Managing Through Economic Cycles

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5 Minute Read

McQueen Financial Advisors

Uncertainty about the direction and timing of economic growth can lead to interest rate volatility. All financial institutions face greater uncertainty as the economy transitions from one stage to the next. Often, uncertainty creates opportunity if we can make sensible decisions. Economic cycles are the primary driver of yield curve changes, and 2022 delivered many challenges. We closely monitor economic indicators such as GDP growth, employment, personal spending, and inflation in order to provide sound advice. We also consider the unique needs and risk profile of each client. Read on for a deeper understanding of where we are in the current economic cycle, why considering economic cycles is important and how we can use this information to make informed decisions.

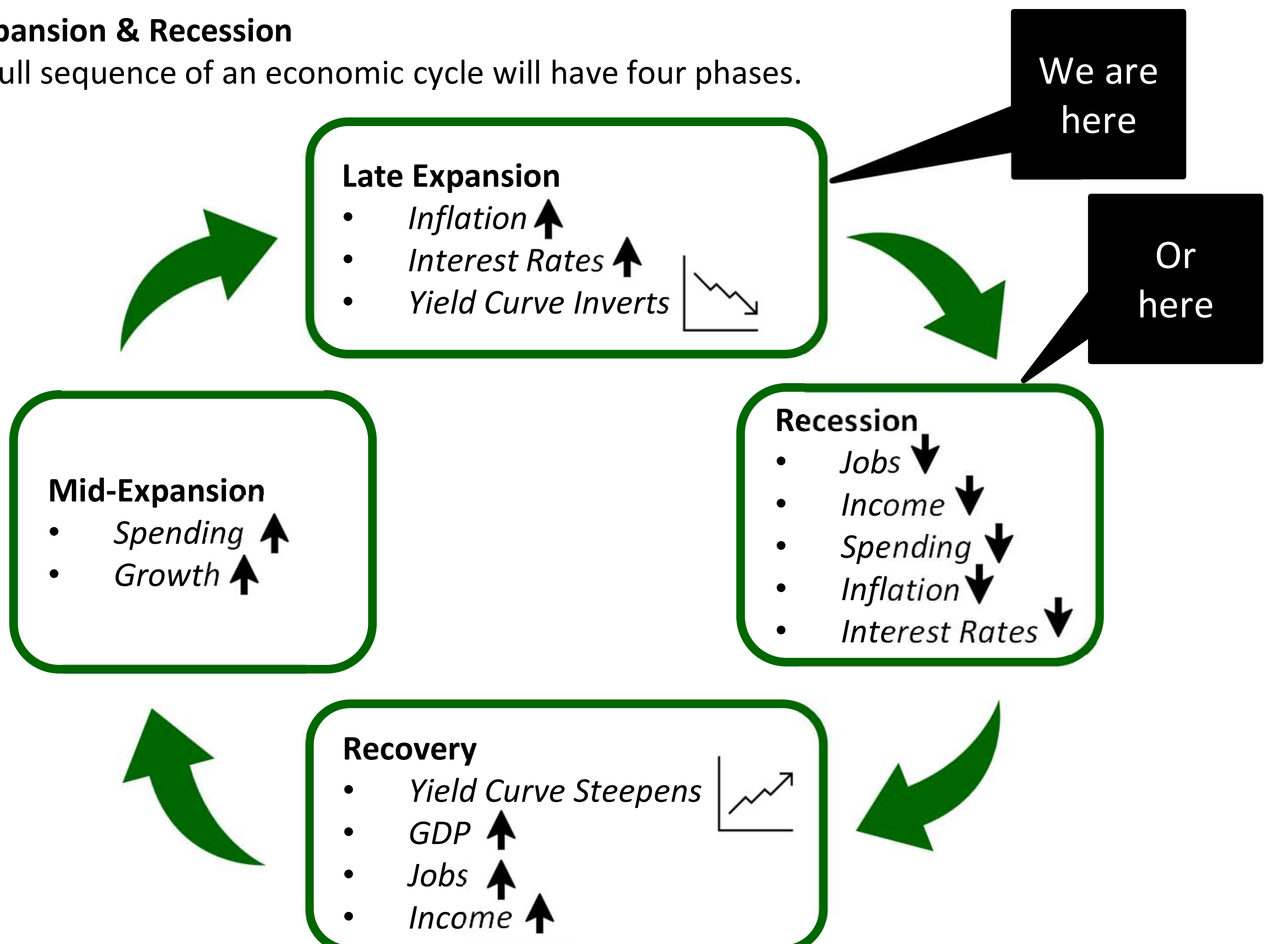
Importance of Economic Cycles

Many factors can influence yields and the slope and shape of the yield curve. At a basic level, the economic cycle is perhaps the most important factor which drives yields up or down. That's because the Federal Reserve and bond investors will react based on economic indicators and their growth or recession expectations. The economy fluctuates in unexpected ways. Some trends may indicate strength while others weakness. A successful strategy often depends on understanding current economic conditions, changes over time and the potential impact.

"The economy fluctuates in unexpected ways."

Expansion & Recession

A full sequence of an economic cycle will have four phases.



Late Expansion or Recession Phase?

Depending on who you ask, the U.S. economy is currently either in the late expansion phase or recession. In a late expansion, the economic cycle reaches maturity where growth peaks and business activity moderates before sliding into a recession. We pay close attention to several economic indicators such as employment, inflation, GDP growth and others to help identify where we are in the current business cycle. Some measurements may show changes before others and the trend of economic indicators rarely follows a pattern.

Economic Indicators and Cycles

Here are just some of the economic indicators that we study, to help us make recommendations and guide decisions.

"The trend of economic indicators rarely follows a pattern."

Economic Indicator	Expansion	Recession
Economic Growth (GDP)	Positive GDP growth trend as business activity improves	Low or negative GDP growth as business activity slows
Employment	Lower unemployment as businesses add workers to meet higher demand	Higher unemployment as demand for goods and services softens
Consumer Spending	Consumers spend a larger percentage of pay on more goods and services	Lower spending related to smaller paychecks & uncertainty about the future
Inflation	Higher consumer demand creates inflation	Falling demand lessens the upward pressure on prices
Interest Rates	The Fed raises short term rates to slow an overheated economy	The Fed lowers short term rates to boost growth and business activity

Inverted Yield Curve Recession Indicator

We often look at the slope and shape of the yield curve for clues on how the U.S. economy will perform. When short term rates rise above long-term rates, it's called an inverted yield curve. It's not common, so when the yield curve does invert, it gathers a great deal of attention. An inverted yield curve is associated with the belief that longer-term interest rates will fall, typically due to a recession. In the last 60 years, the yield curve has become fully inverted only 9 times. In every prior instance, the economy has slipped into recession on average 16 months after the yield curve inversion.

Quick Fact: *An inverted yield curve typically precedes a recession, but it doesn't cause a recession. Instead, the inversion reflects expectations that long-term yields will decline, which typically happens in a recession.*

Recession Indicators and Higher Short-Term Rates

Faced with slow growth or weaker economic conditions, the Federal Reserve's typical response is to reduce short term rates to stimulate the economy. This is common, related to the normal ebb & flow of economic cycles. However, it is the opposite of what is happening now. Instead of cutting rates to stimulate growth, the Fed is boosting interest rates. Why?

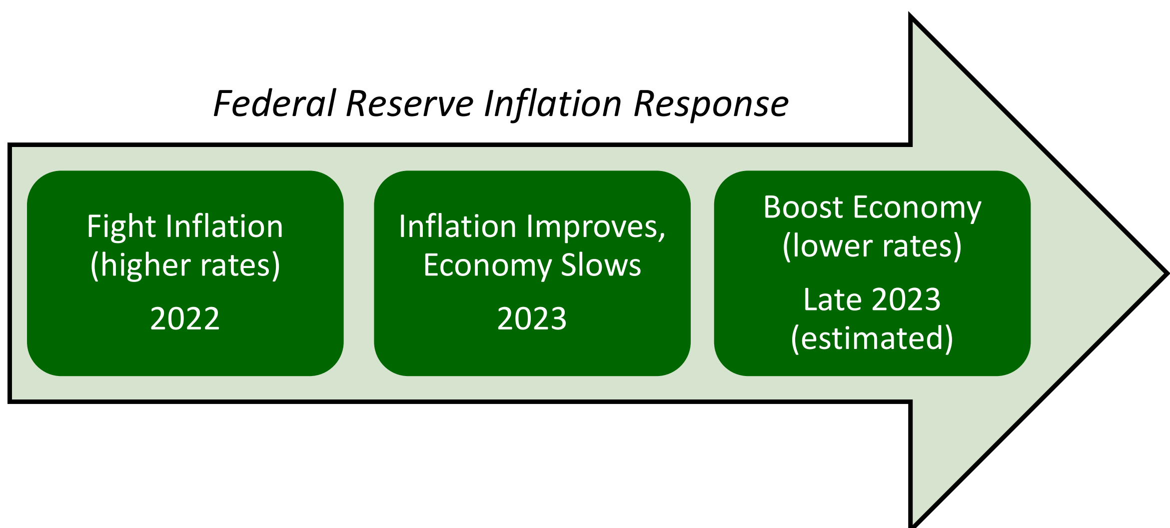
Inflation

The Fed's typical response to inflation is to boost short-term interest rates. This action is rare and was last used on a large scale when Ronald Reagan was President and Paul Volcker was the Fed Chairman (early 1980s).

"Inverted yield curve doesn't cause a recession"

Federal Reserve Action

When inflation ramps up, the Fed must first act to control it by increasing interest rates. This action will likely result in weaker economic conditions. Once inflation improves, the Fed will likely cut rates to boost economic activity. When the Fed reverses course, it is called a Pivot Point, which is widely expected in late 2023.



It appears that the U.S. economy is in late expansion stage. The yield curve is inverted and the Fed is raising rates to control inflation. These simultaneous conditions are uncommon. Understanding the economic cycle can help with budgeting, protecting earnings and achieving performance goals. Consider the following actions items:

Action Item: ALM Modeling & Testing

- Review ALM model capabilities and the ability to quickly simulate planned activities and unplanned events.
- Run more simulations related to growth, run-off and stressed scenarios.
- Perform additional liquidity stress tests assuming simultaneous loan growth, increased use of unfunded commitments and deposit run-off.

McQueen's 24/7 On-Demand ALM Simulation Tool takes less than a minute

Action Item: Funding

- Delay raising deposit rates for as long as possible. Deposits may remain in-tact due to economic uncertainty.
- Raise deposit rates in response to the need for funds, not merely local competition.
- Compare cost of borrowing vs local CDs.
- Carefully review structured borrowing options. Cheaper doesn't always mean better.

"These simultaneous conditions are not normal"

Ask for our recent reports entitled "Funding Options" & ""FHLB Structured Borrowings"

Action Item: Loans

- Raise loan rates now.
- Reduce indirect loan dealer reserves, if applicable.
- Limit long-term mortgages.
- Take advantage of large demand for 2nd Mortgages & HELOCs.
- Understand that 'toy' loans may be stressed as economic conditions deteriorate.
- Consider SBA floating rate loans, which offer limited risk.
- Review & update risk-based pricing grid.
- Consider slower loan growth, especially if expensive non-core funding is necessary.

Talk to your MFA advisor about CECL adjustments. Ask for our recent reports entitled "Loan Rates & Dealer Reserves" & "Loan Pricing".

Action Item: Investments

- No Negative Convexity
- No Callable Bonds
- Limit Mortgages
- Carefully review corporate bond credit quality
- Muni bond credits should hold up well due to U.S. Govt assistance
- Invest a little longer at some point in time

Talk to your MFA advisor about investment strategies for your unique balance sheet and goals.

Action Item: General Thoughts

- As the economy weakens, we can expect that delinquency and charge-offs will increase. Higher CECL reserves will follow.
- Need strong earnings now to prepare for possible future stress.
- Higher interest rates are generally favorable, but an inverted yield curve may compress margins.
- A higher loan-to-deposit ratio may result in expensive funding. Borrowing rates are very high in relation to local core deposits.

"Need strong earnings now"

Talk to your MFA advisor about the changing economic forecast and CECL impact. Ask for our Inverted Yield Curve report.