Economic & Market Perspectives

Winter 2022

"Monetary actions affect economic conditions only after a lag that is both long and variable"

— Milton Friedman

The Fed's impact lag

Economist Milton Friedman once noted that there is a delay between the time monetary policy is enacted and the time that policy has its impact on the economy. We are starting to see signs that monetary policy is having an impact as the economy cools and inflation retreats from a near 40-year high.

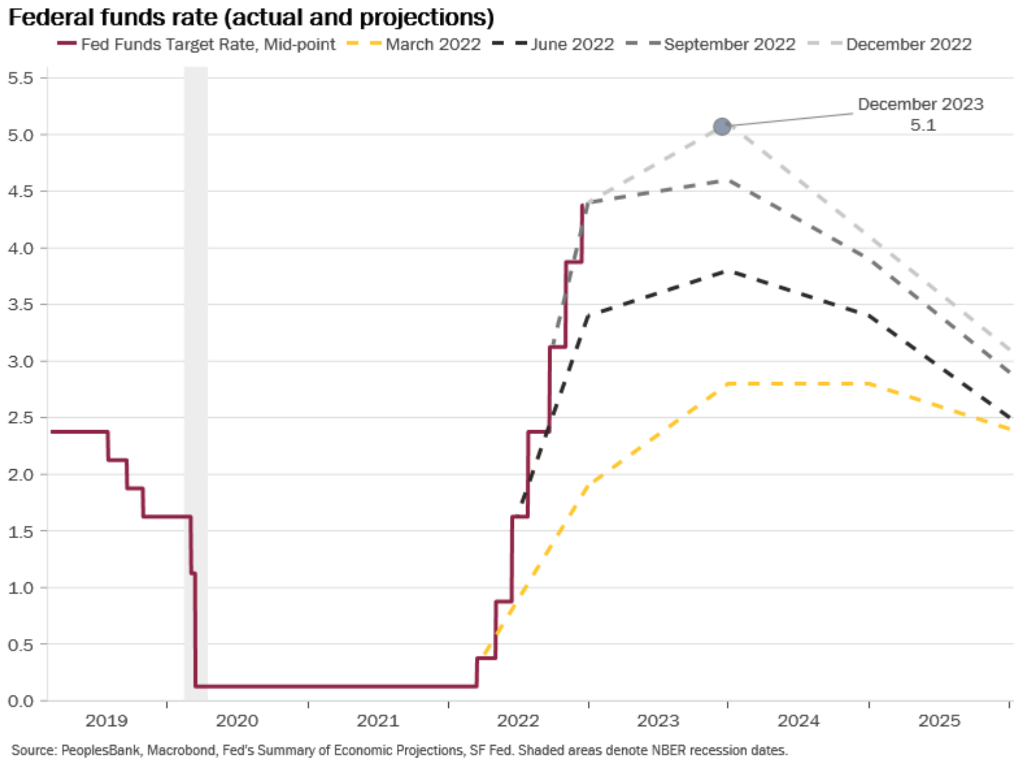
Federal Reserve officials, including Fed Chair Jerome Powell, have expressed concern about doing too little in terms of tightening monetary policy to get inflation under control. On the other hand, they are keenly aware of doing too much and making monetary policy so restrictive that it throws the economy into recession. Ideally, they are shooting for a "soft landing" by cooling demand and inflation without causing a significant loss of jobs as companies adjust to a slowing economy.

It is a difficult balancing act. The Fed needs to set monetary policy based on current economic data and forecast further monetary policy based on economic projections. So far, they have missed the mark on inflation, underestimating its staying power. As a result, the pace and magnitude at which they raised their benchmark interest rate – the federal funds rate – this year has been very aggressive.

At its December meeting, the Fed announced a 50 basis point interest rate hike to a target range between 4.25 percent and 4.5 percent — the highest rate in 15 years. This was the seventh consecutive rate hike this year and followed four consecutive, super-sized hikes of 75 basis points. While markets initially cheered what appeared to be a dovish tilt in monetary policy – that is, slowing the pace of interest rate hikes from 75 basis points to 50 basis points – the Fed quelled any hopes for a more dovish monetary policy stance by indicating rates will go higher for longer until inflation falls back to their long-run target.

The Fed began raising its benchmark rate back in March of this year, and since then, it has made significant upward revisions to its forecast for the path of interest rates – see Chart 1 on next page. The most recent forecast, released as part of December's Summary of Economic Projections, shows the central bank continuing hiking rates through 2023 to 5.1 percent, a larger figure than previously expected.

Chart 1



The Fed's "impact lag" on the economy will most likely be felt this coming year. Economists at The Conference Board believe that persistent inflation and rising hawkishness by the Fed will cause economic weakness to intensify and spread more broadly throughout the U.S. economy over the coming months, with a recession to begin around the beginning of 2023.

Economic activity cools and inflation may have peaked

Despite growing concerns of recession, the U.S. economy has rebounded from two consecutive quarters of contraction in the first half of 2022. The economy expanded in the 3rd quarter of 2022 with real Gross Domestic Product (GDP) increasing at an annual rate of 3.2 percent. The increase in the third quarter primarily reflected increases in exports and consumer spending that were partly offset by a decrease in housing investment, according to the Bureau of Economic Analysis. And there are indications the U.S. economy will continue to expand in the final months of 2022 – the Atlanta Fed's GDPNow model estimate for real GDP growth in the 4th quarter of 2022 is 3.7 percent.

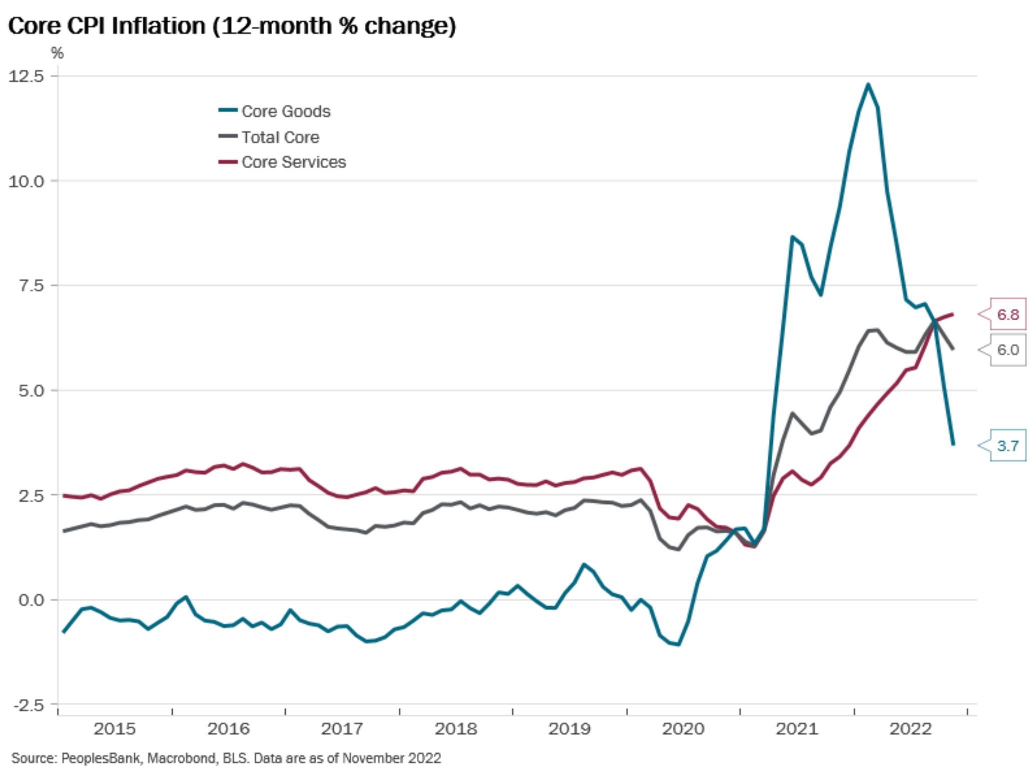
Consumer spending has remained resilient in the face of high inflation and rising interest rates, buoyed by excess savings from pandemic-related stimulus and historically high saving rates. The stock of excess savings grew rapidly in 2020, coinciding with a jump in the personal saving rate, which peaked at 33.8 percent in April 2020. The level of excess savings and the personal saving rate have come down significantly over the past year as consumers continue to spend. Excess savings fell to $1.7

trillion in the second quarter of 2022 from $2.3 trillion in the third quarter of 2021, and the saving rate dropped to 2.4 percent in November, which is well below the pre-pandemic average of 7.4 percent. There are worries that consumers are taking on higher-interest debt to maintain current spending levels. Credit card balances increased 15 percent year-over-year in the third quarter of 2022, marking the largest increase in more than 20 years, according to the New York Fed.

The Fed's hawkish policy has had a significant impact on the interest rate-sensitive housing market. Housing sector activity, which accounts for about 5 percent of GDP, continues to weaken with the substantial increase in mortgage rates – the average 30-year mortgage rate ended the year at 6.6 percent, up from 3.7 percent at the end of 2021. Existing homes sales fell 7.7 percent in November, the tenth straight monthly decline. Home prices fell for the fourth month in a row in October, while U.S. home builders' confidence dropped for the twelfth consecutive month in December.

There are signs inflation may be easing. The Consumer Price Index (CPI) was 7.1 percent for the 12 months ending November, down from a peak of 9.1 percent in June. And the change in core CPI, which excludes food and energy, was 6 percent in November, falling from 6.3 percent in the prior month. While we have seen a significant drop in goods inflation as supply-demand imbalances improve, service inflation continues to rise. In the past year, service inflation has increased 6.8 percent, the fastest pace since 1982 – See Chart 2 below.

Chart 2

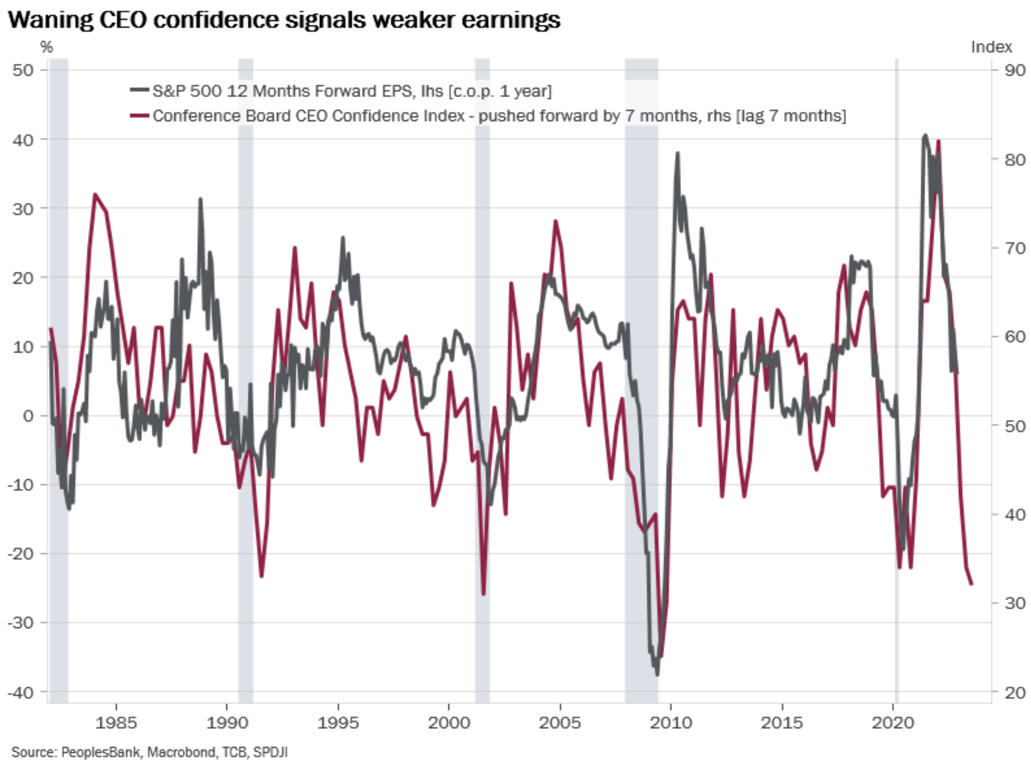


Services inflation is a bigger challenge for the Fed as the cost of labor is a significant expense for companies, and the labor market remains tight. The U.S. economy added 263,000 jobs in November and payrolls grew an average of 282,000 per month over the past three months, exceeding the 2019 monthly average of 164,000. The unemployment was 3.7 percent in November, near a 50-year low, and the demand for labor remains strong. There are 1.7 job openings for every unemployed person looking for work, down from a recent high of 2 in March. And it appears employers are retaining existing workers as initial jobless claims – a proxy for layoffs – remain low, averaging 221,000 over the 4-week period ending December 24, which is slightly above the 2019 weekly average of 218,000. The continuing supply-demand imbalance in the labor market is putting upward pressure on wages – average hourly earnings grew 5.1 percent from a year earlier in November.

The outlook for corporate earnings growth weakens

Persistently high inflation, the prospect of higher interest rates for longer, and an increased likelihood of a recession are negatively impacting Chief Executive Officer (CEO) confidence and the outlook for corporate profits – see Chart 3 below.

Chart 3



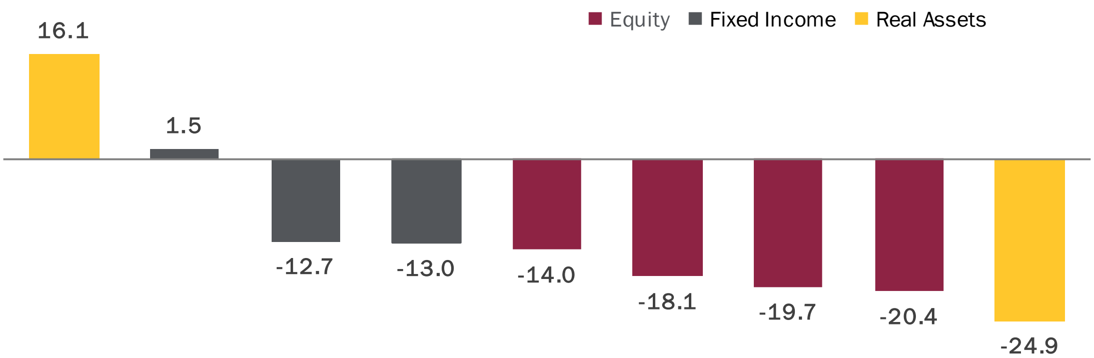
CEO confidence is at the lowest level since the Great Recession with an overwhelming majority of CEOs – 98 percent – indicating they are preparing for a U.S. recession, according to The Conference Board. And analysts are lowering earnings per share estimates for S&P 500 companies for the fourth quarter.

For fourth quarter of 2022, the estimated earnings decline for the S&P 500 is -2.8 percent, according to FactSet. Looking ahead to the first and second quarters of 2023, analysts are projecting earnings growth of 0.7 percent and 0.3 percent, respectively. For the calendar year 2023, analysts are projecting earnings growth of 5.3 percent, which is below the trailing 10-year average (annual) earnings growth rate of 8.5 percent.

The worst may be behind us

The Fed's hawkish policy stance certainly had a more immediate impact on financial conditions, which tightened in 2022. Stocks recorded their worst year since 2008 and bonds had their worst year ever as prices buckled under the weight of rising interest rates, historically high inflation, and concerns about slowing economic growth and recession. Only commodities and cash posted positive returns for the year – see table below.

YTD RETURNS (%)



	Commodity	Cash	High Yield	Fixed Income	DM Equity	Large Cap	EM Equity	Small Cap	REITs
YTD	16.1	1.5	-12.7	-13.0	-14.0	-18.1	-19.7	-20.4	-24.9
2021	27.1	0.0	1.0	-1.5	11.8	28.7	-2.2	14.8	41.3
Ann.	-2.6	0.6	5.4	2.7	2.3	8.8	1.0	7.2	6.6

Source: J.P Morgan Asset Management *Guide to the Markets -U.S.* Data are as of December 31, 2022.
Cash: Bloomberg 1-3m Treasury, Commodity: Bloomberg Commodity Index, DM Equity: MSCI EAFE, EM Equity: MSCI EME, Fixed Income: Bloomberg US Aggregate, High Yield: Bloomberg Global HY Index, Large cap: S&P 500, REITs: NAREIT Equity REIT Index, Small cap: Russell 2000. Annualized (Ann.) return represents period from 12/31/2007 to 12/31/2022.

The major U.S. stocks indexes – the Dow industrials, S&P 500, and Nasdaq Composite – rallied several times during the year on hopes inflation was peaking and the Fed would ease the pace of monetary tightening, but those rallies lost momentum as Fed officials continued to signal that they were not finished raising rates. On the year, the Dow slid 8.8 percent, the S&P 500 declined 19.4 percent, and the Nasdaq Composite fell 33.1 percent.

Overseas, stock markets have also struggled. On the year, the pan-continental Stoxx Europe 600 dropped 12.9 percent, while in Asia, the Nikkei 225 shed 9.4 percent and the Hang Seng ended the year down 15.5 percent.

Bonds prices fell with the rapid rise in yields this year – the 10-year Treasury note closed the year with a yield of 3.88 percent after ending 2021 with a yield of 1.43 percent. Bonds did not provide their usual diversification benefit. The traditional 60/40 investment strategy (60 percent stocks/40 percent bonds), using the S&P 500 and Bloomberg U.S. Aggregate indexes as proxies, dropped 16 percent in 2022.

Commodities closed out the year as the top-performing asset class, having benefited from a spike in the price of oil in the first part of the year and concerns about supply disruptions because of Russia's war with Ukraine.

While the worst may be behind us, we continue to see risk in financial markets skewed to the downside over the next six months. Given the forecasts for recession and flat earnings growth in the first half of 2023, we remain defensively positioned: underweight equity and fixed income and overweight cash.

Within equity, we have a slight overweight to U.S. stocks and a value tilt within U.S. large cap and mid-cap. Non-U.S. equity markets offer more attractive valuations than U.S. markets, and we have gradually reduced our underweight to non-U.S. stocks relative to U.S. stocks over the past year.

Within fixed income, we are neutral duration relative to our benchmark. Duration is a measure of a bond's price sensitivity to interest rate changes. We believe the prospects for slower economic growth and lower inflation will limit the upside to intermediate- and long-term yields and eventually put downward pressure on shorter-term yields. We are maintaining an overweight to cash relative to our strategic target, which gives us optionality when the outlook improves.

We continue to have a tactical allocation to commodities as a hedge against inflation as well as geopolitical risk. Commodities continue to look attractive in the long-term because of supply and capacity constraints even though demand may soften in the near-term with a slowdown in global economic activity.

We expect to see above average volatility in financial markets until there are signs that inflation, and especially service inflation, is trending down and the Fed is pivoting to a less restrictive monetary policy. In the meantime, we are committed to implementing diversified investment strategies across client portfolios – diversification is still the best way to manage risk over the longer-term.

For more on our tactical asset allocation, see table on next page.

The Investment Strategy Team

PBWM's STRATEGIC AND TACTICAL ASSET ALLOCATION

	Asset Class	Strategic (%)	Over/Underweight (%)	Tactical (%)
Equity	U.S. Stocks	30	3	33
	International Developed Stocks	22	-2	20
	Emerging Market Stocks	8	-3	5
Fixed Income	Core Bonds	38	-3	35
	Non-Core Bonds	0	0	0
	Cash Equivalents	2	3	5
Real Assets	Real Estate-related securities	0	0	0
	Commodity-related securities	0	2	2

PeoplesBank Wealth Management's (PBWM's) strategic and tactical asset allocation for its moderate growth total return strategy as of October 2022.

Notes

PeoplesBank Wealth Management's (PBWM's) asset allocation process develops both long-term (strategic) and shorter-term (tactical) recommendations. Strategic recommendations are based on how the Wealth Management Investment Strategy Committee (ISC) believes investment portfolios should be positioned in a generally neutral market environment over the next ten years. Tactical recommendations are based on where the ISC sees either increased opportunity or risk over the next one to two years. The ISC is responsible for developing both the strategic (long-term) and tactical (short-term) asset allocations for Wealth Management's investment management and trust relationships. The ISC is comprised of the senior members of the Wealth Management team. The ISC is also responsible for monitoring and updating strategies, managers, and funds within client portfolios. The ISC meets monthly. If you have questions or would like additional information regarding PBWM's investment process, please call or send an email to your relationship or investment officer.

Sources: Atlanta Fed, Fed Bureau of Economic Analysis, FactSet, Federal Reserve, J.P. Morgan Asset Management, Macrobond, MarketWatch, San Francisco Fed, The Conference Board, and The Wall Street Journal.