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## Is the US economy bending, breaking or broken?

The US economy is proving resilient, but we continue to expect rapid monetary tightening to trigger a recession later this year. Recent banking turmoil will lead to tighter credit conditions, adding to headwinds. Although we don't expect a systemic financial crisis, we highlight key waymarks to monitor the risk of a more acute credit crisis.

### Key Takeaways

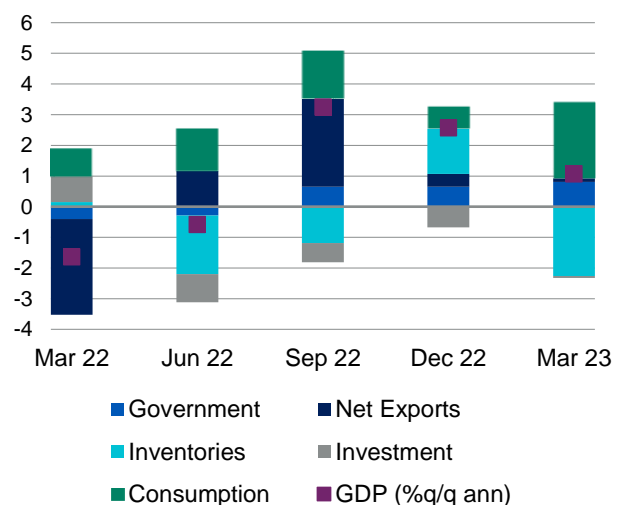
- US GDP growth slowed below trend in the first quarter of 2023. But when volatile inventories are removed, underlying growth actually picked up. Timely data for Q2 has been mixed, but ongoing consumer resilience warrants watching.
- However, our models still point to elevated recession risk, and a recession beginning later this year remains our base case. Stresses in the banking sector mean that credit conditions are likely to continue to tighten, consistent with the Fed killing the cycle.
- Given that we think a recession is necessary to restore price stability, recent economic strength increases the risk of a more persistent inflation overshoot. This would see the Fed tightening even further, as in our "Fed has two bites of the cherry" alternative scenario.
- A systemic financial crisis on the scale of 2008 remains unlikely, but is another source of downside risk. Key indicators to monitor the risk of a credit crunch include unrealised losses in the banking sector; the flow of deposits to money market funds; bank earnings data; and use of the Fed's liquidity provisions.
- These indicators suggest that the banking sector as a whole remains under stress, with some institutions in particular looking especially vulnerable. While there will be negative economic spillovers, the Fed seems to have the tools to contain systemic risk.

### Strong underlying US growth in Q1

Q1 GDP growth came out slower than expected at 1.1% quarter over quarter annualised, versus the 1.9% expected. However, the miss was largely due to a drag from inventories and when these are removed the economy actually grew at a faster pace of 3.4% q/q annualised.

Indeed, the core growth driver of the US economy – consumption – actually rebounded. Durable goods demand contributed 1.3ppt to GDP and services demand was also robust (see Figure 1).

Figure 1: Inventory drag masks robust consumption



Source: Haver, abrdrn (April 2023)

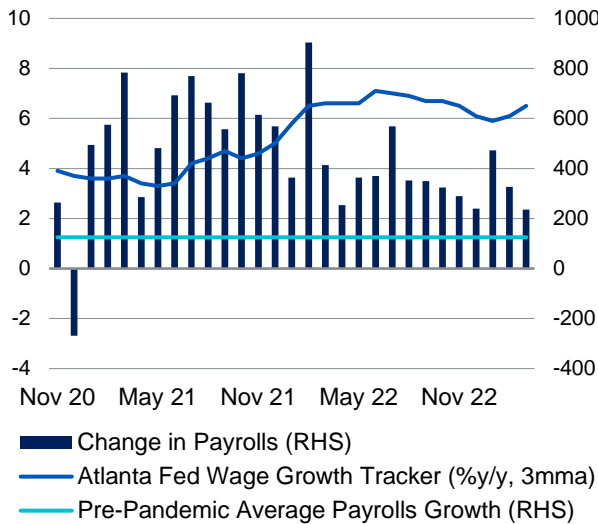


**Near-term economic resilience may be adding to inflation pressures**

On top of the solid GDP report, there have been other recent signs of economic resilience.

Although employment growth has been slowing, it is still well above average and the labour market remains tight. Concerningly, this tightness is now manifesting in a tick back up in composition-adjusted wage growth (see Figure 2).

**Figure 2: Jobs growth still above average and wage growth pushing higher again**



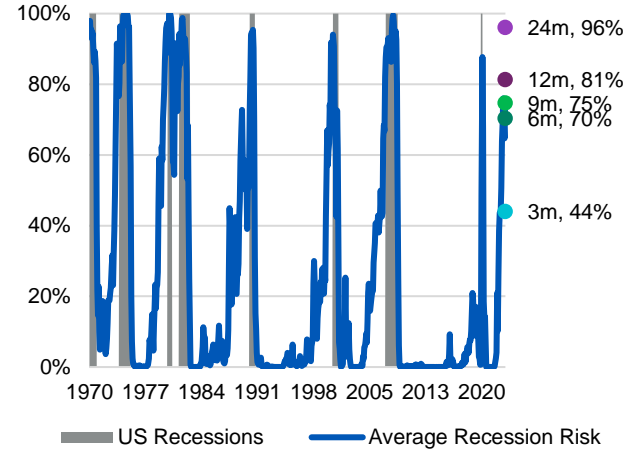
Source: BLS, Atlanta Fed, Haver, abrdrn (April 2023)

Additionally, the April Markit PMIs came in stronger than expected. Contrasting with the weakness in the recent regional Fed manufacturing surveys, the national manufacturing survey moved back into expansionary territory. Meanwhile, the improvement in the services sector goes some way to closing the wide gap that has been evident between the Markit and ISM measures of services activity.

**Recession remains our base case**

Despite this apparent resilience, our recession models suggest that risks of recession remain elevated. At the three-month horizon, recession risks are sitting just below 50%, and at the six- to nine-month horizon the risk increases to 70% (see Figure 3).

**Figure 3: Recession risk still elevated on our models**



Source: Bloomberg, Haver, abrdrn (April 2023)

The latest Conference Board data suggest consumer expectations remain at recessionary levels. Moreover, debt servicing costs for households have been flashing red for some time.

Finally, the yield curve, which has been inverted since last summer, began to normalise through March. Typically the yield curve inverts 12-14 months ahead of a recession, but the curve then re-steepens just before a recession occurs. This is because investors begin to price rate cuts from the Fed in response to the recession.

All of this is consistent with our forecast for the US to enter into a recession in the second half of this year.

However, should recent resilience persist, the labour market remain tight, and wage pressures stay elevated, then the Fed would need to tighten policy further. We think that a recession is necessary to restore price stability. So the question is really one of the timing of the recession and relatedly how far rates will ultimately increase before the economy enters a downturn.

Put another way, data resilience, rather than raising the probability of a soft landing, may instead be pointing to a slightly higher probability of our “Fed has two bites of the cherry” alternative scenario. This scenario still involves a recession, but later and with more Fed rate hikes along the way.

**But an even worse outcome would be a credit crunch**

Against this near-term economic resilience, the ongoing stresses in the banking system are an important source of downside risk. While we continue to think a systemic banking crisis of the severity of 2008 remains unlikely, the troubles at First Republic are a reminder that crises often come in waves.

And failures that seem to reflect idiosyncratic issues at specific institutions can quickly morph into system-wide problems.



So there is only so much comfort one can take from the fact that we seem to have moved past the most acute phase of the banking sector turmoil.

Either way, a significant tightening in credit conditions is likely to follow. Banks are facing pressure on both the liability and asset sides of their balance sheets. Regional banks in particular seem to be very exposed to the sudden shift in confidence. Net interest margins are likely to come under pressure, and credit facilities will be withdrawn. In a sense, this is exactly what the Fed tightening monetary policy was meant to achieve, albeit perhaps in a rather more orderly fashion.

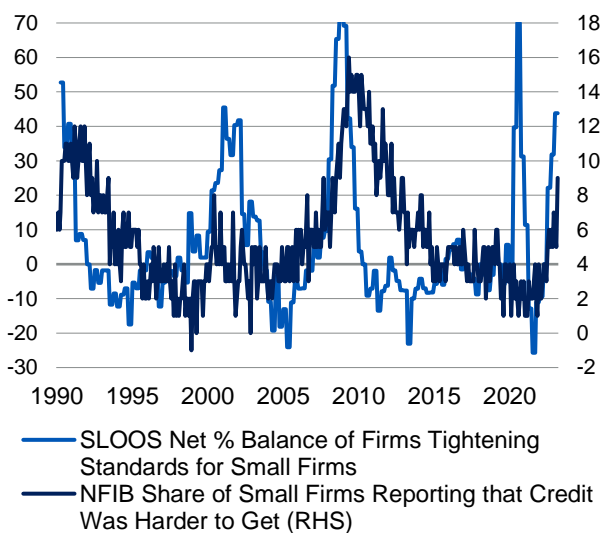
We discuss below the key indicators to track both in terms of how this credit tightening is evolving, and the risks of a more severe crisis.

### Credit conditions are likely to tighten further

Even before the recent turmoil, the Fed’s Senior Loan Officers Opinion Survey (SLOOS) had begun to show that banks were tightening lending standards and demand for commercial and investment loans was softening.

The next data release for this quarterly series – which will include the period of banking stress and its aftermath – will be in early May. In the meantime, the latest NFIB survey showed that the percentage of firms reporting that credit was harder to obtain increased to 9% in March, suggesting a further deterioration in the SLOOS data (see Figure 4). This series peaked at 15% in the global financial crisis, so we are not yet at “credit crunch” levels of stress.

**Figure 4: Credit conditions were already tightening and look set to tighten further**



Source: Federal Reserve, NFIB, Haver, abrdn (April 2023)

The Fed’s Beige Book, which is a qualitative summary of economic conditions across the 12 Fed districts, also signals that consumer and business lending volumes and loan demand are declining. Banks noted tighter lending

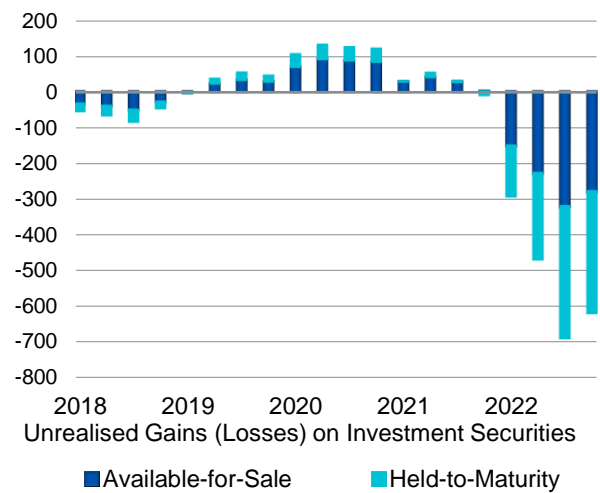
standards given macroeconomic uncertainty and liquidity concerns.

### Banks are heavily exposed to interest rate risk

Given the sharp increase in interest rates over the last year, many banks are sitting on large unrealised losses on investment securities which have substantial duration exposure.

The latest data from the Federal Deposit Insurance Corporation (FDIC) suggest that in Q4 2022 unrealised losses in the banking system stood at around \$620bn (see Figure 5). Typically, these assets will be held to maturity, at which point they move to par, so losses aren’t usually realised.

**Figure 5: Banks’ unrealised losses sat at \$620bn at the end of 2022**



Source: FDIC, abrdn (April 2023)

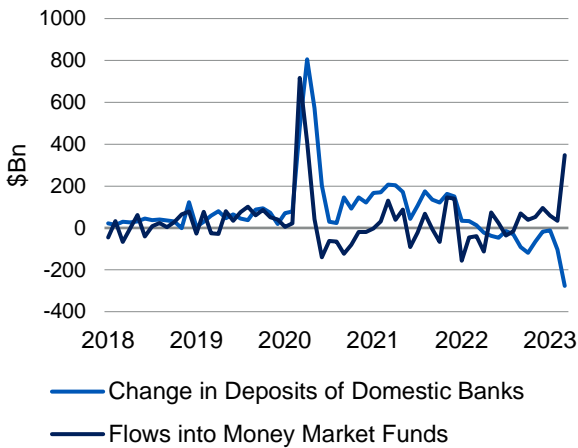
However, issues arise when liquidity is low and banks are forced to sell securities and realise losses. This can be particularly damaging if confidence is already compromised, as was the case with Silicon Valley Bank (SVB). The size of losses within the system means that other banks could be vulnerable to the same dynamics if depositors get spooked.

### Banks also face pressure on the liability side

Competition for deposits has increased both among banks and with money market funds, as depositors have “woken up” to the possibility of receiving higher rates elsewhere and the counterparty risk of their own bank.



**Figure 6: Capital has flowed from banks to money market funds**

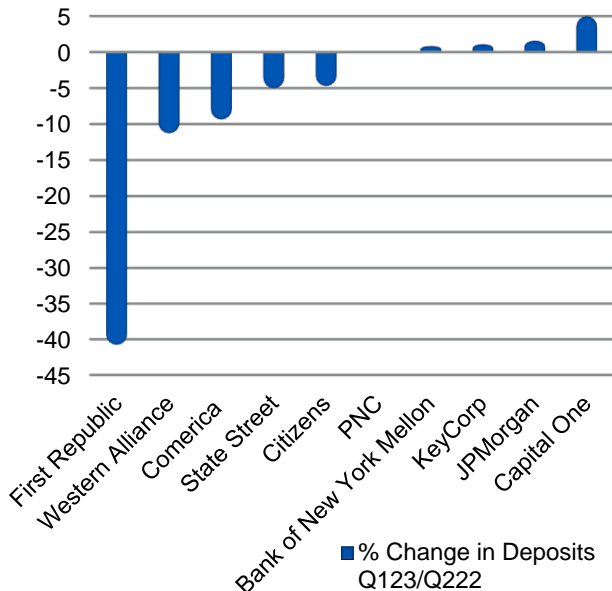


Source: Federal Reserve Board, Bloomberg, Haver, abrdrn (April 2023)

Deposits at domestic US banks declined by around \$270bn in the first few months of this year, with over \$340bn flowing into money market funds (see Figure 6).

This outflow of deposits is not equally distributed, with larger banks like JP Morgan seeing deposits increase in the wake of the turmoil while others have seen significant deposit outflows (see Figure 7).

**Figure 7: Deposit losses have been highly concentrated in certain regional banks**



Source: Bloomberg, abrdrn (April 2023)

**Authors**

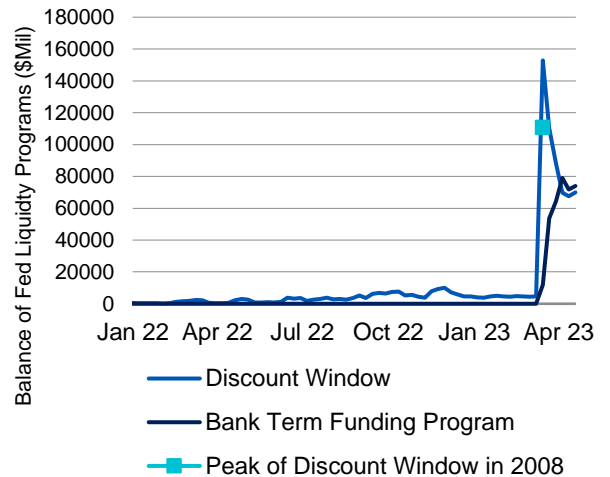
Abigail Watt, Luke Bartholomew, and Paul Diggle

First Republic, which recently failed, saw deposits down over 40% in Q1; the bank's deposit outflows were much more significant than those of other regional banks over that period. But this fourth banking failure leaves regional banking stocks vulnerable to volatility.

We continue think that the Fed has the tools to provide sufficient liquidity to the banking sector, meaning that a broader banking crisis and credit crunch can be avoided.

The latest data from the Fed suggest that banks are continuing to use these facilities. Balances in the Discount Window and Bank Term Funding Program increased to \$69.9bn and \$73.9bn respectively in the week to 19 April (see Figure 8). This seems to be consistent with banking stress remaining elevated, but systemic risks fading somewhat.

**Figure 8: Banks are still making heavy use of liquidity facilities**



Source: Federal Reserve, Bloomberg, abrdrn (April 2023)



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