CITY NATIONAL ROCHDALE
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The Bottom Line
Relevant Insights for the Savvy Investor

It's Complicated

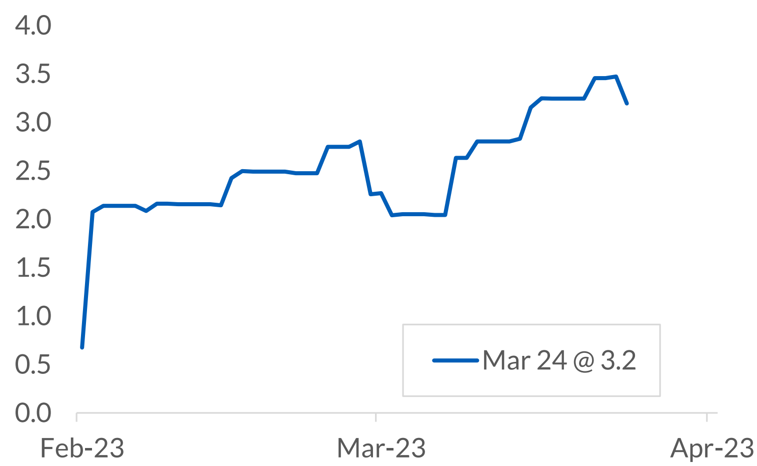
Just days before the news of the stress in the banking system that raised fears of the ghosts of 2008 appearing, Fed Chair Jerome Powell was on Capitol Hill discussing the probability of a more grueling rate hike path than previously expected.

Economic growth, after cooling in Q4, was picking up steam in early 2023 with a robust labor market, reaccelerating consumer spending, and inflationary pressures not falling fast enough. Growth in Q1 is projected to be 3.2% (chart 1), well above the 20-year average of 2.2%.

Then came the swift FDIC takeover of two domestic banks and liquidity concerns of a major global bank in Switzerland. Although a surprise, and with headlines that have created great uncertainty and market volatility, we do not believe these failures will create a systemic risk to the broad financial markets or the economy. This is because the failed banks appear to be an isolated problem, and they catered to a small portion of the economy (venture capital and cryptocurrency markets). Most importantly, their problem was liquidity, not solvency or credit. Even more importantly, the larger domestic banks are well-capitalized and subject to annual stress testing.

The Fed has aggressively used its balance sheet to help with the banking system's liquidity issues. The Fed has provided easier access to affordable liquidity (discount window borrowing and the newly established bank term funding program). This should help reduce some of the liquidity concerns in the broader banking system. Adding good news to this, the deposit flight appears to be waning.

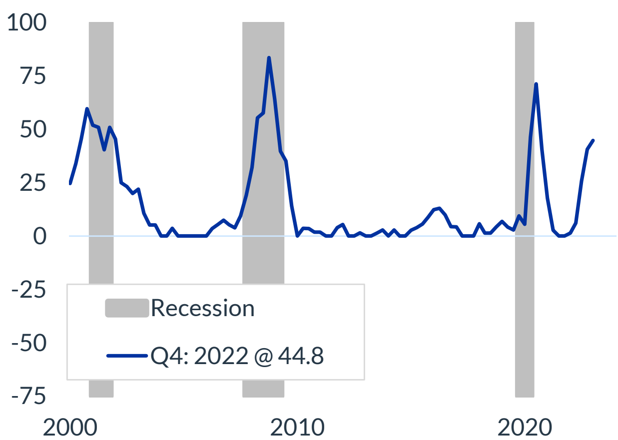
CHART 1: Atlanta Fed GDP Now - Q1 GDP
%, seasonally adjusted annual rate



Source: Federal Reserve Bank of Atlanta, March 17, 2023.
Information is subject to change and is not a guarantee of future results.

But this does not mean a return to the strong economic growth of earlier in the year. Already underway, in the past few quarters, banks have been tightening credit conditions (chart 2). At the same time, the Fed has been aggressively raising interest rates, which have put a damper on demand. This has caused bank lending to decelerate (charts 3 and 4). It was most notable last summer with skyrocketing mortgage rates

CHART 2: Tightening of Credit Standards
%, not seasonally adjusted



Source: The Federal Reserve, Q4 2022.

Information is subject to change and is not a guarantee of future results.

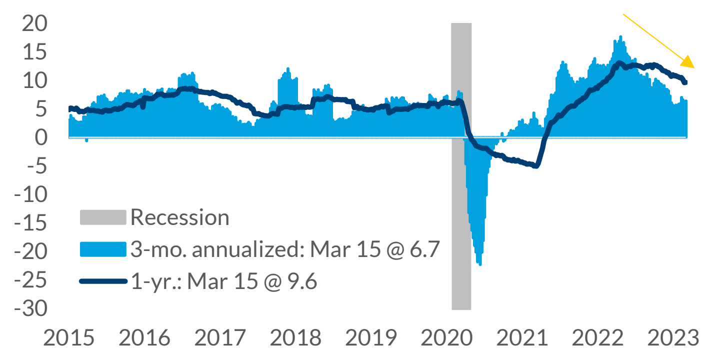
and severely reduced home purchases. The decline in demand has been spreading to other areas of the economy.

It is important to point out that the recent banking turmoil will impact the economy. Banks, primarily regional and community banks that had been a vital driving force in providing credit to small- to mid-sized companies, will probably now have a more expensive deposit base. This, along with the expectations of an upcoming recession, will cause them to aggressively tighten conditions, limiting their ability and willingness to lend – much more so than before than just a few weeks ago.

The Fed recently raised the federal funds rate for the ninth straight time to the level of 4.875%. The Fed hinted that it might be nearing the peak in the federal funds rate. Based on their updated projections, there is just one more hike of 25 basis points planned for this year. The Fed does not expect the recent banking turmoil to derail the economy, but we know they are watching the banks closely to see the impact they will have on slowing the pace of economic growth.

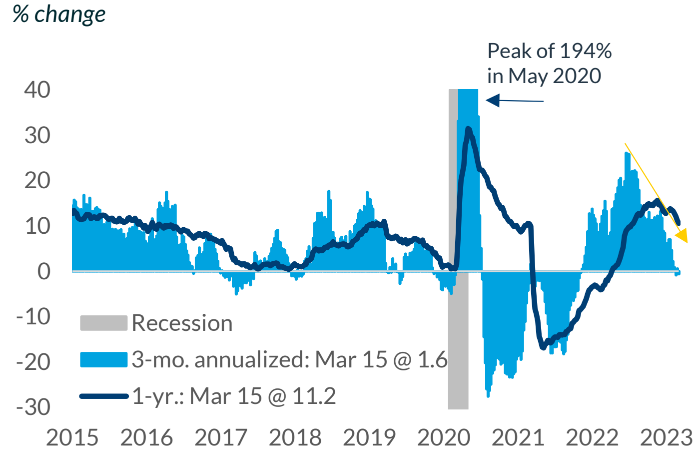
As for raising the funds rate, the Fed wanted to set the tone that the current bank failures were an isolated problem and would have a limited impact on the safety of the broader banking system. Furthermore, it shows the Fed remains vigilant in fighting against the high level of inflation.

CHART 3: Consumer Loans
% change



Source: The Federal Reserve, as of March 15, 2023. Information is subject to change and is not a guarantee of future results.

CHART 4: Commercial & Industrial Loans
% change



Source: The Federal Reserve, as of March 15, 2023. Information is subject to change and is not a guarantee of future results.

Market Trends

After a strong rally to kick off 2023, volatility has returned to financial markets with renewed worries about the direction of Fed policy, concerns over the health of the banking system and the potential for recession ahead. Though we are now likely in the later stages of the equity bear market, we think additional declines in the near term are possible until uncertainty subsides and investors gain greater clarity on the path for rate hikes, economic growth and corporate profits.

LABOR

The labor force participation rate of prime-aged workers (25-54 years of age), the percent of the population working or looking for work, has now reached the level before the pandemic.[1]

THE FED

The Fed has raised the federal funds rate by 25 bps. to 4.875%, and they hinted that it might be nearing the peak in the current hiking cycle.[2]

HOUSING

Existing home sales rose for the first time in 13 months, indicating that the weakness in the housing market may be stabilizing.[3]

AUTO SALES

The price of used cars is increasing due to the lack of supply. Leases are usually three years long, and three years ago was the peak of the pandemic when few cars were sold/ leased.[4]

INFLATION

The inflation rate has fallen to 6.0%, but the Fed remains concerned about the continued strength of housing costs and services requiring a great deal of labor.[5]

MANUFACTURING

The manufacturing sector may be entering a recession as consumer behavior has shifted away from goods to services, like travel, restaurants, ball games, theater, etc.[6]

Sources

1. Bureau of Labor Statistics, February 2023
2. The Federal Reserve, March 2023
3. Commerce Department, February 2023
4. Goldman Sachs, Manheim Used Car Price Index, February 2023
5. Bureau of Labor Statistics, February 2023
6. Institute of Supply Management, February 2023

Index Definitions

The Consumer Price Index (CPI) measures the monthly change in prices paid by U.S. consumers.

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