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 crunch 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.
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