2:00 pm, September 5, 2024

## Financial Sector Advisory Council Meeting

### Council Attendees

Hayley Boesky, BofA Securities
Frank Brosens, Taconic Capital Advisors
Gabriel Casillas, Barclays Capital
Chris Edmonds, Intercontinental Exchange
David Finkelstein, Annaly Capital Management
Britt Harris, On Eagles Wings
Jarvis Hollingsworth, Irradiant Partners
Travis Machen, Morgan Stanley
Henry McVey, KKR
Mark Seidner, PIMCO
Allison Thacker, Rice Management Company
Matthew Zames, Zames Group

### Federal Reserve Bank of Dallas Staff in Attendance:

Lorie Logan, Sam Schulhofer-Wohl, Robert Triplett, Seth Searls, Mike Schetzel, Karel Mertens, David Teeples, Jeff Garrett, Heidi Mitchell, Roberto Coronado, Jody Stanley, Rebecca Zarutskie, Christine Docherty, Alessio Saretto, Jim Dolmas, Pia Orrenius, Enrique Martinez-Garcia, Alex Richter, Anthony Murphy, Ron Mau, Ali Ozdagli, Haoyang Liu, Amy Chapel, Lorenzo Garza, Amy McGregor, Ally Hoffman, Ben Munyan, Garrett Golding, Hugo De Vere

### Discussion of Economic and Policy Outlook:

Council members noted how the risks to the economic outlook were in better balance than in recent meetings, highlighting both downside risks to employment and upside risks to inflation. Members discussed the recent cooling in the labor market, although they observed that the increase in the unemployment rate was driven in part by increased labor supply. They also noted that some consumer tailwinds may be waning, with household liquid assets as a share of GDP returning toward pre-pandemic levels, and that a fading fiscal impulse, lower immigration, and lagged impacts from a restrictive monetary policy stance could also weigh on growth ahead.

On inflation, council members noted a range of short- and medium-term factors that posed upside risks, including the possibility of increased tariffs, declines in immigration that might remove a source of downward wage pressure, and the risk of ongoing increases in property and casualty insurance premiums.

Council members discussed the policy path, with most expecting the Federal Open Market Committee (FOMC) to pursue a gradual approach to normalization. Members noted that GDP growth remained solid, and asset valuations in equity and credit markets remained elevated. Members observed that in the past, the FOMC had not pursued front-loaded interest rate cuts unless there were clearer signs of a cyclical downturn, such as increased firings and wider credit spreads. A few members, however, observed that the transmission of lower rates to the economy was likely to be similarly weak as the recent transmission of higher rates, and that a faster return to a neutral monetary policy stance could stimulate housing construction in a way that might attenuate supply-driven housing price growth.

**Discussion of the Early August Episode of Volatility:**

Council members discussed the catalysts for, and amplifiers of, the short-lived market shock that occurred on Friday, August 2 and Monday, August 5. Members identified the fundamental triggers as weak employment data in the United States and an unexpected increase in the Bank of Japan's policy rate, the combination of which heightened U.S. recession fears and narrowed U.S.-Japan rate differentials. Unwinds in crowded and levered positions in momentum and short-volatility trades, such as yen-funded carry trades, were viewed as meaningfully amplifying the response in foreign exchange, equities, and especially equity options. It was noted that the spike in spot VIX meaningfully exceeded the spike in near-dated VIX futures. Members also highlighted amplification from thin August liquidity conditions.

The council then discussed the extent to which the episode reflected transitory factors – for example, positioning that was partly or largely unwound – or more enduring factors that might render markets more vulnerable to future shocks. A few members proposed that changes in market structure and regulations have contributed to a higher frequency of volatility episodes. For example, electronic trading firms account for a growing share of liquidity provision across markets, but members suggested that these firms sometimes provide relatively less resilient liquidity when volatility spikes. It was noted that artificial intelligence and machine learning could amplify the speed of market responses to shocks in the future. Meanwhile, dealers' ability to provide liquidity was viewed as unlikely to improve in the medium term as growth in financial assets outpaces balance sheet capacity.

**Discussion of Other Risks in the Financial System:**

Members cited a broad range of economic, market, and geopolitical risks. Several members highlighted potential downside risks to employment, as well as the prospect that a deterioration in the labor market would weigh on credit market valuations, which members viewed as surprisingly resilient so far in this cycle. A few members noted that private equity and credit funds, as well as recipients of private financing, could face challenges as investor allocations to private markets stabilize or decline. In addition, the infrequent marking of private credit valuations delays the

realization of losses and could result in an underpricing of risks. Members discussed a handful of trends in the banking sector that could pose risks, including the growing adoption of banking-as-a-service models; the expansion of synthetic risk transfers, especially in Europe; and the increasing use of reciprocal deposits, which could create operational vulnerabilities.

Internationally, it was noted that economic headwinds in Germany and China could generate negative growth spillovers to the U.S.; China continues to work through an overhang in property inventory, leading to ongoing property price declines, while Germany's manufacturing sector – especially its auto sector – is facing competitiveness challenges.  Members also discussed the long-term U.S. fiscal outlook, potential shifts in immigration and trade policies, and possible spillovers from geopolitical conflicts.