Economic Update

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Virginia Association of Community Bankers
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Economic Update

Background for the Current Economic Conditions

- Recovery from COVID Pandemic
- War in Ukraine
- Inflation, Fed Policy and Interest Rates
- Silicon Valley Bank Collapse/Run on Deposits at other Banks

Economic Outlook

- Current Situation on Inflation, Interest Rates, Growth and Employment
- Future Outlook on Inflation, Interest Rates, Growth and Employment
- Implications for Community Banking in Virginia

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Recovery from COVID Pandemic

- Surge in Demand

  Pent Up Demand Fueled by Pandemic Savings and Stimulus Checks

  Initially in the Goods Sector and later in Services sector

- Supply Bottlenecks in International and Domestic Supply Chains

  Significant increase in transportation costs and times

- Labor Shortages and Low Participation Rate – Wage Growth

- Inflation – initially thought to be transitory

  however, it turned out to be more permanent

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War in Ukraine

Gas/Energy Shortages

- Initial increases in prices
- Moderated by mild winter in Europe and reorganization of supply chains

- Food grain shipments from Ukraine and vicinity were disrupted
  - Initial increases in prices
  - Moderated with restoration of supply

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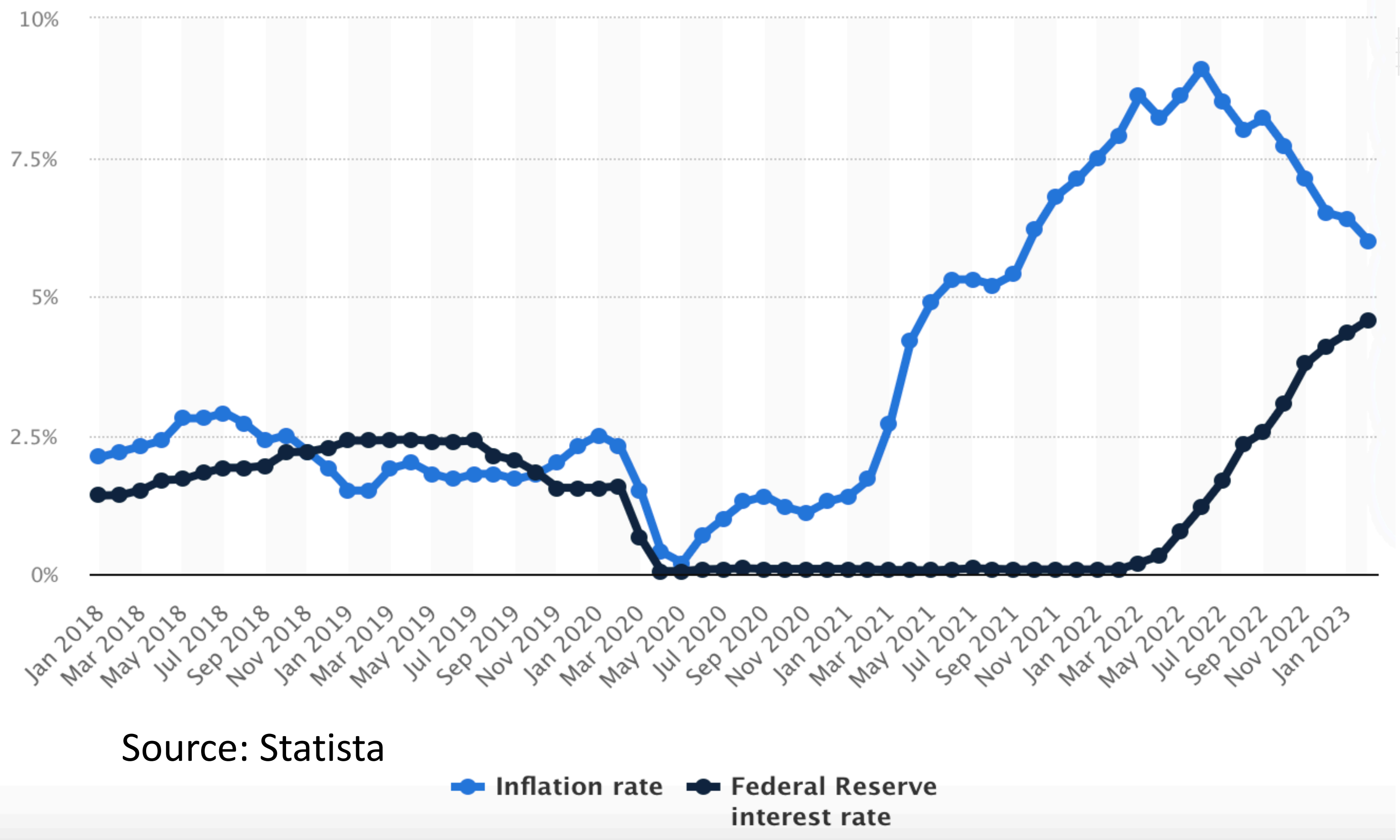
Inflation, Fed Policy and Interest Rates



Source: Statista

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Silicon Valley Bank (SVB) Collapse

- Bank with a State Charter with $200+ Billion in Assets and $170+ Billion Deposits (90%+ uninsured).
- $110+ Billion invested in Treasury Bonds and Govt. Backed MBS
- Large unrealized losses (~$15 Billion) on the long-term bonds as interest rates increased
- Slow down of growth in high-tech/growth sector
- Loss of $1.8 Billion in sale of US Treasuries and MBS
- March 8: Outlined plan to raise $2.25 Billion of Capital
- Social media fueled run on deposits on March 9 (~$42 Billion withdrawals initiated)
- Put under FDIC receivership on March 10
- Deposits and loans acquired First Citizens, NC
- Q: Was SVB behaving, in part, like a pseudo bond mutual fund?
- Failure of Risk Management and/or Supervision

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Run on Deposits at Other Banks

- Run on Deposits and Collapse of Signature Bank, New York
- Problems at Credit Suisse and takeover by UBS
- Rescue of First Republic Bank by big banks with deposits of $30 Billion
- Other banks are also likely to have large unrealized losses resulting from the increases in interest rates
- Fed has implicitly guaranteed all deposits.
- Potential Crisis seems to have been (at least temporarily) averted
- Bank Lending is likely to be lower
- Could have a negative impact on economic growth
- Some economists are suggesting that there is no need for further rate increases by the Fed to slow down the economy to control inflation
- Crisis or just a tremor?

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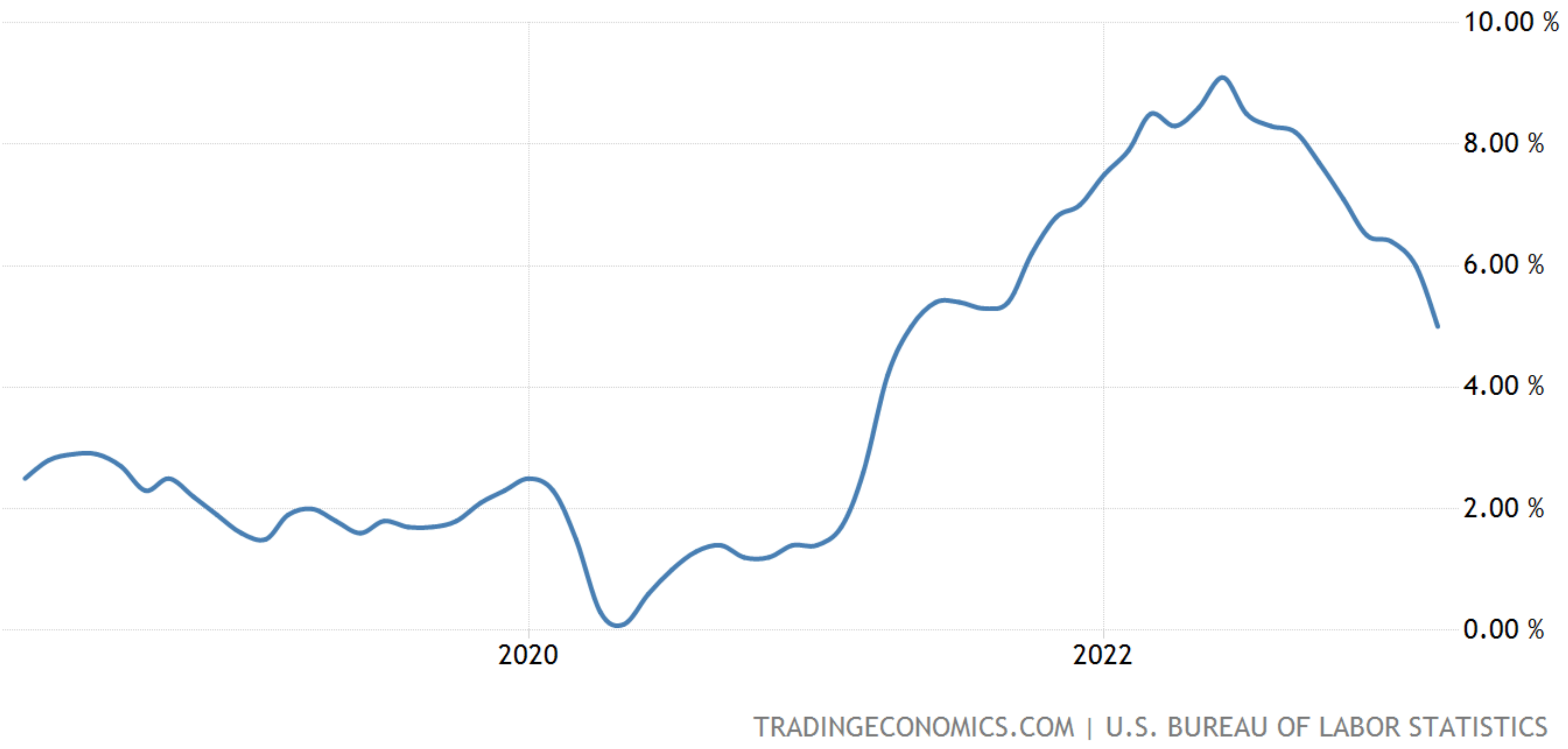
Current Economic Situation - Inflation

Inflation is declining: Annual Inflation Rate down to 5% (March 2023) from a recent high of 9.1% (June 2022)



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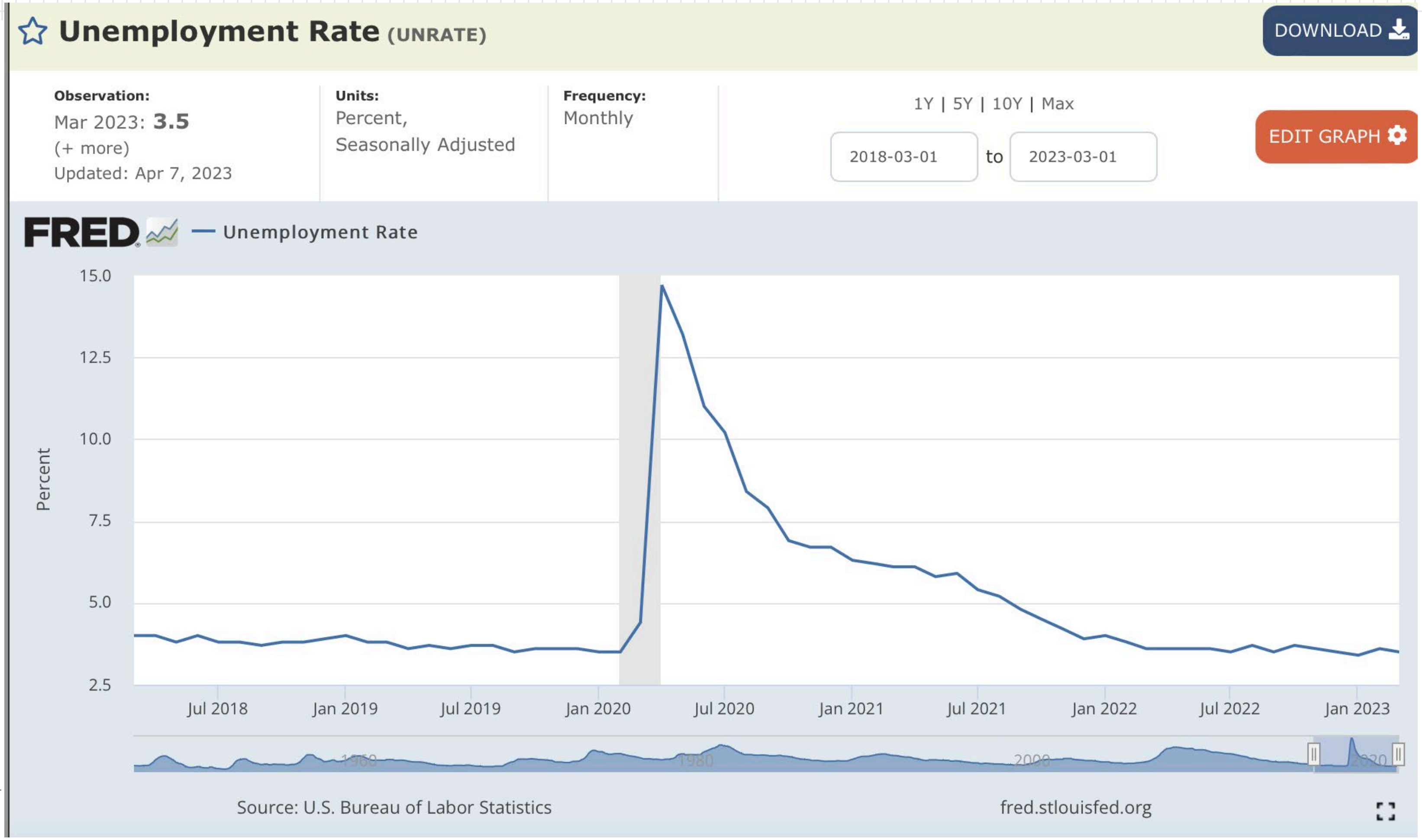
Current Economic Situation - Unemployment

Unemployment is down to 3.5% (March 2023) from a recent high of 14.7% (April 2020)



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Current Economic Situation - Growth
Real GDP Growth

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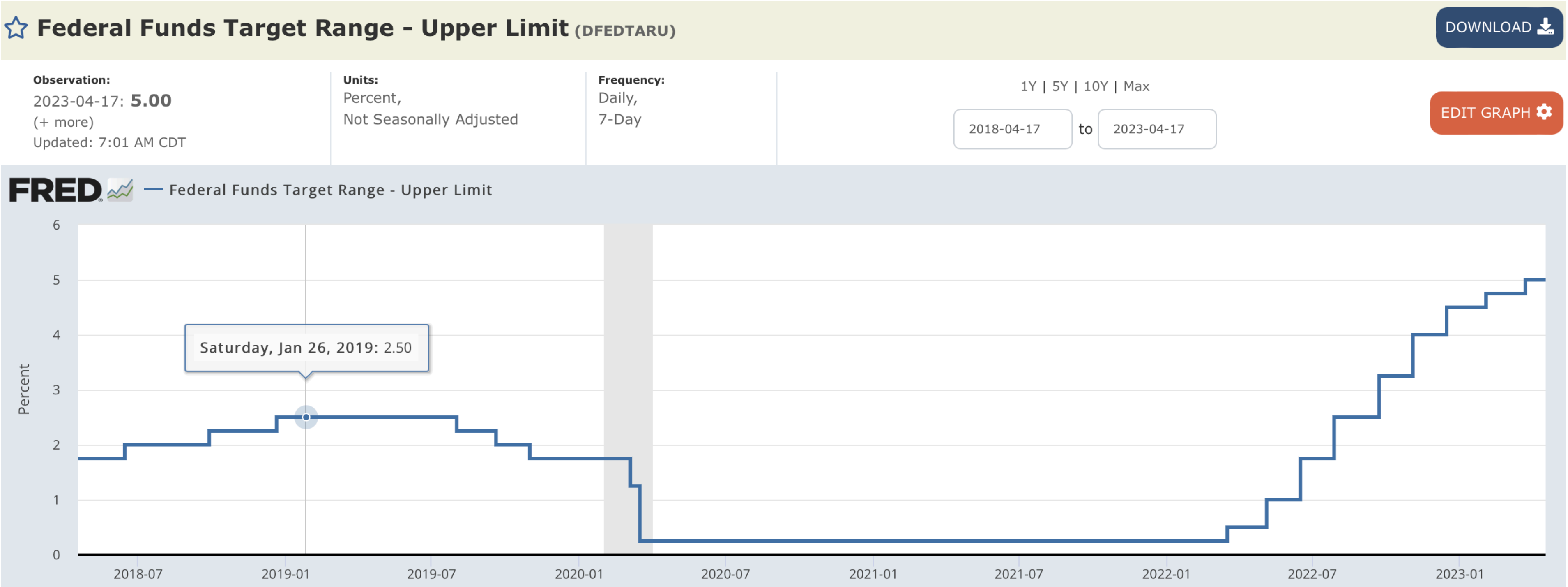
Current Economic Situation - Interest Rates

Federal Funds Target Range - Upper Limit - 5% (March 2023)



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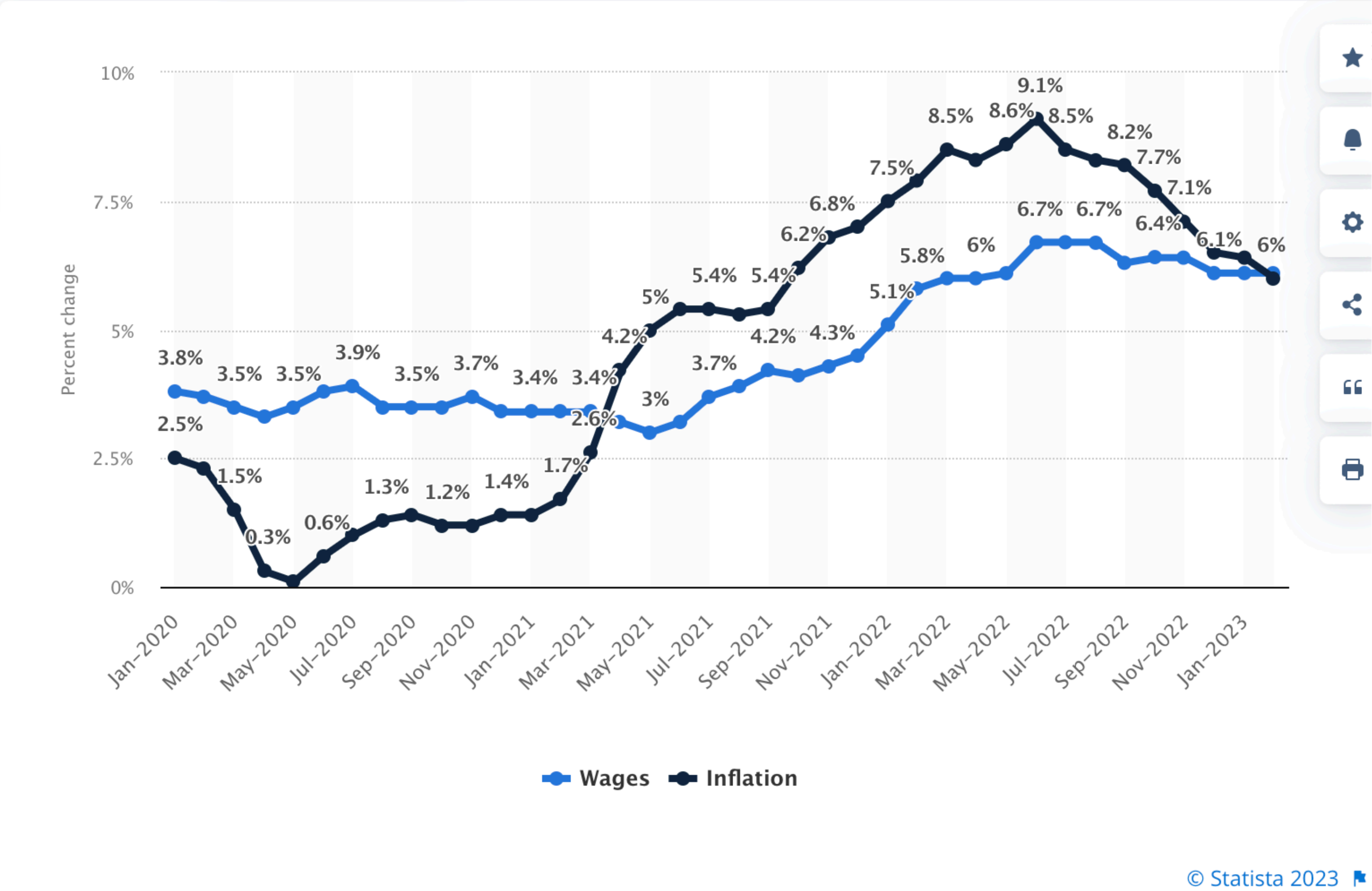
Current Economic Situation – Wage Growth

6%+ (March 2023) – Atlanta Fed



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Economic Outlook (next 6-12 months) Inflation

Inflation

Optimistic scenario – Keeps steadily declining towards the Fed's target of 2%

More likely scenario – Becomes steady at about 4% because of wage growth, services sector inflation and recent increase in Inflation Expectations.

Pessimistic scenario – Stays in the 5% to 6% range.

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Economic Outlook (next 6-12 months)
Real GDP Growth

Real GDP Growth

Optimistic scenario – 2 to 3%

More likely scenario – 0.5 to 2% range

Pessimistic scenario – -1 to 0.5% range

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Economic Outlook (next 6-12 months)
Interest Rates

Target Federal Funds Rate

Optimistic scenario – Fed can start reducing the Federal Funds rate by the end of the year if inflation declines steadily

More likely scenario – Increase it by 0.25% (or stay at the current rate) if inflation gets sticky at about 4%

Pessimistic scenario – Increase it by 0.50% or more if inflation gets sticky at the current level of about 5%.

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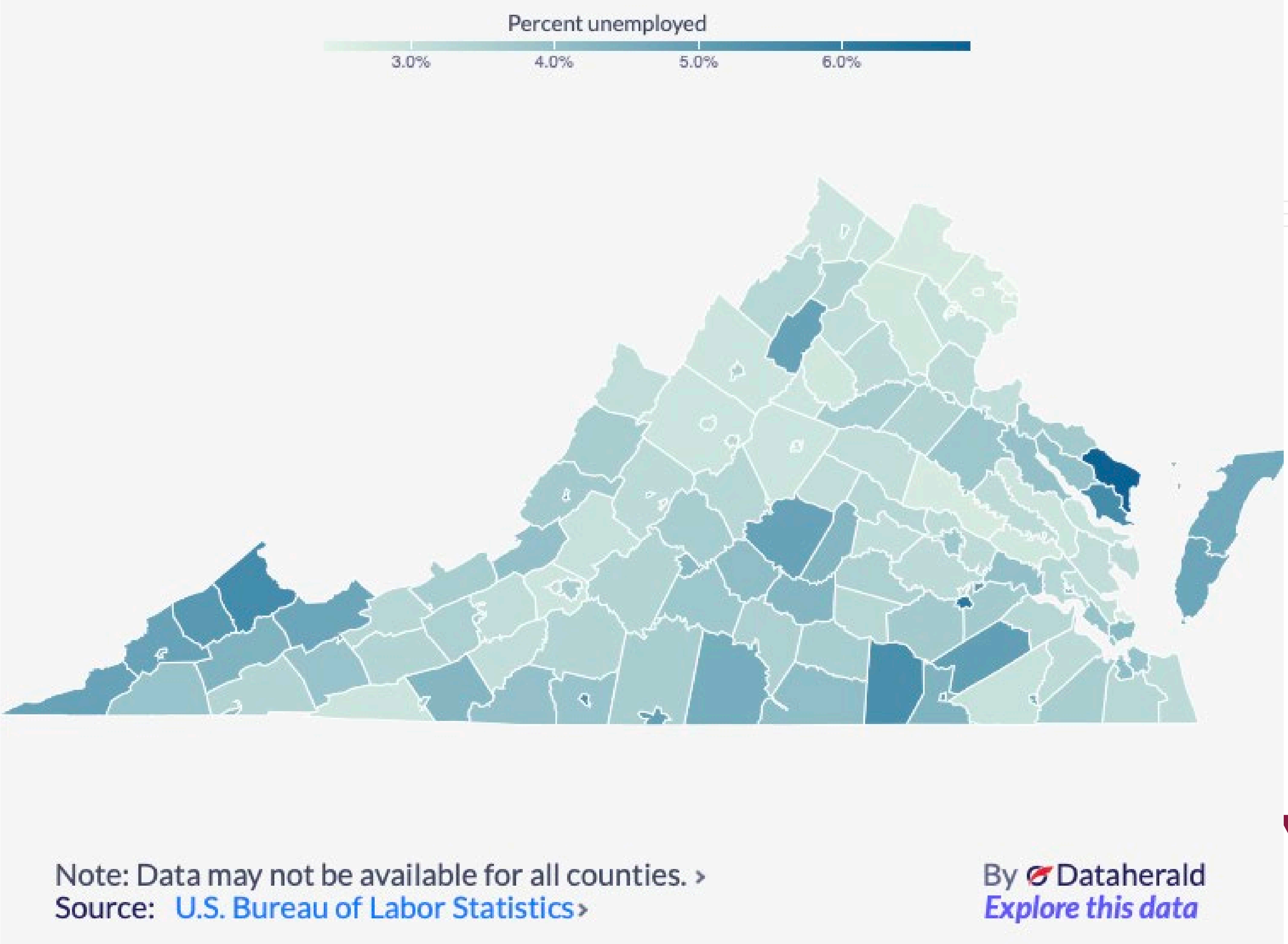
Unemployment (Virginia)



Source: Roanoke Times

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Possible Risks for Banks

- Interest Rate sensitive loan customers (such as Commercial Real Estate) may get into further trouble if they have to refinance.
- Potential for some of the deposits to move to higher interest paying money market mutual funds – not very likely because of insurance of deposits
- Reduced loan activity because of higher interest rates

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Q & A

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Notes:

- Crisis or Tremor?
- Failure of Interest Rate Risk Management and Supervision
- To what extent SVB was operating as a high duration bond mutual fund with the depositors' money? Bond mutual funds are and should be marked to market.
- Interest Rate sensitive loan customers of banks could be in trouble
- Inflation has migrated from food and energy to other goods and now to the services sector.
- Wage growth 6.1% (Atlanta Fed) – inflationary
- Inflation expectations are up by around 0.4-0.5%
- Inflation may be more sticky – around 4%

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