PeoplesBank
WEALTH MANAGEMENT

Economic & Market Perspectives

Fall 2023

"It's tough to make predictions, especially about the future."

— Yogi Berra

As major league baseball's regular season comes to an end and prognosticators turn their attention to the postseason and which teams have the best chances to win it all, we are reminded of Yogi Berra's perspective on predictions.

The Federal Open Market Committee (FOMC) met in September to assess the state of the economy and decide about the level of interest rates and projected path forward. At the post-meeting press conference, Federal Reserve Chairman Jerome Powell was asked a question about how much confidence he has in the Fed's Summary Economic Projections or SEP. Powell said, "Well, forecasts are highly uncertain. Forecasting is very difficult. Forecasters are a humble lot with much to be humble about." Yogi would have appreciated that response.

While forecasting is an inexact science, FOMC meeting participants nevertheless submit their economic projections four times a year. As the economic data changes, so too do the Fed's projections. The FOMC updated its September SEP for economic growth, employment, inflation, and their benchmark interest rate to reflect a resilient economy, strong but slowing labor market, and signs that inflation is moderating somewhat.

Stronger growth requires higher rates

Economic activity has been expanding at a solid pace and consumer spending has been a key driver. The U.S. economy grew at a 2.1% annual pace in the second quarter of 2023, although the increase in consumer spending was cut almost in half from a prior estimate. The Atlanta Fed's GDPNow model indicates growth may be even stronger in the third quarter, with the economy growing at a 4.9% annual pace. Fed officials in September significantly revised up their assessment of real GDP growth for this year to 2.1% from 1% in their June SEP.

The labor market remains tight as businesses continue to hire. Layoffs are near record lows and the unemployment rate is just 3.8%. However, employment growth is trending down – the 6-month moving average for number of monthly jobs added is 187,000, which is slightly above the monthly average for 2019, the year prior to the pandemic. Weekly unemployment claims have dropped to an eight-month low, signaling a still strong labor market. The supply and demand imbalance is improving as the number of job openings has fallen, helping to reduce the jobs-to-workers gap. Still, the scarcity of workers continues to put upward pressure on wages as employers compete to fill jobs. Hourly pay grew 4.3% over the past year, which is well above the 3% a year before the pandemic. In the September

SEP, FOMC participants lowered their outlook for the unemployment rate to 3.8% at the end of 2023 and 4.1% at the end of 2024, compared to their June projections of 4.1% and 4.5%, respectively.

Inflation has moderated since the middle of last year, but it still remains well above the Fed's longer-run target of 2%. The Fed's preferred measure of inflation – the PCE price index — rose to 3.5% over the 12 months ending in August and the core PCE rate of inflation, which excludes the more volatile food and energy categories, fell over the past year to 3.9%, a two-year low. The Fed also monitors longer-term inflation expectations – as reflected in a broad range of surveys of households, businesses, and forecasters, as well as measures from financial markets -- and they remain well anchored, according to Fed Chair Powell. Fed officials in September made little change to their projections from June. FOMC participants see core PCE inflation falling to 3.7%, 2.6%, and 2.3% by the end of 2023, 2024, and 2025, respectively. The September SEP also show core PCE inflation reaching the Fed's 2% target by the end of 2026.

The Fed in September kept the federal-funds rate at a range of 5.25% to 5.5%, a 22-year high, and stressed that bringing inflation sustainably down to 2% will take time. The latest economic projections show one more quarter-point rate hike this year, prompting some to describe this as a 'hawkish pause'. If the economy evolves as projected, FOMC participants project that the appropriate level of the federal-funds rate will be 5.6% at the end of this year, 5.1% at the end of 2024, and 3.9% at the end of 2025. In other words, they expect to keep interest rates 'higher for longer' and plan to continue the process of significantly reducing their balance sheet.

The Fed will continue a balancing act of trying to bring inflation down without causing a recession. The September SEP seem to indicate that Fed officials believe they can engineer a so-called 'soft landing'. Some of the economic data suggest this may be more of a challenge than anticipated.

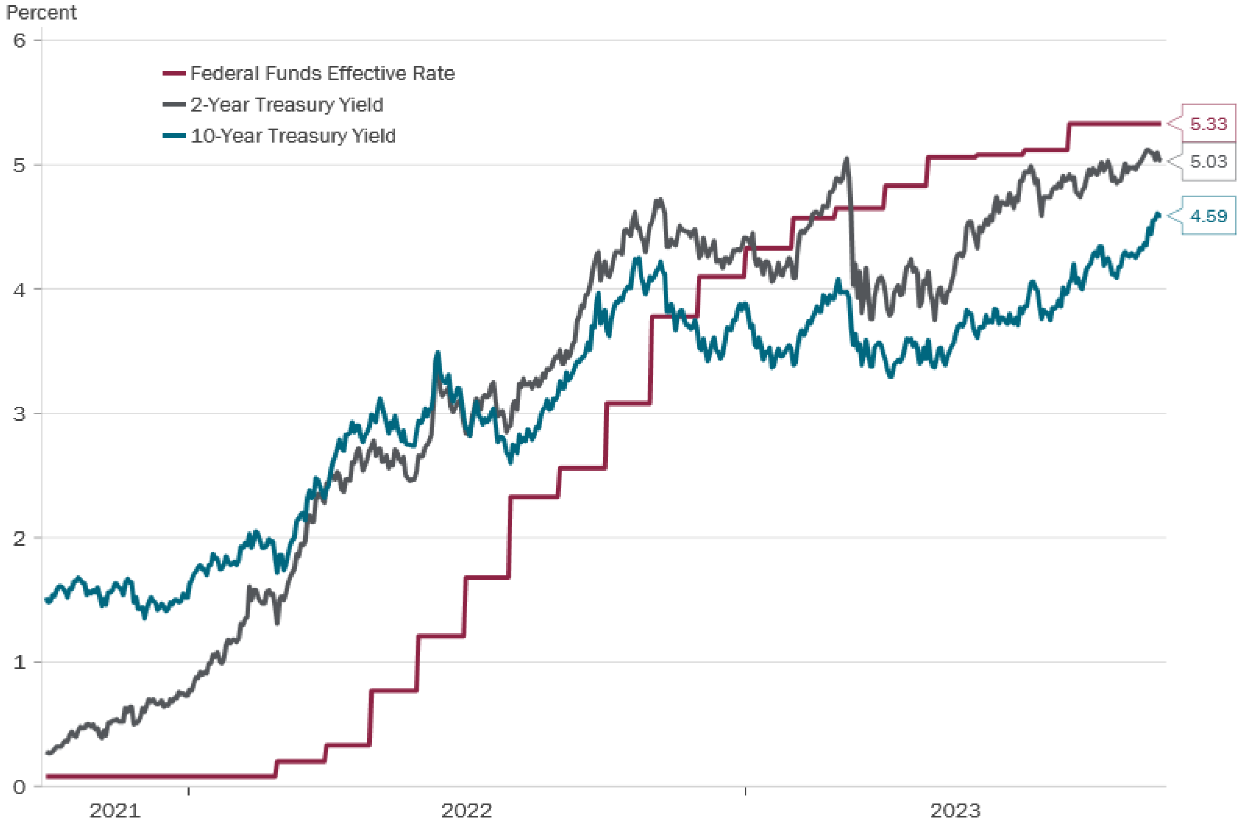
Higher interest rates present challenges

Treasury yields have paralleled the rapid rise in the fed funds rate -- see Chart 1 on the next page. For savers this has been a welcomed phenomenon, but higher rates have led to increasingly higher interest costs for individuals and businesses, which is casting some doubt on the continued strength of the economy.

Robust consumer spending has bolstered a resilient economy over the past four quarters. There are questions around how long consumers can continue spending at the same level in the face of high inflation and interest rates. The personal saving rate fell to 3.9% in August, well below the long-term average of 8.5%, and by most measures, the excess savings built up during the pandemic are nearly depleted. To maintain current levels of spending, consumers are adding expensive credit card debt, which recently hit an all-time high of over $1 trillion – this will become even more of an issue should we see any softening in the labor market.

Consumer confidence – an important leading indicator of the economy's strength – fell in September for the second consecutive month, reflecting concerns about rising prices (especially for groceries and gasoline), higher interest rates, and the political situation, according to The Conference Board. A separate measure of consumer sentiment improved slightly at the end of September, but consumers were unsure about the future of the economy given the possible shutdown of the federal government and labor disputes in the auto industry, according to the University of Michigan.

Chart 1 - Treasury Yields and Federal-Funds Rate



Source: PeoplesBank, Macrobond, Federal Reserve, U.S. Department of Treasury, Morningstar

The housing market continues to bear the brunt of a higher interest rate environment as mortgage rates have increase significantly over the past 21 months. The average 30-year fixed mortgage rate has more than doubled, jumping from 3.27% at the end of 2021 to 7.77% at the end of September. The combination of higher home prices (resulting from low supply) and high mortgage rates has driven the housing affordability index down to its lowest level on record. Elevated mortgage rates and challenging affordability conditions are pushing new home sales down, weakening builder confidence, and putting a damper on housing starts, according to the National Association of Home Builders.

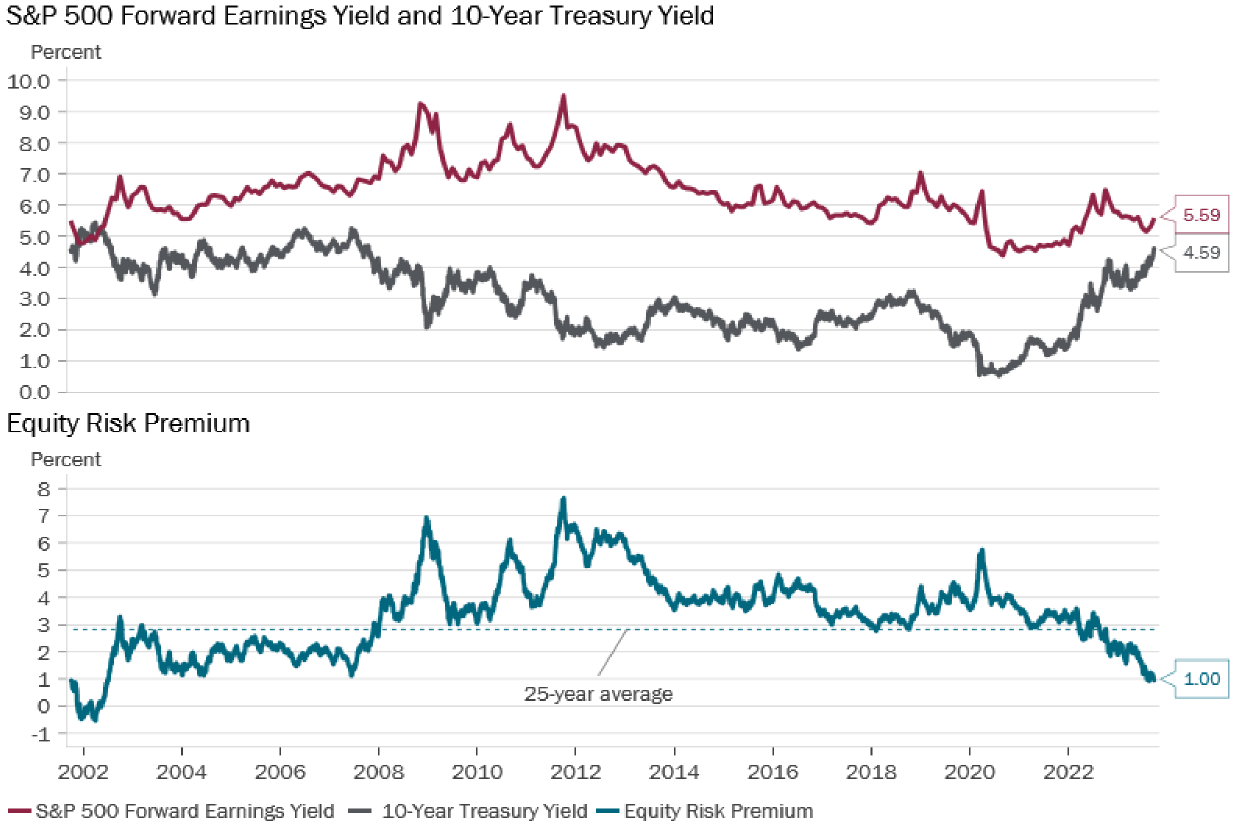
Corporate profits continue to face headwinds. The S&P 500 is expected to report a (year-over-year) decline in earnings of -0.1% for the third quarter – this would be the fourth straight quarter that the index has reported a decline in earnings, according to FactSet. Even though S&P 500 profits have been negatively impacted by higher inflation and labor costs, profits are expected to grow more than 8% in the fourth quarter and 12% next year. However, in the new 'higher for longer' rate environment, analysts at Goldman Sachs believe the key risk for S&P 500 profitability will be higher interest expenses and lower leverage.

Proceeding with caution

The yield on the 10-year Treasury note jumped 50 basis points, or 0.50%, in September, ending the month at 4.59%. This rapid rise in yields reflects investors' expectations that the Fed will keep rates 'higher for longer' in an effort to slow the economy in order to tame inflation.

As interest rates rise, the relative attractiveness of stocks compared to bonds decreases. The equity risk premium – the difference between the S&P 500 forward earnings yield (the inverse of the price-to-earnings ratio) and the 10-year treasury yield -- is near 21-year lows and well below the 25-year average – see Chart 2 below. Many investors would rather move their money into safer securities such as bonds, with shorter maturities yielding in excess of 5%, than take on the additional risk of investing in stocks, with an earnings yield that is only slightly higher.

Chart 2 - Equity Risk Premium Near 21-Year Lows



Source: PeoplesBank, Macrobond, U.S. Department of Treasury, S&P Global, FactSet.

Stocks struggled in September, underperforming bonds and commodities, which got a boost from surging oil prices on the back of an additional cut in production announced by Saudi Arabia. Both stocks and bonds posted negative returns for the third quarter as yields backed up and investors reacted to the uncertainty around the economy and monetary policy.

As we look ahead, keeping in mind the aforementioned comments about the difficulty in making predictions and forecasts, there are significant headwinds causing us to proceed with caution. In addition to inflation, high interest rates, worried consumers, and pessimistic business-owners, historically reliable recession indicators, such as the yield curve and leading economic index, are flashing warning signs:

- The 10-year/2-year Treasury bond spread has been in negative territory for more than 300 consecutive days. The spread reached severely negative territory several times in the late 1970s/early 1980s period, when Paul Volcker ran the Fed. After that, much smaller inversions preceded the early 1990s, early 2000s and Great Financial Crisis recessions, according to Macrobond.

- The U.S. Leading Economic Index has now fallen for nearly a year and a half straight, indicating the economy is heading into a challenging growth period and possible recession over the next year, according to The Conference Board.

In comparison, the Fed's economic projections are more optimistic, forecasting a 'soft landing' for the economy. In other words, Fed officials believe they can bring inflation under control without causing a recession.

The Fed may be discounting the lagged effects of its 'higher for longer' monetary policy. As we noted above, Fed officials have penciled in one more rate hike this year before they start reducing their benchmark rate next year. Recent history indicates that a recession occurred more than a year after the Fed's rate hikes concluded, according to Macrobond.

While we recently averted a government shutdown, until the new deadline of November 17th, the economy faces other challenges including the end of the student loan payment pause and ongoing strike by United Auto Workers (UAW). Analysts at Goldman Sachs expect the resumption of student loan payments to subtract about 0.5% from GDP growth in the fourth quarter. The UAW strike may expand and drag on, but the overall impact on economic growth should be negligible, according to Goldman Sachs.

In an environment where upside and downside risks appear balanced, we are currently neutral weight both equity and fixed income versus our strategic long term asset allocation targets. Within equities, we are maintaining a 'home bias', with a slight overweight to U.S. equity and underweight to international, in particular, emerging markets. Within fixed income, we are slightly underweight investment grade bonds and have a small tactical weighting to high yield bonds, as we believe the pick-up in yield offsets the incremental increase in default-risk. And we have a slight overweight to cash given the attractiveness of short-term yields. As the Fed ends its rate hiking cycle, longer duration fixed income, including investment grade bonds, will become a more attractive alternative to cash. For an overview of our strategic and tactical asset allocation, see the table on the next page.

The Investment Strategy Team

PBWM's STRATEGIC AND TACTICAL ASSET ALLOCATION

	Asset Class	Strategic (%)	Under/Overweight (%)	Tactical (%)
Equity	U.S. Stocks	30	3.5	33.5
	International Developed Stocks	20.3	-0.3	20
	Emerging Market Stocks	9.7	-3.2	6.5
Fixed Income	Inv. Grade Bonds	38	-3	35
	High Yield Bonds	0	2	2
	Cash Equivalents	2	1	3
Real Assets	Real Estate-related securities	0	0	0
	Commodity-related securities	0	0	0

PeoplesBank Wealth Management's (PBWM's) strategic and tactical asset allocation for its moderate growth total return strategy as of September 2023.

Notes

PeoplesBank Wealth Management's (PBWM's) asset allocation process develops both long-term (strategic) and short-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: Barron's, Bureau of Economic Analysis, Bureau of Labor Statistics, FactSet, Federal Reserve, Federal Reserve Bank of Atlanta, Federal Reserve Bank of St. Louis, Goldman Sachs, Macrobond, MarketWatch, Morningstar, S&P Global, The Conference Board, The Wall Street Journal, and U.S Department of Treasury.