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VIEWPOINTS

May 2023

APPROACHING STALL SPEED

Banking system concerns of a month ago have largely faded following liquidity support from the Federal Reserve and the passage of time without further failures – though not without consequence. The extension of credit from smaller regional banks is likely to decline (see chart below), and while brief, the period of instability adds to preexisting angst among businesses and consumers regarding the likelihood of recession. Despite this backdrop of softening growth expectations, the abating of systemic concerns drove gains in equity markets to levels approaching the prior highs for the year.

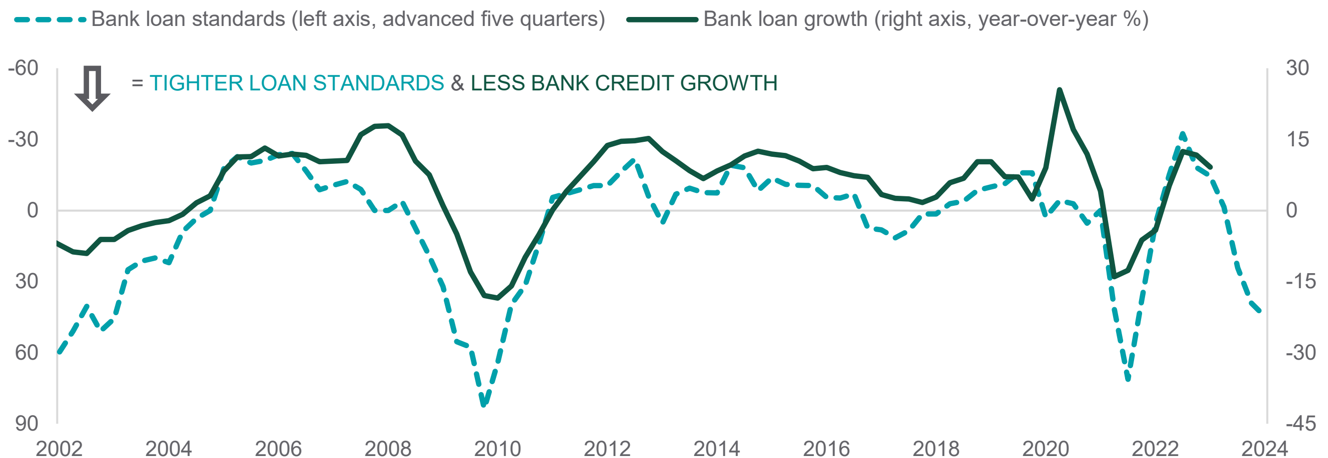
Inflation readings in March continued to moderate with headline Consumer Price Index (CPI) declining to 5.1% from 6.0%, but core inflation measures followed most closely by the Fed have failed to show the same degree of improvement. The core CPI reading for March (5.6%) actually inched up slightly from February as we await the expected upcoming turn lower in the data from areas like housing. The Fed and European Central Bank (ECB) both moved rates higher in the past month, with the markets pricing in just one more move for the Fed, while the ECB is expected to continue hiking until mid-year. Increasing risk of a mild recession in the U.S. is likely to limit the magnitude of the Fed's rate hike cycle to perhaps one or two more moves, though we expect a longer plateau at the terminal rate than current market expectations (which show the Fed cutting rates before the end of the year).

Gains in equities this year against a backdrop of falling earnings expectations have led to valuations that provide limited upside in the base case. With our view that any possible recession in the U.S. will be shallow and short-lived, we see better risk/reward in bonds than in U.S. equities at current pricing levels.

As a result, we incrementally increased our overweight to bonds this month, funded by moving U.S. equities to a modest underweight. In addition, we are modestly underweight emerging market equities on a more sluggish economic reopening in China, as well as continued geopolitical issues limiting valuations. Looking forward, market volatility should be expected to remain elevated as the trajectory of growth and inflation remain uneven.

BANK PULLBACK?

Tighter loan standards – historically a leading indicator of loan growth – suggest a nearing pullback in bank credit supply.



Source: Northern Trust Asset Management, Piper Sandler, Bloomberg, Federal Reserve. Bank loan standards are the net percent of U.S. banks tightening lending standards in the Senior Loan Officer Opinion Survey on Bank Lending Practices (latest as of 1/31/2023). Bank loan growth is U.S. domestically chartered commercial banks commercial and industrial loans (latest as of 3/31/2023).

BASE CASE EXPECTATIONS

Approaching Economic Stall Speed

Recent banking issues and consequent impacts on bank lending, as well as spillover economic effects from worsening sentiment, add pressure to the growth trajectory. Other lending sources (think private credit) can partially backfill credit availability, but overall growth should be fairly flat over the next year.

Monetary Tightrope

Given concerns regarding financial stability from unexpectedly rapid rate increases, the Fed will likely resort to a slower path of monetary tightening. But inflation has remained sticky, likely necessitating further rate increases. We continue to believe the Fed is close to done raising rates, but will remain there throughout 2023.

RISK CASE SCENARIOS

Labor Market Durability

More persistent tightness in the labor market leads to more stubborn core inflation, necessitating an unexpected monetary policy response that is negative for financial markets.

Debt Dislocations

Further banking fallout (a risk heightened by the steeply inverted yield curve) and/or lack of progress on a debt ceiling deal (which would likely further invert the yield curve) hurts sentiment.

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