Confidence must be earned

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INVESTMENT TALKS

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

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"Regional bank stocks have been affected more by investor concerns around deposits".

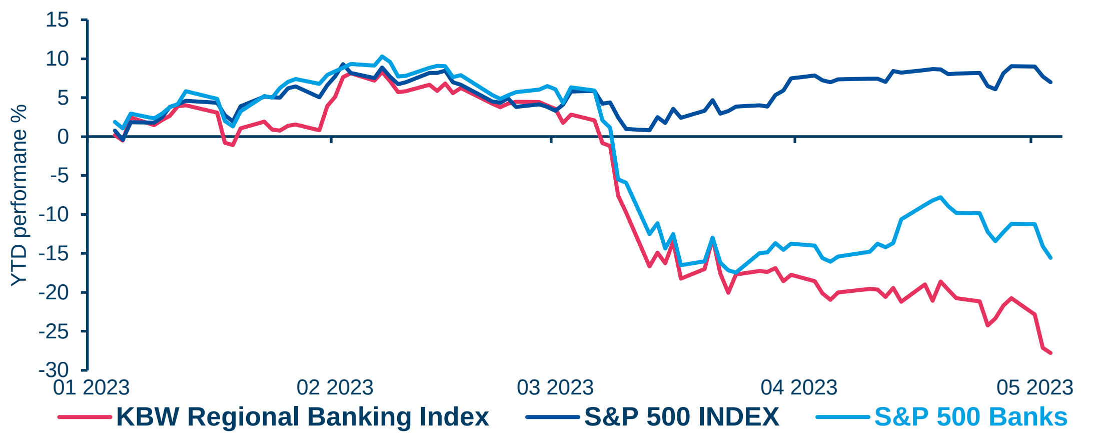
US banking sector in brief

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. **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.

Regional banks performance

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.

Figure 1: US bank stocks slump



Source: Amundi, Bloomberg at 3 May 2023.

Impact of the regional bank turmoil 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**.
- **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.**

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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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