SMITH AFFILIATED CAPITAL

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INVESTMENT COMMENTARY

Banking Panic Contained for Now, But Aftershocks Will Drag on Growth

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The initial panic linked to the failure of a few regional banks has been quelled, at least for now, thanks to the aggressive response by the Treasury, Federal Reserve, and the FDIC. But the underlying strains that precipitated the panic are still very much alive; by some estimates nearly $1 trillion of unrealized losses are sitting on bank balance sheets that are vulnerable to deposit flight. Panics are usually the proximate catalyst for massive withdrawals, and since policymakers successfully restored confidence in the safety of deposits, a full-fledged banking crisis has been avoided. Unsurprisingly, the financial markets have also responded positively to the government's rescue operations. Realized volatility in both the bond and stock market has declined, and high-yield corporate bond spreads, which are a proxy for borrowing conditions, have stabilized below their July peaks and historical average.

It would be premature to say that we are out of the woods. Banking crises rarely happen overnight; rather they morph into one over several months. Hence, we are paying close attention to liquidity, bank lending, bank deposits, and lending standards. Odds are that the strains on "zombie" bank balance sheets will lead to a tightening of lending standards that will reduce the availability of credit and weigh on GDP growth. Even before the panic erupted, we expected a mild recession in the U.S. to begin sometime in the second half of the year. But the tightening of lending standards could turn a mild recession into a deeper one. That's not our baseline forecast, but the downside risks to the economy have been elevated depending on how severely regional lending institutions deny credit to business and consumer borrowers.

Importantly, small banks that are most vulnerable to deposit outflows are more critical to certain parts of the economy than others. Of the $4.5 trillion of loans on small bank balance sheets, commercial real estate loans are by far the most important component, accounting for more than $2 trillion of the total. However, that still leaves a sizeable chunk of lending to other sectors, including $900 billion of residential mortgage loans, $800 billion of C&L loans, and $500 billion of consumer loans. What's more, small banks have been the biggest driver of lending over the past year, with loans expanding 14 percent compared to the 7 percent increase by large banks. Clearly, these institutions can have a significant impact on the broader economy, and a lot depends on how the aftereffects of the banking turmoil plays out in coming months.

A First Quarter for the Books

A look back at the start of the just-concluded first quarter might give the impression that nothing of importance happened during the period. Between January 1 and March 30, the S&P 500 notched a respectable 7 percent gain, the Treasury 10-year yield slipped a modest 25 basis points, and that widely monitored recession indicator, the 2-year/10-year yield spread ended the quarter virtually spot-on with the 55-basis point inversion seen on the opening day of the year. That surface stability, of course, masks one of the most turbulent intra-quarterly moves in recent memory, stoked by controversial Fed rate hikes, changing market perceptions regarding the economic outlook, and, most notably, the banking kerfuffle that appears to have quieted down at least for now.

With extraneous shocks receding from the headlines, investors can return their attention back to the basics that stoked the market turbulence during the quarter. As noted, the full ramifications of the banking turmoil have yet to come into focus, as it started too late to have a meaningful impact on the economy's performance during the first quarter. Incoming data points to a decent growth rate for the period, tracking a pace close to the 2.6 percent increase in GDP notched in the fourth quarter of last year. Consumers, the economy's main growth driver, provided most of the heft, as incoming data is tracking a growth rate of over 4 percent in personal consumption for the period.

That healthy quarterly growth is all front-loaded, paced by a spending surge in January, and the momentum is fading. The January surge was driven by some temporary forces, including unusually warm weather, the boost to incomes from social security payments that were bloated by the outsize cost of living adjustments, and quirky seasonal adjustments to the raw data. Those catalysts are all in the rear-view mirror and the tailwinds they provided are facing stiffening headwinds. Real personal consumption retreated in February, which undoubtedly reflects a natural pullback from the artificial strength in January. But household fundamentals are poised to weaken in the months ahead. Credit-card interest rates have spiked, inflation is eating into household budgets, particularly among the lower and middle-income segments, credit availability is already tightening due to the banking woes, and wage growth is slowing as employers focus more diligently on controlling labor costs. The sturdy first-quarter growth in consumer spending should be the high-water mark of the expansion as the economy moves towards a recession that we expect to unfold over the second half of the year.

Consumers Set to Pull Back

Although consumers are the backbone of the economy, accounting for 70 percent of total activity, they will not be leading the economy into a recession. With the job market still holding up and a hefty – though dwindling -- pool of excess savings on balance sheets, a dramatic cutback in spending is not likely over the near term. Consumer spending tends to be a lagging indicator during cyclical turning points, as households rarely zip up their wallets until unemployment starts to steadily rise. That, in turn, also lags cyclical turning points, as employers hold on to workers until they determine that weakening sales will persist and make the hoarding of labor too expensive to maintain. Given the labor shortage and difficulty of filling positions over the past two years, the hoarding process is likely to last longer this time.

As noted, households are facing stiffer headwinds that are poised to slow spending as higher borrowing costs, tighter lending standards, and slowing job growth take an increasing toll. While slowing consumption will not send the economy into a tailspin, other catalysts will take the lead. By several measures, manufacturing is already in a recession, battered by a post-pandemic shift in demand from goods to services and sagging exports. The Institute for Supply Management (ISM) reports that its index of manufacturing activity in March slumped to the lowest level in nearly three years, marking the worst quarter for factories since the depths of the pandemic. What's more, all the subcomponents of the index fell below the 50 threshold that separates expansion from contraction for the first time since 2009.

Importantly, the slump in manufacturing will deepen in the coming months, as new orders fell sharply in March and remain in contraction territory for seven consecutive months. A key reason why bookings are falling off a cliff, foreshadowing production cuts, is that inventories are piling up, undercutting the need for more goods from customers. Indeed, one of the most overlooked factors behind the economy's vigorous post-pandemic rebound is the outsized boost from restocking by firms as supply chain constraints eased, enabling businesses to rebuild depleted stocks and build a buffer against future supply disruptions. Now, the pendulum has swung too far in the other direction. With the notable exception of autos, inventories are bloated relative to sales in most sectors. With the high cost of financing those stockpiles and sales slowing, businesses are striving to unload inventories, slashing orders in the process and turning a major growth driver into a significant drag on activity over coming quarters.

Inflation Slowing, but Not Fast Enough for the Fed

As the banking panic erupted in the week leading up to the FOMC meeting on March 21-22, it was nip and tuck as to whether the Fed would hike rates again. Earlier expectations of a 50-basis point increase were taken off the table, and the choice in question was whether the Fed would leave rates unchanged or hike by 25 basis points. Despite fears of amplifying stress on the banking system, it opted for the 25-basis point increase, believing it had the necessary macro prudential tools to deal with the banking woes while reaffirming its commitment to the inflation fight. Now, all eyes are focused on the next FOMC meeting scheduled for May 3.

With nearly a month to go before the meeting, the consensus on Wall Street is about evenly split, with slightly more than 50 percent believing the Fed will keep rates unchanged, despite the strong indication from monetary officials that at least one more increase is in the cards. Assuming the banking stress stays contained, we do expect the Fed to implement another 25-basis point increase at the upcoming meeting. Clearly, progress on the inflation front is unfolding far too slowly for the Fed's comfort. The 0.1 percentage point slowdown in the overall consumer price index in February leaves the increase over the past year at a still lofty 6 percent. Additionally, the underlying details of the latest CPI report are worrisome. The core inflation rate that excludes food and energy prices increased 0.5 percent during the month, greater than the 0.4 monthly increase in January. Compared to a year ago, the core CPI only slipped to 5.5 percent from 5.6 percent, and core service prices, the stickier component that is the primary driver of overall inflation, increased faster in February than in January – 0.6 percent versus 0.5 percent. Surging shelter costs, paced by another buoyant 0.8 percent increase in rents, continue to be a stubborn and primary influence behind the sustained increase in service prices.

Things do not look much better when shelter prices are excluded. This stripped-down component has increased by an annual rate of 5.3 percent over the past three months from 5.2 percent in January and 3.1 percent in December. The Fed is closely watching this so-called "supercore" inflation component because it is heavily influenced by labor costs, which remains stubbornly elevated. According to the Atlanta Fed's wage tracker, which is not distorted by compositional changes in the workforce, wages increased 6.1 percent in February from a year ago, the same as in January.

The good news is that wage growth is not accelerating, and the job market, while still tight, is showing signs of easing. While service prices remain stubbornly high, the run-up in goods prices during the pandemic is rapidly unwinding as supply chain snarls are clearing up, pent-up demand is fading, and businesses are discounting merchandise to lighten inventories. Pipeline pressures are retreating dramatically; producer prices fell 0.1 percent in February, the second decline in the last three months, and the 4.6 percent increase over the past year is less than half the pace of a year ago and the slowest since March 2021. We suspect that the pullback in producer prices will continue in the coming months and lead to a marked slowdown in consumer goods prices over the second half of the year. The overall inflation rate will be slower to recede, thanks to sticky service prices, but significant progress should be seen later this year and into 2024. The outsized increase in shelter costs is still being buoyed by leases signed earlier in the year, but current market rents are tailing off sharply and will soon constitute a major drag on overall prices.

One and Done

Despite nascent signs of easing inflation, the Fed no doubt believes it is necessary to stay ahead of the inflation curve until conditions for a sustained disinflationary trend are in place. That would include, most notably, a sustained downshift in employment growth, somewhere closer to 100,000 a month, as well as meaningful signs of slowing wage gains. We believe the stage is set for these trends to begin and become firmly entrenched over the second half of the year as the economy enters a mild recession. Hence if, as expected, the Fed bumps rates up again at the May 3 meeting, it should be the last of the tightening cycle.

The Fed's updated projections unveiled at the last FOMC meeting indicate that a sizeable number of officials expect to hike rates at least two more times this year. The odds are that the banking upheaval has caused some policymakers to rethink that hawkish sentiment, particularly since a raft of economic data since that meeting has come in much softer than expected. The financial markets have moved decidedly to the dovish side, pricing in several rate cuts over the second half of the year. We fall somewhere in the middle. Unless the banking turmoil erupts again, the Fed is likely to pause after the next increase as the expected tightening of financial conditions would be the equivalent of at least one more rate hike. However, unless inflation moves more quickly towards the Fed's 2 percent target than is likely, we won't see the Fed cutting rates until next year as it fears losing credibility and risks a premature easing that has come back to bite them in the past when inflation reaccelerated.

RATES AND TOTAL RETURNS QUARTERLY AND ANNUAL COMPARISON

U.S. Treasury Market	Yield (%)			Total Return (%)	
	3/31/2022	12/31/2022	3/31/2023	1st Qtr	1Yr
6 Mo Bill	1.02	4.75	4.88	1.22	2.60
2 Year Note	2.32	4.40	4.03	1.46	-0.17
5 Year Note	2.45	3.96	3.58	2.39	-2.55
10 Year Note	2.33	3.83	3.47	3.76	-6.79
30 Year Note	2.44	3.94	3.65	5.99	-20.19

Municipal Bonds	Yield (%)			Total Return (%)	
	3/31/2022	12/31/2022	3/31/2023	1st Qtr	1Yr
Barclays General Obligation Index	2.60	3.55	3.25	2.78	0.26
Barclays New York Bond Index	2.71	3.61	3.28	3.22	0.57
Barclays California Bond Index	2.51	3.34	3.07	2.55	0.70
Barclays Revenue Index	2.72	3.73	3.43	2.96	-0.08

Equities	Levels			Total Return (%)	
	3/31/2022	12/31/2022	3/31/2023	1st Qtr	1Yr
S&P 500	4530.41	3839.5	4109.31	7.48	-7.75
DJIA	34678.35	33147.25	33274.15	0.93	-1.98
Nikkei (Tokyo) US $ Terms	27821.43	26094.5	28041.48	7.01	-5.72

Commodities	US $			Percent Change (%)	
	3/31/2022	12/31/2022	3/31/2023	1st Qtr	1Yr
Gold Comex Spot ($ per oz)	1937.44	1824.02	1969.28	7.96	1.64
CRB Future Com. Pr. Index*	295.18	277.7467	267.7272	-3.61	-9.30
W. Tx Int. Crude ($ per bbl.)	100.28	80.26	75.67	-5.72	-24.54

Currencies	Levels			Percent Change (%)	
	3/31/2022	12/31/2022	3/31/2023	1st Qtr	1Yr
Yen	121.70	131.12	132.86	-1.33	9.17
Sterling	1.31	1.2083	1.2337	-2.10	-6.10
Euro	1.11	1.0705	1.0839	-1.25	-2.06

Global Bond Markets**	Levels			US $ Terms (%)	
	3/31/2022	12/31/2022	3/31/2023	1st Qtr	1Yr
German 10 year	0.55	2.57	2.29	4.42	-13.26
Japanese 10 Year	0.21	0.41	0.33	0.41	-8.84
UK 10 Year	1.61	3.66	3.49	5.10	-16.39
Barclays US Emerging Market	5.28	7.26	7.36	2.15	-4.64

Source: Bloomberg Financial Data
*Thomson Reuters/Jefferies CRB Commodity Excess Return Index
** Global Bonds Represented by Bloomberg Barclays Indices