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Stress in US regional banks continues, while the Fed moves towards a pause

Jonathan DUENSING
Head of US Fixed Income

Paresh UPADHYAYA
Director of Fixed Income and Currency Strategy

Craig STERLING
Head of Equity Research; US Director of Core Equity; US Portfolio Manager

With contribution from

Gabriel Kim, Senior Equity Analyst - Financials

- ***The recent banking stress has been a real test of capital and liquidity regulations enacted after the 2008 crisis.*** *While the banking system has been able to absorb the failure of three regional banks without creating systemic issues, banks have also been active in trying to enhance their liquidity positions by parking maturing securities in cash and accessing the Federal Home Loan facility. They are also more aggressively competing with certificates of deposit and engaging in deposit splitting.*
- ***The Deposit Insurance Fund (DIF),*** *which is created via contributions from banks, has borne the cost of around $35bn owing to the recent failures of banks. While the FDIC had planned even before the March events to raise the DIF ratio, we are vigilant regarding how the corporation is raising the DIF now.* ***On the deposits front, the banking industry has witnessed large outflows, more significantly in the case of smaller banks****, whereas money market funds seem to have benefitted.*
- ***Impact on broader banking system:*** *Banks subject to Fed stress testing include a wide range of banks with different tiers of capital, liquidity and testing requirements, with a lower probability of failure as a result when compared to banks that are not subject to such requirements.* ***In general, we are convinced that while there are concerns and stress around the regional banks, large banks and the banking system overall remain robust****.*
- ***Impact on Fed policy and Treasuries:*** *We believe the impact of banking stress has probably led to a lower terminal fed funds rate. If volatility in financial markets increases due to the banking stress, we expect US Treasuries to rally on a flight-to-quality.*
- ***FOMC May meeting review:*** *The FOMC raised the federal fund rate by 25bp but dropped future guidance. Chair Powell toed a hawkish line, saying that the Fed is far away from hitting its inflation target but acknowledged that the tighter credit conditions for households and businesses could affect economic growth. We think that the Fed is setting the table for a conditional pause in monetary policy. While the financial markets may become excited about the prospect of the Fed moving to or near a pause,* ***we would advise caution regarding any near-term course reversal by the Fed since the incoming inflation and economic data are not likely to support rate cuts.***

Assessment of US regional banks

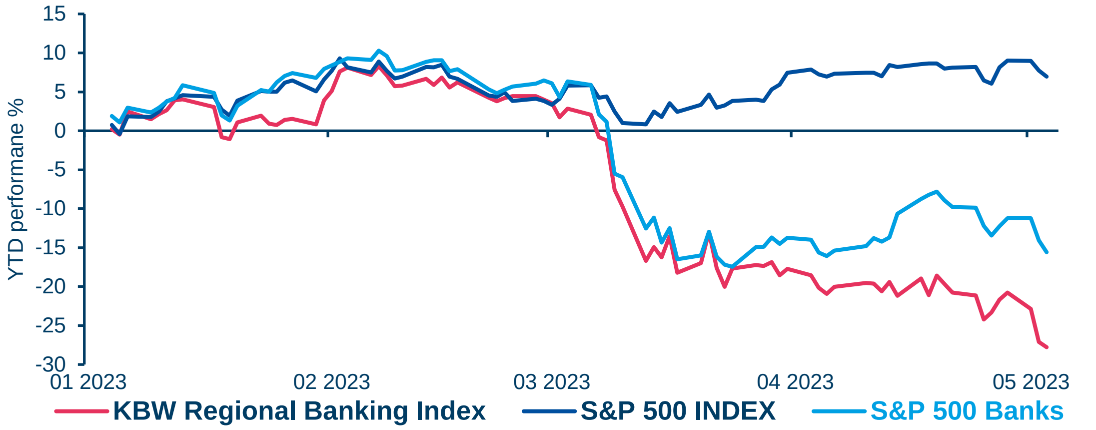
The main risk that banks face currently is liquidity risk. Regional banks have taken some of the following actions to enhance their funding:

- Increase liquidity buffers by parking maturing securities in cash, which now earns a 5% rate;
- Access Federal Home Loan bank advances (secured borrowing), which increased from $800bn on 22 December 2022 to $1tn on 31 March 2023;
- Compete more aggressively with higher-cost certificates of deposit (CDs) and brokered deposits to retain deposits and more effectively compete with uninsured money market funds;
- Banks, more on the right tail of the uninsured deposit curve, are mostly commercial banks and we are seeing such banks engage in deposit splitting, which works as follows – Bank A has a business client with $500k of deposits ($250k above the insured limit) and Bank B has a business client with $500k of deposits (also $250k above the insured limit). Deposit splitting occurs when both banks split the deposit of their customer in half and send the other half to the other bank, thereby achieving 100% deposit insurance coverage at two banks rather than 50% coverage at one.

Recent bank failures represent the first real test of capital and liquidity regulations enacted in the post-financial-crisis years. On the one hand, the US banking system has been able to absorb the failure of three large regional banks with no direct systemic risk fallout. On the other, regional bank stocks are down by approximately 28% year-to-date (YTD) (Figure 1), reflecting deep concerns among bank equity investors that the US banking system remains vulnerable to deposit runs, given that there is still $8tn of uninsured deposits.

"Although bank stocks have slumped due to investor concerns on deposits, regional banks have been affected more by this negative sentiment".

Figure 1: US bank stocks slump



Source: Amundi, Bloomberg at 3 May 2023.

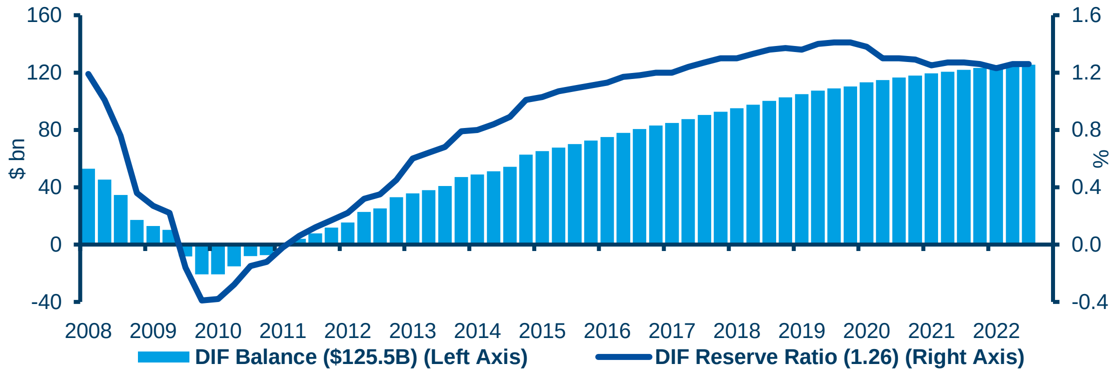
Today, bank regulators seem to be more willing to give banks the benefit of time. Prior to March, the regulatory reaction function was less known. So, in this sense, the financial system is in better shape. While there are more ideas about how to fix the banking turmoil, very little has changed with respect to key areas of investor concerns, including liquidity and capital requirements, regulation, and deposit insurance structure.

Two factors to watch in assessing the crisis evolution

1. Federal Deposit Insurance Corporation (FDIC) dynamics

As of the end of last year (before the recent banks failures), the size of the Deposit Insurance Fund, which is paid for by banks, was approximately $128bn (Figure 2), and the DIF ratio was close to 1.3% (DIF balance divided by insured deposits of approximately $10tn). Recent bank failures have cost the DIF $35bn ($20bn for Silicon Valley, $13bn for First Republic and $2bn for Signature). Even before the March events, the FDIC had pre-existing plans to raise this DIF ratio to 2%, requiring $107bn of additional insurance premium in the DIF.

Figure 2: Deposit Insurance Fund (DIF), 1Q08–3Q22



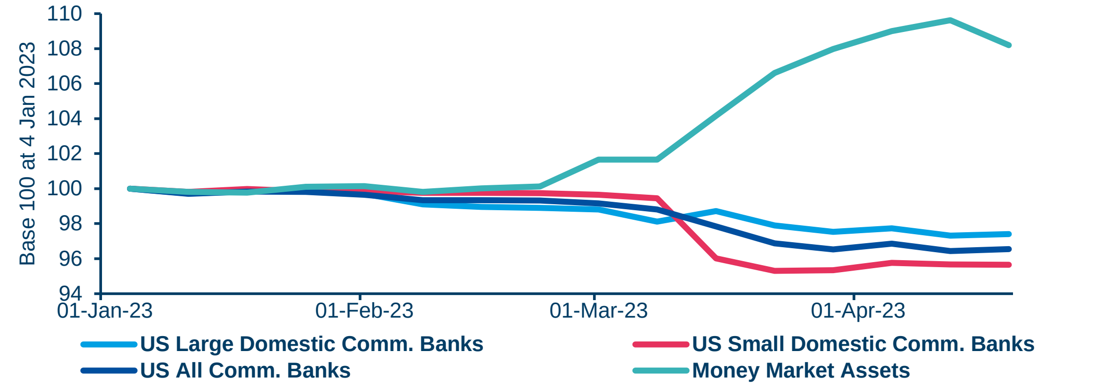
Source: Amundi, FDIC, at 3 May 2023. Deposit Insurance Fund (DIF) ratio is calculated as the ratio of the DIF to insured deposits, as of quarter-end.

2. Commercial bank deposits dynamics

Another key trend to monitor in assessing the crisis evolution is the development in commercial bank deposits. Collectively, all US commercial banks have experienced a decline of approximately 3.5% in total deposits YTD (Figure 3), with larger banks experiencing relatively more contained deposit outflows than smaller banks. In terms of absolute data, YTD, total deposit outflows from US commercial banks are around $614bn, with a 4.3% decline in outflows from small vs a 2.6% decline for large commercial banks. On the other hand, the loss of bank deposits has been the gain for money market assets, which, supported by inflows, have risen in size.

"US commercial bank deposits have fallen, whereas we have seen an increase in money market assets".

Figure 3: Deposits movements in US banks and money market funds



Source: Amundi Institute, Bloomberg, latest data at 19 April 2023.

"It is unlikely that the turmoil could extend to large banks, given their high capital levels".

Outlook on banking stress

How far the crisis can go is a difficult question to answer because this will depend on regulators and bank managers sifting through many ideas to come to the best solution together in a timely fashion. Investors are not taking comfort in the fact that the three bank failures to date have been cleaned up quickly. Instead, investors are looking at the industry's $18tn of deposits and saying $8tn of those are uninsured, and then trying to assess the next bank that could in troubles.

"Banks with a higher mix of uninsured deposits are at higher risk".

We think **commercial banks that have a higher percentage of uninsured deposits are most vulnerable**, and so the market is sorting banks by greatest to least uninsured deposits. For this crisis to be contained, bank investors need to regain confidence in the safety of banking industry deposits. We are convinced that, while there are concerns and stress around the regional banks, the **large banks and the banking sector remain robust**. We remain very vigilant on any potential stress that could emerge from liquidity issues and avoid banks where balance sheet strength is limited. In contrast, **we like banks with high returns on equity and large capital buffers**.

A lesson learned from the 2008 financial crisis is that regulators eventually find the solution and many of the solutions developed and implemented in the past have applicability today. For example, at the height of the financial crisis, to calm business deposit outflows, the FDIC successfully created and implemented the Temporary Liquidity Guarantee Program (TGLP), a component of which guaranteed in full all non-interest-bearing transaction account deposits. Thus, a similar solution updated to today's requirements also aimed at commercial operating deposits seems imminent. Today, the market is pricing in a more severe recession and a liquidity crisis, which is increasing confidence in the ability to find a solution to the industry's deposit outflow.

"Stress in the banking sector could increase market volatility, leading to a 'flight-to-quality' regarding US Treasuries".

Impact of the bank stress on Fed policy and US Treasuries

We believe the impact of banking stress **has probably led to a lower terminal fed funds rate**. During the March press conference, Chair Powell noted that recent tightening in credit conditions is equivalent to 25-50bp of Fed rate hikes. Before the collapse of SVB, the market implied terminal fed funds rate hit around 5.75% on 7 March. Regarding the d**emand for US government bonds**, if we continue to see stresses in the US banking system leading to some contagion, it is likely to inject additional volatility in US and global financial markets. In this scenario, we would expect US Treasuries to rally on a flight-to-quality. This has been the trend since the collapse of SVB, as we have seen rallies in US 2Y and 10Y Treasuries, with sharp falls in yields.

May FOMC meeting review: Delicately moving to a conditional pause

"The FOMC hiked the fed funds rate by 25bp, but dropped guidance for future rate hikes".

Key takeaways

- Fed hiked by 25bp, taking the fed funds rate to 5.00-5.25%.
- FOMC dropped guidance for further rate hikes, but did not close the door entirely.
- Press conference: Powell retained a hawkish tone, with a focus on inflation remaining too high and the need to keep monetary policy restrictive for some time.

The Federal Reserve hiked the fed funds rate by 25bp, to a range of 5.00-5.25%, a level not seen since 2006. The rate hike was widely expected. Moving into this month's Federal Open Market Committee (FOMC) meeting, the biggest anticipation was not the rate hike but the forward guidance. The Fed did not disappoint, as it dropped guidance for further rate hikes but retained the possibility of another rate hike depending on the evolution of inflation and economic data. During the press conference, Chair Powell toed a hawkish line that the Fed is far away from hitting its inflation target. Post the meeting, equity markets sold off, as investors viewed the Fed as not being in a hurry to ease monetary policy.

FOMC statement: One significant change

There was not any material change to the Fed's economic assessment, where it continued to see economic activity expanding at a modest pace with robust job gains. While expecting the US banking system to be sound and resilient, the Fed continues to anticipate that tighter credit conditions for households and businesses should weigh on growth, hiring and inflation. Significantly, there was an important change to the forward guidance. **The change in the language from "additional policy firming may be appropriate" to "determining the extent to which additional policy firming may be appropriate"** suggest the Fed is setting the table for a conditional pause in monetary policy. This will continue to leave the Fed data-dependent.

"We advise caution regarding any near-term course reversal by the Fed since the incoming inflation and economic data are not likely to support rate cuts".

Press conference: Mildly hawkish tone

Chair Powell struck a slightly hawkish tone during his press conference. He reiterated that the process of getting inflation back to the 2% target has a long way to go. Powell went further, stating that the FOMC's inflation outlook does not support rate cuts, pushing back on market expectations of modest rate cuts by year-end. He noted that the drop of some additional firming was "meaningful", but that the Fed will make any determination regarding another hike on a meeting-by-meeting basis and based on the implications for the outlook for economic activity and inflation. **The Fed chair addressed concerns about the banking system, stating that conditions have broadly improved since early March and he re-emphasised that Fed focus will now be on credit tightening.** He referenced that the upcoming Senior Loan Officer Opinion Survey (SLOOS) to be released on 8 May was broadly consistent with other data. He also singled out that mid-sized banks tightened conditions further. Finally, Chair Powell said the Fed needed a few months of data to determine if monetary policy is sufficiently restrictive and continued to reiterate the importance of lifting the debt ceiling several times during the press conference.

Market reaction and investment implications

Initially, there was little market reaction to the statement, but as the press conference ended, there was a sell-off in financial markets. Powell's emphatic pushback on the near-term prospects of a rate cut was the catalyst for the weaker asset price performance. Following the press conference, equity markets declined, with falls in the Dow, S&P 500 and NASDAQ.

While the financial markets may become excited about the prospect of the Fed moving to or near a pause, we would advise caution regarding any near-term course reversal by the Fed since the incoming inflation and economic data are not likely to support rate cuts. Following Treasury Secretary Yellen's announcement that the x-date, when the US government runs out of funds, could come in early June, market attention will also turn to the prospects of a government default. **As a result, we expect to see more volatility in financial markets in the coming month**.

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Definitions

- **Basis points (bp):** One basis point is a unit of measure equal to one one-hundredth of one percentage point (0.01%).
- **Monetary policy reaction function:** A function that gives the value of a monetary policy tool that a central bank chooses, or is recommended to choose, in response to some indicator of economic conditions
- **Quantitative tightening (QT):** QT is a contractionary monetary policy aimed to decrease the liquidity in the economy. It means that a CB reduces the pace of reinvestment of proceeds from maturing government bonds. It also means that the CB may increase interest rates as a tool to curb money supply.
- **Volatility:** A statistical measure of the dispersion of returns for a given security or market index. Usually, the higher the volatility, the riskier the security/market.

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Chief editors

Monica DEFEND
Head of Amundi Institute

Vincent MORTIER
Group Chief Investment Officer

Matteo GERMANO
Deputy Group Chief Investment Officer