

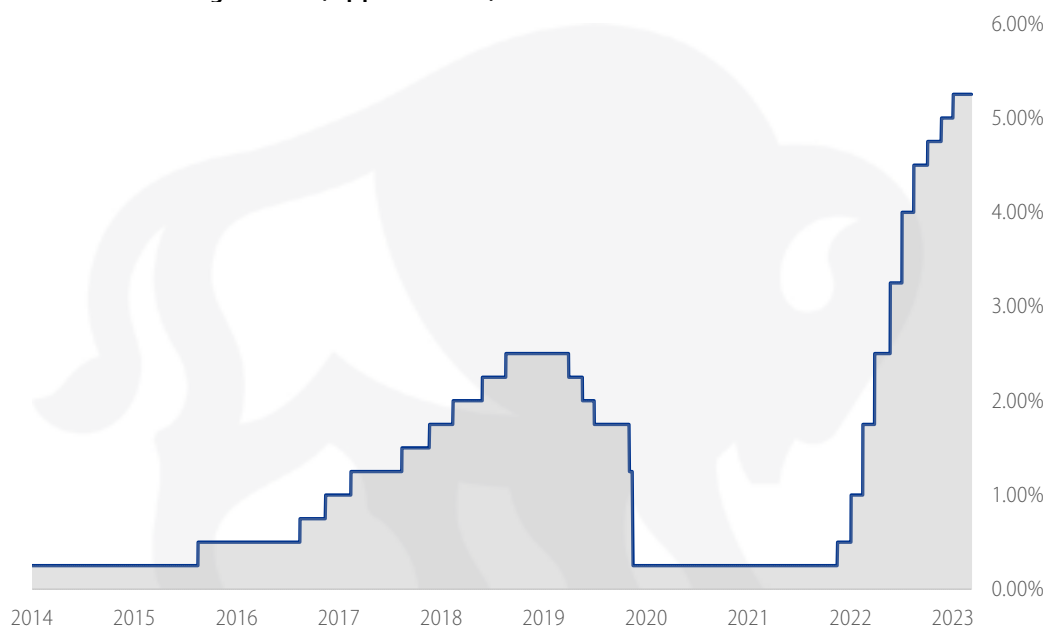
Economic Summary – Q2 2023

For more than a year and a half, traders and economists had predicted the U.S. economy was on the verge of recession. Early in 2022, two consecutive quarters of negative GDP growth met the textbook definition, but the National Bureau of Economic Research never officially declared a recession had taken place. And in fact, *it didn't matter* as the unemployment rate continued to fall and inflationary pressure continued to build.

In December, the Bloomberg survey of the nation's top economists had shown a first quarter median growth forecast of 0.0%. But once again, the actual GDP data far exceeded forecasts with solid a +2.0% final Q1 reading. Bloomberg's March survey had indicated a second quarter median forecast of +0.6%, but with the quarter now ended and much of the data input collected, the Atlanta Fed's GDPNow estimate stood at +2.2%. It appears that the frustratingly resilient U.S. economy has outperformed forecasts yet again.

Since persistent growth translates into higher prices, inflation continued to be the Fed's primary focus throughout the second quarter. Headline price pressures were easing quickly, but core prices proved much more stubborn. On May 3rd, Fed officials announced another 25 basis point rate hike, bringing the overnight target above 5% *for the first time since 2007*. Although this marked the 10th consecutive FOMC meeting in which committee members voted to raise rates, Chairman Powell promised future decisions would consider the cumulative effect, granting the committee an opportunity to pause at the next meeting.

Federal Funds Target Rate (Upper Bound)



Source: Federal Reserve

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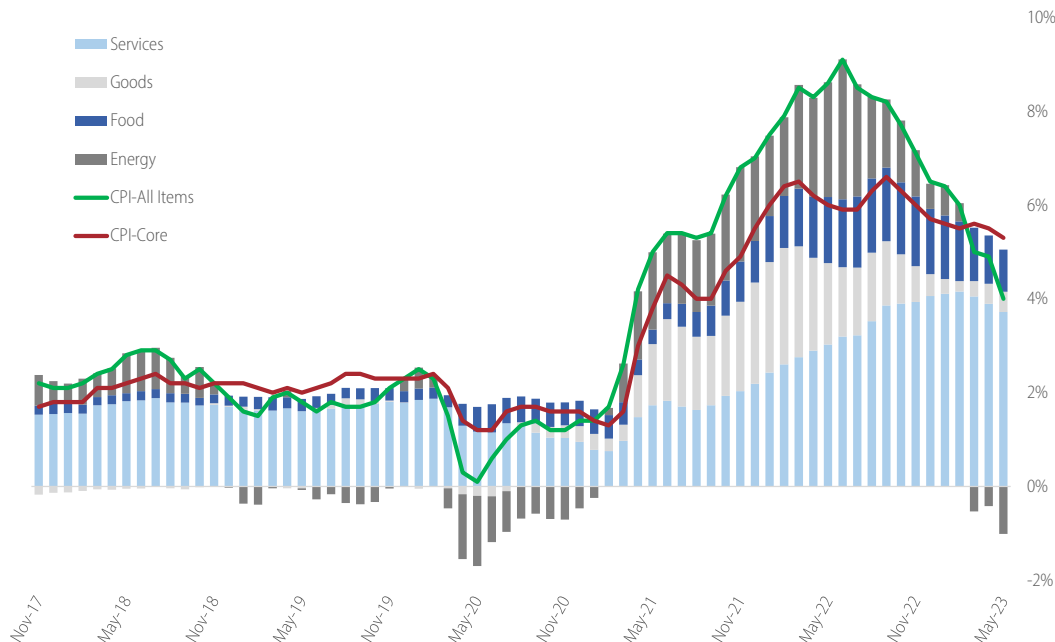
This more aggressive forecast reflected the committee’s desire to keep the markets from reading too much into the pause and thereby easing financial conditions prematurely. *This should not have been a surprise.*

At the post-meeting press conference, Powell said all the things he was supposed to say – his most telling admission was the committee had not seen enough progress on core inflation and that they wanted to see it moving down decisively before ending their tightening campaign. It was worth noting that the committee’s summary of economic projections showed both headline and core inflation still above their +2.0% target at the end of 2025.

The May consumer price index (CPI) report was released just before the start of the June FOMC meeting and the message was mixed. Overall CPI rose just +0.1% in May, primarily the result of a -3.6% drop in energy prices. The year-over-year pace was a bright spot, with the headline CPI retreating from +4.9% to +4.0%. Because energy prices were so high a year ago, the *annual change* in overall inflation appears much cooler by comparison. This trend will be even more pronounced in the June CPI report but will reverse itself in July and August.

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



The annual price to insure an automobile has risen +17% over the past year as insurance companies struggle to keep up with settlement costs.

Source: Bureau of Labor Statistics

Core CPI rose +0.4% in May, the sixth straight month at or above +0.4%. On an annual basis, core CPI came in at +5.3%, the 18th consecutive month above +5.0%. When Powell talked about not making progress on core inflation, he was pointing to the May CPI report.

The longer it takes to wrestle prices lower, the more likely it is that inflation becomes embedded. Concerns are most evident in the service sector where demand is unlikely to cool without a significant weakening of the economy, while the supply of labor remains woefully inadequate. The imbalance gives inflation-hammered U.S. workers a clear upper hand in wage negotiations:

- Delta Airlines reached a new agreement with pilots in May granting an immediate 18% raise and an additional 13% over the next four years. Both United and American pilots are in negotiations while the pilots' union at Southwest is laying the runway for a strike.
- A potentially crippling west coast port strike was narrowly averted as a tentative agreement on a new contract covering 22,000 dockworkers was announced in June.
- More than 300,000 UPS employees voted to strike if a new contract isn't reached by the end of July.
- Tens of thousands of hotel workers in Southern California and Arizona walked off the job just days before the July 4th holiday demanding higher wages to combat the rising cost of living.

In the strange post-pandemic employment era, it's unclear whether job growth is good or bad.

Record prices for food, transportation and rent have been well documented, but inflation has quietly spilled over into related expense categories as well. The annual price to insure an automobile has risen +17% over the past year as insurance companies struggle to keep up with settlement costs, and the average charge for an auto repair has risen +19.7% (BLS) over the past year due primarily to increasingly complex auto technologies and the ongoing shortage of skilled mechanics.

Across industry groups, there simply isn't enough labor. The common and easy narrative is that Americans don't want to work. The reality is that the employment-to-population ratio for prime age workers (ages 25-54) climbed to 80.7% in May, the highest since 2001, while the broader 15-64 age group reached a 16-year high of 71.9% (St. Louis Federal Reserve).

Bond yields had been trending higher for much of the quarter, but the Fed's sobering assessment on inflation and the idea that the FOMC would need to inflict more pain added to the market sell-off.

The only group not surpassing pre-COVID employment levels are seniors, 65 and older. A recent Federal Reserve labor study showed 2.4 million more seniors chose to retire during the pandemic than demographic models had predicted. Just 22.8% of this bunch were working in May, down from 25.2% before the pandemic. Unfortunately, this is also the fastest growing demographic. By 2030, every surviving member of the baby boom generation will have turned 65.

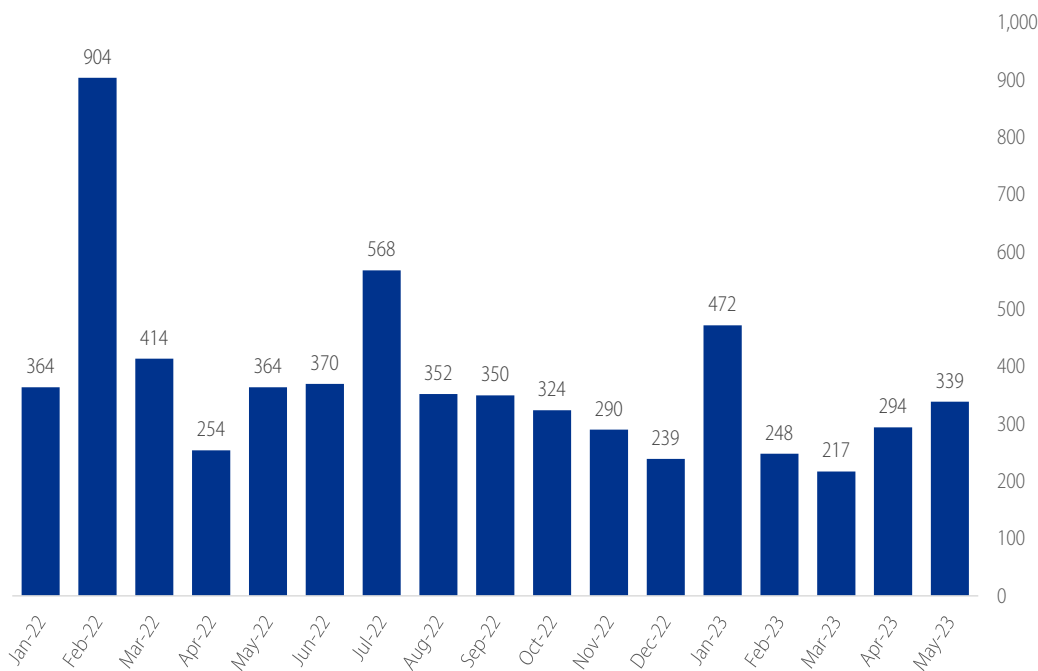
Employers are reacting to the shrinking labor pool. IBM, Dell, and Google joined Apple and Tesla in scrapping company degree requirements, while government agencies in Georgia and Florida will now be permitted to hire workers with or without a college degree, as long as experience requirements are met. Eight other states had already made similar concessions.

In the strange post-pandemic employment era, it's unclear whether job growth is good or bad. The Fed, recognizing an abundance of available jobs fuels wage pressure, would like to see the unemployment rate rise. Ex-Treasury Secretary Larry Summers has repeatedly said unemployment would need to climb above 5% and remain there for years to fully contain inflation. Fed policymakers have been less specific, *and far less dramatic* than Summers, but the idea's the same: the labor market is too tight.

That being said, the unemployment rate fell to a new 54-year low of 3.4% in April. In May, U.S. businesses added +339k workers to payrolls, while prior month revisions added another +93k. Through the first five months of 2023, payroll growth has averaged a surprisingly robust +331k workers.

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Non-Farm Payrolls Total Change (in thousands)



Source: Bureau of Labor Statistics

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Considerable market attention during the quarter was focused on the possibility that failure to raise the federal debt limit could result in a Treasury default. It got tense, but it didn't happen. A compromise was ultimately reached, with the next crisis scheduled for early 2025. However, six months of extraordinary spending measures managed to drain the Treasury, which meant a massive amount of issuance would be necessary to replenish the general fund. Estimates of T-bill issuance required before yearend have topped \$1 trillion.

The possibility of a soft-landing, in which the inflation rate gradually returns to the Fed's +2.0% target while the economy sidesteps recession, seems to have gained traction at quarter end. This might be wishful thinking.

Treasury yields were again extremely volatile during the quarter, but the ultimate direction was up. The 12-month T-bill yield ended the period at its highest point in 23 years, while two's approached a 16-year peak. A determined Fed and an overabundance of bonds promise ongoing pressure.

Q2 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 | 3/31/23 | 4.75%-5.00% | 4.69% | 4.59% | 4.03% | 3.57% | 3.47% |
| High | | | 5.39% | 5.39% | 4.90% | 4.16% | 3.84% |
| Low | | | 4.69% | 4.41% | 3.78% | 3.30% | 3.31% |
| End | 6/30/23 | 5.00%-5.25% | 5.28% | 5.39% | 4.90% | 4.16% | 3.84% |

Source: U.S. Department of the Treasury

Fed officials recognize (even if they aren't fully articulating it) that the easy part of driving inflation lower is over.

Economic and Interest Rate Outlook

The possibility of a *soft-landing*, in which the inflation rate gradually returns to the Fed's +2.0% target while the economy sidesteps recession, seems to have gained traction at quarter end. *This might be wishful thinking.* Headline inflation will almost certainly *appear* to cool in June, but after that the base effect will reverse itself in subsequent months. Fed officials recognize (even if they aren't fully articulating it) that the easy part of driving inflation lower is over. The FOMC paused its tightening campaign in June but will most likely resume rate hikes at the July meeting. Committee members continue to anticipate the lagging effect of 500 basis points of cumulative tightening, while signaling additional hikes are in the queue. Beyond an increasingly restrictive interest rate policy and passive shrinking of the Fed's balance sheet, several other brakes will be applied to the U.S. economy in the coming months:

- The prime rate has risen in lockstep with the funds rate and now stands at 8.25%. The average SBA fixed rate on loan balances below \$25,000 is Prime +8%, meaning small businesses would be paying a crushing 16.25% interest rate on new loans.
- The banking crisis appears to be contained for now, but the severe bond market sell-off in May and June will have a negative impact on quarter end balance sheets. At the same time, depositors can easily find higher yielding investment options and are incentivized to further reduce low interest bank balances. The net result will have a negative impact on lending.
- An estimated \$1.4 trillion in commercial real estate loans are coming due over the next two years. These loans will be refinanced at significantly higher interest rates with considerably lower asset valuations. Expect a large number of businesses to mail their keys back and walk away. With regional and community banks holding an estimated \$2.3 trillion in commercial real estate debt (Moody's), banking system concerns are warranted.

With mortgage rates creeping back toward 7%, refi opportunities have dried up. This source of cash is tapped out.

- Total U.S. credit card balances held steady at a record \$986 billion in the first quarter. It was the first time since the New York Fed began tracking the data that Americans didn't reduce their balances during the first three months of the year. The average rate on cards carrying a balance rose to a record 20.92% in the first quarter, the highest since tracking began in 1994.
- Between the second quarter of 2020 and the fourth quarter of 2021, 14 million Americans refinanced their mortgages while extracting \$430 billion in home equity value (New York Fed). With mortgage rates creeping back toward 7%, refi opportunities have dried up. This source of cash is tapped out.
- The three-year moratorium on federal student loans payments has ended, with borrowers scheduled to make their first payments in October. This will impact an estimated 27 million Americans. In addition, the Biden administration's proposed student loan forgiveness program, which would have retired entire loan balances for roughly 70% of borrowers, was struck down by the Supreme Court in late June.
- The debt ceiling crisis isn't over, it's just hibernating until after the 2024 election. The underlying problem isn't likely to improve over the next 18 months. Roughly 85% of the federal budget is already being allocated to essential entitlement programs and national defense, while debt expense continues to rise along with interest rates. The CBO projects that by 2050, interest costs will consume more than a third of all federal revenue.

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There are some puzzling positives in the mix - The S&P 500 was up nearly +16% in the first half of the year while Nasdaq increased by almost +32%. A bullish stock market and record low unemployment combined to push consumer confidence to a 17-month high in June (Conference Board).

As consumer inflation is expected to remain above the Fed's target for the foreseeable future, economists and the media may soon be dusting off their stagflation banners.

However, it's hard to imagine the U.S. economy not faltering in the second half of the year, and if a recession does emerge, it's equally tough to imagine the debt-strapped federal government providing much assistance. As consumer inflation is expected to remain above the Fed's target for the foreseeable future, economists and the media may soon be dusting off their *stagflation* banners. And, with the first presidential primary just seven months away, politicians can be counted on to further amplify the discomfort.

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