The Weekly Market Update – 3/20/23: Making the Case for a Fed Pause

Major Indices (Price Returns)	Close	Last Week	Quarter-to-Date	Year-to-Date	Trailing 12-Months	All-Time High	% to High
S&P 500	3,916.64	1.43%	2.01%	2.01%	-10.46%	4,796.56	22.5%
Dow Jones Industrial Average	31,861.98	-0.15%	-3.88%	-3.88%	-5.99%	36,799.65	15.5%
NASDAQ Composite	11,630.51	4.41%	11.12%	11.12%	-15.42%	16,057.44	38.1%
Russell 2000	1,725.89	-2.64%	-2.01%	-2.01%	-15.73%	2,442.74	41.5%
MSCI EAFE (USD)	1,986.73	-3.19%	2.20%	2.20%	-8.83%	2,398.71	20.7%
MSCI Emerging Markets (USD)	951.56	-0.39%	-0.50%	-0.50%	-18.76%	1,444.93	51.8%
Bloomberg Commodity Index	102.59	-1.87%	-9.05%	-9.05%	-10.44%	237.95	131.9%
Barclays U.S. Aggregate Bond	91.07	1.40%	2.47%	2.47%	-9.70%	112.07	23.1%

Source: FactSet

As the U.S. Federal Reserve Bank (Fed) meets this week, investors are watching for its views on banking system financial stability and inflation. The Fed's Open Market Committee (FOMC) concludes is second meeting of 2023 on Wednesday, 3/22/23, and questions remain about whether or not the central bank will raise its overnight bank lending fed funds interest rate target for the ninth consecutive meeting. Much has changed since the FOMC last met on 2/1/23. U.S. February consumer data (solid jobs growth and wage gains reported by the Bureau of Labor Statistics, BLS) was solid, and inflation (as measured by the BLS' Consumer Price Index) remained elevated. However, we attribute the sudden crisis affecting many U.S. regional banks in March largely to the 450 basis points (bp) of fed funds rate increases over the past twelve months (the fed funds target range is currently 4.50% to 4.75%) as the rapid increase in rates created unrealized losses in fixed income investment portfolios that were exposed when depositors withdrew cash held at the banks. To us, this highlights that highly restrictive (higher interest rates) Fed policy often impacts sectors of the economy in an uneven fashion and the full effect of rapidly rising interest rates could play out over 18 months or more. The housing market was an early victim of Fed policy and mortgage borrowing rates surged in 2022, and now the banking industry is impacted. While the Fed would likely welcome reduced bank lending and investment (to combat inflation pressures), the emergence of a regional bank funding and capital crisis is an unintended consequence. This raises questions about the potential for additional stress that may be building in the U.S. economy. In our opinion, this opens the door for the Fed to hold its interest rate target unchanged at this week's meeting. This would give more time to assess the delayed impact of previous rate hikes and alleviate some pressure on bank deposits (to the extent depositors are leaving in search of higher yields). A Fed pause in interest rates could be temporary if inflation and consumer spending remain strong, but if data slows, this would be a prudent decision, in our view. The yield on the U.S. 2-year Treasury bond was 3.95% on 3/20/23, down from 5.06% just twelve days earlier. We believe this suggests increasing economic concerns from bond investors, predicting that a Fed interest rate hiking pause is increasingly likely.

U.S. retail sales were lower than expected in February, but first quarter (1Q23) economic trends remained elevated. The U.S. Census reported that retail sales declined 0.4% (seasonally adjusted) in February vs. January (month-to-month; M/M) as mixed results reflected M/M weakness in home furnishings, restaurants, apparel, gasoline, and building materials, with gains in online sales, health and beauty, general merchandise, and grocery. On a year-over-year (Y/Y) basis, retail sales increased 5.6% (not seasonally adjusted), a deceleration from January's 8.1% growth but better than 5.2% in December. Combined with spending strength in January, retail sales, as a component of consumer spending, suggest a positive contribution to 1Q23 economic growth, despite February's more muted growth. The Atlanta Federal Reserve Bank's GDPNow model, which tracks U.S. data as reported (no projections), reflects a trend for the U.S. economy to grow 3.2% in 1Q23 (as of 3/16/23).

The U.S., and potential global, bank crisis remains front and center this week as uncertainty is high. While the largest money-center banks in the U.S. and money-market funds appear to have received an influx of cash deposits (per Morningstar), some regional and community banks face pressure on deposits. In the near-term, a few banks will need to raise capital, placing pressure on the sector.

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