Beneath the Surface

April 2023

SIGNET

Bank Stress Tests Missed The Stress

- At the 90th birthday celebration of Milton Friedman, then the world's leading monetary economist, Ben Bernanke summarised Friedman's work in identifying the leading causes of the Great Depression's enduring contraction. Friedman & Schwartz (1963) believed that the Federal Reserve's actions and inactions were ultimately responsible for this economic episode. The leading causes were highlighted as: (1) the aggressive hiking of interest rates from 1928; (2) maintaining the gold standard in 1931, which led to foreign dollar deposits leaving the banking system and a money supply contraction; (3) quantitative easing in 1932, which was quickly followed by evidence of economic relief, but was not followed through effectively enough and (4) a failure in early 1933 to neutralise the contraction of money supply and sever the link between gold and the dollar. Bernanke completed his speech on behalf of the Federal Reserve (informally) with the infamous conclusion: "I would like to say to Milton and Anna: Regarding the Great Depression. You're right, we did it. We're very sorry. But thanks to you, we won't do it again."

- Such a statement should bring comfort. However, after the excessive and irresponsible Covid-related monetary stimulus of 2020-21, we are now watching the Federal Reserve drain the money supply at the most rapid pace since the Great Depression (M2 YoY is -5.1%). To compound matters, we are also experiencing, arguably, the most aggressive interest rate hiking policy ever – and certainly since 1980. Not so comfortable now. While the monetary mistakes of 2020-21 are now quite visible, the repercussions of the aggressive tightening are only now starting to manifest; the smaller banks and shadow banking system were always likely to be the proverbial 'canaries.' How prepared is the Fed, and the economic system, for such monetary volatility? A quick review of the Fed's bank stress test scenarios gives us an answer, and a useful clue to understanding the abrupt and unexpected weakness of US banks recently; the regional banking index is down by 35% in three months.

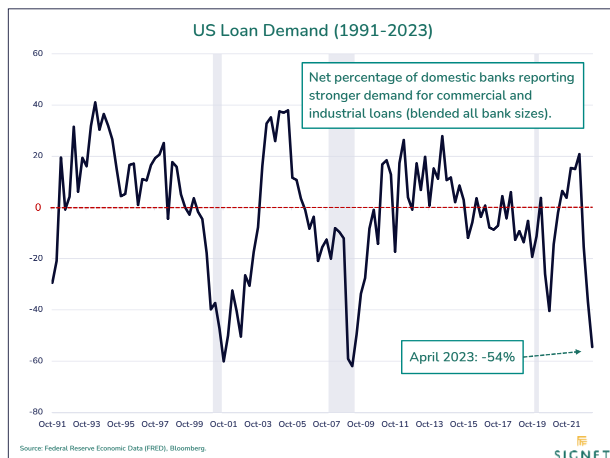
- The 2022 'Severely Adverse' bank test scenario covers Q1 2022 to Q1 2025 and estimates the impact of a severe global recession against 28 key economic and market variables. An extract is posted in the table below. We can see the scenarios the banks and the Fed have been programmed to expect – and what they are not expecting. Critically, while the banks could expect GDP and asset prices to plummet, with rising unemployment, they were not expecting inflation to suddenly spike. They weren't expecting market interest rates to blow out, with losses to their Tier 1 capital (assets) and the subsequent deposit flight (liabilities). In other words, the bank stress tests only captured one hypothetical dimension to a bad recession and completely missed the macroeconomic dimension that has evolved over the last year. In February, the Fed announced that 722 banks had reported unrealized losses exceeding 50% of their Tier 1 capital (31 banks reported negative tangible equity). How should we expect the economy to respond to unexpected stresses? Risk taking is probably curtailed. The demand and supply of credit, an example is in the chart below right, is likely to further tighten and that's not good for economic growth or an aggressive investment stance.

Federal Reserve 2022 Stress Test Scenario (Severely Adverse)

Date	GDP	U-3 Rate	CPI Inflation	3-Month T-Bill	10- Year Treasury	30-Year Mortgage	Prime Bank Loan Rate	Dow Jones Index	House Price Index
Dec 2021 (Actual)	**5.7**	**3.9**	**7.0**	**0.1**	**1.4**	**3.1**	**3.2**	**35,500**	**277**
Q1 2022	-1.4	7	2.3	0.1	0.7	3	3.1	26,749	246
Q2 2022	-6.2	8.1	1.5	0.1	0.7	3.5	3.1	23,345	232
Q3 2022	-4	8.9	1.3	0.1	0.7	3.7	3.1	22,372	221
Q4 2022	-1.8	9.4	1.3	0.1	0.8	3.8	3.1	21,885	213
Q1 2023	-1	9.8	1.4	0.1	0.9	3.8	3.1	22,858	205
Apr 2023 (Actual)	**1.6**	**3.4**	**5.0**	**4.9**	**3.5**	**6.4**	**8.0**	**33,700**	**297***
Q2 2023	1.3	9.9	1.4	0.1	1	3.7	3.1	24,317	200
Q3 2023	1.3	10	1.4	0.1	1.1	3.7	3.1	26,263	195
Q4 2023	6.6	9.5	1.5	0.1	1.2	3.6	3.1	28,694	191
Q1 2024	6.2	8.9	1.5	0.1	1.3	3.5	3.1	31,612	195
Q2 2024	5.8	8.5	1.5	0.1	1.3	3.4	3.1	34,530	198
Q3 2024	5.5	8.1	1.6	0.1	1.4	3.3	3.1	38,907	201
Q4 2024	5.2	7.7	1.6	0.1	1.5	3.2	3.1	43,771	205
Q1 2025	4.9	7.4	1.6	0.1	1.5	3.2	3.1	48,634	208

Source: Federal Reserve Dodd Frank Act Stress Test Publications (2022), Bloomberg. With "Actual" additions. 297* = Dec 22.

SIGNET



- **Therefore:** We remain cautious so remain defensively invested. Fixed Income: there are opportunities to target quality and liquidity. Equities: target quality but there's no rush. Commodities: target precious metals.

Research Report Disclaimer: This communication and all the information provided is marketing material. The views and opinions contained herein may not necessarily represent views expressed or reflected in other communications and/or strategies of Signet Capital Management Ltd. (the "Company"). Therefore, this material is intended to be for information purposes only and is not intended as promotional material in any respect. The material is not intended as an offer or solicitation for the purchase or sale of any financial instrument. Please read our Marketing Communication Disclaimer for further assistance.

Marketing Communication Disclaimer: The content of this material is a marketing communication and does not constitute any form of independent investment advice and/or recommendation and/or research. The material is for general information purposes only (whether or not it states any opinions). Nothing in this material is (or should be considered to be) legal, financial, investment and/or other form of advice and/or recommendation on which reliance should be placed. No opinion given in the material constitutes a recommendation by Signet Capital Management Ltd. (the "Company") or the author that any particular investment, security, transaction or investment strategy is suitable for any specific person. Although the information set out in this marketing communication is obtained from sources believed to be reliable, the Company makes no guarantee as to its accuracy or completeness. All information is indicative and subject to change without notice and may be out of date at any given time. Neither the Company or the author of this material shall be responsible for any loss that you may incur, either directly or indirectly, arising from any investment based on any information contained herein. This material may include charts displaying financial instruments' past performance as well as estimates and forecasts. Any information relating to past performance of an investment does not necessarily guarantee future performance. Please seek independent advice.