MARCH 24, 2023

SPLITTING THE BABY

Faced with a choice between price stability and financial stability this week, Federal Reserve policy makers tried to pursue both – but with a hawkish twist that showed inflation risk is still uppermost in their minds. Other major central banks have done the same, hiking interest rates even as banking turmoil raises the risk of a credit crunch or, worse, a spiraling loss of confidence in the financial system.

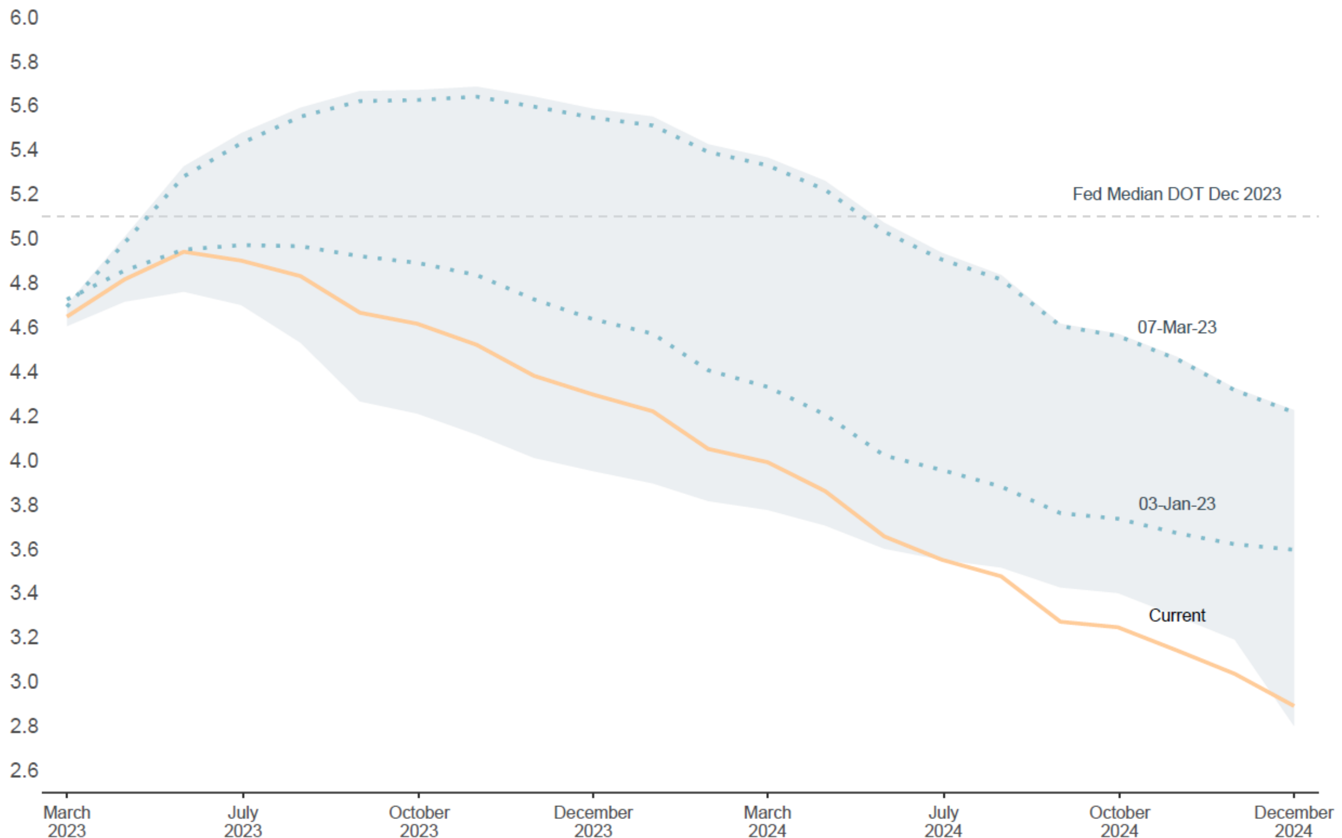
On Wednesday, the Fed raised its policy rate by 25 basis points, to 4.75-5.0%, continuing its monetary tightening, but at a slower pace than if a banking crisis hadn't suddenly erupted this month. Chair Jerome Powell also signaled that a pause in rate hikes was likely in months to come, pointing to softer language in the FOMC statement. In a nod to fears of contagion from the banking crisis, Chair Powell assured Americans that their bank deposits were safe. He came close to promising that the authorities would be ready to extend more emergency help to backstop deposits, including uninsured deposits, if necessary to stem further deposit runs.

Chair Powell's message of confidence to banks' customers and shareholders was initially undercut when Treasury Secretary Janet Yellen told Congress the same afternoon that the government was not considering a blanket guarantee of all deposits. The following day, she amended her written testimony to add, "Certainly we would be prepared to take additional actions if warranted." These statements did not quell the growing unease among investors about the fragility of the global banking system. Bank equities had a tumultuous week as early gains gave way to lingering fears of contagion. US banks rebounded somewhat on Friday to end the week down 0.7%, eased by assurances from Fed officials that the banking system was not in a liquidity crisis. Across the Atlantic, European banks shed 1.6% and are on track for their worst month in three years as eyes turned towards Deutsche Bank for the latest source of banking turmoil.

Secretary Yellen's cautious comment on guarantees was, in part, a recognition of reality. Extending a blanket guarantee of all deposits, as some banks have called for, would require Congressional action – a challenging proposition in today's divided Congress. That does not mean the government is sitting on its hands. Secretary Yellen also confirmed this week that the Treasury, the Fed, and other bank regulators are considering further steps to bolster depositor confidence. Importantly, she noted that the government would stand ready in the case of another bank collapse to backstop uninsured deposits over the $250,000 limit for federal insurance.

Source: RockCreek, Bloomberg

The emerging banking crisis has completely reversed the Fed funds market implied path
Development in futures year-to-date



Note: Shaded region represents the upper and lower bounds of Fed funds futures pricing from January 3 to March 22. On March 8, SVB announced a capital raise plan before quickly collapsing by the end of the week.
Source: RockCreek, Federal Reserve, Bloomberg. As of March 22, 2023

Coming full circle – why the Fed was back to 25 basis points

It has been just ten days since Chair Powell signaled to Congress that rate hikes may need to go faster and further than the Fed had planned at its February meeting. The economy – and inflation – were running hotter than expected. That is still true – as far as we know. But **the collapse of two US banks**, and the **near-death experience of a third**, has altered the economic outlook dramatically.

Leaving aside the potential for further financial instability, the economic impact of the banking crisis – acknowledged as such by Secretary Yellen this week – justifies a shift in Fed policy and rhetoric in purely monetary terms. A credit crunch is now likely to crimp activity as banks raise deposit rates, to hold customers, and seek to bolster their balance sheets. A lending pullback as a result of the bank turmoil could be the equivalent of an interest rate hike of anything between 25 and 50 basis points – or even higher.

One potentially serious – and less discussed – ramification of the banking crisis is how the effects on regional banks could threaten key provisions of the Inflation Reduction Act. “The IRA, a large part of it, is [meant] to bring solar and wind and clean energy to low-income communities,” **Afsaneh Beschloss told the Financial Times-Moral Money**. “One of the biggest places that was supposed to happen was through local community banks. That is going to be hugely impacted.” There are 4,600 community banks in the US, with about half serving markets with populations less than 50,000. In these communities, they play a critical role in providing credit and investment, and recent developments may make it more difficult for these banks to lend to these underserved communities.

The Fed focused its policy action and messaging this week mainly on the macro goal of delivering price stability, as a means to maximum employment. While policymakers had considered pausing interest rate hikes, Chair Powell pointed to continued concerns about inflation, and still-tight labor markets, as tilting the decision towards a quarter-point increase. This may be the last rise this year, but the Fed does not expect any easing of monetary policy until 2024 despite markets pricing in rate cuts later this year.

There was already a fog of uncertainty around what is happening in the global economy. Recession has been predicted for more than a year, but growth in the US has stayed positive. The layering of banking problems on top of the post-pandemic shifts in the economy just makes the fog even denser. The Fed is hoping that its continued tightening brings inflation down without crashing the economy.

Its job would be easier if other parts of government helped in the fight against inflation. As University of Michigan Professor Betsey Stevenson pointed out in **a RockCreek discussion** moderated by RockCreek Senior Global Strategist **Caroline Atkinson**, fiscal tightening would support the Fed and could be targeted more efficiently than the blunt tool of rate increases allows. Unfortunately, neither tax increases nor spending cuts are likely to be agreed in the current US political context. Two other inflation-fighting measures also seem out of reach politically, at least for now. Immigration reform, perhaps including increased visas for guest workers, would help to address the labor shortages that worry the Fed.

An old-fashioned panic … in a very modern setting

The worst may be yet to come. The deposit runs that forced the collapse of two US banks – Silicon Valley Bank (SVB) and Signature Bank – are still plaguing a third, First Republic, with some similarities to SVB. Despite last week's efforts by the eight largest US banks to shore up the California bank, its share price has fallen further this week as it looks to stave off any further deposit outflows. Pressures have also spread to PacWest, based in Los Angeles, although its leadership says that it has sufficient cash to meet all uninsured deposits. Chair Powell noted reassuringly mid-week that overall deposits at potentially vulnerable banks had stabilized. Keeping – or restoring – customer confidence is now key. It is likely over the next few weeks and months that more depositors will move out of local and regional banks too.

The panic of 1907, which led eventually to the creation of the Federal Reserve system, took 90 days to play out as deposit flight spread across the uninsured private banking system. In today's world, bad news and runs on deposits can happen at lightning speed, as **Citigroup CEO Jane Fraser noted**. But the underlying concerns are similar to those of the last century. Banks live or die by confidence. If customers doubt that a bank will be able to meet its obligations – whether because of liquidity shortfalls, inadequate capital, or risky bets going bad – they will move their money to safety.

Where were the regulators?

As Chair Powell and Secretary Yellen have acknowledged, the rapid collapse of the sixteenth largest US bank – SVB – indicates regulatory failure as well as a failure of bank management. The Fed is undertaking a review of what went wrong, led by the Vice Chair for Supervision, Michael Barr. It helps that he is new to the Fed, and therefore not implicated in what went wrong. But some believe an outside review is also called for. Reports that the Bank of England spotted problems in SVB and alerted US regulators as much as a year before it failed are not wholly reassuring. Why was it not possible to insist on improvement?

Perhaps inevitably, as with any government rescue operation, there is discomfort with how losses are allocated and who gets bailed out. As **Dr. Stevenson pointed out this week** in the RockCreek discussion, most Americans have perfectly safe bank deposits, below the $250,000 limit. Why not let the wealthy depositors in SVB and Signature take a loss? “For most Americans, their money is safe, and the problem they're facing is prices are rising,” **Stevenson said**. “So I do want to see the Fed keep their eye on that prize.”

The problem, as Dr. Stevenson and others agree, is that a broader panic that spreads to many mid-sized banks would hurt ordinary Americans, from consumers who take out auto loans or mortgages, to small business owners and local construction companies. Rising interest rates have weakened many regional banks – deemed “non-systemic” and therefore subject to less regulatory scrutiny. A **paper published this week in the Social Science Research Network** (SSRN) suggested that as many as 186 regional banks are at risk of failure if even half of their uninsured depositors withdraw funds.

When “non-systemic” institutions threaten the system

History shows that it is often the institutions on the periphery of the banking system that trigger systemic risk. From Thailand’s non-banks that sparked the Asian financial crisis, to the mortgage providers that were behind the global financial crisis, smaller institutions outside the regulators’ focus often overload on risk, during easy times.

Harvard Professor Carmen Reinhart put the blame for the crisis squarely on the low interest rates of the past decades. “We have had 15 years of a secular decline in nominal and real interest rates – negative, deeply negative sustained real interest rates,” **Dr. Reinhart said** in the RockCreek discussion. “Negative interest rates are a tax on savers and an inducement to leverage, and they’re also an inducement to take on risk, which is exactly what we’ve seen in those balance sheets.”

A systemic problem arises if fears spread widely and wildly, on the basis of similarities that may be superficial – but become self-fulfilling. A liquidity run that may be based on unsubstantiated fear can quickly lead to collapse and insolvency. It was to stop runs of this kind that **federal deposit insurance was introduced in the US in 1934** and raised in the aftermath of the 2008-09 financial crisis. And it was to halt the spread of depositor fears that regulators deemed SVB and Signature bank “systemic”, allowing them to intervene and make depositors whole, under current legal constraints.

It is reasonable to expect shareholders and bondholders to assess risk and put market pressure on badly managed banks to improve. It is less likely that depositors have time or expertise to do that. As financial policymakers consider what reforms are needed to strengthen the system, they will undoubtedly look at the trade-offs between extending deposit guarantees – which are ultimately paid by all banks and their customers – and pushing for higher capital buffers and stricter liquidity provisions.

CoCo pops

In Switzerland, the regulator’s decision to preserve some value for Credit Suisse shareholders while wiping out $17 billion of contingent convertible (“CoCo”) bondholder debt took markets and other regulators by surprise and has led to ramifications in markets for these bonds, sometimes called AT1s.

These callable bonds sit below other credit in the capital stack, and are commonly used to shore up capital – hence the name "Additional Tier 1" instruments. But investors – and other regulators – expected them to be

senior to equity. CoCos have become popular instruments for high-net-worth individuals, as they provide good yield and access to blue chip names.

FINMA put out a defense of its treatment of the bondholders, pointing to the legal prospectuses. The EU and Bank of England reacted quickly to market concerns with statements affirming their commitment in their jurisdictions to the traditional seniority.

It will take a while to see how this affects banks and the CoCos market going forward. A legacy of the global financial crisis, the CoCos market now totals $260 billion globally; last year $75 billion of AT1 paper was issued. There are 19 bonds due to be called this year, but the recent market turmoil may make it tougher for these banks to raise money should capital levels fall below regulatory requirements.

IPCC: a two-year journey, two decades ahead

Over the past two years, the UN's Intergovernmental Panel on Climate Change (IPCC) has released three comprehensive years reports assessing the physical science underpinning climate change, its impact on biodiversity and ecosystems, and adaptation and mitigation strategies. This week, the IPCC released the fourth and final installment of the 6th Assessment Report (AR6), drawing on significant findings of preceding sections and noting key policy takeaways for policymakers, practitioners, and investors.

As the world is already at the 1.1°C milestone, the report noted the scale, scope, and pace of investments that are needed to move toward clean energy deployment, resilient infrastructure, sustainable agriculture and food systems, improvements in air quality, and advances in healthcare technology. To address these issues, investments in these spaces must increase exponentially over the next decade.

The report also underscored the need for a concerted partnership between the public and private sectors to achieve the necessary financing and marshal investments that protect natural habitats, safeguard marginalized communities, and overall improve human well-being.

Emerging Markets

It was a better week in emerging market equities, though things remain muted on a month-to-day basis. This performance is, perhaps, a far cry from expectations going into 2023, and close to 3% behind developed markets.

EM Asia's outperformance versus the rest of EM is being driven by Taiwan, not by – as some expected – China. Taiwan's lead in the region is due to TSMC's strong stock price recovery, but it also reflects the country's gradual recovery in domestic demand and stabilization in consumer confidence.

On the other hand, China's results can be attributed to a lack of clarity on the pace of consumption recovery and financial benefits from the country's re-opening. Admittedly, China's re-opening alleviates only one of the many concerns that global investors have about the country's long-term earnings power, and only time will tell how other risks play out. The rest of 2023 is shaping up to be a year of valuation re-discovery as global investors revisit the Chinese opportunity set.

Outside of Asia, Mexican assets continued their strong run of recent weeks. Consumer staple names were the top performing assets this week, reacting to moderating food and energy prices.

The big news in Latin America, however, was Brazil's Central Bank decision to keep rates unchanged. While the central bank's decision was not unexpected by market analysts, it was President Luiz Inácio Lula da Silva and his government's vociferous protestations to the bank's decision that drove market sentiment lower. This is not surprising, as the independence of the central bank is a valued pillar of the country's young democracy and any language threatening the status quo is never welcomed by markets.

RockCreek Update

As part of RockCreek's celebration of International Women's Month, Senior Global Strategist Caroline Atkinson welcomed two leading female economists for a timely discussion of global economic challenges: Harvard Professor and former World Bank Chief Economist **Carmen Reinhart** and University of Michigan Professor and former member of President Obama's Council of Economic Advisors **Betsey Stevenson**.

Watch the video here, or **listen to the podcast here**, or **stream on Spotify** or **Apple Podcasts**.

Maria Woodman spoke about investing in the energy transition at the **Berkeley-Haas** conference, Mobilizing Capital to Achieve Net-Zero by 2050, organized by RockCreek advisor **Dr. Laura Tyson**.

Watch the discussion here (starting at 4:16:00).

With more to come,

Team RockCreek

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