GPA GOVERNMENT PORTFOLIO ADVISORS

Weekly Economic Update—March 27th, 2023

Despite a paucity of fresh economic data, it was hardly a quiet week in the financial markets. Both stocks and bonds hopped on a roller-coaster and the only good thing is that the ride has not veered off the rails – at least not yet. There clearly was no paucity of instigators for the bumpy journey, most of which stoked the upheaval before the week began. The failure of a few regional banks was the initial spark, sending the markets into a tizzy over contagion fears and how the Federal Reserve would react to the growing uncertainty. The Fed was in the traditional "quiet period" before a scheduled policy-setting meeting when the banking problems erupted, so investors had to wait until this week to get answers.

Unsurprisingly, the Fed's response generated widely divergent opinions in the financial markets. The fractious reaction was not so much aimed at what the Fed did, but what it expects to do. Hiking the federal funds rate by a quarter-percentage point to a range of 4.75% to 5.0% taken at this week's FOMC meeting was generally expected, although many thought that the Fed should have left rates unchanged given the uncertainty over the headline-grabbing banking panic. From the Fed's point of view, tackling both the needs of the economy and the liquidity problems facing the banks was something it was well equipped to do, and one should not obviate action on the other. We agree with that judgement as refusing to increase its policy rate – which was widely expected to range between a quarter and a half-point before the banking panic surfaced – would have signaled an abandonment of the inflation fight and undercut the Fed's credibility.

Simply put, the Fed put its multi-tasking skills to work by tethering the rate hike with the promise of providing whatever liquidity troubled banks might need through both the conventional discount window as well as a new bank term funding vehicle that provides loans for up to one year to banks, savings associations, credit unions and other depository institutions who pledge Treasury securities and other qualifying assets as collateral. What's more, the new facility values these assets at par, not at the sharply reduced market prices caused by surging interest rates over the past year. Hence, the securities do not have to be sold at a loss to meet deposit withdrawals, which mitigates the solvency issues that plagued the banking system during the 2008 financial crisis. Although bank borrowing at the lending facilities swelled over the past two weeks, the financial support and assurances to safeguard the financial system by the Fed and Treasury Department injected a note of stability into the markets.

But while market participants accepted the quarter-point increase, the ninth hike in consecutive meetings over the past year, without too much fuss, they are in total disagreement with the Fed's intentions going forward. In his post-meeting press conference, Fed chair Powell strongly suggested that at least one more rate hike is likely, as inflation is running far too hot amid a still robust labor market. Indeed, despite the turmoil and uncertainty over the fall-out from the banking stress, Fed officials made no change in their outlook for the federal funds rate at the end of the year compared to the last set of quarterly projections made in December. According to the new Summary of Economic Projections (SEP) released after the meeting, the median rate is expected to rise to 5.1 percent at year-end, the same as December. What's more, the expected rate for next year was raised, from December's 4.1 percent forecast to 4.3 percent.

A key takeaway from the SEP is that the Fed does not expect to cut rates this year, which aligns with its expectation that inflation will run hotter this year and next than thought In December. Ironically, the Fed is willing to keep its foot on the brakes even as it lowered its expectation for GDP growth, suggesting that it is willing to accept more economic pain for the sake of bringing inflation under control. For the financial markets, however, this scenario is hardly what to expect. Instead of believing in the Fed's steadfast commitment to stay the course, investors are betting that the central bank will be cutting rates – and cutting them soon. The contrast with the Fed's forecast couldn't be more stark, as the fed funds futures market is

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pricing in a funds rate of under 4 percent by the end of the year as of Friday morning. The huge gap between the Fed's 5.1 percent and the market's 3.85 percent year-end forecast reflects the latter's expectation of much weaker economic conditions in coming months than is assumed in the SEP forecast of GDP, which will require a much swifter rate-cutting response from the Fed.

Importantly, Powell indicated in the press conference that upcoming rate hikes would be steeper if not for the tightening of financial conditions brought about by the banking stress. He readily admits that the financial aftershocks, including most notably the reduced availability of credit as banks turn more conservative in their lending practices, are unknown. He did, however, note that the more restrictive conditions could have the same growth-retarding impact as would a quarter or half-point increase in the federal funds rate. We should point out, however, that banks have been tightening the lending screws since late last year, as indicated by recent Senior Loan Officer Surveys conducted by the Fed. Keep in mind that the latest survey, which shows that more than 35 percent of banks were tightening lending standards in the first quarter, was taken in February, before the banking problems surfaced.

From our lens, the recent banking difficulties do not pose a systemic threat to the financial system and the markets are pricing in more economic damage and Fed rate cuts that are likely to take place. With inflation running well above the Fed's 2 percent target and slow to recede amid a still-tight job market that is putting upward pressure on wages, we expect two more rate hikes before the Fed moves to the sidelines in June. No doubt, the rate hikes already put in place are starting to have their intended effects, but it is believed that the Fed will stay on this course until something breaks and drives a stake in the inflation dragon. So far, the economic contour is bending but it is a ways from breaking.

Case in point is capital spending. Just as companies are hoarding labor in the wake of widespread worker shortages over the past year, they are not yet slashing capital budgets, perhaps fearful they will be caught short of capacity if the next rebound in activity echoes the surprising post-pandemic surge that left companies scrambling for goods. Among this week's light data calendar, the Commerce Department reported that orders for nondefense capital goods less aircraft rose 0.2 percent in February following an upwardly revised 0.3 percent increase in January. Total orders have leveled off in recent months, but at historically high levels; the February volume hit a new record.

That said, we expect capital spending to reach a breaking point soon as the headwinds from tighter credit conditions and the most aggressive rate-hiking campaign since the 1980s take a toll on activity, weakening both the willingness and financial capacity of companies to absorb the high financing cost of sustaining outlays. The looming slowdown in capital spending will follow a similar downshifting in consumer demand and lead the economy into a mild recession over the second half of the year. However, the downturn should not be deep enough to spur the Fed into a rate-cutting pivot until next year, when more visible signs of disinflation come into focus.

FINANCIAL INDICATORS

INTEREST RATES	Mar 24	Week Ago	Month Ago	Year Ago
3-month Treasury bill	4.65	4.40	4.82	0.54
6-month Treasury bill	4.71	4.65	5.11	0.97
3-month LIBOR	5.13	4.96	4.96	0.97
2-year Treasury note	3.78	3.83	4.80	2.28
5-year Treasury note	3.41	3.51	4.21	2.55
10-year Treasury note	3.78	3.43	3.95	2.48
30-year Treasury bond	3.65	3.63	3.93	2.60
30-year fixed mortgage rate	6.42	6.60	6.50	4.32
15-year fixed mortgage rate	5.68	5.90	5.76	3.63

STOCK MARKET				
Dow Jones Industrial Index	32,237.53	31,861.98	32,816.92	34,861.24
S&P 500	3,970.99	3,916.64	3,970.04	4,543.06
NASDAQ	11,823.96	11,630.51	11,394.94	14,169.30

COMMODITIES				
Gold ($ per troy ounce)	1,981.00	1,993.70	1,818.00	1,954.60
Oil ($ per barrel) - Crude Futures (WTI)	69.20	66.33	76.45	112.62

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/ Quarter	Two-Months/ Quarters Ago	Average-Past Six Months or Quarters
New Home Sales (February) - 000s	640	633	622	603
Existing Home Sales (February) - 000s	4,580	4,000	4,030	4,308

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