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Canary in the coal mine

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Customers waiting outside American Union Bank in New York City, April 26, 1932 during a bank run.

PHOTOGRAPHY

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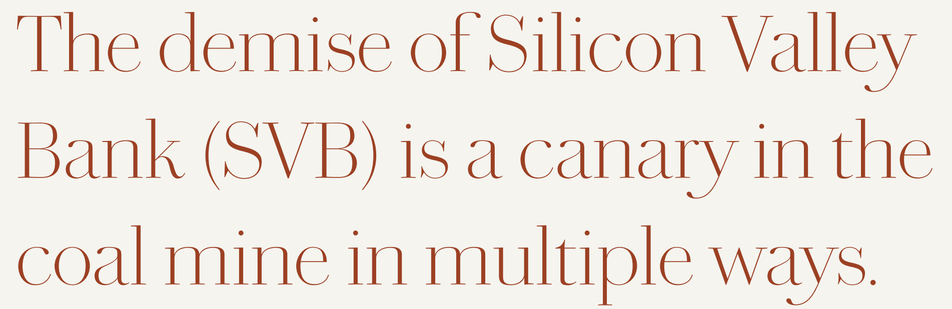
From our December 2022 Tactical Playbook

It is unlikely that we will escape this low interest rate environment without repercussions. ***Investors should brace themselves for surprises.*** *There are pockets of hidden leverage in this economy and financial system that policy makers have not yet identified, so* ***the worst may be yet to come****.*

We believe that liquidity and credit will likely be the dominant themes in 2023*, regardless of growth conditions ("slow death" vs. severe recession shock).* ***Increase liquidity, tilt towards high quality and defensive, and be ready to be nimble and opportunistic.***



The demise of Silicon Valley Bank (SVB) is a canary in the coal mine in multiple ways.

1. Most directly, it has revealed the vulnerabilities within a financial system that has become bloated with frothy valuations, reckless risk taking, excess leverage, and widespread complacency all enabled by a decade of abundant liquidity.

2. While the causation may be somewhat blurred, the collapse of SVB, along with the broader banking crisis that followed has, in our view, all but guaranteed a hard landing for the U.S. economy, driven by an accelerated tightening of lending standards, a rapid slowdown in credit growth, and a Federal Reserve that is more constrained than it has ever been in generations.

3. Important from a historic perspective and consequential on a forward basis, SVB's collapse has brought to light a systematic flaw in the management of checking account deposit rates, likely forever changing the behavior of regional banks.

A surprise that is not surprising

Fundamentally, the challenges in the U.S. banking system today are the intended consequences of the Federal Reserve.

While inflation may currently seem like an afterthought the sizzling hot February CPI report came and went, with minimal market reactions the Fed's ongoing campaign to curb stubborn inflation is the root cause of a confluence of events that ultimately led to chaos and turmoil over the past few weeks.

Last year, we accurately predicted that liquidity and credit would be the dominant themes of 2023.

The main objective of monetary tightening and raising interest rates is to increase the costs of borrowing and to incentive saving over investing, which in turn slows down economic activity, reduces labor demand, eases wage pressure, and ultimately eliminates the risk of a self reinforcing inflation spiral.

Monetary policy takes time to work its way through the system to affect growth and inflation. Although the U.S. economy has proven to be surprisingly resilient over the past year despite strong headwinds from higher rates and quantitative tightening, the resulting effects have been percolating by creating pockets of strain that eventually push the economy towards weakness.

Since March 2022, the Federal Reserve has raised the fed funds rate by five percent—the fastest pace since the 1980s. Until this month, the U.S. financial system had managed to avoid wreckage while navigating the great unwinding of over a decade of historically cheap money.

Nonetheless, as we stated in our publications last year, when policy reversals happen this rapidly and dramatically, it is unlikely that we will make it through without repercussions . Finally, we are seeing the consequences play out in real time.

We didn't know exactly where the first cracks would occur, but we anticipated events like this to happen. Intuitively, the most vulnerable players are those that had grown reliant on cheap capital and abundant liquidity. Technology and venture capital are usually the first exposed as the tide turns.

The rapid collapse of Silicon Valley Bank—a decently sized bank that specializes in lending to tech-focused venture capital funds — was a surprise. Yet, the fact it happened was not surprising.

An anatomy of SVB's failure

At first glance, it may be tempting to claim that the collapse of SVB was an idiosyncratic event. SVB was unique in many ways with a long history of being the famed chief banker for tech focused venture funds.

Even in the best of times, most startups fail. SVB's deep knowledge of the tech industry and thus, willingness to lend to earlier stage businesses that lack a path to profitability, reinforced customer loyalty over the years.

This became a double-edged sword. During the post COVID, liquidity fueled venture capital (VC) boom, the asset size of SVB more than tripled. Subsequently, after the "disruptive growth" bubble burst and initial public offering (IPO) activity peaked in the second half of 2021, unprofitable VCs and startups began to draw down their cash balances to fund operating losses.

In early 2023, the continued cash drain began to translate into SVB's forced selling of its held to maturity long duration assets, thus crystalizing otherwise unrealized losses and further impairing equity.

When Peter Thiel—the billionaire famous for being a co-founder of PayPal and an early investor in Facebook—alerted the portfolio companies in his VC to move deposits away from SVB, the news spread like wildfire in the gossip fueled world of Silicon Valley. The bank's tech savvy customers moved quickly and en masse. Within a matter of hours, SVB lost $42 billion in deposits—a quarter of its total.

Every aspect of the collapse of Silicon Valley Bank seems profoundly modern. A client base of "visionaries" whose profession is investing in the future. A panic whipped up by tweets. Deposit withdrawals via smartphones.

Still, at its crux, SBV's fall has all the characteristics of a classic bank run.

The issues that led to SVB's downfall are not unique, as evidenced by the significant repricing of the equity and debt issued by other banks in the days (or in some instances, hours) that followed.

Indeed, SVB's concentrated exposure to tech and VC and the fact that virtually all of its deposits were greater than the $250k Federal Deposit Insurance Corporation (FDIC) insurance limit have likely amplified the pressure.

Still, if we remove these unique elements, what led to SVB's failure appears to be a classic asset-liability mismatch.

Assets: (hidden) mark-to-market losses

Banks have two major revenue streams. Aside from the fees earned for providing various services, the core function of a bank is lending by taking deposits, making loans, and capturing spreads.

Following the COVID pandemic in early 2020, extraordinarily accommodative monetary and fiscal policies created a vast amount of liquidity in the economy and the financial system, which via various channels translated into a historic surge of bank deposits on which the banks paid next to nothing. Even as the Fed began to raise rates, customers were largely indifferent. After all, it had been decades since cash management was perceived as a source of meaningful income.

As deposits poured into banks at a record pace, the demand for credit from the private sector grew but could not keep up.

So, banks did what banks do, that is, lend out the excess deposits and started to invest in debt securities. After having learned hard lessons from the Great Financial Crisis (GFC), many banks looked for yields in duration rather than credit. In 2020 and early 2021, they loaded up on fixed rate long dated government bonds and government guaranteed mortgage backed securities. After all, nothing is easier to liquidate in a crisis than Treasuries.

While the larger "systemically important" (SIFI) banks added derivatives into their portfolios to limit sensitivities to rate shocks, the small and medium-sized banks with less than $250 billion in assets exempted from stringent stress tests due to a regulatory rollback in 2018—did not hedge their duration exposures.

As the Fed tightened aggressively through 2022 to combat inflationary pressure that was more resilient than expected, the fed funds rate rose from zero percent to 4.5% by the end of the year.

Correspondingly, yield curves shifted upwards, and market values of the debt securities on bank balance sheets fell 10% to be exact, as reported by the FDIC. An important contributor to the price losses is mortgage based securities, which experienced significant duration extension as the rapid move up in mortgage rates significantly lowered prepayment probabilities.

In response to the devaluation of their duration-sensitive debt holdings, the smaller banks responded with an accounting solution: they redesignated these securities holdings from "available to sale" to "held to maturity" to prevent mark to market losses from flowing through their income statements. Had such losses been realized all at once, more than a quarter of U.S. banks' equity would have been wiped out.

Deposits: miscalculation of stickiness

In hindsight, it was reckless for any bank to leave significant duration exposed on its balance sheet. Nonetheless, such vulnerability on the asset side of the banks' balance sheets might not have escalated into a real solvency risk if only the banks had been able to hold on to their deposits.

Clearly, we now know how the story played out: small and mid-sized banks overestimated the stickiness of their deposits.

As the fed funds rate continued to rise through 2022 and early 2023, bank deposit rates barely moved. Consequently, the gap between the rates at which depositors received on their bank deposits versus the yields on money market funds or Treasury bills widened (as of 3/29/2023). Naturally, some depositors began to move their cash balances away from banks to invest in higher yielding investments.

As the exodus of deposits continued and gradually accelerated in the second half of 2022, some of these smaller banks had to start selling their long duration securities in order to raise capital to fulfill the withdrawals as was the case with SVB.

Suddenly, the hidden mark to market losses were longer hidden. From there, panic quickly set in and the situation spiraled.

After the collapse of SVB, hundreds of billions in deposits were moved from smaller banks to a combination of money market funds, T-bills, and larger, better capitalized banks.

In our view, the divergence between the fed funds rate and interest rates on checking accounts is the fundamental reason behind the deposit outflows. The failure of SVB has echoes of the Savings and Loan (S&L) crisis in the 1980s: higher rates as a source of instability for deposits and government-issued debt are highly unusual compared to previous banking crises (e.g., the GFC), where the source of instability was the toxic combination of credit losses and illiquidity on banks' balance sheets.

Defending the American Dream

As deposits left regional and community banks at record pace, policymakers quickly stepped in to restore confidence across the banking system to minimize the risk of contagious bank runs.

Policy makers have the tools needed to effectively stop the bleeding. In fact, the mere existence of such tools and the policymakers' willingness to deploy them if needed are often enough to restore financial stability and slow down the stampede. At its core, banking is about confidence.

Earlier this week, markets cheered with bank stocks rallying broadly following the news of the acquisition of SVB by First Citizens, a regional bank itself. We think it is important, given this story and the market's reaction, to make clear to our readers, especially as we look ahead and examine the ripples from this banking crisis: systematic risk in the U.S. banking industry was never a question.

Since the initial failure of SVB, our expectation has already been that, while the Fed was likely willing to let a few dominoes fall, ultimately it would step in to stop the chain reaction, as the Fed had done time and time again, as a "lender of the last resort."

Indeed, a lack of policy oversight on the regional level has contributed to the current banking crisis. Tighter regulation needs to be implemented and in the long term will improve the health of small and medium sized banks.

There are many differences between this banking crisis from the GFC. The most important of them all is that this banking crisis, if not contained, has the potential to pose an existential threat to a large number of regional and community banks.

Despite public statements and in some instances aggressive rhetoric, we have good reason to believe that no politicians on either side of the aisle will take actions that point to a future where the U.S. is left with a handful of mega cap banks.

Large banks focus on large, established companies and financial engineering. The significant banking consolidation that has taken place in the past few decades has already made it more challenging for smaller companies to obtain loans. This void is partly what gave rise to private credit; however, as we discussed in prior publications, shadow banking has its own embedded problems that may be particularly relevant at the moment.

At the end of the day, small banks have been and will remain a critical component of entrepreneurship, self made success, and innovation which are a part of the fabric of this country and has been the key to the continued success of the United States and its role as a dominant economic world power.

A stance against the continued survival of more than four thousand regional and community banks is a stance against the American dream. And no policy maker or politician would stand in the way of that.

Irreversible damage

While the Fed can restore financial stability, what it cannot do absent an outright 5% rate cut—which we can confidently say has a zero probability of occurring—is stopping depositors from moving their capital out of banks and into money market funds or T-bills.

There has been a sea change. The significant yield gap, thanks to the banking crisis, is now well publicized.

Lingering credit concerns with small and medium sized banks provide yet another incentive to be more thoughtful with one's cash management strategy.

The mindset of depositors has changed permanently, which in turn has implications for bank deposit rates, thus creating significantly higher funding costs.

This puts into question the future path of profitability of regional and community banks, which rely heavily on lending.

Banks may attempt to retain customers by raising deposit rates, which unfortunately, may be a self-defeating strategy, as doing so would severely damage profitability, in turn prompting even more credit concerns.

Some banks may be able to get through this crisis on their own, thanks to healthier balance sheets with minimal asset liability mismatches.

Many vulnerable banks are tapping into the Fed's emergency funding facility, the Bank Term Funding Program to raise capital and make up for any funding shortfalls. This temporary patch, along with the policy makers' promises to guarantee uninsured deposits, should prevent large scale systematic defaults in the banking system. However, the cost of funding rising overnight from nearly zero to the market rate of 5% essentially all but guarantees that some weaker banks will become materially unprofitable for at the least the next few years.

Even if the fed funds rate falls substantially in the coming years, it will still take a long time to overcome the lingering concerns of bank credit risks and to ultimately rebuild their depositor base as we witnessed in the aftermath of the GFC.

A less painful alternative to the zombification of the weaker banks is consolidation, where smaller banks are strategically acquired by larger banks with stronger credit worthiness.

In any of these scenarios, what is apparent to us is a pullback from lending driven by a decrease in both appetite and ability (thanks to higher funding costs) by smaller regional banks. The more interesting and important story is what this means for the broader economy.

Plumbing reshaped

One of the most important and lasting implications of the collapse of SVB is meaningfully higher funding costs, driven by the increased awareness by depositors of bank credit risk coupled with potential secularly higher inflationary pressure and interest rates.

The inevitable change in how regional and community banks manage their deposit rates will reshape the U.S. banking system, with profound implications for the broader economy. We unpack our diagnosis into three parts:

First, small banks are economically important as they make up a majority of the loans to the real economy.

There are over four thousand banks in the U.S.. Among them, only ten are large, national banks, such as JPMorgan Chase, Bank of America, and Citibank—with assets greater than $250 billion. The remaining are regional and community banks that play an important role in the U.S. economy. Representing roughly half of the balance sheet of the banking system, these smaller banks account for roughly 50% of commercial and industrial lending, 80% of commercial real estate lending, 60% of residential real estate lending, and 45% of consumer lending.

Regional and community banks punch above their weight on an asset-adjusted basis. Compared to the national banks, the smaller banks have a greater impact on the real economy.

Regional and community banks cater to a local audience: businesses and projects that are too small to make economic sense for large, national banks to undertake.

In addition, these customers' borrowing needs are often highly nuanced and require personal, labor intensive attention throughout the credit underwriting process. They do not fit the cookie cutter, automated financing requirements large lenders apply to their smaller customers.

As their names suggest, regional and community banking is a relationship driven business, with the unique advantage of local expertise. Picture the conversation between a restaurant owner who is looking to raise capital for expansion or upgrades and the banker who eats at the restaurant two times a week.

As the saying goes, the success of the American economy was built on the backs of small businesses (that were financed by small banks).

Second, as smaller banks face meaningfully higher funding costs and consequentially severe profitability headwinds that are likely to sustain for several years, we expect a sharp pullback in lending by regional and community banks.

With the collapse of SVB and the banking fallout that followed, the credit environment in the U.S. has entered a new phase of lower credit availability and higher likelihood of financial accidents. Ongoing pressure will likely encourage the small and medium sized banks to become more conservative about lending in order to preserve liquidity in case they need to meet depositor withdrawals.

Given drastically higher funding costs and a more pessimistic growth outlook, any new lending in our view will be set at significantly higher rates with more conservative underwriting, which in turn will dissuade demand for borrowing.

Disruptions to the supply of liquidity to local businesses can have profound economic consequences, e.g., a self sustaining slowdown. In a moderate scenario, such credit contraction will weigh on economic activity among small businesses and delay local investment projects.

If the strain on the banking sector continues to worsen and credit ultimately seizes up, that could translate into higher risk of corporate defaults, thus an even more muted appetite for banks to provide loans. How small banks will struggle through the current challenges and how they will alter the their business models with regards to lending still remain to be seen.

Judging by the direction in which things are traveling, we believe it is clear that financial and credit conditions to the extent that they are affected by the behavior of small banks are tightening rapidly.

Third, as small banks pull back in lending, big banks are unlikely to step in to fully and seamlessly fill the void.

As discussed earlier, some weaker, smaller banks may be absorbed by larger banks. In this scenario, the main question then becomes whether the credit void that is created by the retreat of regional and community banks can be filled by the acquiring larger banks.

The concern is not around the availability of capital, as the largest banks have ample liquidity as well as strong balance sheets thanks to the stricter regulations implemented after the GFC.
Rather, it is a matter of fit.

In niche sectors where lending is highly relationship driven, like most community banks, or requires deep industry expertise, such as the tech startup world, the business models will not fold neatly into a large national bank that is more used to traditional commercial and industrial lending.

In short, while the borrowing lending dynamic will ultimately sort itself out over time, the void from credit pullbacks by the small and medium-sized banks will not be filled overnight as the larger banks step in. In the meantime, the flow of credit in certain sectors will remain challenged.

Commercial real estate: the next domino to fall?

Commercial real estate lending makes up a large portion of regional and community bank loan portfolios. There are two main reasons behind such concentration.

One is that commercial real estate lending is often relationship based, and thus particularly well suited for the business model of the smaller banks that have a local client base.

The other reason is that over the past five years, while large banks pulled back from commercial real estate lending, smaller regional banks stepped in and snapped up the business.

This was partly due to the regulatory rollback that exempted banks with $100—$250 billion in assets from the Fed's stringent annual stress tests, thus enabling regional banks to be more competitive against the larger banks.

In addition, in early 2022, the Fed added a harsh condition of an automatic 40% price markdown for commercial real estate in its annual stress test, applicable only to the largest banks deemed systematically significant. This likely limited the large banks' risk appetite and pricing competitiveness in the space.

Looking ahead, we expect regional banks overall to pull back from commercial real estate lending, despite the high margins associated with this category of loans, which admittedly could be quite tempting given higher funding costs and the expectation of challenged profitability over the next few years.

Of course, there are always exceptions. In aggregate, we believe that regional banks are currently hyper focused on shoring up liquidity, based on our expectation (or the benefit of the doubt) that these regional banks have learned the hard lessons of the risks of doubling down from the “thrifts” or consumer savings institutions in the 1980s.

Recall that many “zombie thrifts” invested in increasingly risky projects, hoping that they would pay off in higher returns. Unfortunately, they became insolvent before the returns materialized.

As valuations came down, defaults picked up, banks became more reluctant to provide loans and in some instances–stopped providing prices altogether. The lack of credit, as refinancing comes due, further drove down valuations, thus creating a downward spiral.

In fact, even before the fall of SVB, small bank lending growth already started to decelerate as the real estate sector began to exhibit signs of stress, in particular within the office space.

Looking ahead, the situation is quite dire.
The commercial real estate space faces the challenge of a significant maturity wall (as many borrowers had extended loans last year hoping that rates would be lower by now). Simultaneously, credit conditions have begun to tighten, and debt markets have just lost a significant credit supplier (small banks). This is particularly worrisome for smaller loans with vulnerable geographical profiles and refinancing needs in the near future.

With essentially a complete pullback of credit from the banking system, across large and small banks, we believe that a large portion of the liquidity supply going forward will likely come from private capital outside of the traditional banking system, such as asset managers and private debt funds.

Intuitively, these private sector lenders are presented with a potentially attractive opportunity to take advantage of the rapid drainage of credit supply, not only gaining market share, but also demanding a higher premium on lending rates, even against high quality assets such as industrials.

The beginning of the end

The main takeaway from the banking crisis is even tighter credit and lower growth than our previous outlook, with the impact distributed unevenly across parts of the economy.

Regional and community banks are facing significant challenges, from higher funding costs to continued deposit risks, from regulatory pressure to asset declines, not to mention likely future credit losses as growth deteriorates and delayed tightening effects from past Fed hikes.

An accelerated pullback in lending by regional and community banks, which account for roughly half of total banking sector lending, will weigh heavily on credit growth and in turn economic activity, with more severe impact on some sectors and parts of the economy, such as retail, commercial real estate, and smaller, local businesses.

As for the larger national banks, they had already begun to tighten lending standards and pull back lending in 2022. We expect this dynamic to continue in the coming quarters.

A sharper credit contraction broadly across the banking system appears to be an inevitability. Consequently, the stage is now set for an even more meaningful slowdown in credit growth—compared to our outlook in early March—as we look ahead.

This, in turn, will translate into an accelerated slowdown in economic activity and growth than we previously expected.

The linkage between credit and growth is through the tightening of financial conditions, which, as we have experienced intimately in the past year, have a highly nonlinear path.

In addition, the transmission works with a significant lag. For example, debts come due over a period of time. Instances of refinancing stress seen in the real estate market today trace their root cause to the rapid rate increases that primarily took place last summer. The seed of the current banking crisis was planted in early 2022.

The bottom line is that the effects of tightening credit conditions on economic growth will take time to build.

As we have stated for a while—especially after it became apparent in summer 2022 that inflation had become entrenched—this hiking cycle would likely end in a recession.

The course has been set and the fall of SVB and the banking crisis have likely accelerated the path. From here on, we could see a larger and more rapid deterioration in growth and the labor market. This is the beginning of the end.

Again, with all that said, things take time to take full effect. While we are confident on the direction and ending, we are a lot more uncertain on the speed. We may see some back and forth in financial conditions and market actions in the near term as the Fed prepares to turn more dovish.

From here on, we expect that more cracks will begin to emerge. It is quite likely that commercial real estate may be the next domino to fall. Credit tightening and liquidity drainage should trigger more financial accidents. We are monitoring the conditions in venture capital and private credit closely.

The reason to cut: monetary condiditons likely have alreaady overtightened

As Mark Twain once said, "A banker is a fellow who lends you his umbrella when the sun is shining, but wants it back the minute it begins to rain."

Since one person's debt is another person's asset, the reference of "lender" or liquidity provider can in fact apply more generously to almost all participants in the financial system, from depositors to asset holders.

Depending on the perspective, we are all debtors to some and creditors to others. As history has repeatedly shown, the interdependence creates the potential for credit troubles in one part of the financial system to escalate into a widespread contagion via a falling domino effect.

The significance of the current banking crisis is not the risk of contagious bank runs as financial stability has been restored by the policy makers.

Rather, the real significance from now on is the irreversible higher cost of funding for small banks, which translates into years of negative profitability, and a sustained decrease in lending appetite. The withdrawal of such liquidity, coupled with already deteriorating economic conditions, would only further increase credit risks in the system, leading to tightening of lending standards, thus further decline in available liquidity—a self-sustaining credit contraction.

As Chair Powell commented at the latest Federal Open Markets Committee (FOMC) meeting, credit tightening has the same effect on the economy and financial conditions as interest rate hikes.

While he emphasized repeatedly that the effects of the banking crisis were still too early to tell, from our conversations with macro traders and strategists on the buyside, the general view is that the equivalent impact of tighter financial conditions plus tighter lending standards is somewhere around 1.5% 2% rate hikes, which would take the fed funds rate to well past 6%, and above the top end of the distribution of the Fed's dot plot for rates at the end of 2023.

In other words, following the banking crisis, monetary conditions may have tightened to a degree where the risks of a sharper slowdown in the economy have increased.

Intuitively, such overtightening is highly deflationary. Said differently, the market has done the work on the Fed's behalf. The obvious action to take would be to sit back, watch the dominoes fall and the story to play out, and wait for the deflationary pressure to take effect.

Still, less than two weeks after the run on SVB, the Fed raised rates by another 25 bps.

Our take on the situation is that the Fed is simply constrained by dynamics on both sides.

On one hand, the rapid tightening of credit and growth deterioration (consequences of the banking crisis) will take time to play out. We are simply too early in the game.

More importantly, the inflation problem is still not solved. Maybe there is enough pressure in the system that the labor inflation issue may eventually work out on its own, but the Fed cannot pivot purely based on forecast, especially after their grave miscalculations on inflation based on forecasts in 2020 and 2021 that got us into the trouble we are in today.

Remember, the story begins and ends with inflation. At its crux, the main issue is labor tightness.

The reasons to hike: the labor market keeps working overtime

While the Fed may have liked to pause its hiking cycle and recast its forward guidance in the face of the unfolding credit crunch, inflation remains far too high for comfort. We have seen some improvement at the headline level but breaking down core inflation reveals three areas with distinct paths.

Core goods inflation has played a critical role in the progress on inflation as it continued to roll over from its pandemic high of 12%. Though we expect to see some volatility amidst the broader downtrend as the goods sector resets, pricing pressure has shown genuine progress.

On the other hand, Consumer Price Index (CPI) shelter prices continue to run frustratingly high despite cooling fundamentals in the rental market. While we expect Bureau of Labor Statistics (BLS) rents indices to catch up to the moderation in new lease rents, it is taking time.

Finally, with more clarity on these areas, the Fed has zeroed in on core services ex housing as a litmus test. While it is good to be cautious when slicing and dicing inflation indices, the Fed's goal is to zoom in on the hottest part of the economy and more specifically the hottest labor markets. Here, we continue to see businesses take advantage of strong demand to pass on price increases to keep up with elevated cost pressure.

The Fed hesitated to change course as it understood that the disinflation process takes time, and progress can reverse as inattention to the price problem unearths the still simmering demand within the economy.

The source of this underlying demand has been the resilient labor market. Job growth has been remarkably strong so far in 2023 which, coupled with elevated wage growth, has continued to drive demand. We do expect hiring to slow as labor demand has pulled back and the breadth of hiring across industries has fallen. However, the remarkable level of labor market tightness when the Fed started hiking has delayed the transmission of policy tightening.

The impact of labor market tightness is visible across the economy.

For instance, typically in the construction sector, when interest rates rise, building slows, and employment falters. In 2022, we saw investment in structures collapse to recessionary levels as the Fed hiked at its fastest pace in a generation, but employment remained intact. Prior episodes of similar construction contractions corresponded with hundreds of thousands of jobs lost, pressuring the broader economy.

This break from traditional dynamics can be tied to several factors that are not unique to one sector: pandemic related disruptions to supply chains, the transition from boom to rapid tightening, and labor shortages.

In combination, these factors left builders with a congested pipeline of projects even as the housing market slowed sharply. As builders work complete their projects and hold off on new ones, we are likely to see construction employment soften. The lagged pass-through effect, even in construction, one of last year's weakest sectors, distills the challenge of effectively slowing the economy's momentum that we have witnessed and could persist in the near term.

Similarly, we have all seen countless headlines announcing layoffs across public companies, particularly in tech, finance, consulting, and other white collar industries. Though the cumulative numbers and the impact on those affected are sizable, the spillover to the broader economy has thus far been muted for a few reasons. For one, the scale of announced figures often pales in comparison to the size and the churn of the U.S. labor market. On average, there were 1.5 million layoffs a month in 2022, which was just shy of a record low in data going back to 2001.

More critically, thanks to the tightness of the labor market, many of these workers have been able to fill openings elsewhere. While it may simply take time for severance to be exhausted or belt tightening to spillover to other industries, the announced layoffs have yet to signal problems beyond the struggling sectors.

Finally, employers in the hottest parts of the service sector continue to exhibit behavior suggesting the challenge of staffing over the prior two years may be hard to forget. Retailers usually ramp up hiring in the fall and winter before reducing head count following the December holiday season. So far in 2023, however, these seasonal layoffs have been strikingly muted, rivalled only by 2022's record low. Similarly, airlines, which have struggled to meet resurgent demand, have reported needing to staff at higher levels to maintain adequate capacity.

While we do not expect labor hoarding to insulate service sector workers in the event of a downturn, it has kept a higher floor on employment even as other parts of the economy have started to falter.

Taking a step back, the labor market remains a mosaic, with each sector seemingly facing its own idiosyncratic story. While we have undoubtedly seen some loosening over the past few months, it has not been enough to bring wages back to a level that is consistent with target inflation. The tightness of the labor market coming into the current slowdown means that Fed policies will take additional time to impact employment, making their tightrope walk even tougher.

By the time they detect sufficient weakness in the target areas of the economy, the downward momentum may be difficult to stop.

Where are we going and why are we in this handbasket?

In the meantime, while the labor market keeps the Fed from rescue rate cuts, the broader economy continues to manage through the impact of tightening to date. In fact, the economy appears to have more than just managed in the first quarter. Right up until the run on Silicon Valley Bank, reflation had been the name of the game. As Chair Powell addressed Congress on March 8, the 2-year yield touched a 17-year high, with markets increasingly anticipating a higher terminal rate for longer. Initial reports for 2023 have shown consumer spending surging and business spending stabilizing after a slowdown in Q4 2022. The string of upside surprises flew in the face of dour economic expectations coming into the year when many analysts were calling for a recession.

The economic data have pushed up expectations for Q1 2023 GDP (gross domestic product) growth to above its pre-pandemic run rate. While some of this momentum may have faltered in the back half of March, the U.S. economy was on the verge of a brief rebound.

Given the rapidly evolving nature of the current macro landscape, one cannot rest on the laurels of one strong quarter. Much of this data is backward looking and forward looking indicators suggest this bout of growth is likely to be brief.

The Leading Economic Index—a compilation of cyclical and market based indicators—is well into recessionary territory.

Breaking the index into its component sectors presents a more nuanced story. Four out of the five areas outlined below suggest more problems than promise for the economy in the quarters ahead, but each also shows reasons to doubt its predictive power in the current cycle.

MANUFACTURING

Manufacturing can often weaken before the economy tumbles into recession as consumers pull back on discretionary goods and businesses forgo equipment spending before other belt tightening measures. We have certainly seen manufacturing slow in recent months, but is this just the first sign of slower spending to come? Well, it is little surprise that the goods-producing sector retrenched over the past year. The pandemic's economic distortions unleashed a surge of consumer goods demand, while businesses increased orders to build out capacity and replenish inventories. These trends were inherently unstable, and, in turn, we have seen them reverse as economic activity normalized.

Looking ahead, manufacturing could stabilize once businesses work through their excess inventory, but challenges are likely to persist. Consumers continue to prioritize service spending, while businesses are likely to reign in capex as interest rates rise. While China’s reopening may provide some relief, exports are unlikely to be a panacea as developed nations face similar pressures to the U.S. economy.

HOUSING

Residential construction is often seen as a leading indicator, as it is one of the first to feel the impacts of monetary tightening with builders and buyers feeling the pinch of higher borrowing costs. This was on full display in 2022 as rising interest rates stopped a construction resurgence in its tracks. However, the transmission of construction weakness to the rest of the economy has been delayed this cycle, as we touched on above.

Moreover, the market has been a surprising pocket of resilience recently, as buyers and builders adjust to higher borrowing costs. While sales are unlikely to return to their recent highs, the lack of new existing home inventory may continue to skew sales towards new builds and keep builders busy until the broader economy turns.

CONSUMER SENTIMENT

How consumers feel about the economy can influence how they spend. That, at least, is the logic behind consumer confidence's forecasting abilities. At the moment, consumers do not feel tremendous about the economy's prospects, but this is not a recent shift. Consumer sentiment began to decline as inflation rose in the back half of 2021, before hitting a trough in the middle of 2022.

As sentiment continues to flounder, it remains to be seen when this soft survey data will feed into consumer behavior. Usually, when we see consumer confidence fall as much as it did in 2022, we are already in recession. Nonetheless, consumers have continued spending. This apparent contradiction may in part explained by the large pile of savings shielding consumers as the economy turned last year. While the excess savings accumulated during the pandemic was not distributed evenly, it allowed consumers to maintain their spending in aggregate as inflation crimped real incomes. Moreover, this stash has yet to be exhausted helping laid off workers, particularly in higher paying industries, cushion spending as they look for new work.

Looking forward, it is difficult to see what will spook consumers. Early data has suggested that even the recent banking crisis has been unable to rustle consumer so far. While there are innumerable shocks that could strike the system, we remain focused on the slow moving credit and liquidity crunch that is likely to continue revealing sources of instability lurking in the economy. In the meantime, consumers' complacency is likely to remain until the labor market turns.

YIELD CURVE

The inversion of the yield curve is widely known to portend recession. The explanation for its predictive power may vary from simply reflecting the bond market's intuition that the Fed will need to cut rates or the pressure it puts on bank lending, but in either case this current shape of the yield curve suggests an economic downturn is looming. Historically, however, it does not necessarily mean that a recession is already in progress as the time from inversion to downturn can vary from cycle to cycle. Unfortunately, in the current moment, we have already begun to see the yield curve steepen after a prolonged inversion, suggesting rate cuts are imminent. Due to the rapidity of this recent move against the backdrop of already elevated bond market volatility, we could see it reverse as the market backs away from its rate cut bets. Though, more importantly, the yield curve's inversion in the current context reinforces much of what we already know, without helping detect when or where problems will arise.

JOBLESS CLAIMS

Jobless claims are the highest frequency data that can often be the first sign that the labor market is heading for trouble. Currently, claims remain remarkably low. Even the layoff announcements of the past few months have been slow to reflect in claims data. Part of this may be due to delays from announcement to workers filing claims, but, as we discussed above, the tightness of the labor market overall has helped mask troubles in more challenged sectors. We may ultimately see claims rise as the labor market continues, but for the moment this is one of the few indicators not flashing red.

The course is set

The Fed has good reasons to not hike or to cut as credit tightening is doing the work for them, and labor is still an issue. In our view, March could mark the final hike. However, if financial conditions loosen too much with the market working against the Fed, we may see one more, but that would likely be the final hike.

Our view is that the Fed will hold until they see clear evidence that labor has weakened, which could worsen hockey stick style. The reality is that even when the Fed begins to cut, they are unlikely to ease quickly enough to reverse the economic deterioration that would have already occurred for three reasons:reasons: (1) the starting point is likely too late given their reliance on economic data that is generally delayed by some degree, (2) the inability or unwillingness to cut or ease fast enough once the economy is already in a self sustaining slowdown, (3) monetary actions work with a long lag.

While the causal relationship may be somewhat blurred, the collapse of SVB and banking crisis that followed, has in our view all but guaranteed a hard landing for the U.S. economy , driven by accelerated tightening of lending standards, a rapid slowdown in credit growth, and a Federal Reserve that is more constrained than it has been in generations.

We know the direction, are confident in the ending, but are less certain with the speed. The path is nonlinear. So, what does this mean for investors?

The negative impact to the economy from the banking crisis has elevated the downside risk to an economy that was already slowing. That said, we cannot abandon our playbook just yet. Slowing the economy's momentum and bringing down inflation will take time, and the murkiness of the outlook is likely to keep the Fed frustratingly data dependent. This is likely to keep rate volatility elevated.

While the immediate consequences of the banking crisis will center on areas of the economy that benefited most from near-zero interest rates, it is likely to ultimately push the broader economy into recession, suggesting little upside for equity beta on a six- to twelve-month basis. In the near term, there is a high probability of a technical-driven relief rally as the Fed becomes more dovish. Within the stock market, the last month has presented additional challenges for companies that rely on smaller enterprises and capex spending for their revenue, as regional bank issues and credit tightening may pinch these categories more than we previously anticipated.

We continue to favor quality, as we await a more definitive turn in the economy and particularly inflation before we look through to the next cycle and return to more cyclically dependent elements of the market.

In our view, liquidity and credit will continue to be in the driver's seat, as we incur the consequences of the fastest policy tightening in a generation. On the offensive side, look for the next dominoes to fall.

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