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UOB Investment Insights

Thinking Ahead

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The Federal Reserve's latest rate hike and its implications on the economy and key sectors

- The United States Federal Reserve (Fed) hiked interest rates by another 25 basis points (bps) at its latest meeting. Does this mark the end of its rate hike cycle?
- First Republic Bank became the latest US bank to fail earlier this week and was acquired by JPMorgan Chase and Co. However, this development is unlikely to pose systemic risks to the wider banking sector.
- Instead, further banking sector turmoil could arise due to the commercial real estate sector, which faces challenges as a result of the high interest rate environment.

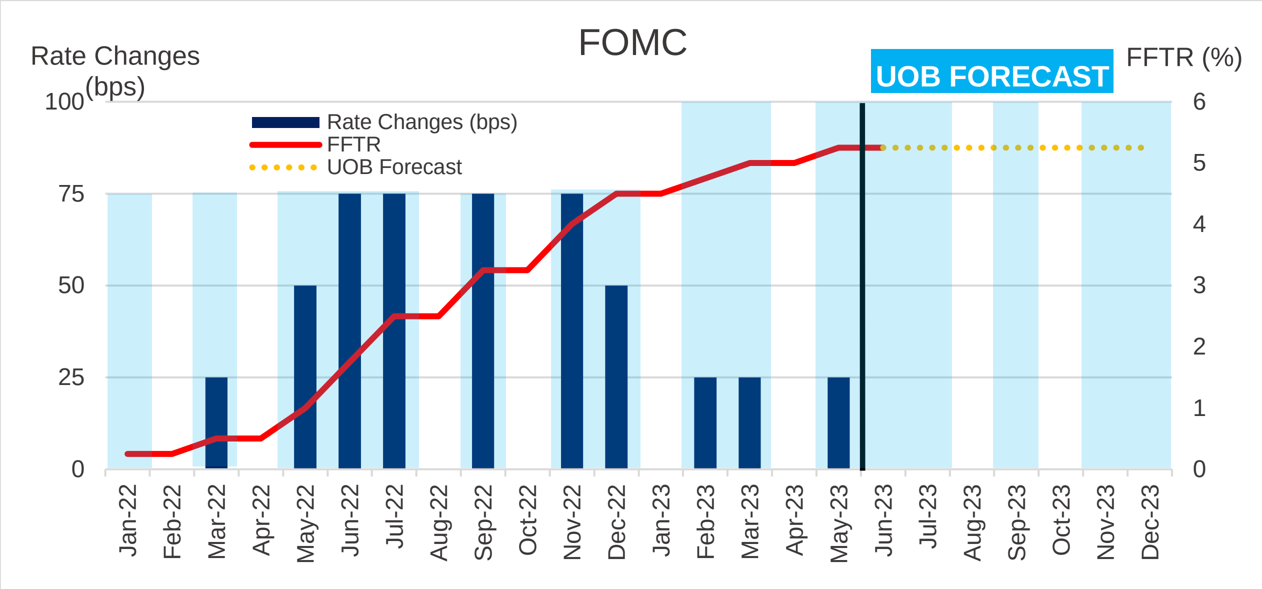
What's next after the latest Federal Reserve rate hike?

- At the 3 May Federal Open Market Committee (FOMC) meeting, the Fed went ahead with a widely expected 25 bps rate hike to lift the Fed Funds Target Rate to 5.00% – 5.25%, the highest since September 2007. The Fed's policy guidance, however, was tweaked to allow the possibility of a rate pause from here, citing the lagged impact of prior policy tightening, although Fed Chair Jerome Powell emphasised the central bank will assess monetary policy on a "meeting by meeting" basis.
- The banking sector turmoil in March proved to be a turning point, as it spotlighted the unintended consequences and broader economic risks of aggressive policy tightening.
- Fed officials are now less aggressive in their policy outlook, with some calling for prudence in future policy moves. Bank lending has tightened significantly in the US, which poses the risk of cooling the jobs market and weighing on consumption. Tighter credit conditions have the same effect as policy tightening, meaning the Fed has to do less on its part.
- However, with inflation staying well above the 2% target, Fed officials have stressed that they need to keep interest rates high and dismissed speculation of rate cuts later this year.

Our View: End of the tightening cycle, but no rate cuts expected this year

- Our view is that this will be the last rate hike of the cycle, and we expect the Fed to keep interest rates unchanged at 5.00% - 5.25% for the rest of the year.
- We do not expect the Fed to cut rates later this year, primarily because of persistently high inflation, robust consumer spending and the view that any recession would be mild.

UOB's Projected US Federal Funds Target Rate Trajectory (as of 4 May 2023)



Source: UOB PFS Investment Strategists, UOB Global Economics & Markets Research.

JPMorgan takes over First Republic Bank

- More upheaval was seen in the US banking sector earlier this week, after the US Federal Deposit Insurance Corporation (FDIC) seized First Republic Bank, and JPMorgan Chase & Co. agreed to take over the troubled lender.
- Similar to the case of Silicon Valley Bank, First Republic Bank's demise is a unique situation owing to its niche business concentrating on high-end consumers, a high proportion of deposits above the federally insured level of US$250,000 and low-interest mortgages it provided to wealthy clients. Fears surrounding the bank's health prompted an acceleration in deposit outflows.
- First Republic Bank may not be the last US regional bank to fail, with PacWest Bancorp now under the spotlight and weighing a range of options including a sale.
- Nonetheless, we do not foresee systemic risks for the wider banking sector, although sentiment towards the sector will remain cautious for the time being.

Will the commercial real estate sector and commercial mortgage-backed securities trigger another bout of banking sector turmoil?

- A big part of the banking sector stress stems from the Fed's aggressive rate hikes over the past year, leaving banks with heavy unrealised losses on their holdings of US Treasury bonds and mortgage-backed securities[1] (MBS).

[1] Mortgage-backed securities (MBS) are investment products issued by banks, which package home loans and other real estate debt into collateralised bonds before selling them to investors at a discount. Payouts to investors are scheduled like bond coupons.

- The Fed's Quantitative Tightening (QT) also led to a decline in bank deposits, as investors flocked to higher-yielding money-market funds.
- Going forward, two areas stick out as potential risks: the commercial real estate (CRE) market with approximately US$5.4 – US$5.6 trillion in outstanding debt, and commercial mortgage-backed securities[2] (CMBS).
    - In the US, small and medium-sized regional banks account for around 70% of all CRE loans, with the smallest banks having the largest proportion of CRE debt on their loan books.
    - As CMBS issuance fell in 2022, banks have been taking on more of the burden of CRE lending, where assets are illiquid and take longer to dispose of.
- This trend poses a few risks:
    - The CRE market is facing challenges due to high borrowing costs and a slowing economy. If there is a severe recession, we could see rising defaults in the retail property sector. Additionally, more people are working from home post-pandemic, which has led to a spike in vacancy rates for offices and lower property values.
    - The decline in commercial property valuations and a potential jump in defaults could then lead to increasingly stringent lending standards from banks, which ultimately feeds back into weaker economic activity.
    - To top things off, approximately US$1.2 - US$1.5 trillion of CRE debt is set to mature over the next two years, and this pile of debt will need to be refinanced in an unfavourable environment of higher interest rates and tighter credit conditions.
- The other potential risk comes from the shadow banking sector such as private lenders, real estate investment funds and hedge funds, which are less regulated and often highly leveraged. If one of these players collapses, the web of complex transactions could ensnare other financial institutions and trigger stress in the broader financial system.

The commercial real estate sector is unlikely to pose a systemic risk to the banking sector

- It is prudent to be aware of potential "Grey Swan" events. If we see a scenario where the economic slowdown is deeper than expected and banks face rising unrealised losses in their CRE loan books, another round of banking sector turmoil cannot be ruled out. US policymakers may again be forced to step in to shore up investor confidence.
- However, it is unlikely to become a systemic risk.
    - This is because the risky part of a bank's loan portfolio comes mainly from the office-related sector. However, most banks and insurance companies tend to have diversified loan portfolios, and most banks are well-capitalised to cover potential losses.
    - While defaults may rise, it is unlikely to hit levels seen in the Global Financial Crisis as any potential stress will be centred around CRE rather than a broad housing and mortgage crisis.

[2] Commercial mortgage-backed securities are narrower in scope than mortgage-backed securities, as mortgages for commercial properties form the only underlying securities.

- As such, though the most vulnerable banks could come under pressure, the impact to the broader banking sector may be manageable as the hit will come primarily from lower earnings margins rather than widescale capital losses.

What you can do

- We do not expect commercial real estate risks to create systemic issues for the overall banking sector. Nonetheless, it could trigger renewed market volatility, especially when the broader economy is showing signs of slowing and recession risks are building.
- Heading into the recession stage of the economic cycle, investors should build resilient portfolios to work towards their long-term financial goals and avoid concentrating their investments in any one sector or market.
- Global multi-asset strategies can help to lower portfolio volatility. Investors can also lock in higher yields via Investment Grade (IG) bonds, as the global monetary tightening cycle is nearing the end.
- Investors with the appropriate risk appetite who are looking at tactical market opportunities can consider our Top Ideas of Asia/China/ASEAN to tap on China's re-opening, as well as Global Healthcare to ride on the long-term trend of an ageing global population.
- Speak to a UOB Advisor on how to position your portfolio according to your risk appetite.

Right By You

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