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U.S. ECONOMIC & INTEREST RATE OUTLOOK

IN THIS ISSUE

- **Expeditious**

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The most rapid portion of the recovery is behind us, but the U.S. economy is still in high gear. Job openings are plentiful, wages are rising, and consumers are still willing to spend. However, persistent inflation and the policy response to it are raising fears that economic momentum may soon run out.

The Federal Reserve has gone from being humble to nimble to expeditious in recent months. At the May meeting, it ramped up its fight against inflation and vowed to continue to do so at pace. Markets have underperformed as they digest this new Fed orientation: Interest rates have marched higher and equities lower over the past few weeks. Unlike the previous tightening cycle, the speed of this recovery has taken away the Federal Reserve's option to hike rates gradually and deliberately.

The risk of a hard landing this year is low. But tighter monetary and fiscal policy, coupled with lasting supply-side bottlenecks, could dampen next year's growth prospects.

Key Economic Indicators

	2022				2023				Q4 to Q4 change		Annual change	
	22:1a	22:2f	22:3f	22:4f	23:1f	23:2f	23:3f	23:4f	2022f	2023f	2022f	2023f
Real Gross Domestic Product (% change, SAAR)	-1.4	3.4	2.7	2.5	2.1	2.2	2.1	1.9	1.8	2.1	2.7	2.3
Consumer Price Index (% change, annualized)	9.2	7.8	4.9	3.1	2.7	2.6	2.5	2.4	6.2	2.5	7.4	3.3
Civilian Unemployment Rate (%, average)	3.8	3.5	3.3	3.3	3.3	3.4	3.4	3.5			3.5*	3.4*
Federal Funds Rate	0.16	0.78	1.78	2.33	2.84	2.88	2.88	2.88			1.26*	2.87*
2-yr. Treasury Note	1.44	2.74	3.07	3.30	3.43	3.44	3.44	3.44			2.64*	3.43*
10-yr. Treasury Note	1.94	2.95	3.20	3.40	3.50	3.50	3.50	3.50			2.87*	3.50*

a=actual
f=forecast
*=annual average

Influences on the Forecast

- Real gross domestic product (GDP) in the first quarter surprised to the downside, contracting 1.4% on an annualized basis. A large trade deficit proved to be the biggest drag on growth, alongside slower inventory accumulation. But the rest of the report showed an otherwise healthy economy. High inflation didn't dampen consumer spirits, as spending increased at a 2.7% annualized rate, led by a shift from goods to services. Business and residential investment also grew nicely.
- Inflation may have finally peaked, after reaching its highest rate in four decades. The headline consumer price index (CPI) increased at a slower monthly pace in April, as energy prices reached a plateau. However, the core measure gained more

momentum. Airfares jumped 18.6%, in April driven by higher fuel prices and continued demand from reopening. Measures of shelter costs are elevated and are likely to stay firm throughout the year. On the other hand, supply-driven inflation of goods may be cooling, at least for now.

We expect a gradual descent in inflation, amid lingering supply bottlenecks, tight labor markets and strong corporate pricing power.

- Payroll growth continued at a robust pace with 428,000 jobs created in April, keeping the unemployment rate steady at 3.6%. Wage growth remains elevated, rising 5.5% over April 2021, the second highest rate since the pandemic-related surge in the spring of 2020. The estimated count of the labor force fell slightly, after a year of strong growth, leveling off near its pre-COVID size. We think strong labor demand and waning financial buffers will drive workers back into the labor force.
- After signaling greater urgency to act, the Federal Reserve raised the overnight interest rate by 50 basis points, the first half percentage point increase since 2000. Persistent inflation is now seen as the biggest risk to the economy and employment. As a result, two more hikes of the same magnitude in the June and July meetings are almost certain. We expect tightening will continue into the first quarter of 2023, ending at a rate range of 2.75-3.00%.
    - The Fed announced the start of its balance sheet runoff. Starting in June, a portion of the central bank's holdings of Treasuries and mortgage-backed securities will not be reinvested at maturity, reaching a steady rate of $95 billion per month in September. No end date or target balance sheet size has yet been determined.
- Treasury yields continue to rise amid elevated inflation and looming quantitative tightening. The selloff in the long-end of the Treasury market accelerated further, with the 10-year yield rising above 3.00% temporarily. Yields are likely to continue to increase in the near term, but slower growth and lower inflation will limit further ascent.
- The housing market remains hot, with the inventory of houses available for sale dropping to a four-decade low and prices continuing to increase. Resilient demand will continue to provide support to the market, but the strength is unlikely to sustain. Higher mortgage rates and home values are eroding affordability, which will weigh on sales in the coming months. These factors are likely to take some steam out of price and rent increases, both influential to inflation.