STONEBRIDGE
Capital Advisors

Stonebridge Economic Outlook
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Overview

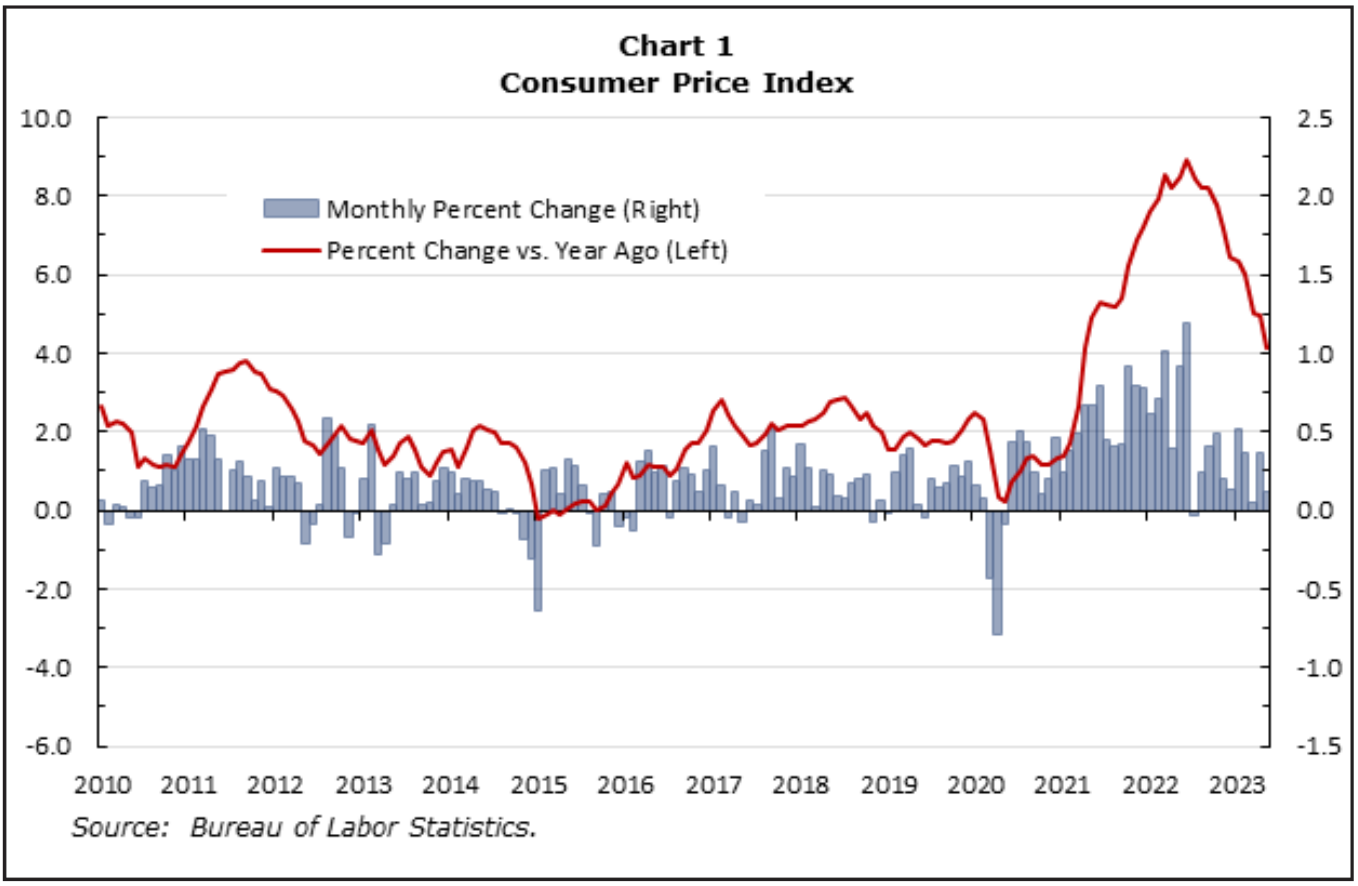
Economic activity, as measured by real gross domestic product (GDP), grew at a relatively soft 2.0 percent annual rate in the first quarter of 2023, after a mere 0.8 percent increase over the four quarters of 2022. Real GDP growth for all of 2023 is projected to remain soft. The question is whether it will be soft enough to subdue inflation. At first blush, the outlook for real GDP growth over the remainder of the year, combined with the sharp deceleration in consumer price inflation so far this year, increases the likelihood of the always elusive soft-landing for the U.S. economy. The proponents of a soft landing were encouraged further by the expectation of the Federal Reserve keeping its target range for the federal funds rate steady at 5.0-5.25 percent at its June policy meeting. The hope was that it would mark the end of its recent tightening cycle. Although the Fed acted as expected, it upset the soft-landing scenario by suggesting that additional rate hikes might be needed before inflation is subdued. This was most obvious in the policy committee's forecast for the federal funds rate to end this year at 5.6 percent, suggesting two more rate hikes of 25 basis points each.

Apparently, inflation may not be as easily subdued as the soft-landing scenario implies. In particular, real final sales of domestic product (real GDP excluding the change in business inventories) grew at a solid 3.4 percent annual rate in the first quarter. The 3.8 percent jump in real personal consumption expenditures accounted for the bulk of the strength in real final sales, due in large part to the 7.8 percent increase in real disposable income in the first quarter. Apparently, the 8.2 percent cost-of-living increase to Social Security benefits in January accounted for much of the increase in consumer income. Excluding government benefits, real disposable income grew a scant 0.3 percent at an annual rate in the first quarter. The softness in real GDP growth in the first quarter was due primarily to the dramatic slowdown in the accumulation of business inventories, which detracted 2.1 percentage points.

In the second quarter, real final sales growth is unlikely to be as robust as it was in the first quarter, but still expected to be positive. Consumers have the means, both in terms of income and balance sheet, to promote real spending growth in the second quarter. Moreover, it is very unlikely that the change in business inventories will detract from real GDP growth again in the second quarter. In fact, the forecast is for a slight restocking of business inventories to provide a mild boost to real output growth. The result should be real GDP growth of 1.5-2.0 percent at an annual rate in the second quarter. Although not stellar, real GDP growth likely will be better than in the first quarter and probably enough to maintain upward pressure on inflation in the near term.

In the second half of the year, inflation is still likely to be stubbornly elevated as consumers continue to tolerate higher prices. Not until the fourth quarter will consumers exhaust their means to maintain spending, especially if the Fed hikes interest rates further. More consumer debt at a higher interest expense will put pressure on household budgets, forcing them to slow spending growth at some point. Some market participants are encouraged by the recent jump in consumer credit as evidence that banks are lending and consumers are spending. I interpret this jump in credit as the beginning of the final phase of the monetary tightening cycle, as consumers use credit to offset the loss of real income due to wages not keeping pace with prices. Obviously, such a strategy to maintain real consumer spending cannot endure forever.

Hence, what happens to inflation in the second half of the year, as measured by the consumer price index (CPI), is key to the outlook. As shown in Chart 1, which plots the monthly percent change of the CPI (bars) and the year-over-year percent change in the CPI (line), inflation has slowed markedly since early last year. The percent change in the CPI from a year ago was 4.1 percent in May, sharply lower than the 8.9 percent



increase in June 2022. When the June 2023 data are released mid-July, the monthly percent change in the CPI is unlikely to match the 1.1 percent spike in the CPI registered in June of last year. As a result, CPI inflation in June, as measured from a year ago, is expected to slow to 3.4 percent.

What happens to the monthly inflation data beyond June will be key to what happens to interest rates over the remainder of the year. At the moment, I expect monthly percent changes in the CPI to remain elevated by pre-pandemic standards, resulting in the percent change in the CPI from a year ago to reaccelerate in the second half of this year from its anticipated low of 3.4 percent in June.

The assumption underlying the inflation outlook is that real aggregate demand growth, despite its sluggishness, is still expected to outpace the U.S. economy's potential to produce goods and services. Although global supply disruptions may have eased, the ongoing shortage of skilled workers and the disappointing trend in labor productivity growth impose a severe constraint on the economy's potential output. Under such circumstances, demand growth need not be robust to put upward pressure on price inflation. This implies that a recession may be the only way to achieve the Fed's target of lowering inflation to 2 percent.

Table 1
U.S. Economic Forecast

	2023						
	Q1	**Q2f**	**Q3f**	**Q4f**	**2022**	**2023f**	**2024f**
Real Gross Domestic Product	2.0	1.6	0.7	-0.6	0.8	0.9	1.5
Consumer Price Index, All	4.6	3.5	4.4	4.0	7.1	4.4	3.0
Consumer Price Index, Core	4.7	5.2	4.3	4.0	6.0	4.4	2.8
GDP Chain-Type Price Index	4.1	3.3	4.0	3.8	6.4	3.8	2.6
Civilian Unemployment Rate	3.4	3.5	3.7	3.9	3.6	3.9	5.2
Price of WTI crude oil ($/bbl)	76.5	74.0	75.0	75.0	82.8	75.0	80.0
Trade-Weighted Dollar	120.3	119.4	118.2	115.0	124.8	115.0	116.0
S&P 500 Operating Earnings	52.5	50.4	49.0	44.0	197.0	195.9	204.0
Percent vs. Year Ago	6.4	7.5	-2.7	-12.6	-5.4	-0.6	13.5
91-Day Treasury Bill Rate	4.8	5.1	5.5	5.7	4.2	5.7	3.5
10-Year Treasury Note Yield	3.8	3.6	3.9	4.2	3.8	4.2	4.0
30-Year Mortgage Rate	6.4	6.5	6.7	7.0	6.7	6.8	6.2
Bank Prime Rate	7.8	8.2	8.6	8.8	6.8	8.7	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.

Potential real GDP is the measure of the output the economy can produce at full employment without putting upward pressure on prices. Potential output growth is essentially the sum of the growth rates of total hours worked and labor productivity. When the economy operates at full employment, the potential growth of hours worked is determined primarily by labor force growth. There is very little debate about this aspect of the measure. However, the potential increase in labor productivity is often a topic of discussion. For example, the total hours worked in the business sector in the first quarter of this year were up 2.0 percent from a year earlier, while productivity of business workers fell 0.6 percent over the same period. Real output of the business sector over the year ending in the first quarter was 1.5 (1.47) percent. Real GDP grew 1.6 percent over the same period.

What is the potential growth rate for the U.S. economy over the next few years? First, the labor force has grown at a 1.5 percent pace over the year ending in May but that is unlikely to be sustained. A more likely expectation is for the labor force to grow less than 1.0 percent over the next year, given that the bulk of the new entrants into the labor force has been foreign-born workers. The native-born component of the labor force increased a mere 0.7 percent over the last year.

On the other hand, a sharp upturn in worker productivity could offset the lack of workers. Unfortunately, there is nothing on the horizon to suggest productivity will improve dramatically this year or the next. Productivity improvement is not easily achieved. A certain amount of innovation is needed just to maintain productivity levels. It is the major innovations that drive the trend in productivity higher. Artificial intelligence (AI) may offer some hope in this regard, but it will take time and a major round of business fixed investment, for AI technology to be incorporated broadly enough to have a meaningful impact on productivity. I suspect that the outlook for weaker demand growth will delay investment in an expensive technology that has promise but is still limited in its application.

Indeed, to fight inflation in the absence of a surge in productivity, the Federal Reserve is expected to hike interest rates at least two more times to this year in the hope of slowing demand growth below potential. The ideal outcome, the so-called soft landing, would be to slow growth just enough below potential to lower inflation to a sustainable pace. The challenge currently is that potential growth may be so low that only a recession will get inflation back in check. Additionally, the civilian unemployment rate probably has bottomed for this business cycle at 3.4 percent, but any increase over the remainder of the year should be small.

In this inflation scenario, real aggregate demand will struggle with prices continuing to rise faster than income. As previously stated, some analysts are encouraged by the recent increase in credit card debt as evidence of consumer resilience. I suggest that taking on more consumer debt may reflect an attempt by consumers to maintain real spending levels in the wake of lower real wages. Consumer debt-financed spending cannot continue indefinitely. At some point, consumers will be forced to retrench, which at the moment, is expected to happen in the fourth quarter of 2023.

Some argue that with the federal debt limit being deferred until January 2025, fiscal policy is now positioned to prevent a recession. I contend that fiscal policy may be able to delay the recession, but it cannot prevent it. In that regard, any fiscal action to stimulate a slowing economy would likely contribute to consumer price inflation as well, which would require the Fed to hike rates even more. The fiscal stimulus from the 8.7 percent cost-of-living increase in Social Security benefits in January may provide some insight into the consequences of a new government sponsored relief program. This is especially relevant given that 25 percent of all adults in the U.S. receive a Social Security benefit; in 2022, retired workers and their dependents accounted for 76.9 percent of total benefits, disabled workers and their dependents accounted for 11.6 percent, and survivors of deceased workers accounted for 11.5 percent. In fact, if real disposable income was

unchanged from its first quarter level over the remainder of the year, it would still be up nearly 2.0 over the four quarters of 2023. This would be more than enough to support real consumer spending growth at the same rate and certainly enough to provide real GDP growth of 1.4 percent. I expect inflation to remain problematic and to detract from real disposable income as the year unfolds.

A shock of some sort likely caused the last four recessions in the U.S., so it is reasonable to expect a shock to trigger the next one. At the moment, several factors potentially could deliver a shock to the economy, including a sharp spike in energy prices (not just crude oil), a return of a more dangerous variant of COVID or another virus, or some financial crisis that devastates household wealth; however, none seem likely. Of course, anything I can identify as a potential shock, even if it happens, may not be shocking enough to derail the economy. By definition, a shock is not shocking unless it is unexpected.

The bottom line is that the slowdown in aggregate demand expected this year will not be enough to subdue inflation without additional rate hikes by the Fed. Indeed, it might need to be shockingly restrictive to achieve the desired outcome. Even if the Fed does not engineer a recession, it still will likely lead to a profits recession. 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 eventually declines; the unemployment rate rises, although maybe not as much as the loss of output would normally deliver; and inflation will slow but not without bouts of resurgence and concern. Only then will the Fed be encouraged to cut its federal funds rate target.

The outlook for long-term Treasury yields is complex. If inflation reaccelerates in the second half of this year, long-term Treasury yields probably will move higher as well. During this phase, credit spreads are likely to hold steady, suggesting that yields on corporate bonds will keep pace with Treasury yields. Of course, once market participants are convinced that the Fed is finished or nearly finished with their rate hikes, longer-term Treasury yields will retreat once again. However, credit spreads will widen as corporate yields remain steady, if not increase further in response to the prospect of a profits recession. As a result, I expect the yield on 10-year Treasury notes to peak at about 4.2 percent in the fourth quarter rather than in the third quarter, reflecting the stubbornness of inflation despite disappointingly weak real output due in large part to changing demographics.

U.S. Dollar's Reserve Currency Status?

The U.S. dollar plays a central role in the international monetary and financial system. It is the foremost funding currency, with about half of all cross-border loans and international debt securities denominated in U.S. dollars. Around half of international trade is invoiced in U.S. dollars, and around 40 percent of international payments are made in US dollars. Since the dollar is so widely accepted to settle international transactions, it is widely held as a reserve currency by central banks, representing 61 percent of all reserves. Of course, most of the U.S. dollars held as reserves by foreign central banks are U.S. Treasury obligations denominated in dollars (including U.S. Treasury bills, notes or bonds).

Why is the U.S. dollar so widely acceptable for international payments? The U.S. dollar became a reserve currency in 1944, in large part because of the importance of the U.S. dollar in financing World War II. It was the Bretton Woods Agreement that formally established the dollar as a reserve currency, but its status has been sustained despite the collapse of the Bretton Woods Agreement in the 1970s. The primary reason the U.S. dollar remains acceptable for international payments is because it represents the full faith and credit of the United States. In other words, the dollar is backed by the largest economy in the world, a country that operates under the rule of law, and a country that has the military strength to defend the law and protect its interests.

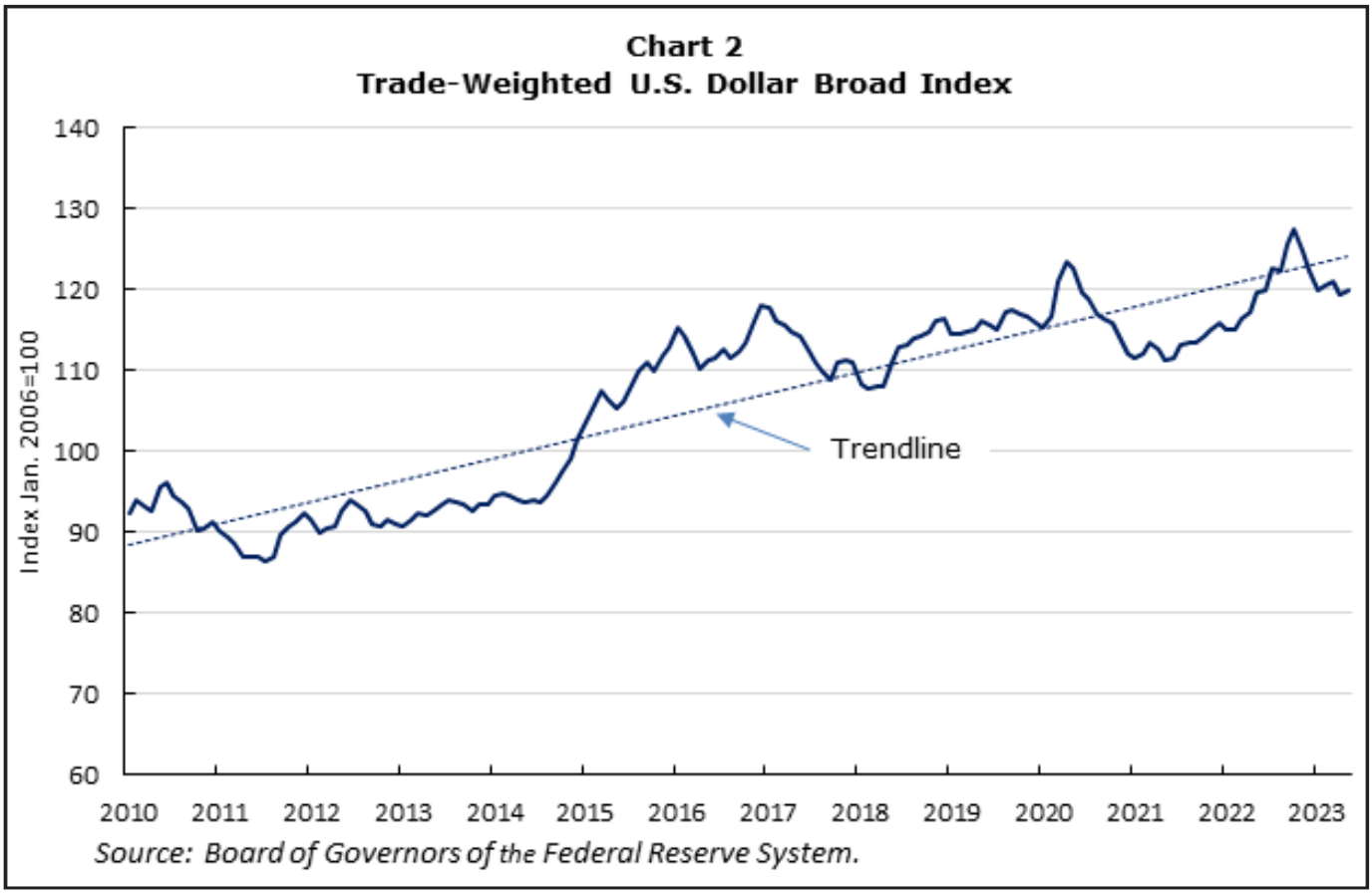
What are the currency reserves of the U.S. and how does it rank in the world? U.S. reserves are primarily in the form of gold. As of March 2022, the largest store of gold reserves was held by the U.S. (8,134 tons), representing roughly 75 percent of nation's reserves. By comparison, Germany had the second largest store of gold reserves (3,359 tons), followed by Italy (2,452 tons), France (2,436 tons) and Russia (2,302 tons) rounding out the top five. In fact, much of the gold reserves of other central banks are held at the Federal Reserve Bank of New York (the largest store of gold in the world) because the U.S. is considered a safe haven by other central banks. The remainder of U.S. reserves are currencies of other countries.

Interestingly, if reserves (both gold and foreign currencies) are valued in U.S. dollars, China has the largest level of reserves of any country in the world. Russia is in fourth place and surprisingly the U.S. is not even in the top ten. The concern is that because the U.S. has been operating on a debt model denominated in U.S. dollars for a very long time, it could overwhelm the U.S. economy at some point. More importantly, the U.S. should never put itself in a situation where it jeopardizes its ability to service outstanding debt (failure to raise the debt ceiling or approve a budget).

What needs to happen for the U.S. dollar to lose its reserve status? Another way of asking this question is what would cause central banks to lose confidence in the U.S. as the safe haven? Remember, the only reason anyone would want dollars is to spend or invest them in the U.S. What would happen if we stopped doing business with other countries or defaulted on the dollar-denominated obligations of the U.S. government that foreigners owned? It could contribute to a loss of confidence in the dollar as a reserve currency, reducing foreign demand for U.S. Treasury obligations. This would suggest the need for a higher interest rate on U.S. Treasury debt issuance to attract investors. As a last resort, the U.S. Treasury would be forced to issue obligations denominated in a currency other than the U.S. dollar.

Finally, what would be the consequences of the dollar losing it reserve status? The obvious effect is that the foreign exchange value of the U.S. dollar would fall, making imported goods and services produced elsewhere more expensive to U.S. consumers and exported goods and services produced in the U.S. less expensive to foreign consumers. Of course, if the dollar loses its reserve status because of the collapse of the rule of law or of the U.S. government defaulting on its debt obligations, investors will face something far more problematic than dollar weakness.

My conclusion is that the U.S. dollar most likely will remain a reserve currency for the foreseeable future, although it could become less dominant in that role. In fact, I hope it loses some of its importance as a reserve currency so that its foreign exchange value can adjust downward to correct the ongoing U.S. trade deficit, as the economics of international trade would suggest. As shown in Chart 2, the foreign exchange value of the dollar is down from its recent peak but has trended higher over the last 13 years. This seems unreasonable given that U.S. international trade has been in deficit every quarter over this same period. I know there is a lot of political energy around the desire for a strong dollar but I would prefer a stable dollar. A few analysts still recommend a return to something like the gold standard as a way to assure a more stable currency. Not only is this unreasonable given the limited supply of gold reserves at central banks, but it also would be politically unpopular among investors. After all, under a gold standard, only the U.S. Treasury would be allowed to own gold (other than for manufacturing purposes) and at a dollar price set by the Treasury.



Budget Deficits and Debt Ceiling

Recently, Congress and the Biden administration reached a deal recently to suspend the debt ceiling until January 2025 in exchange for limits on discretionary spending over the next two years, expedited permitting for pipelines and other energy infrastructure, and expanded work requirements for food and income assistance programs. Based on the debate surrounding the federal government raising its debt limit, it is fitting to address a couple of misconceptions about the budgeting process and the debt ceiling.

First, there may be some confusion about what purpose the debt limit serves. If its sole purpose is to restrain federal government spending, then it has failed miserably. Unless there is another reason for the debt ceiling, we could save ourselves a lot of anxiousness and frustration by removing it permanently. An alternative is to revise the budgeting process so that every new government spending proposal would be required to include new tax provisions to fund the proposal. Spending could not be approved without the revenue provisions, except in the event of war.

Second, a few people seem to have the misconception that since Congress debated spending cuts for discretionary programs only, the budget deficit and the resulting federal debt outstanding only apply to discretionary spending. Although this is not the case, it may look that way, especially to people enrolled in Social Security and Medicare. For fiscal year 2022, income tax revenue, both individual and corporate, totaled $1,737 billion dollars, while discretionary spending totaled $1,664 billion (see Table 2). Accordingly, there was more than enough income tax revenue to pay for discretionary spending alone, yet there was a budget deficit of $1,312 billion.

Table 2
Federal Government
Fiscal Year 2022
(Billions of Dollars)

Total Spending	6,210
Mandatory Spending	4,074
Social Security	1,212
Medicare, net of premiums	709
Medicaid, CHIP, and market subsidies?	695
Other?	1,458
Discretionary Spending	1,664
Defense	747
Nondefense	912
Net Interest Expense	476
Total Revenue	4,897
Payroll Taxes	1,484
Individual Income Taxes	2,632
Corporate Income Taxes	425
Deficit	1,312

Source: Congressional Budget Office, May 2023.
?CHIP is the Children's Health Insurance Program.
?Other mandatory spending includes the outlays for several programs such as veterans' benefits, deposit insurance, and student loans to mention a few.

However, discretionary spending represents only about a quarter of total federal government spending. Mandatory spending and net interest expense represent the rest. Mandatory spending, which includes outlays generally governed by statutory criteria and are generally not constrained by the annual appropriation process, totaled $4,074 billion or about 66 percent of total federal spending in 2022, while net interest expense totaled $476 billion or about 8 percent of spending. Mandatory spending includes most federal benefit programs, such as Social Security, Medicare, and Medicaid. Social Security and Medicare are financed primarily with dedicated payroll or income tax revenue, Medicare premiums, and proceeds from trust funds. It is easier to connect spending with revenue.

Funding for Medicaid and other mandatory spending programs, such as veterans' benefits, student loans, and the cost of bank failures that exceed the FDIC's funds, is not as straightforward as Social Security and Medicare.[1] For the most part, these programs do not enjoy dedicated tax revenues or trust funds for their funding. Instead, they rely on income taxes to fund their programs but are considered mandatory for the most part.

Net interest expense was relatively benign during the zero-interest rate environment prior to the pandemic. If there is no interest expense associated with debt, then taking on more debt is easy. With interest rates no longer at zero, this component of federal spending

[1]Some mandatory programs, such as Medicaid, the Supplemental Nutrition Assistance Program, and veterans' disability compensation and pensions, are considered mandatory but require benefits to be paid from amounts provided in appropriation acts.

is likely to rise dramatically over the next few years as old debt is refinanced at higher rates of interest, as well as the interest expense associated with new debt. According to the Congressional Budget Office (CBO), net interest expense will be about 15 percent of all federal spending in 2033, nearly doubling its share of spending in the next decade. It will be interesting to see what might happen if the CBO is correct and the interest paid on the federal debt outstanding represents 33 percent of all income tax revenue. This too would be about double the share of income tax used to pay interest on the debt in 2022.

Regardless of how the budget is dissected or categorized, the conclusion is that total federal spending exceeded total federal revenue by $1,314 billion in fiscal year 2022, resulting in a deficit that required the U.S. Treasury to issue new debt obligations to fund. This issuance added to the total federal debt outstanding, which stood at $30,869 billion at the end of fiscal year 2022. It is this measure of federal debt that would be subject to the debt ceiling if it is reinstated in 2025 as directed by recently enacted Fiscal Responsibility Act of 2023. By the way, in its recent budget update (May 2023), the CBO estimates that the total federal debt outstanding subject to the debt limit will be $32,492 billion by the end of the current fiscal year on September 30 and $52,387 billion by the end of the fiscal year 2033.