US Banking System & The Economy – Are Things Getting Better or Worse?

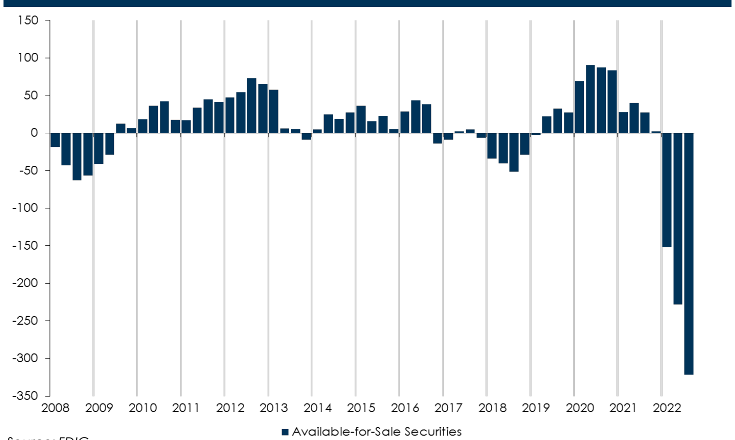
May 2023

- **Bank failures, tighter monetary policy, and rising fear of a "hard landing" have heightened economic uncertainty**
- **Despite these challenges, inflation is subsiding, consumer spending is stable, and the labor market remains strong**
- **In light of the market turbulence, investors are reacting to any news, positive or negative, in search of clarity about the future**

Bank Failures, the Fed, and Inflation

Recent events involving Silicon Valley Bank, Signature Bank, and First Republic Bank have altered investors' outlook on the possibility of an economic recession, shifting it from a no landing scenario to a more cautious expectation of a soft or hard landing. These failures were largely attributed to poor risk management and concentrated deposit bases. However, the financial industry is under stress due to the Federal Reserve's rapid interest rate hikes aimed at curbing inflation. Following the pandemic stimulus, banks received an influx of deposits and invested these funds into Treasury and Agency securities. As interest rates rose, the value of these securities decreased, leading to unprecedented levels of unrealized losses, and leaving financial institutions, particularly those with additional idiosyncratic risks, vulnerable to a "run on the bank."

Unrealized Gains/(Losses): All Commercial Banks (Billions)



Source: FDIC

Lending Demand and Deposit Growth

With the Federal Reserve's persistent efforts to combat inflation by implementing tighter monetary policy, the benchmark rate used by banks to lend to consumers and other financial institutions has risen. This may lead to a decline in lending activities and heightened credit standards. From a deposit perspective, outflows were initially volatile due to the movement of investors towards larger banks and higher-yielding cash securities, like money market mutual funds, but this trend has since stabilized. Given the inflationary landscape, the Federal Reserve will likely implement at least one more 25-basis point rate hike, which would further strain lending and the economy. Consequently, increasing the likelihood of a hard landing scenario.

Banking Industry Q1 2023 - Earnings

Overall, the impact of the banking issues on large institutions was minimal, and regional banks reported better-than-expected earnings due to in-line deposit outflows and increased net interest income (NII) from higher interest rates. However, a few regional banks, such as First Republic Bank, experienced significant drops in deposits, rekindling investor concerns about a worsening environment. Nevertheless, it seems the banking contagion is contained within a small group of banks that did not appropriately manage their interest rate risk, and predominately positive bank earnings have instilled confidence in the market, at least for the time being.

Recession & Recovery

Regional banks play a crucial role in facilitating small business growth, supporting commercial real estate, and driving overall economic development. If banking stress persists and lending continues to decline, the likelihood of a recession and credit crunch will increase. However, it is important to recognize that recessions are part of the normal economic cycle. Typically, a recession is declared after two consecutive quarters of negative GDP growth. As GDP is a lagging indicator, the stock market will likely have already hit its bottom by the time a recession is officially announced. Since 1926, there have been 16 recessions, with an average duration of 13 months. The longest recession was 43 months (The Great Depression), while the shortest was two months (Covid). As markets have become more efficient, the period from peak to trough (and subsequent recovery) has shortened. The following chart illustrates the significance of remaining invested and focusing on long-term objectives.

S&P 500: Recoveries are Getting Shorter in Duration

Source: Bloomberg

Market Outlook

Despite indications of an impending recession, the stock market has experienced a rally, inflation has decreased, supply chains have improved, the labor market has remained strong, and bond spreads have maintained their stability. Although certain areas, such as commercial real estate, have displayed some weakness, future prospects depend on the length of the Fed's pause and the timing of rate cuts. Despite the year-to-date rally, asset class valuations remain attractive in comparison to historical levels. International equity continues to be significantly less expensive than U.S. equity, and the traditional negative correlation between stocks and bonds is resurfacing. In the years ahead, portfolio diversification will continue to play a critical role in achieving long-term investment objectives and mitigating the uncertainties arising from monetary policy.

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