Investment Strategy Bulletin

Central banks tread cautiously in the face of stress

Investment Solutions 24 March 2023

Key takeaways

- Central banks are continuing to hike rates in order to fight high inflation, while combating financial stress with different tools, primarily through liquidity provision
- Our baseline expectation remains that the Fed's rate-hiking cycle should peak at 5.5%, and the ECB's at 3.5%, with rates held at that level for the rest of 2023 - but this outlook is highly conditional on stability in the banking sector
- While swift action by policymakers is helping restore financial stability, a tightening of bank lending standards could dampen demand and price pressures, leaving less work for central banks to do

Central banks in the US, eurozone, Switzerland and the UK pressed ahead with rate rises this month in the face of banking stress. Policymakers' swift actions to deal with the crisis so far give us cautious optimism that contagion can be contained, while the impact of tighter bank lending conditions strengthens the case that rate-hiking cycles are close to their peak.

Federal Reserve close to peak rates

The Federal Reserve (Fed) raised rates by 25 basis points (bps) on 22 March, but the language in its policy statement was softer than in previous months. A reference to "ongoing increases" in rates was dropped, suggesting that a peak in rates is near, following turmoil at US regional banks. Existing measures of quantitative tightening were kept in place.

Notably, strong macro and inflation data since the start of the year did not lead Fed officials to raise their macroeconomic or peak rate projections. They acknowledged huge uncertainty over the impact of banking stress, which makes these forecasts more than usually prone to change.

The Fed had a difficult balance to strike at this meeting. Its twin missions: controlling inflation, while also ensuring the stability of the US financial system, have become harder to juggle. Before mid-March, bringing down price pressures was its only real concern. Then tackling financial stress became its priority. Yet its inflation obligations have not gone away.

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Data as of 24 March 2023 unless otherwise stated.

The case for hiking rates from a purely price stability perspective was strong. Since the Fed's last meeting, consumer demand, labour markets and inflation have all shown signs of persistent strength. Before recent banking failures, the debate was over whether a hike of 25 bps or 50 bps would be more appropriate. While energy prices, goods inflation and supply chain disruptions have by and large normalised, services inflation remains too strong. Retail sales continue to look robust. Wage growth, while slowing, is still above levels consistent with the Fed's inflation target. Measures of 'core' inflation, stripping out food and energy, accelerated month-on-month in February. Persistent inflation may be a less acute problem than banking turmoil, but it remains a source of concern for policymakers.

A dual-track strategy on rates and financial stability

Up to a certain point of course, central banks will continue their attempts to deliver two mandates simultaneously: minimising financial stress via liquidity facilities and new tools for commercial banks, while fighting inflation by raising interest rates. We believe the Fed will continue to adopt this two-pronged approach. The European Central Bank (ECB) and the Swiss National Bank (SNB) both went ahead with 50 bp hikes in March even after recent banking turmoil.

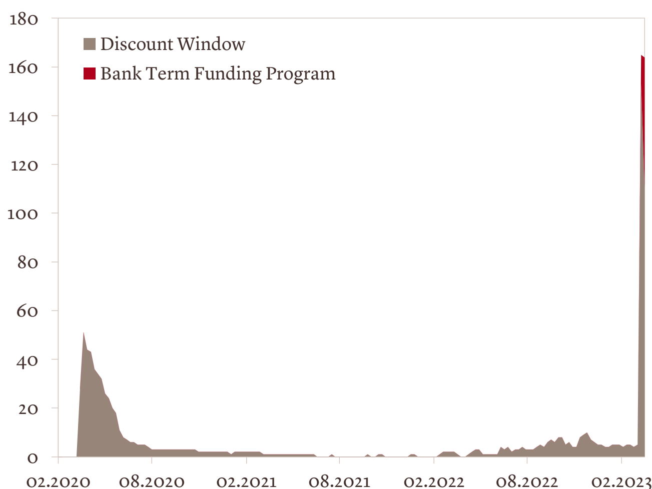
A pause in hiking cycles risked being perceived by markets as a lack of confidence by central banks in their own stability measures, or prompting fears that regulators know more about hidden stresses than investors. It could also have fed a narrative that hiking is over and rate cuts lie ahead, leading risk assets to rally and financial conditions to loosen, undoing some of central banks' hard work to date.

This is not 2008

We would also argue that current risks are not systemic in nature. Banks today look better regulated, with more capital and less exposure to riskier parts of real estate than before the Global Financial Crisis. Outside of the failed banks, recent problems appear to reflect more a shortage of liquidity than issues with credit quality (e.g. loan defaults). Central banks' recent actions – from deposit protection at failed banks and coordinated liquidity programmes to the emergency Credit Suisse rescue deal – have been swift at stemming problems, even if they have not yet fully allayed all concerns, e.g. through a blanket guarantee on all US deposits. For the week ending 22 March, US banks borrowed almost USD 54 bn from the Fed's new Bank Term Funding Program and USD 110bn from its 'discount window', a longstanding emergency borrowing facility (see chart 1). While market action remains volatile, indicators of systemic stress do not point to widespread contagion. And

1. Use of Fed liquidity facilities jumped sharply after bank failures but stabilised at high levels last week

Take-up of Federal Reserve discount window and Bank Term Funding Program, in USD billions



Sources: Federal Reserve, Lombard Odier

2. US regional banks under pressure

SPDR* S&P Regional Banking ETF, price history

*SPDR: Standard & Poor's depositary receipt
Sources: Bloomberg, Lombard Odier

if current measures are not enough to contain contagion risks, central banks have additional tools at their disposal to restore stability.

ECB and SNB press ahead with hikes

In Europe, the ECB accompanied its recent 50 bps rate hike – and a retention of its quantitative tightening measures – by a commitment to provide liquidity to banks, or to create new tools to handle any contagion as needed. It also dropped guidance given in previous meetings that it would keep "raising interest rates significantly at a steady pace," giving itself more flexibility to react to events as needed. Updated ECB forecasts now see a meaningful improvement in growth to 1.0% in 2023, with inflation falling to 5.3% this year and 2.9% next. We still see some further tightening ahead, with rates peaking at 3.5% and remaining there for the rest of the year.

Meanwhile, the SNB and the Bank of England also hiked rates by 50 bps and 25 bps respectively on 23 March, the latter after an unwelcome re-acceleration in headline inflation to 10.4% in February, as it reiterated that evidence of more persistent price pressures could require further hikes. SNB President Thomas Jordan also kept a hard line on inflation, despite having overseen an emergency takeover of the country's second biggest bank in recent days, and did not exclude further tightening ahead. However, across many developed economies we see rates close to a peak. In our view, the narrative of sub-par growth, easing labour markets and continuing disinflation remains on track, even if monthly data is providing some bumps along the road.

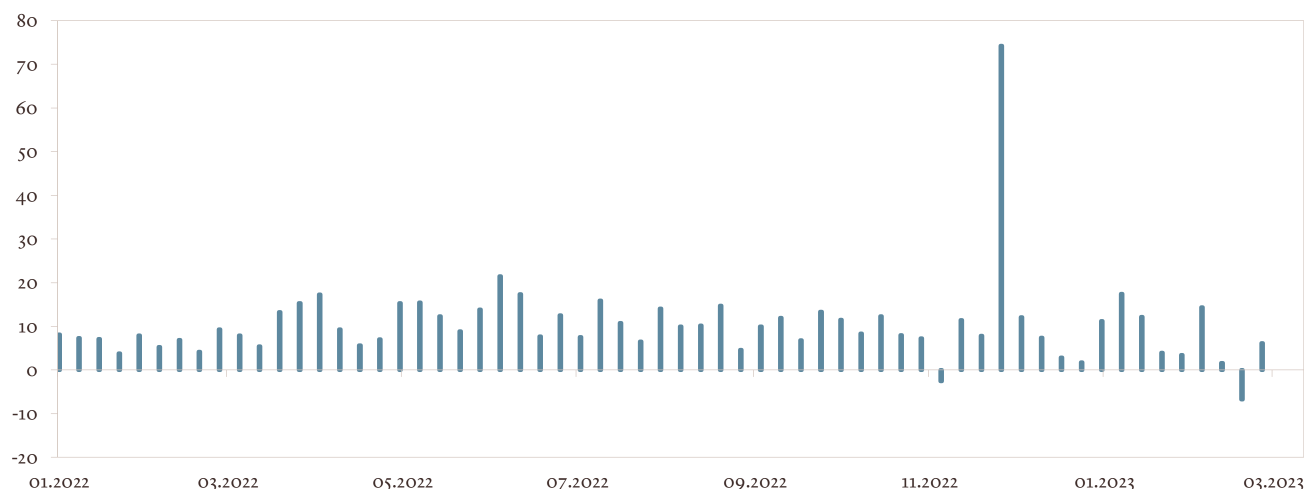
Risks of further stress remain

Of course, unforeseen risks may emerge. Taming high inflation and raising rates at the fastest pace in decades is likely to have unpredictable consequences. Recent bank failures may have been the result of poor risk and balance sheet management, but the common backdrop is one of tightening liquidity that is causing cracks to appear. It is impossible to rule out further weaknesses within other institutions or markets, while the threat of a crisis of depositor and investor confidence can never be eliminated.

We are closely monitoring lending conditions in the US, especially in small and mid-sized banks, where the stress is most prominent (see chart 3). There should be enough time between now and the next US rate-setting meeting on 3 May to make a clearer assessment. For now, we still see the Fed implementing one further 25 bps hike in May and one in June to take rates to a peak of 5.5% (see chart 4, page 4). In summary, if market conditions remain calm, we think that central banks will proceed with rate hikes as planned – and if the situation at banks worsens, inflation should fall more quickly.

3. Evolution of small-bank lending will be a key indicator to watch in weeks to come

Loans and leases in bank credit, small domestically chartered commercial banks, in USD billions



Sources: FRED, Lombard Odier calculations

Meanwhile, fed fund futures markets imply cuts in rates as soon as the second half of 2023. Fed Chair Jerome Powell has consistently pushed back against this narrative. For now, and absent any financial meltdown that requires rate cuts and quantitative easing, we still see the need for central banks to maintain the pressure on financial conditions and keep rates on hold this year. They do, however, remain more than usually data and event-dependent going forward.

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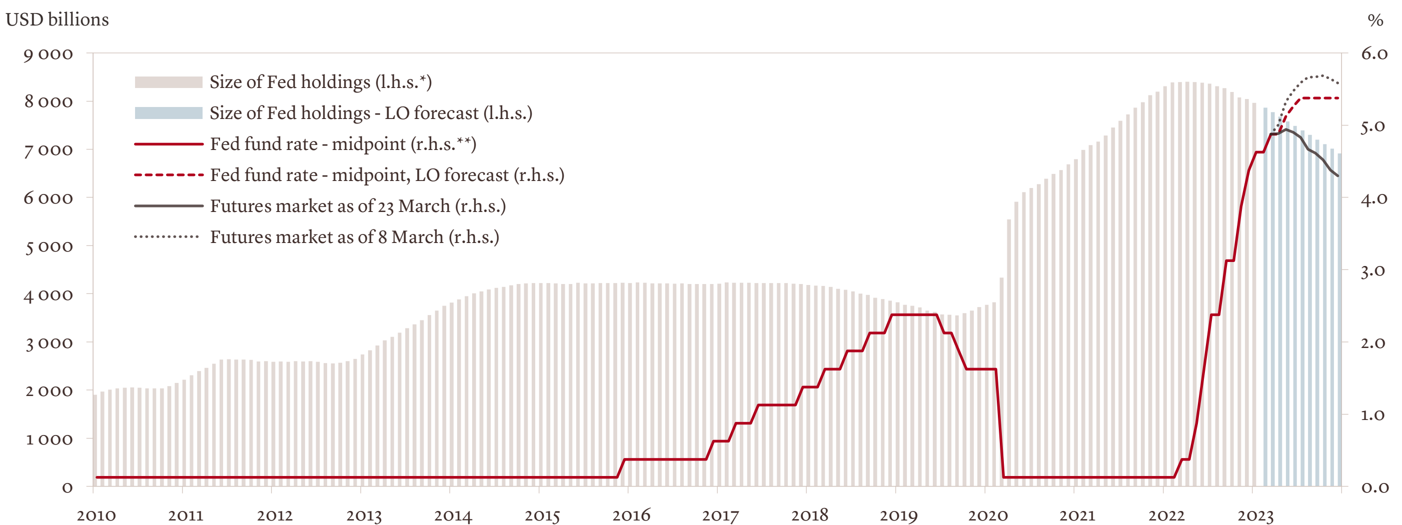
4. US monetary policy clearly restrictive, approaching peak policy rate

Sharp reversal in market expectations following banking stress



* left hand scale, ** right hand scale
Sources: Bloomberg, Federal Reserve, Lombard Odier

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