MORNING BRIEFING
March 14, 2023

The Lender Of Last Resort

Check out the accompanying chart collection.

Executive Summary: While the Fed and FDIC have acted swiftly to contain the SVB debacle, could it still balloon into a financial crisis like previous ones that triggered a credit crunch and recession? It could if it set off a wave of disintermediation at banks broadly, but we doubt that will happen; we think the regulators' actions will work. … So the incident doesn't change our outlooks for the economy, stock market, or bond market. But it does revive the "Fed Put." That's because the Fed's actions to stabilize the banking system also stabilize financial markets.

The Fed I: Something Broke. Melissa and I are ready to concede. The inverted yield curve has nailed it again! In the past and once again now, yield-curve inversions have signaled that if the Fed persisted in raising interest rates, something in the financial system would break. Sure enough, the SVB debacle may be that something this time around (*Fig. 1* and *Fig. 2*).

We had been arguing that nothing bad may happen this time around, because the banking system is in much better shape now as a result of increased government regulation and supervision since the Great Financial Crisis. The SVB debacle reveals that might not be the case, as soaring interest rates are causing disintermediation. More depositors now may move their funds from their bank accounts to money market instruments. That in turn may force the banks to boost their deposit rates, narrowing their profit margins.

Exacerbating the problem is that the SVB crisis is putting more pressure on regional banks, as it reminds depositors that the FDIC insures deposits only up to a maximum of $250,000. The money center banks have a similar issue, but they are deemed to be too big to fail. So they actually may benefit from the crisis if depositors switch from accounts at regional banks to the money center banks.

There's more: The FDIC estimates that soaring interest rates reduced the value of the bond portfolios of the banks by around $600 billion at the end of last year. Most of them are classified as held to maturity (HTM). The rest are classified as available for sale (AFS). HTM securities, which management has the intent and ability to hold until maturity, are carried at amortized cost. AFS securities are carried at fair value, and their unrealized gains and losses are reported as net increases or decreases to accumulated other comprehensive income.

So the losses on the HTM bonds aren't a problem unless the banks are forced to sell them to raise money to pay fleeing depositors. That's what happened at SVB. In the old days, it was easy to spot a bank run by the long line of depositors hoping to withdraw their funds outside the bank. Now it all happens over smartphones, raising the risks of "flash" bank runs.

Let's have a look at the latest weekly balance sheet data for commercial banks, data that we intend to monitor closely in coming weeks:

(1) *Loans.* During the March 1 week, loans and leases at the banks totaled $12.1 trillion, consisting of $6.5 trillion at large domestic banks and $4.5 trillion at small domestic ones (*Fig. 3*). They were all at record highs. There's clearly no sign of a credit crunch in the loan data, so far.

We doubt that will change as a result of the SVB situation as we currently understand it. The main sources of lendable funds for the banks are deposits, maturing securities, and borrowing. On a y/y basis through the March 1 week, deposits are down $477 billion, securities are down $369, borrowings are up $332 billion, and loans are up $1,179 billion (*Fig. 4*). Yes, we know, something is missing. Cash assets of commercial banks are down $725 billion over the same period mostly as a result of quantitative tightening (QT). (We will write more on this in the near future.)

(2) *Securities.* As of the March 1 week, US Treasury and agency securities held by commercial banks totaled $4.4 trillion, with $3.2 trillion held at large banks and $1.0 trillion at small banks (*Fig. 5*). On a y/y basis, they are down $343 billion, $324 billion, and $11 billion, respectively. We don't have data to show the amounts of securities that are AFS and HTM.

(3) *Deposits.* Bank deposits peaked at a record-high $18.1 trillion last year during the April 13 week (*Fig. 6*). They are down $520 billion since then through the March 1 week, led by a $559 drop in deposits at large banks and $7 billion at small ones.

The period of decline coincides with the implementation of QT last summer. In addition to QT weighing on deposits, disintermediation also was going on, as suggested by the fact that retail money market funds are up $395 billion y/y through the March 8 week (*Fig. 7*).

(4) *Borrowing.* The Fed's weekly commercial bank balance sheet includes borrowing from banks and nonbanks. It totaled $2.0 trillion during the March 1 week, with $638 billion at large banks and $428 billion at small ones (*Fig. 8*). (The remainder of the borrowing was attributable to foreign-related banks.)

(5) *Bottom line.* The question now is whether the implosion of SVB is a financial crisis that will trigger an economy-wide credit crunch and a recession. It could be, though we doubt it. We expect that the fallout will remain relatively contained by the actions taken by the Fed and the FDIC, announced on Sunday.

In other words, the incident doesn't change our economic or financial market outlooks. We remain in the soft-landing camp, giving this scenario a 60% subjective probability versus 40% for a hard landing. We remain convinced that the 10-year Treasury yield peaked at 4.25% last October 24 and that the S&P 500 bottomed on October 12.

The Fed II: The Fed Put Is Back. Our ongoing positive predilections are predicated on our belief that the actions taken by the bank regulators over the weekend will work. They certainly will do so for all SVB's depositors. The widespread fear is that these actions won't stop depositors from pulling their cash out of uninsured bank accounts, which totaled $10.5 trillion during Q2-2023, according to FDIC data. That compares to $7.4 trillion of insured deposits of $250,000 or less (*Fig. 9*).

To reduce the risk of this happening (and mitigate the adverse consequences if it does happen), the Fed issued a *press release* on Sunday titled "Federal Reserve Board announces it will make available additional funding to eligible depository institutions to help assure banks have the ability to meet the needs of all their depositors."

The Fed announced the creation of a new emergency lending facility called the "Bank Term Funding Program" (BTFP). It will offer "loans of up to one year in length to banks, savings associations, credit unions, and other eligible depository institutions pledging US Treasuries, agency debt and mortgage-backed securities, and other qualifying assets as collateral. These assets will be valued at par. The BTFP will be an additional source of liquidity against high-quality securities, eliminating an institution's need to quickly sell those securities in times of stress."

Also: "[d]epository institutions may obtain liquidity against a wide range of collateral through the discount window, which remains open and available. In addition, the discount window will apply the same margins used for the securities eligible for the BTFP, further increasing lendable value at the window." (Here is a *link* to the term sheet.)

Our conclusion is that the Fed Put is back. This time, it's aimed at stabilizing the banking system, which also stabilizes the financial markets. Under the circumstances, the Fed may pass on a rate hike at the FOMC meeting next week. Or if it goes with a 25bps rate hike to 4.75%-5.00%, it might use the SVB debacle as proof that the federal funds rate then would be restrictive enough and opt to hold it there for a while.

Calendars

US: Tues: Headline & Core CPI 0.4%m/m/6.0%y/y & 0.4%m/m/5.5%y/y; Real Earnings; NFIB Small Business Optimism; API Weekly Crude Oil Inventories; OPEC Monthly Report; Bowman. **Wed:** Retail Sales Total, Core, and Retail Control -0.3%/0.2%/-0.3%; Headline & Core PPI 0.3%, 5.4%y/y & 0.4%m/m/5.2%y/y; Empire State Manufacturing Index -7.85; Business Inventories 0.1%; NAHB Housing Market Index 42; MBA Mortgage Applications; TIC Net Long-Term Transactions; Crude Oil Inventories & Gasoline Production; IEA Monthly Report. (Bloomberg estimates)

Global: Tues: Italy Industrial Production -0.4%; Spain CPI 1.0%m/m/6.1%y/y; UK Average Earnings Index Including & Excluding Bonus 5.7%/6.6%; UK Claimant Change -12,5k; UK Employment Change & Unemployment Rate 40k 3m/3m & 3.8%; China Industrial Production 2.6% y/y; China Retail Sales 3.4% y/y; China Unemployment Rate; Japan Monetary Policy Meeting Minutes; China NBS Press Conference. **Wed:** Eurozone Industrial Production 0.5%m/m/0.2%y/y; Germany WPI; France CPI 1.0%mm/7.2%y/y; Japan Core Machinery Orders 1.8%m/m/-3.5%y/y; Japan Trade Balance -1,069b; Australia Employment Change 48.5k; Australia Unemployment & Participation Rates 3.6%/66.6%; Australia RBA Bulletin. (Bloomberg estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): Forward earnings fell last week for the SMidCaps, but rose for LargeCap. Through the week ending March 9, LargeCap's forward earnings rose 0.3% w/w to 0.5% above its 54-week low during the week of February 10, but is down in 16 of the past 23 weeks. MidCap's dropped 0.1% w/w to a 55-week low and has fallen in 22 of the past 25 weeks. SmallCap's fell 1.0% w/w to a 71-week low and is down in

20 of the past 23 weeks. For a 37th straight week, none of these three indexes had forward earnings at a record high. However, forward earnings remains on a modest downtrend for these three indexes compared to their deep declines during the Great Virus Crisis and the Great Financial Crisis. LargeCap's is 5.7% below its record high at the end of June; MidCap's is 8.1% below its record high in early June; and SmallCap's is 13.1% below its mid-June record. Forward earnings momentum remains near two-year lows. The yearly rate of change in LargeCap's forward earnings was negative for a third straight week, edging down to a 24-month low of -1.6% y/y; that compares to a record-high 42.2% at the end of July 2021 and is up from -19.3% in May 2020, which was the lowest since October 2009. MidCap's rate of -1.2% y/y is at a 26-month low, which compares to a record high of 78.8% in May 2021 and a record low of -32.7% in May 2020. SmallCap's rate of -6.4% y/y is at a 28-month low, down from a record high of 124.2% in June 2021; it compares to a record low of -41.5% in June 2020. Analysts' consensus earnings forecasts for 2023 have been heading lower since June. Here are the latest consensus earnings growth rates for 2022, 2023, and 2024: LargeCap (5.1%, 1.4%, and 12.1%), MidCap (16.7, -8.9, 13.0), and SmallCap (5.3, -4.1, 17.5).

S&P 500/400/600 Valuation (*link*): Valuations tumbled w/w to nine-week lows for these three indexes through the March 9 week. LargeCap's forward P/E fell 0.9pt w/w to 17.0 and is down from a nine-month high of 18.2 in early February. It's still up 1.9pts from its 30-month low of 15.1 at the end of September, which compares to an 11-year low of 11.1 during March 2020. MidCap's forward P/E fell 1.0pt to 13.4 and is 1.3pts below its recent 10-month high of 14.7. It's now 2.3pts above its 30-month low of 11.1 at the end of September, which compares to a record high of 22.9 in June 2020 and an 11-year low of 10.7 in March 2020. SmallCap's forward P/E dropped 1.0pt w/w to 13.2 and is now 1.1pts below its recent 12-month high of 14.3. It's 2.6pts above its 14-year low of 10.6 at the end of September and compares to a record low of 10.2 in November 2009 during the Great Financial Crisis. That also compares to its record high of 26.7 in early June 2020 when forward earnings was depressed. The forward P/Es for the SMidCaps have been mostly below LargeCap's since August 2018. MidCap's P/E relative to LargeCap's has improved from a 23-year-low 28% discount last July to a 21% discount, which is near its best reading since November 2021. SmallCap's discount has improved from a 21-year low of 32% last April to 22% last week; that's near its lowest discount since August 2021. SmallCap's P/E had been mostly above LargeCap's since 2003. Looking at SmallCap's P/E relative to MidCap's, it was at a discount for a 91st straight week; the current 1% discount is its lowest since July 2021 and an improvement from its 20-year-low 9% discount in December 2021.

S&P 500 Sectors Quarterly Earnings Outlook (*link*): Following the Q3-2020 earnings season when the US economy emerged from the Covid shutdown, analysts began raising their consensus forecasts for future quarters instead of lowering them as is the historical norm. That six-quarter streak of positive revisions throughout the quarter ended during Q1-2022, and the declines began to accelerate considerably beginning with Q3-2022. Analysts expect the S&P 500's earnings growth rate to weaken q/q in Q1-2023 to -7.1% y/y from -1.4% in Q4-2022 on a frozen actual basis and to -4.6% from -3.2% on a pro forma basis. Just four sectors are expected to record positive y/y percentage earnings growth in Q1-2023, up from only two sectors doing so in Q4-2022. Here are the S&P 500 sectors' latest expected earnings growth rates for Q1-2023 versus their blended Q4-2022 growth rates: Consumer Discretionary (28.7% in Q1-2023 versus -15.8% in Q4-2022), Energy (17.1, 59.2), Industrials (18.4, 42.3), Financials (5.6, -11.7), Consumer Staples (-3.7, -0.7), S&P 500 (-4.6, -3.2), Real Estate (-8.1, -3.3), Utilities (-9.6, -4.7), Information Technology (-11.1, -8.0), Communication Services (-13.6, -28.1), Health Care (-18.6, -2.7), and Materials (-34.0, -20.4).

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