growth of the private credit industry. First of all, it is closely linked to the growth of the private equity industry over the past 10 years, as private equity sponsors typically rely on private credit funds to finance their leveraged buyouts. Secondly, the introduction of tighter banking regulation reduced the availability of bank financing to riskier corporations, with credit funds happily filling the gap, backed by pension funds and insurance companies starved for yield. The BIS rightly points out that, compared to banks, private credit is less vulnerable to maturity and liquidity risks as investors are locked into the products for the long term. The opaquity of the sector and its links to the banking system through capital call facilities and NAV loans, however, are a source of concern. In our eyes, it is not without irony that institutions such as the BIS are now bemoaning the intransparency of an industry that became big on the back of banking regulations they advanced. Similarly, the observed rise in the role of hedge funds, asset managers and stablecoins as (pro-cyclical) liquidity providers in the Treasury market that the BIS observes is at least partially a function of the constraints faced by the previously more influential broker-dealers due to new regulations introduced in the wake of the Great Financial Crisis. Again, while the BIS report unfortunately doesn't include a longer time series on hedge fund exposure to the Treasury market, we find it encouraging that the industry managed to halve it between 2019 and 2022 without causing significant turmoil.

3 Putting things into perspective

Read in isolation, the BIS's reports frequently sound alarming. Just see Martin Wolf's recent article on the 2025 report in the Financial Times[6]. We fed the 2025 publication into ChatGPT and asked it to rate the level of concern expressed by the economists on a scale from 0 to 10; it returned a solid 7, noting that the BIS identifies "a complex web of risks that could undermine global economic stability". The problem is that the chatbot gave us the same sentiment score for every preceding text we had it analyse. Unsurprisingly, being tasked with identifying, monitoring, and addressing financial stability risks, the BIS focuses on the downside, giving its publications a negative touch. Beyond this, some secular trends and long lingering risks may be worth knowing about but have little importance in the short- to medium-term. It is a significant risk for market participants to become obsessed with exactly these risk factors, eventually turning into "perma-bears" who constantly loose out on opportunities. As investors, we, therefore, need to put things into perspective. In our attempt to achieve this in an innovative and objective fashion, we employed DeepSeek, praised for its strong analytical capabilities and, according to some sources, popular in financial services, risk management, and educational tools[7]. We let the AI read all 28 BIS Annual Economic Reports published since 1997 and asked it to rate the overall sentiment on a scale from 0 (sunny days) to 10 (perfect storm) relative to all other reports ("Concern Score"). Again, we noted a negative bias, with 4 being the best score ever assigned to a publication. We subsequently prompted the model to focus less on long-term concerns and instead to quantify the BIS's reading of the short- to medium-term outlook for the world economy ("Short-term Concern Score"). The results are presented in Figure 1 and Figure 2 alongside the returns of the MSCI World.

4 Quantifiable patterns in the BIS's sentiment

Looking at the first Concern Score, we can broadly distinguish three periods of heightened concern: one in the late 1990s in the wake of the Asian Financial Crisis, one beginning in June 2007 as the Great Financial Crisis of 2009 commenced, and one following the start of the COVID-19 pandemic and lasting until today. Interestingly but not surprisingly, the BIS sounded somewhat less concerned throughout the burst of the DotCom bubble, a valuation-driven stock market crash with relatively little impact on the broader economy. The reports also sound rather positive during the 7 years following the Great Financial Crisis and the Euro crisis. In hindsight, the Covid pandemic looks like a regime shift marking the transition from a relatively calm post-crisis environment characterized by low inflation, low interest rates and moderate growth towards a less predictable world.

It is needless to say that our Short-term Concern Score is highly correlated with the first Concern Score. Nevertheless, a slightly different pattern emerges. The score reaches its most positive level in 2004 and 2017, both years that were preceded and followed by periods of low volatility and strong equity market returns. But it also turned positive in June 2000, shortly before the burst of the Dotcom bubble, as well as in June 2021, when the world economy had rebounded strongly from the Covid shock, but shortly before the outburst in inflation sent markets tanking, and in 2024, when inflation and interest rates were finally moving in the right direction. When plotted alongside the performance of the MSCI World, the scores nicely demonstrate the difficulty of using economic analysis in investing and the inability of even the best economists to predict the next truly important event with reasonable certainty. The BIS reports reliably turn bearish on the world economy when an adverse shock has just materialized. This worked well as a market-timing indicator before the Great Financial Crisis (like a plethora of other slow-moving macro indicators), when the BIS's reports showed sentiment turning highly negative. At the same time, markets had reacted with only a roughly 15% drop. It is important to remember, though, that this report still described what was happening in the subprime sector as "turmoil" and pointed out that "the consensus view is still that the global economy will avoid a sharp and synchronized downturn of the kind seen in 2001, although it will slow significantly in 2008".

Saying that the economists at the BIS foresaw the Great Financial Crisis would hence be an exaggeration. The outstanding negativity of the 2025 report, on the other hand, is a function of the tariff shock in the first half-year and looks more like a look in the rear-mirror as global trade demonstrates resilience and a boom in AI-related investments has compensated for sluggish consumption. It is noteworthy that the current situation thus materially differs from that in 2007, when early declines in house prices, whose impact on general consumer confidence was not yet clear, coincided with "greater constraints on the availability of consumer credit" and a "decline in corporate investment"[8]. Then there is the underlying uneasiness about public debt and the rise in non-bank financial intermediaries, most importantly, private credit. Interestingly, the BIS itself finds that private sector debt levels in most economies are not unusually high while struggling to pinpoint the exact risks that may stem from the new breed of financial intermediaries whose resilience is yet "untested". The discomfort in the face of the unknown is understandable, but investors should not confuse anxiety over a rapidly changing world with forebodings of an imminent crisis. Perhaps the BIS's quarterly review can provide additional and more timely insights, but that is another project. We are already working on it.

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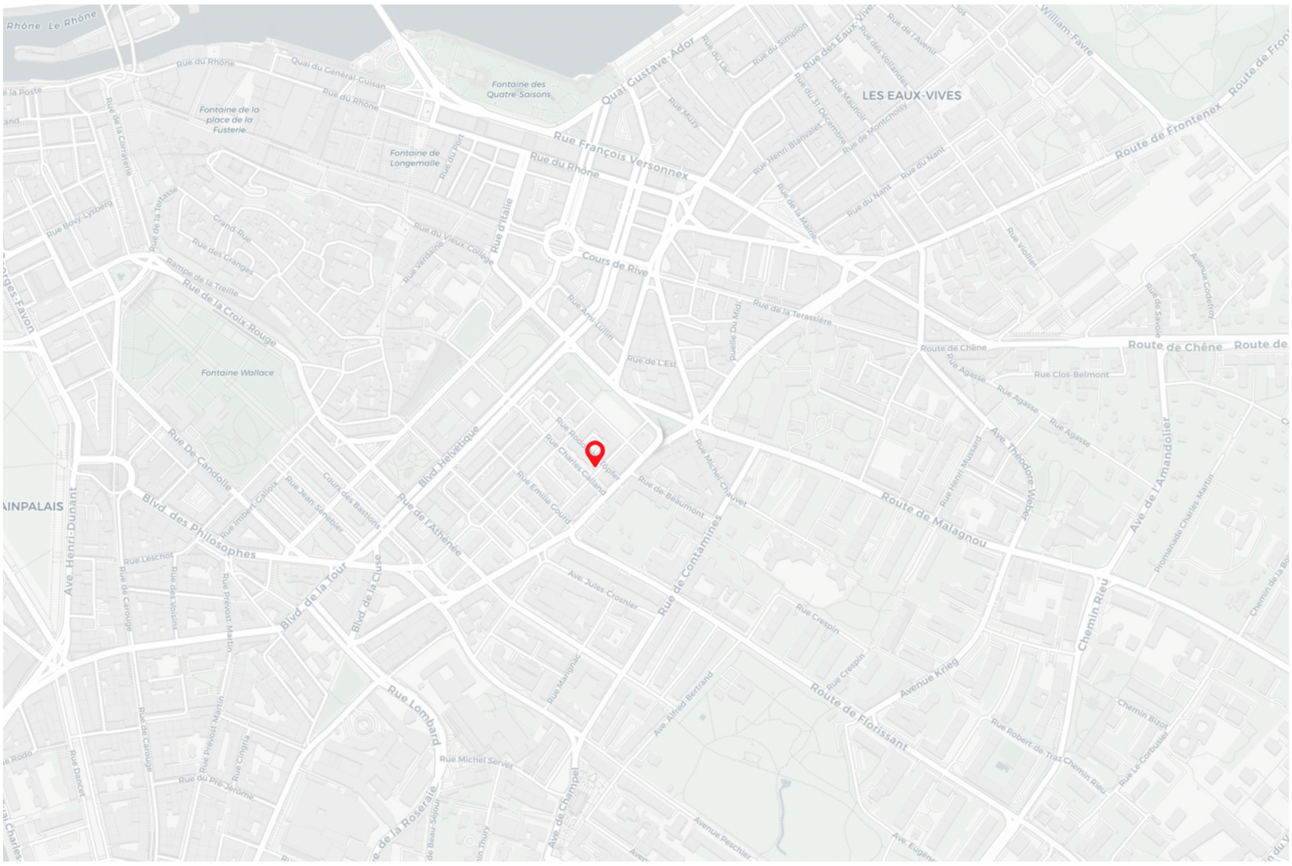

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