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Uncertainty ahead for inflation and growth

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- 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.

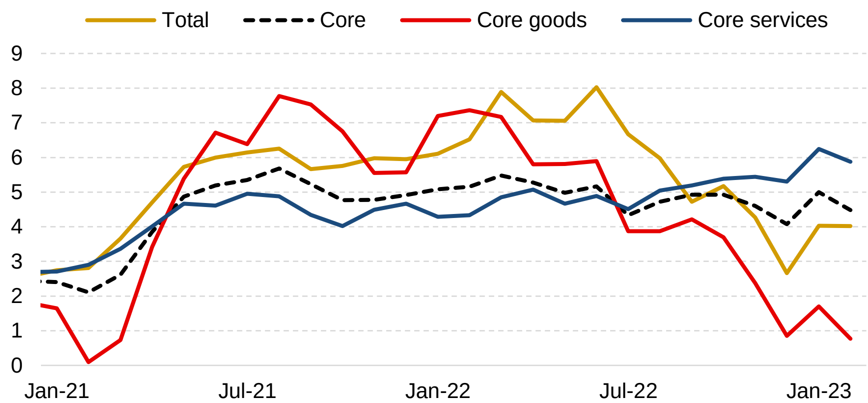
Price growth is not slowing fast enough, but financial stress will likely help

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.

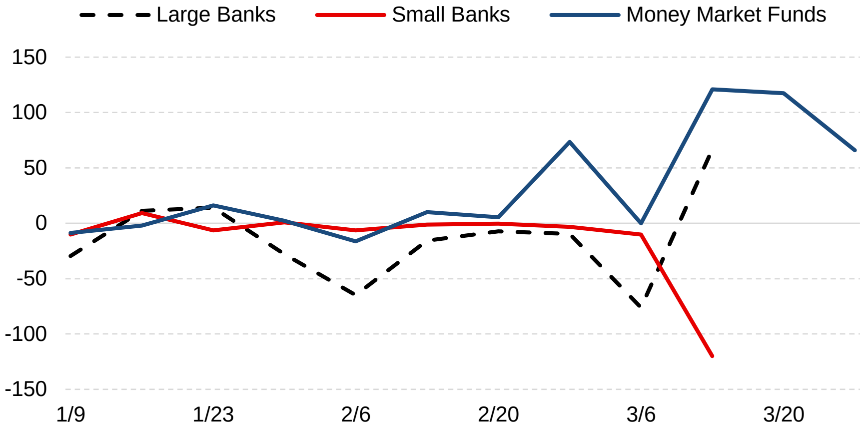
Price growth was slightly down in February
PCE Price Index, 6-month moving average, % annualized



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

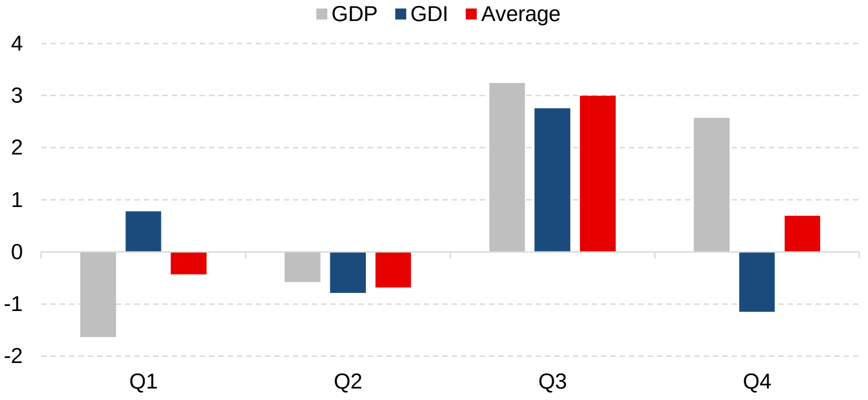
The uncertainty is how long this deposit flight will occur for and how much credit standards will be tightened. It's only been a couple of weeks since the banking panic began, so it's possible that the fallout and deposit flight may be short-lived. In which case, credit standards may not tighten by as 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.

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