May 22, 2023

Economic Update

So far this year, the economy has dealt with many variables that continue to hinder growth. The markets have also been taken for a ride following aggressive interest rate hikes, bank closures, and debt default negotiations. What follows is an update on the outlook of economic conditions over the upcoming months. Our recommendations and advice for your portfolio are data driven – real economic data points – not the mainstream media talking points. We continue to monitor these trends closely. Our approach remains conservative to protect clients' assets from large scale declines.

BANKING:

The financial banking crisis is far worse than what is being reported. The assets of the three bank failures this year have exceeded the total assets of failed banks in 2008. These bank defaults are not contained only to the U.S. This is also an international issue. There are more banks that will follow in default, and this could extend beyond just regional banks.

The banking crisis can be explained by realizing that high-risk loans issued by banks were virtually free during 10 of the last 14 years. This system contributed to a 40-year high inflation rate. Therefore, bank assets, and the income stream they provide, are worth far less than Treasury Bills. The banks simply cannot afford to pay depositors more than they are receiving in interest from their assets because profit margins would disappear. If the banks don't increase the interest being paid to depositors, it will lead to money being withdrawn from the banking system. Banks are then forced to sell assets to meet the liquidity requirements which puts further downward pressure on these assets. The size of the bank does NOT matter. All banks suffer under this dynamic. Putting further pressure on the banks' assets will be an increased unemployment rate and the refinancing of the $2.5 trillion vacant commercial real estate loans. Although the mainstream media seems to ignore this reality, the regional bank index has dropped -40% since February.

As we have discussed, it is wise to have cash on hand if things escalate to the point of any type of bank run. If this were to occur, all banks could temporarily shut down, not allowing debit or credit cards to work because they are all tied to banks. Having emergency cash on hand for food and gas is a precautionary measure.

INFLATION:

Early in May, the Fed increased the federal funds rate to a target of 5.0 - 5.25% - it's 10th interest rate increase in just a little over a year. While these elevated interest rates are a positive for savers, borrowers will continue to bear higher financing costs putting stress on consumers. Real earnings growth has now been negative for a record of 25 consecutive months. This means the standard of living has been dropping every month for over two years as our purchasing power continued to decline. Inflation also continues to affect business earnings. Companies in the S&P 500 have reported earnings growth down -3.26% y/y, while those in the NASDAQ 100 have reported earnings growth down -8.08% y/y.

BUSINESS SENTIMENT:

Adding to the above, credit is tightening for consumers and businesses. Interest rates are increasing, as spending, hiring and credit availability are all declining. Small businesses contribute 45-50% of the U.S. gross domestic product (GDP). How are those small businesses feeling about the economy currently? According to the April NFIB Small Business Optimism Index, confidence dropped lower than it did during the pandemic. Pessimism is growing amongst these owners as they struggle with finding qualified workers for their open positions.

REAL ESTATE:

Housing affordability remains at all-time lows since high interest rates have compounded affordability challenges. At the same time, new listings are down -19% y/y as inventory levels remain low. U.S. commercial real estate prices fell in the first quarter for the first time since 2011. Nearly 20% of office spaces are currently empty in the U.S., which exceeds the vacancy rate during the 2008 global financial crisis. San Francisco's downtown vacancy rate has increased from about 4% in 2019 to nearly 30% today. If office landlords continue to see increased vacancies, this could result in landlords turning the keys back over to the banks.

SUMMARY:

Overall, the trend of these data points covering the labor market, goods production, consumer expectations, housing, and financial markets, are pointing towards a weaker economy. The
US Leading Economic Indicators confirms these expectations with the index falling for the 13th straight month in May and the Philadelphia Fed Manufacturing Index in negative territory for the 9th consecutive month.

As always, we at Kapusta Financial Group, would like to thank you for the trust and confidence you place in our team.

110 Fort Couch Rd., Suite 108, Pittsburgh, PA 15241
Tel: 412.851.1400 | Fax: 412.851.1403 | Email: kfg@kapustafinancial.com