GUGGENHEIM

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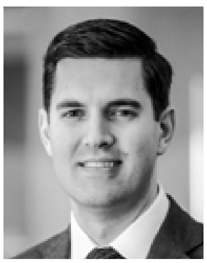
Macroeconomic and Investment Research

A Not-So-Funny Thing Happened on the Way to the Terminal Rate



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The market clamor over the Federal Reserve's (Fed) execution of monetary policy in recent years has overshadowed its other important job—regulating and supervising our nation's financial institutions and monitoring the whole financial system for potential risks. It is one of those things that we only notice when something goes wrong. Rarely are these two assignments at odds with each other, but it is becoming increasingly clear that aggressive monetary tightening was the straw that broke Silicon Valley Bank's (SVB) back and brought on a crisis. Suffice it to say that it is never a good time for a bank run, but it is an especially bad time when the Fed is fighting inflation.

While it's true that SVB was an outlier in terms of the mismatch between its highly run-prone funding base and longer-duration asset composition—and therefore its troubles were idiosyncratic—a close look at trends among FDIC-insured banks over the past 15 years shows that what happened at SVB is indicative of a system-wide phenomenon. The nearby charts show that from 2008 up until the pandemic, a moderate and steady stream of new deposits led to relatively small quarterly changes in securities holdings, while the Fed's cautious post-crisis monetary policy regime helped to keep the change in unrealized losses (and gains) manageable.

But all that changed when the pandemic hit in 2020. In the first two years of the pandemic, banks got a massive influx of nearly $5.2 trillion dollars in new deposits, of which fewer than $2 trillion were FDIC insured. The unprecedented growth in deposits was no accident: it was the direct result of the coordinated fiscal-cum-monetary helicopter drop of liquidity. So, what did banks do with this money? Loan demand was weak because the economy was still depressed, so loan and lease balances only rose by about $730 billion. With few lending opportunities, banks deposited $1.9 trillion in cash at the Federal Reserve, and used most of the rest of the deposit deluge to buy around $2.25 trillion in securities, 87 percent of which was U.S. Treasury or Agency MBS securities. This, too, was no accident: bank liquidity regulations (e.g. Liquidity Coverage Ratio and liquidity stress testing) dictate that banks have to hold a high amount of high-quality liquid assets like cash or Treasurys or Agency mortgages. To say that buying these liquid, *credit*-risk free

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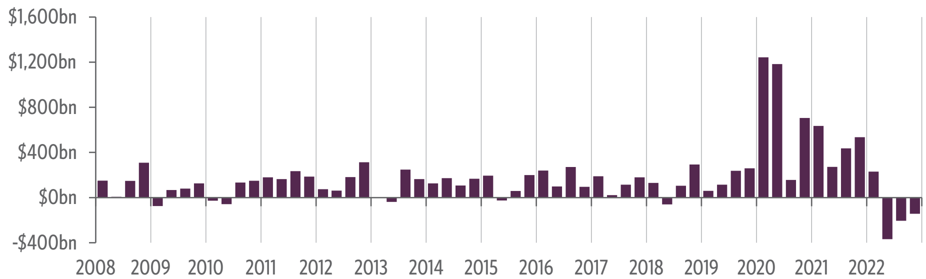
> The unrealized losses arrived in force when the Fed started to raise rates.

securities was welcomed by regulators would be an understatement. Initially these securities were held as available for sale but when Treasury yields bottomed in the summer of 2020, more were moved into the held to maturity bucket to shield them from negative marks.

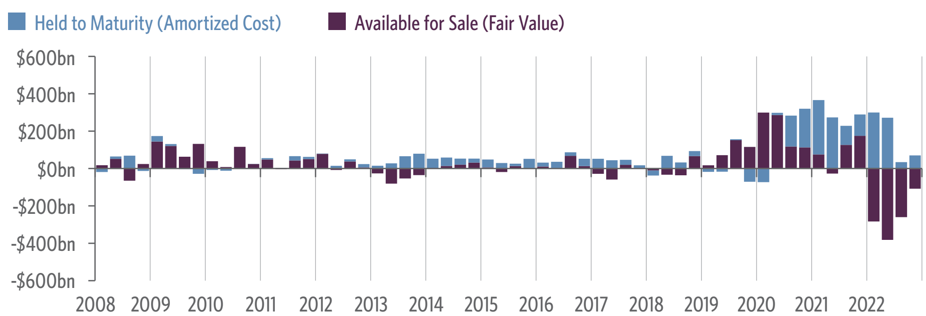
The unrealized losses arrived in force when the Fed started to raise rates in March 2022 and the yield curve shifted up. Meanwhile, the Fed’s abrupt transition from quantitative easing to quantitative tightening caused bank deposit inflows to reverse, forcing some banks to seek more expensive sources of funding and reckon with large unrealized losses on their securities. With only $10 trillion out of $19.2 trillion in total bank deposits insured by the FDIC, depositors (and now regulators) are rightly concerned about what this all means.

Banking System Problems Hiding in Plain Sight

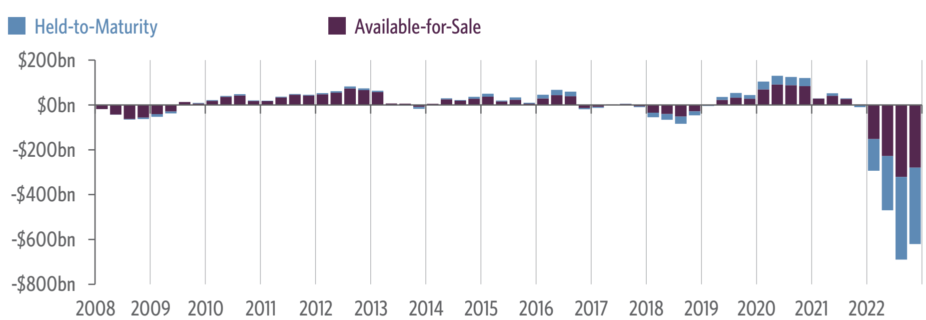
Quarterly Change in Deposits of U.S. Commercial Banks



Quarterly Change in Securities Holdings of U.S. Commercial Banks



Unrealized Gains (Losses) on Investment Securities of U.S. Commercial Banks



Source: Guggenheim Investments. FDIC. Data as of 12.31.2022.

> "Funding market stress will lead to tighter credit conditions for the economy.

With this context, we can see that the easing of terms on the Fed's discount window and the creation of a new Bank Term Funding Program (BTFP) were not just a forceful response to the SVB bank run, but also a way to address possible similar scenarios that may play out across the banking system. The facilities will unlock access to substantially more liquidity for banks while shielding them from needing to take adverse marks on underwater bond positions (unrealized losses on securities positions of FDIC-insured banks totaled $620 billion as of Dec. 31). Meanwhile, the weekend news of UBS's takeover of Credit Suisse and the announcement of daily auctions through the Fed's dollar swap lines with foreign central banks should help to calm fears of a wider global conflagration.

While these measures will buy time for banks and regulators to work through the problem, funding market stress will lead to tighter credit conditions for the economy. Loan rates, terms and underwriting standards are going to tighten for bank customers and bank profitability will take a hit, particularly for mid-size and small banks as they boost deposit rates and replace lost deposits with more expensive funding sources. For their part, regulators seem to be trying hard to avoid expanding FDIC coverage beyond the current $250,000 limit, but if conditions continue to deteriorate, they may be left with no other choice.

How does the Fed move forward on the policy front? Two weeks ago the Fed appeared to be teeing up a 50-basis point hike at this week's meeting, but we think a move of that size is now off the table. Instead, we expect another quarter point hike, which is 75 percent priced in by the market. The European Central Bank decision to deliver a 50 basis point hike last week will also provide air cover, with Fed Chair Jerome Powell likely to note—as President Christine Lagarde did—that monetary policy tools will stay focused on monetary policy objectives, namely bringing inflation back to target. At the same time, Chair Powell will reiterate that regulators have put in place a very robust liquidity backstop for banks, and they have confidence in the capital, asset quality and liquidity profile of the American banking system. The Fed's messaging will likely draw a contrast between the conditions that led to the Global Financial Crisis (GFC) and today, highlighting tighter macroprudential oversight that has been put in place, but questions will rightfully be asked how, despite the lessons learned in the GFC, SVB and Signature Bank could collapse so suddenly.

The Fed will also have to acknowledge, however, that it still has more work to do on taming inflation and cooling off the labor market, which is why we think a quarter point hike is more likely than pausing. A pause (or even a premature cut in rates) runs the risk of signaling that the Fed is not serious about fighting inflation and could backfire if the market interprets it as a sign of even greater financial stability concerns. For this reason, we expect the updated dot plot to convey a baseline path of several more quarter-point rate hikes in 2023. We expect Fed officials will pencil in additional 25 basis point hikes at the May and June meetings, which would bring the projected terminal rate to 5.5 percent. Whether the market believes this—or the Fed ultimately can deliver it—will largely depend on how wide the current banking crisis spreads.

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While we expect to see a lot of volatility in and around the next several Federal Open Market Committee meetings, we are also looking further down the road to the debt limit battle that looms this summer. Banking sector problems have created a political opportunity for even more finger pointing and blame shifting, and some lawmakers seem prepared to test the Treasury-Fed backup plan to prioritize debt service payments to avoid a default on the national debt. Despite all this political brinksmanship, eventually we will get a debt limit resolution, and what comes next may be just as important for the banking system. That's because Treasury will need to issue hundreds of billions of dollars in T-bills to replenish its depleted cash balance, which is currently being run down because Treasury has exhausted its legal borrowing authority. As Treasury's cash balance ramps up by a half trillion dollars or more this fall, some liquidity will likely be drained out of the banking system as well as the Fed's Overnight Reverse Repo Facility. This could further disrupt banks, but regulators believe that the BTFP, discount window, and the Federal Home Loan Bank System will be there to provide a liquidity backstop.

Regulators are committed to protecting the banking system, but other weaknesses will continue to be revealed as quantitative tightening proceeds. The Fed's battle against inflation has gotten harder and lonelier as the sharp rise in interest rates has started to bite. Nevertheless, this is a battle it has pledged to win, even if there is collateral damage. We continue to anticipate a recession starting as early as midyear, and the economic slowdown will ultimately help the Fed achieve its inflation-fighting goals. As all of this plays out, investors will be well served by being appropriately vigilant in their security selection, duration positioning, and asset allocation decisions. To that end, the events of the past week have shown that investment-grade fixed income can outperform equities, consistent with our expectation that fixed income will rebound and a negative stock-bond correlation will reappear in 2023.