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MARKET SIGHT LINES

The Bank Sector Calms Some, and the Federal Reserve "May" Adjust Policy

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Last week, we wrote about real problems in the banking sector, and another update is warranted. The Federal Reserve (Fed) had a regular meeting this week, providing a policy update, a revised statement, the chair's press conference, and its Summary of Economic Projections (SEP).

So, in this week's Sight|Lines, we offer an update on banking sector troubles, the results of the March Fed meeting, how these have affected market turbulence, and what it means for investors in 2023 and beyond.

THE TAKEAWAY: THE SWISS GOVERNMENT TAKES ACTION, THE U.S. BANK SECTOR CALMS SOME, AND THE FED HIKED RATES 0.25%.

As we discussed last week in our 2023 outlook, we expect market volatility to remain elevated in the first half of 2023, as the lag effect of the historically tight monetary policy shift takes hold. We discussed the effects of higher rates, which generally slow the economy, but can also expose serious business weaknesses and flaws first hidden by low rates and excess liquidity. And that is exactly what happened with the banks, where a rise in market interest rates first generated unrealized losses, only to have a few banks be forced to realize those losses as the economic slowdown caused customers to withdraw deposits. While markets stabilized this week, volatility remains elevated. In summary:

- As mentioned last week, three U.S. banks failed, so the federal government stepped in to backstop those depositors and put in place credit and liquidity facilities to calm bank fears. So far, this has generally been working.
- Despite drawing on a Swiss government credit line, Credit Suisse Group AG, already known as an aggressive institution with mixed results over recent years, remained under pressure. The Swiss government orchestrated a sale to UBS.
- A group of U.S. banks deposited $30 billion in troubled First Republic Bank to help. Then, JP Morgan's CEO, Jamie Dimon, led a coordinated effort among major U.S. banks to help further.
- The Fed hiked rates 0.25%, as expected, but acknowledged the tightening effect of the bank troubles, signaling they "may" hike rates further, inferring they may not.
- The chances for a 2023 recession have increased meaningfully.
- Markets have remained relatively calm this week, including bank stocks.

As we've discussed, we expect heightened volatility through midyear, but the prospect for relief in the second half remains.

IN-DEPTH: IN THE WAKE OF THREE U.S. BANK FAILURES AND U.S. GOVERNMENT INTERVENTION, THE U.S. BANK SECTOR CALMS SOME, THE SWISS GOVERNMENT TAKES ACTION TO HELP ITS BANK SECTOR, AND THE FED HIKED ANOTHER QUARTER-POINT.

Higher rates and tighter financial conditions have exposed serious weaknesses in some banks around the world, first hidden by the low rates and excess liquidity available in recent years. Going deeper:

- As mentioned last week, there have been troubles with U.S. banks:
  - Silicon Valley Bank and Signature Bank were placed in receivership, and the U.S. agreed to make depositors whole.
  - Silvergate Capital implemented a bank liquidation plan. Depositors are expected to be repaid.
  - Several U.S. banks deposited $30 billion in troubled First Republic Bank, but weaknesses remained. So, JP Morgan's CEO, Jamie Dimon, is leading a coordinated effort among major U.S. banks to help further.
- The Swiss government has been very active to avoid troubles in its banking sector:
  - The Swiss government first provided Credit Suisse Group AG, already known as an aggressive institution with mixed results over recent years, with a 50 billion Swiss franc credit line.
  - But Credit Suisse remained under pressure, so the Swiss government orchestrated a sale to UBS for over $3 billion.
- The Fed is trying the balance its fight against inflation with the realization that the bank troubles have tightened financial conditions further:
  - The Fed hiked rates by 0.25%, as expected, saying hikes "may" continue, implying they may not.
  - The statement indicated the bank troubles may cool the economy, hiring, and inflation.
  - In his press conference, Chair Powell said to focus on the words like "may" rather than "ongoing."
- The chances for a 2023 recession have increased meaningfully.
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CONCLUSION

The environment remains more uncertain than prior to the recent bank failures. The challenges of the last couple of weeks have shaken business and consumer confidence, which could dampen demand and help cool inflation. The Fed hiked rates, as expected, but acknowledged that recent bank troubles may well have a tightening effect, so they may slow or pause rate hikes. With this banking crisis hopefully behind us, we still expect relief in the second half of 2023, offering greater clarity on the state of the economy and Fed policy and an opportunity to turn back to the fundamentals – an important step in making our way to the next bull market cycle. In the meantime, the prospect of a deeper-than-anticipated recession may prove a headwind.

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