BofA Global Research Podcasts

Bank risks abate but tighter lending, slower economy likely approaching

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Global
US Economics

Key takeaways

- BofA Global Research Podcasts are an ongoing series of discussions covering growth industries and topical market themes.
- Higher rates have impacted the banking sector but are they enough to slow the resilient consumer?
- We discuss how banking stresses could tighten credit and help spawn the much anticipated slowdown.

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Economic concerns and increased funding costs may combine to help slow a resilient US economy

The consumer economy has remained strong in the face of rate hikes and labor demand has remained resilient. But recent stresses in the banking sector give Michael Gapen more confidence in his view that the US will see a mild recession later this year. Banks had started to tighten lending by the end of the 4Q and a combination of economic concerns as well as higher cost funding and more regulations could lead to even more tightening. Inflows into money markets are notable and probably don't reverse until the Fed is cutting rates again according to Mark Cabana. *BofA Global Research Podcasts can now be found on public podcast platforms, including Spotify, Apple Podcasts, Google Podcasts, and Amazon Music. These podcasts are first released to clients and then to the platforms. You may also enjoy listening to the Merrill Perspectives podcast, featuring conversations on the big stories, news, and trends affecting your everyday financial life.*

Refer to important disclosures on page 8 to 10.

Full Podcast Transcript

T.J. Thornton, Head of Product Marketing and Predictive Analytics: Hello and welcome to BofA Global Research Podcast, where we discuss what's rising from growth industries to rising risks and opportunities in global markets. I'm T.J. Thornton, Head of Product Marketing and Predictive Analytics at BofA Global Research, and we're recording this episode on Tuesday, March 28, 2023.

Essentially, banks need to offset the higher liability cost by ensuring that they have higher revenues that are coming from existing loans, that they've got higher rates on the asset side of their balance sheet. And certainly if deposits are leaving the banking system or if they're leaving a certain set of the banking system, those banks that are impacted do need to pass along higher lending costs and that in essence tightens lending standards, which is what Michael has talked about, as potentially having a headwind in terms of the overall economic outlook.

-Mark Cabana, CFA

It was only a few weeks ago that many were talking about how the Fed might need to raise rates to 6% to slow this US economy down. That talk was quickly silenced as two US banks went into FDIC (Federal Deposit Insurance Corporation) receivership and it became clear that higher rates were indeed having impact. But how much impact, and if the economy does slow, will inflation follow suit allowing the Fed to cut? Joining us to answer these questions and more are Mike Gapen, Head of US Economics for BofA Global Research, and Mark Cabana, Head of US Rate Strategy for BofA Global Research. Thanks for joining us, Mike and Mark.

Michael Gapen, Head of US Economics: Thanks for having us.

Mark Cabana, Head of US Rates Strategy: Thanks for having us.

T.J. Thornton: Okay. So Mike, you didn't change your US GDP (Gross Domestic Product) view after the news that SVB (Silicon Valley Bank) had gone into FDIC receivership and the market now expects Fed rate cuts in the second half of this year, something you don't expect. Is it fair to say you are more optimistic on the economy than the street and why?

Michael Gapen: Yeah, thanks for that T.J. I would say no, primarily because we were already looking for the US economy to be in a mild recession beginning later this year. Just immediately prior to the two banks going into receivership, we'd actually written on how bank lending standards were tightening and credit growth was indeed slowing. We viewed recent trends in this area as consistent with our belief that Fed tightening would slow the economy down and that we would be having a mild recession later this year. Now, you're right, we don't have cuts in our forecast until early 2024, but I think the difference between writing down a baseline or most likely outlook, as opposed to market pricing, which has to take into account distributions of potential outcomes, so pricing cuts later this year, on say, fears or risks of a harder landing that makes complete sense to me. I think we are a little more pessimistic than consensus, and recent events leave us comfortable with that view and with our outlook that we are likely to get something that looks like a mild recession later this year, and we're just viewing recent events as another data point that supports that outlook.

T.J. Thornton: Bank willingness to lend had tightened even before the stock prices of these three banks went to zero. Mike, what happens to bank lending from here, do you think? And how much do changes in lending impact the US economy?

Michael Gapen: Right, there's probably some just correlation here and correspondence between bank lending standards tighten as the outlook for the economy weakens and you would expect loan growth to slow on the back of that, and the data was pointing to that as I mentioned. And I would say in nominal terms, lending to commercial and industrial loans, what we would call C&I (Commercial and Industrial) loans and lending to households have been kind of running about between zero and 5% in nominal terms, if you look on a three month annualized basis. Loan growth has indeed slowed, so we would expect loan growth to slow further in the coming months and quarters, whether it's loans to business, whether it's loans to households, commercial real estate or residential real estate. And do these things matter for the overall economy? They absolutely do. Analysis that we've done and published suggests a significant tightening, or in this case what could be an excess tightening and lending standards above and beyond what the fundamental environment might warrant, that those could lead to declines in personal consumption spending, as well as spending by business on equipment and structures. And it would be consistent with perhaps some job losses. Now obviously whether all that materializes and to what degree, depends on the size of the shock that we're experiencing, how much lending standards in terms tighten further from here that we don't know. It's just we've been characterizing this as saying it opens up some downside risk to the outlook. If bank lending standards continue to tighten, then I would expect some adverse shock to credit growth, which again would likely downstream into less spending by consumers in business and maybe lead to less hiring.

T.J. Thornton: Okay. And as a quick follow up there, is it fair to just think about big ticket items maybe as being at more risk, if we did see a tightening in lending rather than some of these smaller ticket items that a consumer might purchase like apparel or of course consumer staples?

Michael Gapen: Yeah, in general, that's exactly right. Some of this is a desired outcome by the Fed in the sense that they're tightening policy to slow down aggregate demand. Obviously, they don't want to overdo it, if they could avoid it. But lower credit availability and higher cost of credit will tend to hit those bigger durable items first because households do finance those, most of the time. So you would expect, if credit standards tighten appreciably that you would see lower demand and lower spending on durable items like new cars, used cars and household appliances. But it also means that the ability to use, say credit cards or unused balances on credit cards or other contingent credit lines by small business, that those may be curtailed as well. Total lending capacity generally comes down, but you're right, T.J., we would expect to see it perhaps most explicitly in some of those durables items.

T.J. Thornton: Okay. And when the two year yield fell dramatically in the wake of the bank news and the Treasury yield curve steepened as a result, there was some talk about how when you see that amount of steepening, it often coincides actually with the beginning of a recession. Mark, what sort of information content is there in these dramatic steepening episodes and does the one we saw suggest that we may actually finally be in the midst of this highly anticipated recession?

Mark Cabana: Certainly what we have seen the market price is a shallower path of policy from the Fed, i. e., a terminal rate that won't need to be as high from the Fed and a path of rate cuts that has deepened and been pulled forward to some extent. There's also no doubt some elements of 'flight to quality' in the recent episode, when you're uncertain about the outlook and you're worried about broader banking systemic risks, you want to 'fly' or you want to move your money into the perception of safer assets. And no doubt, treasuries and front-end treasuries were a beneficiary of this to some extent. Now, do the dramatic moves mean a recession is coming? Do lower 2-year rates mean that you're going to get a sharp slowdown in the economy? No, they don't mean that - it just means that there are increased concerns about that and that there's also clearly some preference to own safer haven, lower risk securities due to increased concerns about systemic banking risks.

T.J. Thornton: And Mark, there are two main things driving deposit shifts. One is risk aversion where depositors want to diversify and shift deposits, and the other one is just that depositors are chasing higher rates because their current accounts aren't giving them attractive rates when they can get 4% plus in some cases. Could you explain how that second issue in particular impacts bank lending? Because it seems like that's something that's not going to go away even once concerns of a run fade a bit.

Mark Cabana: Sure. Essentially, the possibility that deposits are leaving the banking system chasing higher yielding alternatives is very much a function of the Fed's broader setting of monetary policy. It's consistent with higher interest rates and how money markets have moved to reflect the overall setting of higher interest rates that the Fed has established. If there is a broader flight of deposits out of the banking system, then you would think that that will certainly challenge bank's ability to make loans or to make loans on similarly attractive terms. And if a bank is worried about deposits that are leaving, moving into money market alternatives, then they're going to fight that and they're going to fight that by trying to raise deposit costs. And if they do raise deposit costs, then that by definition means that their Net Interest Margin or their NIM is going to compress. And banks should be fighting any type of NIM compression by increasing borrowing costs and increasing lending costs to their ultimate clients or their borrowers. Essentially, banks need to offset the higher liability cost by ensuring that they have higher revenues that are coming from existing loans, that they've got higher rates on the asset side of their balance sheet. And certainly if deposits are leaving the banking system or if they're leaving a certain set of the banking system, those banks that are impacted do need to pass along higher lending costs and that in essence tightens lending standards, which is what Michael has talked about, as potentially having a headwind in terms of the overall economic outlook.

T.J. Thornton: Mike, back to the point I made in the intro. There was surprising strength in the US economy. It's still strong looking at the current data, with maybe some suggestions of a bit of a slowdown, but there have been a few explanations for this strength, the fact that most homeowners have fixed rate mortgages, high excess savings from the pandemic, even the recent passage of the IRA (Inflation Reduction Act), which people think may be contributing to some of the strength in hiring that we're seeing now. Do you think any of this might keep monetary policy from working as it's supposed to work?

Michael Gapen: I think on a first order effect, I would say no. Does this mean that monetary policy isn't potent and that the Fed cannot guide the economy towards its longer term macro objectives? I think, no, but I would say that on a second order effect, it certainly affects how much the Fed may have to do and may also affect the lag time with which policy works. I think you're exactly right to point to the strength in the underlying economy is coming mainly from consumer balance sheets, and I do think that's related to the massive wealth accumulation piled up during the pandemic, excess saving, as well as a very strong labor market. But outside of that, we were certainly seeing the effects in other areas of the economy that monetary policy was working. Housing did screech to a halt for much of last year, business spending on equipment and structures slowed, manufacturing output started to decline at the end of the year, and as we've been discussing here, most recently bank lending standards have tightened and credit growth has started to slow. There was certainly plenty of evidence that higher policy rates were having their effect on interest rate sensitive sectors of the economy, but in terms of recession expansion, it's about having that policy tightening migrate onto consumer balance sheets and there certainly are some tailwinds there that monetary policy would say having trouble migrating or navigating. I think monetary policy is working as it's supposed to work, but some of the things that you mentioned like excess saving and strong labor markets mean it may take longer for this to make its way into consumer behavior. The Fed's 'higher for longer' outlook, they're trying to blend some combination of a restricted policy rate plus the notion that we're going to have to lean against some of this underlying support from the consumer for a period of time in order to bring inflation down. It certainly makes their job trickier and more difficult from my perspective.

T.J. Thornton: Okay. And Mark, we've often seen big spikes in money market fund flows when there's skittishness on risk markets. We've certainly seen a big spike right now, and some have referred to it as a bubble in money market funds. What tends to happen after these spikes? Does the money get redeployed into other areas like equities and do you think things might be different this time because of the high rates that are being offered by these money markets?

Mark Cabana: Well certainly, money funds are not allocating the inflows that they receive into equities. They're mandated to have a much more conservative allocation. Typically, what the inflows that we see into money funds are ultimately redeployed into are money market instruments and the instruments that they're deployed into will depend upon where we're seeing the money market inflows. Recently, the inflows that we have seen have been going largely to government money market mutual funds, not prime money market mutual funds. Government money market mutual funds will buy treasury bills, they will buy agency debt, short dated agency debt, or they will invest in Repo (Repurchase Agreement). Number one, they've been going into agency debt issuance in particular Federal Home Loan Bank debt issuance. Essentially what was happening is that banks were borrowing from the home loans. The home loans were then borrowing from money market mutual funds. And in a way, the money that was leaving some of the banks was ending up recycled back into them, but via money funds and the home loan channel. The other thing that money funds are investing in heavily is repo, and they are in particular investing in repo with the Federal Reserve. This repo, it's done through a facility called the Fed's Overnight Reverse Repo facility, ON RRP, as some will describe it. Now, over time, you would think that if banking system risks stabilize, and if money market rates become less attractive, let's say if the Fed were two cut rates over time, you would expect to see some outflows from money market mutual funds, and you would expect to see that this cash ultimately gets deployed in other parts of the economy. But I think it is safe to say that we are unlikely to see very large scale money market mutual fund outflows, until we see banking system stress subside or until we see the Fed ultimately cut rates and using Michael's forecasts, we probably then won't see terribly large money market mutual fund outflows until 2024 or deeper into 2024, as the Fed eventually lowers rates back towards where we expected they'll settle in the longer run.

T.J. Thornton: Mike, goods spend has weakened, goods prices have weakened, commodity prices are well off highs, but services prices remain sticky, and that's something that people are watching closely to understand where inflation goes from here. So Mike, what gets those services prices to ease or at least slow their ascent? And between restaurants and travel, have we already passed a peak in terms of pent up demand for some of these services?

Michael Gapen: Yeah, T.J., I think that our underlying thesis, or one of the reasons we're projecting at least a mild recession in the US economy is that we do think getting inflation down to the Fed's target of 2% stable prices will require, as you point out, reversing some of the stickiness in the services side of the economy when it comes to prices. We should get some payback on goods, as you mentioned, and fallen commodity prices as you also mentioned, but when those kind of wash out, it's about where's underlying services inflation that's still likely too high for the Fed's outlook and where they want inflation to go. Our view is to say, well, to get inflation down to 2%, to get services inflation consistent with 2% outcomes; you probably do need to reverse imbalances in the labor market in a way that would look like a traditional recession. We're not suggesting that has to be a deep recession. We're suggesting kind of a mild recession by historical standards should be enough. But there, in terms of thinking, "well, inflation's just going to come down on its own and pass through and we'll be back to 2%", we doubt that that's going to happen. It will likely involve a backup in the unemployment rate to somewhere between 4.5%-5% over time. I don't think we've passed the peak in pent up demand for some of these services, but to get overall services inflation in-line with the Fed's target, we're thinking you need at least a mild recession. It's consistent with what history would suggest to get the amount of disinflation that we're looking for, going from inflation rates of 6%-8% year on year down to 2%, it has typically required some weakening in labor market conditions and some backup in the unemployment rate. So we're relying kind of on some of that historical evidence to inform our view.

T.J. Thornton: Okay. Last question and this is for both of you. There's a popular view out there that yes, inflation will likely fall some more, especially if we go into recession, but then once things recover, inflation in rates will be a lot higher than they were pre-COVID because of a lot of recent changes. There's been this shift to more domestic supply chains, geopolitical tensions, which are related - the shift to net-zero, which is going to be expensive. Do you agree with this view? And what about technologies like AI (Artificial Intelligence), which actually could be somewhat disinflationary, how do you think that all washes out once we get past this cycle?

Michael Gapen: I do think it's reasonable to think that we're in for some sort of reset in terms of where rates settle out and where inflation settles out and what a new terminal rate or an average terminal rate from the Fed may look like. With pre-COVID, we were in a world where underlying inflation was running around 1.5% and the neutral policy rate of interest was viewed at, let's say around 2% and 10-year treasury yields weren't necessarily higher or much higher. I would say we probably are in for some upward reset on all of those. Underlying inflation is likely to have risen, how high, we don't know, but maybe somewhere between 2%-2.5% from my perspective, which could mean a neutral rate of interest out of the Fed, somewhere between 2.75%, maybe as high as 3%. So I do think some modest reset upward is likely, I'm just not convinced that it's a dramatic material shift higher. But I do think the answer is up and we'll find out over time just how high.

Mark Cabana: From the rates market's perspective, I think that it's safe to say that the market is not pricing a particularly elevated expectation for inflation in the longer run, but we have seen inflation expectations move up from where they were pre-COVID. If you just look pre-COVID, in the 5-years prior, so let's say early 2015 to early 2020, 5 and 10-year break even rates of inflation averaged around 1.75%. Today they are closer to 2.25%, 2.3%. There's been about a 50 basis point increase in the market's pricing of longer run inflation expectations. Now these inflation expectations are still quite low. What the TIPS (Treasury Inflation-Protected Securities) market is reflecting is CPI (Consumer Price Index), as we all know, there's a differential between CPI and the Fed's preferred inflation measure, PCE (Personal Consumption Expenditures). And if you adjust for where PCE is expected to be these breakeven inflation rates really suggest that the Fed may not be successful at achieving their 2% inflation target in time. And what the rates team has been writing about is that we think that some of the market-based measures of inflation expectations just look too low. They don't necessarily properly account for, we think, some of the potential sustained inflationary pressures that we could see over time. Or even if inflation is not realized there, we don't think that they necessarily adequately capture the upside inflation risk premium that may be realized, if we indeed do see some of these structural shifts that result in a more sustained and elevated inflationary pressure over time. So again, the TIPS market does not appear to be particularly concerned about elevated inflation. And we do think that there is certainly some scope for the market to price in greater expectations of upside inflation risk premium, especially if the Fed is seen as turning a bit more cautious in the current setting of monetary policy due to the tightening and lending standards that we have discussed on this call.

T.J. Thornton: Mike, Mark, thanks very much to the two of you for joining us today.

Michael Gapen: Thank you.

Mark Cabana: Thanks so much for having us.

T.J. Thornton: While market expectations around a recession and Fed policy changed after the bank news, Mike Gapen didn't change his GDP forecast. He had been forecasting a mild recession in the second half of this year. The market had become skeptical of this view and then the market came around again as the FDIC stepped in. The reasons to be concerned about bank lending from here are multiple. Fears around a slowdown can impact lending, but so does deposit flight and the higher cost of deposits. This could be a headwind for consumer purchases of durables that are financed and for business spending. And keep in mind that even before the SVB news, parts of the economy were already slowing, even if the consumer showed resilience. Tougher labor markets may change that resilience, but will also help to ease the very high services inflation that we've been seeing. Thanks for joining.

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