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Recession Watch

Recession odds are increasing. The second quarter annual rate GDP decline of 0.9%, albeit less than the 1.6% first quarter decline, only adds to the probability of a recession in our view. Some argue we are already in one. Looking at the elements of the decline, the forward performance of GDP looks weak at best. Consumption (PCE) grew only at a 1.0% linked quarter pace, barely half that of the prior quarter and its lowest since the pandemic during 2020. Consumer spending is presumably rolling over, with the only growth in services.

Of far greater concern for bank loan growth, linked quarter Private Fixed Investment (PFI) plummeted to a 13.5% decline in annual rate from 5.0% growth in the previous quarter. This calls into question whether the high pace of commercial lending growth shown during the first half can even modestly prevail in the second half.

Financials are very dependent on the economic cycle. We have maintained our outlook for decelerating economic growth calling for either stagflation or a shallow recession in 2023. If shallow, the sector should perform as well as the overall market but current data cannot verify this assumption. We do not have enough forward conviction to make a defining call. The market has partly priced in a shallow recession in our view. Sticky inflation could lead to the Fed overshooting its tightening stance, delivering a more severe outcome. This is everyone's concern.

After the 75bp hike in the May Policy Rate it became surprisingly clear that the Fed is chasing commodity prices, which is driving headline inflation, something over which it has no direct control. The hike immediately followed the 8.6% headline CPI report for May. The same pattern emerged from the June CPI print of 9.1%, which will hopefully prove to be the peak as energy prices have moderated. Monetary policy is now committed to further rate increases but with little, short term nominal inflation relief yet visible.

Hence the odds of overshooting with demand destruction are increasingly high. With the underlying real GDP growth trajectory already decelerating, any further demand curtailment easily can continue to drive growth into negative territory. Separately, the latest Purchasing Managers Index has also plummeted, to 47.5 in July from 52.3 in June, arguing for ongoing business spending weakness.

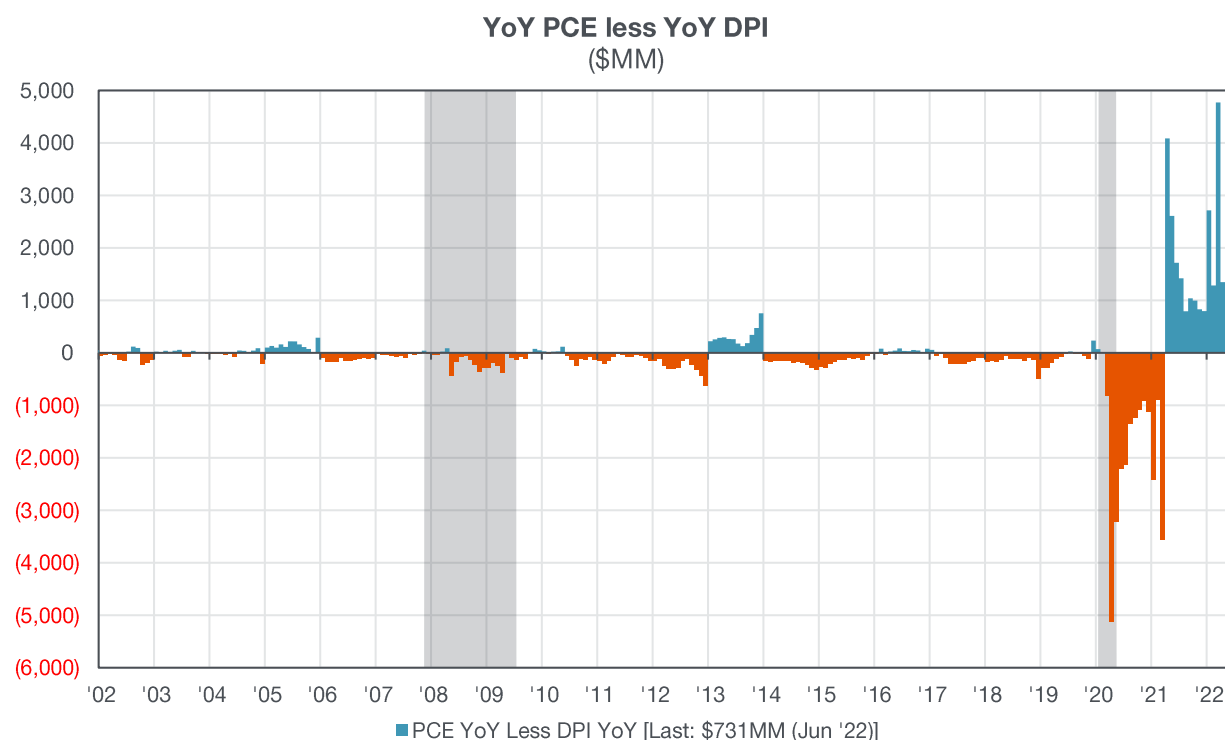
In contrast, second quarter bank earnings conference calls only revealed earnings misses for those with material capital markets exposure, while most regional and community banks were still showing solid loan growth, rapid net interest margin expansion with earnings results overall exceeding expectations. While overall loan growth was generally up 10%+ year-over-year, and linked quarter annualized growth in high double digits, forward guidance was less than sanguine for the second half with some expecting a plateau as the economy slows.

Credit quality also remains exceptional but forward guidance was somewhat cautionary, ultimately expecting some eventual loss rate normalization and deterioration, although not dramatically so at this juncture. Loss reserves have been only modestly building for some, but not dramatic or universal in any

sense. We conclude banks are inputting a moderate economic slowdown and/or perhaps only a shallow recession in their CECL reserve modeling.

Financials traditionally underperform during recessions. This is particularly true for bank stocks when loan growth decelerates, and loan losses rise. Ironically, the higher rates go the better their net interest margins, which can blunt the overall impact depending on the severity and length of any recession. This is unknown at present, and we still expect earnings projections can fall in coming quarters – along with the earnings outlook for the general market. However, with strong consumer and business balance sheets a shallow recession should not drive excessive loan losses. While the sector may perform well enough to match the overall market, until the nature of any upcoming recession is clear it remains vulnerable to negative investor sentiment for financials in general.

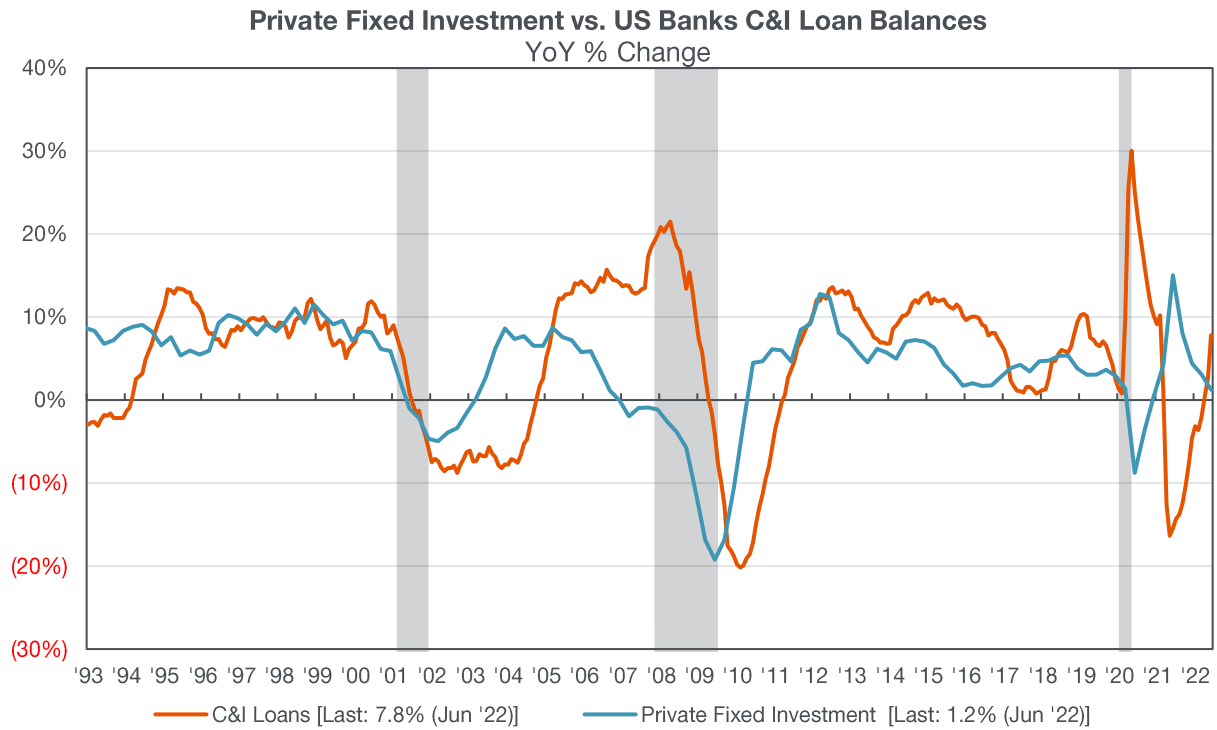
Several macro indicators have recently shown signs of upcoming weakness. Consumer spending is potentially vulnerable to further deceleration as the Personal Consumption numbers have significantly exceeded Disposable Personal Income for many quarters and may be running out of capacity to do so. Historically, PCE nearly matches DPI far more closely than it has over the last two+ years. See the chart below.



Source: BEA

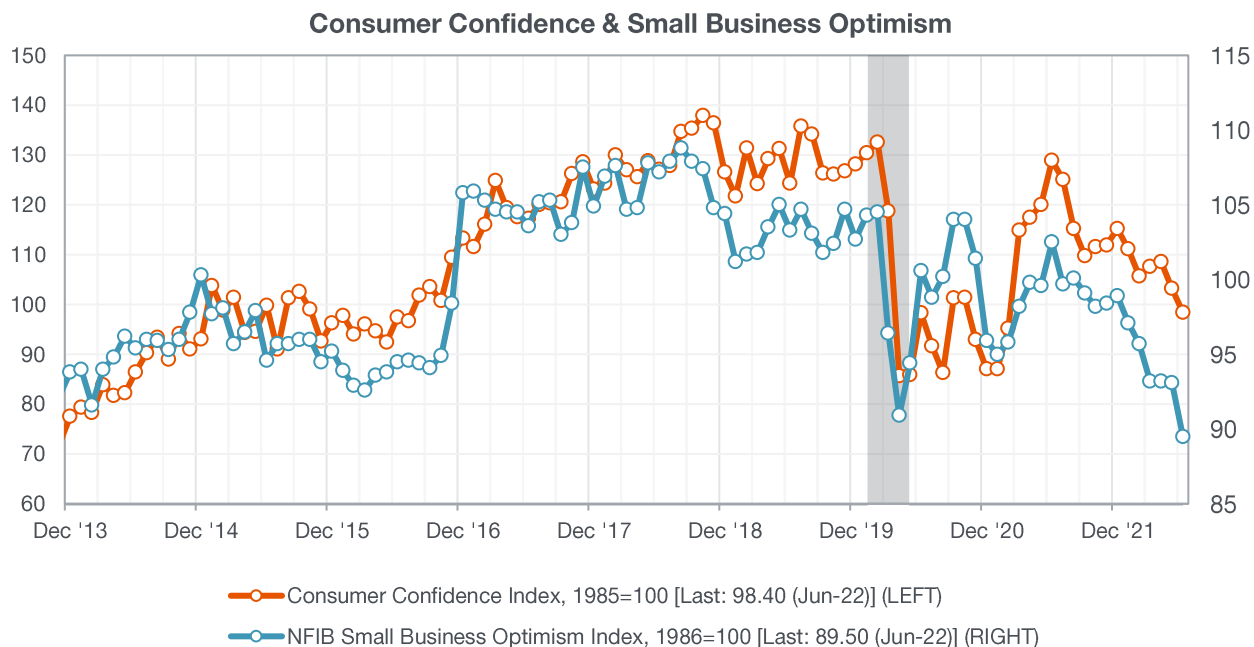
During the pandemic PCE fell below DPI year on year on average by \$2.0 trillion as the savings rate rose sharply. Since the first quarter of 2021 PCE has on average exceeded DPI by nearly \$1.7 trillion. Second quarter DPI averaged year-over-year growth of only 1.9%, against an 8.4% advance in PCE. That is an unsustainable differential. Consumption is presumably headed for lower growth assuming PCE falls back in line with DPI growth in coming quarters. A moderating defense against this occurring is the consumer balance sheet, which is carrying an estimated \$2.7 trillion in excess savings from pandemic government support. It is unclear, in a weakening economy, how much the consumer will continue to spend out of savings.

The relationship between commercial lending and PFI is shown below. Over history the cyclical course of business loans lags PFI, rather loosely, anywhere from 12 to 18 months when tracked on a year-over-year percentage basis. PFI growth peaked in the middle of last year, so the subsequent decline could likely be felt in bank lending during the second half of this year, and any further weakness will spill over into 2023. If we are following any macro indicator more closely than others, PFI fits the bill.



Source: BEA & FRB

Confidence has also meaningfully eroded. Consumer confidence has declined all year and small business optimism has dropped further to a recent low. The latter is particularly worrisome as it foreshadows the trend in Private Fixed Investment. This could clearly constrain business loan demand.



Source: Michigan & NFIB Surveys

The Fed's ongoing response to sticky inflation will ultimately determine whether we are erring on the optimistic side. We are admittedly on the fence pending further data points in the second half. The Fed is highly sensitive to inflation expectations, which have only improved slightly. The July University of Michigan Sentiment Survey indicated 2.8% expected inflation rate in the 5-10 year timespan, down from 3.1% in June, but it crept back up to 2.9% in July. This compares to 2.4% on average pre pandemic. Whether this is considered "un-moored" is in the eyes of the beholder. It isn't good.

Separately, we note that all the rate hikes to date have not had enough elapsed time to actually dampen demand. Most economists believe it takes six months for rate hikes to have their impact. So neither we nor the Fed can really evaluate the effectiveness of recent tightenings. The Fed is still raising rates into the future, with another 75bp hike in July and ongoing hikes during the second half. This will catapult the Policy rate above 3% soon, but that is still in neutral territory, not necessarily braking economic growth. We see yearend Fed Funds in a range of 3.5-4.0%. Real tightening is yet to come.

Second quarter earnings conference calls revealed exceptional loan growth for many but driven almost exclusively by robust C&I while CRE was weak or declining in general. Consumer momentum held up. Guidance on calls was restricted to second half 2022 with no commentary on 2023. Within C&I managements indicated the driver was primarily inventories with capital expenditures only secondary and lukewarm. Second half guidance was cautionary, making it clear that momentum is expected to cool.

Net interest margin expansion continued in dramatic fashion and is likely to continue so. Coupled with earning asset growth fueled by loans as well as securities, net interest income on a linked quarter basis was powerful, in many cases exhibiting high single digit expansion on a linked quarter basis. Deposit betas were revisited but nothing threatening emerged to deflect future prospects for NII. Mortgage banking was predictably weak with little hope for second half rejuvenation as gains on sales continue to decline.

Expense growth on a year-over-year basis almost universally stayed below revenue growth providing positive operating leverage. Inflationary impact on salaries, T&E and other categories was reported but insufficient to threaten positive leverage overall.

Bottom line results generally matched or exceeded analyst estimates. But some analyst estimates continue coming down, particularly for 2023. Price targets likewise as forward P/Es are being reduced in the face of, and to reflect, macro uncertainty.

Credit quality remains exceptional but investors are questioning forward guidance as they remain on “recession watch.” Loss provisions are rising but mostly reflecting loan growth, not incorporating convincing reserve additions over actual loan losses. Most managements disclosed they have updated CECL scenarios to represent recession risk but there was no quantification of the severity of such assumptions. As mentioned credit was expected to “deteriorate and normalize” without sharing any range of expectations going forward. Only early delinquencies in subprime were mentioned. Most stated that future damage should be nothing like what was experienced in past recessions and they argue could not justify the recent level of stock weakness that they have experienced.

Based partly on stress tests and a general cautious stance in front of a possible recession approximately one in five banks suspended or cut back on their share buybacks, expecting to revisit this stance in early 2023.

Lastly there was ample, universal evidence of deposit balances in decline. Most of this was either attributed to Fed actions and/or customers running down their excess liquidity. Municipal deposit run off was also frequently cited. This is expected to continue and loan-to-deposit ratios are going to be on the rise. Unsurprisingly, the deposit mix is steadily shifting to time deposits. Deposit betas are still lagging investor’s somewhat suspicious expectations and are generally guiding to a 25-30% endpoint by 2023.

In sum we have highlighted several items/macros impinging on bank stock performance. In reality there are too many, each bearing their own uncertainties, to properly define the likely future. And we have omitted mentioning three externals – the Ukraine War, supply driven inflation and the risk of another Covid 19 breakout in the fall – none of which will be clear for several months if not quarters. We expect third quarter macros and bank earnings guidance will better clarify the most likely future for the industry. Uncertainty still prevails.

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