On the banking chaos. Foreseeable developments. Implications for monetary policy and financial markets

Andbank Flash Note, Tuesday, 21 March 2023.

It's often said that a hasty decision tends to be a poor decision. It needed a certain amount of time to see how things would really look after the recent events involving Credit Suisse and Silicon Valley Bank. Anyone who came out with an immediate assessment, as soon as the news broke (about Credit Suisse, for example), would probably have concluded we were on the verge of a collapse. But the fact is that events of this kind tend to elicit counter-measures and interventions, so it's best to wait and see what happens, so as to make a more well founded assessment of how things are. That way we avoid wrong decisions (theirs and ours) based on overhasty assessments. Now that we have more information and a better understanding of the situation, we're going to try and make an assessment. I'm going to talk about all this banking chaos using a simile, or analogy, that Milton Friedman used, comparing a central banker to a fool in a shower, which he saw as two quite similar types.

When the fool gets into the shower, he turns the mixer to warm, but naturally the water comes out cold at first. Shivering, he moves the tap further in the hot direction, but the temperature takes time to change, so he turns the tap as far as it will go and ends up under a jet of scalding water. To stop the burning, he frantically turns the tap back in the opposite direction, as cold as possible, and ends up under a jet of icy water. This is a perfect analogy for what has happened with the banks, and it also tells us what's going to happen next (specially with the credit cycle). Like the fool in the shower, the big central banks reacted to the freezing cold of zero inflation by turning the monetary policy tap in the direction of heat. In fact, they turned it as far as it would go and put everything—absolutely everything—on the table, quantitative easing, asset purchase programmes or APPs, monetary base expansion and liquidity programmes. The result has been overheating and inflation. Nothing would happen if it weren't because inflation burns. Which brings me to my first question: Who has been more of a fool in the shower, the ECB or the Fed? The answer is simple: whoever has hotter inflation. And inflation is hotter in Europe, close to 9%, whereas in the US it was more like 6%. It can also be seen in the intensity of the 'hot' monetary policy, because the ECB expanded the monetary base much more, in terms of GDP, and took interest rates deeper into negative territory. And what do the central banks do now that we find ourselves under a jet of scalding hot water, in the form of inflation? Like the fool in the shower, they turn the tap in the opposite direction, using monetary policy to cool the economy with unprecedented interest rate hikes. And I can assure you the tap can't get much colder.

As in the simile of the shower, we're now standing under a jet of icy water and the first to feel it have been the banks. It's fair to say that the banks—especially those engaged in "excessive" asset-liability management practices—managed the situation badly, investing a large part of their deposits in interest-rate-sensitive assets because they simply believed what the central banks were telling them. Remember the 'lower for longer'? That meant interest rates would be lower than consensus forecasts and for longer than everyone thought. Obviously, if that's what the monetary authority had promised, a commercial bank will see no risk in doing what it did. The question is, what now?

What we've seen in the United States with Silicon Valley Bank and others such as Signature Bank, and many others yet to come, happened because in the end, in the United States, unlike in Europe (in this respect Europe is in a better situation in banking terms), banks with a balance sheet total of, I think it's 250 or 300 billion or less, apparently are subject to somewhat laxer conditions, which allows them to do what I've just described, namely, this laxer balance sheet management, with more risk taking and more interest-rate-sensitive assets, which therefore are more vulnerable to interest rate rises. The problem is that more than 90% of the banks are of this type in the US, so we're talking about 90% of banks probably now having serious problems because of the Fed's 'cold' monetary policy. What I mean is that if Mr Powell continues to tighten monetary policy, we'll see quite a few more Silicon Valley Banks, so we'd somehow have to rescue the system again.

So as not to lose the thread, what has happened with these banks— and what foreseeably is still happening now in many other banks in the United States with serious asset valuation problems as a result of this monetary tightening policy— means that there's going to have to be a balance sheet repair and a balance sheet strengthening to avoid the contagion effect and rebuild trust. So this balance sheet strengthening, and transparency exercise by all these banks, is highly recessionary and deflationary. In my opinion, the necessary and sufficient condition to trigger the effects that every analyst would want to see: A cooling economy without having to raise the terminal rate to a level that's lethal for asset values or the stock market value. The higher the terminal rate, the more the stock market suffers, the more bonds suffer, and the more likely we are to see a repetition of 2022. That's why it was necessary to finally see the first recessionary and deflationary effects, without the terminal rate having to go to 6%, 7% or 8%, which was a real possibility.

So the first conclusion, with regard to the United States, is that at last we can say for sure that the terminal rate is closer, and if that's the case, the turning point is closer too, and so is recession, of course. But the turning point being closer does not mean that the equity markets can start a rally. Not immediately. First we need to go through the cooling period, or crisis, or recession, or whatever you want to call it, and the resulting cuts in profits and therefore in company valuations.

Until now, I couldn't say this was the case, and I estimated the terminal rate above consensus, because when I looked to the Bloomberg Financial Conditions Index, it was bouncing back and was in positive territory, making any recession highly unlikely in the short term. With the Bloomberg Financial Conditions index bouncing back, everything pointed to continued growth in credit cycle, activity, and thus, inflation. And that put the Fed in a position where it had to keep raising interest rates. Now, after the episode with the US banks, real financial conditions have cooled very quickly, for real. You can see it in the components of what could be a genuine financial conditions index, which clearly no longer favour growth in credit but the opposite, a cooling of the economy, recession and inflation control. First, the level of mortgage rates are uncomfortably high. Corporate bond yields (used a a proxy for the cost of capital) are rapidly approaching the return on capital. When the difference between the cost of capital and the return on capital narrows, it makes less sense to borrow to finance an investment cycle, so the economy slows. The second factor is the money supply. Not is it growing below nominal GDP, but it's growing in the opposite direction. That, clearly, is another powerful driver of inflation control. Third, we look at metrics of bank vitality— recently, as the Fed raises interest rates, the banks that had loaded up their balance sheets with interest-rate-sensitive securities are facing strong headwinds in terms of the valuation of their assets, right? So the banks need a bail-out, or at least liquidity injections. In any case, with this level of official interest rates, what these banks need to do now is strengthen their balance sheets, and that's going to be highly recessionary. We must also look at the Housing Affordability index, which has deteriorated over the last 12 months, meaning that family economies in many households are stressed right now, because now the financial bill, the cost of their mortgage, the cost of the car loan, of university fees, all this takes between 500 and 800 dollars more per month out of their income. The same in Europe. And that's highly deflationary. We also look at the inverted slope of the yield curve—which is something a lot of people say is the prelude to a recession—. An inverted slope discourages banks from borrowing short-term and investing long-term. And more importantly, it encourages individual investors to park our savings in a relatively safe, short-term instrument, instead of putting our money in a long-term investment, which is what businesses would like us to do. With the inverted slope all that stops, so you cut off a channel of cyclical growth, which means we're in the anti-cycle, or recession period.

A genuine financial conditions indicator also measures the intensity of the change in the money market rate. This rate had been climbing amazingly steeply and this has a very interesting effect. Since the banks initially are reluctant to pay interest on deposits, there's a shift in deposits towards a money market instrument, a typical money market fund. And when that happens, when you switch from a deposit to a money market vehicle, the velocity of money is automatically frozen. Why? Because a

deposit on a bank's balance sheet can be used to lend, so the credit and investment cycle is maintained. But when the deposit moves to a money market, it's different. The money's frozen.

So my conclusion is that financial conditions today, after the events involving these regional banks, are significantly more adverse than they were a month ago. And now we know that these more adverse conditions have accelerated and are an important driver that is bringing us closer to recession, or an economic cooling, and they also mean that, finally, the terminal rate and the turning point are closer. This doesn't point to a market rally. The market must adapt to the cooling, which **means we're still dealing with a complex market environment**. We can't say it's all over, but it's a step forward. We're closer to that long-term rebound.

EUROPE

The game Mrs. Lagarde and the European Central Bank are forced to play is called inflation control versus financial stability. I say 'versus' because it's either one thing or the other. If I want more control over inflation, I have less financial stability. And if I want more financial stability, I have less control over inflation. That's the way it is. Why? Because miracles don't exist. Some people say, "Sure, you can do both, because the European Central Bank treats each objective separately, as something that can be addressed and managed using different tools. For inflation control, it raises interest rates. And to achieve financial stability, it uses liquidity provisions. Well, let me tell you, I don't think that can work. That would mean monetary policy was contractionary and expansionary at the same time. And for me, those two goals, inflation control and financial stability, are two sides of the same coin. And what happens when we toss a coin and it falls to the ground? We see just one side. That means we can have one thing but not the other.

So, the question now is, what will the ECB aim for first? Inflation control or financial stability? If It wants to control inflation it must raise interest rates, and the banks are automatically going to face headwinds in their balance sheets, causing financial instability. Do not doubt that this will be so and don't be fooled by those who say that "banks are stronger after a decade of draconian regulation, so they will now be able to withstand monetary tightening without a problem". This way of thinking is more like a fairy tale than reality. Why? In Europe, the "lower for longer" chant was also said. Remember?

Going back to our question about the main objective of the ECB. To answer that, I only have to read the first sentence of ECB's press release, which says, "Inflation is projected to remain too high for too long.". This suggests that the priority continues to be to control inflationary pressures. In fact, Lagarde said something that left me a little surprised: "The only thing that will stop me from hiking interest rates is either a sharp slowdown in prices or the triggering of a financial crisis." In practice, what she's telling is that this is a real possibility.

Looking beyond the immediacy, I believe that the natural sequence (and by natural, I mean inevitable) is precisely to go through financial stress, which will act as a recessionary and deflationary driver. On the positive side, the European Central Bank's failure to give any forward guidance, and Lagarde's focus on the speed of transmission, all this suggests that the ECB will be cautious about further tightening from now on. Summing up, this hike is not the last one, but the European Central Bank will be somewhat more cautious in the future. Unlike in the United States, where as I said the terminal rate is closer, in Europe I cannot say the same. Indeed the ECB will now be more cautious, but since the objective is still what it is, according to that first sentence of the ECB press release, there will be more hikes.

The question here is, when will we reach the terminal rate in Europe and when will we reach the turning point in interest rates? Well, the price of energy has fallen sharply, which has allowed the European Central Bank to lower its 2023 inflation projection from 6.3 to 5.3, and this could make us think that we will reach the terminal rate soon but, on the negative side, the ECB's projection for core inflation has increased from 4.2 to 4.6 and that's a worry. Officially, core inflation is sticky and,

as wage inflation is continuing to accelerate. And there's still some scope for businesses to pass higher costs on to consumers, the underlying inflation will remain high for quite some time. This means that we won't see the terminal rate soon. In fact, we will not see the terminal rate until core inflation is headed decidedly towards 2%. And that, I fear, is still a long way off.

All in all, the ECB needs to continue to raise rates, because the desired effects on inflation control are not immediate. Notice that Sweden is further ahead than Europe. It's already seeing a contraction of GDP, but with accelerating inflation, without energy, at 9.3, up from 8.7. In other words, it's not immediate, it isn't fast, so we have to maintain these policies.

Are we going to see a recession in Europe, yes or no? Lagarde talked about this, about recession, indirectly, saying that the transmission of monetary policy through the credit channel has been rapid. In fact, there are banks in Europe that haven't granted any loans for months. This is highly recessionary. The foreseeable scenario of further increases in ECB interest rates, together with injections of liquidity, fuels a sense of upheaval and stress in the financial system. In such a situation, the banks become more cautious, tightening their lending standards, and aggravating the effects of monetary policy (accelerating the transmission). And that brings us closer to recession.

You can judge for yourselves whether this is a good or a bad environment for financial markets. **I think it is still a tough environment for financial markets, which means I'm not entirely comfortable with current valuations.** Indeed, the European banking industry today is somewhat more stable than in the past: In the last quarter of 2022, average interest margins were 1.8%, the highest level since 2011. So, we're better off from the point of view of profitability. Banks have also a larger capital cushion than in the past. Does that mean we're out of danger? No. The "inflation control versus financial stability" game is not over yet. More importantly, banking metrics may change rapidly depending on the evolution of their balance sheet's assets, and I fear that the "lower for longer" mantra may have wreaked havoc on asset's sensitivity.

Best