PAUSE, PERHAPS, BUT NO PIVOT

As widely anticipated, Federal Reserve policymakers pushed up interest rates by another 25 basis points this week. With the policy rate now at 5% – after a 500-basis point increase over the past year – the Fed hinted that it may be done hiking. That is not yet a sure thing. And Chair Jerome Powell pushed back on market hopes of a pivot to cutting rates this year.

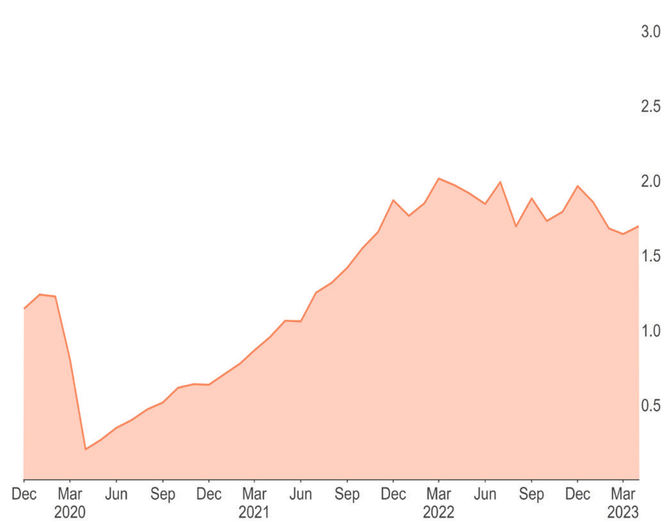
The Fed is still worried about inflation. A credit crunch may be coming, but the jobs market remains tight.

The two days after the Fed's rate decision demonstrated the uncertain economic backdrop that policymakers – and investors – have to wrestle with, Friday's strong labor report showed no reason to believe that inflation is on a downward path from the current underlying pace of 4-5%. But fears of banking instability – which left regional bank stocks down 8% for the week, despite a partial rebound on Friday – show the danger of a coming credit crunch. As banks look to improve their balance sheets and fend off depositor and investor concerns, borrowing to spend and invest will get harder and more expensive. Might the rate hikes so far have had a deeper impact on the economy than the usual indicators suggest?

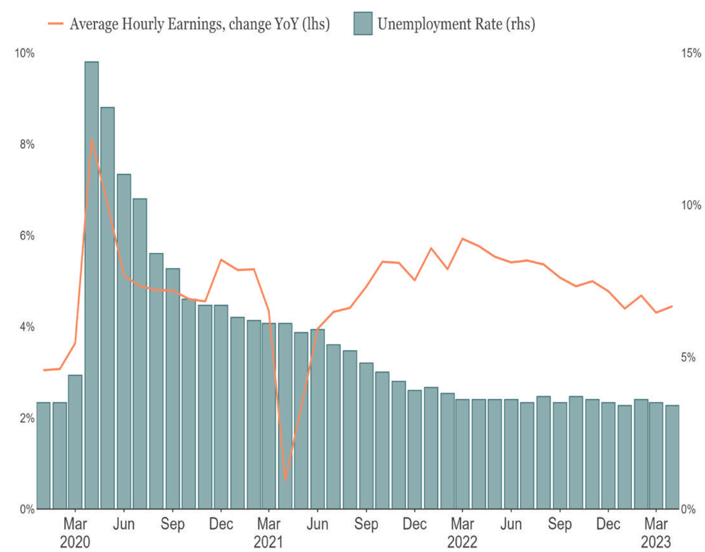
Jobs data earlier in the week hinted at signs of a weakening labor market. Vacancies were down for the third consecutive month to their lowest levels in nearly two years. Meanwhile, layoffs climbed to their highest levels since 2020, and unemployment insurance claims

The labor market remains resilient in the face of higher rates

Job openings per unemployed person, ratio



Wage growth and unemployment rate, percent



Source: RockCreek, Bureau of Labor Statistics.

rose again. On Friday, however, payrolls data showed the extraordinary strength still left in the labor market. Hiring and wages both accelerated more than expected in April. Nonfarm payrolls rose 253,000 last month, well above the 180,000 consensus, and the unemployment rate fell to 3.4%, the lowest rate in decades. Hourly earnings surged 4.4% YoY and 0.3% MoM, the biggest monthly increase since July 2022. The unexpected labor market strength means the Fed will most likely stay higher for longer and leaves another potential hike on the table.

Economists may worry that a strong labor market will keep inflation "sticky", particularly in the labor-intensive service sector where consumer demand has been concentrated following the pandemic lockdown. But there is a welcome aspect of this post-pandemic jobs market. Lower income and minority workers have been drawn into the economy. And one pandemic phenomenon – workers staying on the sidelines, exacerbating labor shortages – has now ended. Just as the Covid pandemic was declared over this week, the ratio of prime age US workers that are in jobs climbed above its pre-Covid level and overall labor force participation ticked above the pre-Covid official forecast.

BANKING BLUES

Fear is the enemy of financial stability. And, like fire, it can spread quickly and unpredictably.

At the beginning of this week, the ailing First Republic bank was finally put out of its misery by the federal regulator and sold to JPMorgan Chase & Co. There was hope that this would draw a line under the US banking crisis that erupted suddenly in early March with the collapse of Silicon Valley Bank (SVB) and Signature Bank, a much smaller bank. First Republic had been under pressure since then. The markets initially rewarded JPMorgan for winning the auction – which closed at 2 am Monday morning. CEO Jamie Dimon said that the acquisition "modestly benefits [the] company overall." A month ago, Dimon noted he saw the banking crisis nearing its end, though a few bank failures were still possible.

The good cheer evaporated as the week went on. The fire spread to apparently less vulnerable institutions, with fewer characteristics in common with SVB. Maybe just being based in California, or being small or mid-sized, or having a lot of assets in longer term securities with visible unrealized losses was enough to frighten depositors and investors. The market's attention shifted to PacWest, then Western Alliance and a handful of other banks. Declarations of robustness from management served to worry rather than reassure. Meanwhile, the FDIC may be planning to make just big banks pay for this year's crisis, with new fees to replenish the Deposit Insurance Fund (DIF), depleted by the government rescue of SVB that month. Market pressure on smaller banks was relieved on Friday. But the rebound still left regional bank shares battered. So far this year, regionals have lost nearly 30%.

The problem is that no bank can really withstand a loss of confidence and run on deposits. Their business is to lend long and borrow short, meaning that sufficient fear can drain liquidity from even a solvent bank. That's why the Federal Reserve was set up as a lender of last resort after the banking panics of the early twentieth century.

For the Fed, the flare up of banking problems now raises two different issues. One concerns risk to the financial system. This is most likely to be contained (as discussed below) although danger remains as long as the fire continues to smolder.

The second issue, which complicates monetary policy, is the risk to economic growth from a credit crunch. European banks have not suffered as US banks have this year. But tightening lending is a risk there as well. The European Central Bank (ECB) raised rates 25 basis points this week, following the Fed, although President Christine Lagarde indicated clearly that the bank expected to tighten further. She acknowledged, as did Chair Powell, that a credit crunch that dampens economic growth and, presumably, reduces inflation pressures would change the calculus for central bank rate policy.

BE CAREFUL WHAT YOU WISH FOR

A cut in interest rates should be good for stock prices and for the economy. But a cut in US rates will only come soon if the economy is being hit harder than expected by tightening monetary policy. In that case, firms' pricing power, earnings, and profits would also be hurt by slowing demand. Earnings have beaten expectations this year – although they are still weaker than in 2022 (see below). Their future path will depend on whether the slowdown that is underway in the economy remains moderate.

A possible credit crunch is now a wild card. Rapidly rising interest rates were expected to curb demand and economic growth. That is how monetary tightening reduces inflation. The resilience of the US economy over the past year in the face of the Fed tightening, in particular the strength of the labor market, has been a puzzle.

One explanation that economists have considered is that the lag between the rise in rates and the economic impact has lengthened. In that case, the tightening that has already taken place will continue to play out even if rates now stabilize. Another possibility is that changes in financial markets have blunted the usual economic impact of Fed tightening. As the central bank raised short-term rates, interest rates at the long end of the market have not responded by as much as expected. During the past year, markets have been more optimistic than the Fed about when rates will turn down. That has muted the rise in longer-term rates that affect mortgages and business loans.

Instead of showing up in a housing price collapse, central bank tightening has affected the banking system directly. As the banking problems in the US have continued, the risk of a credit crunch has grown. Next week will bring new data on lending conditions and credit demand from the Senior Loan Officer Opinion Survey (SLOOS). It is likely, as Chair Powell signaled, that the report will show a pullback.

That would only be the beginning. Some signs of credit drying up are just starting to appear. The National Federation of Independent Businesses March survey showed small businesses had a harder time getting loans last month, while data from UBS shows corporate bankruptcies have jumped. Businesses are struggling to raise money amid higher interest rates and tightening standards will add to the pressure. More defaults are on the horizon.

After this week, bank presidents and boards all over the country will be taking another look at the risks embedded in their balance sheets. They will likely be averse to adding to them.

EARNINGS CLEAR THE BAR

Earnings releases from major companies continued this week, and it seems the US corporate sector has largely passed its earnings test – although you could also say they were graded on a curve, given the bar of expectations they had to meet coming in had been lowered considerably.

Looking back, results from the big banks at the start of earnings season were solid and guidance was relatively healthy as well. Most interesting, major banks increased loan loss reserves, but only slightly higher than the historical average. This implied that they were bracing for only a relatively mild recession and not something more severe.

Next came Big Tech, where earnings were also better than expected. Tech companies lowered guidance but not as much as had been feared, and data showed that demand is softening but not at an accelerated pace. All eyes were on Apple's release following Thursday's close, with the bar set relatively high, and the company surprised to the upside on the back of strong iPhone sales, underscoring Big Tech's place as a refuge.

So far, the real economy has been holding up reasonably well thanks in part to unexpected resilience in the homebuilding sector. Looking forward, it will be important to look beyond long business cycle companies and focus on cyclicals with short lead times for early signs of accelerating weakness.

CREEPING CONCERNS ON THE DEBT CEILING

Risk aversion may also be affected by the stalemate in Washington over the debt ceiling. Last week's note called out the brinkmanship between Republicans in Congress and the White House. That continues. Markets are beginning to show concerns via pricing in Treasury markets. There may also be a more general background worry that could dampen risk appetite while uncertainty persists.

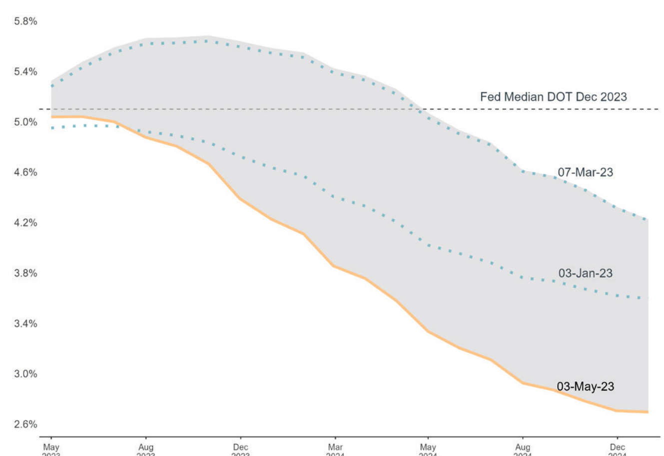
Treasury Secretary Janet Yellen this week notified Congress that the US will run out of money to pay its bills sooner than expected, on June 1. President Biden agreed to sit down with House Speaker Kevin McCarthy, but he said that he will not negotiate on spending or tax measures tied to the debt ceiling. Speaker McCarthy's starting point – the bill he succeeded in passing through the House last week – is a non-starter for Senate Democrats and the President. It would roll back key elements of his signature legislative achievements.

It is doubtful that House Republicans would all agree to anything less than the spending cuts in the bill. Still, as Chair Powell noted, the idea that the US would default on its debt is still unthinkable for most. That crunch point would not come immediately: the US Treasury can prioritize payments to some extent.

BONDS ON THE MOVE AGAIN

After a brief respite following the SVB collapse, the MOVE Index – a measure of volatility in the Treasury market – jumped 15% this week, though the index is still below levels seen at the peak last month. Debt ceiling anxieties added to the ongoing concerns and pushed short-term Bills above the 10-year by levels not seen in almost three decades. On Thursday, the Treasury sold $50 billion of four-week Bills at an unprecedented 5.84% yield. Coupled with higher rates, a looming credit crunch, and banking turmoil, a potential default situation will add more fuel to the economic downturn.

The Fed's implied market path has made dramatic moves since March



Note: Shaded region represents the upper and lower bounds of Fed funds futures pricing from January 3 to March 31. On March 8, SVB announced a capital raise plan before quickly collapsing by the end of the week.
Source: RockCreek, Federal Reserve, Bloomberg. As of May 4, 2023.

By the end of the chaotic week, longer-dated Treasuries recovered some of their earlier losses after stronger payrolls data show the Fed still has more work to do. Futures contracts – which briefly collapsed yesterday after traders upped bets on a Fed pivot in July – moved higher, as markets returned to expectations of a stable policy rate.

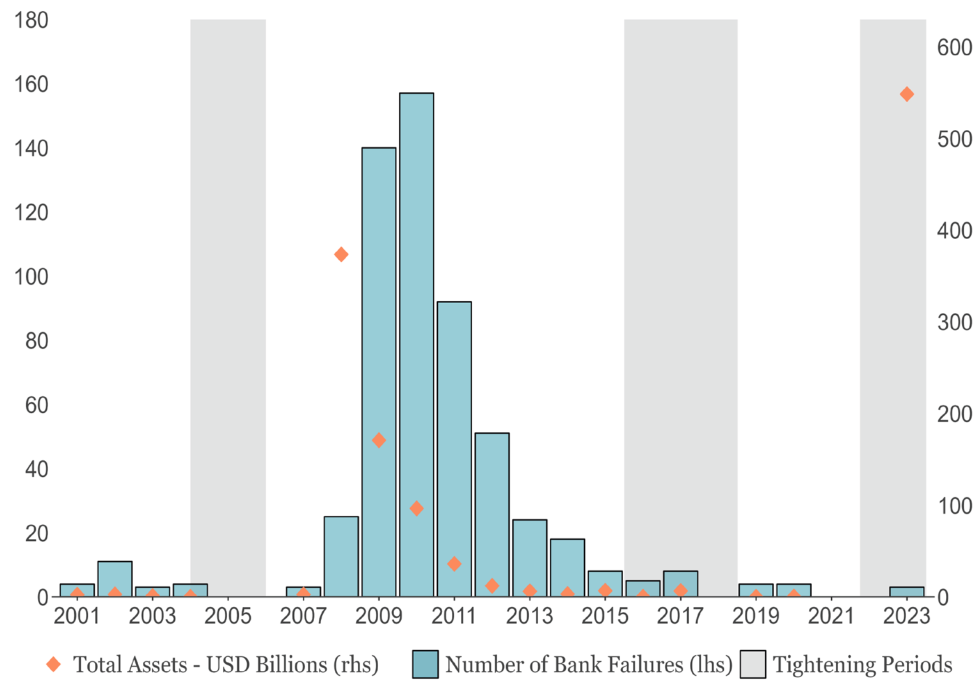
With the debt ceiling deadline looming, any developments going forward will most likely overshadow backwards looking data, including next Monday's lending survey data and CPI data on Wednesday.

WHEN DOES A BANKING COLLAPSE THREATEN THE FINANCIAL SYSTEM?

Can a wave of bank failures and consequent consolidation be managed without a system-wide crisis? In a typical year, between 3 and 4 US banks fail. Since the 1990s, thousands of banks have closed. The US still has over 4,700 banking institutions. That compares with 80 banks in Canada and 360 banks in the UK.

Local, regional, and community banks have played a special role in the US economy. Chair Powell noted their value to society and communities. But a further slow consolidation would not be surprising, nor would it cause economy-wide problems. What would be concerning for the system would be a more rapid consolidation, with larger banks caught up in a fear-driven run. The Fed has seemed overly complacent in the face of this risk, including this week. But it still has the fire-fighting tools that it needs. The run up of bank failures during the crisis in 2008 was preceded by a monetary policy tightening cycle that began in 2004 and reached a peak rate of 5.25% by mid-2006. During that time, the Fed raised the rates 425 basis points, but the first wave of bank failures didn't appear until nearly two years after the Fed reached its peak rate and a full year after it began aggressively cutting rates. By the end of the GFC, over 168 banks had failed, representing $548 billion

The lagged effect of monetary policy tightening may mean more bank failures to come



Source: RockCreek, FDIC, Federal Reserve.

in assets, but most banks to fail were local and community banks, those under the $10 billion asset threshold. So far, the three banks to fail this year are nearly equal in the total assets of all failed banks from 2008 to 2009.

Much like the lead up to the GFC, the last two years saw no bank failures, but unlike then, the current tightening cycle has been much more aggressive, with the 500 basis point increase occurring over the course of just 14 months, not two years. After Wednesday's decision, the peak rate is now 5.25%. But the lagged effect of monetary policy means we may just now be seeing the beginning of a new run up on bank failures–at a much larger scale.

EMERGING MARKETS

The rout in US regional banks did not help matters in emerging markets this week, weighing on the asset class and adding to an existing sense of uncertainty. Most markets finished the week modestly down, helped by generally lower market activity on the back of the labor day holiday. India and Mexico were the exception, perhaps not a coincidence given their role as beneficiaries of the so-called 'China plus one' strategy pursued by many multinationals. To be fair, these markets were also helped by stronger than expected Q1 earnings results. Banks and consumer related businesses led stronger than expected earnings, helped by rising net interest margins and a resurgent consumer respectively.

While Chinese markets have continued to disappoint after January's strong rally, preliminary data coming after the labor day holiday points to a strong recovery in consumption spending patterns, particularly in travel and leisure. Indeed, approximately 274 million people traveled over the five-day 'golden week' holiday, bringing domestic tourism revenues up to 101% of pre-pandemic levels.

It was also interesting to see Chinese banks post a very strong week, a puzzling development given expectations of a government led clampdown on the banking sector. But it seems the Fed's signaling that it would pause interest rate hikes going forward was seen by the markets as giving Chinese authorities greater leeway in funding the weak points of the world's second largest economy without jeopardizing the stability of the Yuan. The Fed's pause is a golden opportunity for Chinese authorities to use the banking sector to unwind some of the current credit risks in the system. This could serve as a welcome signal to international investors that China is cleaning up its balance sheet while simultaneously stimulating growth.

With more to come,
Team RockCreek