173 – 20 March 2023

Testing the Separation Principle

- We think the drastic downward revision in central banks' terminal rate is overdone.
- The current banking turmoil could trigger a steep deterioration in activity, but at this stage, some circuit breakers can still help.

Markets reacted to the continuation of the banking turmoil last week by drastically revising down their expectations for the Fed and the ECB's policy rate, expressing their scepticism at the possibility that central banks could respond to the financial stability issues with liquidity measures alone, without altering their policy stance. While we agree that more prudence is warranted in the pace of tightening – we think that in the case of the ECB resorting to 25bps hikes rather than the recent increments of 50bps should be way forward - central banks are likely to balance the already tangible signals that inflation is taking too much time to decelerate with the mere possibility that the banking stress triggers a steep deterioration in economic activity and hence dampens inflationary pressure.

We don't want to downplay the importance of what's going on. In the US, deposit migration from smaller to larger banks would not be neutral from a macroeconomic point of view. Small banks exhibit in general a much higher loan to deposit ratio than their larger competitors, and they play a crucial role in a sector – real estate – which is already under significant pressure. Higher banks' funding costs – if the risk premium drifts higher – would be another transmission channel (we find a quite tight correlation between banks' refinancing gaps and their lending standards to firms). Yet, some circuit-breakers exist. In aggregate terms, small banks in the US have comparatively less interest-rate sensitive securities on their balance sheet than their larger counterparts (this was a specific issue for SVB). The solution for Credit Suisse found with UBS (and the decisive support from the Swiss government and central bank) implies a write-down of the AT1s, but bonds higher up the seniority ladder seem to be protected.

Confidence always plays a major role in banking crises. In the 1980s, it took years to finally deal with the Savings and Loans saga (which bears some resemblance with the current US predicament). This time, public authorities are clearly intent on acting big and fast.

Can you pull the brakes and accelerate at the same time?

As the banking turmoil failed to abate last week, the market as of Friday was expecting the Federal Reserve (Fed) to pause, reversing its recent view that the terminal rate would reach 5.5%, and rate cut bets for the second half of the year have reappeared (see Exhibit 1). While no cuts were priced for the European Central Bank (ECB), the terminal rate has been significantly revised down, with less than one additional 25bps hike now expected after last week's 50bps move (see Exhibit 2). In a nutshell, **investors do not seem to believe in the separation principle**, according to which a central bank can deal with a financial stability issue – usually by extending liquidity – without changing its monetary policy stance. Beyond the policy rate issue, we have read quite a few comments on the apparent contradiction between continuing quantitative tightening (QT) and the resumption of significant growth in the Fed's balance sheet on account of the rush by cash-hungry banks to the discount window and – to a lesser extent – the new term lending facility created by the Fed last week. We think this approach neglects the fact that **not every dollar of a central bank's balance sheet has the same macroeconomic effect.**

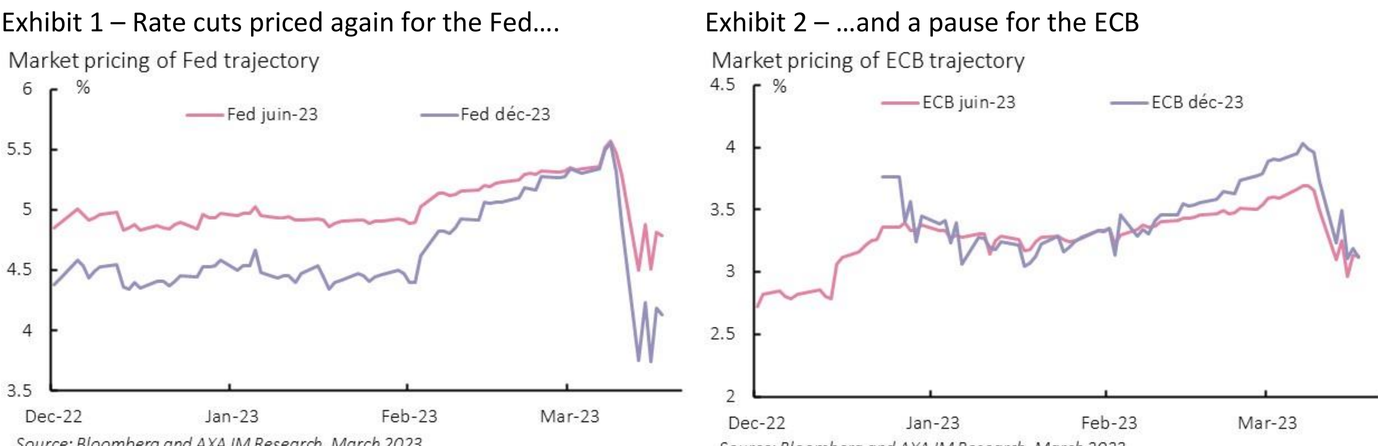


Exhibit 1 – Rate cuts priced again for the Fed….

Source: Bloomberg and AXA IM Research, March 2023

Exhibit 2 – …and a pause for the ECB

Source: Bloomberg and AXA IM Research, March 2023

Indeed, QT is there to reverse the impact of Quantitative Easing (QE), i.e., a deliberate attempt by central banks to affect interest rates across the entire yield curve to boost the economy when deflation was the main risk. The liquidity created in the banking industry was a by-product of the instrument, not its main purpose, even if it could magnify the direct effect on long-term rates. Conversely, when a central bank injects liquidity to help deal with a deposit flight, it's highly likely that the additional central cash is going to be hoarded by the receiving banks on their account at the central bank, rather than circulating through the economy and funding credit origination. If market interest rates fall in such an episode, it's not so much because liquidity flows to the bond market, but quite simply because stress triggers a flight to quality. There is no direct causality.

This is why in principle a central bank can at the same time extend liquidity – and consequently let its balance sheet rise again – while tightening monetary policy, if it considers that there is still too much upside risk to inflation. **The limit of this separation principle obviously lies in the fact that down the line, persistent stress in banks can affect growth and inflation to the point that monetary policy needs to be recalibrated.** That's the question every central banker must ponder right now.

The ECB was chronologically the first to be forced to deal with the issue last week, and we think it has done a great job at balancing its action and message. Forward guidance is the proverbial seven-lives cat of monetary policy. These last few months, while the ECB was pledging it had become data dependent, it was also routinely announcing in its official communication that it intended to continue hiking, often with a very high degree of precision on the quantum of such hikes. This time however, we have moved into an elusive new configuration, something we would call "ultra-conditional forward guidance". In the prepared policy statement, the ECB refrained from directly committing on the future path of

monetary policy, merely listing the inputs which would drive its decision-making (something very close to Philip Lane's tryptic we discussed last week). However, **in the Q&A, Christine Lagarde made it plain that were the ECB's baseline for inflation and growth to materialise, then more hikes would be warranted**. At the same time, she insisted on the high level of uncertainty surrounding its baseline – its latest forecasts – which did not incorporate the ongoing banking stress. So, in a nutshell, **the ECB "would rather hike" but is not sure it should** in case a spontaneous tightening in financial conditions makes further policy moves redundant.

Our contention is that, as things stand today, the ECB is still more likely than not to continue hiking, and we thus disagree with the current market pricing. The situation is very confusing of course, but our reasoning is simple: **the fact that inflationary pressure is not abating fast enough is *certain*, while we don't know yet *if* the current banking stress will have some persistent effects on the real economy, and hence on inflation**. For us, it's thus a question of balance of risks and credibility for central banks. We don't think they can afford to be seen as neglecting their key mission – bringing inflation back to 2% - by altering their policy stance while they can contribute to dealing with the current financial stability issues with "policy neutral" liquidity injections – including in a concerted manner just like what has been announced on Sunday night by reactivating dollar swap lines between the Fed and the other major central banks.

What however we think has changed is that the central banks need to be more prudent in their tightening pace, because a new source of uncertainty has been added and the probability that we will reach a point in the next few months at which so far resilient economies "snap" is now materially higher. **This should be consistent with hiking by increments of 25 basis points rather than continuing with 50 as the ECB hawks wanted**. Our level of confidence is of course low given the speed at which new developments need to be considered, but we would see the terminal rate at 3.75%, with three 25bps hikes. In the meantime, should the banking turmoil persist, we would see it as likely that the ECB would re-start some medium-term liquidity provision facilities to deal with any disruption in the readiness of banks to transact between each other.

The Fed is now on the frontline this week. In principle, it would appear to be in a somewhat more comfortable position than the ECB if it chose to alter its course. Core inflation is decelerating, even if it's a slower process than what the Fed would want to see, and the policy rate is further into restrictive territory than in the Euro area. Arguably, the epicentre of the banking stress is in the US, even if the focus of the news flow moved to Credit Suisse at the end of last week. **Yet, we think the Fed would suffer a significant dent to its credibility if it chose to pause this week before it gets clear that the liquidity and various government support measures have failed to address the current turmoil and the economy gets hit**. We thus still expect the Fed to hike – by 25bps – this week. Of course, the "dot plot" will be difficult to manage given the added uncertainty. We – and everyone else – were expecting before the Silicon Valley Bank (SVB) issue emerged an upward revision of the terminal rate in the "dot plot" from 5.1% to 5.5% given the persistence in inflation. A likely "compromise solution" would be for the dot plot to duly point to 5.5%, but with many qualifiers from Powell, who could emulate Lagarde last week on stressing "data dependence" in the coming months.

We don't want to downplay the importance of what is going on right now in the banking industry in the United States (US) and Europe. In the next sections we explore how the current turmoil could very easily turn into a significant macroeconomic issue, forcing a recalibration of monetary policy, but our point is that it is not obvious that the "point of no return" has been reached.

Are we back in the 1980s?

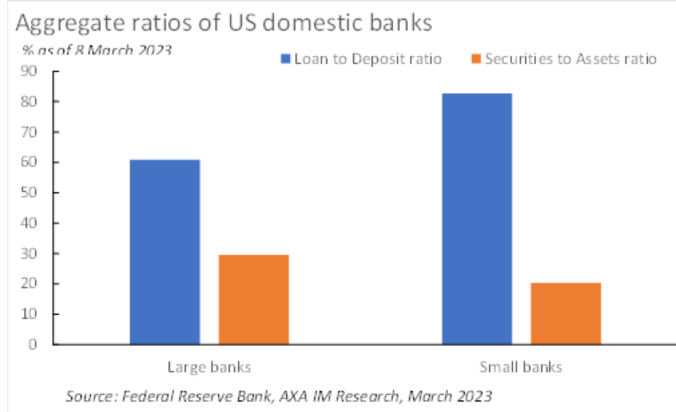
Excessive pattern recognition, i.e., a readiness to derive all-encompassing, and ultimately misleading models from just a few observations, is a common affliction among economists. So it might be that it's your humble servant's enthusiasm about the release of a new album by Depeche Mode which makes him keen to believe the 1980s are back. Still, 1989 may well be a better reference point than 2008 to understand the current banking turmoil, at least in the US.

It's probably unavoidable that the ongoing market stress around banks triggers some unpleasant memories of the Great Financial Crisis. The differences however abound. In 2008 the original issue was that a very trendy asset – subprime mortgages – which had become pervasive across the financial system, was suddenly recognized to be worth next to nothing, raising the risk that some institutions would become insolvent given the absence of meaningful cover since bank capital was ridiculously small at the time. All banking crises share similarities, in particular a steep decline in the readiness of banks to transact with one another, as long as risks are not identified, which forces the central bank to step in with a massive liquidity injection to offset the paralysis of the interbank market. Yet, the root cause of the current banking stress cannot be traced back to the mis-valuation of a financial asset, but to concerns over asset/liability management (ALM) and sectoral concentration in some regional banks, driving deposits away towards larger institutions.

This is why the Savings and Loans (S&L) crisis of the 1980s offers a more interesting historical precedent. Indeed, S&L banks were squeezed between a fall in the value of generally unhedged fixed-rate long-term assets (mortgages and government securities) as the Fed decided to put an end to rampant inflation in 1980, and growing competition for deposits amid de-regulation. Think of it as a giant Silicon Valley Bank. Successive US administrations chose forbearance, loosening capital standards and allowing "zombie" S&Ls to continue operating – most often by taking more and more risk to try to offset their losses on more traditional assets. Ultimately, it's the administration of George Bush senior who tackled the issue, setting up in 1989 a resolution trust which combined federally funded bailouts with the closure of hundreds of the surviving S&Ls. He probably sealed his political fate by doing so: the resolution of the S&Ls triggered a steep slowdown in housing activity – given their crucial role in mortgage origination at the time – which contributed to the recession of 1990 (even if the steep rise in oil prices in connection to the first gulf war was the immediate trigger).

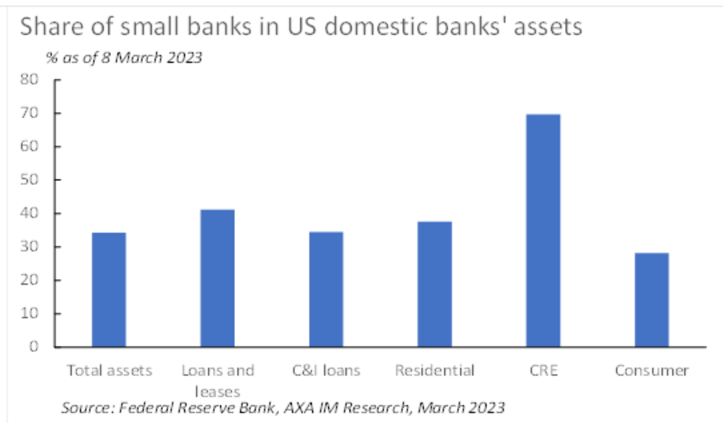
The Fed data framework is not designed to isolate the role of regional banks. Its standard presentation of the aggregate assets and liabilities of the banking industry distinguishes "large" and "small" domestically chartered banks, but the first group is made of the top 25 by asset size. SVB was part of it, ranking 16th in December 2022, and one of the institutions currently under massive pressure, First Republic, is even larger (ranking 14th). Still, we can look at the specificities of the small banks as a first foray into the likely macroeconomic transmission mechanisms from a "flight to size" of US deposits which has already started. In principle, if large banks' overall loan to deposit ratio (LDR) is not too different from the one observed in smaller banks, aggregate credit flows should not be massively affected. Unfortunately**, there is a significant difference in LDR between large banks (59.3%) and small ones (80.1%)**, as can be seen in Exhibit 1.

Exhibit 3 – Small banks' LDR is high



Source: Federal Reserve Bank, AXA IM Research, March 2023

Exhibit 4 – Small banks crucial for commercial real estate



Source: Federal Reserve Bank, AXA IM Research, March 2023

It is thus not straightforward that the deposit migration would be neutral in terms of aggregate credit origination, unless large banks change their business model drastically. Each 1bn dollars of deposits moving from small to large banks would result in USD0.2bn less credit originated to the economy if the LDR does not change. The recent trends do not point to this. Between the end of December 2022 and the week ending on 8 March (latest available data from the Fed), large banks moderated their supply of loans to the economy (+0.6%), creating slack which has been taken up by the smaller ones, which have raised their own supply by 1.6%. If this substitution is now impaired by the deposit migration, the slowdown in aggregate credit origination could be severe.

In addition, the sectorial allocation of loans tends to be idiosyncratic. Indeed, small banks account for a disproportionately high share of commercial real estate (CRE) development loans (see Exhibit 2). **While they account for only 33% of total domestic bank assets, they hold 69% of the existing stock of CRE in the US**. **Their role in mortgages is also a bit higher than what their overall size would suggest** (37%), while their share of consumer credit is comparatively small (28.3%). Again, the developments since the end of last year are quite telling. Between the end of December and the week ending on 8 March, large banks raised their CRE lending by only 0.3% while it rose by 2.5% for small banks. A similar divergence can be seen on residential mortgages (+0.8% versus +2.1%). This points to some consequences of the "deposit migration" from smaller to larger institutions beyond the general effect of differences in the loan to deposit ratio. Real estate has already been the first victim of the US monetary tightening. The continuation of deposit flights away from regional banks could exacerbate this.

Now, partly because of the S&L crisis, asset/liability management has made progress in 40 years, and even if "non-systemic" credit institutions were allowed to fly below the radar, there is no glaring aggregate evidence at this stage that the woes of SVB reflect a generalized ALM problem across smaller banks. **SVB's problem was due to the combination of a concentrated – and intrinsically unstable – deposit base and a very large share of its assets in securities affected by the rise in interest rates, 58% before the crisis, a very unusual ratio. Small banks in general tend to be less exposed to this risk than their bigger competitors**, as securities stand for only 20.4% of their total assets, against 29.6% for the big ones. Of course, we would need more information around hedging strategies and how this exposure can be broken down between the "available for sale" and "banking book" buckets, but at least from a sheer magnitude point of view, SVB's asset-side problem looks idiosyncratic.

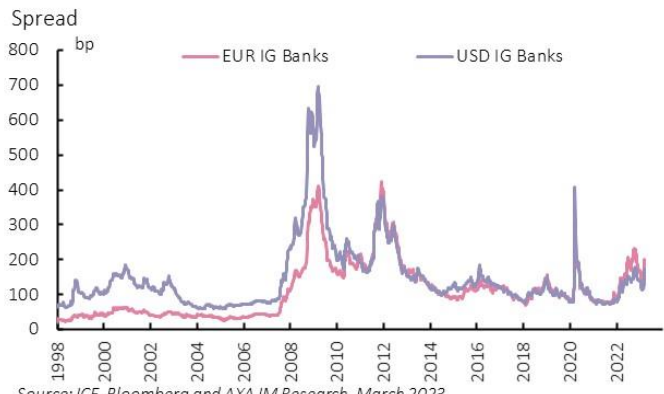
The issue of course is that **this does not protect the banks from a continuation of deposit flight if confidence continues to be shaken**. Ultimately, this is the key transmission channel. Last week, we considered that the Fed, the Treasury, and the Federal Deposit Insurance Corporation (FDIC) had engaged in forceful action. Guaranteeing the entirety of SVB's deposits was a strong confidence booster in our opinion, as well as the creation of a new, "loose conditions" term refinancing capacity. The battleground has now shifted to First Republic. **If a "line in the sand" can be drawn and deposits stabilize, then the macroeconomic ramifications of this crisis – transiting through credit origination – could be limited.**

The banks' funding channel

The European problem is intrinsically different from the US. The Credit Suisse (CS) issue was not new - its business model has been under pressure for years – nor particularly affected by the rise in interest rates – odds are it would be in similar trouble irrespective of monetary conditions. But given the size of CS, contagion is the issue, with the risk of having as often during banking crises a shutdown in interbank lending. Finding a solution quickly to CS was paramount, and this is what was achieved on Sunday, with the takeover by UBS, with central bank and government support. **One key variable to follow in our opinion is going to be the funding costs of banks in the days and weeks ahead**. Indeed, the UBS solution implies a write-down of a specific segment of CS' financial liabilities, CHF16bn of AT1 (Additional Tier 1 bonds) but leaving more senior bonds untouched. We will have to monitor in the coming days and weeks how banks' refinancing costs react to this solution, which at first glance looks rather supportive (moving higher across bond seniority to bail-in more deeply would have been very painful).

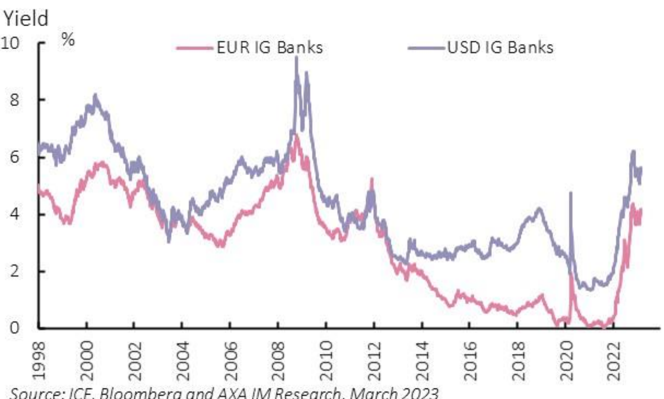
The risk premium attached to funding banks in general has risen over the last few months but remains much lower than on the onset of the Great Financial Crisis (GFC) when compared with risk-free interest rates (see Exhibit 5) in both the US and the Euro area (with the latest data from Thursday's close). True, it also makes sense to look at the absolute level of yields. The rise has been very steep over the last few months, and on average Euro area pay more than 4% for their bonds and their US counterparts 6% (see Exhibit 6). Now, this was "part and parcel" of the central bank tightening. This is precisely what they wanted to engineer, as one of the key transmission channels of monetary policy. What will be crucial is whether the current market turmoil triggers such a significant *additional* rise in the banks' funding costs that monetary policy transmission gets in overdrive and delivers a deeper-than-necessary contraction in activity.

Exhibit 5 – Banks' risk premium still under control



Source: ICE, Bloomberg and AXA IM Research, March 2023

Exhibit 6 – even if absolute yields are high



Source: ICE, Bloomberg and AXA IM Research, March 2023

Habitual readers of Macrocast know that we've been concerned for some months now by the tightening in banks' lending standards and the decline in the credit impulse. Quite often, banks tighten their lending standards because their assessment of borrowers' riskiness deteriorates. But it can also simply reflect the banks' own financial difficulties. In Exhibits 7 and 8 we look at the balance of opinion on lending standards to corporates together with the banks' refinancing gap (i.e., the difference in the interest rate they pay on new debt relative to expiring coupons). The relationship has been historically tight, even if in Europe there seems to be at the moment a more subdued than usual response to the rise in refinancing costs. This a key concern for us: that the ongoing banking stress triggers a further decline in the supply of loans to the economy.

Exhibit 7 – Funding costs and credit standards in Europe

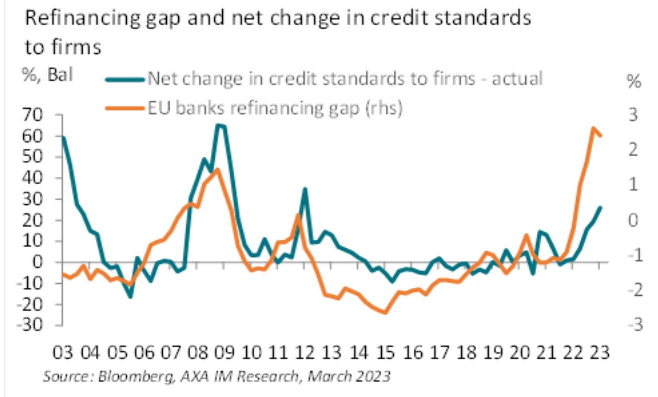
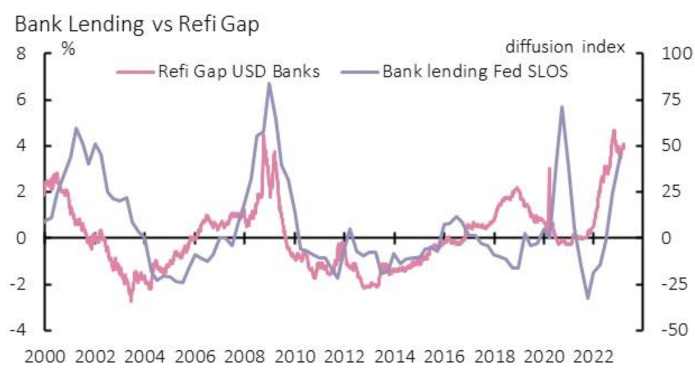


Exhibit 8 – …And in the US



Source: Fed, ECB, ICE, Bloomberg and AXA IM Research, March 2023

As a provisional conclusion – we suspect we will get back to these issues quite often in the coming weeks and months - there are of course plenty pf reasons to be concerned about the spill over from the current banking turmoil to the real economy. There is however still time to mitigate much of it, and the response from central banks – on the liquidity side - and governments has so far been swift. More prudence in the pace of the ongoing monetary policy tightening is probably warranted, but for us, for a pause to materialise, central banks would need to be convinced banking stress has not been ring-fenced. It's going to be a choppy ride, but to some extent, a reduction in credit origination possibly is one unavoidable step to get inflation properly landing. This may trigger a recession, but since the beginning of the tightening phase we've been arguing that, yes, in general, policy tightenings end up with a recession.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• Market reactions to Fed authorities interventions in banking system, combined bank assistance for First Republic, and broader Credit Suisse developments • CPI inflation (Feb) as expected with headline slowing to 6.0%yoy, but core stickier at just 5.5% from 5.6 • Empire & Philly Fed surveys (Mar) both disappointed and now at levels only lower during recessions • Retail sales (Feb) -0.4%mom - little pull back from Jan • Housing starts (Feb) up robust 9.8%mom	• FOMC meeting (Mar). We expect 0.25% hike, which is still consensus. Difficult 'dot plot' given new financial stability worries, likely stays at 5.50% peak • Home sales (Feb) to see if housing market through the worst following increase in mortgage apps • Jobless claims – direction of trend following volatile couple of weeks • Durable goods orders (Feb) signs of investment • PMIs (Mar, prel) to see if improvement persists
	• Financial turmoil in the US and around Credit Suisse have not caused the ECB to deviate on its path of raising interest rate (+50bps). We now anticipate +25bps hike in May, Jun and Jul. • EMU IP (exc. Ireland) was flat in Jan at +0.1%mom • Final HICP was unchanged at 8.5% and 5.6%yoy in Feb	• Flash PMIs in euro area, Ge and Fr (Mar). Ge indices should improve but Fr indices are likely to be mixed (slightly better for Mfg but declining in Svcs) • Ge PPI (Feb) is expected to decline further due to energy prices but details on goods matter more • ZEW surveys (Mar) should fall after recent stress in banking sector
	• Spring Budget: Firmer growth and fall in energy costs improved fiscal outlook. CX used fiscal windfall to increase spending by £20bn for next 3 years • NHS pay deal may signal end of strikes nearing • U/rate (Jan) held at 3.7% as rise in activity offset by strong rise in jobs and wages momentum slowing	• BoE MPC meeting (Thurs) we expect +25bp but concerns of financials could see a hold • CPI inflation (Feb) – to see a further easing in core? • GfK cons conf (Feb) – scope for gradual improvement • Retail sales (Feb) should increase moderately
	• Trade data (Feb) deficit narrows to ¥897.7bn below market expectations. Exports to China remain weak • Rengo (1st rd) wages up 3.8% - tends to downward rev but upside risks to 2.5% overall shunto we had expected • Tourism recovery slowing – inbound visitors at 1.5m in Feb, flat mom (59% vs Feb 19)	• CPI inflation (Feb) similar to Tokyo CPI inflation data, we expect energy prices to make a negative contribution as gov't subsides come into effect • Summary of opinions released for Mar MPM • Tankan Mfg & non Mfg index (Mar) • Flash PMIs (Mar)
	• Jan-Feb. macro data showed strong recovery in retail sales (3.5%yoy), industrial production (2.4%) and fixed asset investments (5.5%) • PBoC kept the marginal lending facility rate (MLF) unchanged at 2.75%, and cut the reserve requirement ratios (RRR) by 25bp to 7.6% releasing RMB 500bn (effective Mar 27) and confirming its easing bias	• 1y loan prime rate (LPR) expected to remain flat at 3.65% in March, 5Y rate at 4.30%
EMERGING MARKETS	• CB: Indonesia (5.75%) & Russia (7.5%) stood on hold. Argentina hiked +300bps to 78% (inflation at 102.5%) • Feb CPI (%yoy) rose in Nigeria (21.9%), Poland (18.4%) & Romania (15.5%). It eased in India (6.4%) • Jan Ind Prod (%yoy) moderated in Colombia (0.2%) & Malaysia. It picked up in India (5.5%)	• CB: Philippines expected to hike +25bps to 6.25%. Taiwan (1.75%) & Turkey to stay on hold (8.5%) • Feb CPI: Malaysia, Singapore & South Africa • Q4 GDP: Argentina & Chile • Feb exports: Korea & Thailand • Retail sales: Mexico (Jan) & Poland (Feb)

Upcoming events		
	US:	Tue: Existing home sales (Feb); Wed: FOMC announcement; Thu: Weekly jobless claims (12-Mar), Current account (Q4), New home sales (Feb); Fri: Durable goods (Feb), Manf. & Services PMI (Mar)
	Euro Area:	Mon: Ge PPI (Feb); Tue: NEW Surveys: economic expectations & current conditions (Mar); Thu: EU20 Consumer confidence (Mar); Fri: EU20 Composite, Manf. & Services PMI (Mar), Ge/Fr Manf. & Services PMI (Mar), Sp GDP (Q4)
	UK:	Tue: SMMT car regs. (Feb), PSNB (Feb); Wed: CPI (Feb), CPIH (Feb), RPI (Feb), PPI input & output (Feb), CBI Ind. Trends survey (Mar); Thu: MPC decision; Fri: GfK consumer conf. (Mar), Retail sales (Feb), Composite, Manf. & Services PMI (Mar)
	Japan:	Thu: CPI (Feb), National 'core' CPI (Feb); Fri: Manf. & Services PMI (Mar)
	China:	Mon: Loan Prime Rate (Mar)

Our Research is available online: www.axa-im.com/investment-institute

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