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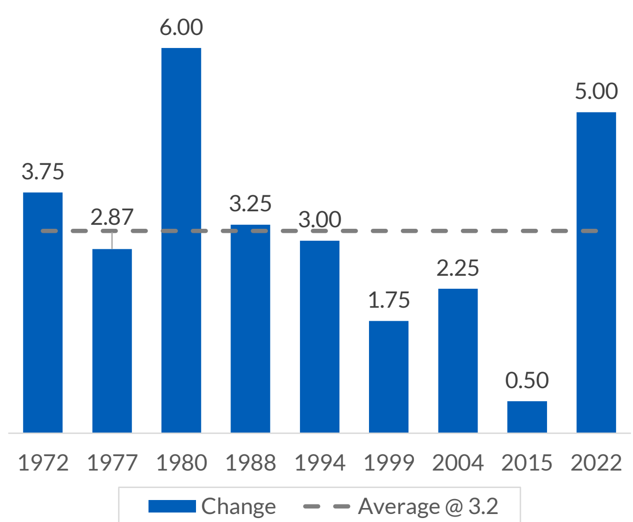
The Bottom Line
Relevant Insights for the Savvy Investor

The Economy Will Weaken, but Not Harshly

The stage has been set for an economic slowdown, with a high probability of it becoming a recession.

The catalyst began last year when the Federal Reserve Bank (Fed) started to raise the federal funds rate. In just over a year, they have increased the rate by five percentage points, making it the second fastest rate escalation in recent history (chart 1). Although the Fed now plans to pause future interest rate increases, they have no plans to cut the overnight rate this year. Instead, policymakers at the Fed will use this period to observe the economic impact of the higher level of interest rates. Although they know that interest rates have moved into a territory that is restrictive to economic growth, they are also aware that monetary policy acts with a long and variable lag.

CHART 1: Federal Funds Rate
change in rate 14 months after initial hike, percentage points



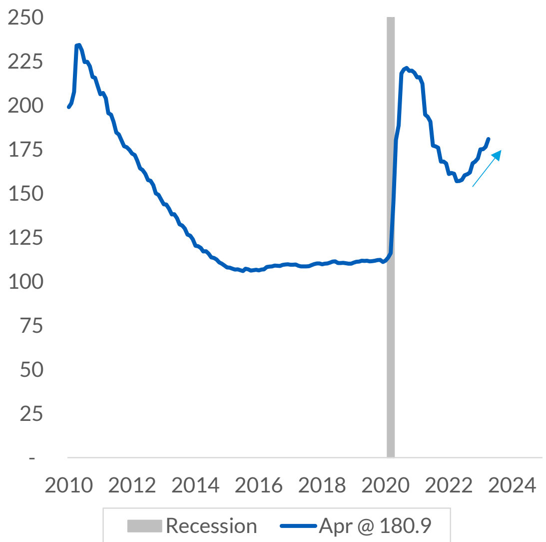
Source: Federal Reserve, May 2023.
Information is subject to change and is not a guarantee of future results.

The pause also gives the Fed time to observe recent changes in the banking system, especially being able to monitor regional banks, which are under pressure following the failure of a few regional banks. There is no fear that a credit crunch will ensue, but a more passive credit squeeze will occur. A credit crunch would result in across the board severe reductions in lending, which would crush economic growth. Instead, a credit squeeze will allow borrowers with good credit scores to obtain funding, albeit at a higher interest rate. This is apt to slow demand and the pace of the overall economy, but not squash it.

Banks have been preparing for an economic slowdown for about a year. Last spring, banks began putting more money aside for possible loan losses and collateral deterioration (chart 2). More importantly, they have become more restrictive in their policies for lending compared to last year, across a wide range of types of loans. The riskier types of loans are seeing the most significant increase in restrictions (chart 3). These tighter lending conditions, especially with loans to businesses (commercial and industrial loans), have historically had a direct relationship with changes in payroll growth/decline (chart 4).

CHART 2: Allowance for Loan and Lease Losses Domestic Commercial Banks

$, billions, not seasonally adjusted



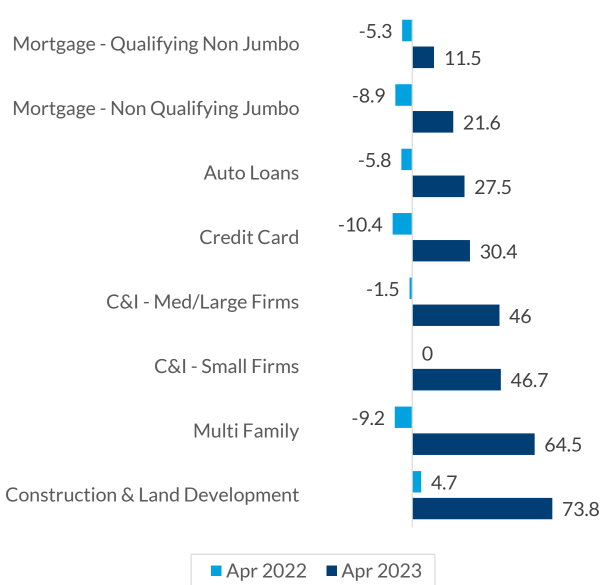
Source: The Federal Reserve, April 2023.

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

Although the higher level of interest rates and tighter credit restrictions will adversely affect the pace of economic growth by reducing demand, the effects are expected to be mild compared with past downturns. It is important to remember that aside from regional banks having some issues, the banking system remains very healthy, with a strong capital position, a high-quality loan portfolio and a high level of deposits relative to loans. On the other side of the coin, households and businesses are in good financial shape. Household balance sheets have been strengthened as leverage has declined and savings have increased. Non-financial corporations have minimal short-term funding needs. Combine all of that with a tight labor market, and it shows that households and businesses are not stretched and will be able to weather an economic slowdown/recession, in our view.

CHART 3: Banks Tightening Standards

%, diffusion index, not seasonally adjusted

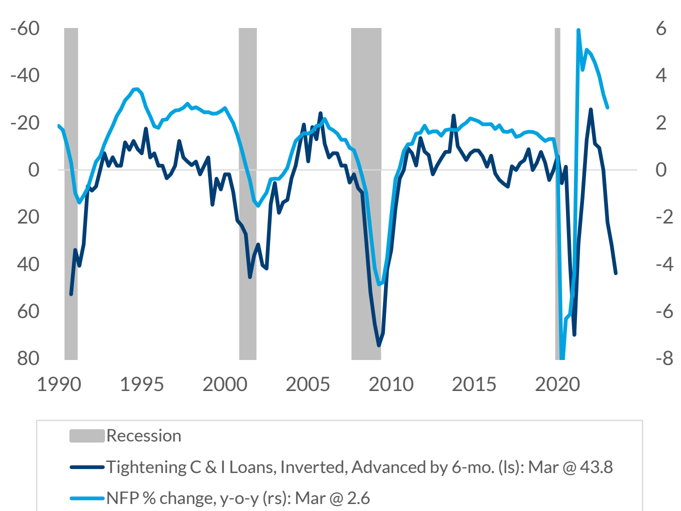


Source: The Federal Reserve, April 2023.

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

CHART 4: Tightening Credit Standards & Change in Payrolls

net % of banks tightening credit standards & yearly % change in payrolls



Source: The Federal Reserve, Bureau of Labor Statistics as of April 2023.

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

Market Trends

After a strong start to the year, both equity and bond markets are now facing the lagged impact of the Fed's rapid rate-hiking cycle, including slowing economic growth and bank sector stress. Add in debt ceiling drama in Washington, and we expect financial market volatility to continue in the months ahead, especially if we are right and the economy heads into an mild recession or if the banking system requires more intervention.

LABOR

Although demand for labor is slowing, the supply of workers remains increasingly scarce, keeping pressure on wages, which were recently nudged up to a 4.4% yearly increase.[1]

THE FED

It appears the Fed will pause interest increases, following 10 consecutive increases for a total of five percentage points; they want time to observe the economic response to past hikes.[2]

HOUSING

There is more evidence of stability in the housing market as a limited supply of existing homes is increasing the demand for newly constructed homes.[3]

DEBT CEILING

Concerns regarding Congress' ability to approve a debt ceiling increase are weighing on consumer sentiment, which dropped to a six-month low.[4]

INFLATION

The yearly change in CPI is 4.9%, pushed down by lower energy, food and medical costs, but service inflation remains stubbornly high at a yearly change of 6.8%.[5]

OIL

With the price of oil at $71.11/barrel, down 37.7% in the past year, it has helped bring down the energy component of CPI by -4.9% in the past year.[6]

Sources

1. Bureau of Labor Statistics, April 2023
2. The Federal Reserve, CNR Research, May 2023
3. US Census Bureau, National Association of Realtors, April 2023
4. University of Michigan Consumer Sentiment Index, May 2023
5. Bureau of Labor Statistics, April 2023
6. Bloomberg Energy, Bureau of Labor Statistics, May 15, 2023

Index Definitions

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

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