MACRO STRATEGY

U.S. Policy Risk vs. Reward

May 8, 2023

Despite taking great pains to steady the banking sector by writing in the statement that "[t]he U.S. banking system is sound and resilient"[1] and Chairman Powell beginning his press conference by noting that "Conditions in that sector have broadly improved since early March and the U.S. banking system is sound and resilient", the Federal Reserve raised the policy rate again. The FOMC met consensus expectations for a 25-basis point rate hike and took the policy rate above 5% as they noted in the statement that they remain "strongly committed to returning inflation to its 2 percent objective."[2]

In response to a question regarding the tightening of bank lending standards, Chairman Powell noted that "I would just say that the SLOOS is broadly consistent…with how we and others have been thinking about the situation and what we're seeing from other sources. You will have seen the Beige Book and listen to the various earnings calls that indicate that mid-size banks have, some of them, have been tightening their lending standards. Banking data will show that lending has continued to grow but the pace has been slowing since the second half of last year."[1] However, we believe what Chairman Powell failed to note was that the data in the survey was likely collected between late March and early April so it would not reflect any additional tightening as a result of stress since early April.

Since the first week of April through the day before the Fed meeting, the KBW regional bank index fell by 9.4% even as 10-year Treasury yields were close to unchanged and mortgage rates were 20 basis points (bps) higher.[3]

Deposits at commercial banks had shrunk by $55 billion and were down $600 billion since year-end.[4] Bank borrowing at the Discount Window and other emergency facilities had remained constant since early April, at more than $300 billion.[4] In short, even before the additional 25bp rate hike, signs of continued stress were obvious.

Immediately after the Fed move, the KBW regional bank index began to fall, ending the day 4% lower than the level seen immediately prior to the announcement.[3] These market movements may impede capital raising and are raising the risk of more bank closures, a development which would exacerbate stresses in the economy.

We believe ongoing stress in the banking system that results in a further tightening of bank lending standards and negative impacts on consumer wealth via lower equity markets raise the risk that the coming recession includes a financial sector component to it, potentially creating a downturn that is more significant in scale and duration.

Endnotes

1. FOMC Statement, Federal Reserve Board of Governors
2. Federal Reserve Board of Governors, https://www.federalreserve.gov/mediacenter/files/FOMCpresconf20230503.pdf
3. Bloomberg
4. Federal Reserve

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MetLife Investment Management

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