

AGRON NICAJ
US Economist

Economic Research Office
anicaj@us.mufg.jp

MUFG Bank, Ltd.
A member of MUFG, a global financial group

Uncertainty ahead for inflation and growth

31 March 2023

- February’s Core PCE Price Index showed slightly calmer price growth from a month earlier, but it’s not nearly enough to indicate a downward trend. Core services inflation remained elevated, and the trend is largely flat, while core goods continued to apply downward pressure to prices. Fallout from the banking panic is likely to have at least some disinflationary effect, but we are unlikely to see the impact until April’s inflation data at the earliest.
- Real GDI showed negative economic growth in Q4 (-1.1%), contrary to the 2.6% growth in Q4 GDP. However, the strong labor market and historically high corporate profit margins suggest that actual economic growth was likely somewhere in the middle, or about 0.7%. Estimates for Q1 2023 GDP show a stronger economy, but most data at this point are too backward looking and don’t incorporate recent events.

Price growth is not slowing fast enough, but financial stress will likely help

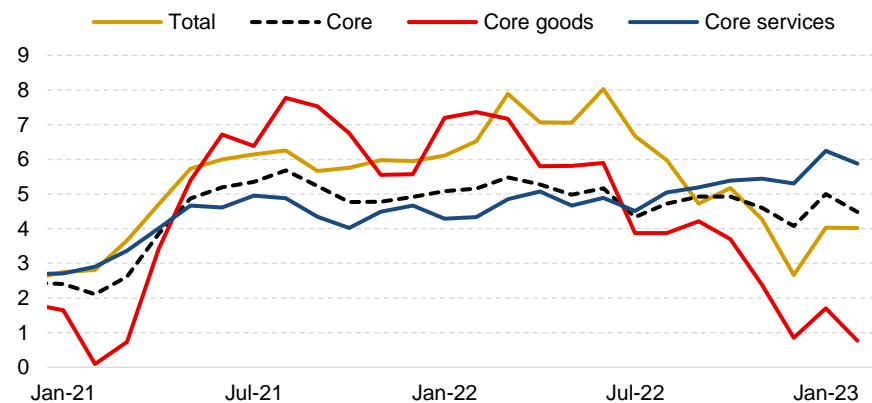
February’s PCE Price Index fell slightly to 5% at an annual rate but was flat at 4% on a 6-month moving average annualized basis. Annual changes in inflation often cloud the underlying trend, and monthly movements can be noisy. Looking somewhere in the middle with a 6-month moving average may be the “sweet spot” for the PCE.

From that view, the Core PCE Price Index fell slightly in February, but the index continues to hover in the 4.5% range. Core goods fell back down to 0.7%, quelling many fears that there may be a rebound. However, the overall picture for inflation is not exactly a good one. Housing continues to be an outlier applying upward pressure on core services, and used autos continues to be an outlier applying downward pressure on core goods. But most other spending categories are running somewhere in between, and higher than the Fed’s 2% target. This consideration now is how much of an impact the latest panic in the banking sector will have.

Rising interest rates act to restrict demand for credit in the economy by making it more expensive to borrow, eventually reducing investment, consumption, and price growth. The ongoing deposit flight at small banks in the US will likely act in a similar way.

Price growth was slightly down in February

PCE Price Index, 6-month moving average, % annualized

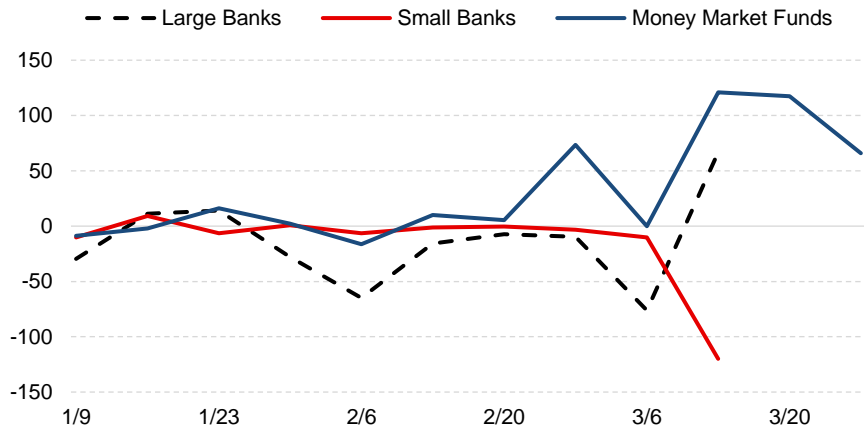


Source: BEA, MUFG Bank Economic Research

Depositors are fleeing small banks in the US because of the perceived risk that the collapse of SVB and Signature Bank has brought. From the perspective of these banks, liquidity is the main concern and maintaining high enough reserves will likely mean tightening credit standards. This will restrict the flow of credit in the US directly, acting in a similar fashion as the interest rate tool the Fed is using to slow inflation.

Small banks are losing deposits to large banks and money market funds

Bank Deposits & Money Market Fund Assets, 2022, weekly, billions



Source: Federal Reserve, ICI, MUFG Bank Economic Research

The uncertainty is how long this deposit flight will occur for and how much credit standards will be tightened. It's only been a couple of weeks since the banking panic began, so it's possible that the fallout and deposit flight may be short-lived. In which case, credit standards may not tighten by as much. However, if the stress placed on small banks is long lasting, the US could experience a credit crunch, which would be good news for inflation, but bad news for economic growth.

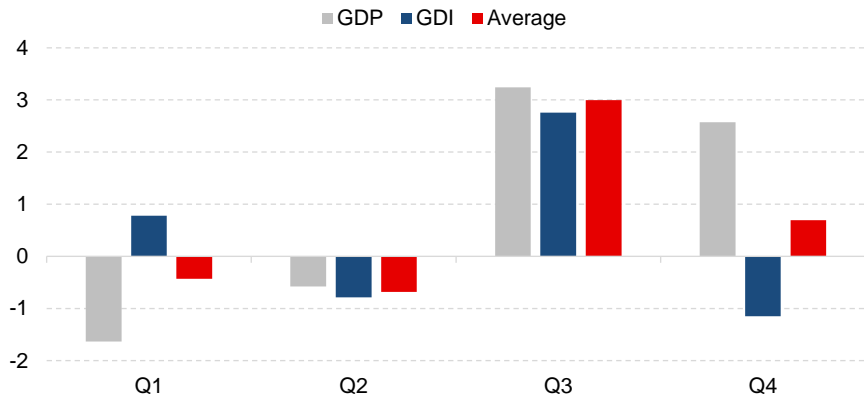
Growth may have been slower in Q4 than previously thought

Real GDI in Q4 showed negative economic growth (-1.1%), while real GDP showed positive growth (2.6%). This marks the largest deviation since Q1 where the debate on whether the US is in a recession or not began.

GDP and GDI should theoretically be exactly equal and accounting discrepancies have historically been small enough to make that nearly the case. This latest deviation suggests that GDP may be overselling growth. It's extremely unlikely that the economy contracted in Q4, as GDI suggests, because employment growth was very strong and corporate profit margins were historically high for nonfinancial businesses (12.7% in Q4). The truth likely lies in the middle, or the average of GDP and GDI (0.7% growth in Q4).

Real GDI suggests a slower Q4

Real GDP, GDI, and the average, % AR, 2022



Source: BEA, MUFG Bank Economic Research

While this has implications for how we interpret Q1 2023 GDP, it doesn't provide much insight on where we are headed. Atlanta Fed's latest estimate for Q1 real GDP growth is 3.2%, which would mark an expansion from Q4 2022, especially when compared to the average of GDP and GDI. But even when the official Q1 data is released, it will not capture much of the banking panic fallout which has likely yet to fully materialize.

Most indicators at this point are backward looking, especially quarterly data such as GDP. Even monthly indicators such as employment and inflation will lag real-time conditions. For this reason, markets may not react too strongly to March's employment report or inflation data. All eyes will be on weekly indicators that incorporate financial conditions, and these will help to provide insights on the magnitude and duration of the banking panic.

Analyst Certification

The views expressed in this report solely reflect the personal views of Agron Nicaj, the primary analyst responsible for this report, about the subject securities or issuers referred to herein, and such views may not necessarily reflect the thoughts and opinions of MUFG Bank, Ltd. and its affiliates or management team. No part of such analyst's compensation was, is, or will be directly or indirectly related to the specific recommendations or views expressed herein.

Disclaimers

The information and views contained herein are not intended for distribution to, or use by, any person or entity in any jurisdiction or country where such distribution or use would be contrary to law or regulation or which would subject MUFG Bank, Ltd. (collectively with its various offices and affiliates, "MUFG Bank") to any registration requirement within such jurisdiction or country. The information and views contained herein are provided for general informational purposes only, are subject to change, and are not intended to be, nor should be used, or considered, as an offer, or the solicitation of an offer, to sell or to buy or to subscribe to or for securities or any other financial instruments, and do not constitute specific investment, legal, tax or other advice or recommendations. The information contained herein reflects the thoughts and opinions of the noted authors only, and such information does not necessarily reflect the thoughts and opinions of MUFG or its management team. Neither this nor any other communication prepared by MUFG Bank should be construed as investment advice, a recommendation to enter into a particular transaction or pursue a particular strategy, or any statement as to the likelihood that a particular transaction or strategy will be effective and it does not take into account the specific investment objectives, financial situation, or the particular needs of any specific person who may receive this information. Any information relating to performance contained herein is illustrative and no assurance is given that any indicative returns, performance or results, whether historical or hypothetical, will be achieved. Before entering into any particular transaction, you should consult an independent financial, legal, accounting, tax, or other advisor as may be appropriate under the circumstances. In any event, any decision to enter into a transaction will be yours alone, not based on information prepared or provided by MUFG Bank. MUFG Bank hereby disclaims any responsibility to you concerning the characterization or identification of terms, conditions, and legal or accounting, or other issues or risks that may arise in connection with any particular transaction or business strategy. While MUFG Bank believes that any relevant factual statements contained herein, and any assumptions on which such statements are based, are in each case accurate, neither the authors nor MUFG have independently verified its accuracy, and such information may be incomplete or condensed. The information is provided "AS IS". The authors and MUFG do not warrant the accuracy of the materials provided herein, either expressly or implied, for any particular purpose and expressly disclaims any warranties of merchantability or fitness for a particular purpose. The authors and MUFG cannot and do not guarantee the accuracy, validity, timeliness or completeness of any information or data made available to you for any particular purpose. MUFG Bank may have issued, and may in the future issue, other reports that are inconsistent with or that reach conclusions different from the information and views contained herein. Such other reports, if any, reflect the different assumptions, views and/or analytical methods of the analysts who prepared them, and MUFG Bank is under no obligation to ensure that such other reports are brought to your attention.

© 2023, MUFG Bank, Ltd. All Rights Reserved.

About Mitsubishi UFJ Financial Group, Inc.'s U.S. Operations including MUFG Americas Holdings Corporation

The U.S. operations of Mitsubishi UFJ Financial Group, Inc. (MUFG), one of the world's leading financial groups, has total assets of \$332.4 billion at March 31, 2022. As part of that total, MUFG Americas Holdings Corporation (MUAH), a financial holding company, bank holding company, and intermediate holding company, has total assets of \$159.2 billion at March 31, 2022. MUFG Securities Americas Inc. is a registered securities broker-dealer which engages in capital markets origination transactions, domestic and foreign debt and equities securities transactions, private placements, collateralized financings, and securities borrowing and lending transactions. MUAH is owned by MUFG Bank, Ltd. and Mitsubishi UFJ Financial Group, Inc. MUFG Bank, Ltd., a wholly owned subsidiary of Mitsubishi UFJ Financial Group, Inc., has offices in Argentina, Brazil, Chile, Colombia, Peru, Mexico, and Canada. Visit www.mufigamericas.com for more information.

About MUFG and MUFG Americas

Mitsubishi UFJ Financial Group, Inc. (MUFG) is one of the world's leading financial groups. Headquartered in Tokyo and with over 360 years of history, MUFG has a global network with approximately 2,100 locations in more than 50 countries. MUFG has nearly 160,000 employees and offers services including commercial banking, trust banking, securities, credit cards, consumer finance, asset management, and leasing. The Group aims to "be the world's most trusted financial group" through close collaboration among our operating companies and flexibly respond to all the financial needs of our customers, serving society, and fostering shared and sustainable growth for a better world. MUFG's shares trade on the Tokyo, Nagoya, and New York stock exchanges.

MUFG's Americas operations, including its offices in the U.S., Latin America, and Canada, are primarily organized under MUFG Bank, Ltd. and subsidiaries, and are focused on Global Corporate and Investment Banking, Japanese Corporate Banking, and Global Markets. MUFG is one of the largest foreign banking organizations in the Americas. For locations, banking capabilities and services, career opportunities, and more, visit www.mufigamericas.com.