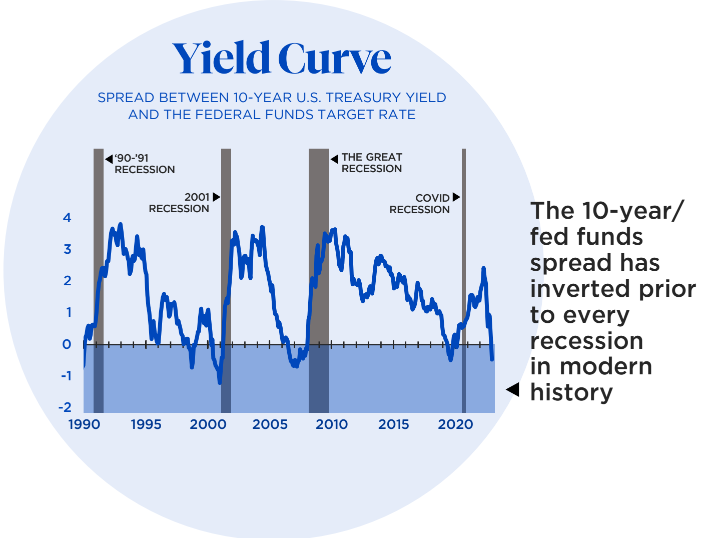
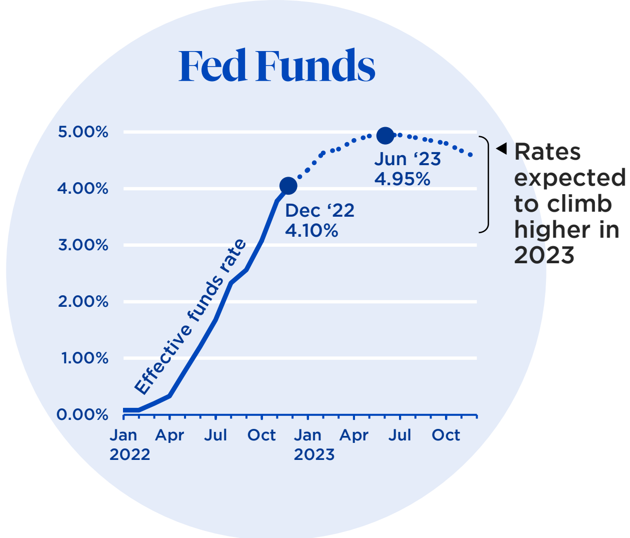
Economic & Financial Markets Monthly Review | January 2023

Slower momentum heading into 2023

Where is the economy now?

The U.S. economy is in the late cycle period with the Fed responding to rapid inflation with a sharp tightening of financial conditions to slow domestic demand. Key leading indicators (including the yield curve) point to elevated recession risks over the next year, especially with the Fed projected to raise rates further in coming months.





Where we are this month

CYCLE END GETTING CLOSER

The business cycle chart moved closer to recession territory with the Fed tightening further in mid-December.

YIELD CURVE FULLY INVERTS

The 10-year to fed funds spread dipped further negative over the past month, adding to the recession warnings from financial markets.

MORE RATE INCREASES EXPECTED

Fed officials have indicated that more rate tightening will be needed in coming months to bring inflation back to trend.

What does this mean

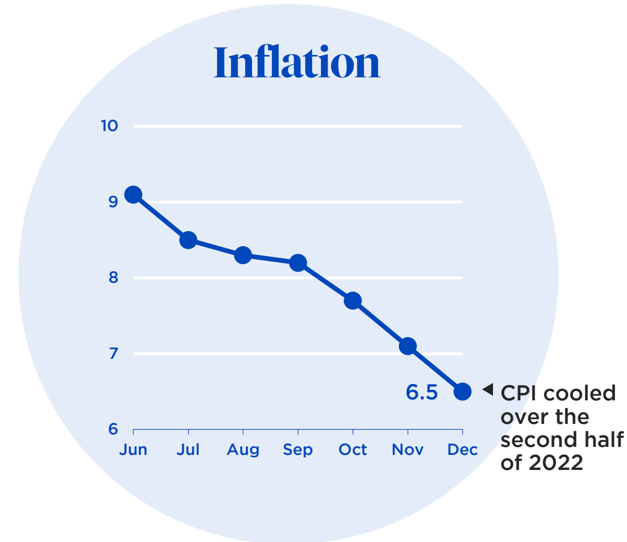
- Many key recession signals, including the yield curve and the Index of Leading Economic Indicators, are flashing red for a recession.
- While current conditions suggest continued growth in the near term, our baseline forecast now assumes that a moderate recession starts by mid-year 2023.

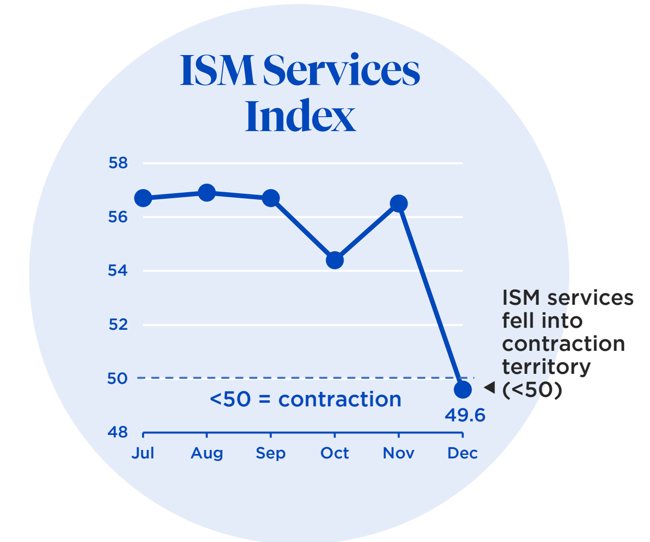
- The full yield curve has been inverted since mid-November, historically a reliable indication that a recession will begin with the next year.
- With the Fed expected to tighten further in coming months, the yield curve inversion is likely to deepen in 2023.

- Financial markets expect the fed funds rate to be around 5.0 percent by mid-year — implying about 75bps of rate hikes in coming meetings.
- The pace of rate increases could slow to 25bps per meeting, starting in early February—but there continues to be upside risk to the Fed rate outlook.

Demand for workers supports resilient labor market

Job gains were solid again in December and job openings remain very elevated, while the unemployment rate fell to a cycle low at 3.5 percent. Also, the headline inflation rate fell further in December but remains much higher than the Fed's two percent inflation target.





Where we are this month

SOLID JOB GAINS FOR DECEMBER

Nonfarm payrolls grew by 223,000 in December as demand for workers by employers continues to run high.

INFLATION COOLS FURTHER

The CPI was weaker again in December, dropping the 12-month change to 6.5 percent — the lowest reading since October 2021.

SERVICES FALL INTO CONTRACTION

The ISM services index plummeted in December to record its first contractionary reading since May 2020.

What does this mean

- With labor supply still highly constrained, wage growth remains much higher than usual — supporting spending by households.
- There was a drop in average weekly hours during December as firms cut back on expenses, which could be a precursor to slower (or negative) job growth ahead.

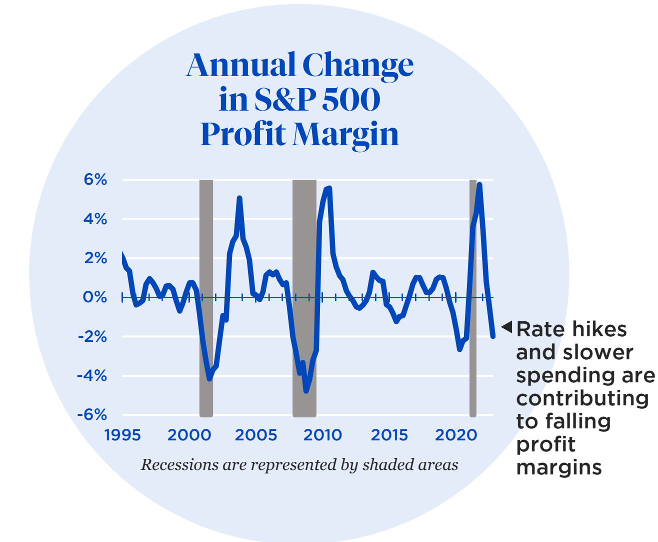
- Falling energy and commodity prices, as well as healing supply chains, have slowed consumer inflation from its mid-2022 peak.
- But costs for housing and services remain hot and could keep inflation elevated through 2023 — with lingering upside risks from disruptions to global supply (i.e. – China Covid opening).

- New orders are now shrinking as high interest rates and rapid inflation for essential items lower consumer demand for services.
- The slip into contraction for the service sector follows recessionary signals from housing and manufacturing over the second half of 2022.

Financial Market Review

Nervousness about 2023 increases investor anxiety

2022 provided investors with no place to hide. Long treasuries fell by nearly 30 percent while equities flirted with a bear market for much of the year. Profit margins slumped to end 2022, another ominous sign for equity market performance and recession odds for 2023.



Where we are this month

MARKETS RETREAT INTO YEAR END

The S&P 500 index fell by nearly six percent as worries about fourth-quarter earnings and slower growth ahead gripped the market.

INTEREST RATES CLIMB HIGHER

The yield on the 10-year Treasury note finished 2022 at almost 3.9 percent, more than 230bps higher than the beginning of the year.

PROFIT MARGINS UNDER PRESSURE

As we enter 2023, firms' pricing power is waning as consumer demand – especially for goods – has cooled.

What does this mean

- The market bounced by almost eight percent during the fourth quarter on rising hopes that cooling inflation may help the Fed to engineer a soft landing for the economy.
- The S&P 500 index ended 2022 just shy of bear market territory with a 19.4 percent decline — the worst annual performance since 2008.

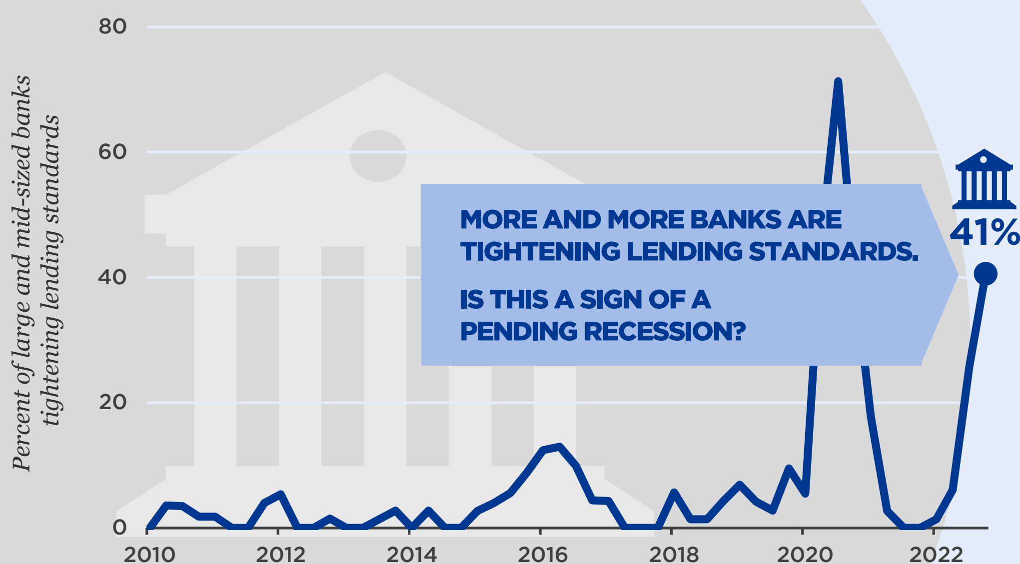
- Fed hawkishness following the December FOMC meeting boosted short-term rates to almost 4.5 percent, close to October's high.
- Inflation protected securities beat Treasuries for the third straight year, achieving a nearly five percent annualized outperformance.

- Inflation's rapid rise provided firms cover to increase prices as wage growth lagged.
- The recent retreat in profit margins is an ominous sign for earnings growth which could slow to a crawl while the topline reels from the impact of slowing consumer spending.

Outlook

A cautious outlook for 2023

After a year in which the inflation rate shot up to its highest level in more than four decades and the Federal Reserve aggressively tightened monetary policy in response, there is reason to be cautious about the outlook for 2023. In fact, there have already been several tell-tale signs of a coming recession, as short-term interest rates have moved above long-term rates, bank lending standards have tightened, and consumer expectations have fallen well below current conditions sentiment. Still, the ongoing strength in the labor market suggests that an outright contraction is not yet imminent while solid household and corporate balance sheets hint that any downturn this year is unlikely to be particularly severe. After the prolonged decline of 2007-09 and the lockdown-fueled standstill of 2020, the year ahead could well be marked by the first garden-variety recession in more than two decades.



2023 Economic Outlook CLICK HERE 12 min

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Latest Forecast

Data as of January 2023

	2021 ACTUAL	2022 ESTIMATE	2023 FORECAST	2024 FORECAST	2025 FORECAST
REAL GDP	5.7%	2.1%	0.5%	0.5%	2.1%
UNEMPLOYMENT RATE	5.4%	3.6%[a]	4.4%	5.3%	4.6%
INFLATION (CPI)	6.7%	7.3%	3.8%	2.6%	2.3%
TOTAL HOME SALES	6.89	5.70	4.85	5.15	5.50
S&P/CASE-SHILLER HOME PRICE INDEX	18.9%	6.2%	0.0%	2.5%	3.0%
LIGHT VEHICLE SALES	14.9	13.8[a]	14.6	15.4	16.2
FEDERAL FUNDS RATE	0.00%	4.25%[a]	5.00%	3.50%	2.50%
5-YEAR TREASURY NOTE	1.26%	3.99%[a]	3.90%	3.30%	2.90%
10-YEAR TREASURY NOTE	1.52%	3.88%[a]	3.70%	3.20%	3.10%
30-YEAR FIXED-RATE MORTGAGE	3.11%	6.42%[a]	5.90%	4.85%	4.40%
MONEY MARKET FUNDS	0.14%	2.27%[a]	4.97%	4.09%	2.90%

[a] = Actual

2023 recession likely

A moderate recession should start in mid-2023 as the sharp Fed tightening drives job cuts and lower consumer spending into 2024.

Inflation to moderate

Consumer inflation should slow over 2023-24 as supply chains heal further but rising costs for labor and services should keep readings above trend.

Rates higher over 2023

The Fed is expected to tighten further with a terminal fed funds rate in the 5.00-5.25 percent range. Since the Fed is unlikely to ease until 2024 to ensure that inflation slows to trend, long-term interest rates should remain elevated over much of 2023 before declining late in the year and into 2024.

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