Economic Summary – Q4 2022

Scott McIntyre, CFA
HilltopSecurities Asset Management
Senior Portfolio Manager
Managing Director
512.481.2009
scott.mcintyre@hilltopsecurities.com

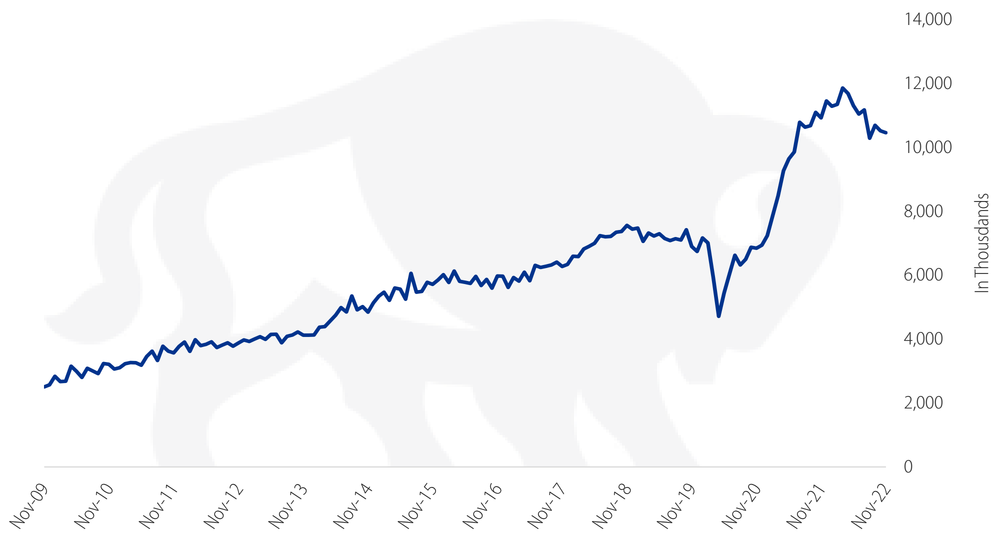
Greg Warner, CTP
HilltopSecurities Asset Management
Senior Portfolio Manager
Managing Director
512.481.2012
greg.warner@hilltopsecurities.com

The U.S. economy appeared stubbornly resilient in the final quarter of 2022, despite the Fed's efforts to suffocate growth. The final reading of third quarter GDP was revised upward from +2.9% to +3.2% on stronger consumer spending, while the Atlanta Fed's (admittedly too-early-to-be-relevant) fourth quarter GDPNow measure was tracking at +3.7% as of December 23rd. Roughly two-thirds of economists in the December Bloomberg survey are forecasting a recession in 2023, but as 2022 closed out, growth was far from weak.

On the too-strong side was employment. The unemployment rate held steady at 3.7% in both October and November, just a fraction above the five-decade low. Only six million Americans were actively seeking work in November, well below the 10.3 million job openings reported in the October JOLT survey.

Roughly two-thirds of economists in the December Bloomberg survey are forecasting a recession in 2023, but as 2022 closed out, growth was far from weak.

Job Opening and Labor Turnover Survey (JOLTS)



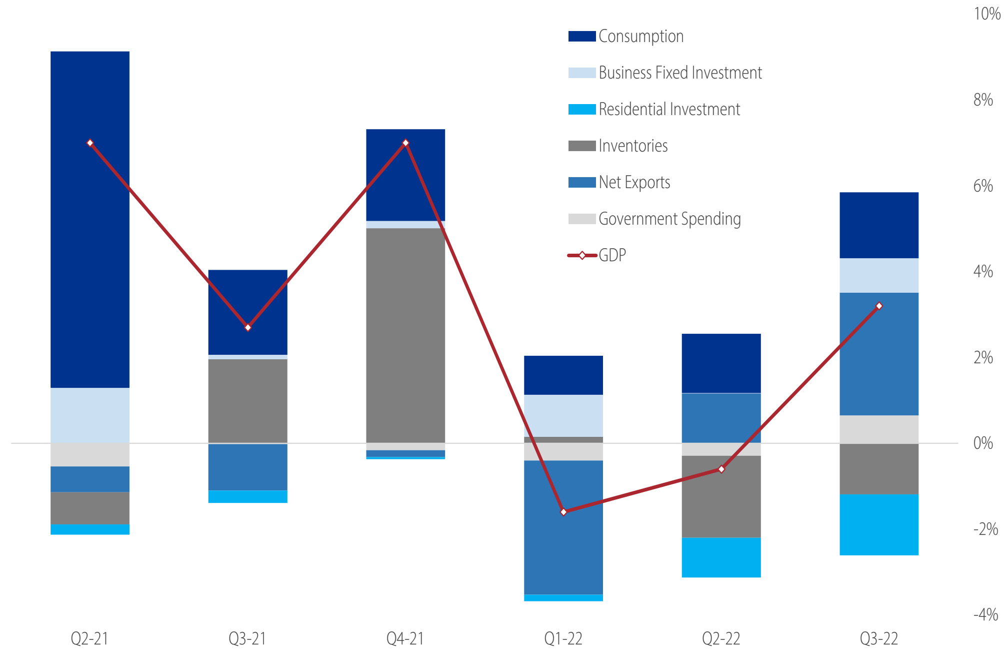
Source: Bureau of Labor Statistics

The mismatch continued to pressure wages. Average hourly earnings increased +0.6% in November, doubling forecasts, and pushing the year-over-year wage gain upward from a revised +4.9% to +5.1%.

Eventually, automation will fill in the gaps; in the meantime, employers continue to pay more to attract and retain workers.

Consumer spending has generally slowed, but more importantly, *it's shifted*. U.S. consumers are buying fewer goods but more services. In fact, the third quarter GDP report showed goods consumption contracting at an annual rate of -0.4%, while services consumption was expanding at a +3.7% pace. Factories can increase production of goods but finding workers to meet demand for services is an ongoing challenge.

Gross Domestic Product (Quarter-over-Quarter Annualized Percent Change)



Source: Bureau of Economic Analysis

When focusing on more recent underlying trends, the outlook brightens significantly. Over the last five months, the increase in headline CPI has averaged just +0.2%, implying an annual inflation rate of +2.4%.

Eventually, automation will fill in the gaps; in the meantime, employers continue to pay more to attract and retain workers. This cost increase has resulted in steadily rising prices at bars and restaurants, hotels, and airlines. Fed officials are concerned that if consumer demand isn't curtailed quickly, these price increases could become embedded.

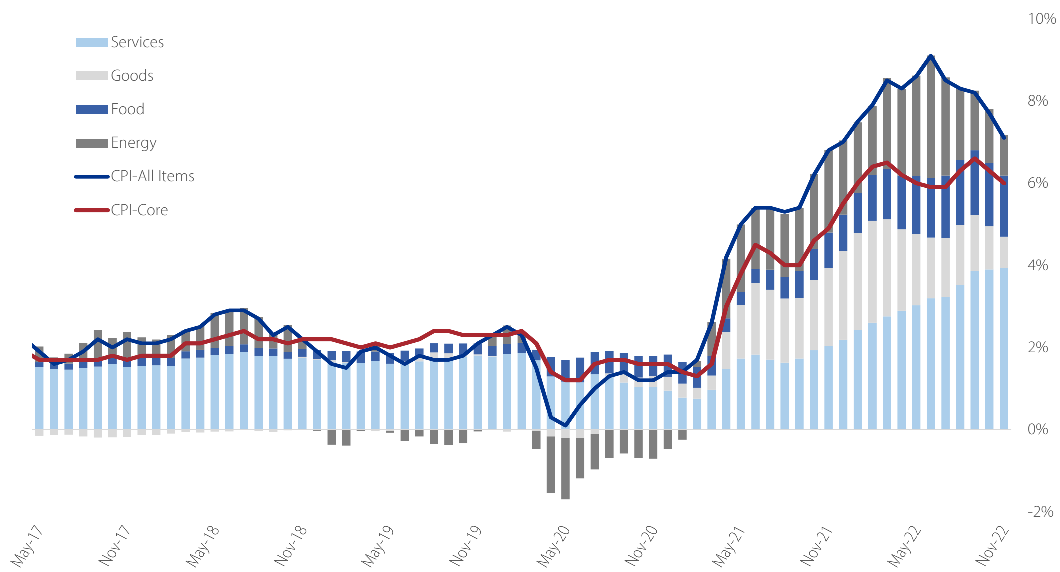
The November consumer price index (CPI) report turned out to be a welcome relief for both the markets and the Fed. Headline CPI rose by just +0.1% in November after troubling +0.4% gains in the previous two months. The core rate (ex food and energy) climbed +0.2%, *the smallest monthly advance in more than a year.* On an annual basis, overall CPI retreated to a +7.1% pace while the core rate slipped to +6.0%, off highs of +9.1% and +6.6% from months earlier.

When focusing on more recent underlying trends, the outlook brightens significantly. Over the last five months, the increase in headline CPI has averaged just +0.2%, implying an annual inflation rate of +2.4%. Core CPI is stickier, but the +0.4% monthly average since July indicates an annualized rate below +5.0%.

The Wall Street Journal reported after Christmas that microchip production has risen to the point of oversupply.

Several key price categories provide ample reason for optimism on the inflation front. The Manheim Used Vehicle Value Index has declined over six consecutive months and is now down -14% year-over-year through November. The chief economist for Cox Automotive indicated recent increases in new vehicle inventories are relieving price pressure on used cars and trucks.

Consumer Price Index (Year-over-Year Percent Change)



Source: Bureau of Labor Statistics

The prices-paid component in the ISM manufacturing index (already in sub-50 contraction territory) dropped from 46.6 to 43.0 in November as an increasing number of factory managers reported easing of prices. Just eight months earlier, the price index stood at 87.1.

Dealer lots are no longer empty as vehicle production slowly (and unevenly) rises. Toyota Motor Corp actually reported record global auto production in November …but the Japanese carmaker is an industry outlier. New vehicle supply is still very lean.

The Wall Street Journal reported after Christmas that microchip production has risen to the point of *oversupply*. Chip inventories are at their highest level in more than a decade. Unfortunately, the bloated supply is in the high-end chips that power electronics, not the low end (but the rigorously tested and extremely reliable) type required for most cars and trucks. Auto insiders expect the shortage to linger well into 2023.

Other supply chain problems are disappearing in the midst of rising goods inventories and fading global demand. After more than two years, the Ports of Los Angeles and Long Beach have reported a return to normal operations, and cargo freight rates are falling in response.

Homebuyer sentiment, according to Fannie Mae, has plunged to a record low in the data series going back 11 years.

Gasoline prices have plunged since their summer peak with AAA reporting a national average price of $3.16 per gallon on December 28th, down from $5.02 in mid-June. However, much of this decline can be attributed to a drop in demand from China as a result of its zero-Covid policy which shut down broad swaths of the Chinese economy during much of the second half of the year.

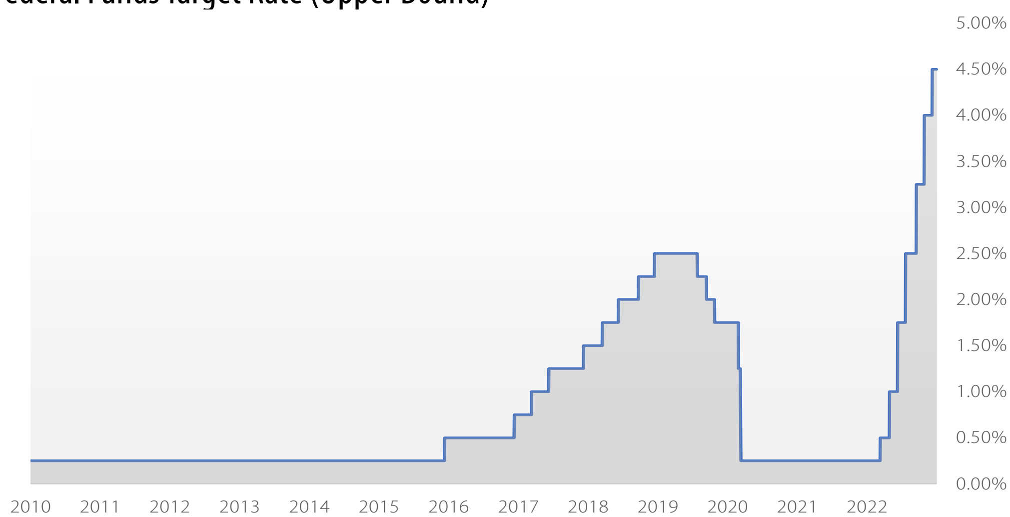
The prices-paid component in the ISM manufacturing index (already in sub-50 contraction territory) dropped from 46.6 to 43.0 in November as an increasing number of factory managers reported easing of prices. Just eight months earlier, the price index stood at 87.1.

Data from the National Association of Realtors (NAR) showed the median sales price for an existing-home fell -2.2% to $370,700 in November, well below the peak of $413,800 back in June, and an increase of just +3.5% from a year ago. Over a two-year period ending in June 2022, the S&P CoreLogic Case-Shiller price index rose more than 40%. Since then, it's down -2.5%. Analysts are deeply divided on the price outlook for 2023, with predictions ranging from small increases to double-digit declines.

National rental prices, according to *Redfin*, increased slightly in November after declines in September and October. The median rent in November was $2,007, still painfully above the February 2020 median of $1,595, but below the August 2022 peak of $2,053. Rents were still +7.5% higher than a year ago but have retreated significantly since March 2022 when the year-over-year increase peaked at a staggering +17.5%. Rental rates for new leases peaked in June and have since been trending lower.

The average 30-year fixed mortgage rate has dropped 66 basis points from its cycle peak in November to close the year at 6.42% according to Freddie Mac, although lending rates remain more than twice as high year-over-year. Homebuyer sentiment, according to Fannie Mae, has plunged to a record low in the data series going back 11 years.

Federal Funds Target Rate (Upper Bound)



Source: Federal Reserve

Fed officials hiked the overnight target rate by 75 basis points for the fourth consecutive time in early November before downshifting to a 50 bp increase in December. This marked 425 basis points of tightening in just nine months, the most aggressive pace in over 40 years.

Rate hikes are designed to slow GDP growth, but that hasn't happened yet, so Fed officials remain in tightening mode. However, there is already ample evidence of waning demand. Households are gradually drawing down record cash holdings accumulated during the pandemic. The personal savings rate, which ended 2021 at 7.5%, had dropped to 2.4% by November, while total outstanding consumer debt reached a record high in October, according to Federal Reserve data.

Rate hikes are designed to slow GDP growth, but that hasn't happened yet, so Fed officials remain in tightening mode. However, there is already ample evidence of waning demand.

The Fed's hard monetary policy shift in 2022 may not have crippled the economy or the labor market, but it certainly hammered investors as the energy sector and cash were the only obvious winners.

With the expanded child tax credit not included in the most recent federal funding package, low and middle income parents are likely to feel increased financial pressure. And, assuming the U.S. economy does fall into recession sometime in 2023, there's virtually no chance another round of stimulus checks will be issued to ease the pain. Nor will the Fed be quick to cut rates before seeing a meaningful and lasting downturn in price pressures.

The Fed's hard monetary policy shift in 2022 may not have crippled the economy or the labor market, but it certainly hammered investors as the *energy sector* and *cash* were the only obvious winners. The big losers included both stocks and bonds.

The Conference Board reported its confidence index climbed to the highest level since April, while inflation expectations fell to their lowest point in 15 months.

The tech-heavy NASDAQ suffered through its worst December performance on record and ended the year down (-33.1%). Both the DOW (-8.8%) and S&P 500 (-19.4%) experienced their worst years since 2008 amid the global financial crisis. According to Yahoo Finance, 865 actively managed stock mutual funds domiciled in the U.S. lost an average of -19% in 2022, while the MSCI World index tumbled -19.5%, losing more than $18 trillion in equity value.

The S&P US Treasury Bond Index lost -11% in 2022 and the Bloomberg Aggregate US Bond Index had its worst year since the index's inception in 1977. Even the traditional buy-it-and-forget-it 60/40 stock/bond portfolio suffered its worst performance of the past century according to Mauldin Economics. All in all, the Financial Times reported that investors lost a combined $30 trillion during the year. *Massive wealth destruction has a tendency to crimp consumer demand going forward.*

Treasuries were wildly volatile during the quarter, but as the year mercifully drew to a close, yields slipped well below the cycle peaks along much of the curve.

Q4 Interest Rates

		Fed Funds	3 mo. T-bill	12 mo. T-bill	2 yr. T-note	5 yr. T-note	10 yr. T-note
Last	9/30/22	3.00%-3.25%	3.25%	3.93%	4.28%	4.09%	3.83%
High			4.44%	4.76%	4.72%	4.45%	4.24%
Low			3.21%	3.90%	4.09%	3.61%	3.42%
End	12/31/22	4.25%-4.50%	4.34%	4.69%	4.43%	4.00%	3.88%

Source: U.S. Department of the Treasury

The new year begins in a period of transition. The domestic and global economies are expected to weaken significantly in the coming months, which as bad as it sounds, is exactly what Fed officials have hoped for.

There was some good news in the midst of a crummy December. Early in the month, the U.S. dodged a potential catastrophe when Congress intervened in a dispute between freight rail operators and unions, which halted a planned nationwide strike. And just before Christmas, the Senate passed a $1.7 trillion funding bill which would push any possibility of a government shutdown forward another year.

Consumer confidence, which soured in 2022, bounced back in December. The Conference Board reported its confidence index climbed to the highest level since April, while inflation expectations fell to their lowest point in 15 months. It may be soft data, but any sign of optimism is welcome, especially given the year it was.

Economic and Interest Rate Outlook

The new year begins in a period of transition. The domestic and global economies are expected to weaken significantly in the coming months, which as bad as it sounds, is exactly what Fed officials have hoped for. A significant number of job postings are likely to dissipate as the holiday season ends and the economy slows. Inflationary pressure should continue to move lower as long as energy prices don't spike. All of this supports a winding down of Fed rate hikes.

Fed officials expect to conclude their brutal tightening campaign in the first quarter, roughly a year after it began, and have indicated they'll hold the overnight target steady for the remainder of 2023. Of course, this outlook is only as good as yesterday's economic data.

Fed officials expect to conclude their brutal tightening campaign in the first quarter, roughly a year after it began, and have indicated they'll hold the overnight target steady for the remainder of 2023. *Of course, this outlook is only as good as yesterday's economic data.*

The FOMC released a fresh "dot plot" at the conclusion of the December meeting which indicated a higher-than-expected peak target rate of 5.125%. This suggests an additional 75 bps may still be in the queue for the first quarter of 2023, opening the door for another 50 bp move on February 1st. After a pause in the second half of 2023, the committee has signaled rate cuts totaling 100 bps in both 2024 and 2025, while the long-term neutral rate was unchanged at 2.5%.

The committee's updated summary of economic projections (SEP) showed significantly weaker GDP ahead, with the 2023 growth forecast trimmed from +1.2% to +0.5%. *If there's a recession within the year, the Fed expects it to be mild*. The committee also increased their PCE inflation forecast from +2.8% to +3.1% for 2023 and from +2.3 to +2.5% for 2024. It's notable that the committee believes risks to GDP growth and inflation are both weighted to the downside.

According to Bloomberg, the time between last rate hike and first rate cut has ranged from five to 18 months since 1995, although history hasn't been a reliable guide in the covid-era.

At the post-meeting press conference, Fed Chair Powell reiterated that reducing inflation "will require a sustained period of below-trend growth and softening of labor market conditions." *Given the resilience of GDP and employment, the committee is likely to be frustratingly patient before announcing a pivot.*

According to Bloomberg, the time between last rate hike and first rate cut has ranged from five to 18 months since 1995, although history hasn't been a reliable guide in the covid-era. After a historically rotten year, investors are anxious for a dose of monetary accommodation, but the Fed will remain hyper-focused on crushing inflation. Prices may have peaked, but it's still a long way to normal.