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# Financial Stability: Cloudy, With A Chance Of Showers

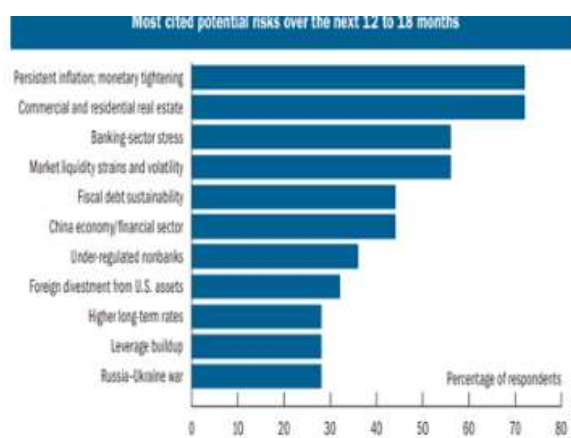
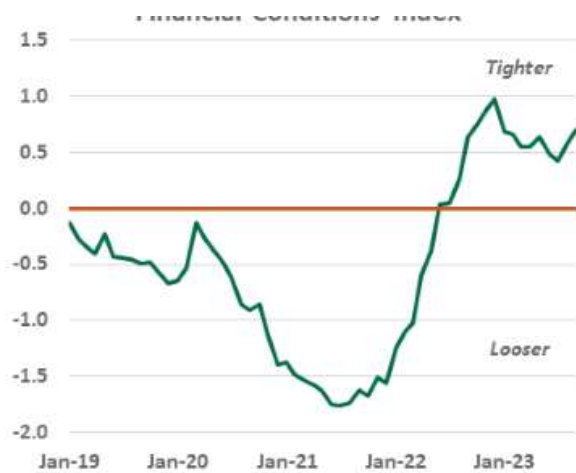
The banking system has stabilized, but latent threats remain.



The Survey of Consumer Finances wasn't the only significant report released by the Federal Reserve last week. The semiannual **Financial Stability Report** (FSR) was also noteworthy.

The last FSR was issued in May, amid the banking turmoil that marred the spring. Interestingly, we rarely talk about that episode much anymore, as threatening as it seemed at the time. Deposit levels at banks have stabilized, and we have seen no further distress.

But the bank failures of last spring led to a tightening of credit. The Fed's own gauge of financial conditions, which places heavy weights on bank lending standards and long-term interest rates, has swung from easy to restrictive in a very short space of time. Further, the **regulatory environment** surrounding banks has become more limiting. As these changes take deeper root, it will produce economic headwinds and stress some portfolios.



Source: Federal Reserve

The latest FSR attempts to anticipate where this stress might surface. The report focused attention on the following candidates:

- There is not a lot of public information about alternative asset classes, so we know little about their sensitivity to interest rates or other market movements. By design, there is a lot of equity in these vehicles that can absorb losses, but most funds also have credit lines that can serve as a channel of financial contagion if trouble arises.
- Higher interest rates and hybrid work have hindered **commercial real estate** values. There are concentrations of exposure to this sector in small banks and certain investment products.
- Tight monetary policy in Western countries has limited demand for exports. As the world's leading exporter, China has borne the brunt of this development. As the world's second largest economy, China is well represented in many investment portfolios. That has been beneficial to returns in most years, but China's **recent financial challenges** could be a source of underperformance and systemic risk.

While not related to interest rates, the FSR also expresses justifiable concern over the potential for international unrest to shock markets and produce instability.

Thankfully, most of the concerns raised in financial stability reports never come to fruition. But that doesn't diminish the value of the surveillance. Let's hope for the best, but prepare for the worst.

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