



Uncertainty and slow economic growth

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The last four recessions were accompanied by shocks to the US economic system: Iraq's 1990 invasion of Kuwait, the September 11, 2001 terrorist attacks on the World Trade Center, the 2008 collapse of Lehman Brothers, and the 2020 COVID-19 lockdowns. Prior to the first three of these downturns, the US economy was already showing signs of weakness and the event itself was enough to tip it into recession. Now, issues in the global banking system triggered by unprecedented central bank tightening, including the failures of two large regional US banks, Silicon Valley Bank (SVB) and Signature Bank (SBNY), followed by the forced takeover of Credit Suisse, a surprising surge in the cost of insuring against a Deutsche Bank credit default, and rumored illiquidity issues at as many as 200 other US financial institutions, present new threats which could constrain bank lending, impacting the willingness of businesses to hire and households to spend. While the US economy overall remains fundamentally sound, buoyed by a robust employment market, healthy household balance sheets and the ongoing rebound in the services sector, which accounts for nearly 80% of GDP, problems in the banking sector may further tighten credit conditions increasing the odds of a downturn.

Recall that even before the SVB failure, there were signs of an economic slowdown. Large tech companies were pulling back, laying off thousands of workers following a period of overexpansion during the pandemic. Rapidly rising interest rates had largely frozen the real estate market. Manufacturing slowed from its torrid post-COVID pace as supply chain issues were resolved and previously large backlogs were worked off. Corporate profits, down 3% overall in the fourth quarter of last year, were declining in many sectors and indices of consumer confidence were showing weakness after two years of outsized cost-of-living increases. And our firm's proprietary [Economic Model](#) and the Leading Economic Indicators (LEI) had for months been signaling the probability of a downturn. Yet, the recovering services sector, reflected in the strong jobs market, overshadowed the challenges to growth and kept the economy growing. Now, some who previously thought the economy would skirt recession, fear the banking crisis or a broader financial market meltdown, could lead to a sharp credit contraction forcing households and businesses to retrench, materially increasing the risk of a pullback in economic activity.

Fortunately, officials at the Fed, US Treasury and FDIC quickly recognized depositor runs at SVB and SBNY stemmed from mismanagement and liquidity issues specific to those banks, not *credit* problems, and mounted a forceful effort to ring-fence these banks, providing depositors with guarantees their account balances would be *fully* protected and that they would have immediate access to them, including amounts above the \$250,000 federally insured limit. To provide enhanced borrowing opportunities for other banks experiencing stress due to customer deposit withdrawals, the Fed increased the frequency member banks can access its discount window and have established a new temporary term lending facility which allows them to borrow the full-face value of the underwater collateral they post. In addition, while *explicit* guarantees of depositor's balances at all banks have not been extended, Fed and Treasury officials have given *implicit* assurances that deposits at other troubled banks will be fully protected. Despite these measures, unease in banking circles has spread. An update last Friday showed banks

borrowed a record amount from the Fed's discount window to meet possible customer demands for funds. In the week ended last Wednesday, banks borrowed a daily average of \$117 billion, up \$32 billion from the prior week, surpassing the average of \$112 billion during the 2008-09 financial crisis. Banks also tapped into the new term funding program a daily average of \$34 billion, up from \$2.4 billion in the program's first week. The recent sharp rise in bank borrowing is evidence of more widespread disruption in the banking industry as other banks, such as First Republic Bank and PacWest, have disclosed they are using Fed borrowings after losing deposits. No doubt, other banks not under immediate pressure are borrowing from the Fed and pledging assets to build up cash in the event panic spreads, despite the stigma attached to needing to borrow from the Fed, the "lender of last resort."

To stem the tide of bank runs, a consortium of small and mid-sized banks has recommended a two-year Federal guarantee of all deposits without regard to the amount. Some members of Congress have suggested a more comprehensive solution, proposing a permanent government guarantee of all deposits, along with regulatory reforms and possibly some increased reserve requirements. Treasury and the Fed, who seem to favor a case-by-case approach, will proffer their proposals. Those who are against a blanket solution, favoring a case-by-case basis, cite moral hazard and unwarranted bailouts for their opposition. Whether the banking crisis is tamped down through regulatory measures, legislation or a combination remains to be seen. But, clearly, the problem, which is far reaching and has the potential to destabilize the entire economy, is now widely recognized and is being addressed at the highest levels of government.

The Fed

As was widely expected, in response to worrisome inflation data, the FOMC increased the Fed's reference rate last week by 25bp, setting the range of the federal funds rate at 4.75% to 5.0%, accepting the risk that higher interest rates could intensify the bank's problems. In recent weeks, economic data has suggested inflation remains sticky, not falling as rapidly as analysts had expected. Average consumer prices are about 6% higher than a year ago. Forecasters expect consumer prices to remain above 3% for most of this year. For much of the 21st century, inflation has been closer to the Fed's 2% target. An elevated inflation rate shrinks consumer's purchasing power and fosters the notion inflation may remain high, causing them to demand higher wages, potentially triggering a wage/price spiral. Today's tight labor market, where unemployment is running near its lowest levels since the 1960s and economic activity is well above trend, amplifies that risk.

Prior to the FOMC meeting, many Fed watchers had urged a more aggressive rate hike to slow the economy by increasing the cost of homes, cars and other items consumers finance with debt. The banking crisis of the past two weeks, precipitated by the Fed's earlier aggressive tightening and resulting from bank mismanagement and failed regulator supervision, scuttled any plans for a larger 50bp rate increase which could have further depressed the value of many financial assets, raising the risk of new runs by depositors on weaker banks. In retrospect, the Fed faced an unavoidably fraught decision between potentially exacerbating problems in the financial markets and seeming to go soft on inflation. They chose the latter, opting to buying some time to deal more firmly with inflation later, signaling that the banking system turmoil might force an end to its rate-rise campaign sooner than seemed likely only two weeks earlier.

Outlook

Economists believe banking industry problems are likely to have the effect of an interest rate increase,

further tightening lending conditions and raising the likelihood of a recession. Estimates of just how much the credit contraction could reduce hiring, economic activity, and inflation are “rule-of-thumb” guesswork at this point. Nevertheless, recent readings of various indices of *financial conditions* show significant tightening stemming from the banking crisis as they track stock and bond prices as a measure of money available in the markets. Stock indices have broadly held up despite the declines in bank stocks, while yields on government bonds, which underpin borrowing costs throughout the economy, have fallen sharply, in part reflecting expectations the recent chaos would lead the Fed to lower rates soon. Other open-market based measures show the effects of tighter conditions, with *inflation expectations*, a measure of where investors expect inflation to be in the future, declining sharply this month. And, *credit spreads*, which measure the cost of corporate borrowing, have widened. While there is considerable uncertainty about how the banking problems will impact the economy, analysts believe a modest tightening of bank lending could shave a half percentage point from economic growth this year, while a “shock” that curtails lending more severely could easily subtract more than 1% from GDP growth, pushing the US economy, which the Fed expects to grow less than 1%, into recession.

Meanwhile, high frequency *leading* economic indicators we monitor continue to send mixed signals. Recent readings of these measures, and our brief comments on each, follow.

Initial Jobless Claims point to continued strength in the labor market. Initial filings for jobless benefits fell by 1,000 to 191,000 in the week ended March 18. Continuing claims, which include people who have already received unemployment benefits for a week or more, were unchanged at 1.69 million. The report shows the labor market has remained largely resilient against a backdrop of Federal Reserve rate hikes over the past year. Unemployment claims continue to hover near historically low levels and job creation remains robust.

M2 Money Supply soared in the first two years of COVID-19, up 40.4% from February 2020 to February 2022. But in the eleven months since then, the M2 measure of money supply declined 2.0%. Not only have we never experienced a Fed trying to fight inflation under an abundant reserve regime, but we’ve also never seen M2 grow so fast for as long, nor decline so rapidly, at least since the 1930s. If recent M2 data are correct, the economy will face stiff headwinds in the months ahead.

ISM Manufacturing Index increased to 47.7 in February, lagging the consensus expected 48.0. (Levels above 50 signal expansion; levels below 50 signal contraction.) The major measures of activity were mixed in February, but all were below 50. The new orders index rose to 47.0 from 42.5 in January, while the production index declined to 47.3 from 48.0 the prior month. The supplier deliveries index fell to 45.2 from 45.6 in January and the employment index declined to 49.1 from 50.6. The US manufacturing sector remained in contraction in February with only four of eighteen industries reporting growth. The new orders index rose for the first time in four months with only three of eighteen industries reporting growth. This is not surprising as consumers have been shifting their preferences away from goods to services.

ISM Non-Manufacturing Index ticked down to 55.1 in February, outpacing the consensus expected 54.5. (Levels above 50 signal expansion; levels below 50 signal contraction.) While the major measures of activity were mixed in February, the services sector continued to grow with thirteen of fifteen industries reporting growth. The new orders index increased to 62.6 from 60.4, while the business activity index declined to 56.3 from 60.4. The prices paid index declined to 65.6 from 67.8 in January. The employment index increased to 54.0 from 50.0, while the supplier deliveries index declined to 47.6 from 50.0. Inflation continued to be high on the list of

respondent's concerns, showing few signs of abating. Inflation is expected to trend well above the Fed's 2% target. Notably, respondent comments reported an increase in job applications, resulting in more new hires. This is good news, since a lack of labor *supply* not *demand* has restrained service jobs from increasing even more rapidly.

Other economic data we have reviewed this month has been similarly mixed.

Employment increased 311,000 in February, exceeding the consensus expected 225,000, as the job market remained strong but not quite as strong as the headlines suggest. The unemployment rate rose to 3.6% from 3.4% in January due to the positive news of an increase in the labor force of 419,000. The labor force participation rate is now 62.5%, the highest since March 2020. However, there were also signs of softness in the February report. Average hourly earnings rose an unusually small 0.2% and are now up 4.6% from a year ago. The 0.2% gain last month was the smallest monthly increase in a year, suggesting that job growth in higher wage occupations or at higher paying companies has slowed. And although a 4.6% gain in average hourly earnings would normally be considered good, it is not a positive indicator for worker purchasing power when consumer prices are up more than 6% over the same period. Meanwhile, despite an increase in jobs, the total number of hours worked in the private sector declined 0.1% in February. Total private-sector wages, which are a combination of total hours worked and average hourly earnings were up only 0.2% last month, the smallest increase in two years. Putting it all together, we find a labor market that is still strong but showing some signs of softness, not invulnerable to a recession.

Consumer Prices rose 0.4% in February while the core index, ex. food and energy, increased 0.5%. These monthly changes were close to expectations. The year-ago inflation rates for the headline number and core continued to moderate into February from even stronger earlier figures, but the latest data show a firm trend for inflation persisting into last month. The monthly change in the core CPI for February represented the strongest change reported since September. Several Fed officials have been focusing on *core services inflation ex. shelter* as an important gauge of the underlying inflation trend. This aggregate also looked firm in February. The core services CPI excluding rent and other equivalent rent rose 0.5% in February, also the firmest reading since September. Overall, if it persists, the recent inflation strength will pressure the Fed to tighten again in May.

Manufacturing shows signs of weakening although monthly signs have been mixed. In the Fed's Industrial Production report, manufacturing output edged up 0.1% in February, with this modest gain coming after a big January increase which itself came after a large December decline. Smoothing through some of the monthly gyrations, manufacturing output was down 2.7% over the three months through February and down 2.5% over the last six months. Timelier regional business surveys point to weakness, perhaps intensifying into this month.

Housing measures have firmed in recent months, showing some signs of life after sharp drops in activity reported throughout much of last year. And while the housing market has likely benefited from the decline in mortgage rates between early November and February, volatility in rates will likely prove an additional drag on housing. The NAHB survey's gauge of homebuilder sentiment increased 2 percentage points in March and a cumulative 13 percentage points over the latest three months following an earlier plunge. Housing starts and permits rose in February with starts increasing 9.8% to a 1.450 million annual rate. Still, starts are down 18.4% versus a year ago.

Durable goods report for February had a disappointing headline and shows moderating trends for the important core capital goods series. Total orders for durable goods declined 1.0% last month on top of a

5.0% January decline. Aircraft orders have dropped off in recent months, weighing down the headline readings, after they surged in December. Important details on core capital goods which exclude defense and aircraft, show recent growth trends have moderated including downward revisions to January increases that had previously looked strong. Factoring in a range of related indicators, real equipment spending is on track to decline overall in 1Q.

On balance, the economy appears to be growing, albeit more slowly under the weight of a year of tightening credit conditions, the corrosive effects of inflation on consumer's real purchasing power and spreading weakness in manufacturing as consumers migrate their consumption preference from goods to services. Still, surveys show consumers, whose spending accounts for over 70% of GDP, to be well financed and willing to spend. So, should we enter a recession, it is likely to be a mild and short-lived affair. And while the odds of a recession have probably risen to better than even in the wake of recent bank failures, it is not a certainty.

Equity investment policy

The earnings season recently concluded, while not as weak as feared, did expose softness in corporate operating fundamentals. Earnings revisions continued to move to the downside with the consensus S&P500 forecast for 2023 revised lower to about \$222 per share. The rising cost of capital remains an important concern for many businesses. In fact, a growing number of small cap enterprises which are particularly sensitive to higher rates due to their floating rate debt, have cited rising interest expense as a key profit margin headwind. Even though large cap balance sheets remain healthy for now, small caps could experience material earnings deterioration, ultimately impacting large caps in the form of lost demand, lower margins and/or asset write-downs/credit losses. Clearly, earnings estimates remain elevated and there are expectations for further estimate cuts to around \$205 per S&P500 share. How much of this earnings deterioration has already been discounted in the roughly 20% decline the S&P500 since its early 2022 high remains to be seen. While we believe much of the bad earnings news to come has already been factored into equity valuations, we would not rule out one final test of last year's S&P500 low near 3600, implying as much as a further 10%+ decline in the S&P500 from current levels. *Although stocks are not cheap at about 17.5X earnings, expectations for a sharp recovery next year should cushion any pullback.*

Reflecting the considerable economic and policy uncertainties, we expect equities to remain volatile over the near-term, particularly around the release of key inflation and employment data and leading up to Fed decisions, until the Fed signals it has reached the end to its credit tightening. Until then, the ebb and flow of expectations for the likely course of interest rates and the odds of a recession will drive sharp market swings. Looking a bit further out, we believe we've already seen most of the likely Fed tightening cycle, rapidly approaching its end, setting the stage for the next economic expansion and the onset of a new bull market. We believe the coming expansion will be vigorous and prolonged, supported by sound fundamentals including falling interest rates, easing credit conditions, sticky but gradually receding inflation, a well-reserved banking system, underpinned by strong consumer and corporate balance sheets.

While there is currently no end in sight to the carnage in Ukraine, the war will eventually wind down and a sizeable investment will be required to rebuild that country's infrastructure and to strengthen defenses in Western Europe and elsewhere. This will create new jobs and, in general, stimulating global growth in the private sector. The reopening of China's economy, following its two-year COVID-19 shutdown, will further support the nascent expansion.

Equity portfolios under our supervision remain close to fully invested despite the short-term risks noted above. We are focused instead on high quality investments that will benefit from the coming expansion. Clients' equities are broadly diversified between large cap *growth* and *value* investments, close to being evenly balanced between the two sectors. Our investment platform also includes modest allocations to small cap US stocks as well as investments in equities domiciled abroad in both *developed* and *emerging* markets. Portfolio turnover remains intentionally low, consistent with our long-term investment horizon and our focus on producing competitive after-tax returns.

Fixed income

The sharp rise in interest rates over the past year has made bonds investable once again. Accordingly, we have extended fixed income portfolio durations in client's laddered corporate bond portfolios, selectively deploying the funds generated by maturing bond holdings which have returned less than 1%, into new, high quality corporate obligations yielding as much as 5% and maturing in 2+ years. Lower yielding money market fund investments were replaced with higher yielding US Treasury bills maturing in less than a year, also yielding close to 5%. The cumulative increases in income generated by these strategic shifts are expected to enhance portfolio total returns over the next several quarters. Looking ahead, we expect interest rates to more fully reflect the sticky inflation we believe will persist, so we have avoided adding longer-dated obligations to portfolios awaiting a better entry point.

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index or purchasing managers' index is considered a key indicator of the state of the U.S. economy. It indicates the level of demand for products by measuring the amount of ordering activity at the nation's factories. **ISM Non-Manufacturing Index:** The Institute of Supply Management (ISM) Non-Manufacturing Index is an economic index based on surveys of more than 400 non-manufacturing (or services) firms' purchasing and supply executives. **S&P500 Index:** The S&P 500 Index, or Standard & Poor's 500 Index, is a market-capitalization-weighted index of 500 leading publicly traded companies in the U.S. **S&P500 Growth Index:** The S&P 500 Growth Index is a stock index administered by Standard & Poor's-Dow Jones Indices. As its name suggests, the purpose of the index is to serve as a proxy for growth companies included in the S&P 500. **S&P500 Value Index:** The S&P 500 Pure Value Index refers to a score-weighted index developed by Standard and Poor's (S&P). The index uses what it calls a "style-attractiveness-weighting scheme" and only consists of stocks within the S&P 500 Index that exhibit strong value characteristics.

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