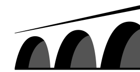

STONEBRIDGE
Capital Advisors

Stonebridge Economic Outlook

March 2nd, 2023

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Overview

In market economies like the U.S., cycles of expansions followed by recessions are a fact of life. For that reason, it is reasonable to anticipate another recession. Exactly when the current expansion will end in recession and why are unclear. I contend that expansions die of shock rather than old age. In that regard, the last time the Federal Reserve orchestrated a recession with higher interest rates alone was the so-called "Volcker Shock" of 1979-82. Although the Fed could shock us again with higher rates, it may be more difficult in today's world of policy transparency. After all, interest rate hikes by the Fed are advertised in advance, removing much of the shock effect by the time they are implemented.

Indeed, each of the last four U.S. recessions (1990, 2001, 2008, and 2020) was caused by a shock other than higher interest rates alone. In 1990, Iraq's invasion of Kuwait shocked an already slowing U.S. economy into a recession. The cause of the 2001 recession is probably the most obscure, given that only in the revised data did it apparently start in connection with the collapse of the "dot-com bubble" (artificially optimistic earnings estimates owing to accounting missteps) rather than the shock of the September 11 terrorist attacks. In 2008, a collapse in home prices and the corresponding mortgage defaults were clearly the shock that caused that recession. The more recent 2020 recession was the result of the shocking economic response to the COVID pandemic. The implication is that forecasting a recession may require forecasting a shock. The problem is that if I knew what might shock the economy into a recession, it would not be shocking.

In the absence of some exogenous shock to the economy, a more restrictive monetary policy still could trigger a recession, but it would require the Fed to do something really shocking. The Volcker Shock involved the Fed announcing that it was no longer using the federal funds rate as a policy tool. Instead, the Fed announced it would target the money supply by using a narrow measure of bank reserves as its tool. By switching to a money supply target, Volcker effectively deflected the political criticism for allowing interest rates to climb to historically extreme levels. Whenever Volcker was criticized by Congress for allowing rates to be so high, he would respond by saying that the Fed no longer targeted interest rates, that the Fed was targeting money supply, and would let markets decide the appropriate level of interest rates. As a result, the federal funds rate climbed to a shockingly high 22 percent in late 1980, well above the peak in inflation of 14.6 percent in April of that year. It worked, but it took a while. Inflation over the next 40 years was relatively benign, until recently, of course. Although 22 percent may not be needed this time to be shocking, a federal funds rate substantially higher than 5.5 percent may.

Fed officials have long bragged that they know how to fight inflation because of their successful defeat of inflation in the 1980s. That is true, but they may have underestimated the pain needed to win that fight on their own. The only way to forecast a recession in 2023 without predicting a shock other than interest rates is to assume that Fed policy will be shockingly restrictive. This means that the Fed raises interest rates higher and keeps them higher for longer than most expect. Recent data on jobs, consumer spending, and inflation increase the likelihood of monetary policy doing more in 2023. In fact, some Fed officials have already suggested the need for the federal funds rate to increase further and faster than assumed earlier this year.

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Table 1
U.S. Economic Forecast

	2023f						
	Q1	**Q2**	**Q3**	**Q4**	**2022**	**2023f**	**2024f**
Real Gross Domestic Product	1.9	0.8	-0.1	-1.4	0.9	0.3	1.5
Consumer Price Index, All	4.6	4.7	4.4	4.0	7.1	4.4	3.0
Consumer Price Index, Core	4.7	4.5	4.4	4.0	6.0	4.4	2.8
GDP Chain-Type Price Index	4.3	4.2	4.0	3.8	6.4	4.0	2.6
Civilian Unemployment Rate	3.4	3.5	3.6	4.5	3.6	4.5	5.2
Price of WTI crude oil ($/bbl)	76.5	78.6	82.5	79.4	82.8	79.4	80.0
Trade-Weighted Dollar	119.5	120.0	116.2	115.0	124.8	115.0	116.0
S&P 500 Operating Earnings	49.2	46.4	41.3	38.4	200.0	175.3	204.0
Percent vs. Year Ago	-0.3	-1.0	-18.0	-23.0	-3.9	-12.4	13.5
91-Day Treasury Bill Rate	4.8	5.2	5.6	5.8	4.2	5.8	3.5
10-Year Treasury Note Yield	3.8	4.1	4.5	4.6	3.8	4.6	4.2
30-Year Mortgage Rate	6.4	6.6	6.8	6.8	6.7	6.8	6.2
Bank Prime Rate	7.8	8.2	8.6	8.8	6.8	8.8	6.5

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.

The forecast is that economic activity, as measured by real gross domestic product (GDP), will continue through the first three quarters of 2023 at an increasingly subdued pace before contracting moderately in the fourth quarter. In other words, a recession is expected to start late this year because monetary policy will be shockingly more restrictive than the consensus now seems to expect. Over the four quarters of 2023, real GDP is now expected to grow a mere 0.3 percent, a pace that is even slower than the anemic 0.9 percent increase over the four quarters of 2022 (see Table 1). Assuming that the potential growth rate for the U.S. economy is roughly 1.0 percent, an actual growth rate less than the potential over the four quarters of 2023 should lead to a higher unemployment rate by the end of the year. Of course, an exogenous shock to the economy is still possible, which would remove the need for the Fed to be excessively restrictive for as long as shown in the forecast.

Consumer price inflation will certainly slow on a year-ago basis, especially in view of the sharp slowdown in consumer inflation in the third quarter of last year.

Nevertheless, consumer price inflation for 2023 is expected to remain elevated at levels well above the Federal Reserve's target of 2.0 percent, forcing the Fed to do more in its fight against inflation. The primary reason will be further advances in service inflation, given the ongoing tightness of the labor market, combined with a mild upturn in goods inflation as the Chinese economy attempts to reopen. Stubbornly high inflation and slow but positive real output growth are expected to galvanize Fed policymakers to push interest rates higher for longer.

A Surprisingly Strong Start to 2023

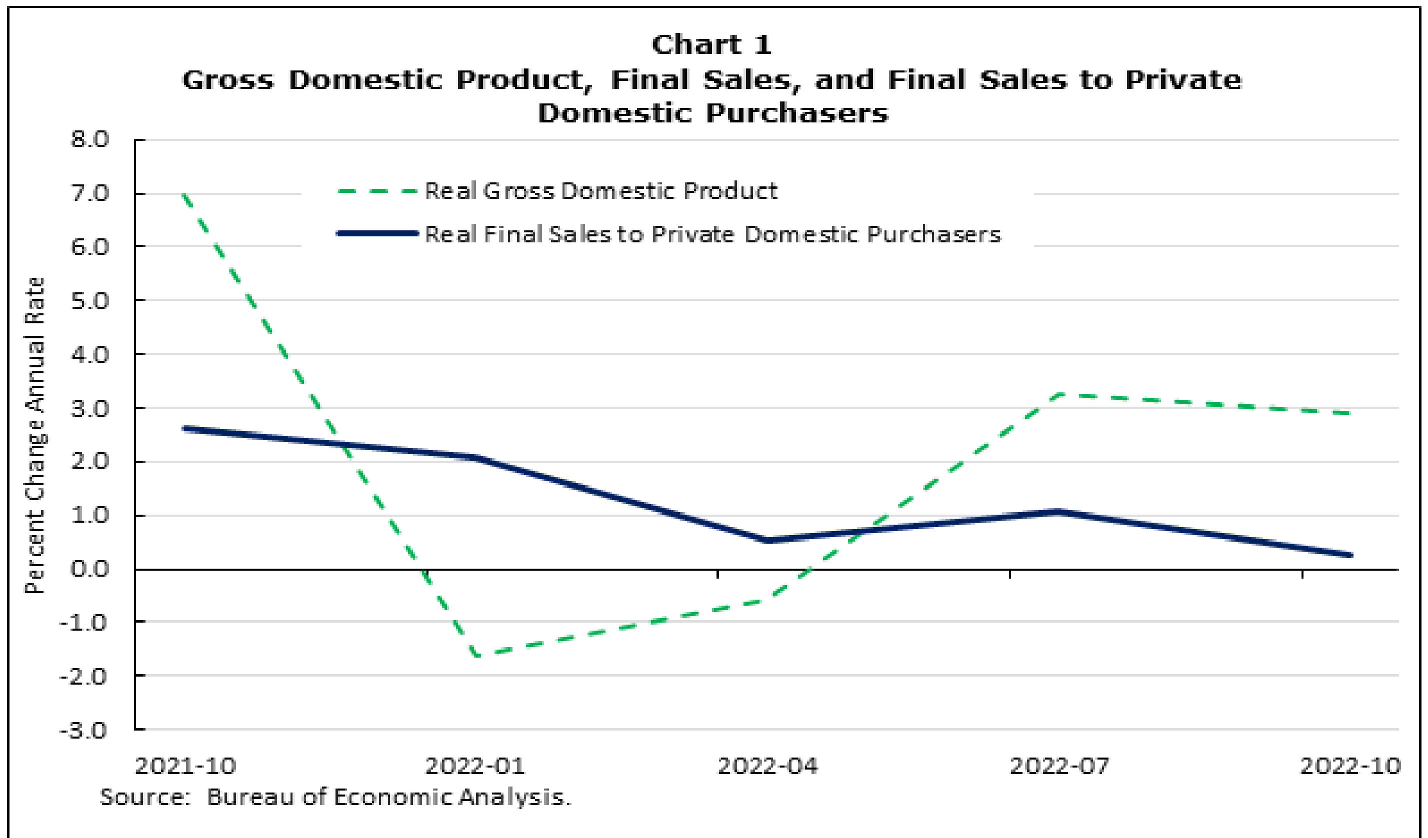
In January, financial markets were relatively sanguine about the outlook for consumer price inflation and monetary policy, given that the S&P 500 index climbed over 10 percent, peaking on Feb. 2, the day after the Fed had decided to raise its federal target range by only 25 basis points. In particular, investors were very excited about Federal Reserve Chair Jerome Powell recognizing the obvious in his press conference following the Fed's January policy meeting on Feb. 1 - that consumer price inflation slowed in the second half of 2022. The market interpreted this recognition as tantamount to the Fed admitting that inflation had slowed enough that policymakers were finished or nearly finished hiking interest rates. Yet, in the official statement following the policy meeting, it was clear that the Fed was not finished and that more rate hikes were planned.

Investor excitement about the future course of inflation and monetary policy changed in February. It started with the January employment report released in early February. According to the Bureau of Labor Statistics (BLS), payroll jobs jumped 517 thousand on a seasonally adjusted basis in January, which revived talk of the Fed engineering a soft landing for the economy. However, the jump in payroll jobs was due to the large seasonal factor used to adjust the estimate. Nonfarm payroll jobs in January actually fell 2.5 million on a not seasonally adjusted basis. It is common for seasonal payroll jobs to plunge in January, as businesses lay off temporary workers hired for the holidays. However, 517 thousand more payroll jobs in January suggest that the seasonal layoffs were considerably less than normal. This could mean fewer jobs will be available in the months ahead, especially if real final sales slow further. The key will be whether real final sales slow further and why.

Also in January, retail sales and real personal consumption expenditures (PCE), both measures of consumer spending, jumped 2.3 percent and 1.1 percent, respectively. Retail sales are not adjusted for inflation and represent a narrow segment of consumer spending. Real PCE is adjusted for inflation and is a far broader measure of consumer spending. More importantly, credit did not drive spending in January; income did. In January, real personal disposable income surged 1.4 percent, raising income to a level that was up a stellar 6.7 percent at an annual rate from the fourth-quarter average.

The inflation data for January caused another stir among investors. According to the Bureau of Labor Statistics, the consumer price index (CPI) rose 0.5 percent in January, more than expected and well above the 0.1 percent advance in December. This was the first step in shaking investor confidence that the Fed was near the end of its rate hikes. Investor confidence was shaken further by the Bureau of Economic Analysis reporting that the PCE price index rose 0.6 percent in January, also above expectations and its largest monthly gain since the 1.0 percent increase in June 2022. I contend that the Fed will not only raise rates further, but probably hike them far more than most now expect.

Effectiveness of Monetary Policy Questioned



The value of all final goods and services produced in the U.S. adjusted for inflation, which is real GDP, grew 1.0 percent over the four quarters of 2022, down markedly from 5.7 percent over the four quarters of 2021. For the most part, real GDP growth last year was a story of two halves, declining at an average annual rate of 1.1 percent in the first half while expanding at an average annual rate of 3.0 percent in the second half. Russia's invasion of Ukraine in February caused crude oil prices to surge and global supply-chain disruptions due to COVID to magnify. This combination elevated consumer price inflation to levels not seen in nearly half a century and contributed markedly to the first-half weakness in real GDP. In the second half, adjustments to crude oil supply, as well as easing of supply-chain disruptions, helped lower consumer price inflation and contributed to a solid rebound in real GDP. Indeed, the quarterly growth rates of real GDP provided little evidence that the Federal Reserve's tighter monetary policy last year had much of an adverse effect on aggregate demand.

Nevertheless, monetary policy may have had its desired effect on the economy, but the special circumstances of war and supply disruptions distorted it. This may be seen more clearly in real final sales to private domestic purchasers, a narrower measure of aggregate demand. Chart 1 plots the quarterly growth rates of real GDP and real final sales to private domestic purchasers for 2022. As shown in the chart, the quarterly growth rate for real GDP, which ended 2021 at a solid pace, dropped into negative territory in each of the first two quarters of 2022 but rebounded again to a rate of about 3.0 percent in each of the final two quarters. There was very little indication in the quarterly growth rates of real GDP that the aggressive tightening of monetary policy slowed aggregate demand last year.

On the other hand, the quarterly growth rates of real final sales to private domestic purchasers trended lower over the four quarters of the year. It is defined as real GDP, excluding the change in inventories, net exports, and

government spending. This narrower measure of aggregate demand shown in Chart 1 focuses on the purchase of final goods and services by private sector entities regardless of where the goods and services were produced. The inference from this data series is that monetary policy may have been more effective at slowing aggregate demand last year than shown in the broader measure of real GDP.

I suspect that the above-trend growth rate of real GDP in the second half of last year, along with the easing of consumer price inflation over the same period, raised the hopes of many analysts that the Federal Reserve was going to successfully reduce inflation without a recession. Although it could happen, I doubt it. The more likely outcome is that if above-trend growth continues, inflation will reaccelerate, creating even more problems for monetary policy and the Fed. At first blush, the January inflation data reported hints at such an acceleration recently.

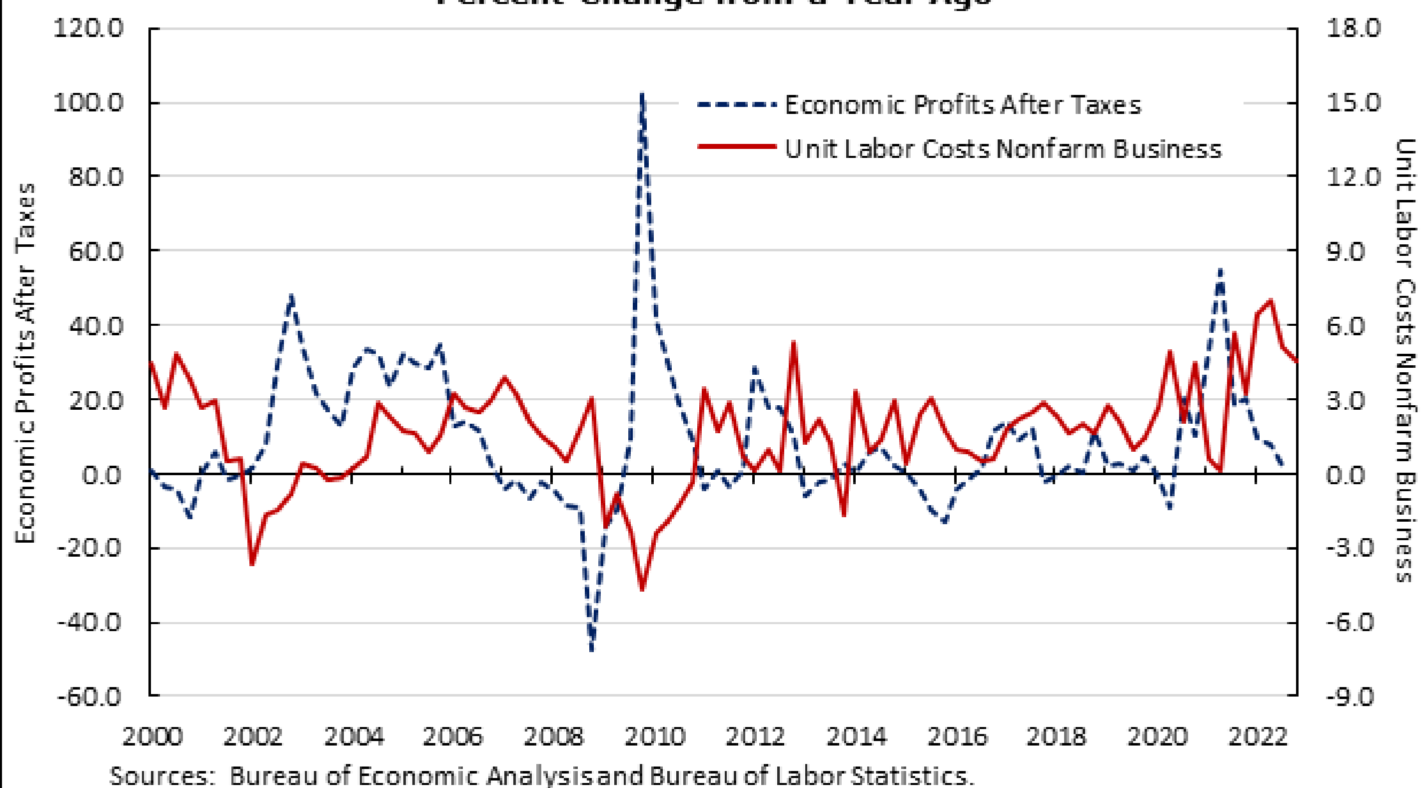
The forecast for real GDP growth in 2023 assumes further weakness in private sector demand but this time without the sharp swings in inventories, net exports, or government spending. As a result, real GDP will more closely reflect private sector demand. This raises the question: in the absence of an exogenous shock, what will the Fed need to do to get real final sales to private domestic purchasers, shown in Chart 1, to continue its downward trend? I suspect it is a great deal more rate hikes than are widely considered at the moment.

It is unclear whether the economy will slow enough to induce the National Bureau of Economic Research (NBER) to declare it a recession. The key to the NBER's decision most likely will be how much of an impact the slowdown will have on employment. Although the unemployment rate is expected to rise in 2023, the increase is expected to be muted somewhat by the impact of demographics on labor. In any event, the U.S. economy will feel like it is in a recession even if the NBER does not agree.

Unit Labor Costs and Corporate Profits

In 2022, the stock market went through several short-term gyrations, reflecting changing sentiments about inflation and monetary policy. The S&P 500 stock price index moved more than 10 percent on 7 different occasions in 2022, three times up and four times down, ending 2022 at a level down 19.4 percent from a year earlier. Expect more of the same in 2023. The stock market will likely not break out of this pattern until the profit outlook becomes clearer. In this regard, even if not an economic recession, real growth may be slow enough that it will cause a profit recession, causing a substantial stock market correction. An upside surprise to growth is being discounted because it would most likely result in inflation remaining elevated longer, leading to even higher interest rates. Keep in mind that the NBER is very slow about officially timing the business cycle. For example, it is not unusual for the recession to be over or nearly over by the time the NBER gets around to telling us about it.

One statistic used to anticipate corporate profits is unit labor costs, which captures many of the factors of profitability. Unit labor costs represent the labor cost of producing a unit of real output, which is labor compensation per hour divided by productivity (output produced per hour). When unit labor costs rise, profit margins tend to fall, driving corporate profits lower, and vice versa. Unit labor costs generally rise because compensation per hour increases faster than productivity.



As shown in Chart 2, the percent changes from a year ago in both unit labor costs and corporate profits tend to vary considerably over time. However, there seems to be an inverse relationship between the two; that is, when unit labor costs trend up, corporate profits trend down. This was the case in 2021-22. Assuming that unit labor costs continue to rise at an above average pace in early 2023, corporate profits likely will slow further, probably turning negative on a percent change from a year ago basis in the second quarter. Of course, higher prices will soften the impact of higher unit labor costs on profit margins but could have an adverse effect on real output and gains in productivity, forcing businesses to reduce payroll and labor costs in an effort to maintain profit margins.

The bottom line is that if the economy slows as much in 2023 as expected, it probably will be due to the Federal Reserve pursuing a far more restrictive monetary policy than what is currently being considered. Indeed, it will need to be shockingly restrictive. Such an economic recession will likely lead to a profits recession as well. Falling profits will not only hit equity prices, but they will also entice businesses to reduce costs, which typically translates into a smaller workforce. Under these conditions, employment slows considerably, including an outright decline; the unemployment rate rises, although maybe not as much as the loss of output would normally deliver; inflation will slow but not without bouts of resurgence and concern; and interest rates will climb to much higher levels than the consensus now expects and will remain elevated far longer. In some ways, the current situation is more similar to the 1970s inflation experience than the consensus or policymakers are willing to admit. The implication is that to restore price stability, the Fed may need to pursue a policy stance similar to a "Volcker Shock" to succeed.