Economic & Market Perspectives

Spring 2023

"If you can walk away from a landing, it's a good landing. If you can use the airplane the next day, it's an outstanding landing."

– Chuck Yeager
United States Air Force officer and
record-setting test pilot

Chuck Yeager is probably best known for flying faster than the speed of sound. His characterization of a successful landing is an apt metaphor as the Federal Reserve considers the challenges posed by a resilient economy and historically high inflation. Fed Chair Jerome Powell and other Fed officials are attempting to engineer a so-called soft landing by raising interest rates enough to cool demand and tame inflation without crashing the economy.

For a while, the soft landing (mild or no recession) was looking like the more plausible scenario with signs of inflation cooling and economic growth weakening. However, the probability of a hard landing (severe recession) or, at a minimum, a bumpy landing is increasing, exacerbated by recent turmoil in the U.S. and global banking system.

The Fed would certainly like to "walk away" from this current cycle of monetary policy tightening without causing significant damage to the economy. That may be more difficult to achieve as the Fed now has to consider financial stability along with price stability in formulating the path forward for monetary policy.

Cooling economy, strong labor market

The U.S. economy slowed significantly in 2022, with real Gross Domestic Product (GDP) rising at a below-trend pace of 0.9%. Economic activity declined in the first half of 2022 but picked up in the second half of the year. Real GDP growth is expected to come in slightly above-trend for the first quarter of 2023—the Atlanta Fed's GDPNow model estimate for real GDP growth in the first quarter of 2023 is 2.2% (as of April 10).

Consumer spending—which accounts for almost 70% of economic activity—continues to hold up despite higher interest rates and inflation. Other key components of economic activity are not holding up as well. The housing sector has weakened considerably, largely due to higher mortgage rates, and business spending has also slowed as a result of higher interest rates.

Business surveys are sending mixed signals. The most recent ISM Manufacturing Purchasing Manager Index (PMI) report indicates economic activity in the manufacturing sector contracted in March for the fifth consecutive month, while economic activity in the services sector expanded in March for the third consecutive month. The Services PMI, however, has been trending downward since its recent peak in November of 2021. Overall, Manufacturing and Service PMIs indicate the economy is weakening.

This pullback in growth is consistent with the Fed's expectations for subdued growth this year and next. The Fed's Summary of Economic Projections (SEP) show median projected real GDP growth at just 0.4% this year and 1.2% in 2024, which are well below their median estimate of 1.8% for the longer-run growth rate. The Fed's outlook for a slowing U.S. economy is shared by economists at The Conference Board, who expect economic weakness to intensify throughout the U.S. economy over the coming months as a result of persistent inflation and Federal Reserve hawkishness.

Even as the U.S. economy weakens, the labor market remains strong. The U.S. economy added 236,000 jobs in March and the unemployment rate came in at 3.5%, which is near historical lows. The Fed expects supply and demand conditions in the labor market to come into better balance over time, with the median unemployment rate projected to be 4.5% at the end of 2023 and 4.6% at the end of 2024.

There are signs the labor supply/demand imbalance is improving. Weekly initial jobless claims—a proxy for layoffs—are ticking up. The 4-week moving average is just under 238,000, which is slightly higher than the pre-pandemic level of 217,500 in 2019. Up to this point, employers appeared to be holding onto workers in the tight labor market. We also saw the number of job openings decrease to 9.9 million on the last business day of February. It is the first time that number dipped below the 10 million mark since May 2021. Although, demand for labor continues to outweigh supply as the number of job openings far exceeds the number of unemployed workers by a ratio of almost 1.7 to 1.

As the labor market supply/demand imbalance improves, it will alleviate upward pressure on wages and prices. Wage growth is moderating but still higher than the Fed would like to see—the 12-month change in average hourly earnings eased to 4.2% in March from 4.6% in the prior month. Continued high wage growth poses a challenge for the Fed. The concern is that businesses will continue raising prices to cover higher labor costs, making it harder to bring inflation down to the Fed's 2% inflation target.

Inflation shows signs of easing

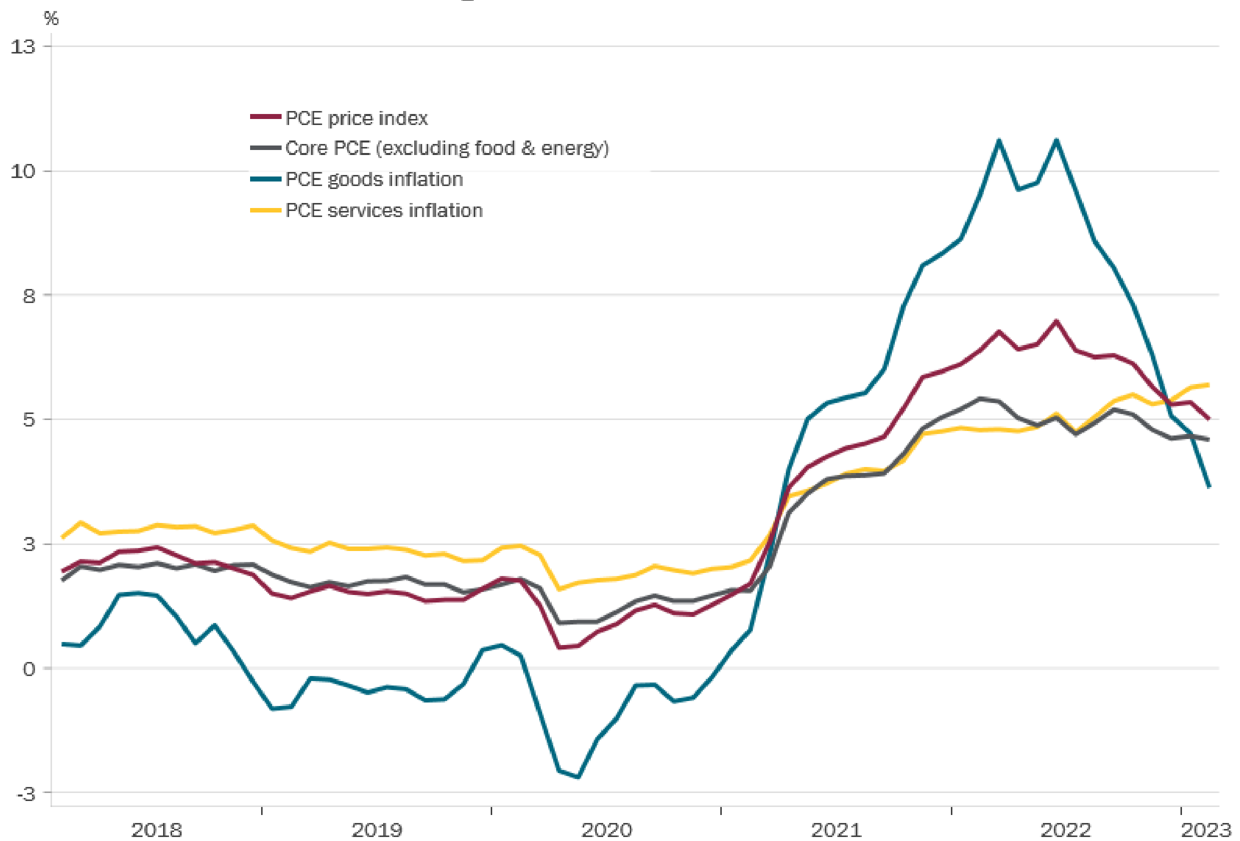
Inflation has moderated somewhat since the middle of last year but recent readings continue to run high and remain well above the Fed's longer-run target of 2%.

Over the 12 months ending in February, total Personal Consumption Expenditures (PCE) prices—the Fed's preferred measure of inflation—rose 5%. Prices for goods increased 3.6% and prices for services increased 5.7%. Excluding the volatile food and energy categories, core PCE prices increased 4.6% from a year ago. See Chart 1 on the next page.

The Fed believes the process of getting inflation back down to 2% has a long way to go and is likely to be bumpy. Goods inflation has fallen significantly since peaking in June 2022 as supply chain

bottlenecks continued to ease. In contrast, the services component of PCE inflation remains elevated and a large part of that is attributable to wage inflation. Getting inflation back down to 2% will require a significant drop in services inflation.

Despite persistently high inflation, longer-term inflation expectations appear to be well anchored. According to the University of Michigan's March survey, while consumers are concerned about inflation in the months to come, long-run inflation expectations remained at 2.9% for the fourth consecutive month. These inflation expectations are not too far off from what the Fed is forecasting. The Fed's median projection in the SEP for total PCE inflation is 3.3% for 2023, 2.5% for 2024, and 2.1% for 2025.



Fed's job is challenging

While the Fed believes reducing inflation is likely to require a period of below-trend growth and some softening in labor market conditions, engineering that so-called soft landing will be challenging given the tight labor market and unexpected crosswinds from the recent turmoil in the banking sector.

The Federal Open Market Committee (FOMC)—the monetary policymaking body of the Fed—announced at the conclusion of its March meeting their decision to raise the target range for the federal-funds rate by 0.25%, bringing the target range from 4.75 to 5%. The Committee noted that it "anticipates that some additional policy firming may be appropriate in order to attain a stance of monetary policy that is sufficiently restrictive to return inflation to 2% over time."

In addition, the Committee indicated that it will continue reducing its balance sheet holdings of Treasury securities, agency debt and agency mortgage-backed securities. According to the San Francisco Fed, these changes in the balance sheet affect financial conditions in a way that results in a higher proxy funds rate (or an analogous level of the federal funds rate) and an even more hawkish monetary policy stance.

Markets are expecting one more rate hike of 0.25% and then a pause, as the Fed assesses the lagged impact of restrictive monetary policy, particularly on economic activity, the labor market, and inflation.

The Fed does not seem to be overly concerned about the mini-banking crisis that we experienced in March. Chair Powell has expressed his view that the banking system is sound and resilient, with strong capital and liquidity. This view is bolstered by the strong actions taken by the Fed, Treasury, and FDIC to ensure that all deposits and the banking system are safe.

However, Powell believes that the banking turmoil will likely result in some tightening of credit conditions for households and businesses, which will weigh on demand, on the labor market, and on inflation.

Recession risk is increasing

The risk of recession was increasing well before the recent turmoil in the banking sector.

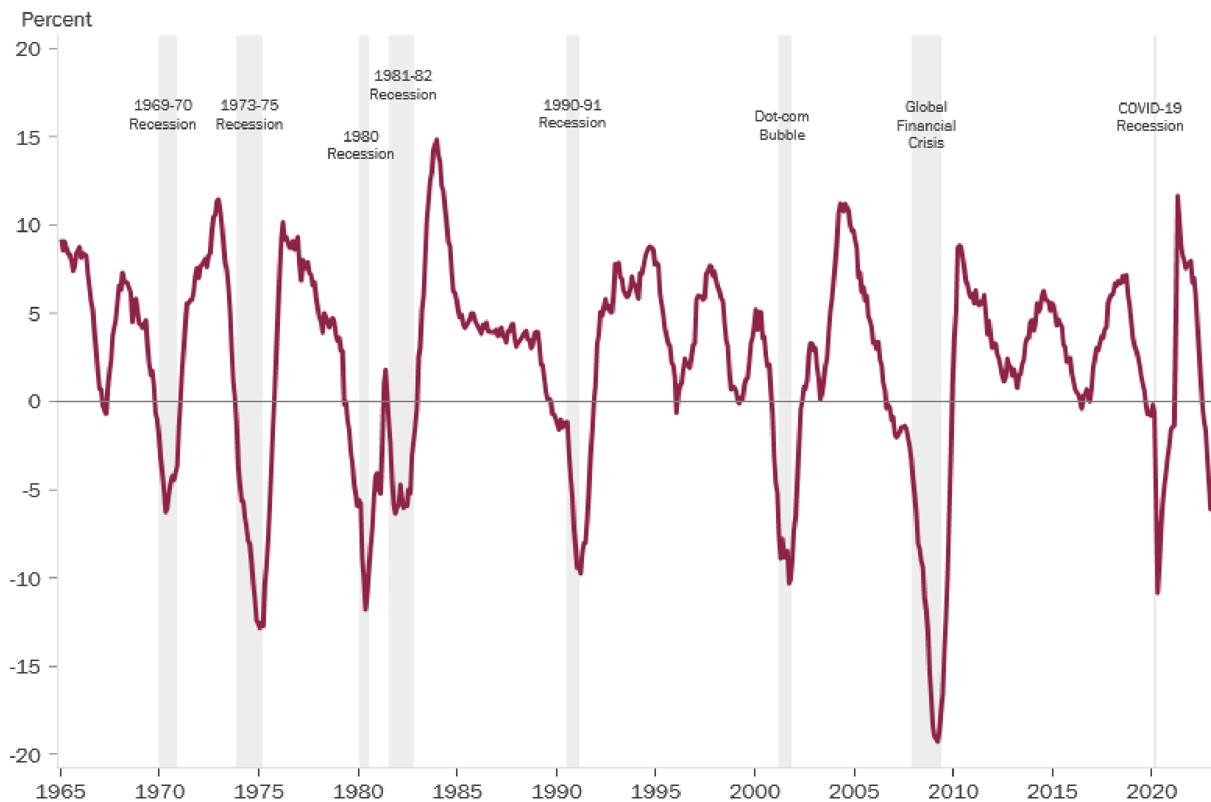
The yield curve has been sending a recessionary signal for some time now. The difference or spread between the 10-year Treasury yield and the 3-month Treasury yield—a historically reliable recession indicator—has been in negative territory since October 2022 and recently hit -161 basis points, its lowest level on record. The New York Fed has developed a probability model based on the 10-year minus 3-month Treasury spread and that model is forecasting a 58% probability of recession in the next twelve months.

Another reliable recession indicator is the Leading Economic Index (LEI), which The Conference Board publishes—see Chart 2 on the next page. According to The Conference Board, the LEI for the U.S. fell again in February, marking its eleventh consecutive monthly decline. Eight of the index's ten components were negative or flat, and the LEI is down 3.6% over the six-month period between August 2022 and February 2023—a steeper rate of decline than its 3.0% contraction over the previous six months (February–August 2022). The Conference Board forecasts rising interest rates paired with declining consumer spending will most likely push the US economy into recession starting in mid-2023.

Many believe the Fed faces a difficult task reigning in inflation without causing significant damage to the economy, and the strong labor market poses a challenge for the Fed. Economists at the Cleveland Fed recently published a paper in which they conclude it would take one year of 7.5% unemployment

from its current low level to bring inflation down to its 2% target. That level of unemployment, 7.5%, was associated with five of the last six recessions, not including the COVID-19 recession of 2020.

Unfortunately, the unemployment rate is a lagging indicator, and we may not realize the full impact of the Fed's monetary tightening cycle until it is too late. In other words, the Fed may hold rates too high and for too long and a hard-landing scenario may be an unwanted and unnecessary consequence.

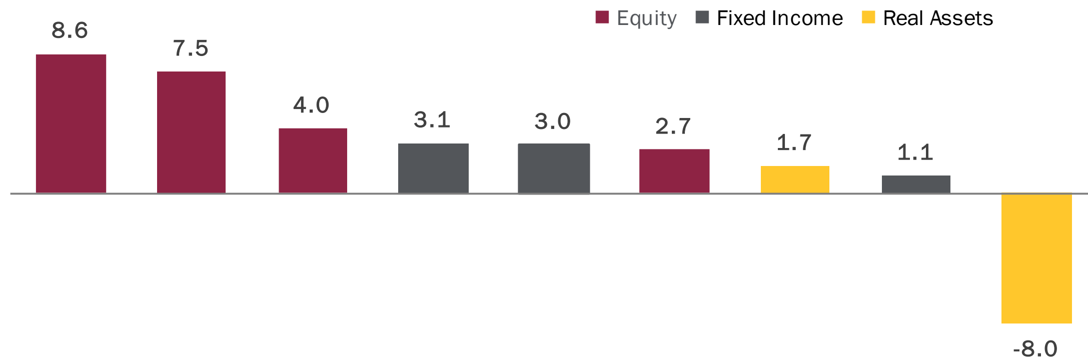


Markets not pricing in 'hard landing' scenario

Equity and fixed income markets had a bumpy ride but ended up posting solid gains in the first quarter of 2023 as investors anticipated a pause in the Fed hikes. Markets survived the regional banking crisis in March, which unfolded as a handful of banks were inadequately prepared for the rapid pace and magnitude of rate hikes over the past year.

Looking at select asset class returns for the quarter, we saw almost a mirror image of what occurred in 2022. The best performing asset classes last year, Commodities and Cash, have been the worst performing asset classes year-to-date. Equity and fixed income, which were laggards in 2022, are now the top performing asset classes this year—see Chart 3 on the next page.

Chart 3 - Select Asset Classes, YTD returns (%)



	DM Equity	Large Cap	EM Equity	High Yield	Fixed Income	Small Cap	REITs	Cash	Commodity
YTD	8.6	7.5	4.0	3.1	3.0	2.7	1.7	1.1	-8.0
2022	-14.0	-18.1	-19.7	-12.7	-13.0	-20.4	-24.9	1.5	16.1
Ann.	2.3	8.8	1.0	5.4	2.7	7.2	6.6	0.6	-2.6

Source: J.P Morgan Asset Management *Guide to the Markets -U.S.* Data are as of March 31, 2023.

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.

Although risk assets have performed well to start the year, we are concerned about the increasing risk of recession over the next twelve months as well as the uncertainty around its severity. We are also concerned about the projected decline in corporate profits in the first half of 2023 as businesses adjust to weakening demand and higher costs driven by inflation and higher interest rates. We just experienced one consequence of the Fed's restrictive monetary policy, with several regional banks getting caught flat-footed as the Fed increased their key interest rate from near zero to just under 5%.

We remain cautiously positioned. We are underweight equity and neutral-weight fixed income and cash. Bond and cash yields offer a compelling alternative to stocks, especially given the higher level of uncertainty. We have a tactical allocation to commodities, which have attractive supply/demand dynamics and potential upside as China's economy reopens from COVID-19 restrictions. For more on our tactical asset allocation, see the table on the next page.

The Investment Strategy Team

PBWM's STRATEGIC AND TACTICAL ASSET ALLOCATION

	Asset Class	Strategic (%)	Over/Underweight (%)	Tactical (%)
Equity	U.S. Stocks	30	2	32
	International Developed Stocks	20	0	20
	Emerging Market Stocks	10	-4	6
Fixed Income	Core Bonds	38	-1	37
	Non-Core Bonds	0	0	0
	Cash Equivalents	2	1	3
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 February 2023.

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.

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