US Macroeconomics

March 13, 2023

Joseph Lavorgna, Chief US Economist | 212.610.1741 | joseph.lavorgna@smbcnikko-si.com

Game Changer

The Fed has raised rates into a slowing economy and an inverted yield curve. It was only a matter of time before something broke. The only question is whether it would show up in financial markets or the real economy first. We now have our answer.

Unprecedented monetary tightening caused massive mark-to-market losses in bank portfolios which has been ameliorated by the Bank Term Funding Program (BTFP). Banks now can post government securities and GSE mortgage-backed securities at par value for collateral. However, this is likely to be only a temporary fix because smaller and medium-sized sized banks still need liquidity.

Diminishing bank liquidity is primarily the result of three factors. One, bank reserves are shrinking 11% annualized because of quantitative tightening. Two, investors are moving their deposits out of commercial banks into government sponsored money market funds where interest rates are much higher. Three, deposit growth is slowing because the economy is slowing, consistent with aggressive monetary tightening.

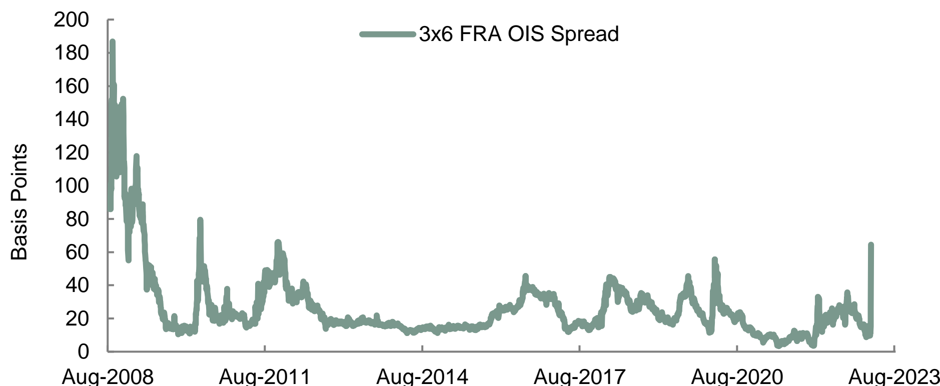
As small- and medium-sized banks raise rates to attract deposits, credit and money creation will further slow. Since this is occurring against the backdrop of recessionary readings in the Fed's Senior Loan Officer Survey, an incipient credit crunchy is likely to intensify in the weeks and months immediately ahead. A recession is almost a near certainty, unless inflation comes down faster than expected and the Fed quickly pivots to rate cuts. So, what does the Fed do?

The Fed has responded to past financial/market crises by either pausing interest rate hikes or pivoting back toward interest rate cuts. This happened following Continental Banks of Illinois (1984), Black Monday (1987), Orange County/Mexican Tequila Crisis (1994), Asian Financial Crisis (1997), Russian debt default/LTCM bail-in (1998), the Greece debt default (2012) and the collapse in oil prices (2015). Will this time be different?

Considering the dramatic widening in money market spreads which gapped out to their widest levels since 2011 — see chart below — the prudent course of Fed action would be a pause in interest rate hikes and an immediate halt to quantitative tightening. The FOMC could state something to the effect of, 'heightened stress in the financial markets has caused an unwarranted tightening in financial conditions that could lead to sharp deterioration of economic conditions.'

If the economy proves more resilient than expected and the BTFP provides a sufficient backstop to systemic risks, monetary policymakers could resume tightening at the May 3rd and June 14th FOMC meetings. Consequently, the Fed could keep a median peak funds rate at 5.125% from 4.625% at present.

Bottom line: **We expect the Fed to pause and announce an end to QT next week**. And the Fed's next move is likelier to be an interest rate cut rather than an interest rate hike. Stay tuned. It is a long way until next Wednesday.



Sources: Bloomberg, SMBC Nikko

Disclaimer
This document has been prepared by SMBC Group (including, collectively or individually, Sumitomo Mitsui Banking Corporation, SMBC Nikko Securities America, Inc., SMBC Nikko Securities Canada, Ltd., SMBC Capital Markets, Inc., SMBC Leasing and Finance, Inc., JRI America, Inc., and SMBC Rail Services LLC) and is being furnished by SMBC Group solely for use by the client or potential client to whom such materials are directly addressed and delivered. SMBC Nikko Securities America, Inc. ("SMBC Nikko America") is a US-registered broker-dealer. SMBC Nikko Securities Canada, Ltd. ("SMBC Nikko Canada") is a US and Canadian registered broker-dealer. SMBC Capital Markets, Inc. ("SMBC Capital Markets") is provisionally registered with the CFTC as a US swap dealer. In the US, capital markets and other investment banking activities for SMBC Group are performed by a combination of SMBC Nikko America, SMBC Nikko Canada, and SMBC Capital Markets. Lending and other commercial banking activities are performed by Sumitomo Mitsui Banking Corporation and its banking affiliates. Derivative activities may be performed by SMBC Capital Markets or Sumitomo Mitsui Banking Corporation. SMBC Group deal team members may be employees of any of the foregoing entities.

This document is for informational purposes only and is not intended to be a research report, advice, a recommendation, an offer to sell or the solicitation of an offer to buy any securities, enter into any transaction or adopt any hedging, trading or investment strategy, or any commitment to underwrite, subscribe for, or place any securities, is not an offer or commitment to provide any financing or extension of credit or service, and does not contain any tax or legal advice. Any transactions or strategies discussed herein do not take into account the particular investment objectives, financial situations, or needs of any client, and may not be suitable for all parties. This document is not subject to the independence and disclosure standards applicable to research reports and research analysts under those laws and regulations. This document has been prepared for and is directed exclusively at Qualified Institutional Buyers, sophisticated institutional investors, and other market professionals. It is not intended for distribution to or use by retail customers.

In preparing this document, SMBC Group has relied on information available from third parties, including public sources, and we have assumed, without independent verification, the accuracy and completeness of such information. Specific prices, indices or measures, including ranges, listed in this document were prepared at or around the time the document was prepared, and are subject to change without notice. SMBC Group makes no representations to, and does not warrant, this document's accuracy or completeness. SMBC Group expressly disclaims any liability for any results in connection with use of the information set forth herein, including, without limitation, any use of the information in the preparation of financial statements or accounting material. Prior to participating in any transaction or strategy, you should consult your own independent, competent, legal, tax, accounting and other professional advisors. SMBC Group does not provide tax advice. Accordingly, any discussion of U.S. tax matters contained herein (including any attachments) is not intended or written to be used, and cannot be used, in connection with the promotion, marketing or recommendation by anyone unaffiliated with SMBC Group or for the purpose of avoiding U.S. tax-related penalties.

This document may contain forward looking statements, which may include projections, forecasts, income estimates, yield or return, future performance targets, or similar analysis. Any such forward-looking statements, prices, indices, or measures are based upon certain assumptions. All forward-looking statements are based on the information available at the time the document was prepared and SMBC Group is not obligated to provide an update. Actual events may differ from those assumptions or available information. Any opinions, projections, price/yield information or estimates are subject to change without notice. There can be no assurance that any estimated returns or projections will be realized, that forward-looking statements will materialize, or that actual results will not be materially different from those presented herein. Past performance should not be taken as an indication or guarantee of future performance, and no representation or warranty, express or implied, is made regarding future performance. The value, price or income from transactions or strategies may fall as well as rise. SMBC Group or an affiliate may have a position in any of the underlying instruments, assets, indices or rates mentioned in this document.

This document is confidential and is the property of SMBC Group subject to copyright, and is furnished by SMBC Group solely for use by the client or potential client to whom such materials are directly addressed and delivered. Any reproduction of this document, in whole or in part, is prohibited, and you may not release this document to any person, except to your advisors and professionals to assist you in evaluating the document, provided that they are obligated, by law or agreement, to keep the document confidential.

© 2023 SMBC Group. All rights reserved.