QUARTERLY ECONOMIC OUTLOOK | FIRST QUARTER 2023

A long, turbulent flight.

"Fasten your seatbelts. It's going to be a bumpy night."

- *Margo Channing, played by Bette Davis, in All About Eve (1950)*

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SEI recently released its first-quarter Economic Outlook. Here is summary of our key perspectives.

- Prior to the upheaval caused by the collapse of Silicon Valley Bank (SVB) and the other banks, economic growth and inflation continued to surprise to the upside.
- The turmoil in the U.S. and European banking systems is a significant event that will likely result in a tightening of lending standards to businesses and consumers. In the past, these episodes have led to, or coincided with, an economic downturn.
- The current episode is not a rerun of the Global Financial Crisis (GFC), when the financial system was severely overleveraged and undercapitalized. In addition, the strains on bank liquidity stem from a mismatching of liabilities and assets. During the GFC, poor credit quality tied to the residential housing market and a lack of transparency into complex investment vehicles damaged trust in the balance sheets of the world's largest and most systemically important financial institutions.
- The U.S. Treasury, U.S. Federal Reserve (Fed), Federal Deposit Insurance Corporation (FDIC), and other regulators have responded quickly and forcefully, bailing out the worst-hit banks and infusing massive amounts of liquidity into the banking system via the Bank Term Funding Program and other lending facilities that should help small and regional banks cope with the outgoing tide of deposits,
- In Europe, the fallout of the Credit Suisse/UBS merger appears to be manageable, although the bail-in of AT1 creditors and their subordinated position to equity holders was a controversial decision.
- Several major central banks, including the Fed, the European Central Bank, the Bank of England and the Swiss National Bank all raised their policy rates in March despite the shock waves emanating across their banking systems. The rising interest-rate cycle is probably coming to an end as things begin to break, but markets are priced for a sharp reversal in policy rates beginning within the next two months. We think that this is an extreme reaction; a pivot to rate cuts would occur only if there is a far more serious threat to the global financial system and real economy than appears to be the case currently.
- Central banks do face a severe challenge, however. It remains to be seen if, as they maintain, central banks can fight inflation and ensure financial stability simultaneously with the different tools at their disposal. The market action in bank stocks, bonds and other financial instruments such as federal-funds futures contracts highlight the current skepticism of investors.
- SEI still believes that inflation will remain "higher for longer." Granted, a recession would reduce inflation on a cyclical basis, but we still doubt that it will fall all the way back to 2%—much less stay that low through a full economic cycle.
- In our view, there are both cyclical and secular pressures that will keep inflation higher than it has been in the past two decades. The aging of the "baby boomers" and the decline in the working population will likely exacerbate the fiscal positions of many countries in the years to come.

A full-length paper is available if you wish to learn more about these timely topics.

Glossary

The **Global Financial Crisis (GFC)** refers to the period of extreme stress in global financial markets and banking systems between mid-2007 and early 2009.

AT1 bonds, also known as contingent convertible bonds, or “CoCos,” comprise bank-issued debt that can be converted into equity if a bank’s capital levels fall below required levels.

“Baby boomers” include individuals who were who was born between 1946 and 1964. The baby boomer generation comprises a substantial portion of the world's population, especially in developed nations.

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