RPIA

The Fed Will Keep Going ... Until Something Breaks

Published: March 14, 2023

2023 has been a year marked by extremes. In early March, the market was fixated on the possibility of the Federal Reserve and other global central banks having to increase the "terminal rate" to levels thought inconceivable just a few months earlier.

For example, the US market was pricing in overnight rates of close to 6% as recently as March 8th, but the collapse of Silicon Valley Bank ("SVB") and the potential financial contagion risks that emerged from it reversed the terminal rate to 4.75% in the quickest interest rate repricing in nearly 40 years.

US fiscal, regulatory, and monetary authorities acted decisively to ensure that depositors were protected. We are reassured that losses were experienced by investors and not depositors. However, we are mindful that the policy response may not reverse the deposit flight from weaker regional U.S. banks – none of whom we have exposure to.

We are judiciously monitoring the risks in all the bank and non-bank financials in our portfolio, and while we look at material weakness in the highest quality issuers as an opportunity to add, we are currently focused on preserving capital first and foremost.

Credit spreads reacted far more forcefully than the broad equity market did to the news, with Investment Grade credit spreads in the 1-3yr term widening 0.27% (27 basis points) in one day, reaching levels last seen at the peak of recessionary concerns in 2022. This is, of course, in opposition to what you would expect, as credit should be a more resilient asset class than equities, given its priority of claim and attractive relative pricing. Bonds overall rallied as interest rates went from pricing in further tightening to a higher probability of a hiking pause or potential rate cuts.

We do not believe that systemic risk has returned to markets, given the strong liquidity position of the most important global financial institutions, and we do not believe that we are on the eve of another credit crisis. Nonetheless, we are cautious as the maxim that "the Fed will keep going until something breaks" rings in our ears. And something clearly did break with SVB.

The difficulty for financial markets is that central banks are caught in the middle of a battle with inflation (that remains persistently high) due largely to the strength of the labour market and a battle for financial stability. The situation with SVB will likely have long-term ramifications for central banks' ability to increase interest rates, along with implications for the regulation of financial institutions in the US.

Our base case view on rates has modestly changed, as this additional uncertainty could increase pressure on economic growth and lead to a potentially shorter rate cycle. Ultimately, we think rate hikes are likely close to an end, and the Fed will pause as soon as the data gives them cover. Unless stress increases substantially in the banking system in the coming weeks, we anticipate a couple of more hikes from them to "complete the job."

Ultimately, we see short-term volatility and further consolidation of the banking industry, which could provide opportunities for active credit selectors like us. The immediate focus will be on deposit flows from smaller institutions and the ongoing government response. We see the recent and rapid repricing of parts of the market as the representation of overshooting probabilities related to deep recession concerns and financial risk. We believe that higher-quality fixed income is likely to be the safest and most attractive segment of the market over what is sure to be a volatile year.

We welcome the opportunity to speak directly at any time to answer questions or address any concerns. Please reply or reach out to our Client Team to arrange a call or meeting.

Important Information

The information herein is presented by RP Investment Advisors LP ("RPIA") and is for informational purposes only. It does not provide financial, legal, accounting, tax, investment, or other advice and should not be acted or relied upon in that regard without seeking the appropriate professional advice. The information is drawn from sources believed to be reliable, but the accuracy or completeness of the information is not guaranteed, nor in providing it does RPIA assume any responsibility or liability whatsoever. The information provided may be subject to change and RPIA does not undertake any obligation to communicate revisions or updates to the information presented. Unless otherwise stated, the source for all information is RPIA. The information presented does not form the basis of any offer or solicitation for the purchase or sale of securities. Products and services of RPIA are only available in jurisdictions where they may be lawfully offered and to investors who qualify under applicable regulation. RPIA managed strategies and funds carry the risk of financial loss. Performance is not guaranteed and past performance may not be repeated.

"Forward-Looking" statements are based on assumptions made by RPIA regarding its opinion and investment strategies in certain market conditions and are subject to a number of mitigating factors. Economic and market conditions may change, which may materially impact actual future events and as a result RPIA's views, the success of RPIA's intended strategies as well as its actual course of conduct.