Economic Summary – Q1 2023

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As the new year began, first quarter economic growth was widely expected to (finally) slow. The December *Bloomberg* economist survey was forecasting no growth for the upcoming quarter, while a *Wall Street Journal* survey of U.S. economists showed an average Q1 GDP forecast of just +0.1%. A majority of economists in both surveys were expecting a mild recession sometime in 2023.

A slowdown in growth was the Fed's plan as policymakers had been applying the brakes for much of last year. A combined rate increase of 425 basis points (bps) over a nine-month period in 2022 was followed by another quarter point hike at the first FOMC meeting of the year on February 1st. At his post-meeting press conference, Fed Chair Jay Powell reiterated that additional rate hikes would be appropriate to restore price stability. He also cautioned against premature easing of policy, preparing market participants for a higher-for-longer outcome.

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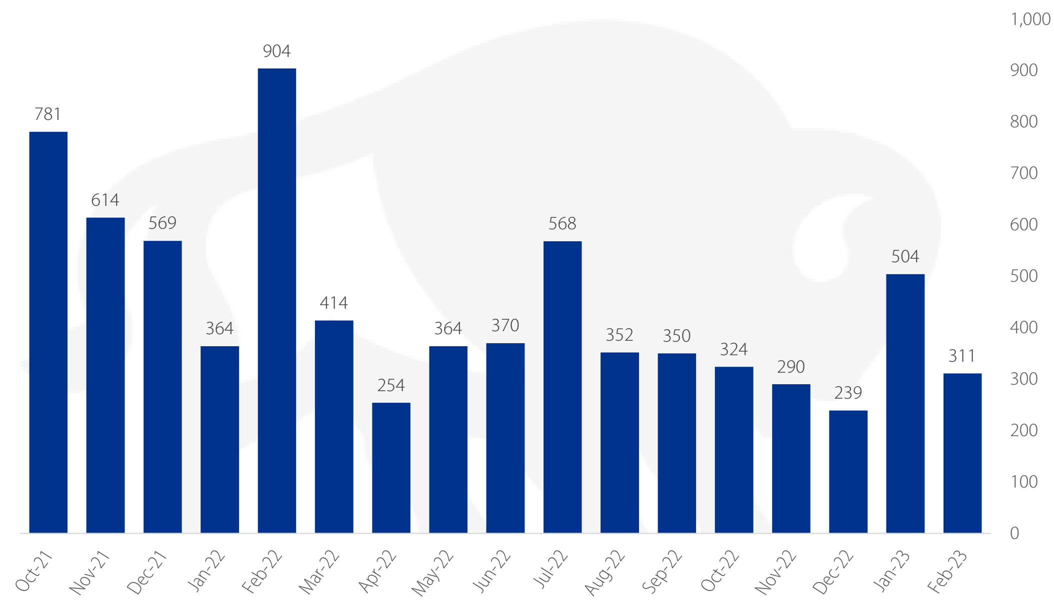
However, investors had heard this all before and promptly dismissed it. The big question at the press conference was whether Powell would scold the bond market for the January rally which had driven yields lower and was undermining Fed policy. But when that topic came up in the Q&A, Powell simply acknowledged that the FOMC's forecast was different than the markets, and the divergence didn't bother him. Bonds countered with another rally, dragging the two-year Treasury note to its lowest yield since September.

The rally came to an abrupt halt two days later when the first of three major economic surprises hinted that the economy might actually be heating up again.

Non-Farm Payrolls Total Change (in thousands)



Source: Bureau of Labor Statistics

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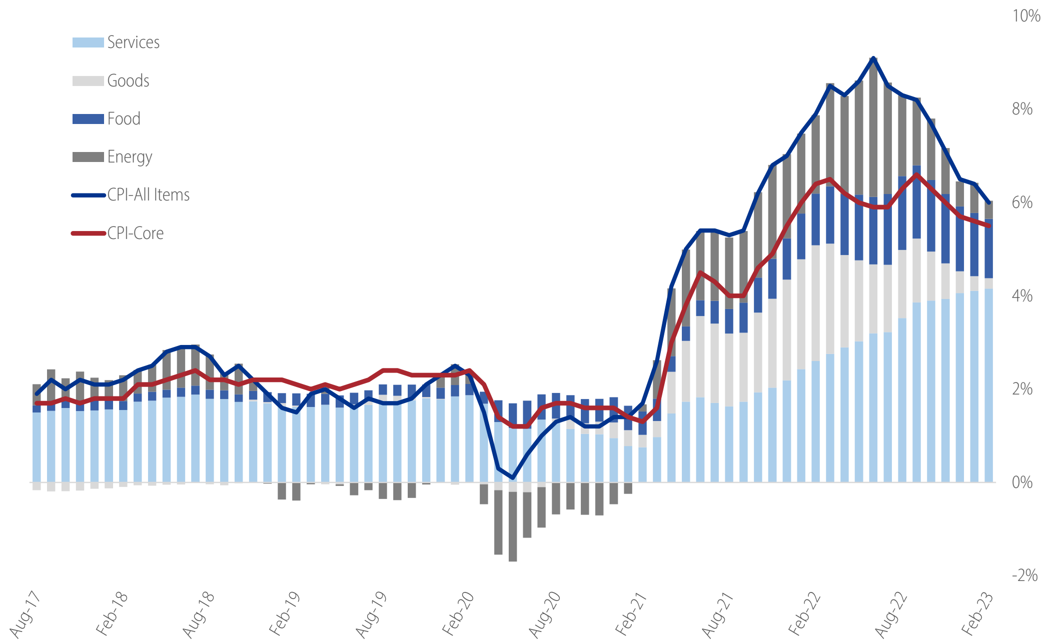
A parade of hawkish Fed officials quickly responded:

- Atlanta Fed President Raphael Bostic told Bloomberg News that the committee could consider *larger half-point moves* at future meetings.
- Minneapolis Fed President Neel Kashkari told a CNBC audience that tightening so far has had a limited effect and the FOMC would need to *raise rates aggressively.*
- New York Fed President John Williams told the Wall Street Journal the committee will need to attain a "sufficiently restrictive stance of policy and maintain it *for a few years.*"

The consumer price index (CPI), originally reported down -0.1% in December, bounced from a revised +0.1% to +0.5% in January, matching the biggest monthly gain since June, while core CPI rose +0.4%.

Eleven days later, unexpectedly hot inflation numbers rattled the markets further. The consumer price index (CPI), originally reported down -0.1% in December, bounced from a revised +0.1% to +0.5% in January, *matching the biggest monthly gain since June*, while core CPI rose +0.4%.

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



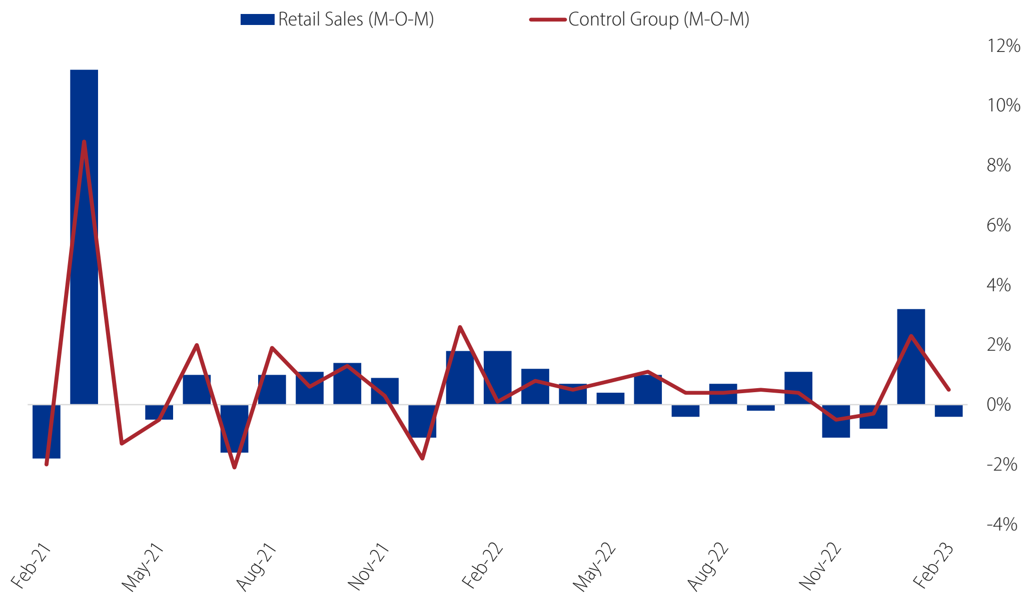
Consumer Price Index (Year-over-Year Percent Change)

On a year-over-year basis, headline consumer inflation barely cooled from +6.5% to +6.4%, the 16th straight month above 6%, while core CPI eased from +5.7% to +5.6%.

Shelter costs, which make up roughly a third of the overall index, rose another +0.7%, while food (+0.5%) and energy (+2.0%) also made significant contributions. There were very few signs of cooling in the report. The optics were discouraging. On a year-over-year basis, headline consumer inflation barely cooled from +6.5% to +6.4%, the 16th straight month above 6%, while core CPI eased from +5.7% to +5.6%.

The following day, January retail sales unexpectedly jumped +3.0%. It was *the biggest monthly gain in nearly two years* and a sharp turnaround following declines of -1.1% in both November and December. The January increase was widespread, with all 13 sales categories advancing.

Retail Sales (Month-over-Month Percent Change)



Source: US Census Bureau

On a year-over-year basis in January, retail sales were up +6.7%, following a +5.1% annual rise in December. Restaurant and bar sales surged +7.2% in January after a flat reading in December, while vehicle sales jumped +5.9% after being down -1.8%.

Since Fed officials have continued to tighten monetary policy in desperate efforts to slow economic growth, the resiliency wasn't welcome. In fact, steadfast consumer demand argued for *additional rate hikes*. The hopeful soft-landing scenario had given way to a "no landing" scenario, wherein the economy continues to expand, the number of posted jobs exceeds the number of active jobseekers, and inflation remains stubbornly high.

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The counterargument to all three unexpectedly strong reports was historically warm January weather throughout the nation, which likely boosted spending, particularly at dining and drinking establishments. The payroll gains in January were further amplified by faulty seasonal adjustment factors that assumed seasonal workers would be laid-off after the holidays. The reality seems to be that employers chose to retain workers in the far-too-lean labor market.

By the end of February, a number of Wall Street firms had concluded the Fed might need to hike another 100 basis points in order to curtail demand and bring inflation back to its 2.0% target. In early March, the two-year Treasury note yield climbed above 5% for the first time in nearly 16 years as investors factored in that expectation. *Two days later, the script rewrote itself.*

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On March 8th, SVB unexpectedly announced it had taken a $1.8 billion loss as it liquidated positions from its $21 billion portfolio of mostly full-faith-and-credit U.S. Treasury securities.

The sudden decision to realize such a massive loss signaled that SVB was in trouble. Panicked depositors tried to withdraw $142 billion over a two-day period, representing 85% of the bank's total deposits. The fact that around 90% of deposits were uninsured contributed to the frenzy. On Friday, March 10th, with SVB illiquid, unable to pay depositors and on the verge of collapse, the FDIC assumed control, resulting in the second largest bank failure in U.S. history.

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Silicon Valley Bank was unique in its big-player, tech-heavy deposit base, and was guilty in its asset-liability mismatch, but the markets made the assumption that it wasn't the only financial institution with a large, fixed income portfolio that had suffered significant market losses as a result of Fed rate hikes and was vulnerable to a run on deposits. As a result, bond yields plunged as depositors and investors moved dollars into money market funds and the safe harbor of government bonds.

On Sunday, March 12th, Treasury Secretary Janet Yellen announced uninsured depositors at SVB (and Signature Bank of New York) would be made whole. She also provided another liquidity option, introducing a new Fed lending facility which would allow all banks to borrow funds against their underwater portfolio securities at their full face value.

Days later, adding fuel to the fire and panic to the streets, Moody's announced it had cut its U.S. Banking System outlook to *negative*, citing "a rapidly deteriorating operating environment."

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At that point, with the March FOMC meeting just a week away, committee members were in their 10-day "quiet period" and unable to address the developing banking crisis. Investors could only speculate on whether Fed officials would dare to worsen the damage with additional tightening.

The European Central Bank (ECB), meeting just days after Credit Suisse received a liquidity lifeline from the Swiss National Bank and three days before UBS agreed to purchase the troubled investment bank, plowed forward with a 50 basis point increase in its overnight deposit rate. ECB President Christine LaGarde made it clear that the central bank would not wane on its commitment to fight inflation.

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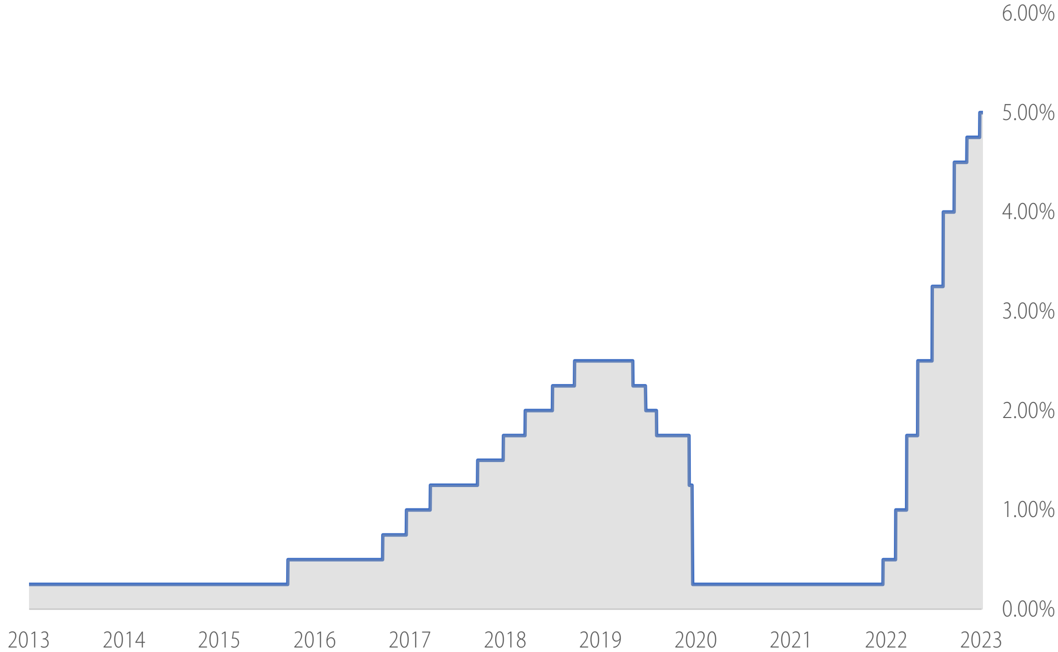
Federal Funds Target Rate (Upper Bound)



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Recent conditions have increased the odds of recession later this year. However, when the Fed is trying to orchestrate that downturn, the threat isn't quite as daunting.

The Atlanta Fed's *GDPNow* measure for the first quarter stood at +2.5% on the last day of March, almost double the +1.3% median forecast in the Bloomberg survey and shattering the +0.1% average forecast from the WSJ economist survey taken back in December. There's a considerable amount of Q1 data that hasn't yet been collected, but it's probably a safe bet that GDP growth will remain positive for now.

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Treasury yields were extremely volatile during the quarter, although both the high and low yields were reached within a wildly turbulent two-week period in March. At quarter end, the bond market had assumed tightening was over and priced-in two 25 basis point rate cuts for the final quarter of the year.

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Q1 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	12/31/22	4.25%-4.50%	4.34%	4.69%	4.43%	4.00%	3.88%
High			4.98%	5.21%	5.07%	4.35%	4.05%
Low			4.34%	4.00%	3.77%	3.41%	3.37%
End	3/31/23	4.75%-5.00%	4.69%	4.59%	4.03%	3.57%	3.47%

Source: U.S. Department of the Treasury

Economic and Interest Rate Outlook

The economic outlook hasn't been remotely clear in years, but it's only grown cloudier. The Fed's target rate is now at a 16-year high, but headline inflation remains extremely elevated. The annual inflation rate should improve dramatically over the next several months simply because prices were so hot last spring. The summer months are a different story since price pressure cooled last year when the weather heated up. Powell has warned about bumps, and the economic picture is constantly morphing, so it shouldn't be a surprise if rapid spring progress turns into a summer slog.

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Whether or not the U.S. experiences a recession or merely a slowdown is strangely irrelevant. Normally when the Fed senses a downturn, it eases policy. This time, it's been tightening policy in an unsuccessful attempt to create the downturn. The personal savings rate has dropped, and consumer borrowing is at a record high, but when five trillion in pandemic rescue funds are dumped into the economy, it takes a while to drain.

The latest Bloomberg survey, conducted in late March, showed the nation's top economists still foresee a soft-landing for the U.S. economy with full year GDP expected to expand by +1.0% in both 2023 and 2024. If a recession is sandwiched in the middle of this year, this survey suggests it'll be a shallow one.

The Bloomberg survey also indicates a majority of economists expect the Fed will raise rates by another quarter point next month and hold the target steady for the remainder of the year, before easing twice in the first quarter of 2024.

These same economists expect the annual rate of consumer inflation (CPI) will drop to +3.3% and the annual PCE rate to +3.4% by the end of this year. Whether the Fed chooses to cut rates before actually reaching its +2.0% inflation target remains to be seen.

The March FOMC meeting provided an updated look at what the policymakers are actually thinking. The Fed's new Summary of Economic Projections (SEP) showed anemic +0.4% GDP growth for all of 2023 and +1.2% in 2024. Committee members expect PCE inflation at +3.3% for all of 2023 and +2.5% in 2024, which suggests the annual pace will sink below 3% in the coming months.

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Powell admitted that FOMC members had discussed a pause at the March meeting, but also downplayed the bank panic, calling the U.S. banking system "strong, sound, resilient, and well capitalized." The Fed's updated "dot plot," like the Bloomberg survey, showed one more 25 basis point hike in May, before holding steady through the remainder of the year. Since Powell has reiterated on numerous occasions that "the historical record cautions strongly against premature loosening of monetary policy," it stands to reason that the Fed could potentially overtighten in 2023 and be forced to ease more aggressively next year.

The long range Fed outlook, which is obviously subject to change, indicates rate cuts totaling 100 bps in both 2024 and 2025, while the long-term neutral rate remains at 2.5%.

The bond market has parted company with the nation's economists and Fed officials and is now signaling, through dramatically lower yields, that tightening is complete and easing is on the near horizon. However, the enormous bond rally over the last three weeks of the quarter reflects more of a flight-to-safety than a conscious decision to lock-in before a policy pivot.

If banking concerns lift and market focus returns to the economic numbers, it's unclear that data will support any further near-term rally given the Fed's determination to maintain policy until inflation is on a sustainable downward path.

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The next scheduled FOMC meeting is on May 3rd, and the March CPI report (released three weeks before the meeting) will carry considerable weight. Policymakers are in a tough spot. Although blame for the recent bank failures fall primarily on the bank officials themselves, Fed rate hikes fueled the losses. Additional hikes might feel reckless, but if committee members were to abandon their inflation fight early, they might foster the impression that the banking situation has worsened.

The U.S. economy held up in the first quarter, but the foundation has grown wobbly and the Fed keeps adding weight. It would be a surprise, and a bit of a disappointment, if GDP growth held up in the second quarter. When the policy objective is to weaken the economy, *the sooner it happens, the better.*