MORNING BRIEFING
March 15, 2023

The Oscars

Check out the accompanying chart collection.

Executive Summary: Within days of the run on SVB, the Fed has donned its "lender of last resort" cape—guaranteeing all bank deposits by all depositors (!), creating a new emergency bank lending facility, and launching a review of what went wrong at SVB. As a result, we don't see sufficient SVB ripple effects to alter our outlooks for the economy or financial markets. … Also: Inflation has proven both more transitory (consumer goods inflation) and more persistent (consumer services) than expected, but both types have moderated lately. … And: Joe examines the S&P 500 Growth index's comeback relative to Value after more than a year as the underdog.

The Fed: Everything Everywhere All at Once. This past Sunday, while Hollywood was preparing for the 95th annual showing of the Academy Awards, banking regulators were scrambling to contain the Silicon Valley Bank (SVB) financial crisis. The movie "Everything Everywhere All at Once" won seven Oscars including Best Picture, Best Original Screenplay, Best Actress in a Leading Role, and Best Supporting Actor. The two directors of the film also won.

If there had been a Best Director of a Bailout award, it undoubtedly would have been shared by Fed Chair Jerome Powell and Treasury Secretary Janet Yellen. Together, along with FDIC Chair Martin J. Gruenberg, they fashioned the latest rescue plan for our banking system—which they previously had claimed was in great shape. But then last week, SVB hit the fan, threatening to set off runs on banks generally, particularly regional ones. That's because the crisis serves a reminder to depositors broadly that the FDIC insures deposits only up to a maximum of $250,000. The money center banks face the same threat but lower stakes, as they are deemed to be too big to fail.

By law, the Fed's job is to keep unemployment and inflation down. In addition to its legal "dual mandate," the Fed is ultimately responsible for maintaining financial stability. Our central bank was established in 1914 to do just that as the so-called "lender of last resort." On Sunday, the Fed effectively agreed to guarantee 100% of deposits for 100% of all depositors. That was in response to the bank run on SVB last week.

More than 90% of SVB's deposits were not insured by the FDIC. Depositors were spooked when the bank revealed that it had to sell some of its bonds at a loss of $1.8 billion to raise cash. FDIC data show that during Q2-2022, deposits totaled $17.9 trillion, with $7.4 trillion insured and the remaining $10.5 trillion uninsured (*Fig. 1*).

To reduce the risk of additional bank runs by uninsured depositors (and mitigate the adverse consequences if they do 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."

That certainly sounds like a guarantee to protect all 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*.)

Yesterday, we wrote: "Our conclusion is that the Fed Put is back. This time, it's aimed at stabilizing the banking system, which should also stabilize 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."

We also concluded: "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 Federal Reserve Board on Monday announced that Vice Chair for Supervision Michael S. Barr is leading a review of the supervision and regulation of SVB in light of its failure. The review will be publicly released by May 1. "The events surrounding Silicon Valley Bank demand a thorough, transparent, and swift review by the Federal Reserve," said Chair

Jerome H. Powell. "We need to have humility, and conduct a careful and thorough review of how we supervised and regulated this firm, and what we should learn from this experience," said Vice Chair Barr.

Also on Monday, Moody's Investors Service cut its view on the entire banking system: "We have changed to negative from stable our outlook on the US banking system to reflect the rapid deterioration in the operating environment following deposit runs at Silicon Valley Bank (SVB), Silvergate Bank, and Signature Bank (SNY) and the failures of SVB and SNY." The rating agencies seem to have a history of "better late than never" when it comes to rating downgrades in the wake of crises.

US Inflation: Everything Everywhere All at Once But Less So. And the Academy Award for the Biggest Economic Surprise of 2022 goes to . . . inflation. It has defied Fed expectations by being both transitory and persistent: Consumer goods inflation has been transitory, while consumer services inflation has been persistent. In any event, overall measures of consumer inflation continue to moderate. Consider the following:

(1) *Expected and actual inflation.* The New York Fed's consumer expectations survey was released on Monday with February's results. It shows that the Fed has succeeded in lowering inflationary expectations. The one-year-ahead series is down from a peak of 6.8% during June 2022 to 4.2% in February (*Fig. 2*). The three-years-ahead annualized series is down from a peak of 4.2% during September and October 2021 to 2.7%.

Not surprisingly, the one-year-ahead expected inflation rate closely tracks the actual y/y inflation rates as measured by the CPI and PCED (*Fig. 3*). The CPI inflation rate peaked at 9.1% during mid-2022, falling to 6.0% in February. The PCED measure is down from 7.0% during June 2022 to 5.4% in January. Collectively, these three measures continue to show a moderating trend.

(2) *Consumer goods inflation.* The most transitory inflation rate has been the one for consumer durable goods (*Fig. 4*). The CPI shows it soaring from -0.9% during June 2020 to a peak of 18.7% during February 2022. Since then, it has plunged back below zero at -1.8% during February.

Much of that rapid round trip was attributable to a buying binge for durable goods fueled by the government's pandemic relief checks. The demand shock overwhelmed global supply chains, sending prices soaring. Once pent-up demand was more than satisfied and supply chains normalized, inflation for consumer durable goods came tumbling down.

The CPI for consumer nondurable goods was mostly negative in the low single-digits during 2020 (*Fig. 5*). It soared to a peak of 16.2% during June 2022. It was back down to 6.4% during February.

(3) *Consumer services inflation.* While consumer goods inflation continues to disinflate, there is not yet a clear peak in the consumer services inflation. The services CPI rose 7.6% y/y through February (*Fig. 6*). That's a new high for the current inflation cycle. The CPI for rent of shelter also rose to a new high of 8.1% over the same period. CPI services excluding rent of shelter seems to have peaked at a record high of 8.2% last September. It was down to 6.9% during February.

Strategy I: Growth Overtakes Value. The meltdown in regional bank stock prices following SVB's failure and the rapid decline in Treasury bond yields suggest that investors believe the Fed rate-hike cycle is close to ending. The regional banks could be facing the same music that the larger, major banks were forced to listen to following the Great Financial Crisis. New calls for renewed and increased regulation of the regional banks could lead to dividend cuts and forced shoring up of capital, which underscores the earnings and valuation risk that they face in the future.

With two weeks left before the quarter closes, the newswires soon will be filled with pre-announcements of misses in Q1 results. Indeed, United Airlines surprised investors on Tuesday by *warning* of an expected Q1 loss. The company cited recent weaker demand growth and higher fuel costs. UAL's stock price fell 5.4% on Tuesday on the news. The regional banks and airlines are members of the S&P 500 Value index, which has been underperforming S&P 500 Growth since January.

Within the S&P 500 Growth index, Meta *announced* yet more layoffs and reduced open-job postings on Tuesday in a continued effort to cut costs and shore up its bottom line. The effort appears to be working. Meta's forward earnings and valuation are rising again after falling sharply since late 2021 (*Fig. 7*). Meta's stock rose 7.3% on the news Tuesday and is now the S&P 500's best ytd performer with a gain of 61.2%.

Meta isn't alone in reducing its headcount, which nearly doubled after the pandemic from 45,000 to 87,000. Sizeable job reductions have also occurred at Alphabet, Amazon, and Microsoft, which could help improve their profits, valuation, and stock prices.

The S&P 500's Growth index price has outperformed its Value counterpart after underperforming from November 30, 2021 to January 3, 2023 (*Fig. 8*). During that period, Growth tumbled 29.3% but Value dropped just 0.5%. Since January 3, when Growth's price relative to Value bottomed at a two-year low, Growth is up 1.9%, while Value is down 1.4%.

From a valuation perspective, Growth's forward P/E appears to be on the road to recovery. It had fallen from a peak of 30.3 in January 2021 to 17.6 on January 5 this year. Growth's forward P/E relative to Value bottomed on January 4 at a generational 14-year low of 1.10, when the forward P/E ratios of Growth and Value were 17.8 and 15.9 (*Fig. 9*). The relative P/E is now back up to 1.20 as of Monday's close, with Growth's forward P/Es rising to 18.7 and Value's falling to 15.6 (*Fig. 10*).

Calendars

US: 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. **Thurs:** Import & Export Prices -0.2%/-0.1%; Philadelphia Fed Composite Index -15.6; Housing Starts & Building Permits 1.31mu/1.34mu; Initial & Continuous Claims 205k/1.715k; Reserve Balance with Federal Reserve Banks; Natural Gas Storage. (Bloomberg estimates)

Global: 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. **Thurs:** Japan Industrial Production -4.6%; Italy CPI 0.2%m/m/9.9%y/y; ECB Interest Rate Decision & Deposit Facility Rate 3.50%/3.00%; Lagarde. (Bloomberg estimates)

US Economic Indicators

Consumer Price Index (*link*): Headline & core CPI yearly rates continued to cool in February, though the monthly gains were on the high side. The CPI rose 0.4% in February, following a 0.5% gain in January, after upticks of 0.1% and 0.2% in December and November, while core prices rose at a five-month high of 0.5% in February following January's 0.4% gain. Shelter costs remained hot, rising 0.8%, in line with prior months, with rent of primary residence up 0.8% and owners' equivalent 0.7% higher in February. Services less rent of shelter edged up only 0.1%. Goods inflation rose 0.2% in February, slowing from 0.4% in January, after falling the last two months of 2022. *Here's a look at the yearly rates*: The headline CPI rate eased for the eighth month, from 9.1% last June (the highest since November 1981) to 6.0% this February, while the core rate eased for the fifth month to a 14-month low of 5.5% last month after accelerating from 5.9% in both June and July 2022 to 6.6% by September—which was highest since August 1982. The rate for consumer durable goods (-1.8% y/y) fell further into negative territory in February, while the rate for consumer nondurable goods excluding food (3.1) continued to slow; the services' rate excluding energy remained on an accelerating trend, reaching 7.3% in February—with shelter costs particularly high. *Food costs* (9.5) eased for the sixth month from last August's 11.4%, which was the fastest pace since April 1979. Within food, the rate for food at home (10.2) slowed steadily from 13.5% last August (the highest since March 1979); the rate for food away from home accelerated to 8.4% y/y in February, after easing from 8.6% last October (the highest since fall 1981) to 8.2% by January. *Energy costs* continued to ease from last June's 41.6%, which was the fastest pace since April 1980, sinking to a 24-month low of 5.2% in February, after a temporary blip up to 8.7% in January. Within energy, the rate for fuel oil slowed to two-year low of 9.2% y/y last month after moving up from 58.1% in September to 68.5% in October; it reached a record-high 106.7% last May. The rate for gasoline prices slipped back into negative territory, falling 2.0% y/y during February, after rising from -1.5% in December (the first negative reading since January 2021) to 1.5% in January; it was at 59.9% last June (fastest since March 1980). The rate for natural gas prices slowed to a 21-month low of 14.3% y/y in February, after accelerating from 15.5% in November to 26.7% by January. It was as 38.4% last June, which was the highest since October 2005. The electricity rate ticked up to 12.9% y/y in February, after easing to a nine-month low of 11.9% in January; it peaked at 15.8% last August—which was the highest since August 1981. The *consumer durable goods inflation* rate slowed for the 12th month, from 18.7% last February (highest since early 1940s) to -1.8% y/y by this February—the lowest since October 2017. The rate for new cars was unchanged at 6.3% y/y in February, after easing the prior eight months from last April's near-record high of 14.2% to 6.2% by December, while the rate for used cars & trucks sank further into negative territory to -13.6% in February—the lowest since November 1960. It was as high as 41.2% last February and at a record-high 45.2% during June 2021. The rate for furniture & bedding (2.3) is down dramatically from last February's record high of 17.1%, while the rate for major appliances was -5.9% y/y, down from its recent peak of 12.4% last March. *Consumer nondurable goods inflation* slipped to a 23-month low of 6.4% y/y in February, down from 16.1% last June (the highest since March 1980). The rate for apparel prices edged up for the second month to 3.3% in February, after slipping to a 20-month low of 2.9% y/y at the end of 2022; before that, it fluctuated in a 5.0%-5.5% range from last April through September. It was at a recent peak of 6.8% last March (the highest since the end of 1980). *Services inflation* remained at 7.6% y/y in February, which is the highest since the early 1980s. Within services, owners' equivalent and tenant-occupied yearly rates accelerated last month to 8.0%, a new record high, and 8.8%, the highest since fall 1981; these compare with recent lows of 2.0% and 1.8%, respectively. Over the three months through December, the owners' equivalent rent rose 8.7% (saar) and tenant rent rose 9.2%—exceeding their yearly rates. Meanwhile, the yearly rate for lodging away from home slowed to 6.7% y/y after accelerating to 7.7% y/y in January and bouncing around 3.0% for the final three months of last year; it was at a record high of 25.1% in both March and February of 2022. Turning to medical care, the yearly rate for hospitals' (3.6) services is bouncing in a volatile flat trend, easing from 4.4% at the end of 2022, while the physicians' (1.2) services rate was down sharply from March 2021's 5.3% peak, though has moved up from its recent low of 0.5% during February 2022. Meanwhile, the yearly rate for airfares was little changed at 26.5% y/y during February, down from 42.9% last October (not far from the record high of 45.0% in September 1980); the three-month rate rose 7.9% (saar) after being in negative territory the prior six months.

NFIB Small Business Optimism Index (*link*): "Small business owners remain doubtful that business conditions will get better in coming months," said NFIB Chief Economist Bill Dunkelberg. "They continue to struggle with historic inflation and labor shortages that are holding back growth. Despite their economic challenges, owners are working hard to create new jobs to strengthen the economy and their firms." February's *Small Business Optimism Index* (SBOI) climbed for the second month, by 0.6 point in February and 1.1 points over the period, to 90.9, after dropping 2.1 points at the end of last year. February's SBOI was below the 49-year average of 98.0 for the 14th consecutive month. The last time the index was at or above the average was December 2021 (98.9). In February, five of the 10 components of the SBOI increased while four decreased, and plans to make capital outlays was unchanged at a net 21%. Sales expectations (+5ppts to -9%) was the biggest positive contributor to the index, followed by earnings trends (+3 to -23), current job openings (+2 to 47), expected credit conditions (+2 to -6), and plans to increase inventories (+1 to -7). Meanwhile, current inventory (-3 to -4), hirings (-2 to 17), expect economy to improve (-2 to -47), and now is a good time to expand (-1 to 6) were drags on the SBOI. *Inflation* continued to be small business owners' single biggest problem in February, rising to 28%, after easing to an 11-month low of 26% in January. It is down 9ppts from last July's peak of 37% (which was the highest since Q4-1979). Meanwhile, *quality of labor* remained business owners' second biggest problem in February, at 21%, down from January's 24% and November 2021's record high of 29%, and cost of labor is number three at 12%. The net percentage of owners *raising selling prices* continued to ease, sinking to a 22-month low of 38% in February from a near-record-high 66% last March, while the net percentage of owners *planning to increase selling prices* fell from 29% to 25% in February, back near December's 24%—which was its lowest since percentage since December 2020; it was at a near record high of 52% last March. A net 46% of owners reported *raising compensation* again last month, up from its recent low of 40% last November but below its 50% record high at the start of 2022, while a net 23% *plans to increase compensation* in the next three months—little changed from January's a 20-month low of 22% and down from October 2022's 32% (which matched the record high posted the final two months of 2021).

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