



One Foot on the Brake and One on the Gas

My views on the economic and market implications
of the banking turmoil.

March 2023

Given the speed of events, trying to summarize the impact of the turmoil in the banking sector is like trying to hit the proverbial moving target. (Let's not yet call it a banking crisis. More on that below.)

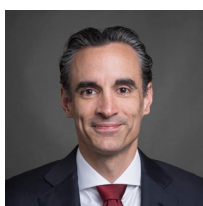
But one thing seems clear: This is another headwind the economy faces—and one more reason I'm comfortable in our Asset Allocation Committee remaining underweight in stocks relative to bonds and cash.

Tightened Financial Conditions

There are two issues small and medium-sized banks face. On the asset side, they are facing losses on longer-duration Treasuries and loans. On the liability side, wealthy individuals and companies are asking for their deposits back.

Because of the reduced value of their assets, these banks will be more reluctant to lend—they can't afford more losses. They'll also be more conservative in how they invest. This means financial conditions will tighten.

The Bloomberg United States Financial Conditions Index indicates that financial



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conditions have already moved to their tightest level since the onset of the pandemic.¹ And it could get worse. I keep thinking of that grim Wall Street adage (presumably dating from before the widespread use of seat belts): "When the Fed slams the brakes, someone's head goes through the windshield."

It's difficult to know if more heads will follow. We haven't borne the brunt of the full effects of the 475 basis points (bps) in rate hikes the Fed has made since last March,² and several signs suggest that the Fed has already slowed the economy considerably:

- Indexes of global economic activity have contracted sharply.
- Leading economic indicators are flashing red.

“...several signs suggest that the Fed has already slowed the economy considerably....”

¹ As of March 20, 2023. Source: Bloomberg® and Bloomberg United States Financial Conditions Index are service marks of Bloomberg Finance L.P. and its affiliates, including Bloomberg Index Services Limited ("BISL"), the administrator of the index (collectively, "Bloomberg") and have been licensed for use for certain purposes by T. Rowe Price. Bloomberg is not affiliated with T. Rowe Price, and Bloomberg does not approve, endorse, review, or recommend this product. Bloomberg does not guarantee the timeliness, accurateness, or completeness of any data or information relating to this product.

² As of March 22, 2023. Source: Board of Governors of the Federal Reserve System (U.S.). A basis point is 0.01 percentage point.

“...it may keep one foot on the brake pedal (through rate hikes) even as it taps the accelerator by providing liquidity....”

- We estimate that house prices could fall as much as 10%.
- The yield curve (the 10-year Treasury yield minus the two-year yield) is inverted by 60 bps.³ (Inversions aren't perfect harbingers of recession, but that's a formidable one.)

Wall Street Seems Complacent

Meanwhile, at around 18 times future earnings, stocks in the S&P 500 Index are about as expensive as they've been on average over the past decade, while consensus estimates are that overall earnings for the index will increase (if just a bit) this year.⁴

To be sure, financial strains mean a more dovish Fed, all things considered. Reduced liquidity and slowed growth in the wake of the banking stresses will do some of the work in cooling inflation that otherwise would be done by rate hikes. It's often overlooked that the Fed has a third mandate—financial stability—alongside the two commonly cited ones: nurturing full employment and controlling inflation.

Targeted Measures Mean Two Feet on the Pedals

But that doesn't mean that the Fed will necessarily begin lowering or even stop raising rates from here. In other words, it may keep one foot on the brake pedal (through rate hikes) even as it taps the accelerator by providing liquidity (or bailouts, if you want to use a dirty word) to the banking system.

It's likely that policymakers will follow their European counterparts in using targeted measures to ease further signs of stress as they appear. For example, the European Central Bank kept on its

planned path of rate hikes last summer but communicated a backstop to stressed Italian sovereign debt. Several months later, the Bank of England kept raising rates even as it headed off a crisis in its pension system by buying the government's long-term bonds (gilts).

A Black Duck, Not a Black Swan: A Financial Crisis Seems Unlikely

It's unlikely that we face a systemic meltdown, such as the banking crisis that began in 2008. I see several key differences:

- We're not currently in a recession. The economy had been in one for nine months before the collapse of Lehman Brothers in September 2008. We're currently near full employment, and families and businesses are still sitting on ample cash—if not quite as much as before.
- Banks are better regulated and better capitalized than they were in 2008, with more cash on hand and stronger capital ratios.
- There's much less speculation on bad housing loans with derivatives layered on top of them. In fact, mortgage delinquencies are near historical lows.
- This time, banks are dealing with mostly paper losses due to Fed tightening. Silicon Valley Bank was investing heavily in U.S. Treasuries—albeit with a massive interest rate risk (duration) mismatch. It's easier to reverse rates and remove the balance sheet pressure this time around, while in 2008 banks were dealing with irreversible credit losses.
- Following the banking reforms of 2010, there's much more

³ As of March 21, 2023. Source: Bloomberg Finance, L.P.

⁴ As of March 21, 2023. Sources: FactSet financial data and analytics: factset.com; the S&P 500 Index is a product of S&P Dow Jones Indices LLC, a division of S&P Global, or its affiliates (“SPDJ”), and has been licensed for use by T. Rowe Price. Standard & Poor's® and S&P® are registered trademarks of Standard & Poor's Financial Services LLC, a division of S&P Global (“S&P”); Dow Jones® is a registered trademark of Dow Jones Trademark Holdings LLC (“Dow Jones”). This product is not sponsored, endorsed, sold, or promoted by SPDJI, Dow Jones, S&P, or their respective affiliates, and none of such parties make any representation regarding the advisability of investing in such product(s) nor do they have any liability for any errors, omissions, or interruptions of the indices.

transparency and much less speculation in unregulated and complex areas of financial markets.*

A colleague of mine is calling this a “black duck” event, in contrast to the “black swan” of 2008.** Black ducks are more common than black swans—you see them around occasionally and don’t bother pulling out your camera.

In other words, don’t panic, but consider lowering your growth and earnings expectations.

*Of course, recent events revealed gaps in that regulation, especially that banks with

less than USD 250 billion in assets aren’t subject to the same stress tests as those above that threshold. Ultimately, this is expected to lead to increased regulation on banks, which will squeeze their margins considerably, so I think bank earnings will remain challenged despite the sell-off. That said, we are seeing opportunities in some areas of financials that have sold off in sympathy, such as insurance.

**Credit to Dave Eiswert, Portfolio Manager of the Global Focused Growth Equity Strategy, for the analogy.

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