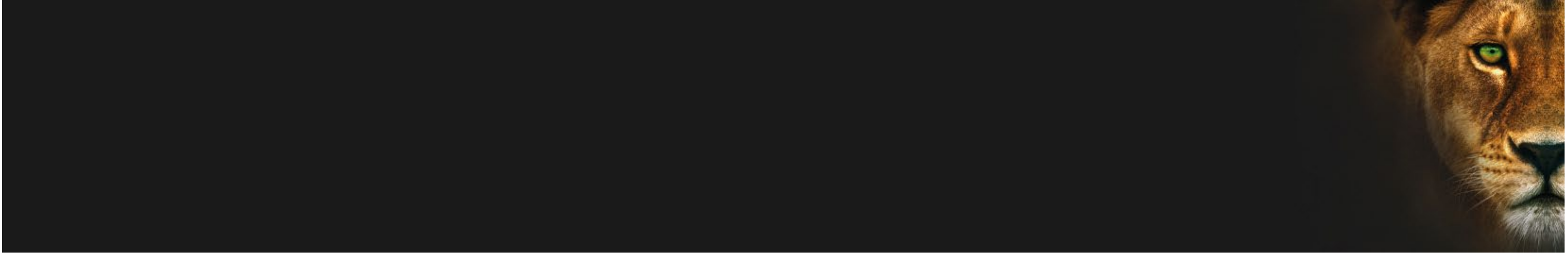

Past performance does not predict future returns

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Are we in the calm before the storm?

We spent much of March trying to figure out what are the medium to long-term effects of the problems in the US bank system. After trying to stick with a relatively optimistic view, we have come to the conclusion there are significant downside risks. As a result, we are likely to be in the calm before the storm.

The unrealised losses issue at US banks is probably manageable. The Fed has done enough to calm investors on that front by creating the Bank Term Funding Program (BTFP). In addition, the side effects of the Fed's emergency liquidity provision to the banks, via both the BTFP and Discount Window, has been a surge in its balance sheet, which jumped $391 billion from 8 March, unwinding nearly two-thirds of the last year's Quantitative Tightening (QT) in just three weeks.

This has clearly supported stock markets. This is the good news. However, in the background, there is a slow burn of deposit flight at US regional banks due to the wide gap between deposit rates and money market rates, which will likely lead to higher funding costs for banks, lower bank profits, tighter lending conditions and a credit crunch for SMEs (small and medium-sized enterprises). This could put marked downward pressure on US GDP.

This funding squeeze at banks will take time to play out. In the meantime, the stock market could well drift higher in the absence of any further bad news. In fact, the early signs of the credit crunch hitting in terms of weaker employment and inflation data could be interpreted as positive, as it would lead to an easier Fed. The impact of tighter credit conditions may not really be fully felt until H2 2023.

A key question over the last year has been what, if any, side effects there would be from the Fed tightening cycle and QT. Now we seem to have at least a preliminary answer: a funding squeeze on small and medium-sized US banks. Small and medium-sized can be a misleading moniker as these banks represent a chunky 40% of US lending.

In broad terms, this is an example of how the rubber finally meets the road in terms of how Fed monetary policy tightening practically affects the economy. It seems the main medium-term ramification of all this will be continued switching of money from low-yielding deposits at banks to higher yielding money market funds. This causes two major problems:

1) It will force regional banks in the US to reprice their deposits, likely hitting profits, which in turn will lead to tighter lending standards and a credit crunch for US SMEs.

2) Bank deposits effectively fund growth in the real economy. If a customer puts money on deposit at a regional or community bank in the US that deposit is likely recycled into a loan for a SME. In contrast, if a customer puts money on deposit at a money market fund, 80% of that goes into the Treasury market to fund the US Government, which can easily fund itself anyway. The Fed by definition does not need other people's money, it can print its own.

In simple terms, bank deposits are 'live' money that help grow the economy. Money market funds represent 'dead' money just sitting in the financial system. Clearly, it makes no sense from an economy-wide perspective for money to be channelled out of banks into money market funds.

Eventually, policymakers will figure it out and find ways to reduce the attractions of money market funds, alleviating pressure on banks and the impending credit crunch.

Until then, it seems likely pressure on profits in US regional banks will build and a credit crunch looms for SMEs. This adds downside risk to US real GDP growth and reduces the probability of a soft landing for the economy.

The risk of a credit crunch for SMEs in the US looks high particularly in Commercial Real Estate (CRE). In CRE, $400 billion of loans come due in 2024 (and the same amount in 2025 and 2026). It could be difficult to refinance this, and most likely at a much higher cost, which will force more delinquencies and in turn hit profits. Virtually all the growth in CRE lending has been driven by smaller US banks.

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