A Volatile Journey to a Better Place

Moving away from an abnormal regime of crisis-era stimulus won't be a smooth process. But the volatility should be easier to stomach knowing that the destination is likely to be a healthier, more balanced economy.

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Highlights

- Although the urgency of the regional bank crisis has subsided, credit is likely to become more expensive and less available than at any point in the last 15 years.
- Tighter lending conditions and a cooling job market should allow the Federal Reserve to take a timeout in the inflation fight. If the economy can slow without plunging into recession, rate cuts may not materialize.
- We believe the cores of the consumer and corporate sectors are well positioned to absorb a slowdown, setting up a move to a more stable equilibrium.

Banking crisis averted; now comes the crunch

Regional banks rarely drive headlines, let alone rattle financial markets. But what we saw in March is what happens when central banks create enough money and then reset the price of money drastically higher. Unintended casualties are inevitable.

As rates have spiked over the past year, certain markets have been breaking — crypto assets, U.K. gilts and now U.S. Treasury portfolios on bank balance sheets. The collapse of Silicon Valley Bank and others were not a reflection of systemic weakness in the banking system, but of issues tied to specific business models and avoidable management errors over interest rate hedging in banks' portfolios.

Forceful, coordinated actions by the Federal Reserve, the Treasury and the FDIC prevented a broader run on banks by shifting the narrative from liquidity to profitability. Banks must still contend with paying 5% short-term interest while holding legacy long-term bonds paying 2%.

Voya IM economic forecast

- U.S. inflation run rate falls to 3% by end of 2023, moving toward (but not below) 2% in 2024.
- U.S. GDP growth slows to 0–1%, possibly dipping slightly negative.
- The Fed hikes once more in May and then holds steady at 5.25%; cuts only materialize if something "breaks."
- 10Y U.S. Treasury yield edges higher but stays within 3.5–4% range.

However, most banks have stable assets and significant capital reserves, giving them time to work through the earnings headwinds. And unlike in 2008, when banks made bad loans to overextended homeowners with no verifiable ability to repay, exposure to government bonds ultimately pays back. Although there may be more casualties ahead, the mix of factors that sparked the most substantial moves in March seems unlikely to be repeated.

The question now is: How will the strain in regional banks affect the economy and Fed policy?

Although the banking system didn't break, lending confidence did.

Banks are battening down the hatches in anticipation of stricter regulation and tighter enforcement. The Fed's latest survey of lending practices (conducted *before* the SVB collapse) showed that standards have tightened significantly over the past year, suggesting that loan growth could plummet (Exhibit 1). We expect the outlook will continue to weaken when the next survey is released in May.

What banks do with their assets influences how the economy functions. Bank assets in the U.S. have increased structurally over decades, rising to nearly 90% of U.S. GDP from around 55% in 2000.[1] When banks are under stress, or if they are concerned about their ability to attract capital, they tend to pull back on lending, slowing the economy. How much the economy slows depends on the depth and duration of credit tightening. The good news is that reduced credit availability is sucking the oxygen from key inflation drivers, relieving the Fed of the need to push interest rates higher.

Cooling job market points to a holding pattern for the Fed

Tighter credit is coming just as the U.S. labor market is finally beginning to cool. Many industries are still dealing with worker shortages, especially for lower-paid service roles and union jobs. However, wage inflation — a key Fed influencer — is turning a corner. Job openings, which track closely with wage growth, have been moving lower (Exhibit 2). New hires, jobs per seeker and average hourly earnings are all easing, and the quit rate is rolling over.[2] This is consistent with a slowing but resilient job market, precisely what the Fed wants to see.

Other front-end economic indicators are showing a slowdown in demand. Freight container costs are plunging, auto prices are peaking, semiconductor prices are down — all signals of cooling inflation.[3]

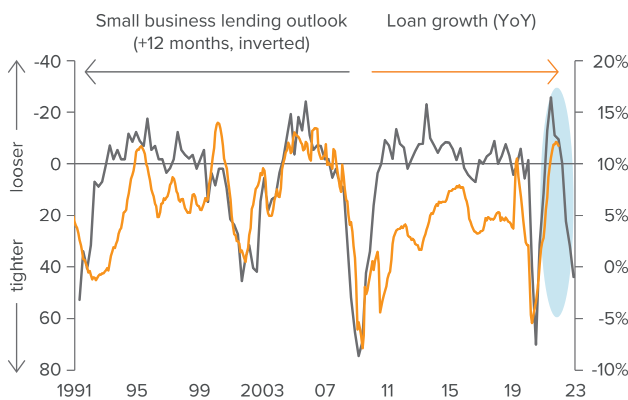
The Fed will likely raise rates one more time in May. But then we expect it to stay put for a while, allowing the economy to soften without plunging it into a recession. This contradicts market expectations that the Fed will gradually reduce rates in the second half of the year.

Why the disconnect? Market pricing for fed funds rate futures represents a probability weighting of all scenarios.

In other words, gradual rate cuts are not the most probable outcome, but rather the average of two extremes.

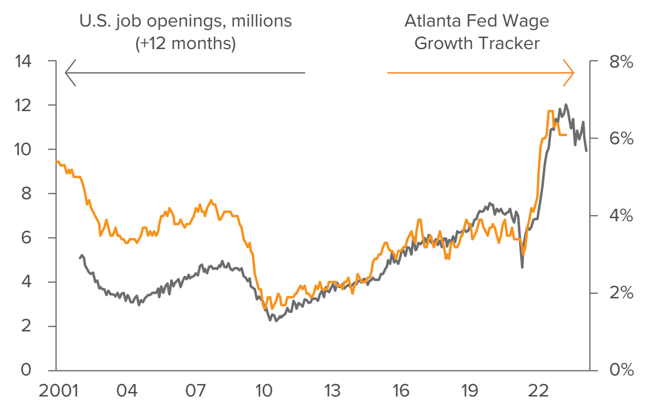
On the one hand, there are no glaring signs of a deep economic downside. But investors must consider the risk of an unexpected shock that forces the Fed to aggressively cut rates. If we are fortunate, the Fed can simply hold around 5% and let time do the work as banks cool the economy.

Exhibit 1: The lending survey says: "Slower growth ahead"



As of 01/31/23. Source: Federal Reserve, Voya IM. Lending outlook based on the Senior Loan Officer Opinion Survey on Bank Lending Practices.

Exhibit 2: Help still wanted...at a lower cost

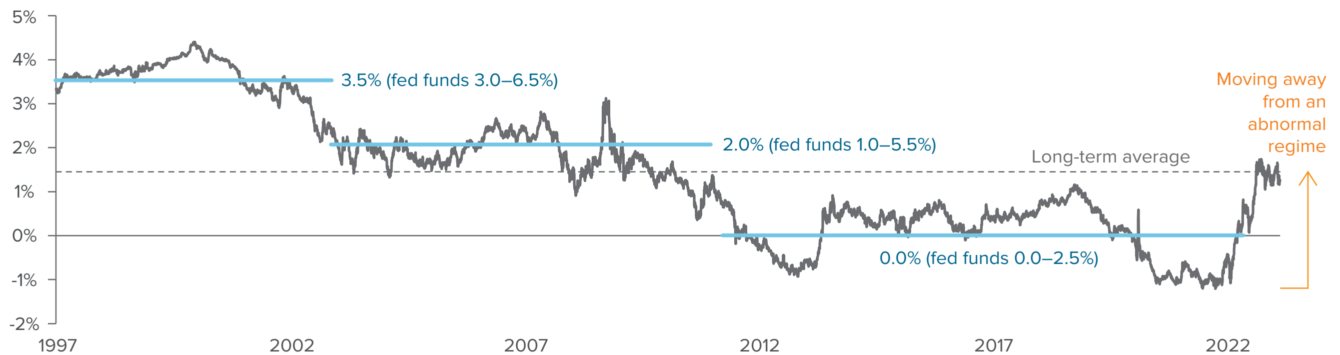


As of 03/31/23. Source: U.S. Bureau of Labor Statistics, Federal Reserve, Voya IM.

1. U.S. Federal Reserve and Voya IM, 03/31/23.
2. U.S. Bureau of Labor Statistics, 04/04/23.
3. Container costs: Baltic Exchange (04/21/23). Auto and semiconductor prices: Federal Reserve (04/12/23).

Exhibit 3: Return to normal

10Y U.S. real yield (Treasury inflation-protected securities) and federal funds rate ranges



As of 03/31/23. Source: Bloomberg Index Services Limited, Voya IM.

By the end of 2023, U.S. inflation should be running at around 3%. Getting to 2% will take more patience, but central banks may be okay with that. The world has become inherently less disinflationary, with slowing global trade, reduced worker supply and demographics all pushing inflation modestly higher. As we get below the 3% level, the Fed may be more inclined to back off.

On the road to a more balanced economy

To us, the situation today looks more like a setup for an economic pause than for a severe downturn. The cores of the consumer and corporate sectors are relatively healthy and aren't showing the types of private sector overreach that often precipitate recessions. One reason is that households and businesses have been managing their finances more conservatively after living through two of the scariest economic events in history in the span of a dozen years.

At a broader level, we're on a journey away from an abnormal regime of prolonged, aggressively stimulative fiscal and monetary policies. We no longer need the emergency measures of the global financial crisis, or to defend against China currency devaluation, or to help the economy through Covid. We're moving away from a labor share tilted in favor of business, away from zero-bound rates, and toward an import/export model that is more oriented toward consumption in emerging markets (especially China).

This rebalancing process may be volatile. A higher cost of credit and the lack of omnipresent liquidity almost guarantee a narrow amount of higher defaults in the near term. This will test business models that were overly reliant on the distortion of ultra-low interest rates. However, there's an important distinction:

Turbulence should be received differently when moving to a more stable equilibrium than when moving toward a stimulus-ridden state of fragility.

We believe the current destination is a healthier investment environment than any we've experienced since pre-2000: positive real yields, reasonable price-to-earnings ratios, less dependence on fiscal and monetary policy, less reliance on China growth. And for the first time in 15 years, fixed income is a competitive asset class again.

So fear the volatility. But don't fear the destination.

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