First Trust
Portfolios Canada®
Monday Morning OUTLOOK

Brian S. Wesbury – *Chief Economist*
Robert Stein, CFA – *Dept. Chief Economist*
Strider Elass – *Senior Economist*
Andrew Opdyke, CFA – *Economist*
Bryce Gill - *Economist*

416-865-8065 • www.firsttrust.ca

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Bank Problems Aren't Over, But It's Not 2008

Yes, we have banking problems. No, this is not 2008. It's much more like the 1970s Savings & Loan problems. In other words, we do not have credit problems today, we have duration (asset-liability) problems. These are exacerbated by the fact that Quantitative Easing inflated total deposits in the banking system.

In the 1970s, the Federal Reserve held interest rates too low for too long. From 1974 through 1978, the federal funds rate was below inflation most of the time, and the "real" federal funds rate averaged -1%. At the same time, because of strict regulations on lending, branch banking, and other issues, S&Ls only made, and held, long-term fixed rate mortgages.

So, S&Ls were paying relatively low short-term rates to depositors (even though they slowly rose as inflation picked up), while earning higher returns on long-term mortgages. As the 1970s progressed, and with Paul Volcker taking over the Fed, short-term rates rose above rates on loans. By the end of the 1970s, the entire S&L industry had negative net capital.

Today, in some ways, we are facing the same problems. Between 2008 and 2021, the Fed held the federal funds rate at close to 0% for nine years, and below inflation 84% of the time. At the same time, because of QE, the M2 measure of money has increased 188%. And because of COVID and financial panic (2008/09) borrowing; total government debt has grown massively as well.

In other words, banks got stuffed with deposits at the same time government debt (of all kinds) exploded. And banks, because of the Fed, could pay depositors very little, while favorable capital rules on Treasury, FNMA, GNMA, and SLMA debt encouraged them to hold long-term bonds.

Now that the Fed is lifting interest rates, two things are happening: 1) bank assets bought at lower rates are worth less and 2) rates paid on deposits are now much higher than rates earned on many of these assets. For example, in 2020, the 10-year Treasury yield was 0.6%. If a bank thought the Fed would not raise rates above 0%, then they could anticipate positive cash flow, even from that low rate. But now, short-term rates are 5%. The result: huge losses.

Before going into what this means for the economy, it is important to say that this didn't need to happen. Today's problems are because of a combination of QE, abundant-reserve monetary policy, and ultra-low interest rates. The Fed told market participants that inflation was "transitory" and therefore many banks expected any increases in short-term interest rates to be short-lived as well. If you believed the Fed, you now have an un-balanced balance sheet.

So, what can the Fed do? If it lowers short-term rates, inflation may be more of a problem, and it doesn't want to do that. So, instead, it is backstopping the problem by going in and taking back, at par, government debt, which in essence is restarting QE. We think this policy helps the government at the expense of private sector loans, but this has been going on for many years now.

The other thing the Fed and FDIC can do is insure "all" deposits, not just up to a $250,000 limit. If they don't do this, money will continue to move to the very large banks, and it is highly likely that more small, medium and regional banks will get in trouble. In other words, the Fed (like in the 1970s) is finding its way through the problems it created by making new policies up as it goes along. It's not 2008. We are not seeing widespread credit problems and markets are not freezing up.

Finally, in the past year, M2 has contracted by 4.1%, the fastest drop the US has experienced since the Great Depression. However, in spite of this decline, M2 is still up $5.4 trillion from where it was pre-pandemic. The decline in M2 will show up as a decline in deposits at some banks, but the bulge in money has still not worked its way entirely through the economy. Hence, for the time being, some modest continued economic growth.

In other words, inflation is likely to remain elevated this year and the Fed is unlikely to cut rates anytime soon. The end of the story is not written. We fully expect more banking problems, but also anticipate these problems to be dealt with by policies that kick the can down the road. The stock market appears to be saying "no problem" – we think it may be overly optimistic about that.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
5-10 / 7:30 am	CPI – Apr	+0.4%	**+0.5%**		+0.1%
7:30 am	"Core" CPI – Apr	+0.3%	**+0.4%**		+0.4%
5-11 / 7:30 am	Initial Claims – May 6	245K	**241K**		242K
7:30 am	PPI – Apr	+0.3%	**+0.2%**		-0.5%
7:30 am	"Core" PPI – Apr	+0.2%	**+0.3%**		-0.1%
5-12 / 7:30 am	Import Prices – Apr	+0.3%	**+0.2%**		-0.6%
7:30 am	Export Prices – Apr	+0.2%	**+0.2%**		-0.3%
9:00 am	U. Mich Consumer Sentiment- May	63.0	**63.5**		63.5