THIRD QUARTER 2023
INVESTMENT COMMENTARY

The Fed's High Bar Points to a Weak Economy

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The Fed's pause at the June FOMC meeting was highly advertised and came as no surprise. The key takeaway from the meeting, however, was the hawkish tone sounded by Chair Powell, signaling that two more rate increases were likely this year, confirming the dot plots unveiled in the SEP following the meeting. Clearly, Powell is setting a high bar not to raise rates going forward while at the same time keeping his options open in case the economy does not align with the expected growth and inflation forecast put forward by the Fed's staff. With less than a month to go before the next FOMC meeting on July 26, it's not likely the backward-looking data released prior to the gathering will give the Fed much excuse not to hike again.

If the Fed goes ahead and pulls the rate hiking trigger, it implies a greater willingness to tolerate a recession for the sake of taming inflation than seemed likely earlier in the year. There seems to be a rationale among some policymakers that it would be easier to lift the economy out of a recession than to wrestle inflation down to the 2 percent target. From our lens, that's a dangerous assumption and one that probably does not have to be tested, as inflation is already well on its way to meeting that target, although it may take a bit longer to get there. While the economy has shown more resistance to rate hikes than expected, that's only because the multi-pronged sources of momentum generated during the pandemic and its aftermath has had more lasting firepower than thought. However, their expiration date is rapidly approaching, and will soon be overwhelmed by recession-inducing headwinds that should short-circuit growth later this year.

The stronger readings of the economic data, together with the hawkish Fed, have also caused a pivot in the financial markets. Recession fears captured headlines a few months ago, and investors priced in Fed easing and lower rates over the second half of the year. That's no longer the case, as the futures market is pricing in a 77% probability of another 25-basis point hike at the July meeting; historically, when fed funds futures assign a probability of an outcome of more than 70%, the Fed has typically followed through. Recession expectations have not been vanquished, but the timing has been pushed back to later this year or early 2024. Stocks have also flourished on the premise that a soft landing or goldilocks economy was unfolding. However, we believe that it is setting itself up for disappointment as the profit outlook will not support the high valuations currently priced in the market.

Strong Output Growth Masks Weak Incomes

The "waiting for Godot" recession is being pushed back further with each data release, lifting the odds that the Fed will step on the brakes even harder than thought a few weeks ago. At the central bankers' symposium in Sintra, Portugal in late June, Fed Chair Powell sounded even more hawkish than he did in the press conference following the June 16 FOMC meeting. Not only did he confirm the likelihood of two more rate hikes signaled at that presser, but he also hinted that the rate trigger could be pulled in two consecutive meetings, in July and September. That, of course, leaves the door open for more tightening moves in the two remaining meetings this year.

The odds of more than two increases this year are low and we still believe that it's a close call between staying put and increasing one more time. That said, the Fed Chair's hawkish comments are understandable considering

the upside surprises in incoming data that are imparting more heft to the second quarter than predicted by policymakers or the consensus of economists. What's more, the economy came out of the starting gate this year with considerably more swagger than previous estimates revealed. Real GDP staged an above-potential 2 percent annual growth rate in the first quarter, revised up from the earlier tally of a 1.3 percent pace. That upside surprise overstates the economy's strength, as incomes generated during the period were exceptionally weak. Gross domestic income fell by a 1.8 percent annual rate in the first quarter, although that too was revised up from a 2.3 percent decline. Still, such a wide divide between the output and income sides of the economy always stirs debate over which is a more reliable measure of the economy's performance. One way to resolve the issue is by averaging the performance of the two sides of the ledger. This exercise produces a slim 0.1 percent growth rate for the period, which is hardly a barn-burning pace that warrants a stiff cooling-off response from the Fed.

Importantly, businesses suffered the brunt of the income weakness in the first quarter, as profits from current production fell by $121.5 billion and margins came under pressure, as unit profits among nonfinancial corporations fell for the first time in four quarters. This may be a sign that companies are not able to fully pass rising labor costs through to consumers. In a tight labor market, that dynamic poses a challenge to employers: accept smaller margins for the sake of retaining workers or push back on wage demands and risk losing workers to a wave of voluntary quits. Given the lofty profits companies have enjoyed throughout most of the post-pandemic recovery, some margin compression can readily be tolerated. But the stock market is not priced for a profit squeeze over an extended period, which sets the stage for a slide in market values unless corporate pricing power strengthens.

A Risky Trade-off

Until recently, businesses have found little resistance to the ever-larger price increases put through over the past two years. That's because households, fortified with copious pandemic-era transfer payments and sturdy job growth had the means to accept higher prices. What's more, there was the feeling among customers that price hikes were justified by product shortages linked to supply-chain snarls, the war in Ukraine that sent energy and commodity prices surging, and rising costs of production due to labor shortages and higher input prices. Consumer acceptance of higher prices is fading and business pricing power is weakening.

While headline inflation has retreated significantly this year, core inflation, excluding food and energy, has fallen much more slowly. The Fed is particularly focused on core non-housing service inflation, which is heavily influenced by labor costs. Unsurprisingly, Fed officials believe the tight labor market, spurring upward wage pressure, is a key obstacle to a faster decline in inflation in this so-called super core segment. That, in turn, underscores the widespread view that the Fed will not stop hiking rates until something in the labor market breaks. So far, it hasn't; at best, it is bending. A recent survey of CEOs by the Conference Board indicates that nearly half the employers of major companies plan to hold on to workers over the next year, despite a deteriorating growth outlook. The hoarding instinct is bolstered by expectations that any pending recession would be mild, and the risk of overstaffing is outweighed by fears of rehiring difficulties when the economy recovers.

The Fed hopes to change that mindset and persuade workers that their jobs are at risk, tilting their priority away from bigger pay raises to job security. Just how far the Fed is willing to go to change the mindset of businesses and labor is unclear, but the increasingly hawkish stance of policymakers suggests more of a willingness to accept a recession for the sake of restoring price stability. That tradeoff may reflect a greater sense among Fed officials that its policy tools are more effective in lifting the economy out of a recession than in bringing inflation to heel. Such thinking is clearly influenced by recency bias and downplays the risk of sending the economy into a harder downturn than the soft landing the Fed still hopes to bring about. It's important to remember that the Fed has been battling high inflation for only the past two years, whereas it had struggled against the tug of disinflation – punctuated by fears of deflation – over the previous twenty years.

Why Inflation Will Fade

As the second half of the year gets underway, we believe disinflationary forces will gain traction and spread beyond energy and food products, which have been the key drags on headline inflation this year. On the demand side, the firepower that underpinned household acceptance of higher prices this year is rapidly fading. A year ago, Americans were flush with an estimated $2.5 trillion in excess savings from unspent funds during the

pandemic and government stimulus payments. Although incomes lagged price increases, these funds more than compensated for the shortfall in purchasing power, allowing consumers to keep on spending on ever-more expensive goods and services.

Entering this year, however, most of the excess savings had been used up, with only around $400 million remaining according to recent studies. Unsurprisingly, consumers have become much more price-conscious, trading down for less expensive substitutes whenever possible and shopping more at cheaper retailers. Even those in the higher income brackets are downscaling their shopping habits. According to Morning Consult, people earning $100,000 or more are 15 percent more likely to shop at Dollar Stores than they were last year. This growing price resistance is prodding a response from companies striving to remain competitive. According to the NFIB, the share of small companies raising prices plunged to 32 percent in May from 65 percent a year earlier. Likewise, the share planning to raise prices fell to 29 percent from 51 percent over the same span.

Meanwhile, the share of companies raising and planning to raise worker pay is also falling, but far more slowly, reflecting the ongoing fear of losing workers. This confluence of forces is filtering down to the bottom line, resulting in a profits squeeze that will eventually coax employers to abandon the hoarding instinct and reduce staff. This is already starting to show up in rising applications for unemployment benefits and a decline in the job-finding rate, as laid-off workers are staying longer on the unemployment lines. Another way companies are reducing labor costs is by reducing worker hours, which, except for a brief plunge during the pandemic, matched the lowest level in 20 years in May. Simply put, the strong bargaining position of workers during the first year of the post-pandemic recovery is waning, and wage demands are likewise poised to ease as labor shifts its priorities toward job security over pay raises. That, in turn, should short-circuit the wage-price spiral that the Fed fears could gain traction.

Indeed, there are signs that the job market itself is not as strong as the payroll data suggest, as more than 40 percent of the increase in nonfarm payrolls over the past year is estimated by the Labor Department's so-called birth-death model. Historically, this model has overstated the number of jobs estimated to have been created by start-up firms when the economy is slowing and edging toward a recession. Some economists believe that about 75,000 phony jobs a month have been created by the model this year, which will be erased when revised figures using tax documents are released later. Simply put, the Fed may be striving to cool off a job market that may not be nearly as hot as it thinks. Instead of relying on the payroll data derived from its survey of businesses, which includes estimates from the birth-death model, a more reliable measure of labor market strength may be seen in the household survey, which showed a sharp drop in employment in April and May.

Financial Conditions Turning Restrictive

The odds of another rate hike by the Fed at the July meeting are high, but we believe that will be the last of the cycle, as the economy is poised to slow considerably over the second half of the year and slide into a recession shortly before the year is over. Inflation will not retreat to the 2 percent target before the end of the year, owing to sticky service prices. Headline inflation will be falling fast, dragged down by declining energy and commodity prices and, later this year, rental prices. Rent increases are still elevated because all leases signed over the past year are included in the BLS measurement of housing costs. Market rents are currently declining and by late this year and next, they will be a powerful drag on housing costs. Importantly, even if core service inflation is slow to recede, the ongoing slide in headline inflation is lowering household inflation expectations, a key objective of the Fed.

The lagged effects of the Fed's rate hikes are starting to weigh on the economy, and their growth-retarding impact will intensify later this year. In addition to higher borrowing costs, the recent banking turmoil is reducing credit availability, posing another constraint on activity. Policymakers have effectively short-circuited the contagion effects of the three regional bank failures as deposit flight has not taken root. Mid-size banks are still vulnerable to a hemorrhaging of hot money and are forced to pay competitive rates to retain these deposits. That, in turn, is hurting profits, which further strains their lending capacity. Simply put, the economy faces powerful headwinds over the second half of the year – high rates, reduced credit availability, dwindling savings, and slowing job growth. This all points to a continuation of the disinflationary trend underway and renders the high yields currently available on Treasury bonds exceptionally attractive, particularly if, as we expect, stock returns amid a deteriorating profits outlook look far less favorable.

Rates and Total Returns Quarterly And Annual Comparison

U.S. Treasury Market				Total Return (%)	
	6/30/2022	3/31/2023	6/30/2023	2nd Qtr	1Yr
6 Mo Bill	2.49	4.89	5.43	1.22	3.61
2 Year Note	2.97	4.03	4.90	-0.89	-0.54
5 Year Note	3.04	3.59	4.16	-1.69	-2.14
10 Year Note	3.01	3.48	3.84	-1.91	-3.55
30 Year Note	3.16	3.66	3.86	-2.36	-9.68

Municipal Bonds	Yield (%)			Total Return (%)	
	6/30/2022	3/31/2023	6/30/2023	2nd Qtr	1Yr
Barclays General Obligation Index	2.94	2.94	3.25	-0.41	2.95
Barclays New York Bond Index	3.32	3.28	3.50	0.16	3.93
Barclays California Bond Index	3.09	3.07	3.32	-0.11	3.49
Barclays Revenue Index	3.40	3.43	3.65	0.04	3.44

Equities	Levels			Total Return (%)	
	6/30/2022	3/31/2023	6/30/2023	2nd Qtr	1Yr
S&P 500	3785.38	4109.31	4450.38	8.74	19.56
DJIA	30775.43	33274.15	34407.6	3.97	14.23
Nikkei (Tokyo) US $ Terms	26393.04	28041.48	33189.04	8.99	20.89

Commodities	US $			Percent Change (%)	
	6/30/2022	3/31/2023	6/30/2023	2nd Qtr	1Yr
Gold Comex Spot ($ per oz)	1807.27	1969.28	1919.35	-2.54	6.20
CRB Future Com. Pr. Index*	291.15	267.7272	261.9932	-2.14	-10.01
W. Tx Int. Crude ($ per bbl.)	105.76	75.67	70.64	-6.65	-33.21

Currencies	Levels			Percent Change (%)	
	6/30/2022	3/31/2023	6/30/2023	2nd Qtr	1Yr
Yen	135.72	132.86	144.31	-8.62	6.33
Sterling	1.22	1.2337	1.2703	-2.97	4.31
Euro	1.05	1.0839	1.0909	-0.65	4.05

Global Bond Markets**	Levels			US $ Terms (%)	
	6/30/2022	3/31/2023	6/30/2023	2nd Qtr	1Yr
German 10 year	1.33	2.29	2.39	0.07	2.40
Japanese 10 Year	0.23	0.33	0.39	-7.78	-5.69
UK 10 Year	2.23	3.49	4.38	-3.10	-8.67
Barclays US Emerging Market	7.17	7.36	7.53	1.12	5.64

Source: Bloomberg Financial Data
*Thomson Reuters/Jefferies CRB Commodity Excess Return Index
** Global Bonds Represented by Bloomberg Barclays Indices

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