ECONOMIC OUTLOOK

REGIONS

August 2023

What A Difference A ~~Day~~ Quarter Makes. Or Does It?

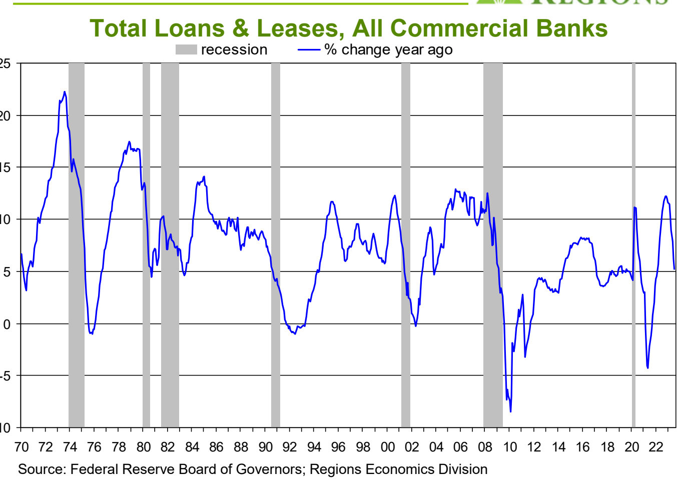
It seems like only yesterday that the newest consensus view was that the credit crunch triggered by the banking crisis was going to push the economy into the recession that many, if not most, analysts had been forecasting for over a year. The release of the Federal Reserve's quarterly *Senior Loan Officer Opinion Survey on Bank Lending Practices* (SLOOS), conducted for more than three decades but which many had only recently seemed to discover, was seen as the final piece of convincing evidence that a credit crunch was indeed at hand and that a recession was sure to follow.

Okay, it wasn't actually yesterday, it was three months ago, which really isn't all that long but at the same time is, as the staying power of consensus views goes, an eternity. Indeed, by the time of the July 31 release of the SLOOS data for Q2, the old consensus view was old news, having been rudely shoved aside, along with concerns over the credit crunch and the banking crisis, with the SLOOS shoved back into oblivion. Though perhaps not yet the newest consensus view, the "soft landing" narrative has taken center stage and is being warmly embraced even by some who had for some time been dismissing such a notion out of hand.

The irony, of course, is that the latest SLOOS data pick up where the prior several quarters left off, i.e., showing further tightening in bank lending standards and further contraction in loan demand in Q2. Yet, unlike the release of the Q1 survey data, which garnered more attention and sparked more dramatic narratives than all of the prior editions in the history of the SLOOS combined ever did, the latest survey was met with a collective yawn, at least by the few who seemed to notice it. To that point, on both the day of and the day after the release of the Q2 SLOOS data, "soft landing" stories continued to dominate the discussion.

In a way, that makes sense, as the signals being sent by the SLOOS data are inconsistent with the soft landing narrative. But, that the soft landing narrative is in the bidding to become the consensus view despite the SLOOS data showing no relief on the lending front must say that there never really was a banking crisis or a credit crunch, or, if there were, neither mattered. As our regular readers know, we've not at any point in this cycle had recession as part of our baseline forecast, but we have anticipated listless real GDP growth over 2H 2023 and into 2024 along with a rising unemployment rate. We've never used the term "soft landing" to describe our forecast, mainly because we have no idea what that term actually means; a term that can mean so many different things to so many different people has no meaning at all to us. Neither have we used the terms "banking crisis" or "credit crunch," other than to dispute either having actually been a thing, at least thus far. As such, it may seem that those who have moved off of their recession calls have settled at where we've been all along, at least in terms of the economic outlook. Rather than drawing any kind of comfort from that, to the extent that is the case, we find that it just makes us nervous. To us, the sudden embrace of the "soft landing" reflects an undue complacency over what we believe to be meaningful downside risks growth.

Some of those downside risks center on the banking system and the broader financial system, including some elements of the SLOOS data that a quarter ago were such big news but in the most recent quarter seem to have gone unnoticed. Before we turn the discussion to the SLOOS data for Q2 (the most recent survey was conducted over the back half of June), we think it worth pointing out the marked deceleration in loan growth amongst commercial banks. As of July, total commercial bank loan volumes were up 5.2 percent year-on-year, marking the ninth straight month in which the year-on-year increase was smaller than that of the prior month. As seen in the chart below, in periods in which loan growth has been decelerating, hitting five percent on the way down has typically been consistent with the economy either being in or heading into recession, and that five percent threshold has not tended to be a stopping point.



Whether or not this cycle culminates in recession or turns into the soft landing that is suddenly in vogue remains to be seen. Either way, it is reasonable to expect decelerating loan growth to give way to year-on-year declines in loan balances at some point in the months ahead. This factors into our expectation, which we've held for some time now, of markedly slower growth in household and business spending in the months ahead, which is in turn consistent with our expectation of listless real GDP growth.

Be that as it may, a glance at the above chart makes it even more curious that the most recent SLOOS data hardly drew notice, going

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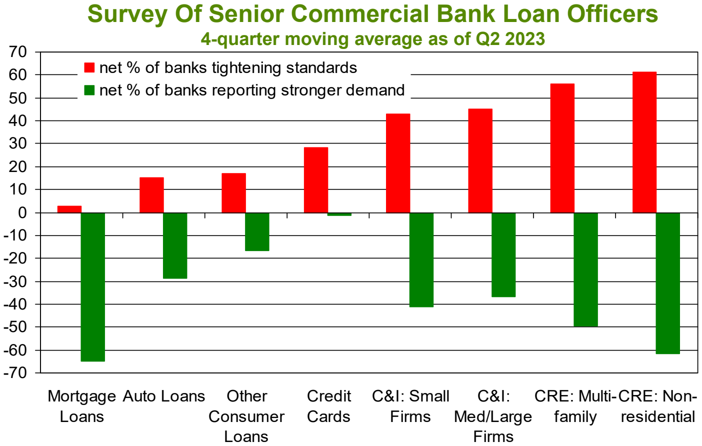
to our point that the suddenly enthusiastic embrace of the soft landing narrative reflects what we think is an undue degree of complacency. As the SLOOS data make clear, the deceleration in loan growth over the past several months is a combination of more stringent lending standards and diminishing loan demand, which is the case across business and consumer loans. That is seen in the following chart, which shows (net) changes in lending standards and loan demand across the various loan types on a four-quarter moving average basis ending with Q2 2023.



Source: Federal Reserve Board; Regions Economics Division

As a point of reference, any value above zero is consistent with banks, on net, raising lending standards, while any value below zero is consistent with banks, on net, reporting decreasing demand for loans. As we noted in the April *Outlook*, banks began upping lending standards on C&I loans and on most types of consumer loans back in Q2 2022, even if that went largely unnoticed amongst analysts and market participants. That also seemed to have been the case as demand for C&I loans and most types of consumer loans began to decline in Q3 2022. As the chart above suggests, the increases in lending standards and the declines in loan demand have since gathered pace. While mortgage loans may seem an outlier in terms of changes in lending standards, keep in mind that mortgage lending standards became significantly more stringent in the wake of the housing market collapse in the mid-2000s and were never eased to any meaningful degree from then on. As such, this left scope for only modest tightening in mortgage lending standards over the past few quarters. Put differently, recent quarters have seen lending standards on other types of loans, both consumer and commercial, rise up to be more in line with where mortgage lending standards have for some time been.

It helps to recall that tightening lending standards can take many forms, including increased interest rate spreads over a bank's cost of funds, higher risk premiums, shorter terms to maturity, lower credit line limits, lower loan-to-value limits, higher minimum credit scores on consumer loans, and higher hurdles in loan covenants for C&I loans. Over recent quarters, tougher lending standards for both commercial and consumer loans have mostly come in the form of increases in the price of credit, i.e., banks increasing interest rate spreads over their base cost of funds and raising risk premiums. Why this matters, at least to us, is that these are changes in the price of credit, as opposed to changes in the availability of credit, and it is the latter that would, were credit made much less available, if not unavailable, be consistent with a "credit crunch." In other words, while the term "credit crunch" has been used, almost reflexively, to describe tightening lending standards over recent quarters, it doesn't exactly fit. This is why we've steadfastly avoided using this term in this context, i.e., saying that credit is more expensive is not the same as saying credit is unavailable. To be sure, marginal borrowers are priced out of the market as the cost of credit rises, but that has not necessarily been a bad thing given that a prolonged period of (artificially) low interest rates helped sustain marginal borrowers who, in many cases in the corporate sector, were adding little if any to overall economic growth. It could be that such borrowers were all along turning to nonbank lenders as opposed to seeking bank loans, making it unclear the extent to which the ranks of marginal borrowers have been thinned out by banks raising lending standards. That said, over the past two quarters over sixty percent of banks increased risk premiums on C&I loans, which could easily have led to some riskier but nonetheless viable companies being priced out of the market for credit.

In addition to understanding how, why banks have been raising lending standards is important to understand. Since the current round began in mid-2022, a less favorable economic outlook has been the most commonly cited reason given by banks for raising lending standards, followed by reduced tolerance for risk, the two of which seemingly go hand-in-hand. Additionally, "worsening of industry specific problems" has been cited by a sizable number of banks as a reason for raising C&I lending standards over the past several quarters. While this is not at odds with the highly uneven performance across individual industry groups over this same span, it does point to one drawback in the SLOOS data, which is the absence of industry detail in the questions pertaining to lending standards on and demand for C&I loans. It is more likely that, rather than standards on/demand for C&I loans changing uniformly across the board, there is variation in both lending standards and loan demand across individual industry groups, but it just isn't clear how that manifests in the aggregated results for the SLOOS questions on C&I lending. Be that as it may, the reasons cited above reflect a normal reaction to the anticipation of deteriorating economic conditions and are not supportive of the "credit crunch" premise.

That said, it should be noted that over the first two quarters of 2023 there was a significant increase in the number of banks pointing to deterioration in current or expected liquidity positions as a reason for raising lending standards. In each quarter, the number of banks doing so was a new high in the life of this response option (which dates back only to 2008), with the Q2 data showing 59.3 percent of banks citing liquidity concerns as a reason for raising lending standards. At the same time, over the first two quarters of 2023 there were marked increases in the number of banks indicating that concerns over the effects of regulatory changes and concerns over deteriorating capital positions factored into their decisions to raise lending standards. Note that the Q1 survey was conducted after the mid-March bank failures, which were widely expected to trigger regulatory and/or supervisory responses aimed at increasing liquidity and capital. These are factors which could directly impact the availability of credit and, as such, would be consistent with a "credit crunch" premise.

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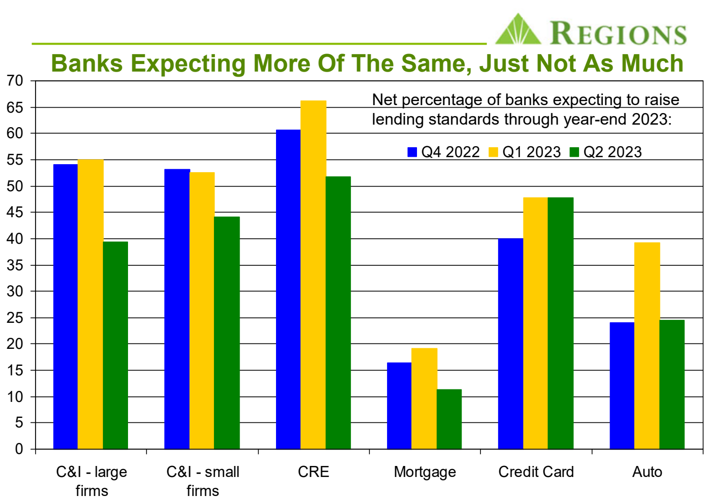
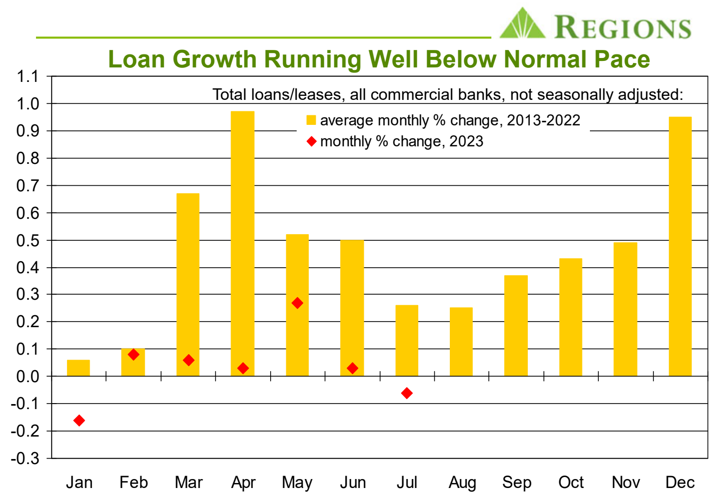
It isn't difficult to envision scenarios in which stresses on liquidity would constrain bank lending. For instance, anything that would trigger further outflows of deposits could stress liquidity and in turn constrain lending. Further increases in the Fed funds rate – it isn't clear that the FOMC is finished – which lead to increases in market interest rates or concerns over the soundness of the banking system – commercial real estate looms as a potential source of stress – could trigger further deposit outflows. Thus far, many banks have relied on brokered deposits to help mitigate deposit outflows but, even so, as of the final week of July total commercial bank deposit balances were 2.5 percent below the level in mid-March before the bank failures. Moreover, brokered deposits are costly and become even more so as market interest rates increase, while being overly reliant on such deposits will draw regulatory scrutiny. So, while this is not to say there will be another spike in deposit outflows, it would seem unwise to rule it out. That, in turn, means an actual credit crunch should not be ruled out, even if that is at odds with the soft landing premise.

Even in the absence of further deposit outflows, banks are poised to raise lending standards further, at least according to the most recent SLOOS data. In the past three editions of the SLOOS, the Fed has asked special questions concerning expected changes to lending standards over the course of 2023. One point many have missed is that banks came into 2023 expecting to raise lending standards further and expecting further declines in loan demand. That was consistent with them already having started to raise lending standards amid a deteriorating economic backdrop. In the wake of the mid-March bank failures, it was not surprising that the Q1 data showed banks expecting to raise lending standards further. Though not to the same degree as in the prior two surveys, the Q2 SLOOS data show banks expected, on net, lending standards to be raised further over the remainder of 2023.



Source: Federal Reserve Board of Governors; Regions Economics Division

Those results are illustrated in the chart above, but the chart also helps make an important, if often overlooked, point about the changes in lending standards reported in the SLOOS data, which is that the change in standards in any given quarter comes on top of those already implemented over prior quarters. For instance, the most recent survey shows 39.3 percent of banks expecting to further raise lending standards on C&I loans to large firms over the remainder of 2023, well below the shares expecting to do so in the prior two surveys. Some have pointed to this, as well as the smaller shares expecting to raise standards on CRE and auto loans, as being a "bright spot" in the data, but this interpretation seems to ignore the cumulative increases in standards seen since Q2 2022. This will be a useful point to keep in mind over the next few quarters when the SLOOS data will inevitably show significant declines in the net percentages of banks raising lending standards on all types of loans. After all, there's only so far banks can raise lending standards, but the absence of further tightening is not the same thing as easing lending standards.



Source: Federal Reserve Board of Governors; Regions Economics Division

Our sense is that we are a long way from the point where the majority of banks will be actively easing lending standards. That is, in the context of the above chart, a somewhat sobering thought as it pertains to the path of the broader economy. The chart compares monthly changes in total loans and leases amongst all commercial banks thus far in 2023 with the average change for each month over the prior ten years. These paltry monthly changes help account for the ongoing deceleration in over-the-year growth we discussed earlier, and for why we expect the over-the-year changes to turn negative in the not-too-distant future. To us, the weak trends in loan growth – which were forming well before the mid-March bank failures – are sending a powerful signal as to the likely paths of business and household spending which are not necessarily consistent with the soft landing narrative.

As we noted above, we find the sudden embrace of the soft landing narrative to be somewhat curious and revealing an undue degree of complacency given what we see as still meaningful downside risks and ominous patterns in bank lending. After all, if you fall into a patch of quicksand, that you landed softly will likely not be all that much of a comfort once you realize you're just going to keep sinking. Not to say that is the most likely outcome for the U.S. economy, but the possibility of that outcome seems to have all of the sudden been highly discounted by many who not too long ago had that as their base case.

A Shot Across The (Fiscal) Bow?

August began with Fitch Ratings downgrading the credit rating of the U.S. from AAA to AA+ in a move that was somewhat but not entirely surprising. Fitch had put the U.S. credit rating on negative watch back in May, citing the debt ceiling fight, so in a sense there was an advance warning of the actual downgrade, but the timing and, to some extent, the tone of the move raised eyebrows. In announcing the downgrade, Fitch not only pointed to "expected fiscal deterioration over the next three years" and concerns over a growing debt burden, but also cited "an erosion of government," in a nod to the recent debt ceiling skirmish that resulted in a truce only days before the "X-date" – the day the U.S. would no longer be able to fulfill its financial obligations.

This marks just the second time in U.S. history that a rating agency downgraded the nation's sovereign credit rating, the first instance being 2011 when Standard & Poor's (S&P) did so. Fitch noting "a steady deterioration in standards of governance" could have been a not so subtle reminder that, with Congress on recess until September and still needing to pass eleven of twelve separate funding bills by the start of the new fiscal year on October 1, a full or partial government shutdown in the fall cannot be ruled out. Those concerns notwithstanding, our focus here is whether, or to what extent, the rating downgrade will increase the borrowing costs of the federal government. After all, if investors believe the credit worthiness of the U.S. has deteriorated to a meaningful degree, they would in turn demand a higher yield on U.S. Treasury securities in order to compensate for the perceived increase in risk.

As it turns out, yields on longer-term U.S. Treasury securities rose sharply during that first week of August, but is unlikely that the downgrade was the main driver. That said, investors were rattled upon the release of the Treasury's quarterly refunding plan, which included larger than expected security issuance reflecting rapidly increasing budget deficits. Moreover, Treasury noted that "further gradual increases (in auction sizes) will likely be necessary in future quarters." The refunding plan led to a jump in yields on longer-term Treasury securities and seemed to validate Fitch's concerns over the growing debt burden. There were other factors, including the possibility of headline inflation reaccelerating, Japan modestly relaxing its yield curve control policy, and the growing embrace of the "soft landing" narrative, that to varying degrees contributed to the run-up in yields on longer-term Treasuries.

Indeed, many analysts and market participants were quick to downplay the significance of Fitch's downgrade in terms of the effects on yields. Many pointed out, and rightly so, that Fitch did not tell us anything we did not already know, i.e., that the U.S. government is on a perilous, if not unsustainable, fiscal path. Others seemed to take a "been there, done that" stance, recalling how S&P's the 2011 downgrade had little, if any, impact on Treasury yields or the broader economy. While we won't dispute the former, we do question the latter given what are significant differences in market conditions and monetary policy relative to 2011 when S&P issued their downgrade.

For instance, in 2011 we were still, even if we didn't know it at the time, in the early stages of what would be a prolonged period in which central banks held interest rates artificially low. Moreover, the Federal Reserve was absorbing considerable quantities of U.S. Treasury securities via its "quantitative easing" policy that led to a rapidly expanding Fed balance sheet. In contrast, global central banks have been aggressively pushing policy rates higher during a time when elevated inflation has pushed longer-term market interest rates higher, while the Fed has been allowing its balance sheet to run down, thus leaving a void in purchases of U.S. Treasury securities to be filled by private buyers, domestic and foreign. The point being that there is at present much less of a buffer against increasingly large Treasury issuance, such that private investors demanding compensation for the increase in risk implied by the ratings downgrade, would have a greater impact on yields now than might have been the case back in 2011.

It is fair to point out that the level of debt is not as relevant as the ability to service that debt, and that is indeed a point we've made frequently over the years when fielding questions/concerns over rising U.S. government debt. With higher interest rates, however, the debt service burden becomes more onerous, even if at present interest outlays as a percentage of GDP are below where they were for much of the 1980s and 1990s. The danger in taking too much comfort from this fact, however, is that it is still nowhere near being clear where interest rates will settle over the quarters and years ahead. Many seem to think that the artificially low interest rates that prevailed over most of the period between the financial crisis and the onset of the pandemic is the norm and, as such, the basis on which to assess the potential debt service burden. We'd take great issue with that view, and while what will eventually be the "new normal" for interest rates is likely somewhere between those levels and where we are today, we'd say it's closer to the latter than the former, in part because we remain skeptical that two percent is a realistic inflation target going forward. That matters given the prospective increases in the level of outstanding debt over coming years.

Many point to the seemingly insatiable appetite for U.S. Treasury securities amongst foreign investors, fueled in part by the status of the U.S. dollar as the de-facto global reserve currency. While both may be true today, there is no guarantee they will be true tomorrow. This is where we think the reaction to what was but a modest relaxation in the Bank of Japan's (BOJ) policy of yield curve control is instructive. While leaving room for sovereign bond yields to increase modestly, the BOJ nonetheless felt compelled to intervene in the market twice in five days to stem the increase in rates. This suggests considerable pent-up domestic demand for Japanese government debt that will be unleashed as the BOJ allows yields to rise.

This is relevant given that Japanese investors are the largest foreign holders of U.S. government debt, and if the BOJ continues to adjust its yield curve control policy, allowing for even larger movements in yields, there could be a considerable rush out of U.S. government debt that would result in sharply higher yields. Moreover, given what looks to be an increasingly unsustainable fiscal path for the U.S. government, the U.S. dollar's status as the global reserve currency could be increasingly hard to sustain. Again, as we frequently point out, that there is no viable foreign alternative today does not mean that there won't be tomorrow.

So, while Fitch's downgrade may not in and of itself be a material development, we'd say that it at least calls attention to longer-term concerns that can, and unless addressed will, ultimately push yields on U.S. government debt higher. We still have time on our side, even if less of it than when concerns over the longer-term fiscal path of the U.S. government first began to be aired, which was a long, long time ago. Not that there is a simple, painless fix – there is not – but the longer we wait, the more it will hurt.

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Q1 '23 (a)	Q2 '23 (p)	Q3 '23 (f)	Q4 '23 (f)	Q1 '24 (f)	Q2 '24 (f)	Q3 '24 (f)	Q4 '24 (f)		2020 (a)	2021 (a)	2022 (a)	2023 (f)	2024 (f)
2.0	2.4	1.5	0.5	0.7	0.5	0.8	1.0	Real GDP[1]	-2.8	5.9	2.1	2.0	0.9
4.2	1.6	1.2	0.6	0.9	0.4	0.3	0.7	Real Personal Consumption[1]	-3.0	8.3	2.7	2.1	0.8
0.6	7.7	1.5	1.5	1.3	1.3	1.6	2.1	Real Business Fixed Investment[1]	-4.9	6.4	3.9	3.4	1.8
-8.9	10.8	-1.9	-3.0	-2.9	-2.4	-0.9	0.6	Equipment[1]	-10.5	10.3	4.3	-0.4	-1.4
3.1	3.9	4.4	4.3	4.1	4.3	4.2	4.1	Intellectual Property and Software[1]	4.8	9.7	8.8	4.9	4.2
15.8	9.7	3.0	5.7	4.4	2.9	0.9	0.0	Structures[1]	-10.1	-6.4	-6.6	7.8	3.8
-4.0	-4.2	4.8	5.8	3.5	-2.4	1.5	1.3	Real Residential Fixed Investment[1]	7.2	10.7	-10.6	-11.1	2.1
5.0	2.6	1.0	0.3	0.9	0.8	1.1	0.7	Real Government Expenditures[1]	2.6	0.6	-0.6	2.9	0.9
-1,208.4	-1,205.5	-1,207.3	-1,225.6	-1,238.0	-1,240.4	-1,240.1	-1,245.6	Real Net Exports[2]	-922.6	-1,233.4	-1,356.7	-1,211.7	-1,241.0
834	929	934	941	949	942	938	931	Single Family Housing Starts, ths. of units[3]	1,003	1,132	1,004	910	940
552	518	479	452	435	411	393	378	Multi-Family Housing Starts, ths. of units[3]	394	474	547	500	404
3.2	1.4	1.3	-0.4	-3.0	-5.3	-4.6	-2.5	CoreLogic House Price Index[5]	6.7	15.6	13.5	1.4	-3.9
15.3	15.6	15.6	15.4	15.7	15.5	15.6	15.6	Vehicle Sales, millions of units[3]	14.5	14.9	13.8	15.5	15.6
3.5	3.6	3.5	3.7	4.0	4.1	4.3	4.4	Unemployment Rate, %[4]	8.1	5.4	3.6	3.6	4.2
2.9	2.6	2.1	1.6	1.1	0.7	0.4	0.3	Non-Farm Employment[5]	-5.8	2.9	4.3	2.3	0.6
8.5	2.5	1.6	1.5	1.9	2.0	2.0	2.1	Real Disposable Personal Income[1]	6.2	1.9	-6.2	3.6	1.9
5.3	3.6	3.2	3.1	2.8	2.8	2.7	2.4	GDP Price Deflator[5]	1.3	4.5	7.0	3.8	2.7
4.9	3.7	3.4	3.3	2.9	2.9	2.8	2.5	PCE Deflator[5]	1.1	4.0	6.3	3.8	2.8
5.8	4.1	3.7	3.8	3.6	3.5	3.0	2.4	Consumer Price Index[5]	1.3	4.7	8.0	4.3	3.1
4.6	4.4	4.0	3.6	3.0	2.7	2.6	2.4	Core PCE Deflator[5]	1.3	3.5	5.0	4.2	2.7
5.6	5.2	4.5	4.0	3.5	3.0	2.9	2.6	Core Consumer Price Index[5]	1.7	3.6	6.1	4.8	3.0
4.56	5.03	5.31	5.38	5.38	5.07	4.71	4.35	Fed Funds Target Rate Range Mid-Point, %[4]	0.42	0.13	1.73	5.07	4.88
3.65	3.59	4.02	4.13	4.13	4.07	4.03	3.88	10-Year Treasury Note Yield, %[4]	0.89	1.44	2.95	3.85	4.03
6.37	6.51	6.99	7.07	7.01	6.88	6.71	6.46	30-Year Fixed Mortgage, %[4]	3.12	2.96	5.34	6.74	6.76
-3.3	-3.6	-3.4	-3.4	-3.3	-3.2	-3.2	-3.1	Current Account, % of GDP	-2.8	-3.6	-3.8	-3.5	-3.2

a = actual; f = forecast; p = preliminary

Notes: 1 - annualized percentage change 2 - chained 2012 $ billions 3 - annualized rate 4 - quarterly average 5 - year-over-year percentage change

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