INVESTMENT BRIEF

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Strategic Investment Group®

Price versus Financial Stability

The March mini banking crisis was an unintended consequence of the abrupt shift by the Fed and other major central banks from a long period of extraordinarily easy monetary policy to a rapid tightening focused on fighting inflation. The period of easy money encouraged investors to move out the risk spectrum and to increase leverage, thus compressing risk premiums and contributing to froth in highly speculative rolls of the dice from crypto, to SPACs, meme stocks, and beyond.

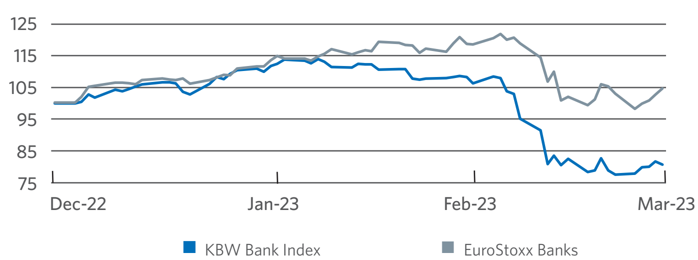
We now face the risk that hidden pockets of leverage previously papered over by ample liquidity could be suddenly revealed. As monetary and financial conditions tighten, asset prices and leveraged positions predicated on the persistence of easy money become vulnerable. At extremes, leveraged positions can become subject to margin spirals. In these vicious cycles, falling asset prices trigger margin calls, leading to the forced sales of assets that further pressure prices and result in additional margin calls.

Where these vulnerabilities lie and how they will manifest themselves as central banks scrape away the protective veneer of abundant liquidity is unpredictable. One example is last September's U.K. LDI crisis that roiled the gilt market until the Bank of England's forceful intervention prevented a margin spiral from spinning out of control. The March mayhem across U.S. regional banks and Credit Suisse is another example of how positions that appear safe when yields are low can become highly unstable and trigger a broader contagion (Exhibit 1).

EXHIBIT 1:

Bank Stocks Plummet in Wake of SVB Failure

Source: Bloomberg. Index. January 1, 2023 = 100.



Tightrope of Monetary Tightening

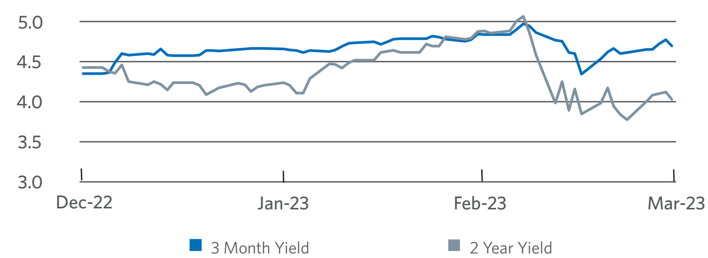
Both of these examples highlight the difficult task facing major central banks. Fighting inflation and maintaining financial stability can be conflicting. The tightening of credit conditions to fight inflation can trigger financial instability that requires targeted injections of liquidity to resolve and discourages central banks from further rate hikes. The bond market reaction to the U.S. regional banking crisis was in part driven by an appreciation of the delicate balancing act facing central banks, and the potential conflict they face in seeking to maintain both price and market stability.

In the immediate aftermath of March's mini-crisis, the yield on the 2-year U.S. Treasury note plunged from about 5.1% to a low of 3.8% as markets reversed their expectations for the future path of U.S. monetary policy (Exhibit 2).

EXHIBIT 2:

Markets Reprice Path of Monetary Policy

Source: Bloomberg. Yields in percent.



The moves in the 2-year Treasury note and the expected path of the Fed funds rate appear to reflect two key judgments by the market. First, in striking the balance between price and market stability, the Fed will lean toward a slower pace of rate hikes. Second, and relatedly, the turmoil in the banking sector has itself contributed to a tightening of monetary conditions that will help reduce inflationary pressures and thus support the Fed's first objective of restoring price stability.

This market view has been reinforced by the actions of the Fed, which reduced the pace of rate hikes to 25 basis points in the March 22 FOMC meeting. Moreover, the Fed and the FDIC engaged in targeted injections of liquidity into the banking sector that together approached the levels reached in 2008 during the Great Financial Crisis.

The market was also right to suppose that the banking crisis would tighten financial conditions and thus help ease price pressures. Two developments contributed to this tightening. First, the banking crisis accelerated a reduction of bank deposits and the money supply that had been ongoing. In addition, banks reacted to the turmoil by tightening standards for commercial and industrial loans to firms.

For the present, the March mayhem across U.S. regional banks appears to have been contained with contagion limited to a few banks. The lasting impact of this event is a reminder of the turbulent nature of the transition from easy to tight policies and of the delicate balancing act central banks face in restoring price stability while avoiding a potentially highly destructive financial crisis.

Note: Opinions expressed herein are current as of the date appearing in this material and are subject to change at the sole discretion of Strategic. This document is not intended as a source of any specific investment recommendations.

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