MV CAPITAL MANAGEMENT

Weekly Market Flash

What's Next for the Economy?

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We have had quite a bit of data dumped on us recently, with even more to come before this week is over as we are writing this before the publication of the BLS April jobs report later this morning. There is a lot to analyze, and some conflicting signals. Let's start with the Fed.

Meaningful Change

Jay Powell couldn't say outright that the Fed is done with raising rates, but he performed an exceptionally clear pantomime of saying exactly that during the post-FOMC press conference on Wednesday. In the official press release the phrase "some additional policy firming may be appropriate," a staple of every press release since March 2022, was conspicuously absent. Powell made a point of saying, during the press conference, that the omission of that language was "meaningful." As in, don't expect to see another rate hike in June unless the inflation reports between now and then are insanely higher than anyone expects. The pause period is here.

But the rate cut period is not here, repeat, not here. When the question came up during the press conference, as it was certainly going to, Powell was ready. No vacillating in a way that could be misinterpreted by investors. We have no plans to cut rates in 2023, he said for something like the two-hundredth time this year. And yet where did interest rates go after that comment? Down, of course. The two-year Treasury yield is around 3.8 percent right now, which is 1.2 percent below the Fed funds rate's new lower bound of 5.0 percent. Yes, the bond market still thinks rate cuts are going to start as early as June. We have nattered on about this time and again in recent commentary, but that's because the bond market's willful insistence on fighting the Fed still mystifies us.

Consumers Holding On, For Now

Powell did sound reasonably upbeat about the economy's chances of avoiding a hard landing, which puts him somewhat at odds with the general consensus among economists that the downturn is nigh. Our own take on this for some time has been that the economy is likely to experience a mild and brief cyclical recession, but nothing more serious in the absence of a parallel financial crisis (we'll come back to this point below). What do the latest numbers tell us?

Let's consider last week's preliminary estimate of first quarter real GDP growth. The headline number was quarter-on-quarter growth (annualized) of 1.1 percent. That represents a meaningful slowdown from the previous quarter's rate of 2.6 percent. But consumer spending in the Q1 report was actually pretty good, coming in at 3.7 percent. Notably, it was big-ticket items like cars and major appliances that showed the highest growth rate. In fact, consumers are still spending more than we would have expected them to be spending at this point given the slowdown in household disposable income and the rise in credit balances.

We're seeing signs of consumer resilience in some of the earnings reports coming out as well. Companies like Procter & Gamble which are benchmarks for consumer spending trends appear to be operating from the same playbook as last year in keeping profit margins high through charging higher prices even while volumes in many categories remain flattish. This trend may not last for much longer, depending largely on whether the labor market continues to run hot. Here again we have some conflicting signals. A report

earlier this week showed that job vacancies have fallen to their lowest levels in two years, which suggests that the market is beginning to cool off. However, another survey released a day later showed job gains coming in at twice the rate economists expected. We'll have to see, of course, which way today's forthcoming BLS jobs report points. For now, though, the consumer seems to be doing okay.

The Credit Conditions Curveball

When we used the phrase "absence of a parallel financial crisis" a few paragraphs above, what comes to mind first and foremost is the fact that instability in the regional banking industry has not gone away. A handful of West Coast lenders have been in the crosshairs this week, with plunging share prices and talk of "strategic options" which usually means "looking for a white knight to buy us." The banks at the center of the unrest include PacWest and Western Alliance (the latter, though, denies that it is actively seeking a buyer and notes that its deposits have actually risen by more than $1 billion since the end of March).

It is noteworthy that the very first thing Jay Powell said in his opening remarks at yesterday's press conference was that conditions in the banking sector had markedly improved since March and that the system itself was sound. That has been our understanding as well, as we have noted in several recent commentaries. Nonetheless, it is a fact of life that banks rely on confident depositors to stay healthy, and those depositors can get spooked very quickly if they perceive that their money might be at risk. If you are, say, a PacWest depositor and you see that PacWest's stock has fallen by 50 percent in one day, then your brain's limbic fight-or-flight neurons are likely to start flashing.

We continue to believe that a systemic crisis in the banking sector is a very low-probability event. In the absence of one, our near-term outlook on the economy is, if anything, a little better than it was even two months ago. But we need to pay heed to what might be around the next bend.

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