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Q2 ECONOMIC UPDATE
IT JUST GOT MESSY

Just when it seemed that the Central Banks could focus just on inflation, along comes a "potential" banking crisis that may yet derail their well-laid plans for a smooth landing and lower inflation. On the surface the policymakers look calm and collected (just like an elegant swan floating across the lake) but one suspects that behind the scenes there is a frenzied atmosphere and a massive amount of work being done on understanding the potential risks.

The post-pandemic world seemingly has one more sting in the tail!

Unsurprisingly, the topic that we look at in this quarterly economic update is monetary policy which is the key issue that is consuming financial markets and is also uppermost in our discussions on portfolio risk and asset allocation with clients.

WHERE NOW FOR CENTRAL BANKS?

The bond market is forward looking as it factors in risks and starts discounting changes in policy well ahead of other markets and policymakers. Despite the further tightening by the US Federal Reserve (Fed), the European Central Bank (ECB) and the Bank of England (BoE) (admittedly at a shallower pace than previously) the forward implied rates have begun to factor in a loosening in policy later this year. We must remember that the Fed fought against the bond market last year when it sold off as it saw an underlying inflation problem only for Central Banks to follow their lead. The bond markets are now predicting that the Central Banks will yet again be behind the curve and over tighten.

At this stage, we reiterate our narrative from earlier this year namely that the major Central Banks are well advanced on the path of moving to a tight monetary regime through interest rates and QT (Quantitative Tightening[1]). We also indicated at the start of the year, that financial stability remains integral to the monetary regime but was not high up the agenda at that time. This is no longer true, and it must be that the probability of a shift to a pause in monetary policy is now closer even if looser conditions may take longer. The Bank of Canada has already done so, and the Fed has also hinted that it will be guided more by underlying economic data. We will therefore pour over incoming data in coming weeks to challenge our base case of a soft landing and a gradual reduction in inflation.

1 Quantitative tightening (QT) is a contractionary monetary policy tool applied by central banks to decrease the amount of liquidity or money supply in the economy.

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We had already reduced risk at the start of the year through asset allocation changes adding more high-grade bonds and lowering beta[2] across all portfolios. This shift was factoring in medium-term risks and underlying valuations across bond and equity markets and remains, as applicable now.

Laid out below are the three main areas we are looking at, and almost certainly replicates what Central Bankers have in front of them, in attempting to work out whether this period of monetary tightening is over and done or whether it will continue or indeed will it reverse.

01 FINANCIAL INSTABILITY: HOW BAD IS THIS BANKING CRISIS?

The Fed has financial stability as one of its three targets for monetary policy (inflation at 2% and full employment being the other two of course). All other Central Banks are less explicit but mimic the Fed when push comes to shove. The odds of the financial system instability overriding inflation concerns have risen appreciably.

Inevitably a regional US banking issue with two banks gone and then a major global bank merged hurriedly in Switzerland has raised the spectre of a rerun of the Global Financial Crisis (2007/08) and resultant financial instability that risks a harder landing and an undershoot in inflation.

However, a tightly regulated big banking sector has created a far more stable financial system which in the words of the Fed during the pandemic has been a “source of strength not weakness”. This may seem an odd statement to make at the outset, but elevated market volatility due to fear does not simply mean that the banking system is weak.

To start with the comforting and significant differences between where we are now and the Global Financial Crisis (GFC):

- The major banks are very well capitalised and have high levels of liquidity including diverse deposits from consumers and companies.
- Balance sheets are less leveraged, and all major banks have a far better handle on risks and are far more transparent in showing the assets on the balance sheets. This was one of the key parts of the 3 Pillar redrawing of bank regulations post the GFC.
- Bad loan provisions have been raised in line with tougher macro conditions ahead of the expected macro downturn and ahead of the potential worsening in loan books.
- Stress tests for the biggest banks have played a key role in restoring confidence over the past decade.
- The big banks have been fairly valuing almost all their assets and have very little or zero Held-To-Maturity assets[3].
- There are strict regulations surrounding the types of assets that count towards cash or near cash items, with the focus on short duration.
- Overall costs have been reduced significantly with revenue much higher thereby increasing the efficiency of banks.
- The major banks have far more diversified funding sources.
- The major banks are profitable and have diversified earning streams.
- However, the peak for bank earnings (including for big banks) has already passed but the diversified nature of businesses means that revenue will still be relatively strong, and profits (albeit smaller) should still be generated.

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[2] Beta is a measure of a stock's volatility in relation to the overall market.
[3] Held-to-maturity (HTM) securities are purchased to be owned until maturity.

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- In the wider world, investment grade[4] and high yield corporates[5] have been extremely active in deleveraging, increasing cash levels and lengthening the maturity of outstanding debt thereby reducing refinancing risks.
- The Central Banks are extremely active and have a set of tools that have already been used to shore up liquidity flows and underwrite depositor confidence amongst regional banks in the US. They have had plenty of opportunity to use automated stabilisers to offset risks.

However, clearly weaknesses have also been laid bare by recent events. The deposit outflow from two US regional banks was unexpected and highlighted the diluted regulations away from the big banks that failed to spot the problems fast enough. Credit Suisse was of course a major shock as the Chairman of the biggest shareholder replicated Gerald Ratner from the early 1990s (effectively pulling the rug from under the bank and management) and inadvertently sparked a chain of events that led to large deposit outflows undermining the ability of the bank to standalone.

This unfortunately happened at a critical time for Credit Suisse management that was already wrestling with large operating losses sparked by multiple litigation pay-outs, lower client confidence and it was critically only at the start of a major restructuring of its business units. It could not survive the turmoil and had to be merged with a strong UBS to create a major global banking giant. This dangerous cocktail is not present elsewhere amongst major banks. In addition, mishandling by Swiss regulators added to the woes but thankfully the Bank of England and the European Banking Authority stepped in decisively and restored sanity, hierarchy, and clarity in the capital structure.

Nevertheless, there are areas of concern that may well weigh heavily on policymakers:

- The US regional banks have taken on extra risks as regulations were diluted and stress-tests were watered down.
- The regulators seemingly did not fully understand the risk within regional banks that led to damaging deposit outflows in some, but not all, stretched regional banks.
- Over the past 10 days there have been huge inflows into money market funds run by major banks such as JP Morgan as depositors look for safe havens.
- The regulations for liquidity management at regional banks were diluted, with Silicon Valley Bank (SVB) an extreme case in the risks that were undertaken – and as a consequence the Fed's role in monitoring stress-testing their balance sheet was also diluted.
- A deeper shadow banking system has taken root as major banks have stepped away from parts of the lending business. The fear is that there may be hidden risks lurking in the background.
- US Regional banks have also begun to dominate the real estate (both residential and commercial) market that was already battling with a significant step up in interest rates and could face significantly higher levels of delinquencies.
- A weaker housing market across all major economies will have an impact across all banks but will be least disruptive for the major banks.
- Loan practices were already being tightened and there is now a danger that the flow of capital to consumers and SMEs (small and medium sized enterprises) will be compromised. This has already been seen in the tighter lending standards. The NFIB (National Federation of Independent Businesses)Small Business Index in mid-April will be closely watched and

[4] Investment grade refers to the quality of a company's credit. To be considered an investment grade issue, the company must be rated at 'BBB' or higher by Standard and Poor's or Moody's.

[5] A high-yield corporate bond is a type of corporate bond that offers a higher rate of interest because of its higher risk of default.

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was already at fairly weak levels ahead of the banking woes. Anecdotal evidence does not make good reading.

– Default rates for higher yielding companies are still close to historic lows but will inevitably move higher as refinancing conditions get tougher for leveraged companies.

All of this translates into greater economic risks for consumers and businesses, even as the big banks remain solvent with strong balance sheets. The danger is that a drive towards even tougher regulations will soon enough lead to tighter financial conditions further undermining economic confidence. The Bank of England's Governor Andrew Bailey and Michael Barr (the Fed's Vice Chair of Supervision) have strongly hinted at tighter regulations fairly soon but have also underlined the strength of the banking system. A full-blown banking crisis that envelopes the big banks is less likely but that does not translate immediately to calmer economic conditions or lower market volatility.

02 RISK OF A HARDER LANDING

A soft landing was becoming more of a central case and is still the base scenario but with elevated risks from various sources such as:

– Tighter lending conditions choking investment by companies particularly amongst smaller enterprises.
– Weaker aggregate demand leading to accelerated job-layoffs just as labour participation rates begin to rise.
– The flow of capital in the US from regional banks is vital for the Small and Medium sized Enterprises (SME) sector and it is inevitable that there will be an adverse impact across many sectors.
– The real estate market had already turned lower, and the risks of a sharper correction have clearly risen.
– Geo-political issues continue to lurk in the background and have the capacity to undermine confidence very quickly.
– Central Banks determined to focus wholly on inflation make a mistake by overly tightening and mis-judge the underlying mood music from regional bank frailties.
– Lower corporate profitability dents investment and job growth.
– Inability of governments to use fiscal policy as an expansionary tool given the elevated debt levels.
– China fails to provide the impetus to global growth that many hoped for.
– Lower productivity and worsening demographics restraining medium-term growth opportunities.

03 THE INFLATION CONUNDRUM

Inflation seems to be past its peak across most major economies, but it is still uncomfortably high (well above target levels) and is likely to remain above target into 2024. The Central Banks cannot and are not arguing that the inflation problem is behind us, but markets, as always, are far more forward looking and can see risk of a harder landing feeding into lower inflation in 2024.

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In the case of the US there is some positive news as the headline annual inflation rate has edged lower for nine successive months and core inflation has eased for five successive months. There may be a few more months of easy wins for headline inflation, but beyond that core inflation may just side-line before edging lower; but still remain above target. Similarly, UK and EU inflation is proving to be stickier for the time being and a lot more volatile.

Our inflation monitor continues to provide some room for hope (particularly for the US):

- Money supply growth (M2)[6] has eased in the US, with the year-on-year rate at -2.35%.
- Global supply chain pressures decreased yet again in February and are now below the historical average, according to the New York Fed Supply Chain Index.
- This supply chain index showed significant downward contributions from the majority of the factors, with the largest negative contribution from the European area delivery times.
- Commodity prices have continued to weaken. Oil, natural gas, industrial metals and agriculture are all well off peak levels.
- Freighter and container pressures have also eased considerably and are heading back towards pre-Covid levels. Lower demand will help in coming months. As an example, the Baltic Global Container Index has fallen from a peak of $11,100 to under $1500.
- Inflation expectations that are closely watched by the FOMC (Federal Open Market Committee) have continued to edge lower.

However, there are areas of concern that may well make Central Banks wary. Focussing on the US is always instructive given the amount of data that is available although similar trends can be seen across most major economies.

- The US labour market remains tight. The Job Openings and Labor Turnover Survey (JOLT) still remains high and remains well above the series average of 0.6.
- Non-farm payroll growth is holding up and the unemployment rate remains at historically low levels.
- Wage growth remains higher than pre-pandemic levels. The service sector is of particular concern given labour shortages across many industries such as hospitality and the retail sector

SUMMARY

The Central Banks are caught between a rock and a hard place and face a tricky time now as there is a far higher probability of a lesser soft landing or a harder landing. They lost credibility last year by moving too slowly and risk another bout of uncertainty and lack of credibility if they call this one wrong. On balance it would seem that our view at the start of the year that the bulk of monetary tightening was behind us is now a base case and it is not surprising that bond markets are now looking at the next phase which is for monetary loosening. Either way we are in for a period of heightened interest rate and sovereign bond volatility and are comfortable with the asset allocation changes that were enacted earlier this year.

[6] M2 is the U.S. Federal Reserve's estimate of the total money supply including all of the cash people have on hand plus all of the money deposited in checking accounts, savings accounts, and other short-term saving vehicles such as certificates of deposit (CDs).

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