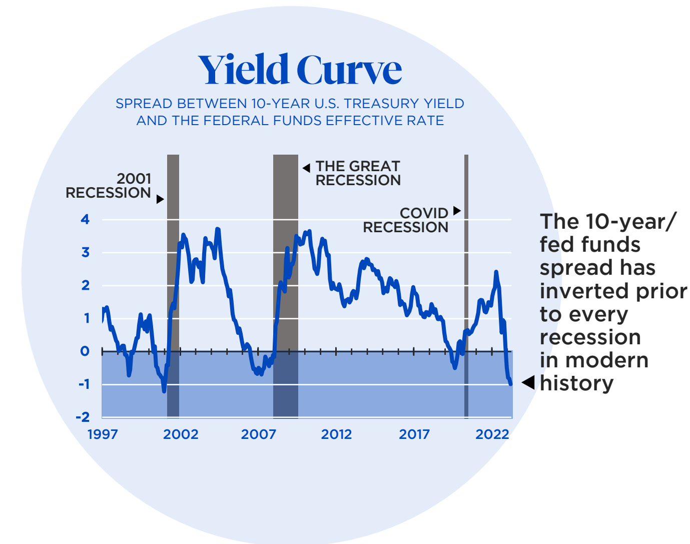
Economic & Financial Markets Monthly Review | May 2023

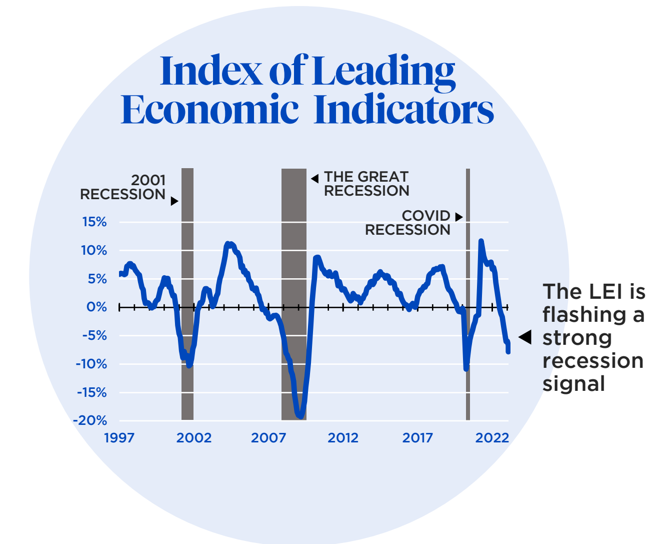
Elevated inflation, bank failures in tug-of-war over Fed policy

Economic Overview

Where is the economy now?

Signs of decelerating economic growth in response to sharp Fed tightening suggest that the U.S. economy is in a pre-recessionary period. Key leading indicators including the yield curve and the Index of Leading Economic Indicators point to elevated recession risks over the next year. But the lead up to the next recession may linger due to continued solid hiring trends.





Where we are this month

NOT QUITE IN A RECESSION

While some indicators suggest the business cycle is closing in on a contraction, the strength of labor market indicates we are not there yet.

SUSTAINED YIELD CURVE INVERSION

The 10-year to fed funds spread remains deeply inverted and the yield curve has shown a full inversion for about six months.

LEADING FACTORS DEEPLY NEGATIVE

The LEI continues to tumble as forward growth signals across the consumer, business, and financial sectors deteriorate.

What does this mean

- Still, key recession signals point to a likely recession over the next year, while a much tighter commercial lending environment adds further downside risk to the growth outlook.
- Our baseline forecast assumes that a moderate recession hits in the second half of 2023. But the timing of a downturn remains uncertain due to positive momentum in the labor market.

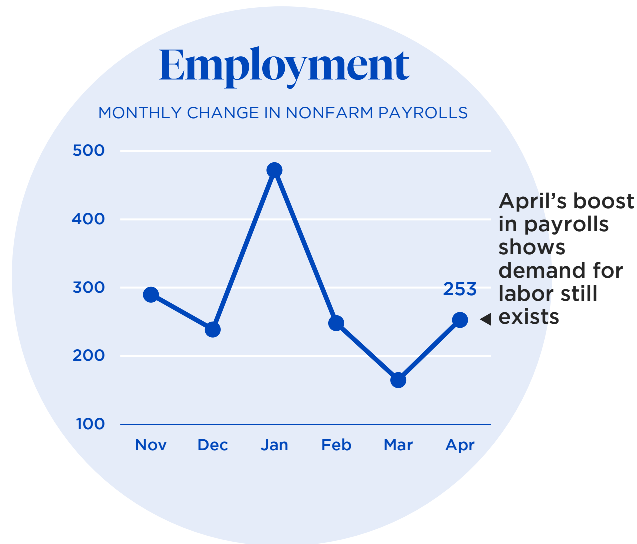
- Since at least 1962, a recession has always followed a sustained yield curve inversion, although the depth of the inversion has not historically correlated well with the severity of the downturn.
- The deep inversion reflects the bond market's high expectation of a recession in the year ahead.

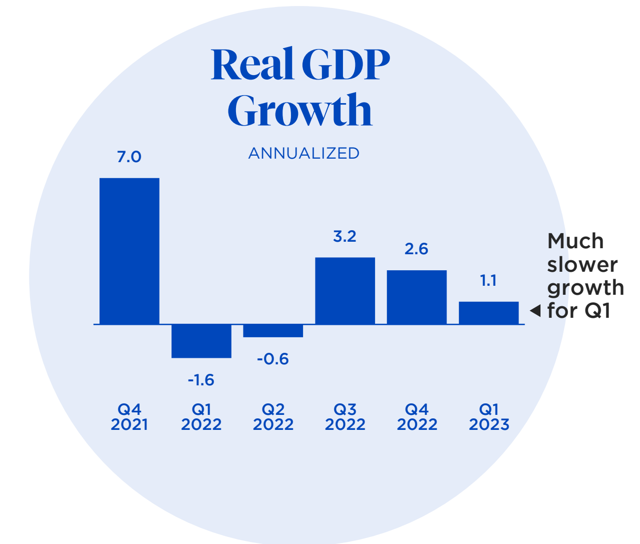
- Through March 2023, the LEI had declined for 12 consecutive months, the worst period since just prior to the 2007-08 Great Recession.
- Aligning with the yield curve inversion, the year-on-year change in the LEI has never been this negative without a recession occurring in the following year.

Economic Review

Labor market keeping the expansion afloat

Job and income gains remained buoyant through April, which should sustain some momentum for consumer spending. But businesses are pulling the reins on expenses and inventories, trends that typically result in a cooler labor market down the road. While the expansion continues for now, the conditions for the next economic downturn continue to take shape.





Where we are this month

JOB GAINS SURPRISE TO THE UPSIDE

Nonfarm payrolls increased by 253,000 in April, while the unemployment rate matched a 70-year low of 3.4 percent.

INFLATION GRADUALLY COOLS

The CPI rose 0.4 percent in April as gas prices popped and higher used car prices drove an upward reversal in core goods prices.

A WEAKER START TO 2023

Real GDP expanded at a meager 1.1 percent annualized pace in the first quarter, as a plunge in business inventories weakened growth.

What does this mean

- Significant downward revisions to February and March temper April's increase, but hiring was widespread across sectors as firms' demand for labor remained robust into the second quarter.
- Reflective of the tight labor conditions, average hourly earnings jumped 0.5 percent in April – offsetting some recent moderation and adding to lingering service inflation concerns.

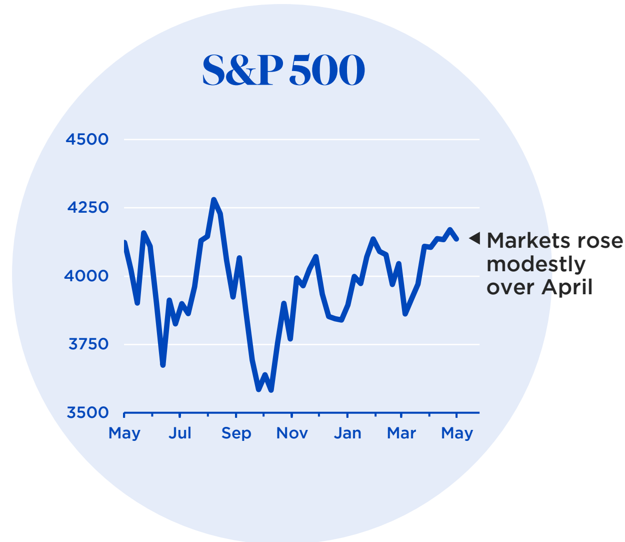
- Core consumer inflation remained rapid and well-above the Fed's target with a year-on-year rate of 5.5 percent as inflation for housing and services was still highly elevated into April.
- In a bit of relief for households, costs food at home dropped for the second straight month. The key core services ex rent inflation measure eased in April, providing encouraging news.

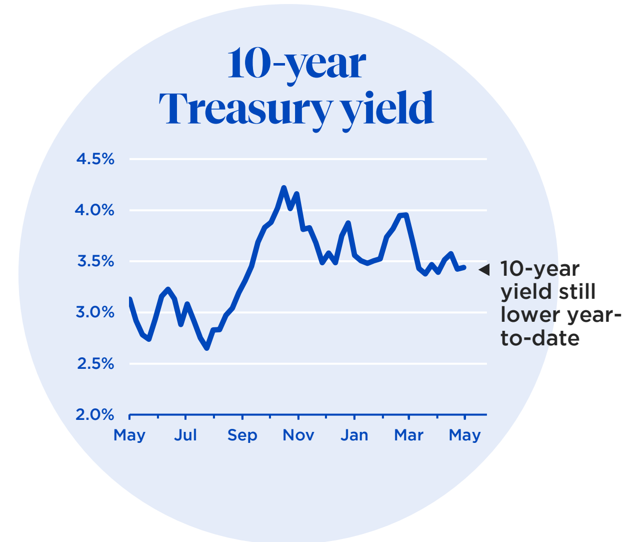
- Consumer spending was buoyant in response to strong job and income gains. This boosted growth in private sales to private domestic purchasers (core real GDP) to a solid 2.9 percent rate.
- Business investment stalled in the first quarter with a sharp decline in equipment spending. This and inventory cuts highlight a broader pullback by the business sector in preparation for a recession.

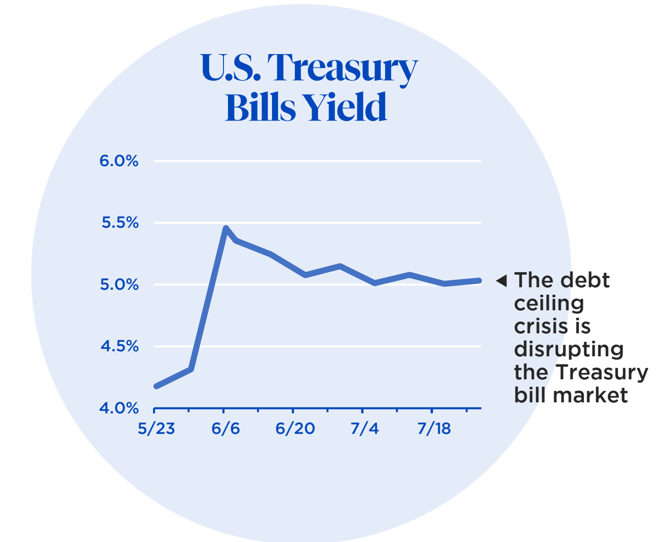
Financial Market Review

Markets remain caught in the middle

The crosscurrents of additional bank failures and better-than-feared corporate earnings kept the market within a tight trading range in April. Better-than-expected profits gave equities new optimism even though the earnings recession should persist. Still, the Treasury market felt the sting of further tremors from regional banks and fear of a US government default on its debt as the "X" date for breaching the debt ceiling approaches quickly.







Where we are this month

EARNINGS BOOST IN APRIL

The S&P 500 posted its first consecutive monthly gain since last fall as nearly four out of five companies beat their Q1 earnings expectations.

VOLITALITY IS THE NEW NORMAL

The 10-year Treasury note yield bounced around in April but settled back to roughly where it started as the Fed raised rates one more time.

THE DEBT CEILING SPIKE

Investors abandoned Treasury bills maturing in June as the debt ceiling impasse lingered into May, spiking some short-term yields.

What does this mean

Earnings boost in April

- First quarter earnings were down about two percent, much better than the forecasted six percent decline, as profits for domestic-focused companies grew nearly three percent.
- Fears of a prolonged earnings recession linger, with positive earnings growth not expected until later this year, even though the outlook for 2024 is brighter.

Volitality is the new normal

- Long-term interest rates continue to be held down by hopes for Fed rate cuts over H2 of 2023, creating some upside potential should Fed easing be delayed into 2024.
- The two-year note rode the wave of Fed expectations and regional bank worries, passing above the 4.25 percent level only to fall off as markets priced in a Fed pause followed by expected rate cuts.

The debt ceiling spike

- Treasury Secretary Yellen has warned that the U.S. will exceed its ability to issue debt to fund the government on June 1st, adding significant uncertainty for maturing Treasury bills.
- The spike in the yields reflects the possibility of a protracted settlement process on previously risk-free paper, further increasing stress for financial firms after recent regional bank meltdowns.

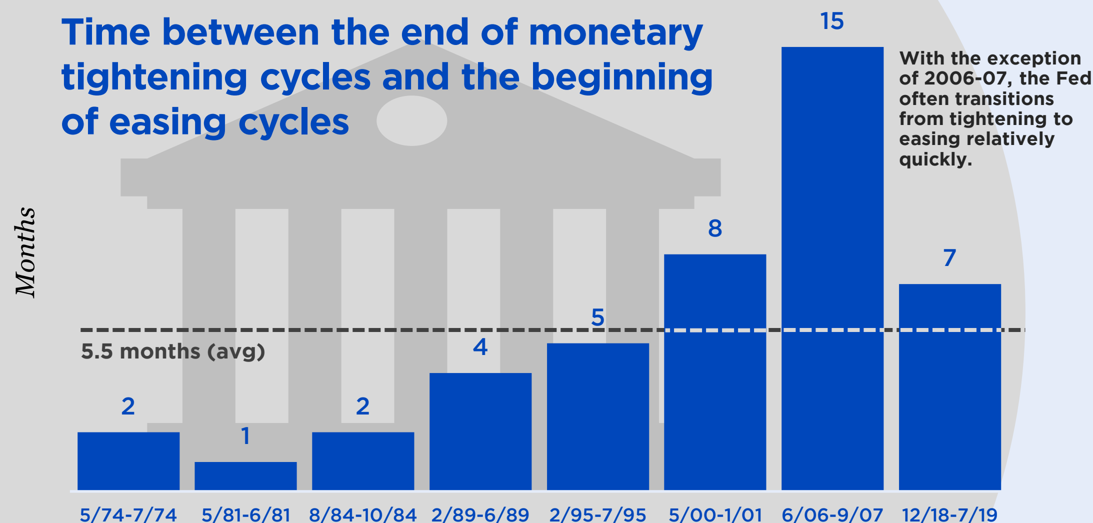
Outlook

Is a long Fed pause forthcoming?

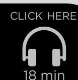
Financial markets expect the Fed to stop tightening rates in June and to pivot to rate cuts within a few months. This would generally be in line with history as the Fed has held rates steady after tightening cycles for only an average of 5.5 months over the past 50 years, with several shorter periods. Typically, stresses on the financial system, as evidenced by the recent regional bank failures, prompt the Fed to lower interest rates to cushion the downside impact on the economy especially as it moves into recession.

However, persistently high inflation is an important distinction in the current cycle, which is likely to keep the Fed from easing rates this year. Since the volatile double-dip recession of the early 1980s, inflationary pressures have been relatively muted in late cycle periods, allowing the Fed to react quickly to signs of deterioration within the consumer and business sectors. While the banking sector remains a downside risk, economic and inflationary conditions on balance suggest a longer-than-average wait for monetary policy easing.

Time between the end of monetary tightening cycles and the beginning of easing cycles



Podcast
Could May's rate hike be the last for this year?
CLICK HERE



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Latest Forecast

Data as of May 2023

	2022	2023	2024	2025	2026
	ACTUAL	ESTIMATE	FORECAST		
REAL GDP	2.1%	1.2%	-0.2%	2.2%	1.7%
UNEMPLOYMENT RATE	3.6%	4.1%	5.3%	4.7%	4.3%
INFLATION (CPI)	7.1%	3.9%	3.0%	2.4%	2.0%
TOTAL HOME SALES	5.67	4.78	5.08	5.50	6.00
S&P/CASE-SHILLER HOME PRICE INDEX	5.8%	-1.7%	1.1%	3.5%	4.0%
LIGHT VEHICLE SALES	13.8	15.0	15.3	16.2	16.5
FEDERAL FUNDS RATE	4.25%	5.00%	3.00%	2.00%	2.00%
5-YEAR TREASURY NOTE	3.99%	3.80%	3.10%	2.70%	2.50%
10-YEAR TREASURY NOTE	3.88%	3.70%	3.15%	2.90%	2.70%
30-YEAR FIXED-RATE MORTGAGE	6.42%	6.30%	5.20%	4.65%	4.40%
MONEY MARKET FUNDS	2.27%	4.97%	3.78%	2.40%	2.03%

Recession timing likely pushed out further

Riding momentum from job and income gains, it is unlikely that a recession will begin until the third quarter or later, with negative impacts extending into early 2024. The recession timing remains highly uncertain, especially when factoring in further sharp tightening of bank lending and potential changes in Fed policy.

Long-term rates could get a near-term lift

Financial markets are pricing in rate cuts in the H2 of 2023. If this does not occur, as we project, long-term interest rates should climb again in coming months with an added lift from a broadly tighter lending environment within the banking sector.

Still, the upside should be limited by signs of weaker growth and fading inflation.

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