SIDEWAYS SHUFFLE

Those looking for clear direction from this week's inflation news didn't find it. The consumer price index was in line with expectations – lower than might have been feared but not yet consistent with the Federal Reserve's hopes for a clear deceleration towards its 2% goal. Markets were cheered by the fact that the absence of bad news makes a Fed pause in rate hikes more likely next month. By the end of the week, though, optimism had faded as investors turned to more pressing issues in the debt-ceiling talks following Treasury Secretary Janet Yellen's renewed call to raise the debt limit. The S&P ended down .19% for the week.

At RockCreek we see no reason to expect an early pivot to interest rate cuts, although market pricing suggests otherwise. A pause is likely but is not yet a done deal. More data on inflation and jobs will come between now and the mid-June Fed meeting. The central bank sees interest rates at current levels as restrictive. Together with the continued strains on bank lending, the current stance of policy is consistent with a slowing economy and – the central bank hopes – with a move downwards in inflation. The coming month will give more indication of whether this is right.

Future Fed decisions will include new faces. Today, President Biden nominated Davidson College economist Phillip Jefferson to fill the Vice Chair seat once held by his now top economic advisor Lael Brainard. He also nominated economists Lisa Cook and Adriana Kugler – currently the US Executive Director at the World Bank – as governors.

THE VIEW FROM THE BANKING GROUND

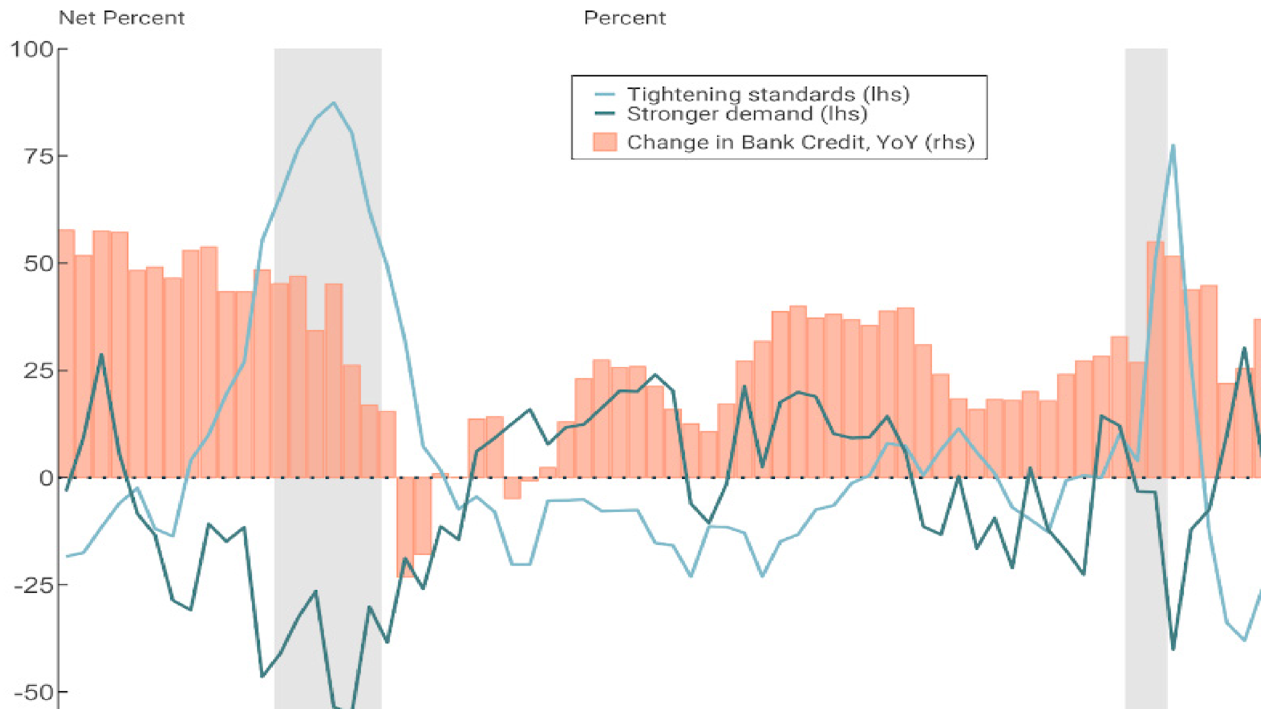
At the beginning of the week, the much-anticipated Fed Senior Loan Officer Survey (SLOOS), which covered lending conditions in the first quarter of 2023, showed that banks, on balance, are further tightening their lending standards and loan demand is weakening. But the shift seen is not as much as initially feared after banking turmoil heightened concerns that lenders would clamp down sharply on credit and push the economy into recession.

The most recent results build upon trends that began late last year which saw banks tighten standards to levels typically seen during recessions as the Fed's rapid interest-rate increases fed into higher borrowing costs.

While the current results quelled some fears that there would be a strong rippling effect after the recent turmoil, the tougher deposit environment will weigh over time on banks' risk appetite and willingness to lend. Commercial and industrial (C&I) loans – an important driver of macroeconomic growth – were hit the hardest with a subdued risk appetite for investment pushing demand to its lowest level, while higher rates bumped premiums to its highest level since the global financial crisis.

A looming credit crunch…?

Net share of banks reporting tightening standards and stronger demand



Note: Net percentage refers to the fraction of banks that reported having tightened standards (stronger demand) minus the fraction that those reported having eased standards (weaker demand).
Source: RockCreek, Federal Reserve SLOOS, H.8.

The flip (business) side of these results came a day later with the National Federation of Independent Business (NFIB) Economic Trends survey (SBET). A separate NFIB survey published last week showed that most small businesses aren't too concerned about the safety and stability of the banking system, But the SBET results showed businesses shared concerns with bank loan officers: an increasingly unfavorable outlook is weighing on business optimism. Over half of business owners surveyed said that the US was already in a recession and the Optimism Index - a measure of health of small businesses in the US - remained below the 49-year average for the 16th straight month.

Despite the looming concerns, investors also see a number of opportunities in the financial space. The US banking sector has seen continuous consolidation over the last thirty years – from more than 12,000 in 1990 to just over 4700 today – and the recent shakeup will most likely lead to a new wave of consolidation as bigger banks look to snap up distressed assets at attractive prices and smaller banks look to reduce their costs and increase buffers amid current market challenges. Consolidation will become increasingly attractive for small and mid-sized banks as higher interest rates pressure funding costs and squeeze profit margins.

These recent survey results were closely watched as the combination of US banking sector stresses and rapid interest rate increases have stoked concerns of a coming credit crunch and recession. As we have commented, the US is not in recession now. But the economy is slowing. And tightening credit conditions mean we may be seeing the beginning of a credit crunch that may help the Fed to push down inflation but raises the odds of a recession in the latter half of this year.

READING THE INFLATION TEA LEAVES

Wednesday's CPI data revealed inflation is making slow and steady progress downward but not enough for the Fed to declare victory. Headline CPI accelerated 4.9% YoY - just below expectations - and the lowest annual growth rate since April 2021. Core CPI, however, is still too high at 5.5% YoY. The biggest driver of core services continues to be shelter, which accounts for over one-third of overall CPI. Looking at the so-called "supercore" - which excludes shelter and used cars, as well as energy and food - prices rose at an annualized pace of 4.1%. Rents typically lag CPI measures in their effect due to the infrequency of data collection and estimations used, but real-time data from Redfin and Zillow show that rent prices have been steadily decreasing over the last year (on a YoY basis), which suggests that this heavyweight component should start easing soon. But using supercore as a guiding metric does leave something to be desired as shelter, energy and food make up 22% of all consumer spending.

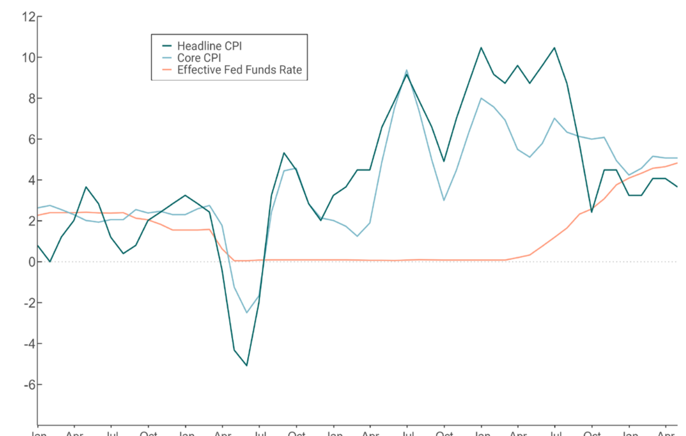
While this week's CPI report gives the Fed a moment to pause, it will take a bit more convincing to get them to start cutting rates. The Fed will see one more jobs report and two more inflation prints before they meet next on June 14.

Markets are pricing in a pause at next month's FOMC meeting, followed by a rate cutting cycle as early as July. While this would be a quick pivot, it's not so out of line with historical trends. Studies show that the median pivot over the last 18 tightening cycles is about 2 months, with the average at 3 months, although ahead of the GFC, the Fed held peak rates at 5.25% for 15 months before embarking on a steep rate cutting cycle. The backdrop of high inflation and a tight labor market now means that the Fed's focus remains on getting inflation down. As such, we continue to believe that it will be some time before the Fed begins easing.

Economists at NFIB noted that the economy was likely to slow down further – which will make raising prices more difficult and slow inflation – and suggest maybe "it's time for the Fed to pause and let nature (markets) take its course". Last week, Powell suggested that "it's possible this time is really different" and "the case for avoiding a recession is, in my view, more likely than having a recession." It remains to be seen if the Fed can pull off a soft landing, but the odds looked stacked against them.

Inflation looks "good", but shelter prices are keeping things sticky

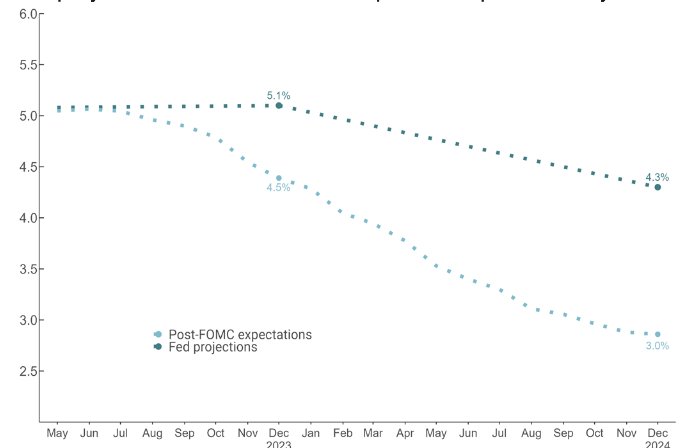
Current Fed Funds rate and CPI, 3-month annualized



Source: RockCreek, BLS.

Markets expect the Fed to begin cutting rates in July after a brief pause

Fed projections and the market-implied rate path on May 3



Note: The current effective Fed funds rate is 5.08% as of May 11, 2023.
Source: RockCreek, Federal Reserve, Bloomberg.

GOOD NEWS AND BAD NEWS FOR EQUITIES

US equities were mixed this week with growth broadly outperforming cyclical sectors. For the most part, good news on the economic front was well-received by the market versus the "good news selling" which has been so common recently. Investors shrugged off strong labor market data while not accepting it as an indication of more Fed rate hikes to come.

Solar stocks performed particularly well, with First Solar leading the pack, after the Treasury Department released new guidance on Friday regarding solar power projects that includes a 10% for those projects that use domestic materials. The late rally helped solar stocks finish up 2.1% on the week.

On the other hand, bad news was bad news as PacWest's disclosure of deposit outflows last week sent its shares reeling on Thursday, casting a darker shadow over the regional banking sector. The KBW Nasdaq Regional Banking Index is now down 7.8% this week and down 40% from its February peak before the sector began to reveal its cracks. Odds are remote that we see a wide-scale banking collapse like we did in 2008.

The sector is much better capitalized than it was back then, but nevertheless still poses a significant risk to markets. We cannot be certain there will be more bank failures over the coming weeks and months, and the spillover effects are unknown. Commercial real estate problems will likely start to increase as long term leases end and companies reduce their space needs. To the extent inflation remains problematic and forces the Fed's hand, the greater the odds the current situation devolves into a more serious credit problem.

So far, retail investors have provided solid support for the market. Allocation to equities in the retail sector is down from its 2022 highs but at 60% is still well above the 40% threshold typical of a bear market trough. The implication here is that more bad news could indeed be bad for equities.

We wrote last week about the US corporate sector exceeding its lowered expectations bar and that remains the case after this week. It is worth noting that this has not been a US-specific phenomenon. Earnings in Europe have been similarly strong and results in Japan have been much better than investors were expecting. Japan is clearly benefiting from supply chain constraints easing within the mainstay logistics segment as well as semiconductor and auto parts. Toyota reported earnings on Thursday that were well ahead of consensus estimates and management went on to forecast higher profits in 2024 buoyed by EVs and increased production. Steel producers and wholesale trading companies were also among the market leaders. Investor sentiment towards Japan runs notoriously hot and cold, but there can be no mistaking it for hot at the moment. Japan's Nikkei 225 is up over 14% year-to-date, handily outperforming the US and Europe.

EMERGING MARKETS

It was a relatively muted week in emerging markets. Investors are beginning to digest the hard truth that China's recovery is turning out to be painstakingly slow. Recent trade data coming out of China shows the pace of export growth has slowed, suggesting weaker global demand for Chinese goods. Imports into China have slowed even more. Likewise, the much-hyped bump in domestic travel and leisure has not quite materialized. While domestic tourism has rebounded to close to pre-pandemic levels, international travel out of China has remained muted, weighing heavily on some of

China's neighbors. It seems Chinese travelers are eschewing international destinations due to a combination of low airline capacity, high ticket prices, and residual fears of COVID conditions outside the country. Indeed, international seat capacity has only recovered to approximately 37% of pre-pandemic levels, and ticket prices to popular destinations such as Thailand and Japan are twice what they were in 2019.

Brazil was an outlier this week, with energy related names carrying the market's strong return. A better-than-expected dividend payout from Petrobras buoyed both the sector and overall market. The lack of expected regulatory pronouncements on the energy sector by the government also helped the sector. A sustained, broader based rally in Brazil will have to wait and will depend on a normalization of monetary policy.

More generally, as we close in on the mid-year mark, emerging markets central banks that were widely expected to begin easing have yet to do so. The good news is inflation has begun to moderate and the US dollar is in a weakening trend – this should provide the final impetus for a lower cost of capital and the conditions necessary for new credit creation.

With more to come,
Team RockCreek