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Corporate Federal Credit Union

Economic Update

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Commentary

March was quite a wild ride for the markets. The rapid failure of Silicon Valley Bank (SVB) and two other U.S. banks led to a drastic rethink on the direction of the economy and interest rates. In just three business days, the market's expectation for the year-end fed funds rate fell from 5.50% to 3.75%. The stock market turned lower as fears of a banking crisis took hold. As we close the month of March, a relative calmness pervades the markets. Interest rates have ticked higher, and the equity market (based on the S&P 500) ended up posting almost a 4% gain for the month.

The SVB crisis was brought on by a combination of rapid deposit growth, weak risk management and significant depositor concentration. In short, the bank invested as though interest rates would remain near zero forever and the significant influx of deposits they received over the previous few years represented the new baseline. Most of their depositors were technology start-up firms, who had significant deposit balances. Since the start-ups were funded by many of the same venture capital firms, the propensity to flee in times of distress was much higher than traditional banks or credit unions that have a wide mix of depositors.

The valuation of SVB's investments significantly declined with the rapid Fed tightening over the past year. After announcing a big loss on a sale of investments and failing in its bid to raise additional equity on Wednesday, March 8, there was a massive deposit outflow. It took only two days for the $200 billion bank to be conserved. It was the largest bank failure since Washington Mutual in 2008.

The Fed's response to the failure was swift and helped to limit the contagion. The first step the Fed took was to fully insure all depositors of the failed banks beyond the normal $250,000 limit. This was executed via the "systemic risk exception," which allows the Federal Deposit Insurance Corporation (FDIC) to waive the requirement that failing banks be resolved at the lowest possible cost to the government if doing so creates financial stability risks. The second step was to create the Bank Term Funding Program (BTFP). This allows institutions to borrow from the Fed for up to one year at very favorable terms.

Assuming that the financial industry is now stabilized, the events that unfolded will still have an economic impact. There will be tighter lending standards, lower bank and credit union balance sheets and more regulatory scrutiny going forward. Smaller financial institutions experienced large deposit outflows in the immediate aftermath of the failures. This will mean less lending to smaller businesses unless the trend reverses. All told, the risks of a hard landing have been magnified.

THIS MONTH

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- LABOR READINGS
- INFLATION READINGS
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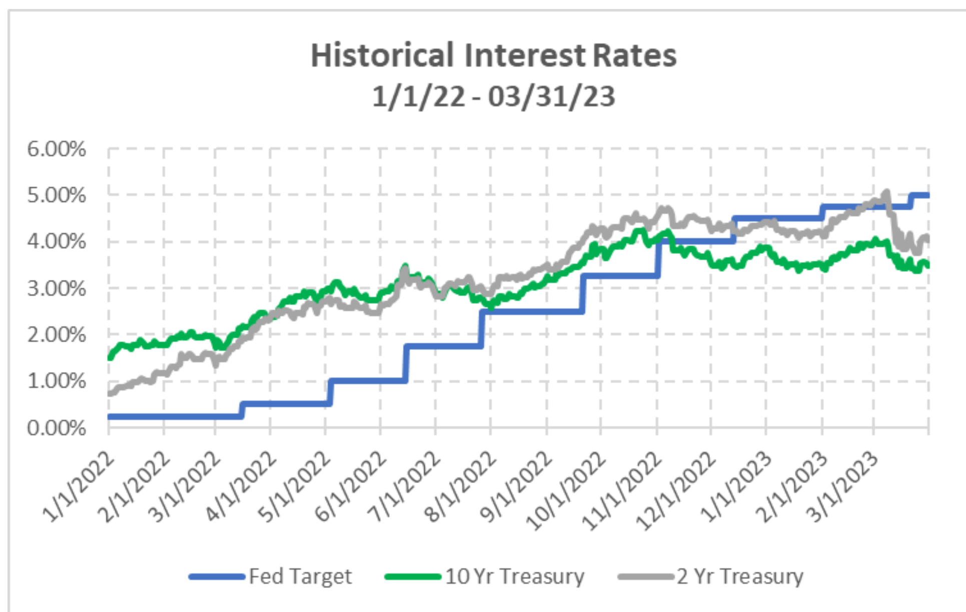
Fixed Income Outlook

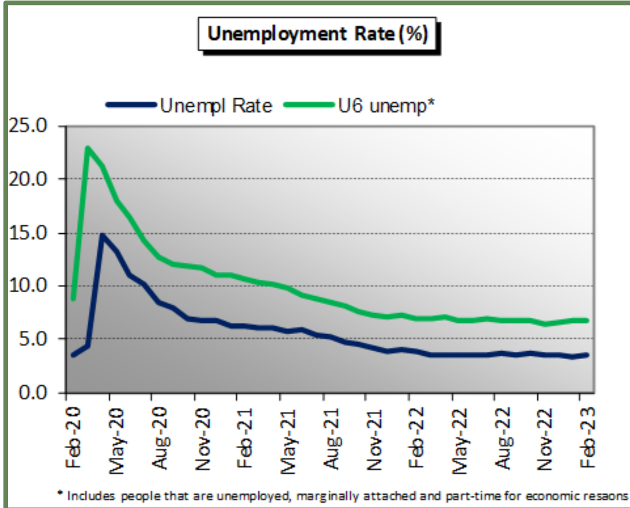
Extreme volatility was the story for March. We started the month with a slew of positive economic reports, which pushed the 2-year Treasury yield to over 5.00% (the highest point this cycle). The Fed appeared to be guiding the markets towards a 50-basis-point hike but had to quickly shift gears after the SVB collapse. The 2-year Treasury yield plunged by over 100 basis points in just a few business days. There was plenty of debate about what the Fed should do at the March Federal Open Market Committee (FOMC) meeting. Ultimately, they decided to lift rates by 25 basis points amidst the elevated inflation levels and calmer markets.

The market is now pricing in one more rate hike this year, followed by a string of rate cuts. The market's projection for the year-end fed funds rate is 4.5% versus the Fed's projected rate of 5.25%. We believe that the current market yields are too low and discount the Fed's resolve to tame inflation.



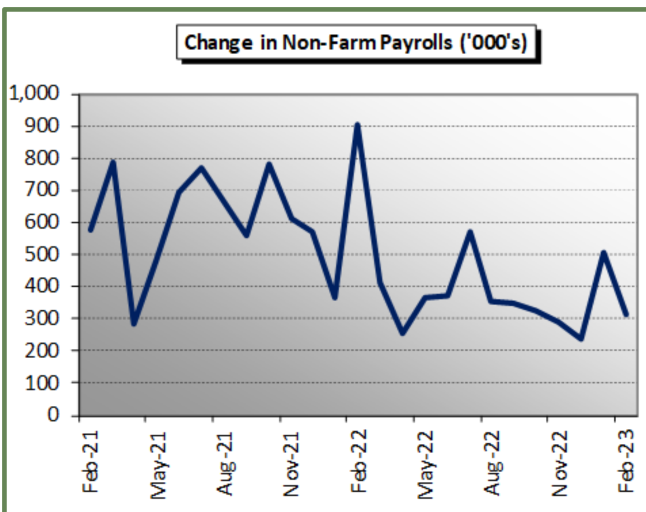
Labor Readings

(Data source: Bloomberg)



Labor Market Still Tight

The unemployment rate increased to 3.6% in February from 3.4% the prior month. The increase was due to positive reasons. The labor force participation rate and the employment to population ratios reached their highest levels since the COVID-19 pandemic.

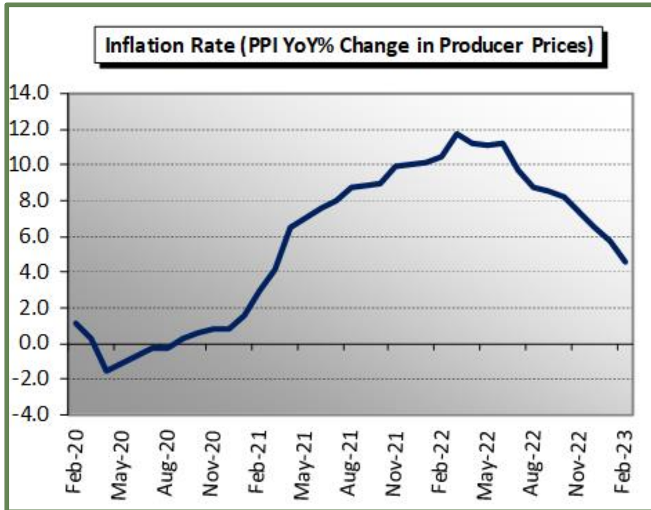


Payroll Growth Higher than Expected (Again)

Payroll growth in February exceeded expectations. This marks the eleventh consecutive month that job growth has exceeded expectations. Jobs gained by 311,000 in February versus an expected gain of 225,000 jobs. Job growth remains too high for the Fed in their battle to bring inflation levels lower.

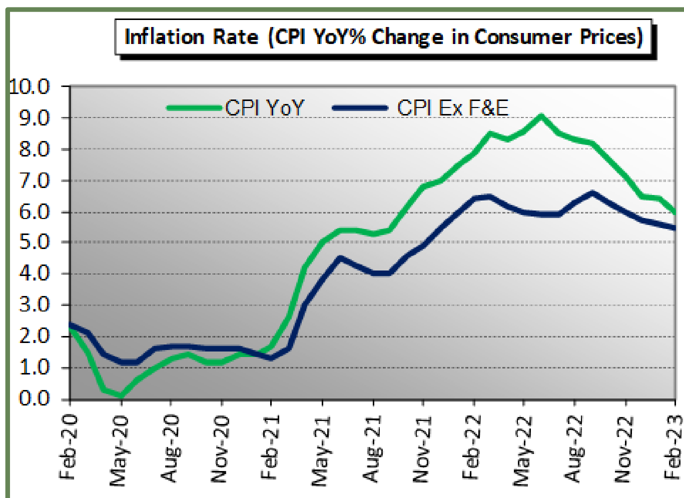
Inflation Readings

(Data source: Bloomberg)



Producer Prices Decline

Producer prices in February unexpectedly declined on a month-over-month basis. The market was expecting a 0.3% monthly increase, but instead prices fell by 0.1%. In addition, the prior month was revised downwards. Both service and good prices fell.

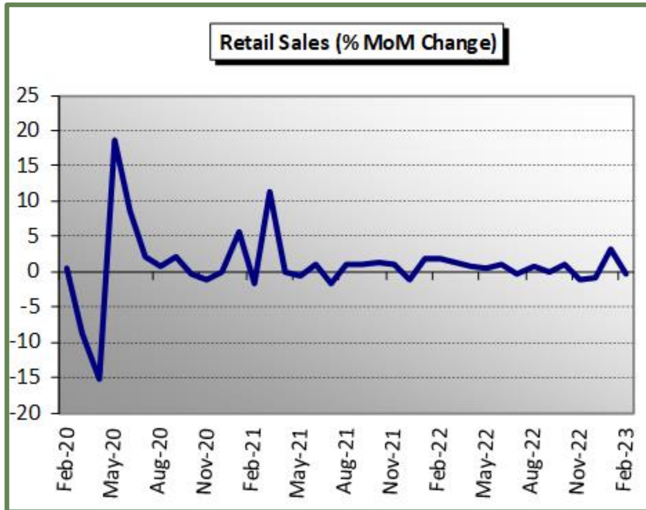


Consumer Inflation Still Too Hot

The inflation data continues to remain elevated. The month-over-month change in core inflation in February rose the most in five months and the year-over-year change was in line with expectations at 5.5%. The Fed is watching a key measure, core services (excluding rents). Core services rose the most since September.

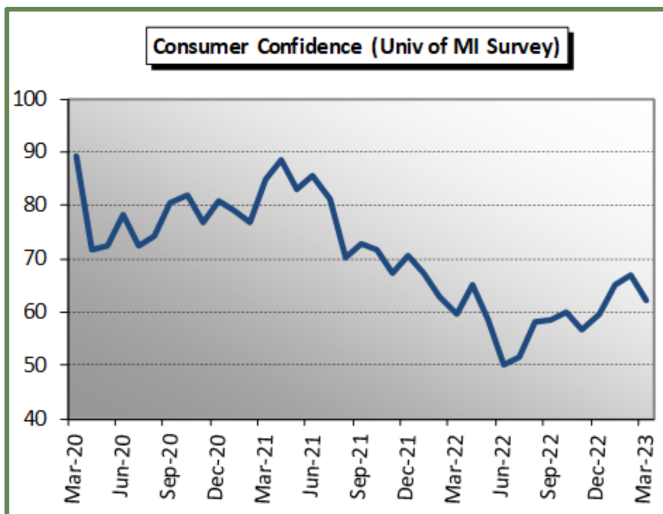
Consumer Readings

(Data source: Bloomberg)



Retail Sales Decline

Retail sales in February declined from the prior month. This was in line with expectations. The large sales gain in January was revised even higher. This implies that despite this month's decline, consumer spending for the first quarter should be relatively strong.



Consumer Confidence Falls

Consumer confidence in March declined largely due to lower future expectations. There was little direct impact from the bank failures on sentiment but increased negative news regarding unemployment and inflation weighed on confidence.