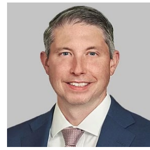
ClearBridge Investments

The Long View: They're Here!



Jeffrey Schulze, CFA
Director, Investment Strategist

"The central empirical finding in dispute is my conclusion that monetary actions affect economic conditions only after a lag that is both long and variable.'"

– Milton Friedman
"The Lag in Effect of Monetary Policy,"
Journal of Political Economy.

Key Takeaways

- Bank failures in March marked the first lagged effect from the Fed's aggressive tightening cycle. Broader risks may materialise later this year as tighter lending standards reduce credit availability, weighing on GDP growth.
- Smaller banks were responsible for 57% of total loan growth last year and are expected to pull back on credit more than their larger peers. This could spill over to their small business customers, who are already facing multiple headwinds to profitability.
- The Fed's reaction function has changed in response to generationally high inflation, and we believe this will manifest as a more muted, later-arriving policy response when a recession emerges. This is a key contributor to our view that a potential recession will be longer and more moderate compared to the "short and shallow" consensus.

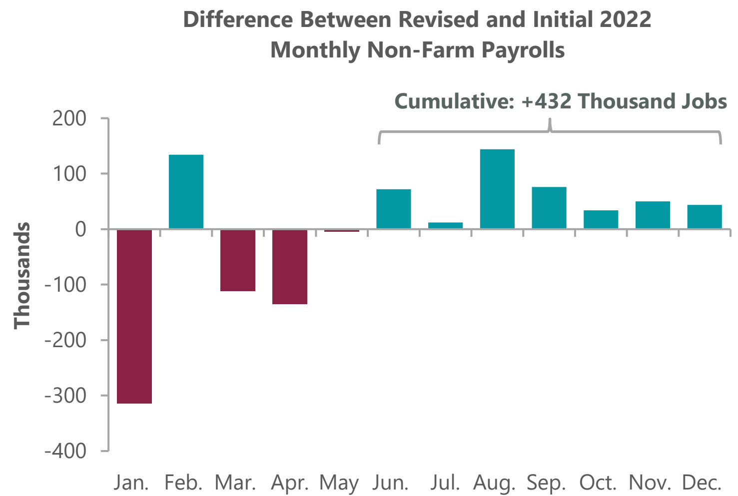
The First Lagged Effects Have Arrived

With the current monetary tightening cycle having recently marked its one-year anniversary, many investors were astonished by the resilience of the U.S. economy in the face of such an aggressive series of rate hikes and quantitative tightening. For example, the labor market added 815,000 jobs in the first two months of the year (408,000 per month), an uptick from the pace of 354,000 per month over the second half of 2022. In fact, annual revisions to employment data made earlier this year showed a cumulative increase of 432,000 jobs in the final seven month of the year, suggesting even less weakening in the labor market than investors perceived entering 2023.

While the labor market is notoriously a lagging indicator, the first signs that monetary policy's infamously long and variable lags may be arriving emerged from the banking sector last month. What began as an isolated, regional bank issue shifted to threatening global systemically important banks (G-SIBs) in a matter of days. While this may conjure bad memories from the

Global Financial Crisis (GFC), the situation today bears little resemblance to that period.

Exhibit 1: Labor Remains Robust



As of 31 March 2023. Sources: BLS, FactSet.

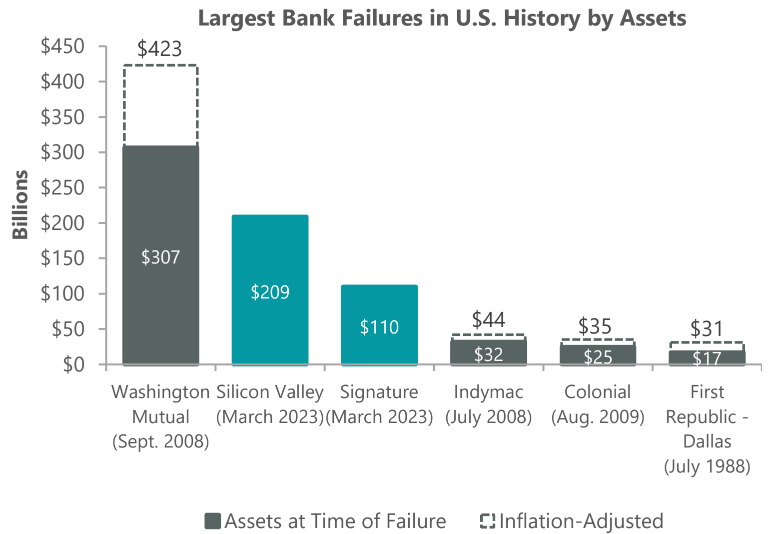
First, the U.S. regional banks which have come under pressure have unique challenges, including high degrees of customer concentration, outsized shares of uninsured deposits, overexposure to industries under strain (Tech/crypto), excessive held-to-maturity assets on their balance sheets and poor management of duration risk on those assets. One or two of these issues are present at many institutions and can be properly managed; the combination of all of them is rare and has proven challenging to those facing them.

Second, the G-SIB that came under the most pressure (Credit Suisse) has faced a series of challenges and scandals in recent years and was considered the weakest of the major European banks. In fact, Credit Suisse was rumored to be nearing failure in the fall of 2022 even though management announced a turnaround plan.

Finally, (and perhaps most importantly), policymakers took swift and efficient action in the face of the brewing crisis in an effort to ringfence the contagion and restore confidence to the banking sector, which ultimately relies on confidence to operate. While it's too soon to declare the crisis over, the steps taken so far appear to be working.

We believe larger impacts from recent stress in the banking sector will materialise later this year as tighter lending standards and wider credit spreads reduce the availability (and raise the cost) of credit, ultimately weighing on GDP growth. This headwind is likely to come at a time when the economy is slowing into a recession, a view driven by an overall red or recessionary signal emanating from the ClearBridge Recession Risk Dashboard. The dashboard is now marking its eighth straight month in red territory, with no changes this month.

Exhibit 2: The Lagged Effects Are Here



As of 31 March 2023. Source: BankRate, BLS and Bloomberg. Assets are rounded to nearest billion.

Exhibit 3: ClearBridge Recession Risk Dashboard

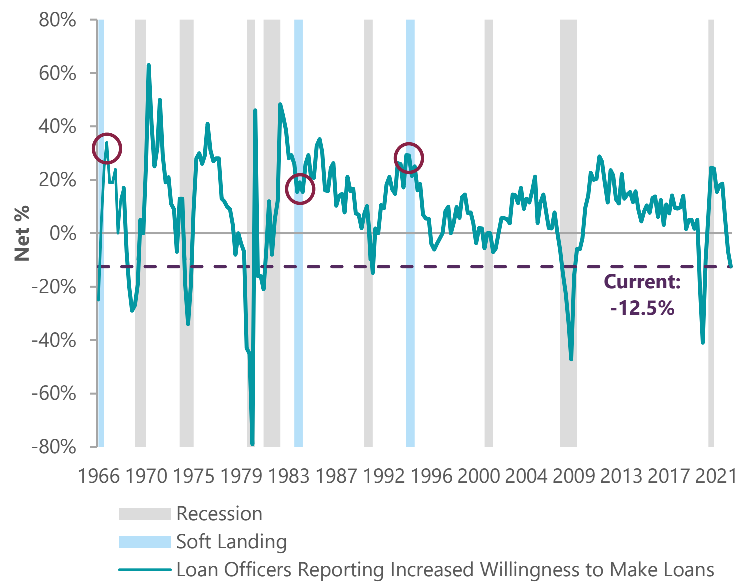
		Current	Rapid Summer Deterioration		
		March 31	August 31	July 31	June 30
Consumer	Housing Permits	Recession	Expansion	Expansion	Expansion
	Job Sentiment	Caution	Expansion	Expansion	Expansion
	Jobless Claims	Expansion	Expansion	Expansion	Expansion
	Retail Sales	Recession	Recession	Recession	Caution
	Wage Growth	Recession	Recession	Recession	Recession
Business Activity	Commodities	Recession	Recession	Recession	Caution
	ISM New Orders	Recession	Caution	Caution	Caution
	Profit Margins	Recession	Expansion	Expansion	Expansion
	Truck Shipments	Expansion	Expansion	Expansion	Expansion
Financial	Credit Spreads	Recession	Recession	Recession	Recession
	Money Supply	Recession	Recession	Caution	Caution
	Yield Curve	Recession	Caution	Caution	Expansion
	Overall Signal	Recession	Recession	Caution	Expansion

Expansion   Caution   Recession

Data as of 31 March 2022. Source: BLS, Federal Reserve, Census Bureau, ISM, BEA, American Chemistry Council, American Trucking Association, Conference Board, and Bloomberg. The ClearBridge Recession Risk Dashboard was created in January 2016. References to the signals it would have sent in the years prior to January 2016 are based on how the underlying data was reflected in the component indicators at the time.

One way to gauge lending standards comes from the Federal Reserve's Senior Loan Officer Opinion Survey (SLOOS) on Bank Lending Practices. Even before recent events, the net percentage of banks tightening standards – increasing spreads, tightening covenants, requiring higher collateralisation, or lowering line sizes – on commercial and industrial (C&I) loans to large- and medium-sized firms was 44.8%, approaching levels consistent with the past four U.S. recessions. On the consumer side, willingness to lend fell to net -12.5%, a level that has presaged prior economic downturns. Importantly, soft landings have historically been accompanied by much more accommodating credit conditions.

Exhibit 4: Lending Standards Retrenching



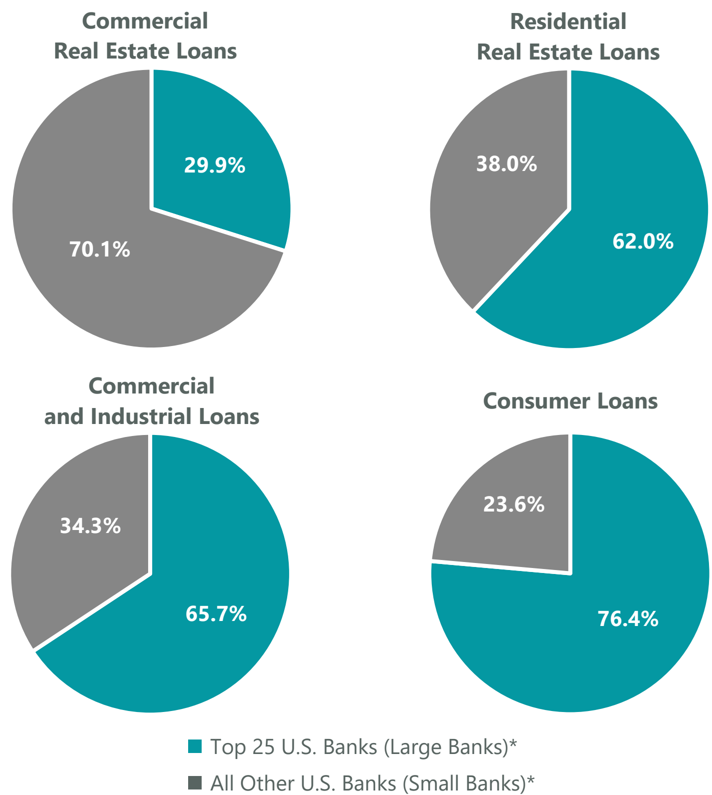
Data as of 31 January 2023, latest available as of 31 March 2023. Sources: Federal Reserve System, FactSet.

The latest SLOOS data *predates* the recent banking sector turmoil, meaning current conditions are likely to be even worse. This is particularly applicable for small and mid-sized banks, which have been under pressure because the FDIC can only take certain actions when a systemic risk is present, which is less likely to be a threat with smaller bank failures. In aggregate, however, smaller banks play a vital role for the U.S. economy. While the top 25 banks account for 70% of total banking assets, the remaining 4,000+ banks punch well above their weight.

Banks outside of the top 25 represent just 30% of total banking sector assets, but account for 34% of C&I loans, 38% of mortgage lending and an astonishing 70% of commercial real estate (CRE) loans. Some of these CRE loans are effectively loans to small businesses secured by property as high-quality collateral. Importantly, small banks are growing their loan books faster than large, accounting for 57% of total loan growth over the last 12 months.

As small bank lending slows, small businesses – those with less than 250 employees – will feel the largest impact. Small businesses are less prone to have relationships with larger banks, and have little to no access to capital markets unlike their larger brethren. As a result, they are more likely to feel the pinch as credit conditions tighten, curbing their ability to grow while weighing on job creation – small businesses account for nearly 90% of the excess job openings since the onset of the pandemic – and the broader economic expansion.

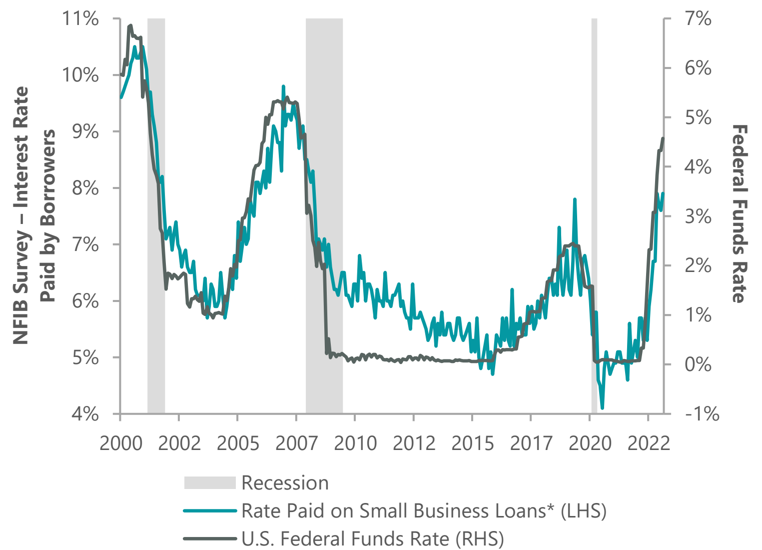
Exhibit 5: Small Banks Pack a Big Punch



*Large banks consist of the top 25 U.S. commercial banks ranked by size of domestic assets – all of which are over $150 billion. Small banks consist of all other U.S. commercial banks with assets under $150 billion. Data as of 24 March 2023, latest available as of 31 March 2023.
Source: Federal Reserve, FactSet.

The difference in access to capital between large and small businesses also highlights how monetary policy acts with variable lags. Large businesses can issue debt in capital markets, often at fixed rates. Since markets are forward looking, the impact from rate hikes (or cuts) can partially be felt even before they happen. By contrast, small businesses primarily borrow from banks at floating short-term rates. As a result, monetary policy impacts are experienced by small businesses only after a rate hike occurs and their borrowing costs adjust. Put differently, monetary policy changes tend to impact large businesses before small.

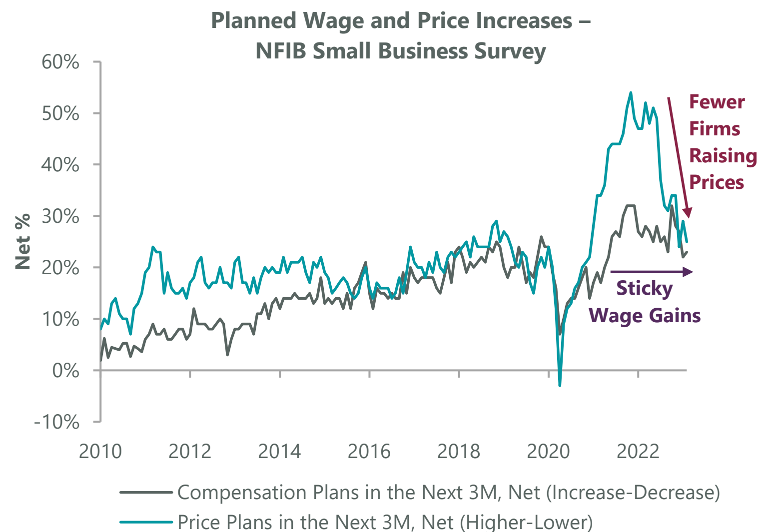
Exhibit 6: Hikes Pressuring Small Businesses



*Actual interest rate paid on short-term loans by borrowers, per NFIB survey. Data as of 28 February 2023, latest available as of 31 March 2023. Source: NFIB, Federal Reserve, FactSet.

This dynamic is important because small businesses are facing multiple headwinds to profitability. In addition to higher rates and tighter lending standards, diminishing pricing power and sticky costs are likely to further erode margins. The NFIB Small Business Economic Trends survey data shows a rapidly declining share of small businesses planning to increase prices in the coming three months, while the percentage planning to raise wages is holding steady. This is a stark reversal from the aftermath of the pandemic, when a larger share of small businesses were raising prices rather than wages, which helped boost margins. We believe the reversal of this dynamic will erode profitability and broaden layoffs in smaller businesses and industries beyond the IT sector later this year.

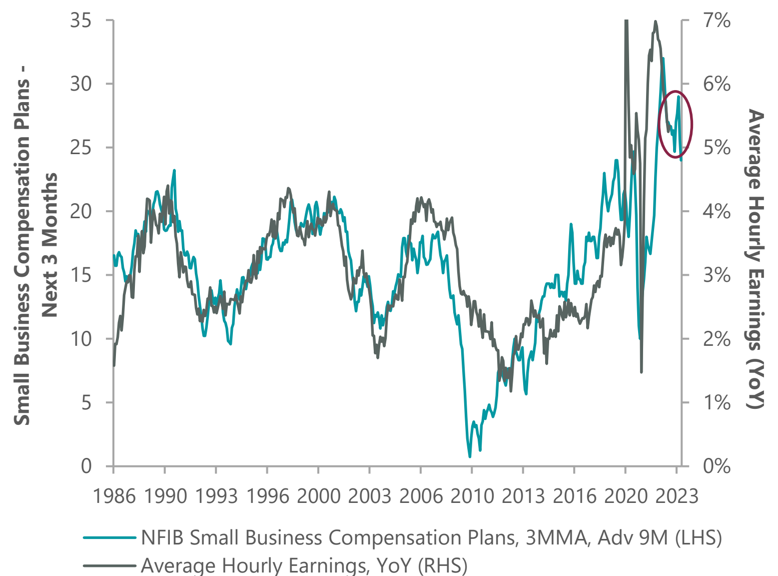
Exhibit 7: Small Business Pain Ahead



Data as of 28 February 2023, latest available as of 31 March 2023. Source: FactSet, NFIB.

An additional nugget that can be gleaned from the NFIB Small Business Economic Trends data regards wages, and in turn inflation. Although wages have been cooling modestly, the share of small businesses planning to raise compensation remains elevated. This data has a strong link to actual wage gains more broadly, suggesting that wages may plateau at elevated levels in 2023.

Exhibit 8: Wages May Remain Sticky



Data as of 28 February 2023, latest available as of 31 March 2023. Sources: BLS, St. Louis Fed, NFIB, FactSet.

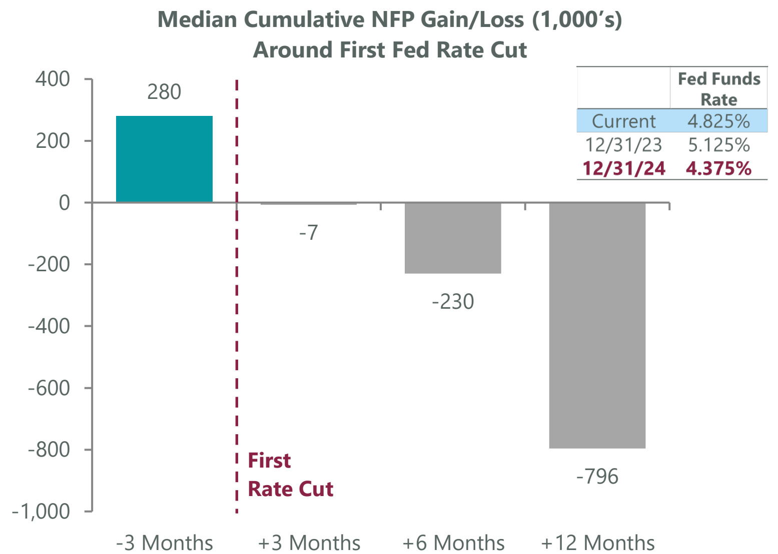
Wage gains are important for equity investors as they will influence the Fed's path in the coming months. Inflation remains the Fed's primary concern, as evidenced by its March decision to forge ahead with a 25 bps rate hike before it could determine if the banking panic had subsided and the threat to financial stability receded. While history suggests the Fed would respond by cutting rates, its reaction function has changed in response to generationally high inflation.

We do not believe the market fully appreciates this shift, as approximately 50 bps of rate cuts are priced into Fed fund futures by year-end, something resembling the playbook from past cycles. Conversely, the Fed dot plot and public comments suggest a prolonged pause following one additional hike. While the last two to three quarters have favored the Fed when its views diverged from the market, the last few weeks have shown that anything is possible.

The Fed's actions in recent months only reinforce the change in its reaction function, in our view. Typically, the Fed initiates an initial rate cut in anticipation of future job losses, with the layoff cycle gathering steam and historically witnessing an average decline of 796,000 jobs in the year following the first cut. By contrast, the Fed dot plot implies the unemployment rate will increase by 0.9% at year-end, equivalent to 1.5 million job losses in less than 12 months.

We have long believed that this change in the reaction function stems from the hard lessons learned in 1967, when the Fed cut rates prematurely in the face of a slowing economy and, crucially, a tight labor market. While this bears some resemblance to the current environment, what happened next is most important. The early rate cuts paved the way for structurally higher inflation in the subsequent decade, an outcome the Fed would like to avoid.

Exhibit 9: The Fed Has Little Tolerance For Job Loss

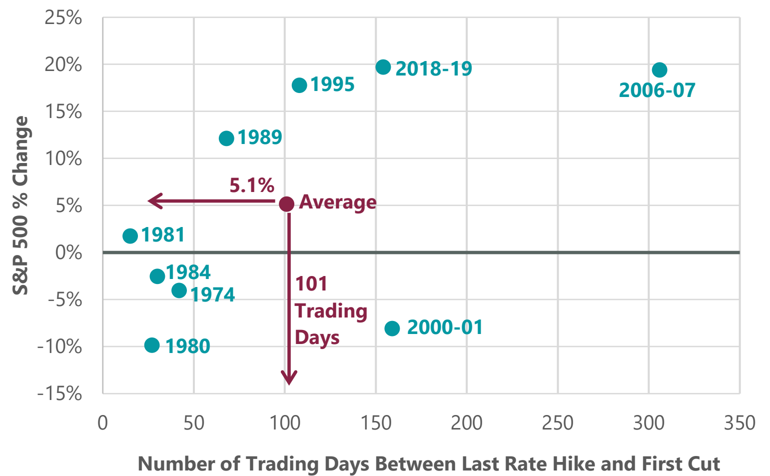


Data as of 31 March 2023. Source: FactSet, BLS.

If a recession is avoided this year, we expect the effects of this shift will materialise as a later and more muted monetary policy response. Fiscal support is also likely to be more targeted after being blamed for the flare-up in inflation. A limited and slower-arriving policy response is a key driver of our view that a potential recession will be longer and more "moderate" compared to consensus expectations for a shorter and shallower recession.

While the banking system flare-up appears to be idiosyncratic, one of its primary contributors was the Fed's aggressive hiking cycle. This may represent the first of several lagged effects to arrive, solidifying our view that recession is on the horizon – an opinion we have held for three quarters. While the timing of the recession is unknowable, a near-term market rally wouldn't surprise us.

Exhibit 10: The Final Hurrah



Source: FactSet, Federal Reserve, S&P.

The S&P 500 Index has rallied by 5% on average (and, on four occasions, more than double that) in the period between the final rate hike and the first rate cut. While this initial cut may take longer to materialise, some investors believe the final hike has already occurred, meaning we could already be in the period supportive of equities. With elevated volatility likely to continue, we believe long-term investors would be best served by using recent and ongoing strength to shift into higher quality and more defensive positioning.

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