STONEBRIDGE
Capital Advisors

Stonebridge Economic Outlook
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Overview

Inflation in the second half of 2022 will remain well above the Federal Reserve's (Fed's) target of 2 percent but well below the torrid pace in the first half of the year. Based on reported data through August and assuming a 0.3 percent advance in September, it looks as if the overall consumer price index (CPI) will increase less than 6 percent at an annual rate in the third quarter versus 10.5 percent in the second quarter. Although still elevated, inflation is expected to trend downward further in the fourth quarter of this year and into next year. A downward trend in core CPI inflation (excluding the volatile food and energy components) is also expected but may be far less dramatic.

In the press release following its September meeting, the Federal Open Market Committee (FOMC) announced it had raised "the target range for the federal funds rate to 3 to 3-1/4 percent and anticipates that ongoing increases in the target range will be appropriate." Following the same meeting, the FOMC also released its annual economic projections from 2022 to 2025 and over the longer run, including its median estimate of the federal funds rate target. According to these estimates, the FOMC expects the federal funds rate to end 2022 at 4.4 percent, up considerably from the current level of about 3.2 percent. It would be very unusual if the Fed followed through with another 125 basis points of rate hikes this year. After all, there are only two more policy meetings scheduled for this year, November 1-2 and December 13-14, suggesting that the FOMC hike its federal funds rate target another 75 basis points at one of the meetings and 50 basis points at the other.

One reason to be skeptical of the Fed hiking another 125 basis points in the fourth quarter is that it is an election year. The midterm elections clearly have not stopped the Fed from hiking rates this year (they never do), but they could alter the timing of rate hikes in the fourth quarter. In election years, the FOMC generally prefers to front-load their actions, which may be what they tried to do by hiking the federal funds rate target by 75 basis points at each of the last three policy meetings. After all, given that the impact of monetary policy on the economy operates with a considerable lag, at some point the Fed will want to assess the impact of the rate hikes already implemented. There is no policy meeting in October, and the November meeting is scheduled to be held the week before the midterm elections, suggesting that the Fed may wait until the December meeting for its next rate hike. That said, hiking the funds rate in December may not be "appropriate" either because of the holidays. In other words, any further rate hikes by the Fed this year will need overwhelming evidence to justify.

The consensus seems to be that the only way the Fed can slow inflation is to push the economy into a recession. Indeed, some contend that we are already in one. After all, a widely accepted definition of a recession is two consecutive quarterly declines in real gross domestic product (GDP), which is what happened in the first half of this year. Proponents of this view argue that it is just a matter of time before the Business Cycle Dating Committee of the National Bureau of Economic Analysis (NBER) makes it official. I am not convinced. Based on the NBER's website, real GDP is not a statistic they typically use to determine whether we are in a recession but rather to help them time the recession once it is reflected in the data they do consider. A close examination of the NBER's business cycle data does not support the recession scenario, at least not yet. However, no hard and fast rule determines a recession, so anything goes. Of course, the preferred outcome is for inflation to slow without a recession or a so-called "soft landing." Although the Fed has a lousy record of achieving such an outcome following a policy tightening episode, in the absence of any missteps in fiscal policy, the Fed may have a chance to do it this time.

The views expressed here reflect those of Daniel E. Laufenberg, Ph.D. as of the date noted and not necessarily those of Stonebridge Capital Advisors. They may change as economic fundamentals and market conditions change. This commentary is provided as a general source of information only and is not intended to provide investment advice for individual investor circumstances. Past performance does not guarantee future results.

Table 1
U.S. Economic Forecast

	2022 Q1	2022 Q2	2022 Q3F	2022 Q4F	2021	2022F	2023F
Real Gross Domestic Product	-1.6	**-0.6**	**1.6**	**1.8**	5.7	**0.3**	1.2
Consumer Price Index, All	9.2	**10.5**	**5.6**	**4.6**	6.7	**7.5**	2.7
Consumer Price Index, Core	6.5	**6.6**	**6.5**	**4.4**	5.0	**6.0**	2.8
GDP Chain-Type Price Index	8.3	**9.0**	**4.3**	**3.0**	6.1	**6.2**	2.2
Civilian Unemployment Rate	3.8	3.6	3.6	3.5	4.2	3.5	4.0
Price of WTI crude oil ($/bbl)	95.2	108.8	**95.2**	**90.1**	77.4	**90.1**	91.5
Trade-Weighted Dollar	115.6	119.1	**122.6**	120.0	115.0	120.0	115.0
S&P 500 Operating Earnings	49.4	**46.9**	53.8	57.2	208.2	**207.3**	209.5
Percent vs. Year Ago	4.1	**-10.0**	3.4	0.8	64.6	**-0.4**	1.1
91-Day Treasury Bill Rate	0.3	0.9	2.7	3.4	0.1	3.4	2.8
10-Year Treasury Note Yield	2.0	2.8	3.1	3.7	1.5	3.7	3.4
30-Year Mortgage Rate	3.8	5.3	5.5	6.5	3.2	6.5	5.5
Bank Prime Rate	3.3	3.9	5.7	6.4	3.2	6.4	5.8

Sources: Bureau of Economic Analysis, Bureau of Labor Statistics, Standard and Poor's, Federal Reserve Board, Department of Energy, and Federal Home Loan Mortgage Corporation.

Annual changes in real gross domestic product (GDP) and all measures of inflation are percent changes from the fourth quarter of the previous year to the fourth quarter of the year indicated. The annual estimates of the unemployment rate, the price of crude oil, the trade-weighted dollar and all interest rates are averages for the last quarter of the year indicated. S&P 500 operating earnings per share are for the period indicated.

Quarterly changes in real GDP and all measures of inflation are percent changes from the previous quarter at annual rates. For the unemployment rate, the price of crude oil, the trade-weighted dollar and all interest rates, quarterly estimates are averages for the quarter indicated. S&P earnings are per share for the period indicated. Trade-weighted dollar is the new broad index from the Federal Reserve Board.

f-forecast; bold type reflects a major change from the previous forecast.

Inflation

Over the first two quarters of 2022, the consumer price index (CPI) surged, and real gross domestic product (GDP) declined. This was far different from the forecast at the start of the year. Inflation was expected to remain high for all of 2022, just not as elevated as it was in the first half. Moreover, strong nominal GDP growth was expected to be more than enough to accommodate inflation, resulting in moderate real GDP growth. Although nominal GDP growth was far stronger than expected in the first half, it was entirely due to surprisingly higher prices.

A particularly disturbing aspect of the latest inflation data was just how stubbornly high core CPI inflation (CPI less food and energy) has been over the last twelve months, climbing 6.3 percent. An examination of the details suggests that the rise in core inflation has been widespread across both goods and services. Core goods prices climbed 7.1 percent over the year ended in August, and core services prices rose 6.1 percent over the same period.

Homeowners' equivalent rent, representing more than 30 percent of core CPI inflation, was up 6.3 percent over the last year ending in August, well above its average of 2.9 percent at an annual rate for the ten years ending in 2021. This component of shelter costs is a derived service item, which means that it does not reflect the actual out-of-pocket costs of homeownership but the cost to homeowners if they had to rent their houses. As actual rents go up, homeowners' costs go up, and as rents go down, homeowners' costs go down. For the first half of 2022, the rent of primary residents rose an average of 6.3 percent annually. Not surprisingly, homeowners' equivalent rent essentially kept pace, rising an average of 5.8 percent. That said, housing demand traditionally is very interest sensitive, suggesting that the surge in mortgage rates so far this year will slow housing demand. However, it is not until households lose their jobs (and income) that mortgages become problematic and defaults rise.

Chair Jerome Powell is emphatic that the Federal Reserve is committed to fight high inflation. There is little reason to doubt him, which is why inflation will likely slow over the next six quarters. However, it is unclear whether the Fed should get all the credit or should even be expected to do it alone. To the extent that it was supply disruptions due to the pandemic, geopolitical sanctions, or labor shortages that caused a large part of the upside surprise to prices in the first half, then any relief from such disruptions could contribute markedly toward easing inflation pressures.

Unfortunately, correcting such supply disruptions will take time. The pandemic needs to end, global energy markets need to adjust to the Russian invasion of Ukraine, and labor needs to become more productive. Monetary policy contributes very little to any of these, suggesting that any progress by the Fed to ease inflation likely will fall short of the Fed's long-term inflation target of 2 percent. Contrary to comments by various market participants, the Fed is not trying to engineer a recession, which would cause people to lose their jobs and income. The goal of the Fed is to slow demand growth to give businesses time to adjust production to offset the adverse effects of supply disruptions.

The supply disruptions due to the pandemic have eased but have not been eliminated. For example, light-weight vehicle sales totaled 13.2 million annualized in August, up from its pandemic low of 8.6 million in April 2020 but still down from the pre-pandemic pace of 16.9 million. The inability of motor-vehicle companies to produce enough vehicles to meet demand reportedly is due to a shortage of computer chips. My personal experience of purchasing a new vehicle this year provides anecdotal evidence.

The outlook for inflation is that the overall CPI will rise 5.1 percent at an annual rate in the second half, down from its torrid 9.8 percent surge of the first half. Moreover, core CPI, which excludes the volatile food and energy components of the index, is expected to slow to 5.5 percent at an annual rate in the second half from 6.2 percent in the first half. Clearly, the lower level of both overall and core inflation in the second half is still well above the 2.0 percent target but at least they would be moving in the right direction.

Second-Half Real GDP Bounce

According to the Bureau of Economic Analysis, second-quarter real GDP declined 0.6 percent at an annual rate, following a decline of 1.6 percent in the first quarter. Both were much weaker than expected earlier in the year. Interestingly, the two consecutive quarterly declines of real GDP were due to unusual weakness in sectors other than personal consumption expenditures (PCE). Real PCE increased in the first and second quarters of 2022 at annual rates of 1.3 percent and 2.0 percent, respectively. It was substantial weakness in other sectors of the economy that caused real GDP to decline. In particular, it was a sharp drop in net exports that detracted from real GDP in the first quarter and a dramatic slowdown in the accumulation of business inventories that was the primary detractor from real GDP in the second quarter.

Although some weakness in these other sectors was expected, the momentum in the data early in the second quarter suggested that real PCE growth would be more

than enough to offset it. That momentum disappeared with the revisions to the April data and continued throughout the remainder of the quarter. More importantly, such a deceleration in the second quarter makes a strong surge in third-quarter real PCE unlikely. Based on the latest data, real PCE is on track to grow 1.0 percent at an annual rate in the third quarter. Since real PCE accounts for about 70 percent of real GDP, a growth rate of 1.0 percent will contribute about 0.7 of a percentage point to real GDP growth in the third quarter and probably not much more in the fourth quarter. Since real GDP is expected to grow 1.6 percent at an annual rate in the third quarter and 1.8 percent in the fourth quarter, real PCE growth alone will not be enough, and other sectors will be adding rather than detracting from real GDP.

First, net exports, which were a massive drag on real GDP in the first half due entirely to a plunge in the trade balance in the first quarter, are expected to improve solidly in the second half, possibly adding as much as a full percentage point to real GDP growth. Second, real government spending on goods and services, which detracted 0.4 of a percentage point from real GDP on average in the first half, is expected to add a bit on average in the second half. This uptick in spending should occur mostly at the federal level.

Third, the change in business inventories, which detracted 1.1 percentage points from real GDP growth over the first half of the year, is still expected to detract from real GDP growth in the second half but only 0.2 of a percentage point. Finally, any drag on growth from residential investment in the second half of the year is expected to be offset by a slight uptick in nonresidential fixed investment as companies spend on equipment and technology to boost labor productivity in the face of very tight labor markets.

Productivity gains will be extremely important to growth in the second half, given that a plunge in productivity accounted for all the decline in real GDP in the first half. For example, real output in the nonfarm business sector in the second quarter was up 1.8 percent from the same quarter a year earlier, the same gain as shown in real GDP. Interestingly, the increase in nonfarm output was due to a 4.2 percent increase in hours worked more than a 2.4 percent decline labor productivity (output per hour worked). In fact, nonfarm business labor productivity dropped 4.1 percent in the second quarter, following a plunge of 7.4 percent in the first quarter. Assuming that labor productivity improves to its trend growth rate of roughly 1.0 percent at an annual rate and hours worked increase another 0.7 percent in the second half, the result would be an upturn in real output of roughly the same 1.7 percent.

The bottom line is that real GDP in the second half of the year is now expected to increase an average of 1.7 percent at an annual rate versus the average decline of 1.1 percent for the first half. As shocking as it may seem, real growth of 1.7 percent may still be above the U.S. potential growth rate when operating at full employment. The reason for this may be a bit opaque. As noted earlier, changes in real output can be characterized as the sum of the changes in hours worked and labor productivity. When the economy is operating at full employment, which it is at the moment, hours worked will grow only as fast as the labor force, assuming everyone who wants a job has a job. The demographics are not very favorable for hours worked to continue to increase as fast as they did over the last year. Hence, a gain in real output going forward, even the modest gain expected in the second half of the year, will require some productivity improvement. Of course, one way to improve productivity existing firms is to stop adding workers, which some reportedly have already started to do. Under such circumstances, new jobs come from new business formations, which may be threatened by the prospect of a recession. The Fed's job of managing monetary policy to fight inflation while avoiding a recession is never easy.

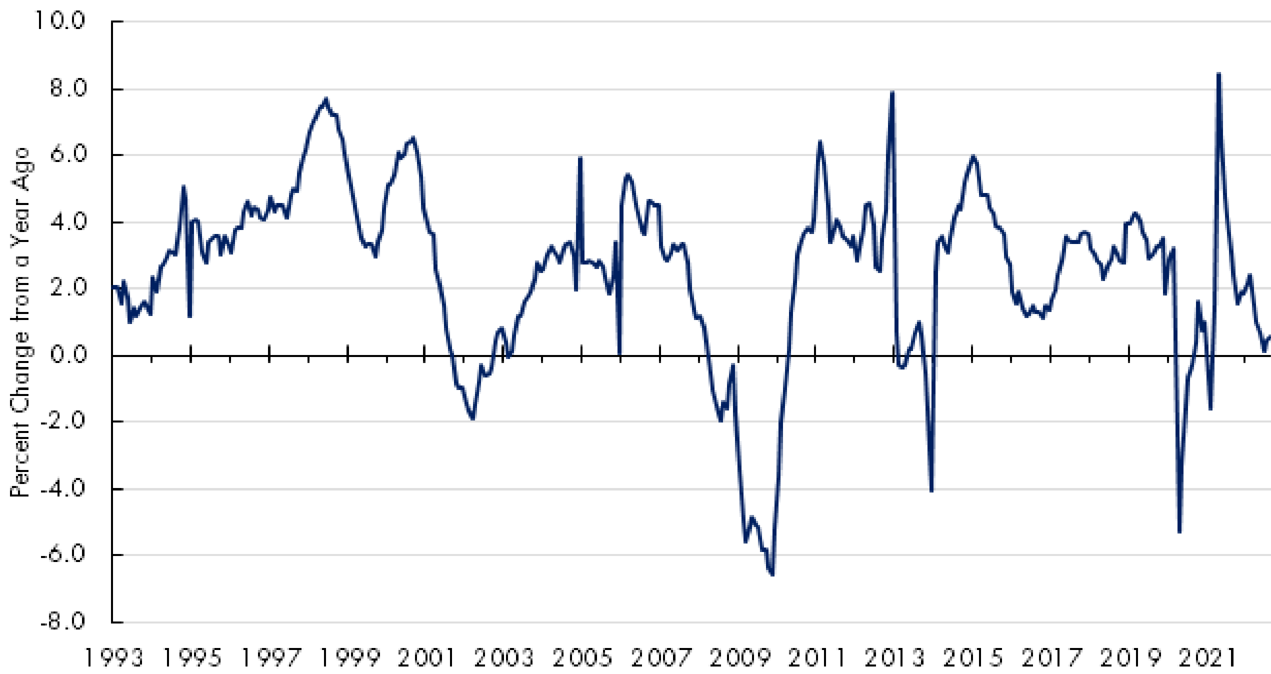
Chart 1
Real Personal Income Less Transfers
Percent Change from a Year Ago
10.0
8.0
6.0
4.0
2.0
0.0
-2.0
-4.0
-6.0
-8.0
1993 1995 1997 1999 2001 2003 2005 2007 2009 2011 2013 2015 2017 2019 2021
Source: U.S. Bureau of Economic Analysis, as retrieved from FRED, Federal Reserve Bank of St. Louis.

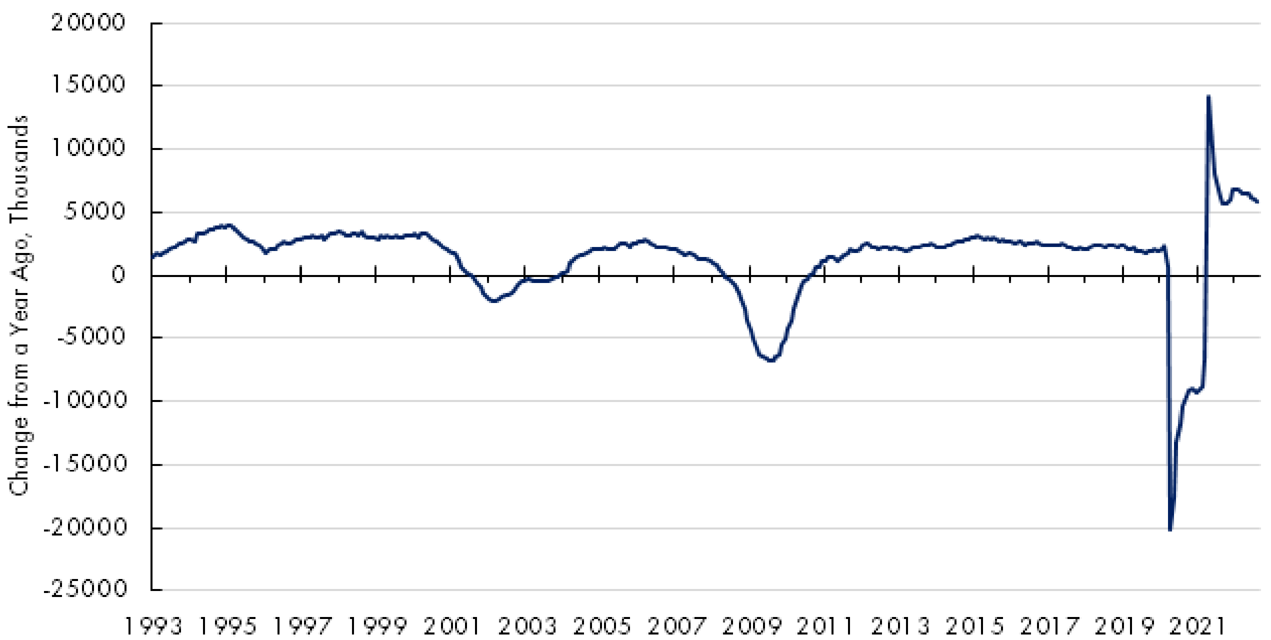
Chart 2
Nonfarm Payroll Employment
Change from a Year Ago, Thousands
20000
15000
10000
5000
0
-5000
-10000
-15000
-20000
-25000
1993 1995 1997 1999 2001 2003 2005 2007 2009 2011 2013 2015 2017 2019 2021
Source: U.S. Bureau of Labor Statistics, as retrieved from FRED, Federal Reserve Bank of St. Louis.

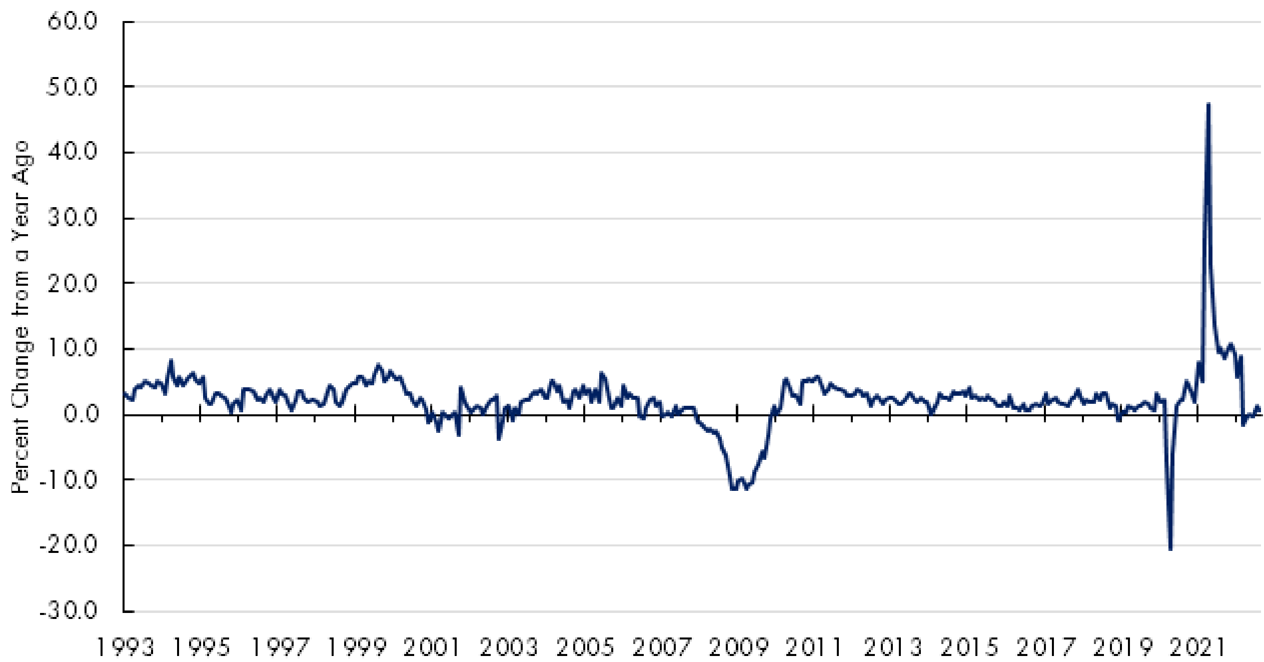
Chart 3
Retail Sales Adjusted for Price Changes
60.0
50.0
40.0
30.0
20.0
10.0
0.0
-10.0
-20.0
-30.0
Percent Change from a Year Ago
1993 1995 1997 1999 2001 2003 2005 2007 2009 2011 2013 2015 2017 2019 2021
Source: U.S. Census Bureau, as retrieved from FRED, Federal Reserve Bank of St. Louis.

Chart 4
Industrial Production
20.0
15.0
10.0
5.0
0.0
-5.0
-10.0
-15.0
-20.0
Percent Change from Year Ago
1993 1995 1997 1999 2001 2003 2005 2007 2009 2011 2013 2015 2017 2019 2021
Source: Board of Governors of the Federal Reserve System, as retrieved from FRED, Federal Reserve Bank of St. Louis.

Timing the Business Cycle

Are we in a recession? The Business Cycle Dating Committee of the National Bureau of Economic Research (NBER) will tell us but usually well after the fact. This Committee of eight academic economists rely on a range of monthly measures of aggregate real economic activity to determine the months of peak and trough in the business cycle. According to the NBER, the measures "include real personal income less transfers (PILT), nonfarm payroll employment, real personal consumption expenditures, wholesale-retail sales adjusted for price changes, employment as measured by the household survey, and industrial production. There is no fixed rule about what measures contribute information to the process or how they are weighted in its decisions." As shown in Charts 1-4, the monthly data considered by the NBER suggest retail sales growth but do not signal that the U.S. economy is in a recession. However, there is nothing in the data to preclude a recession in the near future. As history shows, the economic situation can change quickly.

Also, from the NBER website of Frequently Asked Questions, there are several reasons why two consecutive quarters of decline in real GDP do not always relate to the NBER's recession dates. "First, the NBER does not identify economic activity solely with real GDP, but consider a range of indicators. Second, we consider the depth of the decline in economic activity. The NBER definition includes the phrase, 'a significant decline in economic activity.' Thus real GDP could decline by relatively small amounts in two consecutive quarters without warranting the determination that a peak had occurred. Third, our main focus is on the monthly chronology, which requires consideration of monthly indicators. Fourth, in examining the behavior of production on a quarterly basis, where real GDP data are available, we give equal weight to real GDI [gross domestic income]. The difference between GDP and GDI—called the 'statistical discrepancy'—was particularly important in the recessions of 2001 and 2007–2009." That is, it declined in both real GDI and real GDP which identified the start of these two recessions. Over the two quarters of the first half of 2022, real GDP fell 1.1 percent at an annual rate but, real GDI grew 0.4 percent. It appears that the two consecutive quarterly declines in real GDP alone are not enough to influence the NBER to officially declare the first half of 2022 to be a recession.

Historically, financial assets do not do well in an inflationary environment, so the latest slump in stock and bond prices should be no surprise. The reason is that inflation tends to lead to higher interest rates and wider credit spreads. Stock prices are discounted values of future earnings, using whatever the discount rate is at the time. Assuming stable earnings per share, higher interest rates would cause stock prices to fall. The same is true of bonds, where the coupon payments are fixed. Higher market interest rates mean that the market value of future fixed income from outstanding bonds will fall. Hence, stock and bond prices decline in response to anything suggesting that interest rates are going higher. On the other hand, stock and bond prices rise in response to anything suggesting that interest rates are going lower. The stock market seems to be in a very broad trading range and likely will remain there until the economic consequences of the Fed's policy actions are clearer.

If recession is the outcome, then the trade-off between corporate equities and U.S. Treasury obligations may be reinstated. The drop in economic activity will erode corporate earnings and in turn stock prices. However, a weaker economy will encourage investors to look for the safety of U.S. Treasury obligations. On the other hand, if a soft landing is engineered, interest rates should fall in response to lower inflation expectations but not to a weak economy. In this case, the Fed is far less aggressive about lowering rates than it would be in a recession.

Clearly, the worst-case scenario for financial assets would be stagflation, which is the combination of high inflation and weak growth similar to what happened in the first half of this year. While a sustained period of stagflation cannot be totally discounted, it remains very unlikely. The problem is that the potential growth rate for real output in the U.S. is so low that it will look at times, very similar to stagflation. Improving productivity remains the key to solving inflation, providing sustainably higher wages, raising living standards, and building profits.