



One Foot on the Brake and One on the Gas

My views on the economic and market implications
of the banking turmoil.

March 2023

Given the speed of events, trying to summarize the impact of the turmoil in the banking sector is like trying to hit the proverbial moving target. (Let's not yet call it a banking crisis. More on that below.)

But one thing seems clear: This is another headwind the economy faces—and one more reason I'm comfortable in our Asset Allocation Committee remaining underweight in stocks relative to bonds and cash.

Tightened Financial Conditions

There are two issues small and medium-sized banks face. On the asset side, they are facing losses on longer-duration Treasuries and loans. On the liability side, wealthy individuals and companies are asking for their deposits back.

Because of the reduced value of their assets, these banks will be more reluctant to lend—they can't afford more losses. They'll also be more conservative in how they invest. This means financial conditions will tighten.

The Bloomberg United States Financial Conditions Index indicates that financial



Sébastien Page

Head of Multi-Asset and
Chief Investment Officer

conditions have already moved to their tightest level since the onset of the pandemic.¹ And it could get worse. I keep thinking of that grim Wall Street adage (presumably dating from before the widespread use of seat belts): "When the Fed slams the brakes, someone's head goes through the windshield."

It's difficult to know if more heads will follow. We haven't borne the brunt of the full effects of the 475 basis points (bps) in rate hikes the Fed has made since last March,² and several signs suggest that the Fed has already slowed the economy considerably:

- Indexes of global economic activity have contracted sharply.
- Leading economic indicators are flashing red.

“...several signs suggest that the Fed has already slowed the economy considerably....”

¹ As of March 20, 2023. Source: Bloomberg® and Bloomberg United States Financial Conditions Index are service marks of Bloomberg Finance L.P. and its affiliates, including Bloomberg Index Services Limited ("BISL"), the administrator of the index (collectively, "Bloomberg") and have been licensed for use for certain purposes by T. Rowe Price. Bloomberg is not affiliated with T. Rowe Price, and Bloomberg does not approve, endorse, review, or recommend this product. Bloomberg does not guarantee the timeliness, accurateness, or completeness of any data or information relating to this product.

² As of March 22, 2023. Source: Board of Governors of the Federal Reserve System (U.S.).

“...it may keep one foot on the brake pedal (through rate hikes) even as it taps the accelerator by providing liquidity....”

- We estimate that house prices could fall as much as 10%.³
- The yield curve (the 10-year Treasury yield minus the two-year yield) is inverted by 60 bps.⁴ (Inversions aren't perfect harbingers of recession, but that's a formidable one.)

Wall Street Seems Complacent

Meanwhile, at around 18 times future earnings, stocks in the S&P 500 Index are about as expensive as they've been on average over the past decade, while consensus estimates are that overall earnings for the index will increase (if just a bit) this year.⁵

To be sure, financial strains mean a more dovish Fed, all things considered. Reduced liquidity and slowed growth in the wake of the banking stresses will do some of the work in cooling inflation that otherwise would be done by rate hikes. It's often overlooked that the Fed has a third mandate—financial stability—alongside the two commonly cited ones: nurturing full employment and controlling inflation.

Targeted Measures Mean Two Feet on the Pedals

But that doesn't mean that the Fed will necessarily begin lowering or even stop raising rates from here. In other words, it may keep one foot on the brake pedal (through rate hikes) even as it taps the accelerator by providing liquidity (or bailouts, if you want to use a dirty word) to the banking system.

It's likely that policymakers will follow their European counterparts in using targeted measures to ease further signs of stress as they appear. For example,

the European Central Bank kept on its planned path of rate hikes last summer but communicated a backstop to stressed Italian sovereign debt. Several months later, the Bank of England kept raising rates even as it headed off a crisis in its pension system by buying the government's long-term bonds (gilts).

A Black Duck, Not a Black Swan: A Financial Crisis Seems Unlikely

It's unlikely that we face a systemic meltdown, such as the banking crisis that began in 2008. I see several key differences:

- We're not currently in a recession. The economy had been in one for nine months before the collapse of Lehman Brothers in September 2008. We're currently near full employment, and families and businesses are still sitting on ample cash—if not quite as much as before.
- Banks are better regulated and better capitalized than they were in 2008, with more cash on hand and stronger capital ratios.
- There's much less speculation on bad housing loans with derivatives layered on top of them. In fact, mortgage delinquencies are near historical lows.
- This time, banks are dealing with mostly paper losses due to Fed tightening. Silicon Valley Bank was investing heavily in U.S. Treasuries—albeit with a massive interest rate risk (duration) mismatch. It's easier to reverse rates and remove the balance sheet pressure this time around, while in 2008 banks were dealing with irreversible credit losses.

³ For illustrative purposes only. Actual future outcomes may differ materially from estimates. Estimates are subject to change.

⁴ As of March 21, 2023. Source: Bloomberg Finance, L.P.

⁵ As of March 21, 2023. Sources: FactSet financial data and analytics: factset.com; the S&P 500 Index is a product of S&P Dow Jones Indices LLC, a division of S&P Global, or its affiliates ("SPDJ"), and has been licensed for use by T. Rowe Price. Standard & Poor's® and S&P® are registered trademarks of Standard & Poor's Financial Services LLC, a division of S&P Global ("S&P"); Dow Jones® is a registered trademark of Dow Jones Trademark Holdings LLC ("Dow Jones"). This product is not sponsored, endorsed, sold, or promoted by SPDJI, Dow Jones, S&P, or their respective affiliates, and none of such parties make any representation regarding the advisability of investing in such product(s) nor do they have any liability for any errors, omissions, or interruptions of the indices.

- Following the banking reforms of 2010, there's much more transparency and much less speculation in unregulated and complex areas of financial markets.*

A colleague of mine is calling this a “black duck” event, in contrast to the “black swan” of 2008.** Black ducks are more common than black swans—you see them around occasionally and don't bother pulling out your camera.

In other words, don't panic, but consider lowering your growth and earnings expectations.

*Of course, recent events revealed gaps in that regulation, especially that banks with less than USD 250 billion in assets aren't subject to the same stress tests as those above that threshold. Ultimately, this will lead to increased regulation on banks, which will squeeze their margins considerably, so I think bank earnings will remain challenged despite the sell-off. That said, we are seeing opportunities in some areas of financials that have sold off in sympathy, such as insurance.

**Credit to Dave Eiswert, Portfolio Manager for the Global Focused Growth Equity Strategy, for the analogy.

The specific securities identified and described are for informational purposes only and do not represent recommendations.

INVEST WITH CONFIDENCESM

T. Rowe Price focuses on delivering investment management excellence that investors can rely on—now and over the long term.

T.RowePrice[®]

Important Information

This material is being furnished for general informational and/or marketing purposes only. The material does not constitute or undertake to give advice of any nature, including fiduciary investment advice, nor is it intended to serve as the primary basis for an investment decision. Prospective investors are recommended to seek independent legal, financial and tax advice before making any investment decision. T. Rowe Price group of companies including T. Rowe Price Associates, Inc. and/or its affiliates receive revenue from T. Rowe Price investment products and services. **Past performance is not a reliable indicator of future performance.** The value of an investment and any income from it can go down as well as up. Investors may get back less than the amount invested.

The material does not constitute a distribution, an offer, an invitation, a personal or general recommendation or solicitation to sell or buy any securities in any jurisdiction or to conduct any particular investment activity. The material has not been reviewed by any regulatory authority in any jurisdiction.

Information and opinions presented have been obtained or derived from sources believed to be reliable and current; however, we cannot guarantee the sources' accuracy or completeness. There is no guarantee that any forecasts made will come to pass. The views contained herein are as of the date written and are subject to change without notice; these views may differ from those of other T. Rowe Price group companies and/or associates. Under no circumstances should the material, in whole or in part, be copied or redistributed without consent from T. Rowe Price.

The material is not intended for use by persons in jurisdictions which prohibit or restrict the distribution of the material and in certain countries the material is provided upon specific request. It is not intended for distribution to retail investors in any jurisdiction.

DISCLOSURE CONTINUES ON THE FOLLOWING PAGE.

Important Information (cont.)

Australia—Issued by T. Rowe Price Australia Limited (ABN: 13 620 668 895 and AFSL: 503741), Level 28, Governor Phillip Tower, 1 Farrer Place, Sydney NSW 2000, Australia. For Wholesale Clients only.

Brunei—This material can only be delivered to certain specific institutional investors for informational purpose only. Any strategy and/or any products associated with the strategy discussed herein has not been authorised for distribution in Brunei. No distribution of this material to any member of the public in Brunei is permitted.

Canada—Issued in Canada by T. Rowe Price (Canada), Inc. T. Rowe Price (Canada), Inc.'s investment management services are only available to Accredited Investors as defined under National Instrument 45-106. T. Rowe Price (Canada), Inc. enters into written delegation agreements with affiliates to provide investment management services.

DIFC—Issued in the Dubai International Financial Centre by T. Rowe Price International Ltd which is regulated by the Dubai Financial Services Authority as a Representative Office. For Professional Clients only.

EEA—Unless indicated otherwise this material is issued and approved by T. Rowe Price (Luxembourg) Management S.à r.l. 35 Boulevard du Prince Henri L-1724 Luxembourg which is authorised and regulated by the Luxembourg Commission de Surveillance du Secteur Financier. For Professional Clients only.

Hong Kong—Issued by T. Rowe Price Hong Kong Limited, 6/F, Chater House, 8 Connaught Road Central, Hong Kong. T. Rowe Price Hong Kong Limited is licensed and regulated by the Securities & Futures Commission. For Professional Investors only.

Indonesia—This material is intended to be used only by the designated recipient to whom T. Rowe Price delivered; it is for institutional use only. Under no circumstances should the material, in whole or in part, be copied, redistributed or shared, in any medium, without prior written consent from T. Rowe Price. No distribution of this material to members of the public in any jurisdiction is permitted.

Korea—This material is intended only to Qualified Professional Investors. Not for further distribution.

Mainland China—This material is provided to qualified investors only. No invitation to offer, or offer for, or sale of, the shares will be made in the mainland of the People's Republic of China ("Mainland China", not including the Hong Kong or Macau Special Administrative Regions or Taiwan) or by any means that would be deemed public under the laws of the Mainland China. The information relating to the strategy contained in this material has not been submitted to or approved by the China Securities Regulatory Commission or any other relevant governmental authority in the Mainland China. The strategy and/or any product associated with the strategy may only be offered or sold to investors in the Mainland China that are expressly authorized under the laws and regulations of the Mainland China to buy and sell securities denominated in a currency other than the Renminbi (or RMB), which is the official currency of the Mainland China. Potential investors who are resident in the Mainland China are responsible for obtaining the required approvals from all relevant government authorities in the Mainland China, including, but not limited to, the State Administration of Foreign Exchange, before purchasing the shares. This document further does not constitute any securities or investment advice to citizens of the Mainland China, or nationals with permanent residence in the Mainland China, or to any corporation, partnership, or other entity incorporated or established in the Mainland China.

Malaysia—This material can only be delivered to specific institutional investor. This material is solely for institutional use and for informational purposes only. This material does not provide investment advice or an offering to make, or an inducement or attempted inducement of any person to enter into or to offer to enter into, an agreement for or with a view to acquiring, disposing of, subscribing for or underwriting securities. Nothing in this material shall be considered a making available of, solicitation to buy, an offering for subscription or purchase or an invitation to subscribe for or purchase any securities, or any other product or service, to any person in any jurisdiction where such offer, solicitation, purchase or sale would be unlawful under the laws of Malaysia.

New Zealand—Issued by T. Rowe Price Australia Limited (ABN: 13 620 668 895 and AFSL: 503741), Level 28, Governor Phillip Tower, 1 Farrer Place, Sydney NSW 2000, Australia. No Interests are offered to the public. Accordingly, the Interests may not, directly or indirectly, be offered, sold or delivered in New Zealand, nor may any offering document or advertisement in relation to any offer of the Interests be distributed in New Zealand, other than in circumstances where there is no contravention of the Financial Markets Conduct Act 2013.

Philippines—ANY STRATEGY AND/ OR ANY SECURITIES ASSOCIATED WITH THE STRATEGY BEING DISCUSSED HEREIN HAVE NOT BEEN REGISTERED WITH THE SECURITIES AND EXCHANGE COMMISSION UNDER THE SECURITIES REGULATION CODE. ANY FUTURE OFFER OR SALE OF THE STRATEGY AND/ OR ANY SECURITIES IS SUBJECT TO REGISTRATION REQUIREMENTS UNDER THE CODE, UNLESS SUCH OFFER OR SALE QUALIFIES AS AN EXEMPT TRANSACTION.

Singapore—Issued by T. Rowe Price Singapore Private Ltd. (UEN: 201021137E), 501 Orchard Rd, #10-02 Wheelock Place, Singapore 238880. T. Rowe Price Singapore Private Ltd. is licensed and regulated by the Monetary Authority of Singapore. For Institutional and Accredited Investors only.

South Africa—Issued in South Africa by T. Rowe Price International Ltd (TRPIL), 60 Queen Victoria Street, London, EC4N 4TZ, is an authorised financial services provider under the Financial Advisory and Intermediary Services Act, 2002 (Financial Services Provider (FSP) Licence Number 31935), authorised to provide "intermediary services" to South African Investors. TRPIL's Complaint Handling Procedures are available to clients upon request. The Financial Advisory and Intermediary Services Act Ombud in South Africa deals with complaints from clients against FSPs in relation to the specific services rendered by FSPs. The contact details are noted below: Telephone: +27 12 762 5000, Web: www.faisombud.co.za, Email: info@faisombud.co.za

Switzerland—Issued in Switzerland by T. Rowe Price (Switzerland) GmbH, Talstrasse 65, 6th Floor, 8001 Zurich, Switzerland. For Qualified Investors only.

Taiwan—This does not provide investment advice or recommendations. Nothing in this material shall be considered a solicitation to buy, or an offer to sell, a security, or any other product or service, to any person in the Republic of China.

Thailand—This material has not been and will not be filed with or approved by the Securities Exchange Commission of Thailand or any other regulatory authority in Thailand. The material is provided solely to "institutional investors" as defined under relevant Thai laws and regulations. No distribution of this material to any member of the public in Thailand is permitted. Nothing in this material shall be considered a provision of service, or a solicitation to buy, or an offer to sell, a security, or any other product or service, to any person where such provision, offer, solicitation, purchase or sale would be unlawful under relevant Thai laws and regulations.

UK—This material is issued and approved by T. Rowe Price International Ltd, 60 Queen Victoria Street, London, EC4N 4TZ which is authorised and regulated by the UK Financial Conduct Authority. For Professional Clients only.

© 2023 T. Rowe Price. All Rights Reserved. T. ROWE PRICE, INVEST WITH CONFIDENCE, and the Bighorn Sheep design are, collectively and/or apart, trademarks of T. Rowe Price Group, Inc.