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Add Banking Stress to Rising Rates and Recession May Be Baked In

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Economists have been forecasting a recession would happen since the Federal Reserve (Fed) started raising interest rates back in March 2022. The federal funds rate has risen almost 500 basis points since last year, as the Fed has aggressively attacked inflation. On the other side of the coin, there is a sizable contingent who still assert that a soft landing remains possible. Spoiler alert: I am not in that camp. The exact timing of when a potential recession might begin is lacking, but a fledgling U.S. banking crisis may have shortened the timetable. Let us look at where we are in the business cycle and see if there are any recessionary signals.

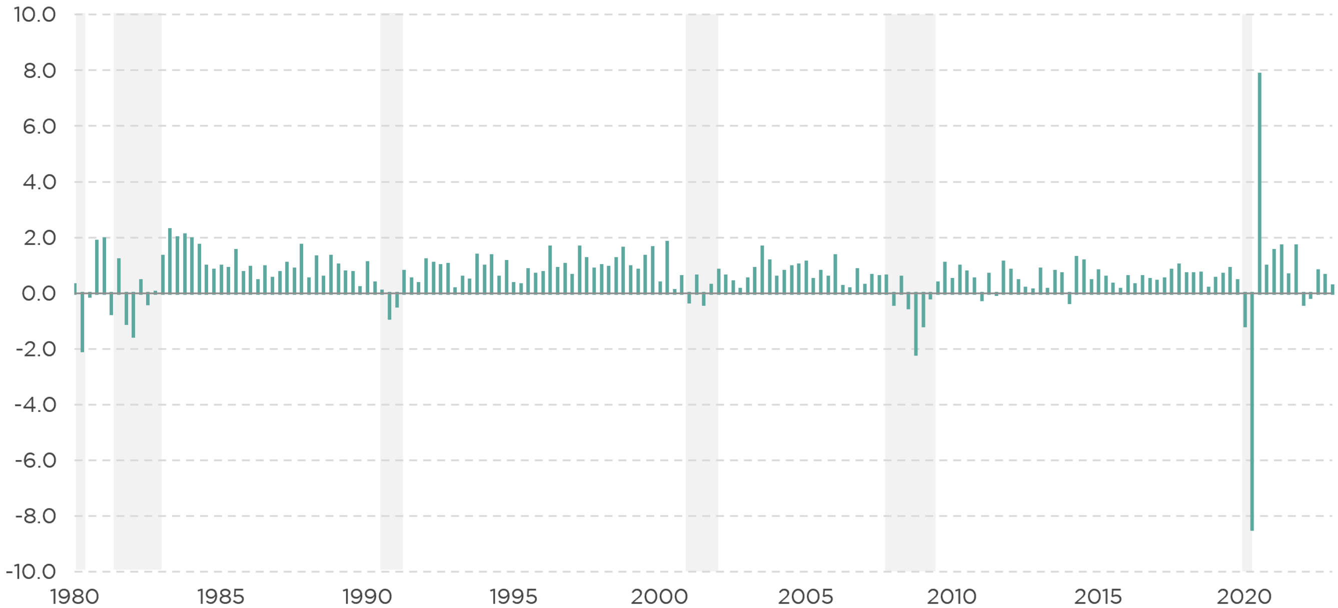
A Look at GDP Gives First Recession Signal

Chart 1 paints a picture of the economy's overall performance over six business cycles, starting with the back-to-back recessions of the early 1980s, sparked by Paul Volcker's war on inflation. The National Bureau of Economic Research (NBER) determines when a recession begins and ends, presaging the next recovery and expansionary part of the business cycle. NBER considers several indicators to determine when a recession began, like income, employment, and production, and seeks to assess whether or not a substantial decline in economic activity occurred.

1

U.S. Real GDP

% Change Quarter-over-quarter, Annualized, As of 1/1/2023



Source: Brandywine Global, Macrobond, Bureau of Economic Analysis

A rule-of-thumb definition of a recession's onset is back-to-back quarterly declines in real gross domestic product (GDP). As the chart shows, declining real GDP characterizes a recession, but not every recession experienced consecutive quarters of falling GDP. Most recently, the U.S. economy did experience two consecutive quarterly declines in real GDP, declining in both the first and second quarters of 2022. Analysts at large though dismissed this occurrence as signaling a recession, pointing to the absence of confirmation in broad economic indicators and arguing instead that the declines largely reflected businesses adjusting their inventories lower.

The first quarter of 2023's GDP report could be an early signal of a recession. While the economy grew in the first quarter, growth slowed to just 1.1%, annualized. The bright light was a near 4% increase in consumer spending; yet, this consumer strength was an early-year phenomenon. The last two months saw dipping retail sales, which should feed into slower growth during the second half of the year. We will be watching upcoming retail sales releases. While nonresidential fixed investment made a modest contribution to growth, equipment spending was a drag, and housing continued to be weak. Over the next couple of quarters, we expect consumer spending and capital spending to weaken further.

Is a Recession Baked In Now?

Most likely, in my view. The U.S. has just experienced three regional bank failures. The failures of Silicon Valley Bank and Signature Bank saw a surge in discount window borrowing. Next, First Republic Bank became the latest bank to fail, earning the dubious distinction of being the second-largest bank failure in U.S. history. Now, other struggling banks, hoping to avoid the same fate, are actively seeking suitors. This turmoil and uncertainty will ripple through the economy just as the steadfast tightening of U.S. monetary policy is also manifesting in financial conditions.

Some experts may believe the banking crisis is over, following the purchase of First Republic's assets and deposits by JP Morgan. I am less reassured. The Fed appears to be staying the course on its rate-hiking path, putting banks and other interest-rate sensitive sectors under further strain. These potent ingredients of the

Fed's earlier hikes and recent bank failures suggest recession is likely baked into the mix.

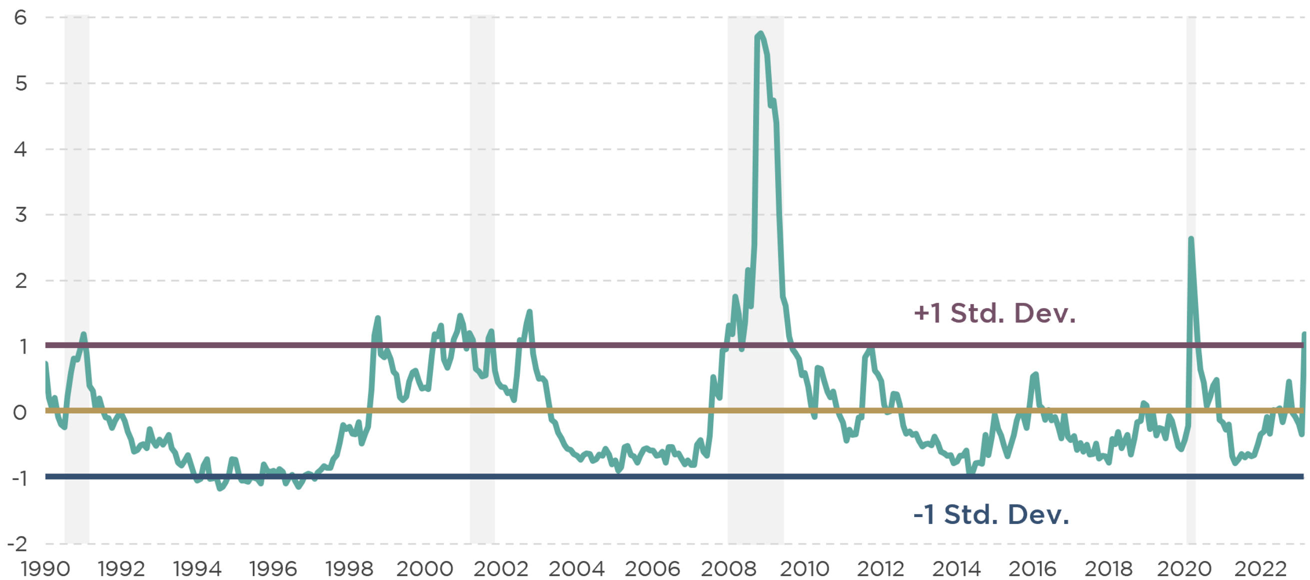
Stress Fractures from Tight Financial Conditions

The U.S. financial system is, I believe, under growing stress. That stress was rising before the three bank failures, the by-product of the Fed's rate hiking cycle. That is the message in Chart 2, created by researchers at the Kansas City Federal Reserve Bank. It consists of a number of variables, including interest rate spreads and asset prices.

2

U.S. Financial Stress Index

As of 3/1/2023



The Kansas City Financial Stress Index is a monthly measure of stress in the U.S. financial system based on 11 financial market variables. A positive value indicates that financial stress is above the long-run average, while a negative value signifies that financial stress is below the long-run average.

Source: Brandywine Global, Macrobond, Federal Reserve Bank of Kansas City

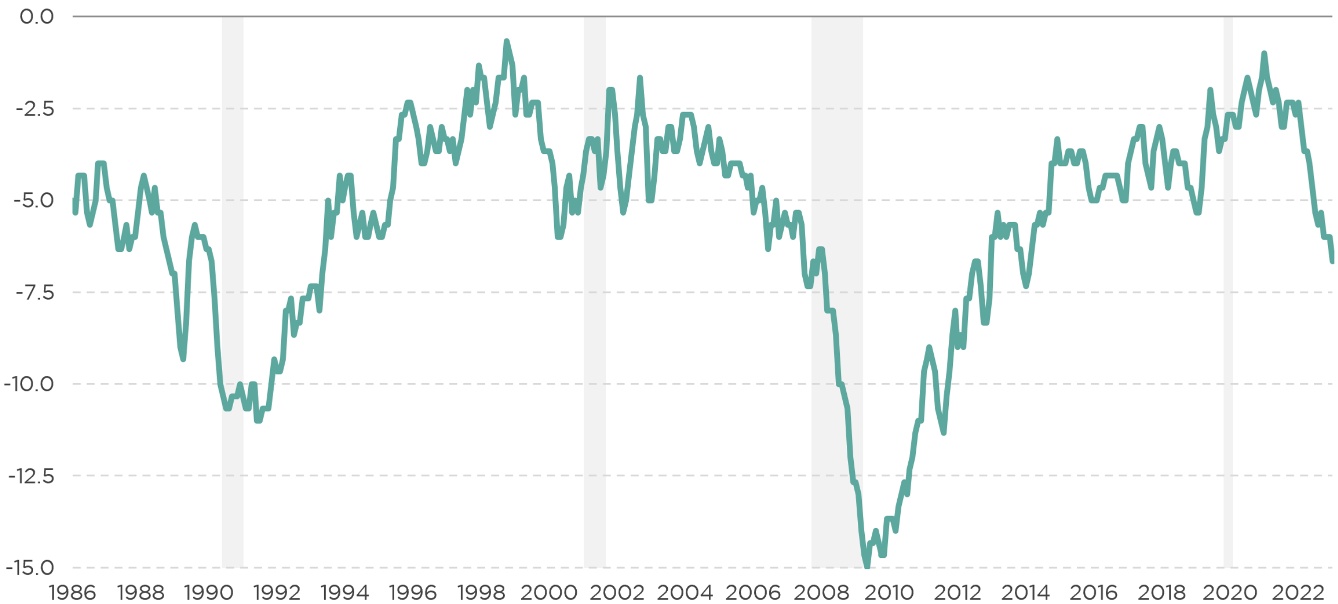
How should this data be interpreted? First, a positive value of the index indicates growing financial stress. Second, it is important to look at how this measure performed around recessions, the shaded areas on the chart. Positive values of this measure tend to be coincident with recession. In sum, there appears to be financial stress, as the banking crisis produced a spike in this stress measure. Will this combination of tight monetary policy and bank failures leak into the real economy?

Small Businesses Cite Growing Credit Concerns

As a result of the banking sector turmoil, we will see deterioration in credit conditions and credit availability for both households and businesses. Credit is already more expensive, as banks pay more on deposits to stanch the disintermediation that occurs during a rising rate environment. The deterioration in credit conditions is already evident among small businesses, based on the National Federation of Independent Business (NFIB) survey of its members (see Chart 3). Small businesses are integral to the U.S. economy, both in terms of employment and output. These businesses depend on bank financing to expand capital stock and finance inventory, among other activities.

3 U.S. Small Business Credit Availability

NFIB Small Business Credit Conditions Availability of Loans, 3-Month Moving Average, As of 3/1/2023



The National Federation of Independent Business (NFIB) Small Business Optimism Index, a composite of 10 seasonally adjusted components, provides an indication of the health of small businesses in the U.S.

Source: Brandywine Global, Macrobond

Chart 3 reports on small business credit availability. Tightening of small business credit conditions generally is evident in an economy experiencing a recession. In the post-Great Financial Crisis (GFC) environment, credit availability was not a small business concern. In fact, fewer and fewer respondents specified credit availability as a business constraint following the GFC. That is all changing now. The chart above shows that squeezing liquidity conditions could be setting the stage for recession. Credit conditions have become a growing concern for small businesses, with more and more identifying credit as an issue. Small businesses typically are the customers of the community and regional banks, banks that are suffering in this current crisis. That turmoil feeds back into economic activity.

Leading Indicators Flash Warning

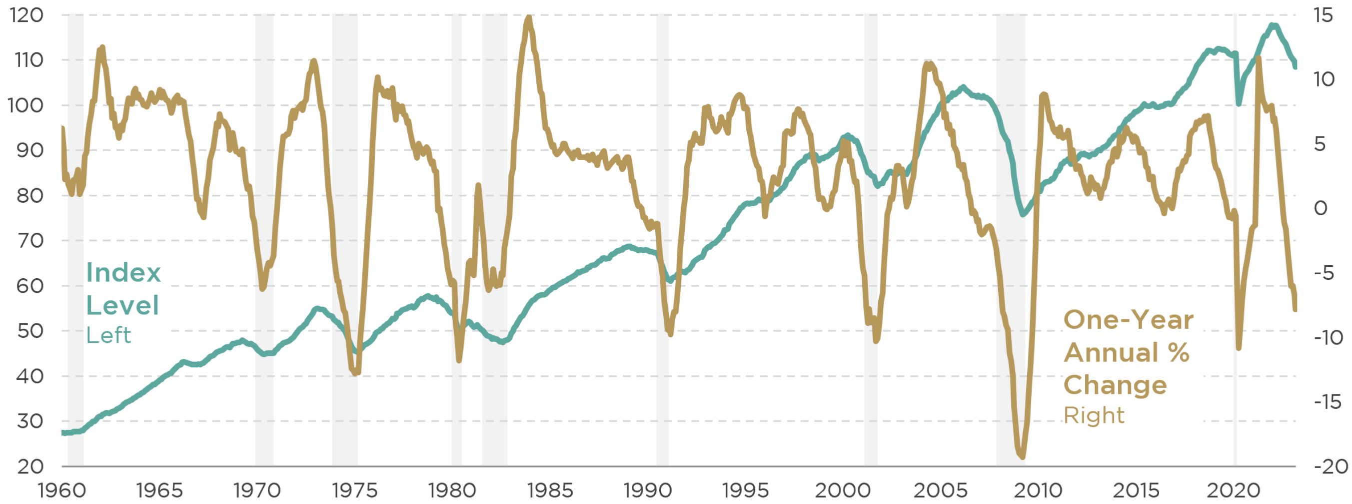
The Conference Board's index of leading indicators also can provide a warning sign of pending economic deterioration. These 10 indicators include measures that lead the economy, like real money supply, building permits, and the yield curve, for example. Chart 4 provides a relatively long history of the leading indicators, going all the way back to 1960.

The chart shows both the absolute level of the series and the year-over-year percent change of the leading indicators. The series does a good job of identifying the stage of the business cycle. The rule of thumb for analysts is to look for three consecutive moves in the series in the same direction. In the most recent business cycle, the level of the leading indicators has fallen *more than three months in a row*, and the index has declined nearly 8% over the past year. Leading indicators are flashing a bright, red recession warning.

4

U.S. Conference Board Leading Economics Indicators

Index (left), % (right), As of 3/1/2023



The Conference Board Leading Economic Index® (LEI) is composite index of 10 components, including: Average weekly hours in manufacturing; average weekly initial claims for unemployment insurance; manufacturers' new orders for consumer goods and materials; ISM® Index of New Orders; manufacturers' new orders for nondefense capital goods excluding aircraft orders; building permits for new private housing units; S&P 500® Index of Stock Prices; Leading Credit Index™; Interest rate spread; average consumer expectations for business conditions. It is designed to signal peaks and troughs in the U.S. business cycle.

Source: Brandywine Global, Macrobond

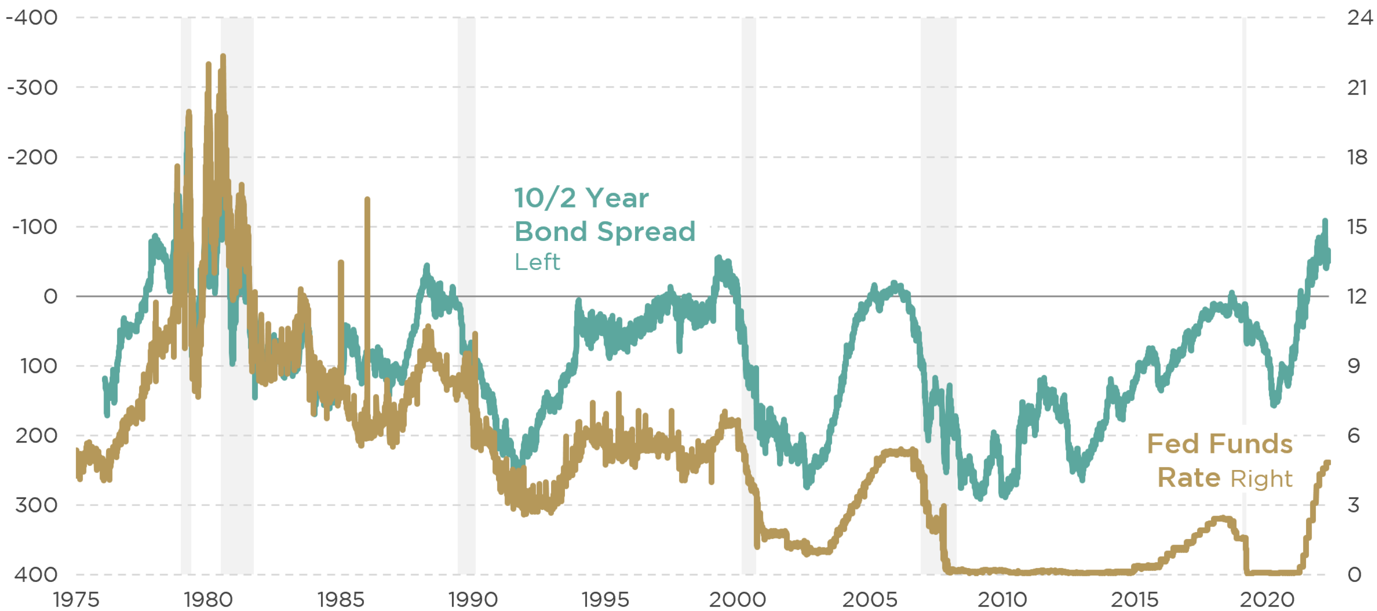
Classic Recession Harbinger Still Inverted

A leading indicator with a solid recession-predicting record is the Treasury yield curve. Chart 5 shows the yield curve, measured by the difference between the 10-year and 2-year Treasury securities, the effective federal funds rate, and past recessions marked by shaded bands. A yield curve inversion tends to signal the approach of a recession and a Federal Reserve that is preparing to lower interest rates to combat weakening economic conditions. Since the beginning of 2012, there is a -79% correlation between the yield curve and the federal funds rate. An inverted yield curve suggests the markets are expecting lower interest rates. Whether this Federal Reserve will comply is not clear.

5

U.S. Treasury Spread and Federal Funds Rate

Basis points (left), % (right), As of 5/1/2023



Source: Brandywine Global, Macrobond, Federal Reserve Bank of New York

Recession Probability, Signs Point to Yes

The evidence presented here makes a strong case that the U.S. could be close to entering a recession. While economic indicators are no guarantee, what is the probability that the economy actually will fall into a recession? The Federal Reserve Bank of New York offers a recession probability analysis that gives some direction (see Chart 6). This regional Federal Reserve bank uses another version of the yield curve, the difference between the 10-year Treasury note and the 3-month Treasury bill, to forecast the probability of a recession occurring in 12 months. The bank sees almost a 60% chance of a recession in 12 months. The history of this measure suggests a recession is very likely.

6 **Recession Probability Based on Treasury Spread**

%, As of 3/1/2024

Source: Brandywine Global, Macrobond, Federal Reserve Bank of New York

Conclusions

\25A0Tight monetary policy and failing banks suggest a U.S. recession is baked in. The U.S. economy is slowing; financial stress is evident; credit availability is constrained by the banking failures—and likely to tighten further; leading indicators are falling; and the probability of a recession, according to some analyses, is rising.

\25A0Whether or not the Fed quickly reverses the direction of its policy will not alter my expectation of a recession. Monetary policy operates with long and variable lags, with an emphasis on long. More banks could fail. Markets do not have confidence that the financial crisis is over. The S&P 500 regional bank index plunged nearly 28% in the days following the fall of Silicon Valley Bank (SVB) and Signature Bank. Thus far, the index has failed to recover. Furthermore, it is likely we are only beginning to see the impact of all the prior cumulative monetary tightening. The combination of this added stress from the banking sector in conjunction with the Fed-generated reduction in liquidity likely will magnify and accelerate the eventual outcome: A recession appears baked into the economic cake.

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