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FINANCIAL ADVISORY GROUP LLC

Second Quarter 2023 Economic and Market Outlook

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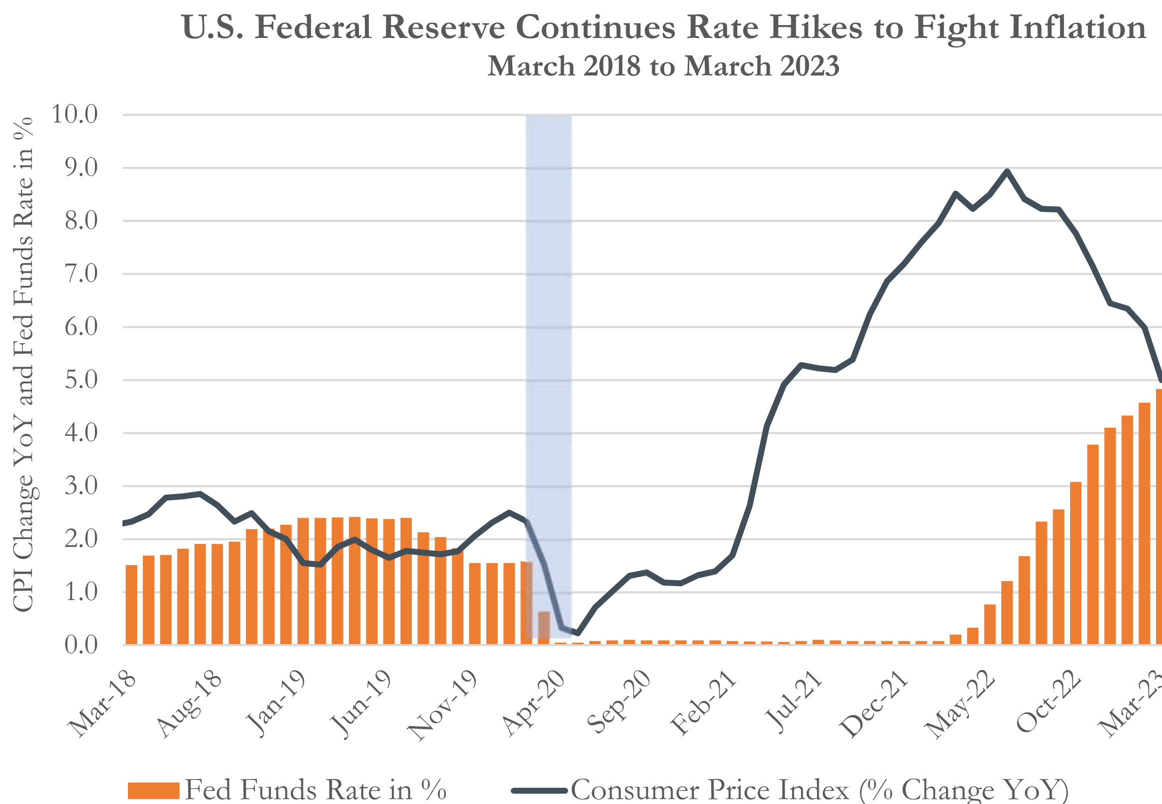
SECOND QUARTER 2023 ECONOMIC OUTLOOK

Inflation expectations and the Federal Reserve's monetary response continue to dominate global markets. After raising its main policy rate nine times in the past 12 months to a range of 4.75% - 5.0%, the end of the current hiking cycle is in sight. The most recent market expectations indicate the Fed will likely bring the rate to 5.25% before pausing, or even cutting, later this year. Importantly, the latest Fed statement did express caution about the recent banking crisis and it toned down its guidance on future tightening, signaling a departure from previous statements. Future rate moves will most likely depend on new incoming employment data and the trend in bank lending activity.

Figure 1: Fed Rate Hikes Are Making an Impact



Source: Board of Governors of the Federal Reserve System (US), Federal Funds Effective Rate [DFF] and U.S. Bureau of Labor Statistics, Consumer Price Index for All Urban Consumers: All Items in U.S. City Average [CPIAUCSL],retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/DFF, April 12, 2023.

Despite the challenges in the banking sector, the Federal Reserve's ongoing attempts to try and control stubbornly high inflation is making an impact. We've updated a chart we've used in previous communications (**Figure 1**) to show that headline inflation, as measured by the Consumer Price Index (CPI), rose just 5.0% in March 2023 from a year earlier. This continues a cooling trend that began in June of last year.

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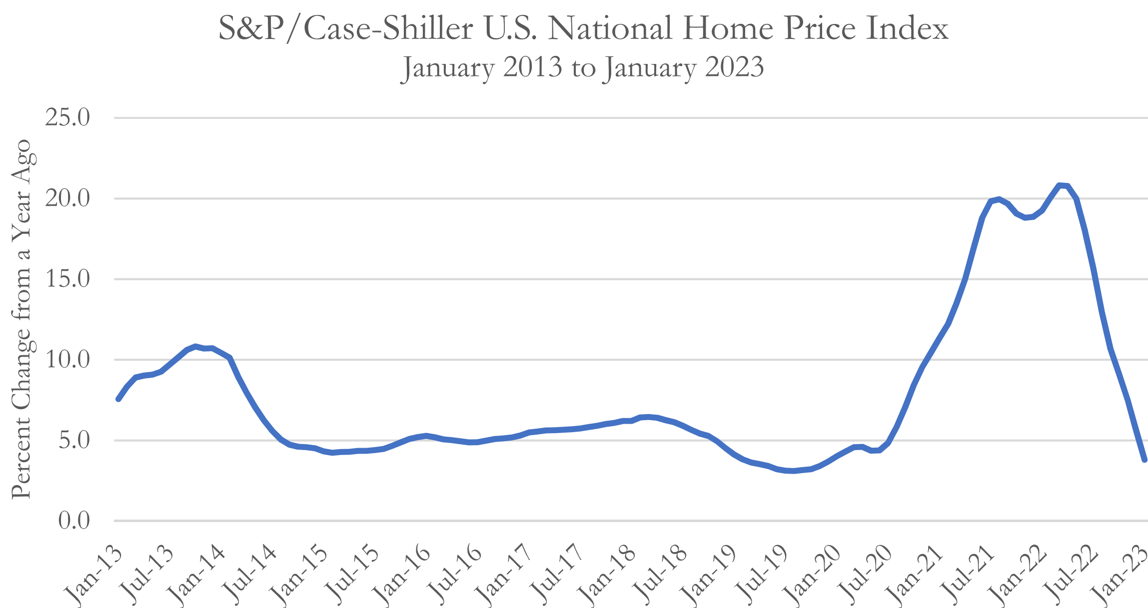
While elements of core inflation, such as housing costs, remain higher than the Fed would prefer, new market rents are softening and homeowners' costs are falling. Shelter costs represent the largest component of the Consumer Price Index and are typically slow to change given rents are negotiated only once per year. As a result, we expect inflation, as measured by both the headline and core CPI and the Federal Reserve's preferred gauge, Personal Consumption Expenditures (PCE), to continue to fall in the months ahead.

CAN THE FED ACHIEVE A SOFT LANDING?

A "soft landing" refers to the Federal Reserve's ability to bring inflation back to its target rate without a significant increase in unemployment or tipping the economy into recession. The fact that the unemployment rate remains near its historical lows even though job openings have fallen and inflation is trending lower suggests that this may actually be a possibility. However, traditional recession indicators such as the inverted yield curve (characterized by short-term bonds yielding more than long-term bonds) signal a slowdown is coming.

One of the largest components of the U.S. economy is the housing market and it is showing signs of cooling. While positive in terms of future inflation expectations, falling house prices can be considered recessionary given their negative wealth effects. Yet this recent trend should be seen in context. Record low mortgage rates and a shift to work-from-home policies during the Pandemic caused house prices to surge 20% year-over-year in 2021. Now that the economy has reopened and mortgage rates have more than doubled, house price growth has returned to more sustainable levels.

Figure 2: The Housing Market is Getting "Back to Normal"



Source: S&P Dow Jones Indices LLC, S&P/Case-Shiller U.S. National Home Price Index [CSUSHPINSA], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/CSUSHPINSA, April 18, 2023

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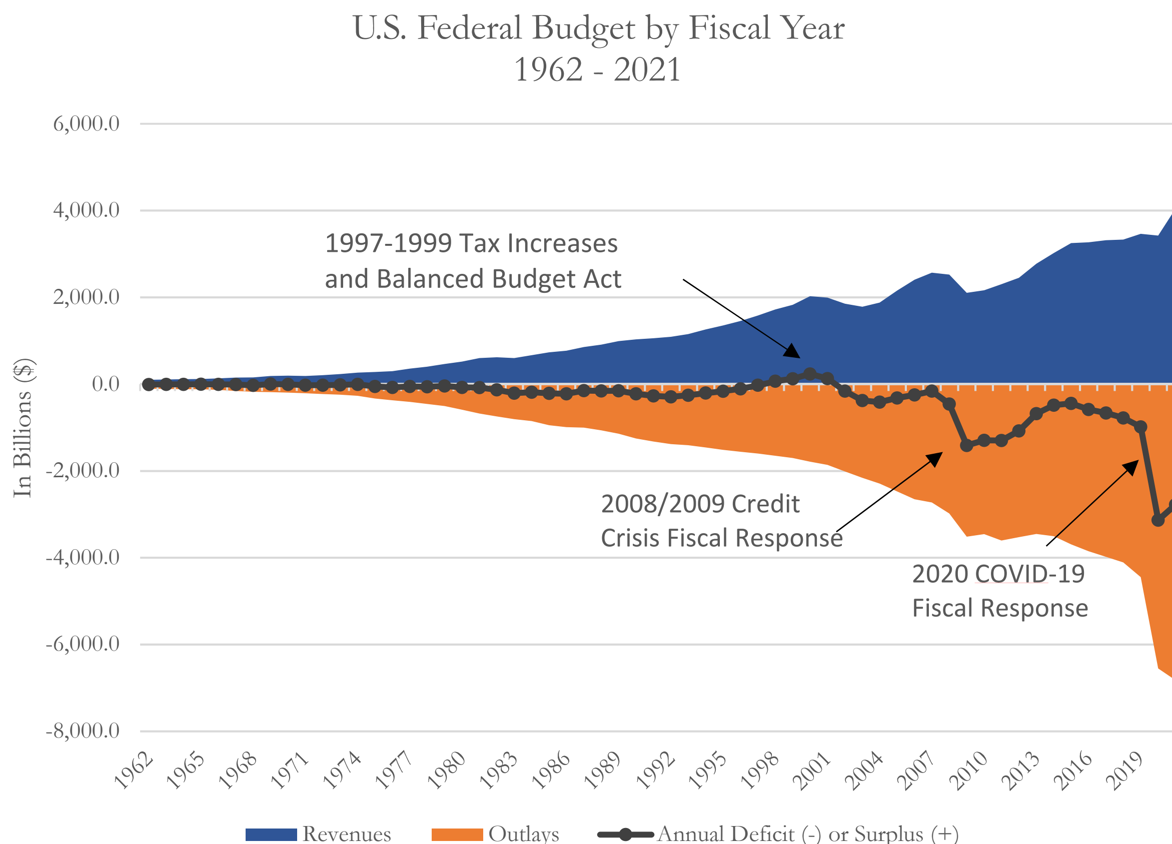
GOVERNMENT BONDS AND THE "DEBT CEILING"

Perhaps the most significant risk facing the U.S. economy after high inflation and rising interest rates is whether Congress agrees on a plan to raise the so called "debt ceiling" to avoid missing payments that are critical to keeping the government operating. According to the U.S. Department of the Treasury, the debt limit does not authorize new spending commitments. It simply allows the government to finance existing legal obligations, such as Social Security and Medicare payments, military salaries, to pay interest on the national debt and pay tax refunds that Congress and presidents of both parties have made in the past. Since 1960, Congress has acted 78 times to permanently raise, temporarily extend or revise the definition of the debt limit. We expect that despite the heightened political environment, Congress will raise the debt ceiling for the 79th time.

Figure 3: The Debt Ceiling Debate: Again



*Source: The Budget and Economic Outlook: 2022 to 2032, Congressional Budget Office May 2022. * The national debt is the accumulation of all past deficits plus the interest owed on the resulting debt. ** The Wall Street Journal, February 15, 2023*

While bond markets have been volatile, we see it as mainly a function of the Fed's attempt to normalize interest rate policy following the Pandemic and to bring inflation under control, not as a sign that the U.S. credit rating will be downgraded or that the U.S. government will default.

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OUR OUTLOOK

The debt ceiling debate will likely introduce some volatility in both stock and bond markets later this year, but we expect that the U.S. will dodge default and thus avoid a dramatic bond market sell-off. Once a deal on the debt ceiling is reached, the focus of the debate will most likely shift to how Congress will limit future discretionary spending in an effort to reduce the Federal debt.

While the Fed is trying to meaningfully slow the economy, it is not intending to trigger a recession. The latest inflation report, while encouraging, suggests that it may take longer to reach the desired 2% target, but the Fed will need to proceed with caution and take into account its effect on the recent bank collapses and risk of further financial instability. The next couple of months will determine whether or not the Fed can successfully manufacture a soft landing.

We are encouraged by the resilience in markets and remain committed to the strategic and disciplined approach by which we manage portfolios. While uncertainty can lead to volatility in the short run, it also provides opportunities to reposition to benefit in the future.

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