BAILEY FINANCIAL GROUP

OF OXFORD HARRIMAN & CO.

Friday, November 10, 2023

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ECONOMIC CHECK IN

3 things we are watching in the current economy.

Recession or "soft landing"? Some market-watchers are ready to open the champagne and celebrate this as the first major rate-hike cycle ever to avoid a substantial recession.

While there's a lot to like in the economy today, it may be too soon to count all the unhatched chickens. Here are three issues that warrant continued attention.

1 – It's still the seventh inning of the economic cycle.

One simple fact is that the economic cycle is not finished yet. The Federal Reserve (Fed) continues to leave the door open on the possibility of additional rate hikes because inflation is not yet at its target level. At the very least, policymakers have made it clear that rates need to stay high for longer.

It may seem like these late innings are moving slower than the early ones – they are. Rate hikes started off fast and furious, but waiting on the actual impact is a much a slower process. In Fedspeak, the phrase that often comes up is "a long and variable lag." The lag is the delay between an interest rate hike and its intended effect. Interest rates are nestled deep in the structural cash flows of the economy – in mortgage payments and machinery financing costs and credit card payments. But many of those credit arrangements are fixed for long periods and do not instantaneously refinance just because the Fed hiked its target overnight rate. Rate hikes only touch a small portion of credit transactions in the present, but gradually those changes spread to a deeper share of the cash flows in the economy as old debts mature or refinance. Slowly the rate hikes affect underlying economic activity and decision making.

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[1]https://www.nber.org/system/files/chapters/c11462.pdf, https://fred.stlouisfed.org/series/CPIAUCSL#0, https://fred.stlouuisfed.org/series/DGS10,
[2]https://www.irs.gov/retirement-plans/minimum-present-value-segment-rates (PM-04182025-6031848.1.1)

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"… The lag is the delay between an interest rate hike and its intended effect. Interest rates are nestled deep in the structural cash flows of the economy…"

The "long and variable lag" has some extra legs in this cycle, because the ultra-low rates that came before were held for far too long – and then they were followed by cash spigot of pandemic relief programs. The dynamics in the housing market are also blunting the impact of the Fed's rate hikes with unintentional consequences. Because mortgages were so cheap before, many homeowners are reluctant to trade their current mortgage for a new one, adding to the problem of limited housing supply and contributing to high housing prices. That dynamic will eventually change when adjustable rates take effect, mostly for sub-prime borrowers.

[1] https://www.stlouisfed.org/publications/regional-economist/2023/may/examining-long-variable-lags-monetary-policy (PM-04182025-6031848.1.1)

2 – The regional bank situation is not resolved.

We saw the first real fallout from rate hikes this March when regional banks faced duress because of bank runs connected with distress in technology and venture capital firms. The shockwave put a spotlight on regional banks, which are holding a substantial share of an undesirable asset these days - namely commercial mortgage-backed securities and property loans.

Reinvestment risk is all about the possibility that those short-term rates deflate somewhere along the way, leaving investors holding cash without good yield options to choose from. One strategy for addressing this risk is to add some longer-dated investments, locking in yield.

It may even seem counterintuitive in situations where there are more appealing rates available for shorter-term offerings. Still, the idea is to go for the longer-term choice, locking in the yield that is on the table today. That could mean extending from a money market account to a short-term CD or from a short-term bond to a medium-term bond.

A bar chart showing that there is $1.3 trillion of U.S. commercial property loans maturing over the next three years. The chart shows loans maturing in 2023, 2024 and 2025, broken down by four different lender groups: banks, insurance, securitizations, and other. The chart shows that there is a concentration of maturing loans held in securitizations in 2023. In 2024 and 2025, the majority of maturing commercial

Now, regional banks have a safer backstop of more FDIC insurance, which is helpful to stop depositors from fleeing. However, regional banks still have this concentrated exposure to the commercial real estate world.

Commercial property loans are structured differently from residential loans. They typically have shorter loan terms and balloon payments at maturity, with the intention of refinancing. Meanwhile, all mortgage rates are sharply higher and many commercial property values are down. The outlook for refinancing is not ideal – bad news for the current lenders and, according to JPMorgan Chase CEO Jamie Dimon, the area most likely to cause harm to banks. As Dimon put it back in May, "The off-sides in this case will probably be real estate. It'll be certain locations, certain office properties, certain construction loans."[2]

According to data from MSCI Real Assets, there's about $1.3 trillion of debt connected to U.S. commercial real estate coming due in the next three years.[3] The timeline to watch is probably even shorter than that, as credit conditions have been tighter and loan loss reserves will be needed to make up for gaps on properties that are not able to refinance and instead face foreclosure.

3 – Debt levels are becoming less manageable.

It's not just regional banks that are facing balance sheet problems. Governments have some growing issues – not least of all the U.S. federal government, which now carries more than $33 trillion of government debt, thanks to higher budget deficits from tax cuts, stimulus payments and even from higher debt-servicing costs.

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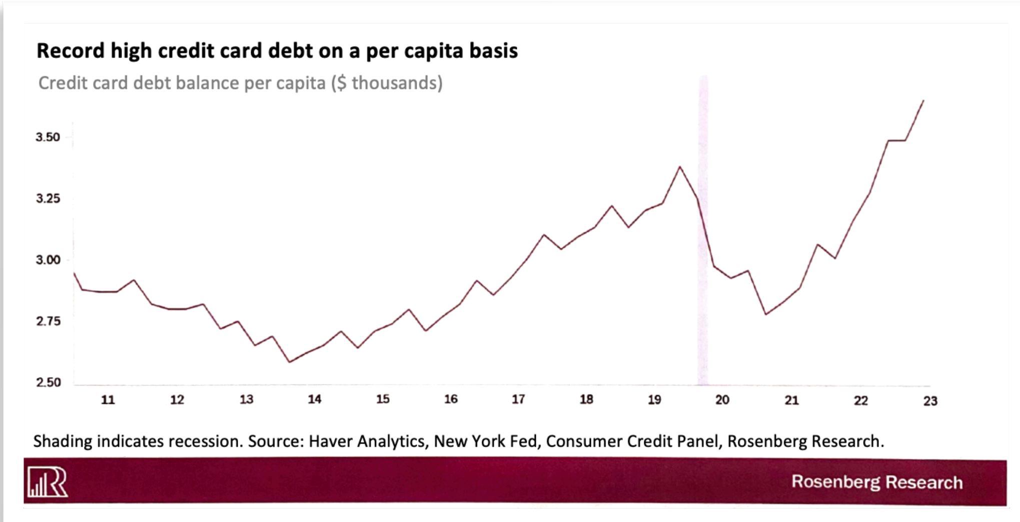
[2]http://www.cnbc.com/2023/05/22/commercial-real-estate-jamie-dimon-says-sourcint-loans-threaten-banks.html
[3]http://www.bloomberg.com/news/articles/2023/06/23/commercial-real-estate-s-extend-and-pretend-is-on-shaky-gound-(PM-05062025-6076899.1.1)



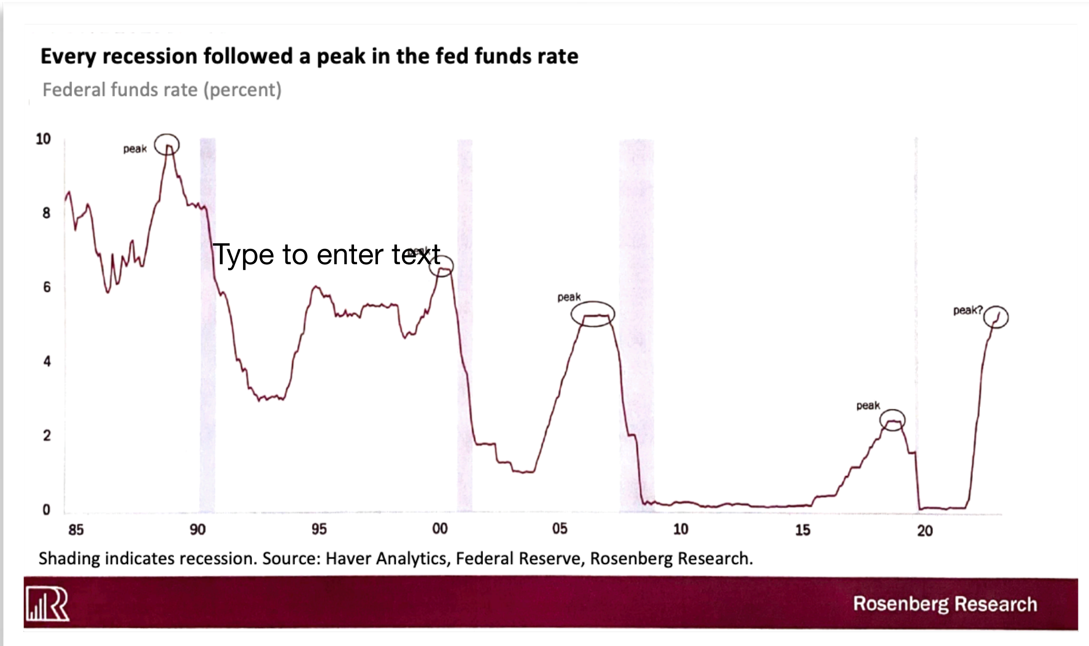
A line chart showing the credit card debt balance per capita in thousands of dollars. The chart shows credit card debt balances per capita starting just below $3,000 in 2010. From 2010 to about 2014, credit card debt balances per capita declined. Then from 2014 to 2019, credit card debt balances per capita climbed, peaking before the pandemic. From late 2019 to early 2021, credit card debt balances per capita declined. Since then they have climbed steeply, now registering around $3,500.

While the economy has continue to show strength, due largely to a consumer buttressed by pandemic stimulus payments, some households are starting to show stress, particularly lower-income earners with debt. Delinquencies have risen on credit card and auto loans since the start of the year, now at their highest level since 2010/11.[4] Rising interest rates are making debt levels costlier for consumers.

After 15 years of low rates, it's a long process to neutralize.

Could there be a soft landing ahead, with a recession-free cycle of interest rate hikes? Certainly. But it could be too early to tell. After 15 years of very low interest rates, it could just be taking longer than usual for rate hikes to have the full effect on the economy.

[4]http://www.washingtonpost.com/business/2023/08/30/delinquencies-credit-auto-loans-(PM-05062025-6076899.1.1)



A line chart the federal funds rate from 1985 to present, along with shading indicating periods of recession. The chart shows that the federal funds rate has always peaked before a recession has begun. Historically, the recession has started several months or sometimes more than a year after the peak federal funds rate. In this historical period, a recession has not begun while rates were still rising.

All of that said (and on a more optimistic note), once we get to the other side of this economic cycle, whenever that is and whatever that might look like, I believe that we will be at the very beginning of decades-long productivity gains that we have not experienced since electricity or the internet, due to artificial intelligence (with incumbent perils!). Much more on that later.

Thinking about today's markets and your own investment situation? Let's connect.