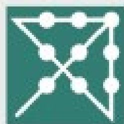

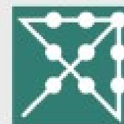

MORNING BRIEFING
March 21, 2023

Giving Credit Where Credit Is Due

Check out the accompanying chart collection.

Executive Summary: The spread between the 10-year Treasury bond yield and the federal funds rate inverted in November; such inversions are predictive of credit crunches and recessions. They also tend to predict financial crises that halt Fed tightening. It's too early to credit the yield-curve inversion for calling a recession, but it was spot on in presaging a crisis like SVB. … Small banks seem vulnerable now to depositor flight, which could prompt a credit crunch impacting small businesses. … But we don't think a credit crunch would hurt consumer spending and homebuying as much as lower interest rates will boost them. … Our message to the FOMC: Give it a rest.

Weekly Webcast. If you missed Monday's live webcast, you can view a replay *here*.

Credit I: Yield Curve Nails It, So Far. It is time to give credit where credit is due. The yield curve is on a roll so far. Consider the following:

(1) *Calling another recession.* The spread between the 10-year Treasury bond yield and the federal funds rate is available since 1954 monthly (*Fig. 1*). It is one of the 10 components of the Index of Leading Economic Indicators (LEI). Like the overall LEI, the yield curve has a good track record of calling recessions when it inverts. There have been 10 recessions since 1954.

The yield-curve spread did not invert prior to the first two recessions since 1954, though it did narrow significantly prior to those downturns. The first inversion of the yield curve occurred in the mid-1960s, but that coincided with a brief bout of disintermediation and an economic slowdown rather than a recession. There were also economic slowdowns in the mid-1980s and mid-1990s when the yield-curve spread narrowed significantly but stopped short of inverting. We've characterized those events as rolling recessions, mid-cycle slowdowns, growth recessions, and soft landings. (There was a mid-cycle slowdown during 2014 to 2016, but the yield spread remained relatively wide.)

The yield curve did invert before the past eight recessions. It did so by 14 months on average before the start of the subsequent recessions. Those were all great calls. This time, it inverted during mid-November 2022. A recession has yet to start, but the latest banking

crisis could be what triggers one, just as the yield curve predicted.

We prefer the yield spread between the 10-year and 2-year Treasury notes because it reflects the market's perception of where the LEI version of the spread is going (*Fig. 2*). It first inverted last year during the week of July 8. It is available both daily and weekly since mid-1976.

In fact, it is premature to give full credit to the yield curve now since a recession hasn't started yet. While the LEI has been falling steadily since peaking at a record high at the end of 2021, the Index of Coincident Economic Indicators (CEI) rose to a record high during February of this year (*Fig. 3*).

Indeed, we remain in the rolling recession camp rather than the "roiling recession" one.

(2) *Calling another financial crisis.* Then again, the yield curve has been spot on in anticipating that the Fed's latest monetary policy tightening cycle would end when it triggered a financial crisis, as tightening cycles often have after causing something in the financial system to break (*Fig. 4*).

Silicon Valley Bank may very well be that broken something this time around. Past banking crises triggered by Fed tightening include Penn Central (1970), Franklin National (1974), Mexico banking crisis (1982), S&L crisis (1990), subprime mortgage meltdown (2007), and now SVB (2023). All of these crises coincided with peaks in the federal funds rate (*Fig. 5*).

(3) *Calling a peak in interest rates.* Melissa and I have previously observed that inverted yield curves tend to signal peaks in the interest rate cycle. The 2-year Treasury yield tends to rise faster than the 10-year yield and exceed it during the tail end of monetary policy tightening cycles (*Fig. 6*).

In our October 18, 2022 *Morning Briefing*, we wrote: "Our bond market analysis suggests that the 10-year Treasury bond yield might peak at 4.00%-4.25%, probably in November after the Fed raises the federal funds rate by 75bps and possibly in anticipation of one final 75bps hike in December that puts the terminal federal funds rate at 4.50%-4.75%." The yield actually peaked at 4.25% on October 24.

Since then, the 10-year yield is down to 3.47%. The 2-year yield peaked at 5.05% on March 8 (following Powell's hawkish congressional testimony) and is now down to 3.92% (*Fig. 7*). Our timely forecast was mostly influenced by the inversion of the yield curve.

(4) *Calling a bear market in stocks.* While the yield curve gets two stars for calling a financial crisis, it's too soon to give it all five stars for calling an economy-wide credit crunch and a recession. The stock market's perma-bears are doing so, but we aren't in their camp. Leading the growling ursine crowd is Morgan Stanley's Michael Wilson. He deserves credit for having turned bearish in late 2021 and for anticipating a rally in October.

According to a March 20 *Fortune* *article*, Wilson now believes that the SVB debacle marks "the beginning of the end of the bear market as falling credit availability squeezes growth out of the economy." He added: "This is exactly how bear markets end—an unforeseen catalyst that is obvious in hindsight forces market participants to acknowledge what has been right in front of them the entire time." He expects analysts to slash their earnings forecasts as the next reporting season approaches, while corporations prepare to lower guidance significantly.

And what does the yield-curve spread have to say about bear markets? It tends to be inverted during such selloffs. But it also tends to turn positive near the tail end of bear markets (*Fig. 8*).

Credit II: Small Banks & Small Businesses Are Codependent. It's not too hard to imagine what could cause the next credit crunch. Notwithstanding the Fed's commitment to back 100% of all deposits, depositors might flee to better yielding money market mutual funds. At the end of Q2-2022, there was $17.9 trillion in deposits, with $7.4 trillion insured and $10.5 trillion uninsured (but now implicitly guaranteed by the Fed) (*Fig. 9*). The outflows might be especially challenging for small banks that had $5.5 trillion in deposits during the March 8 week compared to $10.7 trillion at the large banks (*Fig. 10*).

To stem the outflows, the banks might raise their deposit rates to remain competitive. That would certainly squeeze interest margins, especially among the smaller banks that might find it harder to pass their increased deposit costs through to their lending rates.

Small banks are an important source of credit for the economy. For some perspective, here are some relevant data points:

(1) *Deposits & loans.* Deposits at small banks accounted for a record 31.3% of all deposits during the March 8 week (*Fig. 11*). Small banks accounted for a record 37.6% of all bank loans.

(2) *Loan shares.* Small banks currently account for significant shares of the following loan

categories: commercial & industrial (28.1%), consumer (28.1), residential real estate (37.5), and commercial real estate (67.2) (*Fig. 12*).

To assess the impact of the current banking crisis on the economy, we will be monitoring the weekly deposits and loans data of the large and small banks. To the extent that a credit crunch ensues, our guess is that it will mostly be seen in the data for small banks.

Small banks' customers tend to be small businesses. So we will also be monitoring the monthly survey of small business owners compiled by the National Federation of Independent Business. Of particular interest will be the "percent borrowing at least once a quarter" (30% in February) and the "net percent reporting that credit was harder to get than last time" (5.0% in February) (*Fig. 13* and *Fig. 14*). Both measures have risen since late 2021 along with interest rates, but both remain relatively low.

Credit III: Housing & Consumers Are Rate Sensitive. Debbie and I will also be monitoring the response of homebuyers and consumers to the banking crisis. Our hunch is that the drop in interest rates so far will boost their buying of homes and consumer goods and services more than any credit crunch will depress it.

The drop in mortgage rates during February did provide a short-lived increase in mortgage applications to purchase a home (*Fig. 15*). The problem so far in March is that the drop in Treasury yields hasn't lowered mortgage rates, as the spread between the 30-year mortgage rate and the 10-year Treasury yield widened to a near record 366bps on Friday (*Fig. 16*).

We reckon that consumers still have plenty of pent-up demand for autos because of limited supplies attributable to the parts shortages during the pandemic. However, higher interest rates and tougher lending standards for auto loans could weigh on auto sales. The question is whether the recent drop in interest rates will trickle down to auto financing rates.

Consumer revolving credit is driven more by employment and actual sales of consumer goods and services than by interest rates, suggesting that for most Americans the rate is moot because they pay down all or most of their credit card debt every month. Of course, plenty of consumers don't do so for various reasons. In any event, consumer revolving credit was only 7.6% of personal consumption in January (*Fig. 17*). It was equivalent to 6.2% of disposable personal income (*Fig. 18*).

Credit IV: The Fed Should Give It a Rest. In his previous *press conference* on February 1,

2023, Fed Chair Jerome Powell mentioned the word "restrictive" 10 times. It was mentioned mostly in the same context as the following: "And we said that we continue to anticipate that ongoing increases in the [federal funds] target range will be appropriate in order to attain that stance of sufficiently restrictive monetary policy that will bring inflation down to 2%."

More specifically, Powell said, "So we've raised rates 4½ percentage points, and we're talking about a couple of more rate hikes to get to that level we think is appropriately restrictive."

Of course, there was no mention of a banking crisis, especially since Fed officials have claimed that banks are doing just fine. There undoubtedly will be lots of discussion about the banking crisis at Powell's next presser on Wednesday. He will have to acknowledge that the crisis confirms that interest rates are sufficiently restrictive and that financial conditions are rapidly getting tighter. Further rate hikes are no longer warranted, in our opinion.

Calendars

US: Tues: Existing Home Sales 4.18mu; API Weekly Crude Oil Inventories. **Wed:** MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production; FOMC Interest Rate Decision 4.75%-5.00%. (Bloomberg estimates)

Global: Tues: Germany ZEW Economic Sentiment 16.4; Canada CPI 0.6%m/m/5.4%y/y; Lagarde; Enria. **Wed:** UK Headline & Core CPI 0.6%m/m/9/9%y/y & 0.8%m/m/5.7%y/y; UK PPI Input & Output 0.2%m/m/12.0%y/y & 0.2%m/m/12.4%y/y; UK CBI Industrial Trends Orders -15; Lagarde; Panetta; Mauderer; Balz; Nagel; Lane. (Bloomberg estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): Forward earnings fell last week for SmallCap but rose for LargeCap and MidCap. Through the week ending March 16, LargeCap's forward earnings rose 0.1% w/w to 0.6% above its 54-week low during the week of February 10, but is down in 16 of the past 24 weeks. MidCap's rose 0.2% w/w from a 55-week low, but has fallen in 22 of the past 26 weeks. SmallCap's fell 0.2% w/w to a 72-week low and is down in 21 of the past 24 weeks. For a 38th 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 5.3% below its record high at the end of June; MidCap's is 8.0% below its record high in early June; and SmallCap's is 13.6% 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 fourth straight week, edging down to a 26-month low of -2.1% 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 -1.7% y/y is at a 27-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 -7.4% y/y is at a 29-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 (4.9%, 1.5%, and 12.1%), MidCap (16.6, -8.8, 12.7), and SmallCap (5.3, -4.7, 17.6).

S&P 500/400/600 Valuation (*link*): LargeCap's valuation ticked higher w/w through the March 16 week, but the SMidCaps fell for a second week. LargeCap's forward P/E of 17.2 was up 0.2pt w/w from a nine-week low, but is down from a nine-month high of 18.2 in early February. It's up 2.1pts 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 0.5pt to a 13-week low of 12.9 and is 1.8pts below its recent 10-month high of 14.7 in early February. It's now 1.8pts 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 0.4pt w/w to an 11-week low of 12.8 and is now 0.7pts below its recent 12-month high of 14.3 in early February. It's 2.2pts 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 25% discount. It had been at a 21% discount a week earlier, which was near its best reading since November 2021. SmallCap's discount has improved from a 21-year low of 32% last April to 26% last week; but that's down from a 22% discount at week earlier, which was near its lowest 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 92nd 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 -7.3% y/y from -1.5% in Q4-2022 on a frozen actual basis and to -4.6% from -3.2% on a pro forma basis. 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 (29.2% in Q1-2023 versus -15.8% in Q4-2022), Industrials (18.1, 42.3), Energy (15.9, 59.2), Financials (5.9, -11.6), Consumer Staples (-4.1, -0.8), S&P 500 (-4.6, -3.2), Real Estate (-8.0, -3.3), Utilities (-9.1, -4.7), Information Technology (-11.1, -8.0), Communication Services (-13.5, -28.1), Health Care (-18.7, -2.7), and Materials (-33.7, -20.4).

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