The ADVISOR

Focus on Community Banking Issues

Second Quarter 2023

ECONOMIC ENVIRONMENT

A Tale of Two Outlooks

Prior to March, the "higher for longer" interest rate path appeared most likely, as the resilient labor market and consumer spending data had led many economists to forecast little chance of a near-term Fed pause or cut. However, as the old adage goes, the Fed hikes rates until "something breaks" – and something certainly broke with the failures of Silicon Valley Bank and Signature Bank, with several other regional lenders fighting for survival. Poor risk management can certainly be blamed in these particular cases, but the unprecedented pace of rate hikes created an environment where retail depositors can earn upwards of 5% in short-term T-bills, and as such have been disincentivized to maintain uninsured deposits in certain banks. While we believe the worst of the banking crisis is behind us, these events sparked a rapid shift in the consensus outlook where many see recessionary pressures appearing sooner, ultimately leading to a faster downshift in inflation and subsequent Fed policy reversal.

We continue to believe a soft landing is unlikely, and that we will see a broader economic slowdown towards the end of 2023. This base case is bolstered by the expectation that credit conditions will continue to tighten following the bank failures, which would likely fuel a decrease in consumer spending and business fixed investment.

Ramifications of a Credit Crunch

While the Fed has maintained its restrictive stance, we believe that the banking stress may lead to a significant pullback in lending activity, or "credit crunch," with many banks adopting a renewed focus on liquidity management. This has already started to occur, with the three-week rate of change on bank loans/leases falling materially, led by C&I and commercial real estate loans, and the latest NFIB small business survey showing the largest monthly decline in credit availability in 20 years. So, what does this mean in the context of the broader economic environment? We feel this pullback in lending

EPG RATE FORECAST

April 2023

MARKET RATE	Actual (%) 3/31/2023	Projected (%) 3/31/2024	Yr1 Δ	Projected (%) 3/31/2025	Yr2 Δ
FedFunds	5.00	4.75	-0.25	3.75	-1.00
Prime	8.00	7.75	-0.25	6.75	-1.00
3mthTsy	4.85	4.50	-0.35	3.30	-1.20
6mthTsy	4.94	4.40	-0.54	3.25	-1.15
1yrTsy	4.64	4.25	-0.39	3.20	-1.05
2yrTsy	4.06	4.00	-0.06	3.15	-0.85
3yrTsy	3.81	3.75	-0.06	3.10	-0.65
5yrTsy	3.60	3.55	-0.05	3.00	-0.55
10yrTsy	3.48	3.35	-0.13	2.85	-0.50
30yrTsy	3.67	3.20	-0.47	2.75	-0.45

RATE OUTLOOK DESCRIPTION:

This represents EPG's current view of interest rates.
Depending on the actual timing of the ALM meeting, the forecast may be altered and/or updated.
For the most accurate current rate forecast, please call EPG, Inc. at (781) 235-2666.

Features

- *Economic Environment:* A tale of two outlooks.
- *Fixed Income Strategy:* Tight liquidity and an inverted yield curve limits investing activities.
- *Equity Strategy:* How will a potential recession affect earnings?
- *ALM Strategy:* The impact of a changing business climate.

EPG INCORPORATED

activity may create similar effects to one or more additional Fed fund rate hikes. Over the coming months, we will be closely monitoring gauges of manufacturing and industrial output, areas where a credit-driven reduction in domestic capital spending would likely be felt most significantly. The cumulative effects of the banking crisis should be deflationary, which will assist the Fed in bringing inflation closer to the 2% target.

Inflation on the Downtrend

By all measures, inflation is moving in the right direction. After peaking at 9.1% last June, Headline CPI has fallen to a 5.0% YoY rate in March, and the Fed's preferred measure of Core PCE has followed a similar path from 5.42% to 4.60%. If consumer spending, business spending, wage growth and lending activity continue to slow as expected, inflation should push lower, especially when considering the high monthly CPI runoff in May and June (annual inflation working off higher base). Several other drivers of the initial inflationary surge such as margin expansion and the jump in global food prices are reversing as well. Gross margin compression for retailers and wholesalers has been the largest single contributor to March's negative print in core PPI, which posted its first outright monthly decline since April 2020 after peaking at a 9.7% annual rate last year.

Recent dynamics in the oil market provide a counterargument to the narrative of slowing inflation, with crude having rebounded to roughly $80 per barrel following the announcement that OPEC+ would be curtailing production. Oil demand has picked up this year due to China's reopening, so greater global demand combined with lower supply may keep oil prices elevated for the foreseeable future. Bloomberg Economics' SHOK model estimates that U.S. inflation will rise by 0.2% for every $5 increase in oil prices, so this will be a factor to monitor closely as the Fed continues its fight against inflation.

EPG Rate Forecast: The End in Sight?

Given the ongoing strength in the labor market, sticky core inflation, and outside dynamics such as the recently announced OPEC+ production cuts, we expect the Fed to raise rates by 25 basis points in May. The 25 basis point hike in March showed that the Fed is continuing to prioritize the inflation fight in light of the recent banking turmoil, though the most recent policy statement suggests that the peak cycle rate may be approaching. The statement now reads that the FOMC expects "some additional policy firming" rather than the previously stated "ongoing increases," indicating that most FOMC members see the Fed funds rate as close to the level they consider "sufficiently restrictive." Currently, the Fed funds futures market implies one final 25 basis point hike in May, followed by a pause until September, when a 25 basis point cut is priced in.

After reaching a peak upper-bound Fed funds rate of 5.25%, we expect a pause while the effects of previous rate hikes continue to take hold in the economy. In our view, weakening economic growth led by a more selective consumer, a sustained downtrend in both headline and core inflation, more restrictive credit conditions, and moderating wage growth will cause Fed policymakers to recognize they have tightened too far, leading to 50 basis points of cuts in Q1 2024. We expect the yield curve to remain inverted through next year as longer-term rates fall on muted longer term growth expectations, though the magnitude of inversion is likely to be less severe than it is currently.

Is the Labor Market Losing Steam?

The argument in favor of a soft landing hinges on the labor market, which has held up remarkably well after more than a year of Fed tightening. The economy is still adding jobs, and the unemployment rate shockingly dropped to 3.5% last month in the face of mounting layoffs across the economy. However,

we are now seeing some evidence that the positive trends may be slowly reversing. While the 236,000 jobs created in March was a strong number, it represents the smallest monthly gain in over two years. The labor force participation rate ticked up, while average hourly earnings registered their smallest YoY gain since mid-2021.

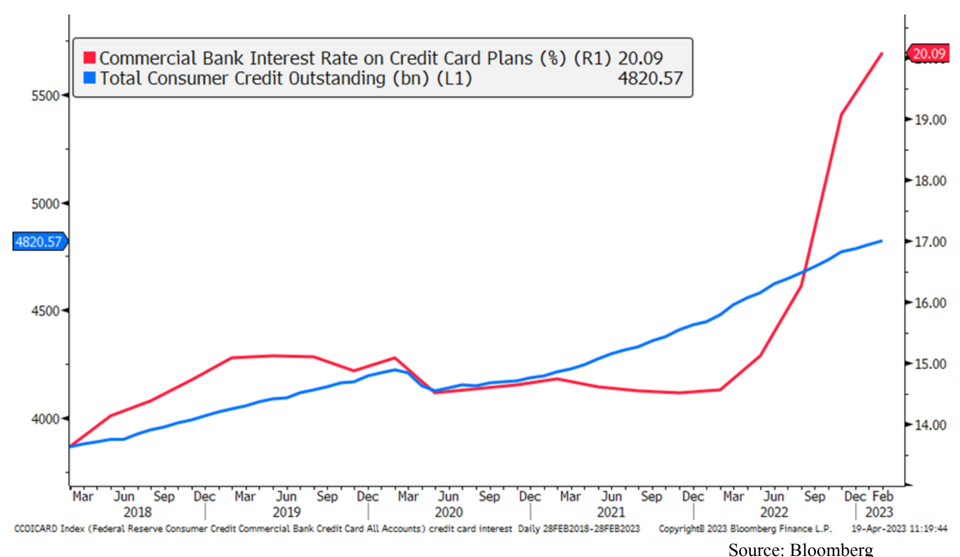
This data tells us that jobs are still plentiful to those looking, but more individuals appear to be looking. Average weekly hours and wage growth have both slowed broadly, indicating that labor demand may be beginning to moderate. This makes sense within the context that more than 170,000 tech sector workers have been laid off globally this year, a larger number of tech layoffs than had occurred in the entirety of 2022. While there are still 1.67 jobs available per unemployed worker, these available jobs are predominantly within lower-paying industries.

Focus on the Consumer

Last quarter, we highlighted the relationship between increasing credit utilization, declining savings rate, and still-high consumer spending. At the time, we viewed the continuation of these trends to be unsustainable, and it appears we are now receiving some clarity to these factors' longer-term trajectory. Interestingly, the savings rate increased through the end of February, which we attribute to an increasing fear of job losses causing consumers to cut back on discretionary spending and higher market interest rates incentivizing individuals to park excess cash in T-bills or money market funds rather than spending it. Even though the savings rate has risen slightly, credit utilization continues to accelerate, showing that consumers are tapping into credit lines for necessities rather than using savings. With credit card interest rates at 5-year highs, servicing this level of consumer debt could become a concern if further job losses materialize.

Consumer Credit Usage Accelerates While Credit Card Interest Rates Remain Elevated

Despite a January spike in retail spending, it is clear that the U.S. consumer is becoming increasingly cautious. In March, the 1% drop in retail sales was the most in four months, driven by softening demand for vehicles & parts, gas, and general merchandise. Moreover, leading indicators suggest that several components of retail sales may contract further. For example, sales of housing-related goods (accounting for almost 10% of retail sales) such as building materials, furniture, and household electronics tend to lag existing home sales, which dropped substantially last year. High mortgage rates are still contributing to a low supply of housing, as holders of sub 3% mortgages are unlikely to move. Given this will likely suppress single family existing home sales through 2023, demand for housing related goods is likely to continue its downtrend. We anticipate that discretionary spending will continue to contract as the impact of monetary tightening and lessened credit availability weigh on economic conditions. ◆



Source: Bloomberg

FIXED INCOME STRATEGY

Fixed Income, A Changing Landscape

The first quarter of 2023 began as initially expected, with the Fed continuing their campaign of raising interest rates on their quest to bring the inflation rate back to the target rate of 2.0%. In early January, the long end of the yield curve began pricing in a recession as investors believed that the economy was likely to slow, based on the aggressive actions taken by the Fed so far. By mid-January, the 10-year Treasury was under 3.40%, nearly 50 basis points below the start of the year. Although market expectations were for further interest rate increases, a recession scenario continued to be priced into the market and the yield curve continued to invert. During the quarter, elevated volatility evolving around market sentiment on monetary policy expectations and liquidity concerns within the banking sector quickly changed the outlook.

On February 1st the FOMC raised rates by 25 basis points after 6 consecutive increases of 50 or 75 basis points, and Powell clarified that the Fed would continue to maintain a restrictive stance on policy as inflation was still running well above the 2% threshold. The economic data released in February turned out to be above expectations, led by 50-year lows in the unemployment rate of 3.5% and 517,000 jobs created in January. Although inflation was moderating from its high last June, it was moving at a slower pace than Fed governors had predicted. This quickly changed market sentiment as interest rates rose on the belief that the terminal Fed funds rate could be headed higher than the 5.10% level previously established by central bankers.

Yield Curve Shape

The longer end of the yield curve continued to reject the idea of higher rates in early March as the inversion expanded to over 100 basis points, from 55 basis points at the start of the year. Two-year Treasuries rose to their highest levels since the financial crisis but was short lived as the banking sector took center stage with the collapse of Silicon Valley Bank and Signature Bank. First Republic was also strained with an asset liability mismatch, raising concerns of deposit runoff and investor concerns about liquidity. Market technicals far outweighed better than expected economic data as investors fled to the safety of U.S. Treasury securities, driving interest rates lower just days after 2-year Treasury yields touched recent highs. Although the Federal Reserve still raised interest rates in March, it was clear that they needed to stabilize the concerns in the financial system. The release of the FOMC Fed minutes in April confirmed that Fed officials stressed the need for policy flexibility.

The Fed announced a term funding program to provide liquidity to U.S. depository institutions, and the larger U.S. banks combined their efforts to deposit $30 billion into First Republic. This combination stabilized markets after a few weeks of elevated interest rate and equity volatility. We continue to expect the FOMC to be data dependent, but also ensure financial stability within the banking community. With this as a backdrop, upcoming inflation and employment data combined with a continued focus on financial stability should push the Fed to modify their language on policy after the next FOMC meeting. In an environment where banks are predominantly in a borrowing position while also tightening lending standards, economic growth should be impacted. With inflation trending lower in the coming months, the Fed will likely pause after the May meeting even with inflation still above their long-term target level. It could be a quick transition from what has been an aggressive tightening environment, according to Fed funds futures contracts, to an easing bias that may be here by mid-summer.

FIXED INCOME STRATEGY

Investment Environment

The investment environment for the banking community is currently pressured by elevated funding costs, limited excess cash, and a primary focus on liquidity. The recent flight to quality in Treasuries and investors' limited appetite to add risk assets has caused spreads across fixed income products to widen entering the 2nd quarter. For example, a 3 year Callable Agency with 3 months of call protection was trading at similar spread levels to a 10-year Callable Agency with 1 year of call protection, both with over 150 basis points of additional yield to comparable Treasuries. Agency MBS also widened in conjunction with lower rates and the assumption that the FDIC could be liquidating the $114 billion in securities from the two failed banks. The holdings are comprised of Agency Mortgage-Backed Securities, Collateralized Mortgage Obligations, and Commercial MBS. Although wider in spread, Agency MBS have benefitted from some price appreciation in Treasuries and currently offer yields just over 5.30%. Hybrid ARMS continue to offer value and have a shorter duration and average life profile than comparable mortgage securities. Hybrid ARMS have been widely considered a 15-year fixed rate alternative, and during quantitative easing, the Fed was purchasing both 15 & 30-year MBS, causing spreads to tighten. During that time the Hybrid ARM sector could not keep up with the price appreciation of fixed rate securities, but even in a quantitative tightening environment, spreads have not retraced and the ARM sector offers an attractive pick-up in yield compared to 15-year MBS. Hybrid ARMs are trading below par, with less interest rate and extension risk than 30-year MBS. The Hybrid ARM sector continues to offer compelling risk adjusted return. Credit sectors did not widen to the same degree as Agency securities during the flight to quality in Treasuries and call protection in the Municipal space remains on the expensive side. Under the belief that interest rates are close to peaking, and that rate cuts are on the horizon, bullet like securities could provide diversification to portfolios. For example, FNMA DUS spreads are close to their widest levels in the past year. Although funding assets is challenging, under the belief that a potential recession looms on the horizon, the down rate protection of DUS bonds would complement portfolios, while offering the potential for improved performance if rates fall. ◆

Source: Bloomberg

Yield Curve Changes Year to Date

Term	12/31/2022	3/31/2023	Change
6 Mo	4.75	4.86	0.11
1 Year	4.69	4.59	-0.10
2 Year	4.42	4.03	-0.40
3 Year	4.22	3.79	-0.43
5 Year	4.00	3.57	-0.43
7 Year	3.97	3.53	-0.43
10 Year	3.88	3.47	-0.41
20 Year	4.14	3.80	-0.35
30 Year	3.96	3.65	-0.31

EQUITY STRATEGY

When will the recession become reality?

With first quarter earnings now beginning, a focus on how inflation fighting rate hikes and elevated consumer prices has impacted corporate earnings has begun. Reduced demand for goods and services is starting to become evident, and the data that is coming forth in the weeks ahead will finally shed light on when a recession is likely to take hold, versus if a recession is on the horizon. With a fundamental shift from pandemic-fueled demand creating inflation, to unprecedented rate hikes and anticipated economic slowdown, slowing sales and rising costs are anticipated to manifest in pressure on earnings. Trillions of dollars of pandemic money supply unsurprisingly, delayed the rollout and impact of initial rate hikes.

While sales may continue to be reported as relatively robust, it appears that associated costs are rising at an even higher rate to produce the goods and services that are being sold. Thus, margins are being squeezed and therefore earnings. Pricing power that companies have commanded over the last several years is under pressure and therefore margin compression is a critical theme when looking at how first quarter earnings will play out, and therefore investor sentiment and action – an important recession indicator.

What is the correlation between when a recession begins and equity market performance?

Knowing when a recession actually begins is an important factor in how equity markets behave. Investor perception about the future and the visibility around such an outlook tends to form the basis for longer term equity market movement. Understanding when a recession actually begins helps identify likely "bottoming out" of equity markets. Since 1929, recessions have created market slumps and according to many analysts, markets tend to find a bottom 9 months or so after a recession begins. This can create downward pressure from that point of 10-20% followed by recovery and upward movement.

Current market activity for this year would reflect the sentiment that a segment of investors believe that the equity market has acknowledged a recession scenario as evidenced by the markets having "bottomed out" towards the end of 2022. This would mean a recession has already been priced into the market. For example, RBC senior equity strategists suggest that the October 2022 lows were the point where a recession was recognized, and this was evidenced by the 25% drop from the market highs at the start of that year. Since the Great Depression, the median drop in markets due to recession recognition has been approximately 27%.

Hence, buying into levels that existed as the new year began reflected a more optimistic view of the "worst is likely here" and that an improvement in economic activity will soon be visible, even if short term volatility remains. This would ultimately be reflected in improving earnings growth. While this view, held more so by individual investors versus institutional investors, has created perceived market rallies, the actual improvement in market index measures has been carried by a few select names. This would reflect not so much a broad based shift in market movement based on investing beyond a recession, but rather individual investor who believe not just that "the worst is soon behind them," but also "buy the dips in the most beaten up sectors and names." The graph below shows that while stock indices have recovered this year, they remain well below their 2021 highs.

Will earnings reflect a slowing economy?

Almost all analysts, economists, and market participants are expecting a recession in the next 12 months. Whether towards the

EQUITY STRATEGY

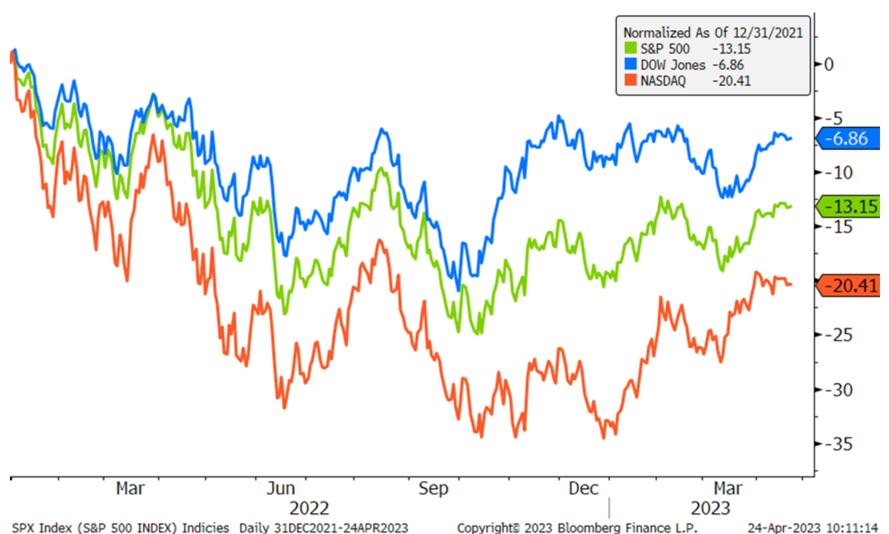
end of 2023 or the beginning of 2024, probabilities assigned to recession likelihood are rising. The New York Federal Reserve for example has assigned a 60% probability of recession and most forecasting has recently increased probabilities for the timing and magnitude of recession.

Price/earnings ratios have climbed as this beginning of year rally has moved the S&P closer to the August levels of 4,200. Over the last several points when this resistance level has been approached, sellers have typically prevented movement beyond. At this level, forward looking P/E ratios are over 18 times. This is compared to 16 times at the beginning of the year. This increase in the forward P/E would indicate an expectation of earnings growth. However, recession fears are becoming reality as slowing economic data and corresponding declining spending activity are anticipated to negatively impact sales. First quarter earnings are likely to show that while sales were robust, elevated costs are already creating earnings compression. According to FactSet, the blended S&P 500 earnings decline for the first quarter of 2023 is expected to be -6.2%, which will also mark the second straight quarter in which the index has reported earnings declines. This scenario of continued elevated costs and now expected sales declines is building a negative outlook for earnings going forward. A likely recession is expected to relieve some pressure on costs, but this may take time, and the combination of declining sales with elevated costs is expected to negatively impact corporate earnings in the near term. As such, any data that shows negative pressure on earnings in first quarter results or expectations of such going forward will likely create bearish investor sentiment.

Are we approaching the point where longer-term equity investors should become bullish?

Current earnings are indicators that we are not yet in a recession. The ability to raise prices up until now has helped companies offset any decline in goods and services sold. Going forward, however, any decline in sales, combined with increasing costs, will impact earnings per share. Liquidity is tightening, credit loss expectations are starting to grow, and spending is slowing. These trends, while not all inclusive, are typical indicators of a recession. Realizing a recession starting point can be an important signal for developing a point of reference from which an equity buy focus can be established. Historically, equity markets have turned positive 8-10 months after a recession has begun. While this depends on a number of factors such as the severity of the recession and corresponding response, identifying when a recession actually begins is an important platform to begin developing a broad based bullish shift within equity portfolio management. We believe this quarter will provide the start for such visibility, which will likely lead to setting a target date for beginning a broad based equity purchase strategy. ◆

Equity Index Performance Since 12/31/21 (% Change)



Source: Bloomberg

ALM STRATEGY

A Changing Business Climate

The operating environment for community based financial institutions has changed dramatically since the failure of Silicon Valley Bank. This includes an enhanced focus on liquidity, a more cautious lending outlook, greatly diminished growth expectations for the remainder of 2023, a faster end to the Fed tightening cycle and very likely a more stringent regulatory environment moving forward.

Is the Fed Picking Winners and Losers?

Although the Fed's handling of the SVB failure will have implications for community based financial institutions for years to come, some will be felt much sooner than that. The decision to fully back all the deposits of the failed institution likely stemmed a potential panic, which if left unaddressed, could have had a cascading effect in the industry. However, one could make a case that even though it immediately calmed markets in the near term, longer term it could cause other significant problems while altering the playing field for FDIC insured depositories.

So, is the Fed picking winners and losers? Absolutely! By deeming SVB as systemically important, and thus too big to fail, the Fed is signaling that certain large banks (B of A, JP Morgan, etc.) will be backstopped, with the implication that deposits in those institutions are safe regardless of dollar amount. However, it is very unlikely that depositors in a much smaller institution would be afforded the same protections. As a result, the Fed is implicitly telling depositors (through its actions) that the bigger banks are safer because of the implied Fed 'guarantee' that smaller banks lack. For example, with an insured limit of $250,000 and no assumed Fed help, depositors will eventually become skittish about maintaining funds well in excess of that limit with a smaller institution. Of course, that threshold is different for each depositor, but at some point as the amount grows the decision will be made to move the money to somewhere with the assumed backstop. In this regard, the Fed is effectively placing a cap on deposits that exceed $250,000 at smaller banks.

What will the impact be in the longer term? If, as expected, the FDIC increases the insured limit above $250,000, that may be enough to protect many smaller to mid-sized community banks. Although this depends heavily upon where that new limit ends up, even a $500,000 limit should provide larger depositors (majority commercial) enough comfort to maintain working capital accounts into the $5 million range, give or take. Effectively, this escalates the deposit insurance dilemma from small / mid-sized community institutions to larger ones, but the issue remains, nonetheless. Excess insurance, (through the DIF, for example), seems the best and most immediate way to address this situation, and in the aftermath of the failure community banks were very quick to alert depositors. Longer term, although it would be easy to say that the most financially stable institutions with the stronger capital positions will be the winners, it may be too much of a stretch to assume that people will dig deep into the financials and analyze each institution before depositing there.

Outlook for the Balance of 2023

Immediately after the failure, financial institutions quickly became much more cautious about what they added to the balance sheet and how they utilized liquidity. This sentiment is being echoed throughout the country, as economists identify this issue as being a key potential driver pushing the economy to a likely recession later this year. As banks restrict credit, businesses find it more difficult and more expense to fund growth, so growth inevitably slows.

Is there a potential silver lining here? Potentially yes, as just a few weeks ago, lenders would fight aggressively for high quality CRE deals, but that attitude has changed quickly. The outcome, at least in the short term, is likely to be reduced competition for deals, leading to more pricing power for lenders in the form of higher rates and

better terms. However, the potential for better rates needs to be judged against the new operating climate, where liquidity is paramount and public sentiment can turn against a financial institution in an instant. So far, we have not seen this with community institutions, but no one wants to be the first. With that said, there is an opportunity currently to add high quality loans at relatively attractive rates, but that most likely need to be funded at marginal costs not much below the loan yield. As we move forward to 2024 and beyond, though, loans added at current levels start to look quite a bit more attractive as the Fed cuts and pressure eases on funding costs. Consider the following:

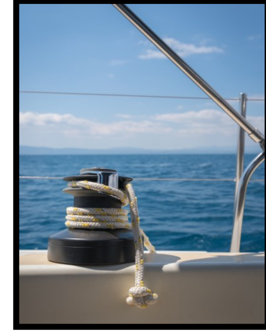
- Current: CRE deal at 6.25% funded overnight at 5%, generating a spread of 125bp
- May 2023: Fed hikes 25bp, lowering the spread to 100bp
- Q4 2023: As the economy slows, people become cautious and liquidity improves
- Q1 2024: The Fed starts to ease and the spread rises back to 125bp
- Mid 2024: A slower economy has lowered overnight funding costs while boosting deposits
- End of 2024: Assets yielding 6% + funded largely with much cheaper deposits

That scenario may seem rosy but is what we believe to be the most likely scenario, driven by our rate forecast. Even if this does happen as outlined, there will be bumps in the road so caution is advised, but there is opportunity to position for 2024 and beyond by accepting tighter margins in the short term. One important caveat not discussed yet- this likely works much better with CRE than residential mortgages due to the differences in prepayment profiles. A 6.50%-7% res mortgage is unlikely to last much past 2024 if this scenario unfolds as stated.

Change in ALM Risk Metrics

Over the last couple quarters, as the Fed has aggressively raised rates and balance sheets have adjusted to a much more rate conscious consumer, risk profiles have changed dramatically. A year and a half ago, pre-Fed action when liquidity was flush, nearly everyone had high sensitivity to falling rates. Fast forward to late 2022, with excess FFs replaced with overnight borrowings, and profiles shifted from exposure to falling rates to rising rates. Now, in the last couple of quarters, we have seen additional changes, this time driven by a rapid shift in the deposit mix from lower cost, higher duration non-maturity deposits to shorter duration CDs. Where the move from excess liquidity to overnight borrowing largely impacted the NII sensitivity, the more recent shift in the deposit mix has impacted the EVE measures.

Although the sharp increase in EVE sensitivity seemed to happen quickly, the fix will likely take much more time. With sensitivity that significantly exceeds policy guidelines now more common than not, there is no single immediate action that will cure the issue. The best approach, in most



cases, is a combination of tactics, each making a small impact that work well in combination:

- Being patient: Although this can be frustrating, it is usually better than attempting a massive balance sheet restructuring that can cause additional, longer-term challenges. Lower rate res mortgages and MBS will amortize down over time.
- Extending funding: Like everything else, this comes with a cost
- Selectively looking to sell longer duration assets: It is difficult, yet not impossible to do in the current rate environment
- Focus on shorter duration lending vs. loans with longer cashflows. This is already in process due to the lack of housing inventory driving a slowdown in res mortgage lending
- Swaps/other derivative approaches help in many instances but can be very expensive, especially as we near the likely end of the increasing rate environment

The 'best' outcome may be nothing more than increased prepayment speeds- while currently near all-time low levels, it will not last forever. ◆

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