MOODY'S ANALYTICS

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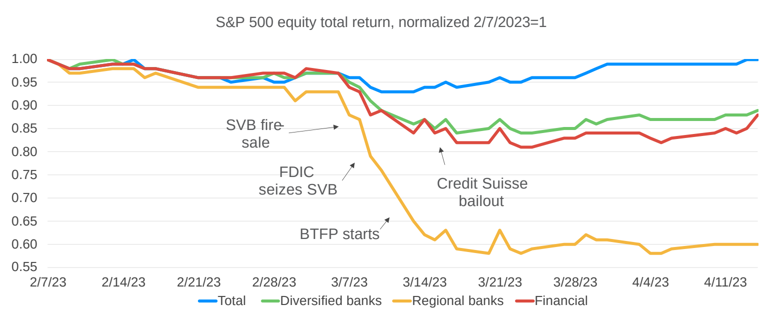
Time for a Fed Pivot

Notwithstanding last month's banking crisis and the coming fallout, the U.S. economy still should be able to skirt a recession in the coming year.

- While the banking crisis appears over, its economic impact has only begun to play out; chastened banks with constrained liquidity and diminished capital are sure to be much more cautious.
- Meanwhile, although supercore inflation remains uncomfortably high, the trend lines are encouraging, and inflation looks increasingly on script to return to the Fed's target by mid-2024.
- With inflation decelerating, the easing job market, and the fragile banking system, the Federal Reserve should soon pause its rate hikes.
- To skirt a recession the Fed must perform this pivot quickly.

The crisis that swept the nation's banking system last month has been quelled by the government's muscular intervention, including the U.S. Treasury's effective guarantee of all bank depositors, the Federal Reserve's emergency provision of liquidity to the system, and the FDIC's quick resolution of troubled institutions. Deposit outflows appear to have abated, especially at small banks that are the most vulnerable, and inflows into money market funds have normalized. Stock prices for regional banks are down about 40% since before the crisis but have stabilized, and big bank stocks have largely recovered as investors believe they will ultimately benefit from their too-big-to-fail status.

Bank Stock Prices Stabilize



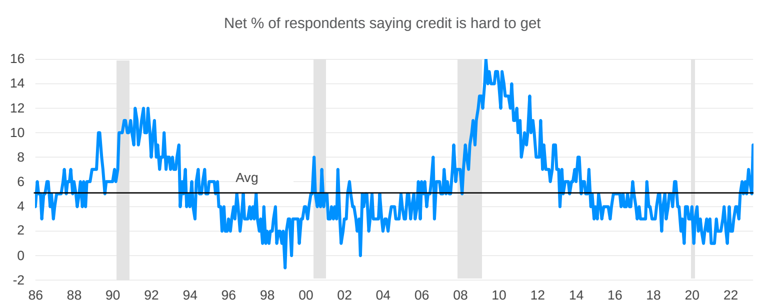
Sources: S&P Dow Jones Indexes, Moody's Analytics

While the crisis appears over, its economic impact has only begun to play out. Chastened banks with constrained liquidity and diminished capital are sure to be much more cautious. Their lending standards, which were already tightening significantly before recent events, will ratchet up substantially.

The tightening will be most pronounced for the always especially risky land and development loans, which are critical for small and midsize homebuilders without the access to capital markets for funding that is available to the big publicly traded builders. Banks will also tighten their commercial real estate mortgage lending, particularly for office buildings that are struggling with the adverse impact of remote work on office absorption. Multifamily developers will also face stiffer standards given the coming surge in supply, rising vacancies, and weaker rents. Outstanding CRE loans, which had been steadily increasingly even at the height of the pandemic, have fallen since mid-March, although this is overstated, since it also reflects the exclusion of loans at Silicon Valley Bank and Signature Bank whose loans are now owned by the FDIC.

Banks are also pulling back on their commercial and industrial lending (loans to businesses). Small businesses, reliant on small and midsize banks for credit, will suffer most. According to a March survey by the small-business trade group the National Federation of Independent Business, the net percent of respondents saying credit is hard to get jumped; in the nearly 40 years of responses, this measure has been meaningfully higher only during the financial crisis. C&I loans outstanding have been falling for the past month.

Small Businesses Say Credit Is Getting Much Harder to Get



Sources: NFIB, Moody's Analytics

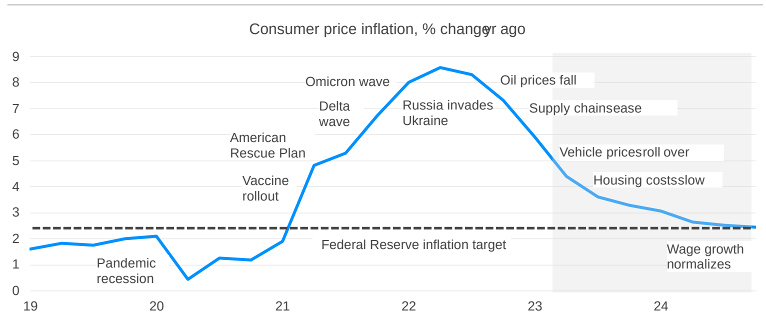
Lending standards for consumer loans, including credit cards, auto loans and personal loans, will be less impacted by the crisis, as much of this lending is done outside of the banking system. Single-family residential mortgage lending standards will not be affected as much either, because the bulk of this lending is directly backstopped by the federal government via Fannie Mae, Freddie Mac, and the Federal Housing Administration. Nonbank mortgage lenders, accounting for the bulk of single-family loan originations, may decide to implement their own underwriting overlays, but to date such moves appear modest.

Tighter underwriting and weakening credit flows will weigh most heavily on construction activity and small-business investment and hiring. Businesses with fewer than 100 employees will be hit hardest, and they account for about one-third of private employment nationwide and one-fourth of gross output. Weaker credit will also be a headwind to consumer spending, albeit less so, and more indirectly through a softer job market and any impact on consumer confidence. Economy-wide, the banking crisis is expected to reduce real GDP growth in 2023 by 0.5 percentage point to near 1%, about half the economy's estimated growth potential.

Inflation on script

Slower sub-potential growth will help further rein in inflation, which looks increasingly on script to return to the Fed's target by mid-2024. More explicit, consumer price inflation, which peaked at 9% on a year-over-year basis in June and has since moderated to 5% in March, is expected to be just over 3% by year-end 2023 and closing in on the Fed's 2.5% implicit CPI target by June 2024. While this remains an uncertain forecast, it seems more likely than it has been since inflation took off when the economy reopened after the pandemic shutdowns.

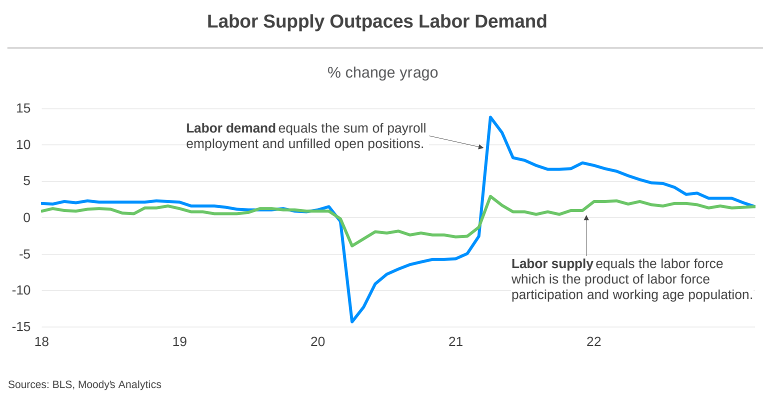
Inflation Is Headed Back to the Fed's Target



Sources: BLS, Moody's Analytics

Most certain is a throttling back of growth in the cost of housing services, which accounts for an outsize more than one-third of the CPI and more than 40% of the core CPI that excludes food and energy prices. Both the homeowners' equivalent rent and rent of shelter CPI measures tie back to market rents with a long lag given that most leases renew annually. Rents surged when the economy reopened and many renter households were forming, but pandemic-related supply-chain and labor supply problems limited new supply. Vacancy rates fell and rents surged. That translated into strong growth in the cost of housing services last year and into this year.

However, in recent months rents have gone flat to down as rental supply has picked up with normalizing supply chains and labor supply. There is a record close to 1 million multifamily units in the construction pipeline that will be completed this year. There is also demand destruction in the rental market, because demand has weakened as rents got too expensive for many potential households, and those households have not formed. The now-weak rents will translate into much slower growth in the cost of housing services through the end of this year.



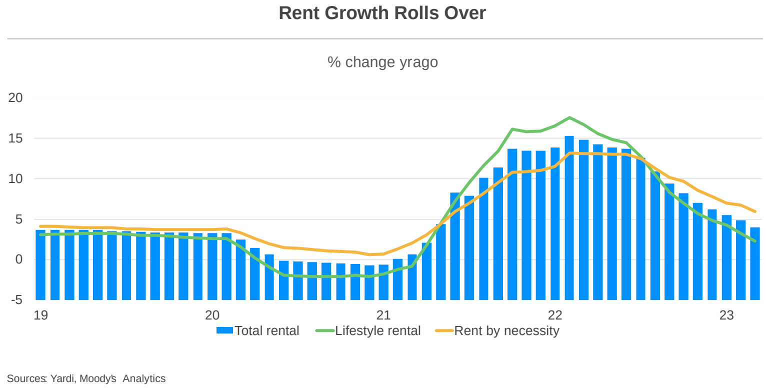
Vehicle prices, which have surged, are also set to fall meaningfully by year's end. Fueling higher prices has been weak global new-vehicle production, particularly in Japan and Germany, because of pandemic-related supply-chain problems. With inventories on dealers' lots depleted, the new-vehicle CPI took off, up almost 20% over the last two years. The used-vehicle CPI has been more volatile and is up by even more, since the limited supply of new vehicles resulted in fewer used vehicles.

But with supply chains finally able to get up and running after China ended its zero-COVID policy earlier this year and global producers adjusting to the disruptions caused by Russia's war with Ukraine, global vehicle production is picking up and inventories are off bottom. It may take a few more months before inventories build sufficiently that competitive pressures kick in and manufacturers and dealers offer bigger incentives and reduced prices, but this is in train.

Supercore rolls over

Most difficult to gauge is the persistence of non-housing and non-energy service price inflation. This so-called supercore inflation reflects the price increases in a range of labor-intensive services such as healthcare, hospitality and personal services. The Federal Reserve is especially focused on supercore, as it most clearly reflects labor costs that monetary policy can impact as higher interest rates ultimately weigh on labor demand.

While supercore inflation remains uncomfortably high, the trend lines are encouraging. First, the Fed's aggressive rate hikes are working to weaken labor demand; businesses are pulling unfilled positions and pulling back on their hiring. Labor demand has fallen below labor supply for the first time since the pandemic shutdowns, and the tight labor market is easing.



Most telling is that wage growth has peaked, and while still too strong to be consistent with the Fed's inflation target, it isn't too far off given underlying labor productivity growth.

Federal Reserve pauses

With inflation headed back to the Fed's target with increasing certainty, the easing job market, and the fragile banking system, the Fed should soon pause its rate hikes. The Treasury bond and federal funds futures markets are even pricing in a significant easing in monetary policy beginning sometime this summer. Indeed, this would be consistent with the dour forecasts of the Fed's own economists. According to the minutes of the March Federal Open Market Committee meeting, Fed staff economists now project a mild recession starting later this year.

The Moody's Analytics outlook is not as bleak, but to skirt a recession the Fed must pivot quickly and end its rate hikes. We expect one more 0.25-percentage point increase in the funds rate, to just over 5%, at the next FOMC meeting in a few weeks. But it would not be surprising if policymakers decided to forgo this rate hike. After all, the economic fallout of the banking crisis is comparable to that of two or three 0.25-percentage point rate hikes by the Fed. And at near 5%, the funds rate is double the estimated 2.5% equilibrium funds rate or so-called r-star—the rate consistent with monetary policy neither supporting nor weighing against the economy's growth. Moreover, the Fed would be wise to put more weight on financial stability when contemplating another rate hike. It took a full government backstop to end the bank runs a few weeks ago. The next earthquake will likely be in the nonbank part of the system, where the Fed has much less sway.

It probably will not kill the economy if the Fed increases rates by another 0.25 percentage point. But why take that risk? The risk of inflation remaining too high appears meaningfully lower than the risk of a recession. The Fed misjudged and waited too long before normalizing interest rates coming out of the pandemic. The result was runaway inflation. It is not fair to be critical of the Fed given the extraordinary uncertainties created by the pandemic and Russian war in Ukraine. However, if policymakers misjudge again and push the economy into recession, that will be on them.