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The closure of three tech-focused lenders over the course of four days in the United States has sent shock waves across financial markets in the form of a substantial uncertainty shock. While the development could be seen as being idiosyncratic in nature, the impact of what’s transpired—including the response from policymakers—could be far reaching. Frances Donald, Global Chief Economist and Strategist, Multi-Asset Solutions Team, discusses what this could mean for the U.S. economy and possible scenarios that could take place in the next few weeks.

The closure of three tech-focused lenders — A framework for navigating a massive uncertainty shock

Make no mistake: The events that transpired over the past few days—and what happens over the coming weeks (and possibly months)—will be studied by scholars, regulators, and historians for years to come.

In our view, the closure of three notable banking entities has injected key risks into the macroeconomic backdrop. Investors everywhere are wondering if the event could morph into a broad systemic risk and whether it would deal an irreparable blow to investors’ confidence in the banking system. Crucially, do events from the last four days represent a canary in the coal mine? Will we see more similar events ahead?

Chart 1: Macro outlook — three key risks



Source: Manulife Investment Management, as of March 13, 2023. Fed refers to the U.S. Federal Reserve. FDIC refers to Federal Deposit Insurance Corporation.

Based on the information we have so far, the likelihood of current events evolving into a broader systemic risk is low; however, low doesn't mean immaterial. As of this writing, market pricing of U.S. bank stocks on Monday suggests that confidence in the U.S. regional banking sector specifically is weakening, although it should be noted that the coordinated efforts between the U.S. Treasury, the Federal Deposit Insurance Corporation, and the U.S. Federal Reserve (Fed) have gone some way to mitigate real risks and sentiment issues over the worst-case scenario that had been percolating since March 10.

What does this mean for the U.S. economy?

From an economic perspective, this past weekend's events have reinforced our base-case expectations on the U.S. economy:

- The odds of a hard landing (which we would characterize as a recessionary environment) and a rise in unemployment are still high. We continue to expect growth to slip into negative territory around Q4 2023; should efforts to contain the fallout fail to work as hoped, the recession could begin sooner.
- The impact of Fed tightening typically takes some time to hit the real economy. Considering that the Fed only started to raise interest rates last March, it's fair to say that the economy has yet to absorb the full effects of recent rate hikes.
- Bank lending standards are likely to become even tighter, which has typically weighed heavily on growth.
- Historically, weakness in the technology and financials sectors has had a disproportionately large impact on the broader economy. Should current events dampen sentiment within these sectors and hurt investment activity, productivity, or employment, we could see a negative impact on the broader economy as well.

Monetary policy: what will the Fed do next?

It's never easy to predict what the Fed might do next, particularly in a time of duress; however, we think the Fed has now lost the luxury of framing its actions and decisions solely around inflation. The central bank must now reassess the potential costs and benefits of each incremental rate hike.

The key questions confronting the Fed in the coming weeks:

- Should it raise rates further on March 22, or will it consider making a dovish pivot?
- Should the medium-term interest-rate outlook be updated to reflect a lower terminal rate?
- Should it separate its financial stability tools from its inflation fighting tool?
- How might the decision to protect depositors affect inflation?

Three possible scenarios¹

1. The Bank of Canada scenario

The Fed could mirror [what the Bank of Canada did on March 8](#) and signal a pause in tightening. In this scenario, a final 25 basis point increase on March 22 would likely include language noting that the U.S. central bank is expecting to hold the policy rate at its current level while it assesses the impact of cumulative interest-rate increases. The Fed could also make references to the need to monitor events in the financial system while signaling that spillover risks from the bank closures are contained.

This scenario would enable the Fed to incorporate language to signal its willingness to increase the policy rate further, if needed, to return inflation to the 2% target.

¹ This information may contain projections or other forward-looking statements regarding future events and is only as current as of the date indicated. There is no assurance that such events will occur, and if they were to occur, the result may be significantly different from that shown here. The information in this material, including statements concerning

financial market trends, are based on current market conditions, which will fluctuate and may be superseded by subsequent market events for other reasons.

In our view, this scenario would be dovish in the short term, effectively capping policy rate expectations for the next few meetings while promoting a measure of stability. Over the medium term, flexibility around the direction of future moves could be maintained while reminding markets that inflation remains an important consideration that could outlast current developments.

Probability: **medium**

2. The Bernanke scenario

In this scenario, an unfavorable inflation print on March 14 would serve as a reminder that there's still some way to go before the Fed's stated goal of price stability is attained. In this instance, the Federal Open Market Committee might choose to paraphrase former Fed Chair Ben Bernanke's [right tool for the right job](#) maxim and communicate that the federal funds rate isn't the appropriate tool to stabilize current weakness in the financial system.

The Fed's fundamental messaging around policy rate decisions will likely be in line with earlier market pricing (i.e., peak terminal rate in the next two or three meetings, followed by an extended pause). In this case, the Fed would also move to backstop acute issues in the financial system with tools similar to what we saw implemented during the pandemic. The goal would be to ensure acute liquidity events are contained quickly.

We think this is the most hawkish of the three scenarios and could possibly lead to heightened volatility in fixed income as markets reprice old views. It could also open the Fed up to criticism about possible policy mistakes.

Probability: **low-medium**

3. The it's over scenario

In this scenario, the Fed will keep interest rates unchanged at the next meeting and signal that there are more acute concerns about the health of the financial system and note its intention to create new facilities to backstop future problems of this nature.

In this case, the Fed is likely to have signaled its intention to engage in monetary easing in the coming months. It would also imply that concerns over recent developments are sufficiently important to supersede inflationary considerations.

Probability: **low**

The bar for rate hikes is now higher

There's still a significant amount of outstanding information to process in the days and weeks ahead. Problematically, a good deal of it will come down to confidence and investor psychology, which is notoriously difficult to predict.

That said, what's now clear is that the Fed—and other central bankers—have lost the luxury of focusing singularly on the fight against inflation. Indeed, the costs associated with higher interest rates are rising and will be weighed against what are likely declining benefits. In our view, this raises the bar for more rate hikes moving forward.

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