On The Mark

Special Edition – March 22, 2023

Fed Decision – Aiming for Stability

Key Takeaways

- Recent stresses in the banking system, including episodes at Silicon Valley Bank, Signature Bank, and Credit Suisse, have put the markets on edge.
- The Fed raised interest rates by 0.25%, meeting market expectations. They emphasized financial stability while acknowledging that inflation and growth have slowed.
- Despite a stressful couple of weeks, the financial system was resilient. We encourage investors to look through this period of volatility and maintain discipline to their long-term investment plans.

The road so far

Over the last two weeks, the FDIC assumed control of Silicon Valley Bank and Signature Bank. Both banks had experienced losses in their fixed-income portfolios and were unable to attract sufficient capital to meet the withdrawals of their depositors[1].

In an effort to increase confidence in the banking system, US regulators provided banks with access to capital through several lending facilities. They also guaranteed all of the deposits of the two banks beyond the $250,000 FDIC insured level. A few days later Credit Suisse, the second-largest Swiss bank, experienced its own funding crisis. The Swiss National Bank (the central bank of Switzerland) hastily arranged the sale of Credit Suisse to UBS (the largest bank in Switzerland).

This set the stage for the Fed's interest rate decision on March 22, 2023. The Fed had already raised by 4.5% over the last year in an effort to lower inflation. This rapid increase in interest rates was a significant driver of the recent stresses in the banking system.

The Fed's message

The Fed raised interest rates by 0.25%, meeting market expectations. It is likely that they did not want to surprise investors by raising rates more (or less) than expected. A pause in rate hikes could suggest the Fed was extremely worried about financial stability (which would worry many investors), while a larger-than-expected rate hike could suggest the Fed was ignoring financial stability (which would also worry investors).

Chairman Powell opened his statement by pointing out that growth has been "modest" and that job gains had picked up. He then highlighted that the "US banking system is sound and resilient" but stated that recent developments in the banking system would likely result in "tighter credit conditions," which will weigh on economic activity, hiring, and inflation. In describing future rate hikes, they replaced the term "ongoing" rate hikes with "some additional policy firming may be appropriate."

[1] While meeting regulatory requirements.

Carry on

The Fed reminded us that even amidst an ongoing (albeit appears to be improving) banking crisis, inflation and growth still matter. In our view, the current stress in the banking system will likely reduce future bank lending and therefore, future economic growth. While not desirable on its own, lower economic activity should also reduce inflation.

Clearly, a banking crisis is not the preferred path to lowering inflation, but this episode did show that regulators (and industry leaders) learned many lessons from the Global Financial Crisis. In my view, those lessons made this crisis much less severe, and I would expect we'll learn a few lessons from this crisis as well. For better or worse, this is the messy, scary, and sometimes painful process of adding resilience to our financial system.

As stability returns to the financial markets, investors will begin to re-focus on the economic cycle. Inflation is still too high, and growth is still surprisingly resilient.

For now, the key takeaways are:

1) There will likely be additional issues with regional banks, but the financial system has survived and shown its resilience.
2) Lower credit creation implies lower near-term paths for both growth and inflation.
3) Long-term investment plans incorporate all types of economic conditions, including this one. The biggest risk to achieving long-term success is abandoning a well-constructed investment plan at the wrong time.

We encourage investors to look through this period of volatility and maintain discipline to their long-term investment plans.

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