FedFin Client Report

Monday, November 7, 2022

Fed Systemic-Risk Fears Cloaked in Cautious Financial-Stability Report

Client Report: SYSTEMIC94

Executive Summary

As we noted Friday afternoon, the Federal Reserve then released its semi-annual financial-stability report in an effort not only to comply with its protocols, but likely also to attract as little attention as possible, with the release and even the report saying only as much about growing risk as the Fed thinks is essential to preserve its credibility. In this report, we provide an in-depth assessment not only of the Fed's latest risk landscape, but also of the steps it recommends be deployed to mitigate it to the extent these are also noted in a largely statistical analysis. As is often the case, the Fed uses aggregate or average data to assess household financial risk, a methodology we fear obscures distributional effects for the majority of households. The data – e.g., re non-financial business leverage – are also often as of the end of the report's data run, not forward-looking. Where projections are forward-looking – e.g., re non-investment grade or private business leverage – the Fed report generally notes concerns without making clear how acute these may be or the probability that drivers that could significantly and adversely affect them. Still, as noted earlier today, its discussion of residential-mortgage risk is surprisingly sobering. The Fed also remains deeply troubled by prime and tax-exempt MMF run risk.

Analysis

Near-term risks are found to be:

- the impact of "unexpectedly" and persistently high inflation and higher interest rates could threaten the financial system or economy via reduced debt-service capacity, financial-market volatility, and other strains;
- shocks caused by cyber events; and
- complex, unrecognized inter-dependencies (e.g., non-substitutable critical infrastructure).

Key vulnerabilities are said to be derived from:

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- **Property-market valuations**: Residential prices are of greatest concern.

- **Liquidity**: Treasury markets are found to have operated smoothly despite a sharp increase in illiquidity and a moderate, but worrisome hike in trading costs. The Fed's solution here appears to be another round of recommendations from the inter-agency group working on Treasury-market reform.

- **Leverage**: Household and corporate debt levels are "moderate," with household vulnerability determined to be "modest" despite rising debt. Still, the Fed fears looming difficulties for borrowers with adjustable-rate obligations should real-estate prices fall farther. Although nonbank financial institution (NBFI) leverage is "elevated," vulnerabilities are "likely moderate" despite Fed concerns about inadequate data and thus "pockets" of potentially systemic leverage. Still, the Fed is confident in the ability of banks and broker-dealers to absorb it. However, the amount of interconnectedness between banks and NBFIs due to outstanding loans is a significant concern.

- **Funding Risk**: Domestic-bank funding risk is low, but structural problems in other sectors presents significant run-risk (i.e., prime and tax-exempt MMFs said to be a "significant systemic vulnerability," open-end bond funds, and stablecoins which are of particular concern due to potential fixed-rate market contagion risk). Life-insurance liquidity risk also remains a significant concern.

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