Summary

Financial news was dominated by concerns over the viability of several U.S. banks, wavering between fear and relief during the week. Economic data included declines in retail sales and consumer sentiment, while housing starts gained sharply. A variety of other data, which included industrial production and regional manufacturing indexes, were mixed.

Equities fell back globally last week, along with concerns over banking system health and economic side effects prompted investors to move away from risk. Bonds benefitted from these flows, as interest rates fell sharply. Commodities were largely also down due to rising fears of recession.

Economic Notes

(0) **Retail sales** in February declined by -0.4%, matching consensus expectations, but reversing a gain the prior month; however, it did include a prior month revision higher. The headline number reflected a -0.6% drop in gas station sales, which follows pricing. Core/control sales, which removes autos, gasoline, and building materials, actually registered a 0.5% gain, compared to an expected decline. Other industry details included strength in non-store/online retail, health/personal care, and general merchandise, while furniture/home furnishings, and clothing all fell back, as did food/drinking places (which had fared well in Jan.). Seasonal adjustments and a warmer-than-normal January seemed to be a bit of an anomaly, resulting in normalization for Feb., with year-over-year sales coming in above 5%. Unfortunately, that's just below the pace of inflation, which means 'real' retail spending is in the negative.

(-/0) **Industrial production** was unchanged in Feb., falling short of the 0.2% increase expected. Manufacturing production rose a tenth, contrary to expectations, while utilities production rose 0.5% (largely dependent on weather/heating needs). On the other hand, mining production (including oil/gas extraction) falling -0.6% brought down the total figure, along with a drop in auto production for the month. **Capacity utilization** was flat at 78.0%.

(-) The **Empire manufacturing index** fell by -18.8 points to a further contractionary -24.6 in March; this was contrary to expectations of a far smaller drop to -7.9. Under the hood, new orders, shipments, and employment all fell by several points to more contractionary levels. Prices paid fell back by -3 to a still-high level of 42. Expectations for business conditions six months out fell by nearly -12 points to a still-positive 3.

(-) The **Philadelphia Fed manufacturing index** for March, on the other hand, rose by 1.1 points to a still very contractionary -23.2, well below the expected improvement to -15.0. Individual results were weak here, too, with new orders, shipments, and employment all down by -15 to -35 points and moving either further or newly into contraction. Prices paid fell by -3 points but remained at an expansionary 24 level—albeit the lowest reading since Aug. 2020. Assessments of business conditions six months out also fell by nearly -10 points back onto contraction at -8.

(+) The **Producer Price Index** for February fell by -0.1% on a headline level, and was unchanged when removing food and energy prices. These readings were well below expectations of 0.3-0.4% gains, and reflected drops in food and trade costs. On a year-over-year basis, the PPI rate fell from 5.7% to 4.6%—high, but seeing continued normalization lower. PPI has been steadily falling back from the high of 11.7% in March 2022. Price gains for goods remain above those of services, but also represent the segment decelerating to the greatest degree by a variety of measures.

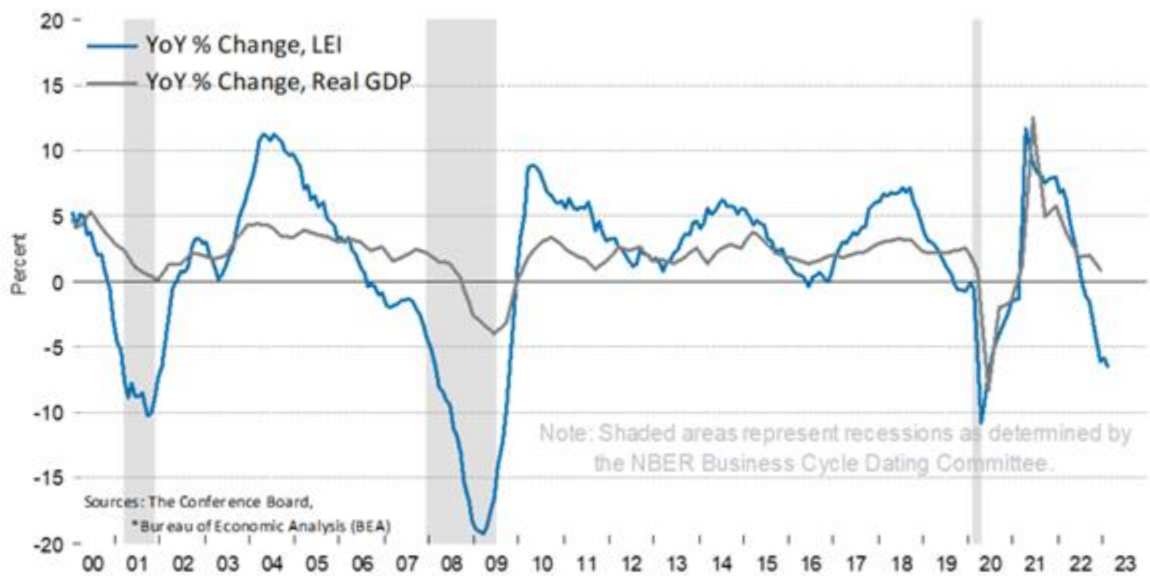
(0) The **Consumer Price Index** for February rose 0.4% on a headline level and 0.5% for core, removing food and energy. Energy prices down -0.6% helped to ease headline pressures, while food prices continued to tick higher at a 0.4% rate. For the single month, shelter continued its strength, up 0.7-0.8%, as home price flattening and rental declines seen in other data have yet to make their way into CPI. Other gainers included personal care, car insurance, apparel, and airfares; decliners included used cars and medical services.

Year-over-year, CPI decelerated to 6.0% and 5.5% on a headline and core basis, respectively. The headline drop was down nearly a half-percent from the prior month, which represented progress. Energy prices remain up 5% on the year, which contributed to persistent prices in a variety of sub-groups, while food prices being 10% higher continue to pressure consumers in a more visible way. Shelter was up 8% as well, with recent declines in home prices and rent remaining sticky, based on methods and timing of measurement. There are other more extreme figures filtering their way through, such as transportation services up 15% for the year, while used cars are down -14%.

(+) **Housing starts** in February rose 9.8% to a seasonally-adjusted annualized rate of 1.450k, far stronger than the expected insignificant 0.1% gain. Single-family starts rose 1%, but the month dominated led by a 24% rise in multi-family. Regionally, a decline in the Northeast (likely weather-based) was offset by a 70% rise in the Midwest. However, over the last 12 months, overall starts remain down -18%, which includes a gain in multi-family offsetting single-family starts down -35%. **Building permits** rose 13.8% in the month to seasonally-adjusted annualized rate of 1.524k, well above the 0.3% expected gain (and the largest single-month gain in two years). Single-family rose 8% and multi-family were up 21%, with the single-family rate still undersupplied (below 800k) relative to need. In both segments, multi-family continued to run at a robust rate, in fact a 50-year high, but also represents risks for that sector due to high volumes and rising financing costs—it's a segment prone to periodic booms and busts.

(-) The preliminary **Univ. of Michigan index of consumer sentiment** for March fell by -3.6 points to 63.4, below expectations of a flat 67.0 level reading. Assessments of both current conditions and future expectations fell by several points, contributing to the overall number, and, per the surveyors, answers had already come in before the Silicon Valley Bank news. Inflation expectations for the coming year declined by -0.3% to 3.8%, while those for the next 5-10 years fell by -0.1% to 2.8% (the slowest pace in a year and a half). Both of these represent good news for the Fed, which closely tracks long-term inflation expectations as a gauge of how far an inflationary 'mindset' has permeated the economy.

(-) The Conference Board's **Index of Leading Economic Indicators** for February fell by -0.3%, echoing the decline for January, and represented the 11th straight negative month. Eight of the ten indicators were flat to negative for the month, with the sole positive data points being the stock market (now since reversed) and building permits. Over the 6-month period ending in Feb., the index is down -3.6%, showing further deterioration compared to the -3.0% drop over the prior 6-mo. stretch ended Aug. 2022. Since the index is comprised of data we already know, the pattern of the combined series is what matters. The total index year-over-year change has fallen below -5%, which has only been surpassed in the last 20 years in 2001, 2008-09, and 2020—all of which represented recessions during the period (as seen in the second chart below). Per the Conference Board, the overall reading unsurprisingly continues to point to an upcoming U.S. recession. The stress in the banking sector started in March, so wasn't reflected in the recent release, but will be in the next report.



(+) **Initial jobless claims** for the Mar. 11 ending week fell by -20k to 192k, below the 205k median forecast. Continuing claims for the Mar. 4 week declined by -29k to 1.684 mil., below the 1.732 mil. expected. By state, initial claims rose in OH and IN, while CA and TX saw the most significant drops. Seasonality issues continue to play a role here, which may improve in coming weeks as old pandemic effects roll off. Regardless, claims continue to stay low and are certainly not deteriorating.

Question of the Week

Where do we stand with the banking system woes?

Following the targeted depositor guarantees and new liquidity facilities aimed at Silicon Valley Bank and others over the prior weekend, financial markets swayed back-and-forth by the day last week as new information was absorbed and risks assessed. The next target of uncertainty was First Republic Bank, which has a long-term reputation of quality management and a loyal client base, but also a high ratio of uninsured deposits (due to its wealthier clientele). It ended up being bolstered by an injection of $30 bil. in deposits from several of the largest U.S. banks, coordinated by the Federal Reserve and U.S. Treasury. This is in conjunction with an ongoing bridge facility, Bank Term Funding Program (BTFP), the U.S. government created to assist in near-term management of bank asset-liability maturity mismatches. It is assumed this facility should be able to absorb much of the current bank industry stress caused by that single problem.

At this point, the consensus is that several smaller or niche regional banks had taken undue balance sheet risks or were overly concentrated in certain sectors, with the general opinion that the mega-banks or industry overall don't appear to be damaged from a structural level. The U.S. and European banking sectors in particular have been described as being in their strongest financial positions since before the 2008 global financial crisis, with stronger capital requirements, ample reserves, and profitability.

But confidence remains a key yet fragile component of the banking system, and pressures on institutions persist. While 2008 remains top of mind due to its recency, there have been other banking 'speed bumps' over the decades which did not topple the entire economy (S&L crisis, for example), although some banks needed bolstering or rescue. The pressures include the impact of the inverted yield curve, due to a period of interest rates rising quickly and significantly (4.5% in 12 months), as well as likely slowing availability of credit going forward, which may weigh on the economy and further tighten financial conditions. This helps by doing part of the Fed's job, accomplishing the same tightening function, although via a different channel. Fed funds probabilities still show the chances of a 0.25% hike this week at about two-thirds, with a one-third chance of a pause, with probabilities wavering by the day last week. To some degree, the ECB's 0.50% move higher last week seemed to reinforce an inflation-fighting mindset as opposed to a pause to stem bank risks. Central banks might like to keep the inflation-fighting function separate from the bank oversight function, allowing for both to be done at the same time, which explains use of targeted vehicles like the liquidity facility and deposit injections.

Adding to discussion about the U.S. regional bank sector last week came new worries over European bank Credit Suisse. However, this was deemed to be a bit coincidental or, at most, related to general contagion risks carrying over to the perceived weakest banks. There, longer-term concerns about profitability of trading and investment banking arms were coupled with concerns over a delay in release of financial reporting due to a 'material weakness' in accounting controls (obviously not inspiring confidence). This was capped off with the refusal of a large Saudi owner to provide additional capital (possibly due to already being the largest shareholder). The timing for world markets was unfortunate, but this wasn't a new development, as CS has been under scrutiny over much of the past year for a variety of bank-specific performance and risk reasons. The Swiss National Bank provided a $50 bil. lifeline, which appeared to calm markets. However, over the weekend, this appeared to be smoothed over further by CS' takeover by Swiss rival UBS, at a fairly low price, coordinated by the Swiss government.

Stress on the banking sector has been common at the end of Fed tightening cycles, notably in 1972, 1984, and 1990. So, the current situation is not really that unusual. The most often-quoted causes of bank failure fall into two categories: (1) problems with credit, as in poor loan quality and rising defaults, sometimes from lax underwriting (which don't appear to be happening at this point); and (2) problems with liquidity, which also appear manageable with most banks, although mismatches in duration between assets and liabilities has caused issues and is now being looked at far more closely. This second issue is what regulators are keyed in on this time, being the reason for the new BTFP liquidity facility, which lets banks take 'advances' on the par value of treasury and agency MBS bond holdings set to mature far in the future, but are currently priced at unrealized losses. (That's why it might not truly be a 'bailout', but more of an 'extension'.)

What are other ramifications? The biggest is that when bank stresses occur, lending has tended to slow down and underwriting becomes more conservative. This reduces credit availability throughout the economy, which slows spending, capital investment, and trade—eventually pulling down economic growth. The latter is what raises recession risks, and the tightening effect is what the Fed claims to want (but we assume without the drama). Some estimates put a potential lending drag on the U.S. and European economies at somewhere between -0.25% to -0.75%, with a lot of room for error. This doesn't seem catastrophic, but when GDP estimates are already fairly low, it can make a decent dent.

Will there be changes in bank regulation? Possibly, but not likely in the near term. This is a deeper issue, as, based on the perspective of the viewer and administration in charge, bank regulation has perpetually been seen as either too tight or too loose. Overly tight and expensive regulations have resulted in complaints from the banking industry, which can lead to relaxation, but going too far in the laissez-faire direction can end with excessive risk taking, then a crisis, investigations, and then more new regulations yet again. These have been difficult to get 'just right' in a cost-effective way that makes everyone happy. Just as the 2008 crisis was partially blamed on the 1999 repeals of some parts of the Glass-Steagall legislation in existence since the early 1930s, the current stress is partially being blamed on the 2018 loosening of some 2010 Dodd-Frank regulations for smaller banks. (There is an ironic twist in that one of the original bill's sponsors, former Rep. Barney Frank (D-MA), was on the failed Signature Bank board of directors for nearly a decade.) However, there is a more urgent call for review of FDIC insurance limits, which could be raised on temporary basis, or continue to be broadened in a targeted way, such as with SVB. A widespread upward change in FDIC insurance coverage across the board from $250k would require Congressional approval. But what is the perfect level?

There could be other side effects from this, such as increased awareness of customers about bank deposit sizes vs. FDIC insurance limits, diversifying banking relationships, looking at bank ratings and asset quality, etc., as opposed to taking bank stability for granted. In the near-term, at least, this could result in more deposits flowing away from smaller community/regional banks and towards the considered too-big-to-fail supernational banks (JPMorgan, Citi, Bank of America, Wells Fargo). To compete, smaller banks would need to offer higher rates and/or enhance services, which could challenge profitability. Their cost of capital could rise anyway, due to the perception that they're riskier than larger banks.

This type of reaction happens after every crisis, but people eventually become complacent and forgetful, so the extra attention may or may not last for an extended period of time. Then again, there could always be a few more troubled banks surfacing before this is all over, so it could be too early to say the stress event is over. But, global central banks appear to be quicker to react in providing backstops than the were in 2008, which could isolate problems before they spread further.

Market Notes

Period ending 3/17/2023	**1 Week %**	**YTD %**
DJIA	-0.11	-3.35
S&P 500	1.47	2.41
NASDAQ	4.44	11.36
Russell 2000	-2.57	-1.70
MSCI-EAFE	-3.13	2.64
MSCI-EM	-0.28	-0.25
Bloomberg U.S. Aggregate	1.43	2.90

U.S. Treasury Yields	**3 Mo.**	**2 Yr.**	**5 Yr.**	**10 Yr.**	**30 Yr.**
12/31/2022	4.42	4.41	3.99	3.88	3.97
3/10/2023	5.01	4.60	3.96	3.70	3.70
3/17/2023	4.52	3.81	3.44	3.39	3.60

U.S. stocks began the week on a sour note, with initial cheers over the SVB fix followed by concerns over wider bank balance sheet problems caused by the inverted yield curve (spreading to First Republic Bank, before a liquidity solution was found). Market sentiment moved back and forth by the day with concerns over other potential banks with similar issues, including systematically important European bank Credit Suisse. Debate continues over the possible path for the Fed this week—with odds continuing to waver between no move and a 0.25% hike, a 0.50% no longer in the running, and odds again rising for a rate cut by later 2023.

By sector, ‘growth’ stocks led the way with gains in communications, technology, and consumer discretionary. This is a group expected to benefit from lower interest rates, as well as is considered a bit of a buffer during slow growth periods, as well as just ‘not being’ financials. The more economically-sensitive ‘value’ group fell back, notably in energy, financials, and materials. Specifically, the regional bank segment (which is the group below the mega-cap money center banks) fell by upwards of -20% to -25%, depending on the index used.

This was lost in the focus on banking, but at the end of last week, the S&P 500’s index composition adjusted a bit, as happens every so often. In this case, ‘Data Processing & Outsourced Services’ (part of Technology) is being moved to Financials under the sub-group ‘Transaction & Payment Processing Services’. This affects eight companies, but most of the market cap is represented by Visa, Mastercard, PayPal, and Fiserv. While the size of Technology in the S&P will drop from about 27% to 24%, the size of Financials increases from around 12% to 14%. In other moves, a few human capital and payroll processing stocks are being moved from Technology to Industrials; and Target, Dollar General, and Dollar Tree are moving from Consumer Discretionary to Consumer Staples. The latter two moves don’t result in meaningful weighting changes, but reflect reassessments of company revenue drivers.

Foreign stocks fell back last week to a further degree than in the U.S. These were related to U.S. banking stress, but also local institution Credit Suisse, although not as large in market cap at this point, but remains an important counterparty for derivatives transactions. The ECB raised the key interest rate by 0.50% to 3.00%, on track with their own projections, but surprising some that assumed global banking concerns and recent liquidity aid to Credit Suisse might be a call for a slower pace or pause. Markets actually cheered the move, as it implied conditions in banking were contained and not prone to spread elsewhere through the financial system. Despite high inflation pressures in Europe, expectations for future rate hikes, though, have been trimmed a bit to just a few more quarter-percent moves to a terminal rate of around 3.50%—below that of the U.S. by at least a percent.

Bonds gained a decent amount of ground last week, as interest rates fell back sharply. This was in response to banking industry issues, which raised recession risks, and chances of the Fed getting to a lower terminal rate than expected just a week ago. Longer-maturity treasuries led the way, as they often do as investors seek a safe haven, although investment-grade corporates also performed positively, but less so as credit spreads widened. Senior bank loans lost ground for the week. Foreign developed market bonds gained, helped by a weaker dollar, with negative emerging market debt results. General patterns here were typical for such a week.

Commodities were mixed, with precious metals gaining over 6%, buoyed by a typical flight to safety move, while energy fell back sharply. Crude oil prices declined -13% last week to just under $67/barrel, with concerns over banking woes ultimately constraining credit, contributing to a possible recession in key markets, which depresses energy demand.

Have a good week.

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Sources: FocusPoint Solutions, American Association for Individual Investors (AAII), Associated Press, Barclays Capital, Bloomberg, Citigroup, Deutsche Bank, FactSet, Financial Times, First Trust, Goldman Sachs, Invesco, JPMorgan Asset Management, Marketfield Asset Management, Morgan Stanley, MSCI, Morningstar, Northern Trust, PIMCO, Standard & Poor's, StockCharts.com, The Conference Board, Thomson Reuters, T. Rowe Price, Univ. of Michigan, U.S. Bureau of Economic Analysis, U.S. Federal Reserve, Wall Street Journal, The Washington Post. Index performance is shown as total return, which includes dividends. Performance for the MSCI-EAFE and MSCI-EM indexes is quoted in U.S. Dollar investor terms.

Notes key: (+) positive/encouraging development, (0) neutral/inconclusive/no net effect, (-) negative/discouraging development.