Caron's Corner Transcript – 3.20.2023

An Inconvenient Trinity: Financial Stability, Policy and Politics

- During times of crisis, measures to contain market volatility intersect with the need for financial stability, Fed policy actions and politics.

- Ideally the three should work in unison, but there are times when they are in conflict. Now is one of those times.

- Liquidity facilities have been established to stem the crisis. This has increased the Fed balance sheet by about $300 billion, making many question if this is QE - and if it's inflationary.

- Regardless it may conflict with the Fed's monetary policy goals to stem inflation, and while the Fed would like to separate decisions about financial stability and monetary policy, they are unfortunately intertwined.

- Politics is always present. For the Biden administration, the optics for the Bank Term Funding Program (BTFP) lending facility has the earmarks of another "bailout" for banks.

- Given the optics of the BTFP, which is big and powerful, it may not be publicized as clearly as it should be, possibly detrimental to restoring confidence in the banking system.

- All in all investors need to adjust their probabilities upward for recession risk. What is happening now is not a non-event and will certainly have credit implications for the real economy.

Jim Caron: This is Jim Caron, Co-CIO of Global Balanced and Risk Control strategies. Well, here we are again with another interesting week ahead of us and it's what I call an inconvenient trinity, which is a cross section between financial stability, Fed policy and politics. During times of crisis measures to contain market volatility intersect with the need for financial stability, Fed policy actions and politics. All three should work in unison, but there are times when they are in conflict and today is one of those times. Liquidity facilities have been put in place to stem today's crisis, increasing the Fed's balance sheet by about $300 billion. If we put this into context, this $300 billion increase in the Fed's balance sheet is essentially the size of Quantitative Easing (QE) 2, but in just a single week! That's pretty big, making many question if this is in fact QE and if it's actually inflationary.

Well, it is a balance sheet expansion, yes, but no, it's not QE because this recent Bank Term Funding Program (BTFP) will end in one year. Only if the BTFP is rolled perpetually does it become QE and a more permanent expansion of the Fed's balance sheet. Nevertheless, this may conflict with the Fed's monetary policy goals to stem inflation, and creates uncertainty on the path of policy and inflation. The Fed would ideally like to separate financial stability decisions from monetary policy, but unfortunately they're intertwined. Oh and politics is always present and politically, the optics for the BTFP lending facility for the Biden administration has earmarks of another "bailout" for banks. Given that the prior Obama/Biden administration sharply politicized the optics of the previous bailout, this could be fodder for opponents in the 2024 presidential election. Why this matters is that messaging from the Biden

administration about the powerful size and scope of the BTFP has been underwhelming thus far. Instead, it may find itself hedging on the significant size and potential effectiveness of the BTFP such that it may not be messaged as boldly or as clearly as it should be in order to restore confidence in the system. So let's get into it.

We have to start by asking where we stand on recent volatility, so let's ask some questions and get some answers. The first question is whether this a systemic event or a heavy blow to confidence? We think it's a heavy blow to confidence and not systemic. Is it a credit crunch or credit tightening? We think it's a credit tightening, not a credit crunch. And how do we measure risks of contagion? Well, these are through the standard channels, the US dollar demand, cross currency basis, liquidity bid/offer spreads, short-term funding markets, rolling short-term liabilities and many other factors. While liquidity and contagion measures have increased in price, the system seems to be functioning well and we have to take this as good news. The contagion doesn't seem like it's spreading into something systemic at the moment.

So what will be the Fed's policy response? What we have to do is differentiate between financial stability and inflation, and try to understand how the Fed may respond. To start, market volatility is the wrong measure to assign to a decision about whether the Fed should hike at the March meeting. It's really more a question of whether things are getting worse or getting a little bit better – and if they're not getting worse then it seems likely that the Fed continues on with a 25 basis point hike. The narrative in the market is that rising rates caused the problem, but let me just say that we disagree. It's not rising rates that caused the problem, but higher inflation. Higher inflation caused rates to rise and if the Fed doesn't get inflation under control, then they're not solving the problem. There is a risk of repeating it on this count, so the Fed should stay the course.

However, one can also see that recent events are catalyzing a tightening of financial conditions that the Fed was unable to achieve with just rate hikes. Perhaps now inflation will fall as businesses slow hiring, wage inflation falls and economic activity, which was starting to reaccelerate in Q1, now probably starts to slow and may keep inflation down more durably and reduce the risk that it becomes unanchored. Said differently, if people were entertaining the notion of a 5.50 to 6% policy rate a few weeks ago - which many were - that number should be lower, where the Fed may be able to achieve its goal by reaching a terminal rate of maybe 5 or 5.25% instead. Perhaps this is a silver lining. Maybe a lower terminal rate and easier policy through the rates channel may offset some of the tightening in the credit channel. As bank lending is affected in the near term, the market will focus on these new negative aspects of credit tightening and may overlook the longer term positive effects of lowering terminal rates and inflation more durably.

Now how these two net out is key in terms of evaluating market opportunities. At this point we need to adjust the probabilities higher for recession risk, but what is happening today is not a non-event. Clearly there will be credit implications for the real economy. But if nothing else breaks along the way, then lower rates may soften the blow and be a longer term positive. Perhaps we can look at this as a glass half full scenario. But we do have to balance the tightening of financial conditions coming through the credit channel with easing that's coming through the rates channel as rates fall. How these two net out

is the key for the future, but today we're clearly going to focus on the tightening of credit conditions, which is why I think the markets are so volatile. Now, we will continue to monitor this fluid situation and be back with more updates, including a post-Fed meeting analysis on the afternoon of Wednesday, March 22. Once again, our motto is that it is better to be balanced than defensive and look to find strategies to control risks in portfolios.

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