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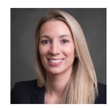
A More Turbulent Path for the Fed

April 2023

Asset Allocation Insights

KEY INSIGHTS

- The Federal Reserve faces a delicate balance as it tries to maintain financial stability while fighting high inflation and trying to navigate a soft landing.
- In our view, broader equity markets do not fully reflect the potential for a more significant downturn in economic growth and earnings later in the year.



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Both the banking industry and the capital markets have gone through a tumultuous period since the Silicon Valley Bank (SVB) collapsed on March 10, 2023. Smaller regional banks, in particular, have borne the brunt of the sell-off as fears of contagion caused a flight of deposits into larger banks and money market funds (Figure 1). However, there does not appear to be a systemic threat to the entire banking industry.

Before the SVB collapse, financial markets anticipated that the U.S. Federal Reserve (Fed) would raise its target federal funds rate by 50 basis points (bps)[1] following hotter-than-expected inflation data in January and February. However, in an effort to combat inflation amid uncertain risks in the banking industry, the Fed announced a 25 bps increase on March 22, 2023—an apparent compromise between a 50 bps hike and no move at all.

Regional Banks Have Sold Off Steeply

(Fig. 1) KBW Regional Banking Index

March 31, 2022, to March 27, 2023.
Past performance is not a reliable indicator of future performance.
Source: Bloomberg Finance L.P.

[1] A basis point is 0.01 percentage point.

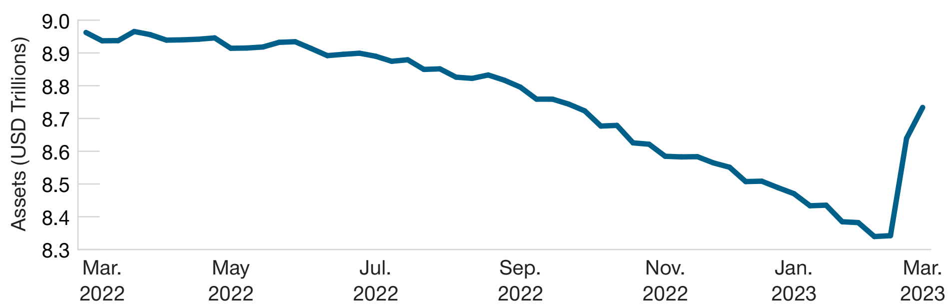
The Fed also swiftly launched a new emergency lending facility, the Bank Term Funding Program. In exchange for qualifying assets, the program helps banks shore up their balance sheets and also provides access to liquidity in case of potential runs on deposits. While this expansion in the Fed's balance sheet has occurred during a period of tightening monetary policy, it is expected to be temporary as the Fed seeks to maintain financial stability while fighting inflation and trying to navigate a soft landing (Figure 2).

Even though it has slowed the pace of rate hikes, the Fed remains dependent on incoming data and has acknowledged that interest rates may need to go higher and stay higher for a prolonged period, which is a headwind for the economy. The aftereffects of the banking crisis also could be problematic as risk-conscious banks tighten lending standards to preserve liquidity.

In our view, broader equity markets do not fully reflect the prospects for a more significant downturn in economic growth and earnings in the back half of 2023. As a result, the T. Rowe Price Asset Allocation Committee remains cautious and underweight to equities.

Fed's Balance Sheet Expansion Is Expected to be Temporary

(Fig. 2) Federal Reserve Assets



March 31, 2022, to March 31, 2023.
Source: Bloomberg Finance L.P.

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