



04.21.23 | INVESTMENT MANAGEMENT

## 3/31/23 Focal Point: Will Rising Interest Rates Spill Over from the Banks?

By Benjamin B. Wallace, CFA

**Benjamin B. Wallace, CFA - Portfolio Manager, Research Director**

Markets move before the economy, based on an expectation of where the economy is going. 2022's poor performance by stocks and bonds reflected both rising rates and an expectation the economy would slow in early 2023. The recent stabilization suggests further deterioration is not expected in the second half of 2023, and there is recovery potential.

However, the economy responds more slowly. The current question is what the impact of the Fed's rapid rate hike campaign will be. As noted (*Markets Changed Course as Economic Winds Shifted*) it only started a year ago, so based on the typical policy lag of 6 to 12 months, those rate hikes are only just now starting to impact economic data. The good news is inflation is slowing and, more importantly, inflation expectations remain low. The bad news is that in the typical cycle the Fed will raise rates until something breaks. This was addressed in the [12/31/23 Focal Point, Will Markets get Rear Ended by the Lagging Economy?](#)

During Q1'23, one risk emerged: banks. The issue is that, unlike a typical cycle where credit risk (getting loans repaid) is the issue, higher interest rates have caused the market value of bank bond portfolios to fall. While a small group of banks were the point of concern, every single bank has a portfolio of bonds, and every bank saw their number one fear, a deposit run, play out at this small group of banks. Steps were taken to stabilize the system, but the full impact is not yet known.

Thus far, this has been a small issue for the markets: regional banks have smaller market caps. Larger banks, if anything, benefited from "safety" and deposit inflows. And, finally, lower rates boosted tech stocks, a much larger part of the market.

But the market isn't everything, and banks are a key cog to the economy. Right now, bank liquidity issues appear contained, thanks to the Fed's new Bank Term Funding Program (BTFP), and its existing discount window and FHLB programs all stepping in to provide liquidity in the first half of March. This prevented the brief loss of bank confidence from turning into a truly damaging run on deposits across the banking sector. And since their peaks, the usage of these tools has already started to decline, suggesting stress has been relieved.

But even despite this, the sudden uptick in bank deposit risk will make banks, especially regional ones, more cautious in their lending, as they look to keep a slightly higher liquidity cushion, just in case. While each bank's action is small, cumulatively this can tighten credit availability in the economy. When layered on top of the past 12 months record pace of rate hikes, this means backdrop of capital access will be very different than a year ago.

Also, it isn't the rate hikes, but the level of interest rates (obviously a hike increases the level). Each rate hike is like adding a brick to a wheelbarrow. Even without adding new bricks, the wheelbarrow is harder to push forward because of the ones already inside of it.

So right now, the question is: *Will Rising Interest Rates Spill Over from the Banks?* It will be a challenge for both Equity and Fixed Income markets to benefit as they did in Q1'23. Should the financial issues truly remain contained, then higher rates could impact Fixed Income returns. If the economy does slow, Equity markets would see a headwind. Thus diversification remains a key tool for managing through this period of uncertainty.

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-The Standard & Poor's 500 is a market capitalization weighted index of 500 widely held domestic stocks often used as a proxy for the U.S. stock market. The Standard & Poor's 400 is a market capitalization weighted index of 400 mid cap domestic stocks. The Standard & Poor's 600 is a market capitalization weighted index of 600 small cap domestic stocks.

-The NASDAQ Composite Index measures the performance of all issues listed in the NASDAQ stock market, except for rights, warrants, units, and convertible debentures.

-The MSCI EAFE Index (Europe, Australasia, Far East) is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the US & Canada. The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of 21 emerging markets. The MSCI All Country World Index is a free float adjusted market capitalization index designed to measure the performance of large and mid and cap stocks in 23 developed markets and 24 emerging markets. With over 2,800 constituents it represents over 85% of the global equity market.

-The Barclays Aggregate Index represents the total return performance (price change and income) of the US bond market, including Government, Agency, Mortgage and Corporate debt.

-The BofA Merrill Lynch Investment Grade and High Yield Indices are compiled by Bank of America / Merrill Lynch from the TRACE bond pricing service and intended to represent the total return performance (price change and income) of investment grade and high yield bonds.

-The S&P/LSTA U.S. Leveraged Loan 100 is designed to reflect the largest facilities in the leveraged loan market. It mirrors the market-weighted performance of the largest institutional leveraged loans based upon market weightings, spreads and interest payments.

-The S&P Municipal Bond Index is a broad, comprehensive, market value-weighted index. The S&P Municipal Bond Index constituents undergo a monthly review and rebalancing, in order to ensure that the Index remains current, while avoiding excessive turnover. The Index is rules based, although the Index Committee reserves the right to exercise discretion, when necessary.

-The BofA Merrill Lynch US Emerging Markets External Sovereign Index tracks the performance of US dollar emerging markets sovereign debt publicly issued in the US and eurobond markets.

-The HFRI Fund of Funds index is compiled by the Hedge Funds Research Institute and is intended to represent the total return performance of the entire hedge fund universe.