PICTET WEALTH MANAGEMENT

US Macro Outlook - Banking on a mild recession

Credit squeeze, growth downturn, and peak policy rate

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FLASH NOTE

SUMMARY

- Recent banking sector stress, although stabilizing, is likely to tighten financing conditions and further raise the probability of a recession in the US. We expect a recession starting from H2, with Q2 growth now downgraded close to zero. Cyclical spending more dependent on credit, including inventories and business investment, should weaken further.
- Weaker growth should help cool the labor market and reduce medium-term inflation risks, with a lag. We continue to expect core PCE inflation to slow to an above-target 3.5% by year end, with no wage-price spiral. Housing inflation is likely to fall more markedly in coming months, along with a gradual deceleration in core services and goods inflation.
- The Fed is very close to reaching peak policy rate. It remains a close call whether the FOMC will hike rates by 25bps or pause in May. The decision will come down to whether officials place more emphasis on solid, but lagging, fundamental economic data, or deteriorating, but leading, credit condition signals. Given the long and variable lags of policy tightening, it may be prudent for the Fed to wait and assess. Either way, if the Fed hikes in May, we believe it is going to be the last one this tightening cycle.
- We still see no rate cuts this year due to above-target inflation, but risks emerge if there is a severe credit crunch. We don't expect changes to quantitative tightening in 2023 but wouldn't rule out an earlier stop as we approach levels of bank reserves scarcity.

A CREDIT SQUEEZE WILL HURT US GROWTH

In our baseline scenario, we expect the recent swift policy response to be effective in avoiding a severe credit crunch in the US.

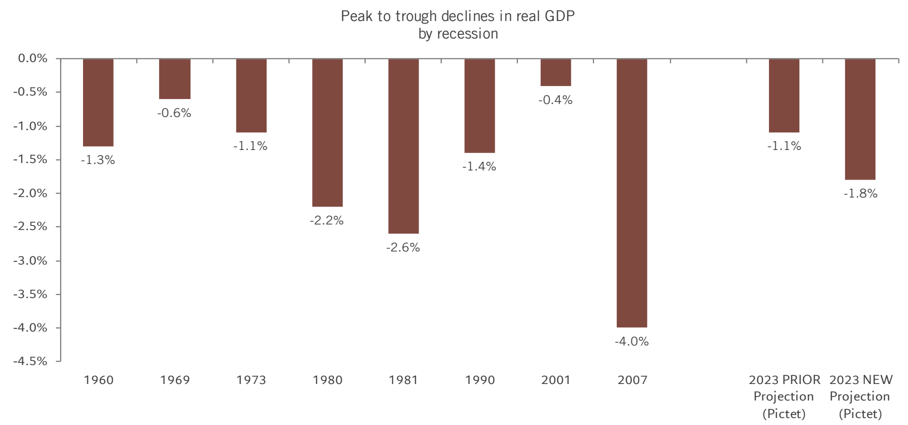
However, even before recent banking stress, loan standards were already tightening sharply. Small and medium-sized regional banks in the US are important lenders, making almost 80% of commercial real estate loans and close to half of consumer and business loans. Although large banks with a more stable deposit base and higher liquidity buffer could compensate for some loss in lending from smaller banks, a rise in general risk aversion should on aggregate lead to a credit squeeze – we will not have the results of the Fed's Senior Loan Officer survey (SLO) until early May, but more timely surveys suggest credit has already tightened in response to the banking sector turmoil (*see appendix*).

We now see a deeper recession in the US starting from Q3 this year, with Q2 growth downgraded close to zero. We expect a peak to trough contraction in real GDP of -1.8%, similar in magnitude to the 1990 recession but significantly smaller than the GFC (*chart 1*).

Cyclical spending more reliant on bank loans should weaken further. Inventories are likely to become a large drag to growth –retailers were already overstocked and firms use bank loans heavily to finance inventories. Business equipment investment should also contract (*chart 2*) – manufacturing PMIs have already darkened significantly, and recent durable goods orders data suggest weakness is forming. Business structures investment, including those in office space and malls, is also at risk of a further slump. Despite a contraction in cyclical sectors, we expect consumer spending to weaken but remain slightly positive – household balance sheets are in a stronger position compared to the onset of previous recessions, offering an extra degree of resilience.

The economic backdrop is likely to deteriorate in earnest in the summer. Importantly, the debt ceiling will start to bind and the pause on student loan payment is scheduled to cease around the same time. We expect Congress to raise or suspend the debt ceiling at the eleventh hour, but financial market turmoil leading up to the X-date is likely to dent confidence, creating a further headwind to growth.

Chart 1: Peak to trough decline in US real GDP, by recession



Source: Pictet Wealth Management, BEA, 2020 recession is excluded, as of 14.04.2023

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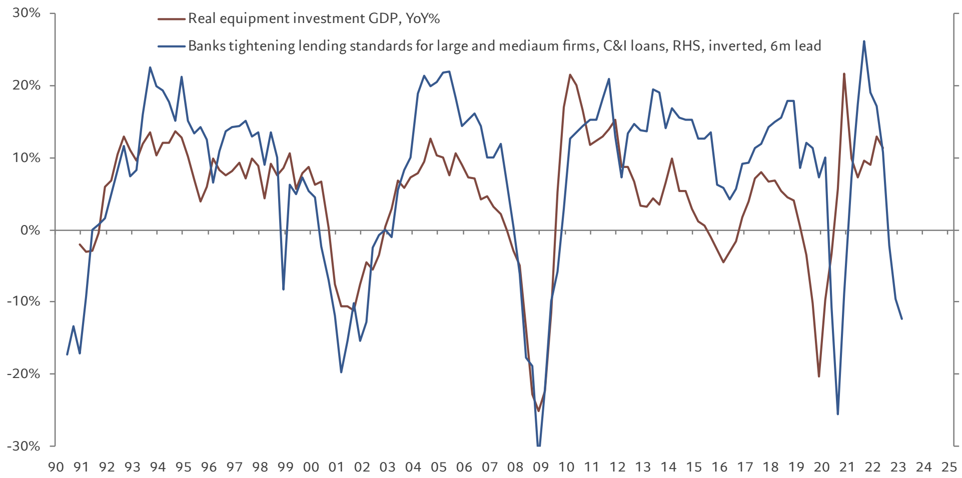
Chart 2: Bank lending standards for business loans lead business investment and indicate a contraction in capital expenditure



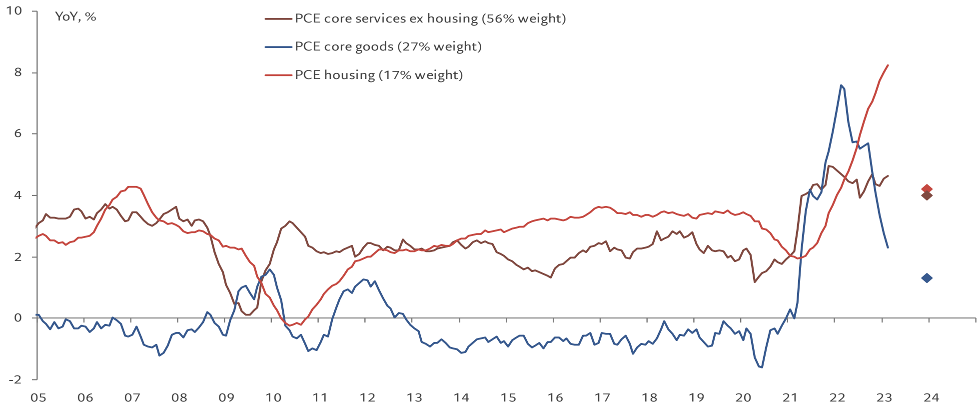
Source: Pictet Wealth Management, BEA, FRB, as of 14.04.2023

INFLATION TO DECELERATE BUT REMAIN ABOVE TARGET

A decline in aggregate demand should become a disinflationary force and reduce medium-term inflation risks, with a lag. From a top town perspective, money supply growth is declining sharply, and inflation expectations remain anchored.

Looking bottom up, core inflation will likely ease only slowly (*chart 3*). Supercore inflation (core services ex housing) could be sticky in the near term, but we still do not think there is a "wage-price spiral" - the recent slowdown in labor demand and the deceleration in wage growth further strengthen the case (*chart 4 and 5*). The slowdown in housing inflation that we've been expecting has finally arrived, and measured inflation should drop more meaningfully in coming months due to earlier decline in actual rent and home prices. Meanwhile, improvements in supply chains, although uneven, should lead to a gradual deceleration in goods inflation.

Chart 3: Core PCE inflation with projections for year end 2023



Source: Pictet Wealth Management, BEA, as of 13.04.2023

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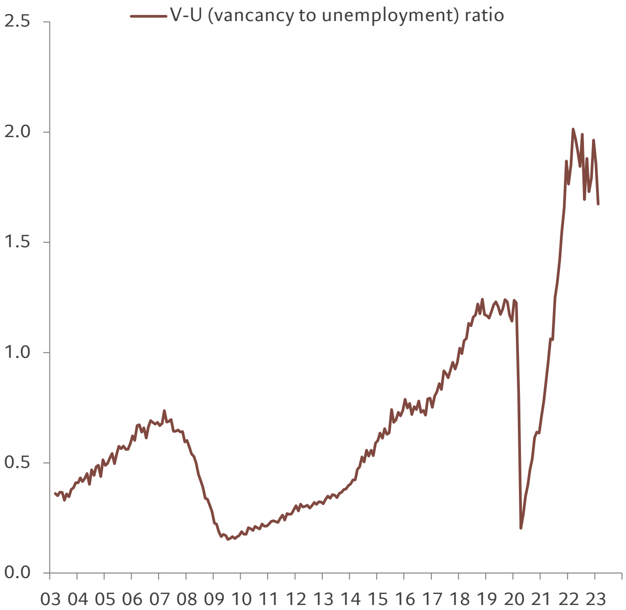
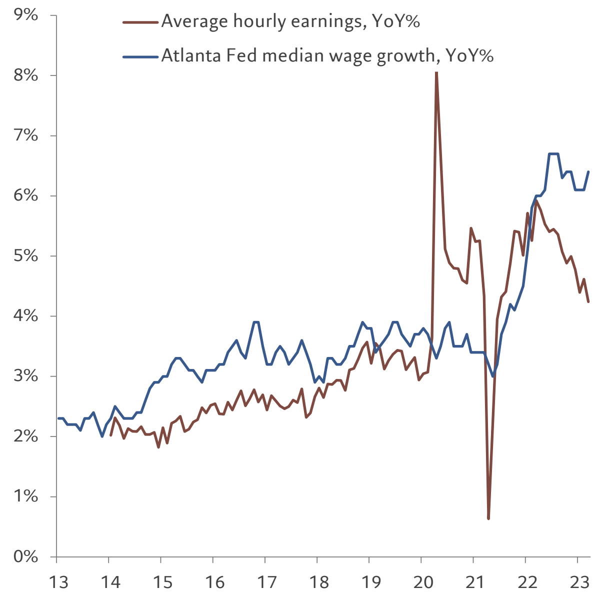
Chart 4: Job market remains tight, but demand is slowing as openings fell



Source: Pictet Wealth Management, BLS, as of 14.04.2023

Chart 5: Wage growth has shown tentative signs of slowing, supporting disinflation in services



Source: Pictet Wealth Management, BLS, Atlanta Fed, as of 14.04.2023

PEAK POLICY RATE IS NEAR BUT HIGH HURDLES FOR CUTS

By effectively tightening monetary policy through lending and confidence channels, stricter credit conditions should obviate the need for further rate hikes. The decision for the May meeting will come down to whether officials place more emphasis on solid, but lagging, fundamental economic data, or deteriorating, but leading, credit condition signals.

A minority of Fed officials are already advocating for "patience and prudence", and the latest minutes show Fed staff is now projecting a mild recession this year. Most Fed officials seem to be comfortable with one last rate hike in May, which was the median interest rate projection at their March meeting.

Our base case has been that the Fed has reached its peak policy rate in March. It remains a close call whether the Fed will hike or pause at its May meeting. If the Fed hikes, we believe it is going to be the last one this tightening cycle.

Importantly, we expect the Fed to hold rates at its peak level this year and don't see rate cuts until 2024. Despite our projected recession, inflation is likely to remain way above 2% this year, putting a high hurdle for the Fed to cut.

Risks of aggressive rate cuts this year do emerge if there is a severe credit crunch – Fed staff projections noted historical recessions related to financial market problems tend to be more severe and persistent than average recessions. A larger than expected contraction in aggregate demand could put more downward pressure on inflation, arguing for a less restrictive monetary policy stance.

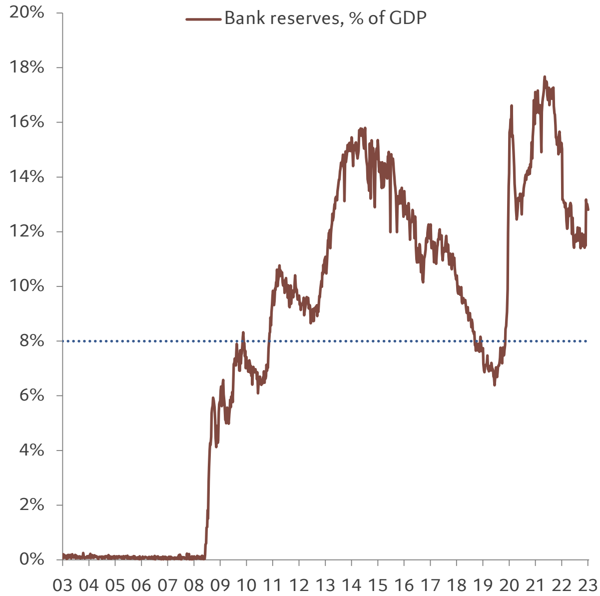
The Fed is still doing quantitative tightening (QT) predictably and passively and the committee prefers to keep it that way. However, an earlier stop is possible if the

Fed runs into reserves scarcity problems. The ultimate size of the balance sheet depends crucially on the lowest comfortable level of reserves in the banking system, which is difficult to estimate even for the Fed (although projections from the NY Fed annual report suggests 8% of GDP as the level at which QT would stop) (*chart 6*).

We remain of the view that QT will operate in the background and rate cuts remain the first policy response to deal with a severe recession. If the unemployment rate starts rising past 5% this year (current Fed median projection is 4.5%), we could start to see possible rate cuts. QT can stay on autopilot in the initial phase of policy easing, but once the rate cutting train is in motion, we expect QT to stop as well (another option would be to lower the caps on Treasuries and MBS first before a complete halt).

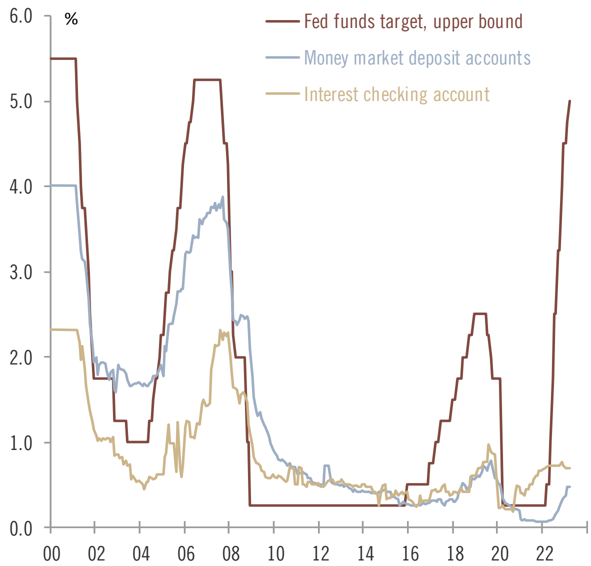
The recent emergency Bank Term Funding Program, and the Fed's long-standing discount window seem to be effectively meeting the unusual funding needs of some banks, and deposit outflows seem to be stabilizing. However, as money market fund yields remain far above deposit rates, further deposit outflows cannot be ruled out (*chart 7*).

Chart 6: Bank reserves are closer to the lowest comfortable level, raising risks of an early QT stop



Source: Pictet Wealth Management, FRB, as of 13.04.2023

Chart 7: US deposit rates are far below money market fund yields



Source: Pictet Wealth Management, Bloomberg, as of 13.04.2023

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APPENDIX: HIGH-FREQUENCY CREDIT CONDITION INDICATORS

Credit conditions provide key insight into the economic and monetary policy outlook - they deserve greater attention during banking sector stress and times of rising economic uncertainty. We think it is useful to present a list of high frequency indicators that we track to gauge funding, lending and broader credit conditions in the US.

The government has acted swiftly to take failing banks into receivership, guarantee uninsured deposits at failed institutions, and establish emergency lending facilities.

If banking stresses were to deteriorate materially, however, further policy options are on the table.

Talks have emerged about a potential increase in the deposit insurance limit (currently at $250,000) or even a blanket deposit guarantee. Such changes would need Congressional approval and is highly challenging politically. There may be an option to bypass Congress but that would be both legally and politically fraught.

Meanwhile, the Treasury Department has signaled it would be prepared use the systemic risk exception clause again for single banks who are failing, hoping that such ex ante "insurance" would be sufficient to bolster depositor confidence and avoid further bank runs.

Key data on credit conditions in the US

DATA	USE	FREQUENCY
Federal Reserve Balance Sheet H.4.1	Bank emergency lending from the Fed	Weekly on Thursday
Assets and Liabilities of Commercial Banks H.8	Bank deposit flows and loan growth	Weekly on Friday
Money market fund flows	Deposit flows	Daily and Weekly
New York Fed survey of consumer expectations	Credit conditions	Monthly
NFIB small business survey	Credit conditions	Monthly
Dallas fed bank lending conditions survey	Bank lending standards	Twice a quarter
Senior Loan Officer Opinion Survey on Bank Lending Practices	Bank lending standards	Quarterly

Source: Pictet Wealth Management

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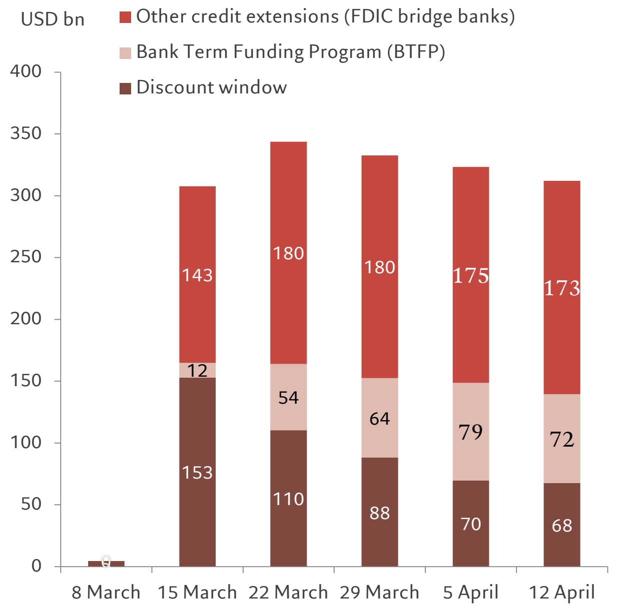
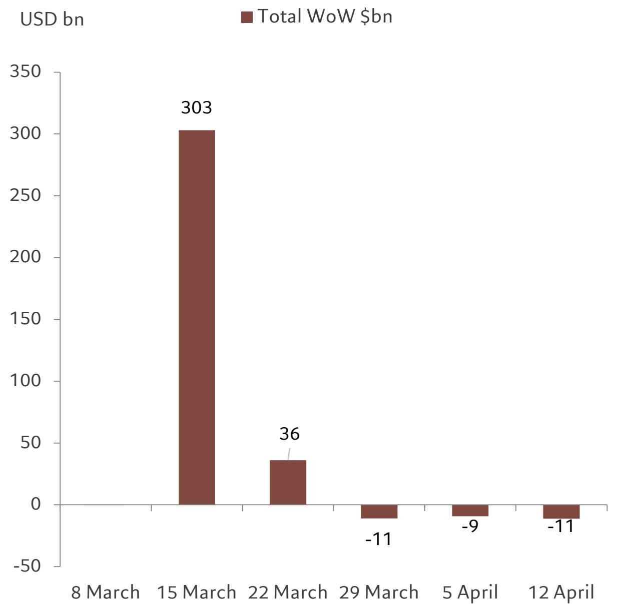
Emergency Fed lending remains elevated



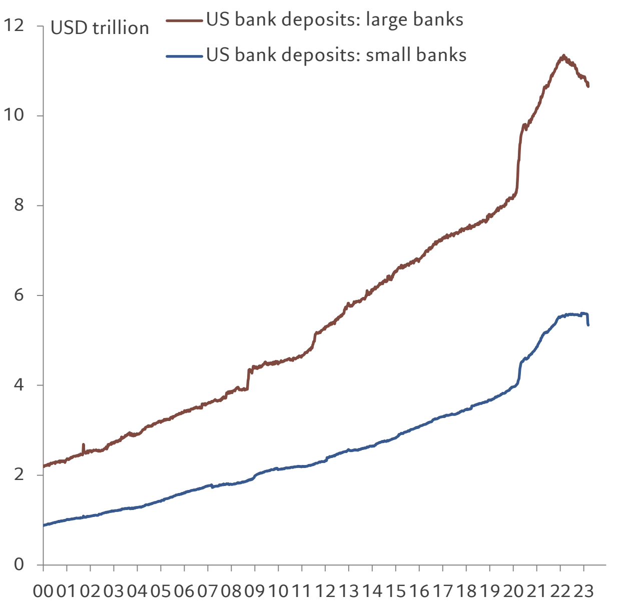
Source: Pictet Wealth Management, FRB, as of 14.04.2023

But has seen declines for three consecutive weeks



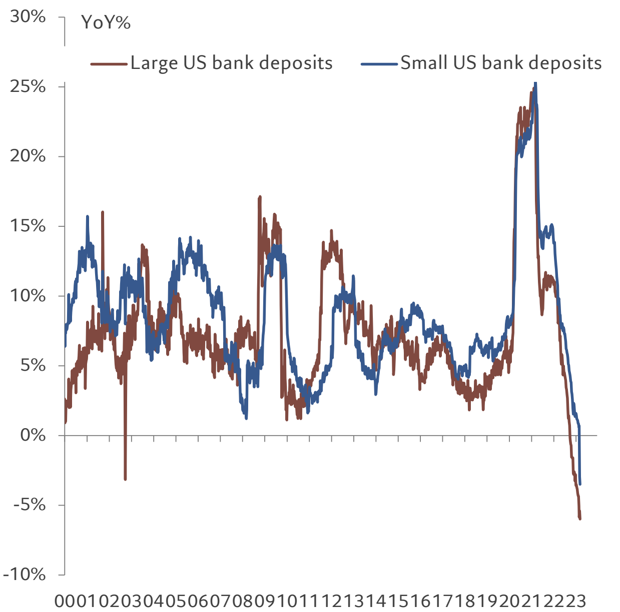
Source: Pictet Wealth Management, FRB, as of 14.04.2023

Bank deposits surged during the pandemic before seeing large outflows as the Fed hikes rates



Source: Pictet Wealth Management, FRB, as of 14.04.2023

Bank deposits contraction accelerated due to banking stress



Source: Pictet Wealth Management, FRB, as of 14.04.2023

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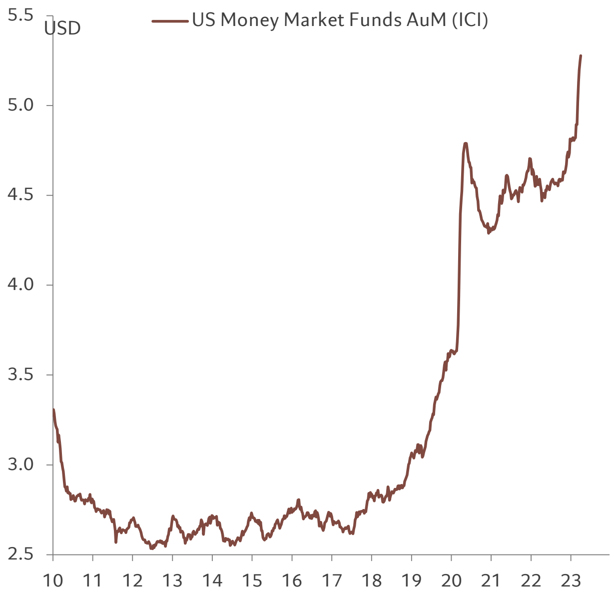
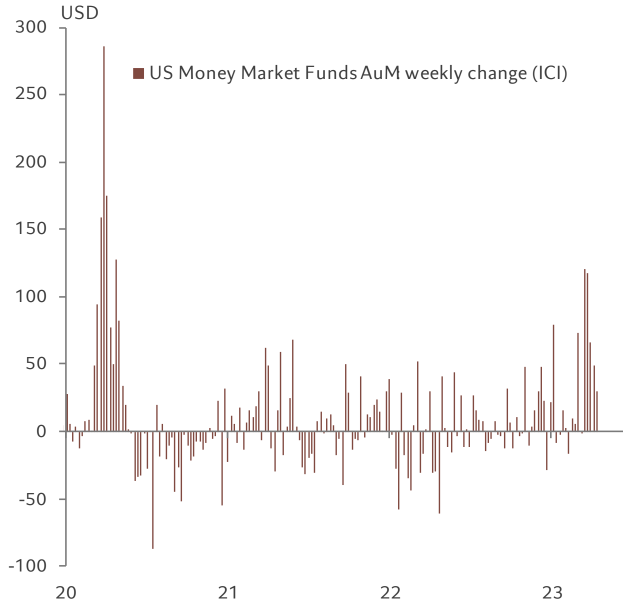
Money market funds have saw significant inflows since recent banking turmoil



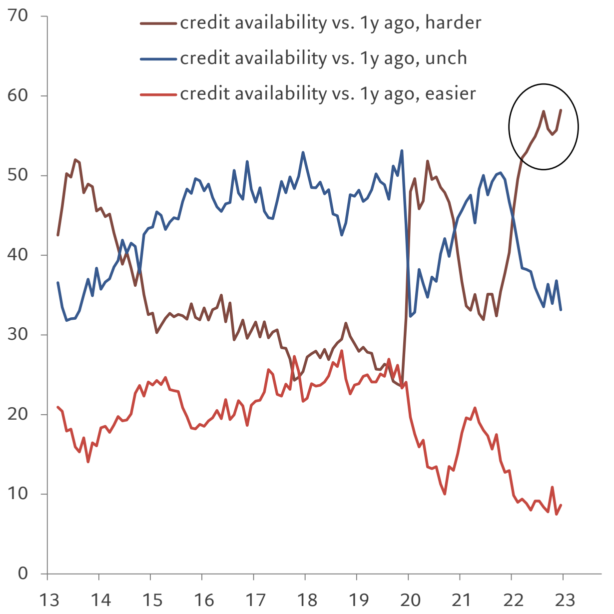
Source: Pictet Wealth Management, ICI, as of 14.04.2023

But the pace of inflows has slowed in recent weeks



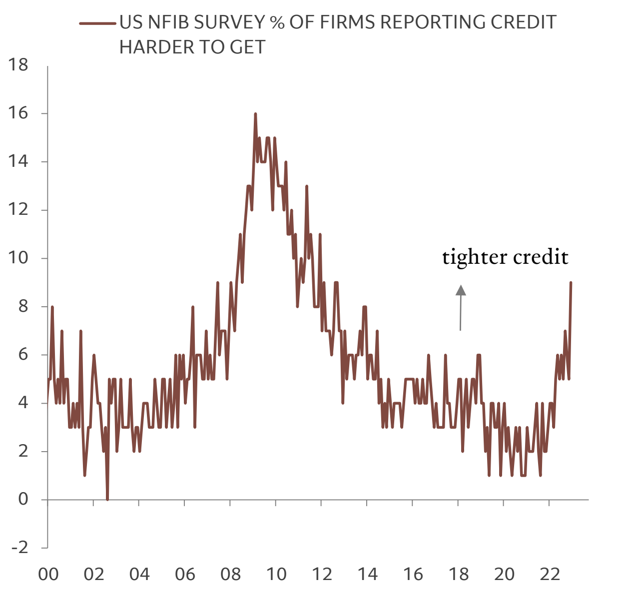
Source: Pictet Wealth Management, ICI, as of 14.04.2023

New York Fed survey – more consumers report credit harder to get after banking stress



Source: Pictet Wealth Management, NY Fed, as of 14.04.2023

NFIB survey – more small businesses report credit harder to get after banking stress



Source: Pictet Wealth Management, NFIB, as of 14.04.2023

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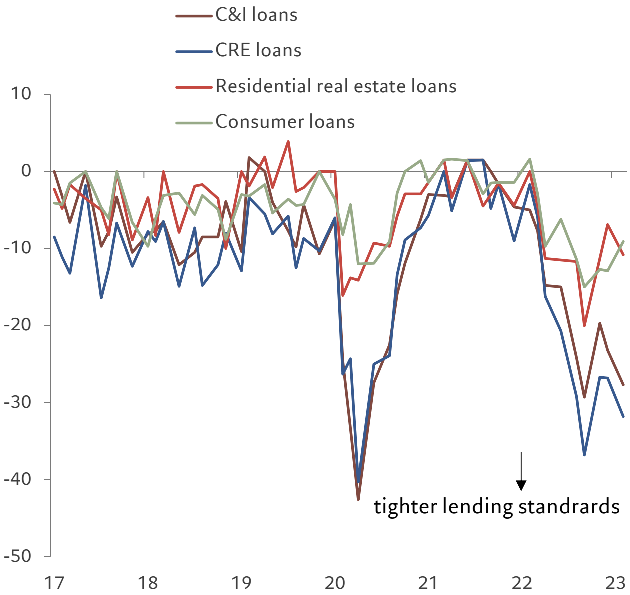
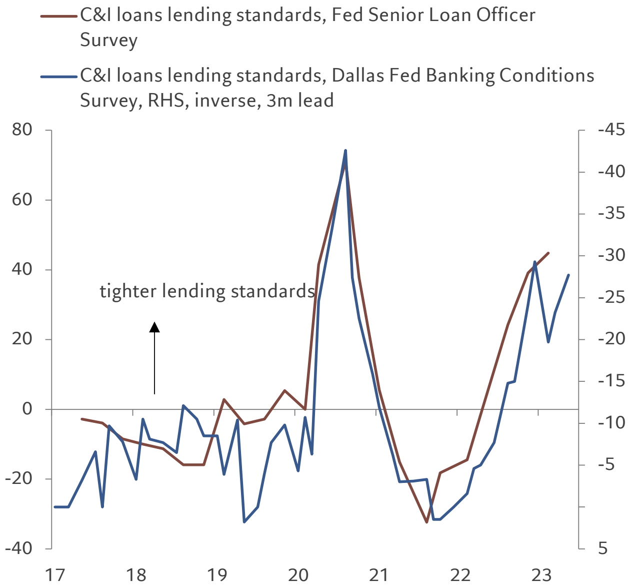
Dallas Fed bank lending conditions survey – lending standards tightened after banking stress



Source: Pictet Wealth Management, Dallas Fed, as of 14.04.2023

Dallas Fed lending conditions suggest SLO credit conditions should tighten further



Source: Pictet Wealth Management, FRB, as of 14.04.2023

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