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Policy, Politics & Portfolios

What federal budget, regulatory, and trade decisions could mean for investors **April 25, 2023**

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- A liquid market allows for the exchange of assets at prices that do not vary widely and unpredictably from one transaction to another. In this way, liquidity provides a source of consistency, which promotes exchange.
- The Federal Reserve (Fed) plays a major role in insuring markets have the liquidity they need to function.

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- Credit crunches tend to be more disruptive to the economy than just credit tightening because they are abrupt and aggravated by deleveraging and asset-price deflation following excessive liquidity creation in the period ahead of the crisis.
- Tighter regulations, lender caution, and more aggressive action by the government helped contain the banking crisis in March 2023 compared to 2008 – 2009.

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- As the Fed continues its tightening policy by raising the fed funds rate and reducing balance-sheet holdings, we expect liquidity to tighten further.
- Lingering concerns over U.S. regional banks and European global banks may complicate central-bank tactics, but we do not think this will end the Fed's tightening cycle.
- Under current conditions, we favor a defensive portfolio posture.

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Linking market liquidity and investment returns

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Liquidity 101

The term "liquidity" is used in many contexts in today's financial world; here, we will discuss what liquidity is, the importance of liquidity, and how policy can affect liquidity in markets.

What is liquidity?

Liquidity broadly refers to the ease of transactions, but it also more directly defines specific characteristics of assets and markets. Liquid assets typically have small and easily predicted differences between the prices that sellers ask and buyers bid. In a liquid market, investors can easily and quickly trade and settle assets, potentially in large quantities, without driving prices sharply higher or lower. What's more, liquid markets are resilient; stable prices tend to balance the number of buyers and sellers at a particular price.[1]

The importance of different aspects of liquid markets depends on the market cycle. In calmer waters, the biggest limiting factor to a trade occurring could be transaction costs — whether a trade is "worth it" based on the price of doing business. But during stress and periods of significantly changing fundamentals, buyers (or sellers) may feel compelled to buy or sell. For example, a rush to buy leaves too little liquidity (called "illiquidity") from sellers, and prices can rise sharply. Conversely, a surge of sellers floods the market with liquidity and can push prices lower.

Why is illiquidity harmful?

Illiquid markets can negatively affect investment and financial operations. First, in illiquid markets, transaction costs and price volatility increase, and may cause investors to transact less and take fewer risks. As investor risk aversion increases, firms trying to raise capital see their costs increase. If the episode is sharp enough or prolonged, investors who fear further price declines can feel impelled to sell assets that are falling in price, and thereby accept significant losses in their portfolios.

How does the Federal Reserve affect liquidity?

The Fed can influence liquidity in the market in a few ways. The first is to change the return to the banks' cash deposited at the Fed or the cost at which banks borrow from the Fed.[2] The Fed also can buy or sell securities, either with the banks or in the open market. This tool allows the Fed to influence the supply of money in the economy. Lastly, by changing interest rates, the Fed can incentivize investors to take savings and invest in securities, reducing the money supply.

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1. These characteristics of liquid markets are described in International Monetary Policy, *Measuring Liquidity in Financial Markets*. December 2002.

2. The Fed can also change the reserve requirement, the percentage of bank deposits that must be held at the Fed, but the Fed changes this percentage infrequently.

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As the lender of last resort, the Fed attempts to short-circuit instability by providing liquidity support to institutions and markets. When banks have inadequate reserves to fulfill their obligations, they can go to the Fed and borrow the money necessary to conduct business. This is a standard function of the Fed to provide immediate, nonemergent liquidity when a bank is solvent. But when a bank has prolonged liquidity shortages and perceived insolvency, the Fed can also step in as a lender of last resort, usually to prevent contagion.

Crises can occur when liquidity dries up — in the next few sections, we will discuss how liquidity interacts with the broader functioning of the economy. We also discuss those sectors of the financial markets that may be vulnerable to further liquidity reduction. Finally, we indicate how our defensive portfolio positioning is still our preferred way to address these economic and financial market risks.

The Federal Reserve influences liquidity through open-market operations, changing reserve requirements, and interest rates.

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Liquidity crises and the economy

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Why so special?

The March 2023 banking crisis largely has faded from the news but still reverberates in the financial markets. Financial markets are most vulnerable to credit disruptions during periods of ample, if not excessive, liquidity that encourage speculation, leveraging, and reaching for yield in supercharged asset markets. Stretched finances leave investors, businesses, and households exposed to mismanaging their assets and liabilities, or to more stringent economic policies. Banks and other financial institutions invariably are at the center of liquidity crises because they control the plumbing through which money created by the Federal Reserve is channeled to the economy.

Contrasting cost- vs. supply-driven pressure on financial liquidity

Deep recessions in 1981 – 1982 and 2008 – 2009 provide a stark comparison between a cost- and a supply-driven pullback in the supply of funds and their effect on the economy. The Fed's efforts to squeeze ultrahigh inflation out of the system with aggressive hikes in interest rates was the main driver of the recession over 40 years ago. By contrast, bank failures in 2008 acted as a catalyst for an unwind of highly leveraged, opaque investments in corners of the shadow banking system that were lightly regulated at best. Behind that, a key difference between 1981 – 1982 and 2008 – 2009 was the absence of aggressive leveraging and speculation in the years leading up to the earlier crisis (see Chart 1). The more wealth-driven economic cycle in the run up to the 2008 – 2009 slump left the economy more vulnerable to a liquidity-induced drop in asset values. It also meant a more drawn-out recovery as household and bank balance sheets were slowly rebuilt.

Liquidity crises then and now

The fallout thus far has been far less systemic than in 2008, in our view. This is partly because deposit outflows in 2023 have been due as much — or more — to rising short-term rates drawing funds to more market-based yields than to the earlier period's loss of confidence in the banking industry.

Other differences between crises in March 2023 and 2008 – 2009 are these:

- Tougher capital rules have restrained banking-industry leverage, limiting fallout from the March 2023 crisis to a few less-diversified institutions, some with concentrated deposit holdings and/or weak business strategies.
- Changes in lightly or unregulated parts of the financial market, increasing security transparency and restraining the growth of highly leveraged complex securities central to systemic risk in 2008.
- Banks' tougher underwriting standards on home mortgages, limiting housing excesses and the hit to household wealth and spending, which aggravated the economic slowdown in 2008 – 2009.
- Quicker, more aggressive action by financial regulators and policymakers, armed with beefed-up authority to resolve even large bank failures, largely because of the shortcomings revealed during the last financial crisis.

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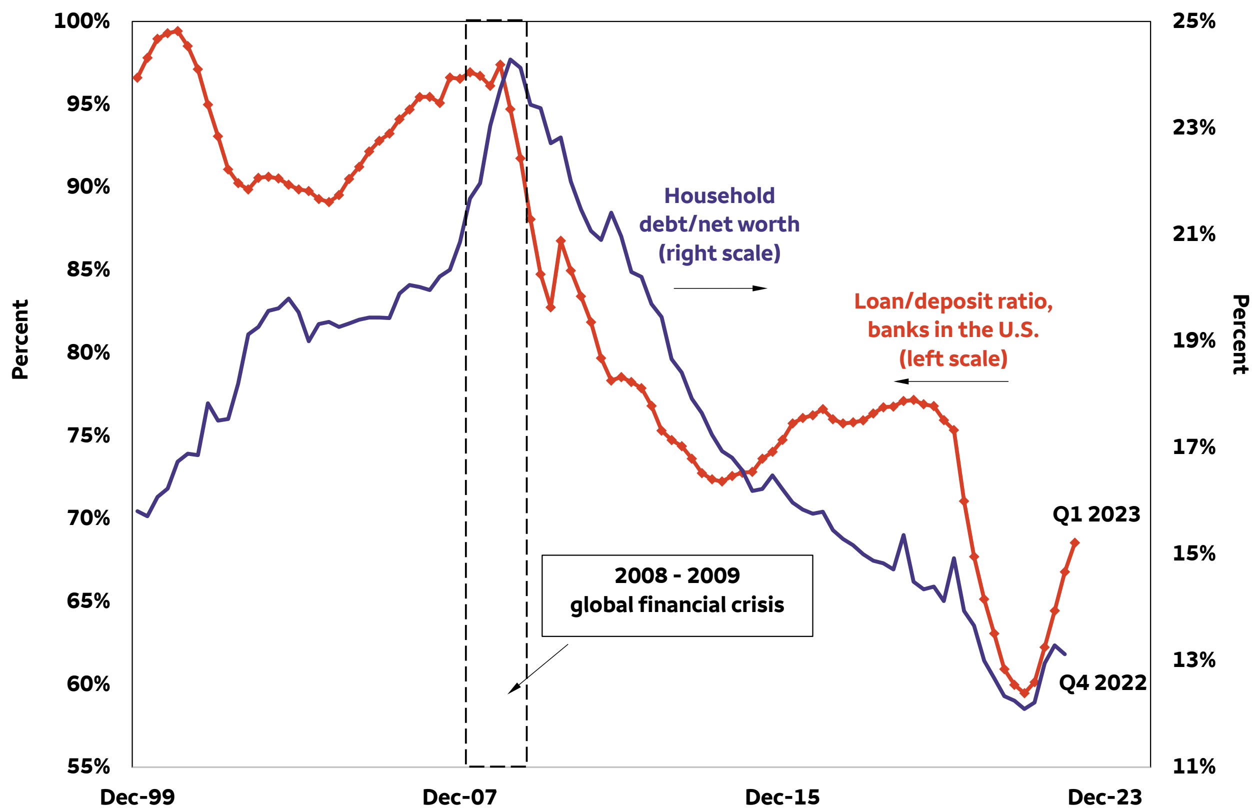
Chart 1. Financial crisis fallout contained by less leverage now vs. 2008 – 2009



Sources: Federal Reserve Board and Wells Fargo Investment Institute. Data as of April 14, 2023.

Crisis containment through strengthened regulations and more vigorous action by authorities is even more important now because heightened political polarization may make additional government action even more difficult than it was in 2008 when partisan divisions nearly sank the Troubled Asset Relief Program (TARP). Complicating any future debate over a government rescue is a threatened standoff over the debt ceiling. And while much of the credit for stanching this year's crisis goes to the Fed, Dodd-Frank restrictions on its emergency-lending authority for bank bailouts could encumber the Fed in a future, more far-reaching crisis.

Investment implications: stay defensive

The combination of credit tightening, still-elevated inflation, and high short-term interest rates reinforces our defensive allocation preferences for the coming 6-18 months (a tactical horizon). We favor:

- U.S. large- and mid-cap equities over small-cap equities
- Quality in equity sectors, including Information Technology, Health Care, and Energy for their long-term revenue prospects and cash-generating prospects
- In fixed income, short- and long-term investment-grade maturities and, in sectors, U.S. Treasuries and municipals (investment-grade and general-obligation or essential-service revenue)
- Commodities for their long-term appreciation potential and shorter-term ability to hedge inflation

Household and banking industry leverage (the latter measured by loan/deposit ratios) are at multi-decade lows, lessening the risk of potential fallout from future liquidity crises.

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What the tightening cycle means for markets

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A balancing act

Today, rising interest rates and decelerating money-supply growth are working to ease inflation but at the expense of reduced liquidity, slower economic activity, and greater market uncertainty. Lingering concerns over U.S. regional banks and European global banks may complicate central-bank tactics, yet we do not think this will put an end to the Fed's tightening cycle.

Liquidity and confidence

The amount of liquidity in capital markets is largely impacted by central-bank policy. With the Fed continuing its tightening policy of raising the fed funds rate and reducing balance-sheet holdings, we expect liquidity conditions to tighten further.

Banks thrive on liquidity and confidence — each informs the other by strengthening or weakening one another. Tighter liquidity can prove ruinous for banks that fail to manage assets effectively and meet cash demands from customers. Near term, additional small and regional banks may struggle, but we do not believe this will pose a risk to the entire U.S. banking system. Regulators responded swiftly to the recent bank failures, plausibly due to lessons learned from credit and liquidity crunches of the 2008 – 2009 global financial crisis and the savings and loan crisis in the 1980s. Fortunately, the larger, global banks appear well-capitalized and have diversified balance sheets.

Yet, a recent poll revealed that approximately half of likely U.S. voters say the recent banking strains made them less confident in the economy.[3] This survey result is consistent with our view that the recent bank failures increase the uncertainty among investors and allow market volatility to linger.

Investment implications of reduced liquidity

As we mentioned in the previous section, financial-market uncertainties about the impact of credit tightening lead us to favor defensive tactical portfolio positioning. In turn, many of those uncertainties concern which equity sectors may next face strains from scarce liquidity.

- In Financials, we remain neutral. Recent sharp declines should create attractive valuations when the economic recovery we expect begins in 2024. The sector has historically outperformed once the yield curve starts to steepen. We believe investors should focus on classic drivers for financial institutions and the sector: liquidity, capital, credit demand, interest rates, and credit-loss cycles. Liquidity is the key driver, especially during market dislocations.

- For the present, some selectivity is in order. Certain segments of Financials, including mortgage real estate investment trusts (MREIT) and business development companies (BDC), appear more vulnerable. Companies in these industries face greater risks. Given their structures, they must disburse nearly all

3. Source: Rasmussen, March 29, 2023

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earnings as dividends. Since they cannot retain capital, these firms require constant access to capital markets. This potential loss of market access is a risk that investors often underappreciate.

- Should the present situation move from a mostly liquidity event to a credit event, certain property types in commercial real estate (CRE), like Office Space, may struggle. Regional banks with sizeable CRE exposure are already under pressure. Those with significant exposure may be even more vulnerable.

The Fed's balance sheet currently exceeds $8.7 trillion.

Source: Bloomberg, March 29, 2023

49% of likely voters say the recent federal takeover of a failed regional bank made them less confident in the economy.

Source: Rasmussen, March 29, 2023

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Risk considerations

Forecasts are not guaranteed and based on certain assumptions and on views of market and economic conditions which are subject to change.

Different investments offer different levels of potential return and market risk. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve.

Equity securities are subject to market risk which means their value may fluctuate in response to general economic and market conditions and the perception of individual issuers. Investments in equity securities are generally more volatile than other types of securities. The prices of small and mid-cap company stocks are generally more volatile than large company stocks. They often involve higher risks because smaller companies may lack the management expertise, financial resources, product diversification and competitive strengths to endure adverse economic conditions.

Sector investing can be more volatile than investments that are broadly diversified over numerous sectors of the economy and will increase a portfolio's vulnerability to any single economic, political, or regulatory development affecting the sector. This can result in greater price volatility. Technology and internet-related stocks, especially of smaller, less-seasoned companies, tend to be more volatile than the overall market.

Investments in fixed-income securities are subject to interest rate, credit/default, liquidity, inflation, and other risks. Bond prices fluctuate inversely to changes in interest rates. Therefore, a general rise in interest rates can result in the decline in the bond's price. Credit risk is the risk that an issuer will default on payments of interest and principal. This risk is higher when investing in high yield bonds, also known as junk bonds, which have lower ratings and are subject to greater volatility. If sold prior to maturity, fixed income securities are subject to market risk. All fixed income investments may be worth less than their original cost upon redemption or maturity.

Income from municipal securities is generally free from federal taxes and state taxes for residents of the issuing state. While the interest income is tax-free, capital gains, if any, will be subject to taxes. Income for some investors may be subject to the federal Alternative Minimum Tax (AMT).

U.S. government securities are backed by the full faith and credit of the federal government as to payment of principal and interest. Unlike U.S. government securities, agency securities carry the implicit guarantee of the U.S. government but are not direct obligations. Payment of principal and interest is solely the obligation of the issuer. If sold prior to maturity, both types of debt securities are subject to market risk.

Exposure to the commodities markets may subject an investment to greater share price volatility than an investment in traditional equity or debt securities. Investments in commodities may be affected by changes in overall market movements, commodity index volatility, changes in interest rates or factors affecting a particular industry or commodity. Products that invest in commodities may employ more complex strategies which may expose investors to additional risks.

There are special risks associated with an investment in real estate, including the possible illiquidity of the underlying properties, credit risk, interest rate fluctuations, and the impact of varied economic conditions.

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