As regulators rally to prevent banking crisis from spreading, what will the Fed do next?

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Swift, powerful policy response

Some key issues created by the crisis have been addressed.

Increased risks in bank sector

Rate increases have created risks, but solvency issues seem likely to be contained.

Importance of Fed's next move

A prolonged or renewed tightening cycle could increase pressure on the banking sector, increasing recession risks and delaying the start of a sustainable economic recovery.

Back when central banks began raising rates aggressively in 2022, one of the questions my colleagues in the Global Market Strategy Office and I asked ourselves was, "Will something break?" After all, we know very well the mantra "monetary policy works with long and variable lags" and that the harder and faster the US Federal Reserve (Fed) and other central banks tightened rates, the greater the likelihood that something would break — we just weren't sure what.

Last September we saw something break in the United Kingdom, within days after the mini budget was released and gilt yields rose dramatically. The policy response was swift and encouraging. The Bank of England stepped in to buy gilts and avert potential contagion. The Chancellor of the Exchequer was replaced, and ultimately the new prime minister also resigned. At that time, I concluded that while there were significant risks that other things would break, I also believed that policymakers around the world were very sensitive to these risks and were likely to step in quickly to avert disaster. And that is what happened over the weekend in response to the brewing US banking crisis.

Pressures came to a head last week, but it had been building for some time driven by aggressive central bank tightening. Silvergate Capital, which is closely tied to the digital asset industry, announced it would shut down, having experienced significant deposit outflows from its clients as cryptocurrencies came under pressure. Then Silicon Valley Bank announced an equity capital raise on Wednesday because of losses in its 'available for sale' portfolio, which it had to sell to meet a high level of redemptions brought on by tighter lending conditions and tech industry headwinds. Silicon Valley Bank (SVB) was shut down later on Friday by regulators as it unsuccessfully tried to sell itself. Over the weekend, regulators shut down Signature Bank.

The market response was very negative on Thursday and Friday, with stocks selling off and the 2-year US Treasury yield falling the most since 2008. There were fears that this may not be an isolated incident but could be the start of contagion given that other banks could be in a similar position to Silicon Valley Bank, being forced to sell assets at a loss to cover deposit withdrawals.

Investors were rightly concerned about the impact of large potential mark-to-market losses on banks' capitalization, which the FDIC estimates at $620 billion[1]. In addition, there were concerns that there could be knock on effects for some tech and biotech companies. Silicon Valley Bank is the banking partner to about half of US venture-backed technology and life sciences companies[2] and many of these companies would not be able to access their cash to meet payrolls and other obligations once Silicon Valley Bank was shut down.

Policy response

Fortunately, the response from policymakers over the weekend was swift and powerful. The US government announced a new facility for managing this banking crisis — the Bank Term Funding Program (BTFP). The BTFP will allow banks to meet customer withdrawals by borrowing from the Fed, using their bond portfolios as collateral without having to sell and take a loss on the securities in those portfolios, as Silicon Valley Bank had to do.

Federal regulators also announced that depositors of Silicon Valley Bank and Signature Bank would be paid in full. This addresses the problem of contagion created by the crisis, and therefore should help contain risks to the financial system as a whole. In other words, the liquidity crisis for these banks, which caused a solvency crisis for them and could have spread to more regional or specialized banks (which, of course, has echoes of the Global Financial Crisis) should be averted by the rapid and comprehensive policy response.

This new facility addresses some of the problems created by the rapid tightening of a very accommodative monetary policy environment. Banks under significant pressure can obtain loans for bonds based on par value (rather than market value) — likely shifting just how many insolvencies may be out there. In creating this facility, the Fed has effectively addressed — at least temporarily — several issues caused by the shift to rapid tightening from long-term ultra-easy monetary policy.

It must also be recognized that regulators had fostered the notion that government bonds could be treated as (credit or default) risk-free, thus encouraging banks and other institutions to rely upon them to boost risk-weighted capital ratios. But government bonds clearly are exposed to significant price risk and thus can create major losses (if they cannot be held to maturity but are not marked-to-market). This facility is a direct consequence of that regulatory decision.

Outlook

We believe the events of the past week reinforce the view that the “Fed put” is alive and well. It seems unlikely that the Fed can raise rates much more, although this new facility could give the Fed a greater ability to continue raising rates than it had on Friday.

The good news for now is that regulators are responding rapidly to evolving market conditions and doing so in a prudent way by allowing banks to fail, while keeping deposits safe. This is likely to stop runs in more internationally important banks, which potentially stand to benefit from a flight to safety.

We do think there is a risk that banks, insurers or other holders of long-term fixed-income assets whether in the US or in other regions may face similar issues. Of course, the ongoing decline in bond yields, if it becomes a trend, should help cushion this problem. So far, given much tighter supervision, regulation and capitalization of the money center banks, financial breakdowns have been isolated and seem likely not to become systemic, though that risk has risen.

Furthermore, if there are significant liquidity shortages in important parts of the financial system globally, we would not be surprised to see the Fed re-introduce dollar swap lines that have become an occasional feature of global financial management during and since the Global Financial Crisis.

Investment implications

To the extent that banking sector confidence has been shaken, there may be a lower supply of credit to the US economy, in turn slowing economic growth (and probably inflation too) and increasing the risk of recession. If lower expected rates continue and the Fed is 25-50 basis points from the terminal rate, then it could potentially lead to a weaker US dollar and support performance of long duration assets and emerging markets (assuming the banking crisis is limited to the US). Oddly enough, it could potentially support US equity markets with a higher exposure to the growth factor and the weaker dollar translating into higher earnings for multinationals.

I expect volatility in the near term, given there is significant uncertainty around the Fed's path going forward. We will get far more clarity from the next Federal Open Market Committee (FOMC) meeting and the dot plots issued at that meeting.

Risk to our base case

We have to recognize there is a possibility that inflation remains persistent in the US despite the tightening in market conditions caused by this financial accident. And there is also the risk that the Fed's actions in containing the fallout from SVB and Silvergate will ease financial conditions, as markets reprice towards fewer rate hikes or an earlier pivot to rate cuts. In this scenario, the economy could once again re-accelerate, shoring up a still tight labor market, and contributing to stickier inflation pressures. The Fed might then need to resume tightening once again.

Either way, the path of inflation moderation going forward may not be satisfactory enough for the Fed to hit the 'pause button' or to start to pivot to easier policy soon. The February US jobs report was robust — even though wage growth was below expectations, new jobs created were above expectations. So Tuesday's US Consumer Price Index (CPI) data will be important as it is one of the last pieces of data the Fed will receive before its next meeting. A prolonged or renewed tightening cycle could increase pressure on the banking sector, increasing recession risks, and delaying the time before a sustainable economic recovery could start.

With contributions from Andras Vig, Paul Jackson, Emma McHugh, and Brian Levitt.

Notes

[1]Source: Federal Deposit Insurance Corporation, as of Dec. 31, 2022.

[2]Source: Kinder, Tabby et al., Silicon Valley Bank shares tumble after launching stock sale, Financial Times, March 9, 2023.

Important information

This does not constitute a recommendation of any investment strategy or product for a particular investor. Investors should consult a financial professional before making any investment decisions.

All investing involves risk, including the risk of loss.

Past performance does not guarantee future results.

Investments cannot be made directly in an index.

In general, stock values fluctuate, sometimes widely, in response to activities specific to the company as well as general market, economic and political conditions.

The risks of investing in securities of foreign issuers, including emerging market issuers, can include fluctuations in foreign currencies, political and economic instability, and foreign taxation issues.

Growth stocks tend to be more sensitive to changes in their earnings and can be more volatile.

Fixed-income investments are subject to credit risk of the issuer and the effects of changing interest rates. Interest rate risk refers to the risk that bond prices generally fall as interest rates rise and vice versa. An issuer may be unable to meet interest and/or principal payments, thereby causing its instruments to decrease in value and lowering the issuer's credit rating.

The S&P 500® Index is a market-capitalization-weighted index of the 500 largest domestic US stocks.

A basis point is one hundredth of a percentage point.

The consumer price index (CPI) measures change in consumer prices as determined by the US Bureau of Labor Statistics.

A contagion is the spread of an economic crisis from one market or region to another and can occur at both a domestic or international level.

Cryptocurrencies are digital currencies that use cryptography for security and are not controlled by a central authority, such as a central bank.

Dollar swap lines are agreements between central banks to exchange their countries' currencies with one another.

The Federal Reserve's "dot plot" is a chart that the central bank uses to illustrate its outlook for the path of interest rates.

Duration is a measure of the sensitivity of the price (the value of principal) of a fixed income investment to a change in interest rates. Duration is expressed as a number of years.

The "Fed put" refers to the belief that, when the economy falters, the Federal Reserve will jump in to support it through monetary policy.

The federal funds rate is the rate at which banks lend balances to each other overnight.

The Federal Open Market Committee (FOMC) is a 12-member committee of the Federal Reserve Board that meets regularly to set monetary policy, including the interest rates that are charged to banks.

UK gilts are bonds issued by the British government.

Inflation is the rate at which the general price level for goods and services is increasing.

Liquidity describes the degree to which an asset or security can be quickly bought or sold. From a firm standpoint, liquidity measures the extent to which an organization has cash to meet short-term obligations.

Mark-to-market losses can occur when financial instruments held are valued at the current market value. If a security was purchased at a certain price and the market price later fell, the holder would have an unrealized loss, and marking the security down to the new market price would result in the mark-to-market loss.

Money centre banks raise most of their funds from the domestic and international money markets, relying less on depositors for funds.

Par value is the face value of a bond.

The terminal rate is the anticipated level that the federal funds rate will reach before the Federal Reserve stops its tightening policy.

Quantitative tightening is a monetary policy used by central banks to normalize balance sheets.

Yield is the income return on an investment.

The opinions referenced above are those of the author as of March. 13, 2023. These comments should not be construed as recommendations, but as an illustration of broader themes. Forward-looking statements are not guarantees of future results. They involve risks, uncertainties and assumptions; there can be no assurance that actual results will not differ materially from expectations.