



## TheECONOMY

### Far From Over: Fed Continues to Battle Persistent Inflation

The Federal Reserve remains engaged in its ongoing battle with inflation. January's CPI report of 6.4% came in higher than the expected level of 6.2%, heightening concerns that inflation may be more persistent than anticipated. While CPI has decreased by 0.1% since December 2022, the rate of deceleration has slowed to a more gradual pace. Prices rose by 0.5% in January 2023, the most in three months, signaling that the slowdown in key areas such as energy, food, and clothing may have stalled or even reversed by the end of 2022.

Another key indicator that the Fed will be keeping a close eye on is the labor market. The U.S. jobs market added a shocking 517,000 jobs in January, snapping a five-month period of declining jobs growth and sending the unemployment rate to a 53-year low of 3.4%. The state of the jobs market is critical to the Fed's strategy as rising wages and consumer spending results in upward pressure on inflation. Continued strength in the labor market raises hopes that a "soft landing" is possible, in which monetary policy is tightened, inflation normalizes and a recession is avoided. While the economy is highly unlikely to tip into recession territory with such an incredibly strong labor market, this outcome is far from guaranteed and depends largely on the decisions of the Fed this year.

Overall, the most recent data suggest that interest rates are likely to remain higher for longer than anticipated.

Looking forward, eyes are now turning to the Fed's March meeting where rates are largely expected to rise by another quarter of a percentage point. Much of the focus is now shifting to the second half of 2023 and the key discussion around whether the Fed will begin to cut rates by the end of the year. While many had anticipated a rate cut by year's end, last month's data have added a degree of uncertainty to those predictions. Market expectations are now divided between a June pause and another quarter-point rate hike.

### Treasury Yields

MATURITY	2/13/23	1/13/23	CHANGE
3 Month	4.636%	4.573%	0.063%
6 Month	4.923%	4.772%	0.151%
1 -Year	4.884%	4.662%	0.222%
2 -Year	4.518%	4.232%	0.285%
3 -Year	4.202%	3.900%	0.302%
5 -Year	3.910%	3.611%	0.300%
10 -Year	3.702%	3.504%	0.198%
30 -Year	3.773%	3.610%	0.163%

Source: Bloomberg

### Agency Yields

MATURITY	2/13/23	1/13/23	CHANGE
3 Month	4.928%	4.732%	0.196%
6 Month	4.926%	4.728%	0.198%
1 -Year	4.893%	4.688%	0.205%
2 -Year	4.647%	4.342%	0.305%
3 -Year	4.426%	4.062%	0.364%
5 -Year	4.131%	3.772%	0.359%

Source: Bloomberg

### Commercial Paper Yields (A-1/P-1)

MATURITY	2/13/23	1/13/23	CHANGE
1 Month	4.540%	4.390%	0.150%
3 Month	4.800%	4.700%	0.100%
6 Month	5.040%	5.000%	0.040%
9 Month	5.170%	5.100%	0.070%

Source: Bloomberg

### Current Economic Releases

DATA	PERIOD	VALUE
GDP QoQ	Q4 '22	2.90%
US Unemployment	Jan '23	3.40%
ISM Manufacturing	Jan '23	47.4
PPI YoY	Jan '23	6.00%
CPI YoY	Jan '23	6.40%
Fed Funds Target	Feb 14, 2023	4.50% - 4.75%

Source: Bloomberg



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## A Look Back at 2022: My, How Times Have Changed!

On February 1, the Federal Open Market Committee (FOMC) voted to raise the Federal Funds rate to a range of between 4.50% and 4.75%, placing the Federal Reserve's benchmark interest rate at its highest level in over 15 years. The move marked the latest increase in what has turned out to be the most aggressive pace of Federal Reserve rate hikes since the early 1980s when Paul Volker was chairman, and the nation was battling inflation close to 15%. While the current inflationary cycle has remained mercifully below the mid double-digit levels of the early '80s, the pace at which the Federal Reserve has raised interest rates ranks amongst the most aggressive in modern history. Considering that less than one year ago, the Federal Funds rate was still pegged at a range of between 0.00% and 0.25%. My, how times have changed! In the remainder of this article, we'll explore the circumstances that led to the Fed's dramatic about-face as well as the outlook for the year ahead.

As we look back at 2022, the FOMC's aggressive policy pivot stands out arguably as the most important market development of the year. The U.S. economy began the year with solid momentum on the heels of a robust 5.9% growth rate in 2021 and, with unemployment hovering at just 3.9%, less than half a percent above its pre-pandemic low. Unfortunately, the inflation surge which began in 2021 was gaining force with the Consumer Price Index (CPI) already running at 7%, fueled in part by the accelerant of prior years' fiscal stimuli. It was, therefore, perplexing to many observers that despite the combination of tight labor markets and surging inflation, the FOMC still judged it necessary to maintain its near zero interest rate policy. As market participants would soon learn, however, that dynamic was about to change.

As if the inflationary imbalances resulting from the mismatch between pent up consumer demand and still-fragmented global supply-chains weren't enough, Russia's invasion of Ukraine in February wreaked havoc on global food and energy markets. Measures of inflation surged through the first half of the year with the Consumer Price Index reaching a 40-year high of 9.1% in June. Meanwhile, sporadic outbreaks of COVID-19 in China forced intermittent closures at the Port of Shanghai, adding to existing supply chain challenges. The Fed initially hoped inflation would be "transitory" but proved anything but as it accelerated and became increasingly broad-based throughout the year. While the pace of inflation moderated during the back half of 2022, a significant amount of economic damage had already been done as consumers and businesses struggled to keep pace with elevated and still-rising prices.

Under the weight of persistent inflation, economic growth slowed notably in 2022, particularly in the first half of the year. Paradoxically, despite rapidly recovering labor markets, the U.S. economy unexpectedly shrank in the first quarter of the year with Gross Domestic Product (GDP) contracting at an annualized rate of 1.6%. The decline in first-quarter activity was originally written off to a ballooning trade deficit, however, the unanticipated contraction in second-quarter growth sparked an intense debate as to whether the U.S. economy was already in recession. While two consecutive quarters of negative GDP growth meets the commonly held textbook definition of recession, the official determination is based upon the interpretation of a wide array of economic variables. Moreover, the rebound in activity that took place during the second half of the year, coupled with the persistent tightening of labor market conditions, suggest it is doubtful the U.S. entered an official recession in 2022. However, considering the ferocity of the Fed's belated response to surging inflation, the outlook for 2023 is considerably less clear.



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By the time the Fed commenced with their first 25 basis point (0.25%) rate hike in March, inflation as measured by the CPI had already risen to 7.9%. Notably, the inflation data available at that time captured prices prior to Russia's invasion of Ukraine which most assuredly implied that peak inflation was on the horizon rather than in the rearview mirror. In the months that followed, the Fed hastened the pace of rate hikes to 50 basis points (0.50%) in May, followed by a string of four consecutive 75 basis point (0.75%) increases in June, July, September, and November. As the year drew to a close, the Fed slowed the pace of rate hikes to 50 basis points (0.50%) in December and most recently 25 basis points (0.25%) in February of this year. In sum, the Fed has raised the Federal Funds rate by 450 basis points (4.50%) since March 2022. Current forward guidance from the Fed suggests the so-called terminal Fed Funds rate will settle somewhere between 5.0% to 5.25% during the first half of this year. As the Fed nears the end of its tightening cycle, the pace of future rate hikes will likely be more measured as policy makers evaluate the impact of prior rate increases.

As we start this new year, the economy has already shown meaningful signs of slowing under the weight of higher prices and the Fed's aggressive interest rate increases. Although consumer spending has remained resilient, higher interest rates have weighed on construction, home sales, and business investment. Moreover, elevated and still-rising prices continue to squeeze consumer wallets, cutting the personal saving rate and giving rise to record high credit card debt. As a result, much of the fuel that helped propel spending over the prior two years appears to be running out, and it is unlikely that consumers will see further stimulus from the Federal government. While the labor market remains a singular bright spot, the combination of elevated inflation and notably higher interest rates has increased the odds that the economy slips into recession sometime in 2023. In response to this growing concern, many market participants now expect the Fed will perform another about-face and begin cutting rates in the second half of the year. Unfortunately, and despite the Fed's best efforts to guide otherwise, history favors the markets in this regard. There have been 13 periods of sustained Fed rate hikes since the early 1950s with ten of those cycles ending in recession and just three achieving the prized soft economic landing.

If the U.S. economy were to slip into recession this year, it would most surely be one of the most anticipated downturns in history. Forecasters surveyed by the Federal Reserve Bank of Philadelphia place the probability of a downturn in the next four quarters at more than 40%, the highest reading since 1975. Meanwhile, economists polled by Bloomberg place the odds of a 2023 slump at 65%. Despite these gloomy forecasts, there is still a chance for the Fed to thread the needle should wage growth ease along with broader inflation, allowing the overheated job market to cool without causing an excessive run up in the unemployment rate. The odds are narrow, no doubt. Public Trust continues to watch the data with bated breath. We eagerly root for the Fed as they walk the yellow brick road in pursuit of the prized soft landing. The tightrope between inflation and recession has rarely ever been more taut.

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