FEBRUARY 16, 2024

WEEKLY ECONOMIC COMMENTARY

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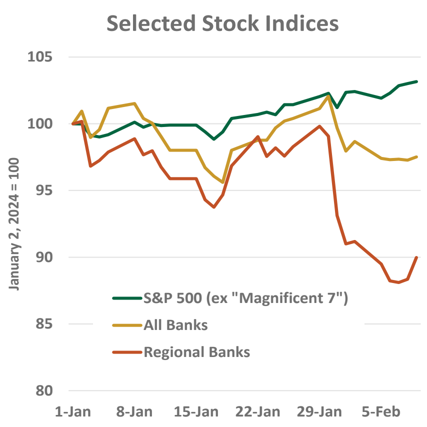
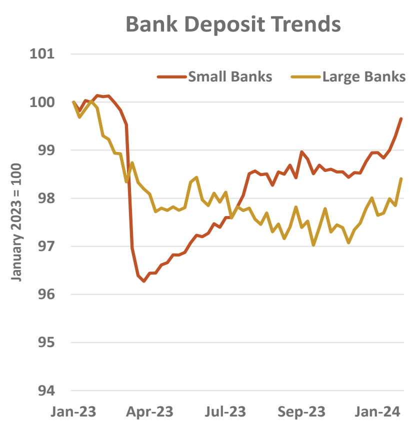
I am great with faces, but I am terrible with names. Once I see someone, I have near-total recall of past interactions: details about their firms and their families return quickly to mind. But the most critical field in my mental address book is often blank.

On one occasion last year, I referred to Mike, the leader of one of our offices, as "Joe" throughout a client meeting. There were confused looks around the table, which isn't atypical when I am presenting. When the misnomer was pointed out afterwards, I was terribly embarrassed.

It is a blessing that our recollections of unpleasant experiences eventually fade. That is the point we had reached with the banking crisis of 2023, whose anniversary is approaching. But recent weeks have brought that episode forward in our consciousness. The names have changed, but some of the details are familiar.

Late winter and early spring of last year were difficult times for the banking industry. The failure of Silicon Valley Bank (SVB) and two others sent shivers through markets. That unfortunate episode had receded into memory, until recent news surrounding New York Community Bank (NYCB) reinstated concerns about the financial sector.





Sources: Bloomberg, Federal Reserve, Haver Analytics

For now, it does not appear that that the situation is concerning depositors. In fact, funding at small and regional banks has been increasing of late, counter to the developments of a year ago. This is an encouraging sign that recent events are being placed into proper perspective.

There were two principal concerns at play during last year's debacle. The first was the impact of higher interest rates on bank profitability. For some firms, tightening from the

Fed caused the cost of funding to rise much more rapidly than the yields earned on assets. As those weaknesses became apparent, money fled the balance sheets of poorly-managed companies.

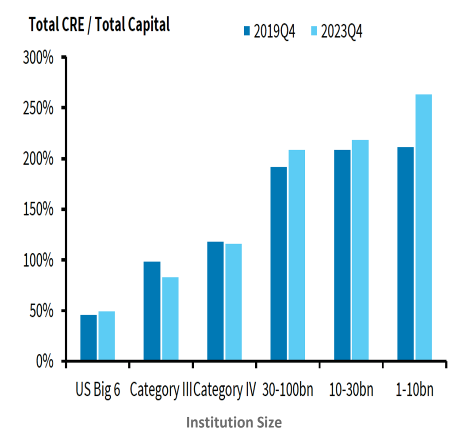
Some observers were convinced that other banks would succumb to the higher-for-longer interest rate environment. But SVB was an extreme case; its gamble that rates would remain low was immense. Most banks controlled their positions much more effectively, and regulators have been reinforcing the need for strong market risk management. Surprises are always possible, but it seems unlikely that we'll see more failures tied to this root cause.

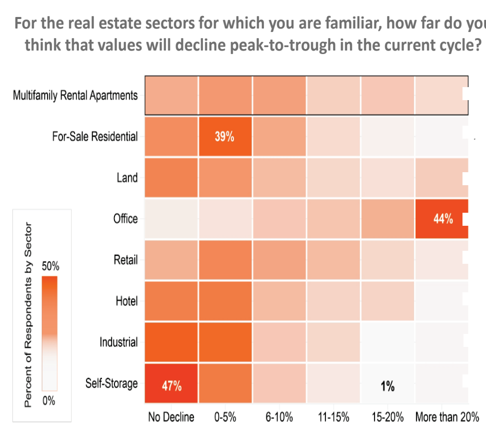
The second source of weakness for the banking industry is still active. Loans secured by office real estate properties are the subject of heightened concern and scrutiny. As we wrote last fall, we appear to have reached "peak return to office," leaving acres of space vacant and rents under substantial downward pressure. The challenge of what to do with the unwanted square footage has been the subject of numerous recent examinations.

As the anniversary of SVB's failure approaches, banks are facing renewed scrutiny.

NYCB has served as a flash point on this issue. Its fourth quarter earnings release included additional provisions for real estate loan losses and a cut to its dividend. (Interestingly, the company had purchased a block of loans from the failed Signature Bank.) The company's stock lost more than half of its value in just two days. A handful of other firms, some outside of the U.S., also announced charges related to commercial real estate (CRE) lending that led their shares to decline.

While there are unique aspects to the NYCB story, it has prompted a renewed focus on bank exposure to CRE loans. Financial institutions hold just under 40% of the credit extended to this sector; investors have the remainder. Within the banking industry, CRE loans are more highly concentrated in smaller, more regional firms, which makes them more vulnerable.





Sources: Barclay's, Mortgage Bankers Association, CoStar

Some have suggested that systemic problems are imminent. We disagree, and here is why:

- Not all commercial real estate is created equal. Apart from office property, this category includes industrial space, apartment complexes and retail developments. These latter segments are performing relatively well; vacancy rates have been stable, and rents are growing.

- Not all office property is created equal. There is substantial diversion in performance between prime (class A) properties and those that are less modern. There is also substantial diversion between locations and property size; while our imaginations often go straight to towers in city centers, the median office building is only a few floors tall.

According to the real estate firm CBRE, nearly two-thirds of office properties are at least 90% leased. On the other side of things, about 7% are leased at 50% or less of capacity. It is those latter buildings, and those who lent against them, that are experiencing distress. This suggests that problems will be isolated and not industry-wide.

- Commercial real estate loans typically have five year terms, at which point they come up for renewal. That spreads the reckoning out over time, and affords both banks and landlords some opportunity to prepare.
- Banks maintain reserves for loan losses, which are based on quantitative and qualitative assessments. In general, CRE reserves are in line with estimates of changes in value; most firms have been adding to these reserves steadily over the past two years.

For all of these reasons, simple comparisons of commercial real estate loans to a bank's capital base can be very misleading. While some firms will experience more stress than others, the industry should be well-positioned to deal with the office bust. As this situation is not new, regulators have been pressing firms to perform honest reckonings of their commercial real estate exposure. And if systemic stress resurfaces, the Federal Reserve can draw on the playbook it used last March to restore order.

Exposure to commercial real estate loans does not represent a broad threat to the banking industry.

These mitigating facts may, however, not be enough to head off negative sentiment. Once concern takes root, it is difficult to unearth. Fear of loss and confirmation bias in screening incoming information (among other behavioral tendencies) can make perceptions of the problem much more serious than the problem itself. As was the case last year, it may take time for calm to be restored.

I was hoping to get some help for this article from one of our crack banking analysts. Unfortunately, I couldn't remember his name to drop him a note. He has three children, though…

Good News

One of the pleasant surprises of 2023 was how quickly inflation decelerated in major economies. Most of the good news came from falling goods prices.

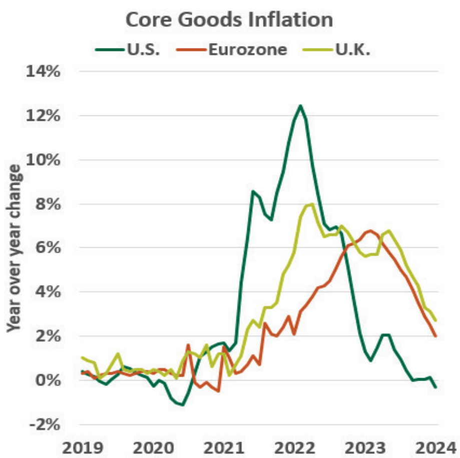
Core goods (which exclude the food and energy categories) account for up to 30% of consumer price indices in Europe and the United States. In the U.S, after peaking at a year over year increase of 12.5% in 2022, prices of core goods are now declining. Falling costs of consumer appliances, home furnishings and cars have led the way.

In the eurozone, non-energy industrial goods inflation has decelerated from a peak of 6.8% year over year in February 2023 to 2.0% in January 2024. Similar disinflationary trends have been observed in the U.K., with core goods prices moderating from a peak of 8% year over year in April 2022 to 2.7% last month.

The pandemic created a series of forces that contributed to a surge in goods prices, with supply chain problems most prominent. Though supply chain pressures heated up a bit recently amid rising shipping disruptions in the Red Sea, supply constraints have generally continued to ease over the past year (see below chart). As we highlighted here, shipping disruptions alone won't be inflationary.

As economies reopened, consumers shifted back to services, exerting downward pressure on goods prices. Inventories in many sectors are back in line with pre-pandemic levels. Lower pricing power amid weakening demand is forcing firms to accept thinner margins to retain market share.

Though falling, core goods inflation is still elevated by historical standards. In the decade prior to the pandemic, non-energy industrial goods inflation averaged only about 0.5% year over year in the eurozone and the U.K. In the U.S., durable goods prices were in deflationary territory, averaging a drop of 0.8% per year from 1998 to 2020. Globalization was a big influence that kept goods prices low, as manufacturing moved to low-wage countries, cutting costs of production.



Sources: Haver Analytics, Federal Reserve Bank of New York

Disinflation will have to broaden beyond goods to reach the 2% inflation target.

With commodity prices remaining soft, we think goods disinflation has a little further to go in the near term. Recent producer price developments are pointing toward further cooling of non-energy consumer goods. Developments in China, the world's factory, also suggest there is some more disinflationary impulse in store. Deflation is becoming more entrenched in the Chinese economy, with manufacturing leading the price cuts.

Weak demand at home and sluggish exports are forcing Chinese businesses to mark down their products. Lower prices of imports will be welcomed by western consumers and central bankers. However, exporting deflation could escalate trade tensions, especially if domestic manufacturers are undercut.

Goods disinflation will ultimately run its course, and is likely to become a modestly inflationary force. With globalization in retreat and supply chains increasingly driven by geopolitical forces over cost considerations, core goods inflation is unlikely to fall to pre-pandemic rates.

Disinflation in durables won't be enough to bring inflation back to targeted levels. But it is sure doing more than its fair share.

Charged Up, Charged Off

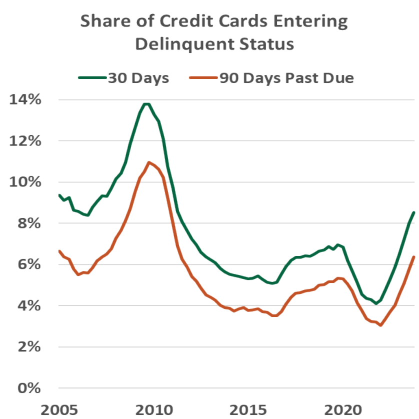
In our best teaching moments, we have helped our audiences overcome *meganumerophobia*, the fear of large numbers. Figures in the billions and trillions can sound scary and may lead to ominous inferences and conclusions. We encountered this last year, as the total balance on U.S. consumer credit cards reached one trillion dollars. Some thought that this was a sign that consumers were in trouble.

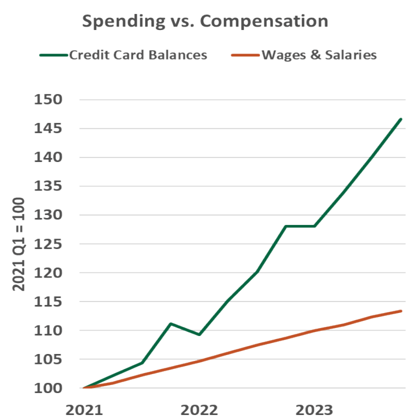
We did not rush to worst-case conclusions. Inflation drove up nominal card balances, and the credit card sum combines card holders who pay in full and those who revolve a balance. More broadly, debt can be used for any number of purposes, and we should not assume more debt is always a bad outcome. We look at delinquencies to judge whether households are overextended. And last week, the signal of debt performance became worrying.

The share of credit card balances entering severe delinquency (90 days past due) has risen from a record low of 3.0% in early 2022 to a 12-year high of 6.4% at the end of 2023.

Total revolving card balances fell as stimulus payments were issued in 2020. Balances now stand 46% above their first quarter 2021 lows. Such a rapid rise in balances, far in excess of the rise in wages, suggests more delinquencies are still in the pipeline.

Past-due debts show some households are falling behind.





Sources: Equifax/FRBNY, Bureau of Labor Statistics, Haver Analytics

Eventually, lenders will cease to attempt to collect bad debts and charge them off. The credit bureau TransUnion reports a record high of 4.6 million credit cards (over 1% of active accounts) were charged off in the fourth quarter. However, the dollar amount of charge-offs remains below the levels seen in the Global Financial Crisis.

While the credit outlook offers reason for concern, the overall consumer view is not yet worrying. The strong job market and rising wages have kept total household debt service ratios well contained under 10%. But a favorable aggregate story will obscure some households that are overstretched and are making difficult decisions about payment prioritization.

We do not suffer *meganumerophobia*. Large numbers are an occupational hazard. But rising delinquencies do give us a chill.