



### ***Fed Rate Hikes***

As discussed in our last dispatch, the demise of Silicon Valley Bank was caused by an unusual set of circumstances of which the Fed's rate hikes are a component of, but not the fundamental cause. However, the Fed hikes did unleash the increasing tensions within the banking sector created by rapidly swelling excess liquidity - most recently in response to the pandemic. Undeniably though, the Fed set the stage for the current bank asset-liability mismatch with their prolonged ultra-easy policy that pushed inflation up. The Fed's focus on consumer inflation is myopic. Financial excesses fueled by ultra-low rates caused two of the last three recessions. Going back would be a sure ticket for a trifecta. Now that the genie is out of the bottle, rate cuts (or pauses) will not be the solution.

As the financial markets and individual investors wait for other shoe(s) to drop in this banking imbroglio, Avalan calls attention to the central points which are getting little to no coverage.

### ***What will Happen at the March 22 FOMC Meeting and Beyond?***

Expectations for the fed funds target rate have whipsawed. Last week, many were talking up odds for a +50BP rate hike in the wake of stubbornly high inflation data and strong labor market results. Now, many pundits are arguing that the Fed will stand pat this week and will soon cut rates.

### ***AVALAN'S Key Takeaway:***

*Higher macro and market volatility is not going away.*

Avalan predicted that the **FOMC would hike the funds target by +25BP, its ninth consecutive increase. This would be accompanied by yet another upward revision in the "dot plot" outlook for the terminal rate for the funds target rate this year.**

### ***We Stand by that Prediction.***

**More important** than what Powell & Co. do this week, or what bank depositors do, for that matter, is what the data will force the Fed to do ahead. We continue to believe that **stubbornly high inflation readings will require further rate hikes this year and that there will be no rate cuts for quite some time.** The dot plot will underestimate future rate hikes, as it has consistently done for the past year. Caveat: The February CPI report will be released Tuesday as the two-day FOMC meeting starts. A *significantly-lower-than-expected* surprise might roil the waters some. However, the alternate core CPI takes from the Cleveland and Atlanta Feds (Median CPI and Sticky Price Index, respectively) come out a few hours later. Over the past several months, those alternates have come in consistently higher than core ex-food & energy CPI.

Avalan and, in the past, Powell have praised the record of these alternates in tracking the ‘true underlying trend.’

## ***Fed Rate Hikers ARE NOT ENTIRELY TO BLAME. RATE CUTS ARE NOT THE SOLUTION. FAR FROM IT.***

The main reason that we do not expect Jay Powell to change his planned strategy is that his rate hikes over the past year have nothing to do with these banking issues. The proximate cause of these bank stresses is high inflation and, hence, increased-yield seeking behavior. Depositors are moving their funds to take advantage of better interest rate offers elsewhere. (better in many cases meaning less negative in real terms) by savers and investors. And banks and financial institutions are competing harder.

**If Powell had never raised rates, inflation would surely be even higher, and depositors would be far more motivated to seek yield.** Similarly, cutting rates now, or even a prolonged pause, would only fuel those inflation fires and exacerbate all these issues.

## ***Risks to the Real Economy is Minimal***

These adjustments triggered particular and unique issues in Silicon Valley Bank and Signature Bank. Maybe in a few more. Still, **one bank’s run is another’s opportunity.** Those deposits have not been stuck in mattresses. They are going to other banks, money markets, bond funds and more profitable investment vehicles. Ultimately, the funds will still be lent and invested. Why else are those institutions paying interest to depositors?



***As Long As*** the Federal Reserve and other regulators are acting to smooth transition issues – and they are – the economic damage will be minimal.

**We hearken back to the various financial “crises” of the 1990s – pesos, Russian debt, LTCM.** Then-Fed chair Alan Greenspan, already believing his “maestro” press clippings, bounced the fed funds target rate up and down within a narrow range to “handle” these episodes. In fact, such rate moves were trivial at best. And the real economy barely showed a mark. The only tangible result of those “rescues,” we believe, was the Fed taking its eye off fundamentals and encouraging moral hazard. The result was the equity/ internet bubble, followed by the housing bust/Great Recession when Greenspan refused to learn any lessons.

## ***Fed’s Ultra-Low-Rate Policy is to Blame***

The Fed’s rate hikes did not cause these issues. Undeniably, though, the Fed set the stage with prolonged ultra-easy policy that pushed inflation up. As we have long argued, the Fed’s focus on consumer inflation is myopic. **Financial excesses fueled by ultra-low rates caused two of the last three recessions. Going back would be a sure ticket for a trifecta.** Avalan continues to expect a new regime of higher macro and market volatility – and it is not going away. This regime requires a new investment playbook, involving more frequent portfolio changes and more granular views that go beyond broad asset classes. Our expectation of a more volatile environment with higher inflation informs our strategic investment views and client portfolios.

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