AXIS
FINANCIAL GROUP

ECONOMIC INDICATORS

Edition 10

"The U.S. banking system was destroyed by design and the big banks played along with it."

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ECONOMIC UNCERTAINTY

In this edition of our Economic Indicators publication, we take a closer look at inflation, gross domestic product, interest rates, the recent bank collapses in the United States and the expected economic outlook ahead. As always, we invite you to review, consider and formulate your own opinions.

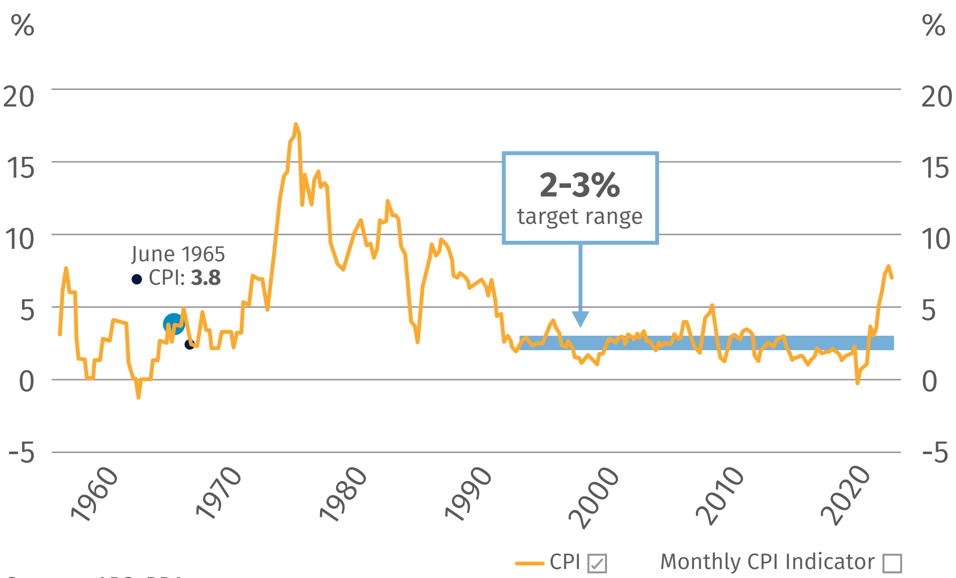
INFLATION

In its May 2023 Statement on Monetary Policy publication, the RBA (Reserve Bank of Australia) suggests that inflation has passed its peak in Australia but remains very high. Headline inflation declined to 7.0 per cent in year-ended terms in the March quarter. The expectation is that inflation will return to the 2.0–3.0 per cent target range, but it will take some time. The central forecast is for headline inflation to decline to 4.5 per cent by the end of 2023 and to reach 3.00 per cent by mid-2025.[1]

The below graph provides a historical view of Australian inflation levels from 1956 to date.

Australian Inflation - Historical

Year-ended percentage change, excludes interest charges prior to September quarter 1998 and adjusted for the tax changes of 1999-2000.



Sources: ABS: RBA

Globally, the IMF (International Monetary Fund) reports in its April 2023 World Economic Outlook publication that the outlook is for global inflation to decrease, although more slowly than initially anticipated, from 8.7 per cent in 2022 to 7.0 per cent in 2023 and 4.9 per cent in 2024.[2]

GROSS DOMESTIC PRODUCT (GDP)

The expectation is for GDP growth within Australia to be below trend over the period ahead. The RBA expects GDP to trough at around 1.25 per cent and then to pick up gradually to 2.00 per cent by mid-2025 as the drag from higher inflation and interest rates wanes and household wealth recovers.[3]

During a question-and-answer session at an RBA Board Dinner held in Perth on 2 May 2023, RBA Governor Phillip Lowe highlighted a need for a lift in productivity growth within the country. He stated that the level of output produced per hour of work in Australia today is the same as it was three years ago. Meaning there has been no growth in labour productivity over three years.[4]

Governor Lowe also noted that should low productivity continue, economic challenges will become more acute and difficult to deal with. He stated that "as a Nation, as businesspeople, as community leaders, as government people, we need to put our shoulder to the wheel here and do what we can to lift productivity growth because that's the only way we can have faster growth in real wages, it's the only way to support the Budget, where there are increased needs, and it's the way to improve our living standards".[4]

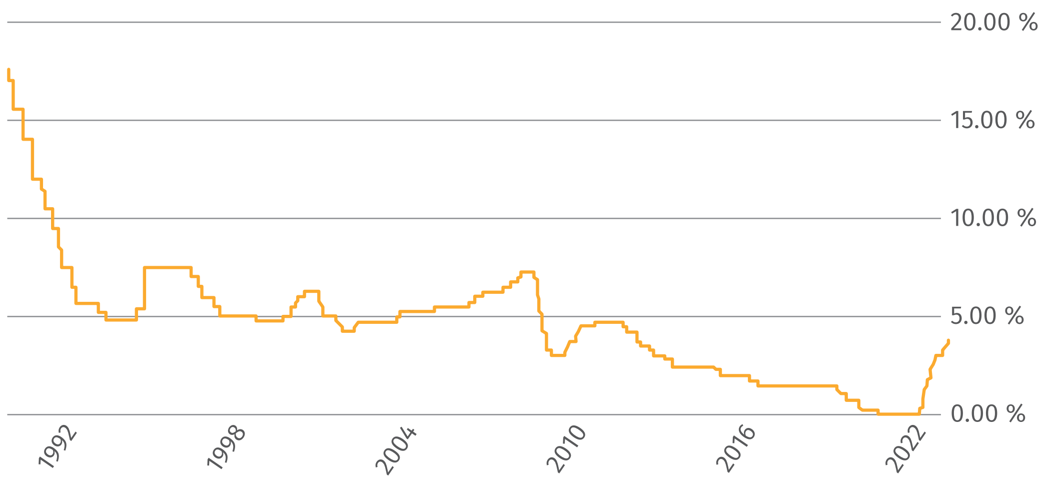
From a global perspective, the IMF projects that global growth will bottom out at 2.8 per cent in 2023 before rising modestly to 3.0 per cent in 2024.[2]

INTEREST RATES

The Australian Cash Rate target is sitting at 3.85 per cent as at 3 May 2023.[5]

The below graph provides a historical view of the Australian Cash Rate from 1990 to date.

Australian Cash Rate - Historical[6]



Points of Interest:

- From May 1992 until September 2008, the cash rate average was around 5.65 per cent.
- During those 16 years (1992 to 2008), the cash rate fluctuated between a high of 7.50 per cent and a low of 4.25 per cent.
- From September 2008 (the start of the Global Financial Crisis) until May 2022, the cash rate average was around 2.29 per cent.
- During those 14 years (2008 to 2022), the cash rate dropped sharply from 7.00 per cent in September 2008 to a record low of 3.00 per cent by April 2009. It then fluctuated between 3.00 per cent and 4.75 per cent until May 2013, at which point 2.75 per cent became the new record low. From there, it commenced a downward trajectory of record lows, bottoming at 0.10 per cent.
- From May 2022 to May 2023, the cash rate has been incrementally increasing and is now sitting at 3.85 per cent, which historically is still relatively low.
- The cash rate has been in historically low territory for the past 15.

The below graph provides a historical view of the United States Fed Funds Rate from 1971 to date.

United States Fed Funds Rate - Historical[7]

The Fed Funds Rate in the United States shows a slightly different yet similar pattern. Persistent record low rates from 2009 through to 2016, at which point they started to rise, only to flatline again in 2020 until early 2022, when they rose sharply to their current level of 5.25 per cent.

Internationally, central banks in many advanced economies have increased policy rates similarly. Although, some have emphasised uncertainty over the outlook for policy rates following the emergence of stress in parts of the banking system in the United States and Switzerland. Government bond yields have declined in line with policy rate expectations, and bond market volatility has increased.[8]

Was it responsible economic management for interest rates to be so low for so long. What impact has this had on the economy at large? Has it played a part in causing the current trend of bank failures in the United States?

UNITED STATES BANK FAILURES

Is it normal for banks to fail? Is there another Global Financial Crisis looming?

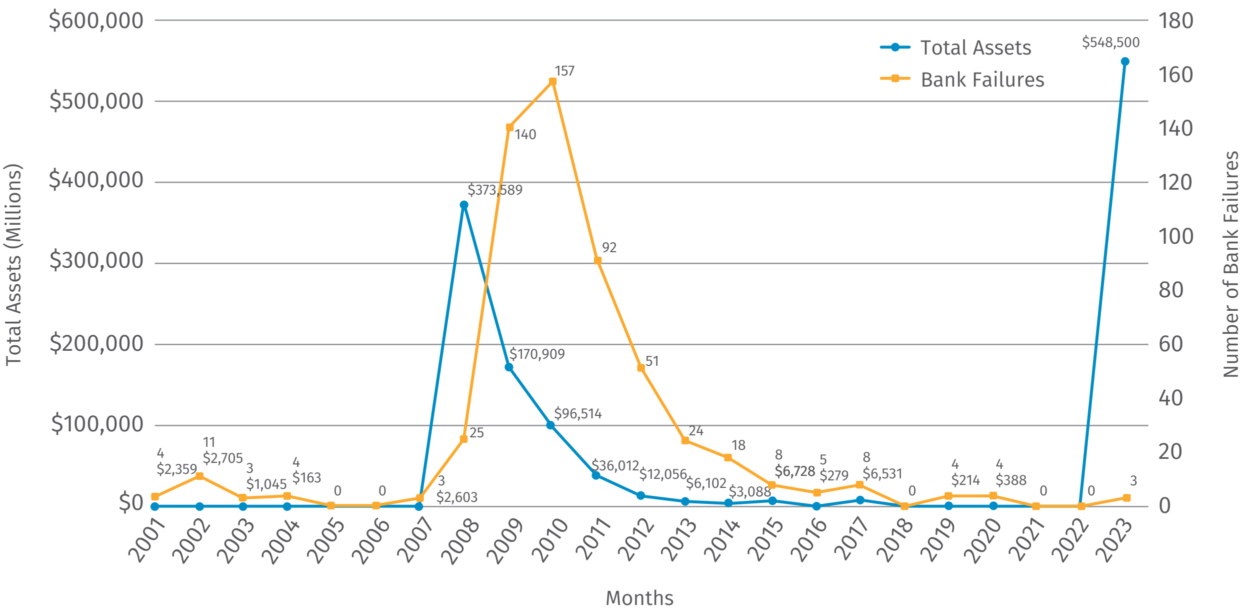
In the United States, the independent government agency that protects bank depositors is known as the FDIC (Federal Deposit Insurance Corporation). It is interesting to note that deposits are only insured up to $250,000 per depositor, per FDIC-insured bank, per ownership category. The equivalent in Australia is APRA (Australian Prudential Regulation Authority) and similarly deposits are protected up to $250,000 for each account holder at each licenced bank, building society or credit union incorporated in Australia.[9]

Statistics noted on the FDIC website indicate that bank failures are not uncommon. There have been 564 bank failures in the United States recorded since 2001. However, drilling down into the data provides some further insights.[9]

The below graph shows the number of United States bank failures each year plotted on the red line and the associated total assets involved with those bank failures plotted on the green line.[9]

Bank Failures in Brief – Summary 2001 through 2023

There were 564 bank failures from 2001 through 2023.



Points of Interest:

- From 2001 to 2007 a total of 25 banks failed involving a total asset amount of around $9 billion dollars.
- From 2008 (the start of the Global Financial Crisis) to 2014 a total of 507 banks failed involving total assets of around $698 billion dollars.
- In the first 5 months of 2023 a total of 3 banks failed involving total assets of around $549 billion dollars.

To put this into perspective, the total assets involved with the 3 banks that have failed in 2023 so far equates to nearly 79% of total assets involved with the 507 banks that collapsed from 2008 to 2014. So, although the total number of banks that have failed in 2023 is relatively low, the total assets involved is significantly high and is greater than what was involved at the height of the GFC (Global Financial Crisis) in 2008.

What causes banks to fail?

Banks fail when the value of its assets fall below the market value of the its liabilities (obligations to creditors and depositors). Asset values can fall due to investment losses and significant deposit withdrawals resulting from a drop in customer confidence levels.[10]

What has been unfolding with interest rates over the years appears to have played a part. Since early 2022, regulatory bodies have lifted interest rates from near zero, record low levels back towards what previously was 'normal levels' to try and bring down inflation.

Rising interest rates increases the amount of interest banks pay out on deposits. Rising interest rates also decreases the value of fixed income assets such as sovereign bonds. Banks can then encounter a situation where the costs of gathering funds end up being higher than their asset yields (return on investments) which subsequently causes the bank to fail.[11]

In a BNN Bloomberg YouTube video published 1 May 2023, Chief Financial Strategist at Odeon Capital, Dick Bove, states that in 2011 the United States Congress released a report that noted one of the key causes of the collapse in banking back in 2008 during the Global Financial Crisis was the failure of the regulators to do their job. He suggested that it will say the same thing in the impending report written on the causes of the recent bank collapses.[11]

In an article titled 'The U.S. Banking System Was Destroyed By QE...And Negative Rates Killed It' published 19 March 2023, PhD Economist and Fund Manager, Daniel Lacalle suggests that "no amount of regulation can avoid these collapses because regulation is the problem. No amount of regulation can prevent a financial crisis when it is the regulator who incentivises accumulation of risk, deems sovereign bonds as 'no risk assets' and the supervisor prints trillions of dollars disguising risk with negative rates."[12]

Lacalle also notes that "the fractional reserve system has always been a problem. Very few people understand how quickly the capital of a bank can dissolve. The entire balance sheet of a bank is a deck of cards and the smallest decline in the profitable asset base (loans) or the volatile liabilities (deposits) would make the entire building collapse because the problem has always been to take additional long-term risk using short-term liquid liabilities (deposits). The mismatch between assets and liabilities makes the entire balance sheet collapse and there is never enough capital and reserves to cover the losses."[12]

Lacalle explains that "a decline in value of bonds, mortgages or investments should not bring the collapse of a bank and a contagion risk. What makes it so fragile? The fact that banks need to leverage those positions multiple times to get a return that, even after increasing debt, is still below cost of capital. And why is the return on assets and equity so poor in banks? Years of repression of interest rates and inflation of sovereign bonds."[12]

The IMF notes in their April 2023 World Economic Outlook publication that "the sharp monetary policy tightening of the past 12 months is starting to have serious side effects for the financial sector, as we have repeatedly warned in previous publications might happen (October 2022 Global Financial Stability Report; January 2023 World Economic Outlook Update). Following a prolonged period of muted inflation and extremely low interest rates, last year's rapid tightening of monetary policy has triggered sizable losses on long-term fixed-income assets. The stability of any financial system hinges on its ability to absorb losses without recourse to taxpayers' money."[13]

Systemic Risk Exceptions

In a bid to strengthen public confidence in the United States banking system on 12 March 2023, the Treasury, the Federal Reserve, and the FDIC invoked "systemic risk exceptions" which allowed them to guarantee billions of dollars of uninsured deposits associated with the Signature Bank and Silicon Valley Bank failures. Under this exception, any losses incurred by the FDIC (to support uninsured depositors) will be recoverable by a special assessment made on banks.[14]

The Federal Reserve Board also announced it will make available additional funding to eligible depository institutions to help assure banks can meet the needs of all their depositors. 14 However, these measures were unable to stop First Republic Bank subsequently collapsing which became the second-largest bank failure in U.S. history on May 1, 2023, with most of its business sold to JPMorgan Chase after federal regulators seized it.[15]

SUMMARY

In summary, the IMF reports that overall risks to the world economic outlook are heavily skewed to the downside, with the chances of a hard landing having risen sharply. The outlook for economic growth remains low by historical standards, financial risks have risen and inflation is still high. In addition to monetary policy, tighter fiscal policy (meaning reduced government spending) can also play an active role in reducing inflation.[13]

During a Fixed Income Strategic Forum 2023 titled Delayed Reaction, Liquidity Contraction, Macquarie Group Limited noted that "liquidity is the most important thing to financial market performance, and currently it is contracting, significantly". Macquarie reports an outlook for recession to occur within the global economy this year but stopped short of forecasting whether it will be a soft or hard landing for financial markets.[16]

History shows that markets are cyclical in nature and generally recover over time which is comforting for individuals with a reasonable time horizon until retirement. However, for retirees and individuals with a short time horizon until retirement, the current challenges in the global economy may require some thought, consideration, and consultation on how to best navigate the unfolding situation.

CONTACT AXIS

As super specialists, we have a keen awareness of key economic indicators and have been assisting individuals with growing and protecting their super for over 25 years.

Give us a call on **1800 111 299** or email **super@axisfg.com.au**

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