Citi Global Wealth
Investments

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North America Strategy

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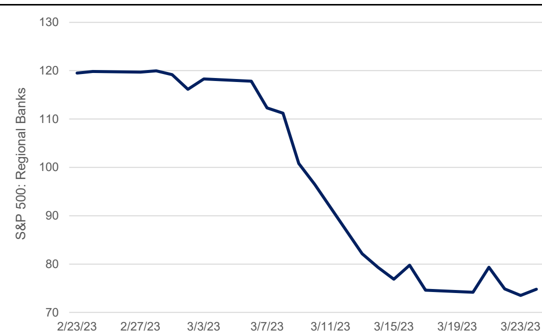
Weekly Insights: March Madness for Banks

- Last week, the S&P 500 gained 1.39%, the Dow Jones rose 1.18% and the Nasdaq composite increased 1.66%, despite the Fed raising rates by 0.25% (Figure 4).
- The S&P 500 is little changed on the month, but the environment has been anything but uneventful with the regional banks in the index down a little over 37% (Figure 1). Days after officials moved to protect the depositors of failed lenders Silicon Valley Bank and Signature Bank, the largest US banks made $30 billion in deposits with First Republic Bank to help stem the outflow of deposits at regional banks. In Switzerland, UBS took over Credit Suisse, creating one very large bank. Over the weekend, First Citizens agreed to buy Silicon Valley Bank, and take on its deposits and loans.
- Given the turmoil, investors will continue to monitor events this week. On Wednesday, banking regulators from the Fed and Federal Deposit Insurance Corporation (FDIC) are scheduled to appear before the House Financial Services Committee. The economic calendar (Figure 3) includes releases regarding home prices and sales, consumer confidence, personal income and consumption, and the Core Personal Consumption Expenditure (PCE) Deflator measure of inflation followed carefully by the Fed. In January, the Core PCE stood at 4.7% y/y.
- While some banks are under stress, the system appears stable. Still, there are implications to consider, such as (a) the links between banking and the economy, and (b) those between financial stocks and the shares of other stock market sectors. What does this mean for investors? Click here for our weekly CIO Strategy Bulletin or turn to the next page to read on.

Figure 1: Chart of the Week – S&P 500: Regional Banks



Source: Haver Analytics as of Mar 24, 2023. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.

3 THINGS TO KNOW

The economy was already slowing

Non-financial businesses and labor markets will not be immune to the spillovers of 2023's financial turmoil. The US economy was already slowing prior to the present banking crisis. Large sectors of the US economy will be impacted by changes in the availability and pricing of credit, in our view. These sectors will see a greater contraction that will have spillover effects. An overall stall in US growth will follow, along with a likely mild recession in 2023.

Keep an eye on vulnerable industries

Looking forward, we expect already weak and vulnerable industries – particularly those dependent on bank lending – to be more deeply impacted than previously expected. While housing has been restrained by the Fed's interest rate pressure, solid underlying demand support remains, albeit at levels far below the 2020 peak. Compare that with demand and supply in major parts of the commercial real estate market, which are weakening now and likely to worsen further (Figure 2).

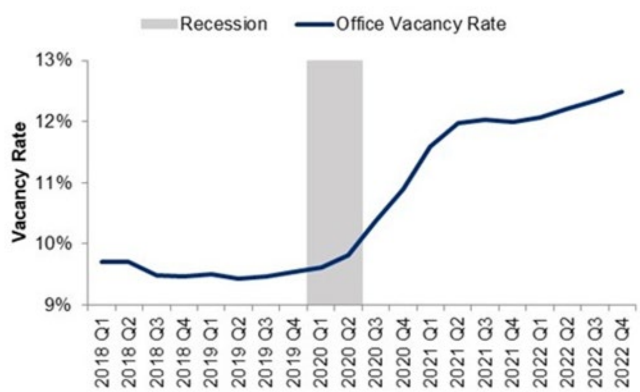
US positioned for a shallow recession

We believe the US economy is positioned for a shallow recession. Owing to a historically mild period of growth in employment since Covid hit in 2020, we would expect the US unemployment rate to rise two percentage points from its recent low over the course of 2023-2024. It's also important to understand the Fed's role in containing the self-reinforcing impact of job declines once they begin.

As Go the Banks, So Goes the Economy

To understand the likely economic impacts from recent events, Citi Global Wealth Investments (CGWI) makes a few key observations about the overall stability of banks in developed markets and the fact that the budding financial distress stems, in part, from the painful interest rate shock the Fed delivered to the US economy. We believe the US economy is positioned for a shallow recession. Owing to a historically mild period of growth in employment since Covid hit in 2020, we expect the US unemployment rate to rise two percentage points from its recent low over the course of 2023-2024. We still disagree with economists who think non-financial businesses and labor markets will come out of 2023's financial turmoil unscathed. The US economy was already slowing before the unexpected failure of two US banks. Already weak and vulnerable industries – particularly those dependent on bank lending – will be more impacted than previously expected.

Figure 2: US office vacancy rate (%)



Haver Analytics as of March 24, 2023. Past performance is no guarantee of future results. Real results will vary.

What does this mean for investors?

Non-financial shares have never avoided following banking shares into a correction. The performance to date of US equity markets has not entirely bucked this trend. Large cap shares have performed better than small cap shares. Smaller firms often don't have the balance sheet strength and liquidity to maintain the confidence of markets.

The economy was already slowing

The impact of the failure of two US midsized banks and the forced marriage of two Swiss institutions is rapidly unfolding. Last week another midsized US bank saw a further collapse in its market value. Most, but not all, developed market banks are well-capitalized and have strong access to liquidity. The banking system is fundamentally stronger and better managed than it was in the crisis of 2008-09. Still, banks face increasing depositor and market scrutiny, intensified by ambiguous comments from regulators and policy makers. We still disagree with economists who think non-financial businesses and labor markets will be immune to the spillovers of 2023's financial turmoil. The US economy was already slowing prior to the present banking crisis. Large sectors of the US economy will be materially impacted by changes in the availability and pricing of credit, in our view. These sectors will see a greater contraction that will have spillover effects. An overall stall in US growth will follow, along with a likely mild recession in 2023. Central banks – particularly the Fed – are actively trying to restrain the economy. This is clear from the Fed's recent decision to proceed with a further 25 basis point increase in its key policy rates amid rising bank uncertainties. But we also think the Fed's tightening cycle will end shortly – if it hasn't already. If there's a rise in unemployment, this reactive Fed has the predisposition to pivot quickly. Despite poor headline optics, underlying inflation is slowing significantly.

Keep an eye on vulnerable industries

While housing has been restrained by the Fed's interest rate pressure, solid underlying demand support remains, though at levels far below the 2020 peak. Compare that with demand and supply in major parts of the commercial real estate market, which are weakening now and likely to worsen further. US office vacancies have risen consistently during the post-Covid recovery. Looking at a broad measure (much wider than office construction and maintenance), non-residential structures investment has been falling for several quarters and its weakness will accelerate with less credit available from banks. Commercial real estate defaults are likely to balloon from their present low levels. With small and midsized banks suffering from deposit flight in recent weeks, bank managements will feel less able to extend new credit or restructure old loans. Even if deposits stabilize, the cost of those deposits has risen sufficiently that banks will need to charge more and lend less (at a lower loan to value) over the years to come. We see negative post-Covid office trends and the unfolding banking crisis multiplying the stresses that commercial real estate owners and investors will face. This is clearly the area where small and midsized banks have pushed for market share, lending most rapidly.

US is positioned for a shallow recession

We believe the US economy is positioned for a shallow recession. Owing to a historically mild period of growth in employment since Covid hit in 2020, we would expect the US unemployment rate to rise two percentage points from its recent low over the course of 2023-2024. As this unfolds, it's important to note the Fed's role in containing the self-reinforcing impact of job declines once they begin. The Fed has previously cut its policy rate in each case of a recessionary rise in unemployment, including the early 1980s episodes. In the 80s, the Fed cut rates during a difficult fight to restrain inflation. We expect the same reaction from this Fed in the year to come. The bond market has recently moved much closer to our view of the US monetary policy outlook and may have "shot beyond" it. Aggressive easing expectations could be set back if US and world policymakers succeed in quashing concerns over the health of financial institutions. With great volatility, markets now price in more than one Fed rate cut by July. Such cuts would only be likely if the present turmoil worsens.

Portfolio considerations

Non-financial shares have never avoided following banking shares into a correction. The performance to date of US equity markets has not entirely bucked this trend. Large cap shares have performed better than small cap shares. Smaller firms often don't have the balance sheet strength and liquidity to maintain the confidence of markets. The Russell 2000 small cap index has underperformed the Russell 1000 large cap index by about 5 percentage points year-to-date. We expect further near-term underperformance of small and midcap shares. There are, however, some areas where investors may hold onto the view that "what happens in financials stays in financials." Industrial property REITS are sharply outperforming office REITS. As noted previously, we see the office market as the most troubled sector fundamentally, but tightening bank lending standards won't leave other property sectors untouched.

Economic Calendar and Financial Market Returns

Figure 3: US Economic Releases

Date	Time	Event	Period	Survey	Prior
3/27/2023	10:30	Dallas Fed Manf. Activity	Mar	-11	-13.5
3/28/2023	8:30	Wholesale Inventories MoM	Feb P	--	-0.40%
3/28/2023	8:30	Advance Goods Trade Balance	Feb	-$90.0b	-$91.5b
3/28/2023	8:30	Retail Inventories MoM	Feb	--	0.30%
3/28/2023	9:00	FHFA House Price Index MoM	Jan	-0.30%	-0.10%
3/28/2023	9:00	S&P CoreLogic CS 20-City MoM SA	Jan	--	-0.51%
3/28/2023	9:00	S&P CoreLogic CS 20-City YoY NSA	Jan	--	4.65%
3/28/2023	9:00	S&P CoreLogic CS US HPI YoY NSA	Jan	--	5.76%
3/28/2023	10:00	Conf. Board Consumer Confidence	Mar	101.5	102.9
3/28/2023	10:00	Conf. Board Present Situation	Mar	--	152.8
3/28/2023	10:00	Conf. Board Expectations	Mar	--	69.7
3/28/2023	10:00	Richmond Fed Manufact. Index	Mar	-8	-16
3/28/2023	10:00	Richmond Fed Business Conditions	Mar	--	-6
3/28/2023	10:30	Dallas Fed Services Activity	Mar	--	-9.3
3/29/2023	7:00	MBA Mortgage Applications	24-Mar	--	3.00%
3/29/2023	10:00	Pending Home Sales MoM	Feb	-3.50%	8.10%
3/29/2023	10:00	Pending Home Sales NSA YoY	Feb	--	-22.40%
3/30/2023	8:30	Initial Jobless Claims	25-Mar	--	--
3/30/2023	8:30	GDP Annualized QoQ	4Q T	2.80%	2.70%
3/30/2023	8:30	Continuing Claims	18-Mar	--	--
3/30/2023	8:30	Personal Consumption	4Q T	--	1.40%
3/30/2023	8:30	GDP Price Index	4Q T	--	3.90%
3/30/2023	8:30	Core PCE QoQ	4Q T	--	4.30%
3/31/2023	8:30	Personal Income	Feb	0.20%	0.60%
3/31/2023	8:30	Personal Spending	Feb	0.30%	1.80%
3/31/2023	8:30	Real Personal Spending	Feb	-0.10%	1.10%
3/31/2023	8:30	PCE Deflator MoM	Feb	0.40%	0.60%
3/31/2023	8:30	PCE Deflator YoY	Feb	--	5.40%
3/31/2023	8:30	PCE Core Deflator MoM	Feb	0.40%	0.60%
3/31/2023	8:30	PCE Core Deflator YoY	Feb	--	4.70%
3/31/2023	9:45	MNI Chicago PMI	Mar	43.6	43.6
3/31/2023	10:00	U. of Mich. Sentiment	Mar F	63	63.4
3/31/2023	10:00	U. of Mich. Current Conditions	Mar F	--	66.4
3/31/2023	10:00	U. of Mich. Expectations	Mar F	--	61.5
3/31/2023	10:00	U. of Mich. 1 Yr Inflation	Mar F	--	3.80%
3/31/2023	10:00	U. of Mich. 5-10 Yr Inflation	Mar F	--	2.80%

Source: Bloomberg as of Mar 24, 2023

Figure 4: Financial Market Returns

Close as of (3/24/23)	Yesterday Closing Price	Latest Week % Chg	One Month % Chg	Three Month % Chg	Six Month % Chg	52 Week % Chg	Yr to Date % Chg
US Markets							
S&P 500	3,970.99	1.39	0.02	3.28	7.52	-12.15	3.42
Russell 2000	1,734.92	0.52	-8.23	-1.48	3.29	-16.41	-1.49
Russell 1000 Growth	2,383.65	1.63	3.76	10.07	9.35	-14.27	10.45
Russell 1000 Value	1,444.86	0.97	-4.88	-3.38	5.03	-11.62	-3.49
NASDAQ Composite Index	11,823.96	1.66	3.76	12.63	8.80	-16.68	12.97
DJ Industrial Average	32,237.53	1.18	-1.77	-2.91	8.95	-7.12	-2.74
S&P 500 Sectors							
S&P 500 / Consumer Discretionary -SEC	1,102.47	0.4	-1.34	9.36	-4.10	-24.18	9.65
S&P 500 / Consumer Staples -SEC	761.34	1.4	0.33	-3.12	5.08	-2.00	-2.28
S&P 500 / Energy -SEC	598.03	2.3	-7.33	-10.52	10.21	1.71	-11.05
S&P 500 / Financials -SEC	515.97	0.6	-12.90	-8.82	-0.19	-20.54	-9.44
S&P 500 / Health Care -SEC	1,484.65	1.5	-0.74	-6.54	3.74	-6.13	-6.36
S&P 500 / Industrials -SEC	820.48	0.7	-3.13	-1.49	14.34	-5.91	-1.31
S&P 500 / Information Technology -SEC	2,552.04	2.0	7.57	17.31	17.56	-8.48	17.49
S&P 500 / Materials -SEC	484.05	2.1	-5.33	-2.29	12.33	-12.80	-1.12
S&P 500 / Real Estate - SEC	223.61	-1.2	-6.64	-4.36	-4.93	-23.38	-3.77
S&P 500 / Communication Services -SEC	188.77	3.4	9.50	18.35	12.98	-20.14	18.45
S&P 500 / Utilities -SEC	333.82	-1.2	-0.99	-7.48	-8.46	-8.41	-6.88
International Markets							
MSCI Canada	1,922.61	0.55	-4.68	-1.53	4.13	-19.20	-1.16
MSCI EM (Emerging Markets)	972.17	2.17	0.03	1.82	7.32	-14.49	1.65
MSCI Europe	1,812.70	2.05	-1.60	4.64	25.04	-4.41	4.68
MSCI United Kingdom	1,082.92	1.73	-3.94	0.24	17.87	-7.79	0.78
MSCI Japan	3,277.44	0.89	2.61	4.48	11.42	-9.04	4.42
MSCI AC World	625.06	1.46	-0.47	3.18	10.07	-11.82	3.25
Fixed Income, Commodities & US $							
10-year Treasury Absolute Level (%, end of period)	3.38	3.39	3.94	3.75	3.69	2.34	3.88
Crude Oil WTI (NYM $/bbl)	69.26	3.48	-9.51	-13.82	-11.90	-32.50	-14.57
Gold (NYM $/ozt)	1983.80	0.52	9.17	9.03	17.79	-2.28	7.72
United States Dollar Index	103.12	-0.57	-1.99	-1.15	-8.90	4.38	-0.39

Source: FactSet as of March 24, 2023. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.

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Credit risk	**Moody's**[1]	**Standard and Poor's**[2]	**Fitch Ratings**[2]
Investment Grade			
Highest quality	Aaa	AAA	AAA
High quality (very strong)	Aa	AA	AA
Upper medium grade (Strong)	A	A	A
Medium grade	Baa	BBB	BBB
Not Investment Grade			
Lower medium grade (somewhat speculative)	Ba	BB	BB
Low grade (speculative)	B	B	B
Poor quality (may default)	Caa	CCC	CCC
Most speculative	Ca	CC	CC
No interest being paid or bankruptcy petition filed	C	D	C
In default	C	D	D

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Additionally, the underlying collateral supporting non-Agency MBS may default on principal and interest payments. In certain cases, this could cause the income stream of the security to decline and result in loss of principal. Further, an insufficient level of credit support may result in a downgrade of a mortgage bond's credit rating and lead to a higher probability of principal loss and increased price volatility. Investments in subordinated MBS involve greater credit risk of default than the senior classes of the same issue. Default risk may be pronounced in cases where the MBS security is secured by, or evidencing an interest in, a relatively small or less diverse pool of underlying mortgage loans.

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