Lockwood Investment Insights

Insights Brief: Six Things We're Watching in the Markets

MARCH 2023

1. Continued market volatility from bank stocks

The banking system runs on trust. Americans have become more concerned about the security of their deposits. Some depositors have decided to switch banks because of the relatively low cost for depositors to change their banking institution.

Regulators have acted swiftly to contain the risk to a small number of banks. Regulators are focused on preventing liquidity issues from turning into solvency issues and preventing runs on additional banks. Likely they need to do more to bolster confidence in the banking sector. Continued market volatility in bank stocks, particularly those seen as vulnerable to viability concerns, could signal that the concern has not yet abated.

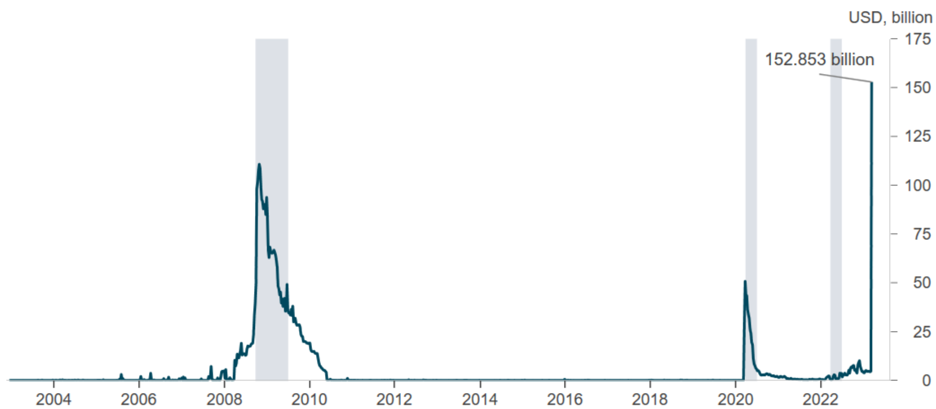
2. Heightened use of new Federal Reserve lending facility and other tools

The Federal Reserve has created an additional Bank Term Lending Facility (BLTP). It has also bolstered the swap lines for dollar liquidity with foreign central banks. These are clear signs of financial concern.

Borrowing at the Fed's discount window soared to record levels, $153 billion, representing a greater value than during the Great Financial Crisis in 2008-09. The new bank facility was already tapped for $12 billion during the first week of its existence. The Federal Home Loan Bank (FHLB) system, another venue for banks to seek emergency funding, issued $304 billion, as banks bolster liquidity. Demand for liquidity of this magnitude heightens concerns about the size of the problem.

Federal Lending to Banks Eclipsed 2008 Financial Crisis Peak

Assets: Liquidity and Credit Facilities: Loans, Primary Credit



Source: Lockwood, Macrobond, Federal Reserve; Frequency weekly, as of Wednesday, March 15, 2023; Gray band indicates recession

3. Questions About FDIC deposit limits

Given recent events, it's possible the Federal Deposit Insurance Corporation (FDIC) could look at raising the limit on deposits. It's also possible that stricter regulatory measures could be imposed on banks, particularly smaller banks. We could see larger regulatory capital cushions, and banks themselves may tighten credit conditions for borrowers.

This combination could mean a lower rate of return (ROE) for bank stocks. It also probably portends slower economic growth.

4. Dissenting voices on the March 22 FOMC Meeting

The Federal Reserve Open Market Committee (FOMC) met on March 22 and raised the overnight policy rate 0.25% to a range of 4.75% - 5.00%. Because of the events over the past few weeks, financial conditions will tighten on their own, without any effort on the Fed.

This bank crisis makes the Federal Reserve's job more difficult, as increases in interest rates could compound issues at other banks. The Federal Reserve has intended to tighten financial conditions but is now seeing deleterious effects of those tightening moves. On the other hand, if the Federal Reserve backs off the tightening plan, it could be perceived as signaling the bank crisis is worse than the market currently believes. It's likely the Federal Reserve will seek to separate and compartmentalize fighting inflation versus fixing market liquidity concerns.

5. Credit spreads in areas sensitive to smaller and medium-sized bank lending

Remember, 2022 was by far the worst year ever for bonds. We're watching to see if sectors that are sensitive to small- and medium-sized bank lending show signs of stress, particularly if there are regulatory moves to tighten credit and constrain capital. Credit spread widening in ABS (asset-backed securities), commercial and industrial loans, commercial and residential real estate and other sectors could show stress and tightening credit conditions.

6. Resolution of the federal budget impasse

We will have some political noise to sort out during 2023. Expect the battle over the federal budget to heat up over the summer. A lot is at stake if Congress pushes the budget battle to the last minute. Markets have been vulnerable historically to budget brinksmanship from the Congress.

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Sources: Lockwood Advisors, Inc., Macrobond, Federal Reserve, Board of Governors of the Federal Reserve System.

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