STONEBRIDGE
Capital Advisors

Stonebridge Economic Outlook
September 21st, 2023

Daniel E. Laufenberg, Ph.D., Chief Economist

Overview

Although the U.S. economy so far this year has essentially followed the script outlined in my earlier forecasts, it may not be so obliging in the second half. In particular, many policymakers suggest that the U.S. economy is on track for a so-called "soft landing," which includes further improvement in inflation, positive real GDP growth, and still low unemployment. Of course, policymakers are inclined to favor such an outcome. For example, the Federal Reserve never forecasts an economic recession, yet we still have them. In this regard, the Fed is often accused of going too far with rate hikes. I contend that the economy is far better off if the Fed goes too far rather than not far enough. After all, the worst-case scenario would be stagflation, which is a combination of little or no growth and very high inflation. In that regard, I still think a meaningful economic correction, if not an official recession, is needed to force inflation to fall to a level less problematic for the economy.

While inflation slowed considerably in the first half of 2023, much of the slowdown was transitory in nature and associated with the easing of the pandemic effect. I contend that inflation is likely to be stubbornly elevated, most likely forcing the Fed to hike short-term interest rates again, but more importantly, to keep short-term interest rates higher for longer. Such a move by the Fed most likely will push longer-term interest rates higher as well. Indeed, much of the highly anticipated hike in long-term interest rates has occurred in recent months.

On the other hand, market participants are applying considerable pressure on the Fed to stop raising rates, if not to start reducing them. They contend that inflation has improved enough already and with the lagged effect of monetary policy, inflation is expected to improve further over the remainder of the year. However, I contend that the Fed will need clear evidence that inflation has slowed to a more sustainable pace before they stop. If the Fed provides guidance suggesting that they are finished hiking rates before they have such evidence, long-term interest rates actually could edge even higher, reflecting the expectation that any pause in short-term interest rates by the Fed may be short-lived.

The Details

The basic features of the outlook for the second half of 2023 are very similar to the previous forecast, with only a few minor adjustments to the quarterly estimates. First, although consumer price inflation slowed markedly over the first half as expected, the slowdown was more pronounced in the second quarter than projected earlier. According to the Bureau of Labor Statistics, the percent change in the consumer price index (CPI) from a year earlier slowed to 3.0 percent in June, which was slower than the 3.4 percent anticipated in my earlier forecasts. Nevertheless, the year-over-year percent change in the CPI was expected to reaccelerate in the second half of 2023. Based on data for the first two months of the third quarter, the CPI has done just that. In August, the CPI was up 3.7 percent from a year earlier. Of course, it will not return to the torrid pace of last year, but it is expected to be roughly 3.8 percent on average and well above the Fed's target of 2.0 percent over the remainder of the year.

Second, as expected earlier, the unemployment rate averaged 3.5 percent in the first half of the year. In those previous forecasts, the unemployment rate was expected to edge higher in the second half, especially in the fourth quarter. For the most part, that aspect of the forecast has not changed. In particular, according to the Bureau of Labor Statistics, the unemployment rate for the first two months of the third quarter (July and August) averaged 3.65 percent. This compares to the third-quarter estimate of 3.6 percent in the February forecast and 3.7 percent in the June forecast. In the fourth quarter, the unemployment rate is now expected to average 4.0 percent, compared to 4.5 percent in the February forecast and 3.9 percent in the June forecast. Although there have been few surprises in the unemployment rate so far this year, the robustness of payroll job growth has been a bit surprising. If my interest rate forecast is correct, job growth will slow markedly either late this year or early 2024.

Table 1
U.S. Economic Forecast

	2023 Q1	2023 Q2	2023 Q3f	2023 Q4f	2022	2023f	2024f
Real Gross Domestic Product	2.0	**2.1**	**2.0**	-0.2	0.8	**1.5**	1.2
Consumer Price Index, All	**3.8**	**2.7**	**3.6**	**4.0**	7.1	**3.5**	3.0
Consumer Price Index, Core	**5.1**	**4.7**	**3.0**	3.9	6.0	**4.2**	2.8
GDP Chain-Type Price Index	4.1	**2.0**	**3.0**	3.4	6.4	**3.2**	2.6
Civilian Unemployment Rate	3.4	3.5	3.7	4.0	3.6	4.0	5.2
Price of WTI crude oil ($/bbl)	76.5	73.7	**83.0**	**82.0**	82.8	**82.0**	80.0
Trade-Weighted Dollar	120.3	119.4	**120.0**	118.0	124.8	118.0	119.0
S&P 500 Operating Earnings	52.5	**54.8**	**53.7**	44.0	197.0	**205.0**	205.0
Percent vs. Year Ago	6.4	**8.8**	**6.6**	-12.6	-5.4	**4.1**	0.0
91-Day Treasury Bill Rate	4.8	5.1	5.5	5.7	4.2	5.7	4.0
10-Year Treasury Note Yield	3.7	3.6	4.1	4.4	3.8	4.4	4.0
30-Year Mortgage Rate	6.4	6.5	6.7	7.0	6.7	6.8	6.2
Bank Prime Rate	7.7	8.2	8.5	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.

Third, short-term interest rates, which are essentially driven by the Federal Reserve's federal funds rate policy, have climbed very much in line with the earlier forecasts. The February forecast projected the 3-month Treasury bill yield to average 5.6 percent for the third quarter and 5.8 percent for the fourth quarter. In the June forecast, the projections were 5.5 percent and 5.7 percent, respectively. Interestingly, the current forecast is for the 3-month Treasury yield to, once again, average 5.6 percent for the third quarter and 5.8 percent for the fourth quarter, reverting to the levels shown in the February forecast. This implies that the Federal Reserve may feel the need to hike its federal funds rate target at least one more time this year. Whether that happens at this month's policy meeting (September 19-20) or the next meeting (October 31-November 1) is unclear. The bottom line is that short-term interest rates may be near their peak for this tightening cycle.

Fourth, as expected, long-term interest rates have moved higher this year, but not as aggressively as they would normally. In the February forecast, the yield on the 10-year Treasury note was expected to average 4.1 percent in the second quarter based on the historical relationship between short and long Treasury yields. However, the 10-year Treasury yield averaged 3.6 percent in the second quarter and is on track to average about 4.1 percent in the third quarter. Long-term interest rates only recently have started to climb higher, with the 10-year Treasury yield averaging 3.9 percent in July and 4.2 percent in August. The 10-year yield currently stands at 4.4 percent. Nevertheless, the 10-year Treasury yield in the fourth quarter needs to remain elevated, if not move higher, to have the desired effect on aggregate demand and inflation.

Finally, real GDP growth in the first half of the year exceeded earlier expectations somewhat but appears to be on track now to register an even larger upside surprise in the third quarter. Indeed, it is this newly acknowledged strength in real GDP growth that has raised questions about the effectiveness of monetary policy to fight inflation by restraining demand growth with higher interest rates, causing investors to expect inflation and the corresponding restrictive monetary policy to last longer than anticipated earlier. Paradoxically, it is the expectation of short-term interest rates to remain higher for longer and what those expectations mean for long-term interest rates that may finally cause the economic slowdown to lower inflation.[1]

In summary, the U.S. economy has followed the Stonebridge script rather well through the first half of the year, offering very little reason to revise the outlook dramatically for the second half. Based on data reported so far for the third quarter, the economy appears to be on track to be more robust than anticipated earlier, including a solid gain in real GDP and relatively strong job growth. Of course, the downside is that consumer price inflation most likely will reaccelerate in the third quarter, putting pressure on interest rates to move higher or at least remain high for longer.

Whether the economy can remain robust in the fourth quarter is unclear. If consumer prices rise at a 4.0 percent annual rate in the quarter on top of the price increases already in effect, it could become problematic for real consumer spending. Moreover, to the extent that consumer debt (dissaving) is already being used to finance spending in the third quarter, it is unlikely that it can be sustained very long if interest rates remain elevated. Hence, a substantial slowdown in real economic activity is expected before the end of the year. As such, real GDP is projected to be flat to down in the fourth quarter, which likely will contribute to the unemployment rate edging higher on average. Of course, this scenario depends considerably on the 10-year Treasury note yield ticking up to about 4.5 percent over the next few weeks and staying there until the economy clearly shows signs of rolling over. Not until then will inflation begin to stabilize at a more acceptable level, probably something much closer to 2.0 percent.

At its September meeting, the Federal Open Market Committee (FOMC) - the policy committee of the Federal Reserve - decided to maintain the target range for the federal funds rate at 5.25 to 5.5 percent, but once again reinforced its commitment to return inflation to 2 percent over time. The Fed's policy committee implied that it is prepared to hike the federal funds rate at least one more time this year, especially if inflation remains elevated. Since I expect inflation to do just that, I would not be surprised if the Fed hiked rates again at its next meeting on October 31-November 1.

Moreover, the Fed could justify another rate hike if the upward revision to real GDP growth for 2023 shown in the FOMC's economic projections from the September 19-20 policy meeting is correct. In fact, it may be sufficient if the economy continues to look solid into the fourth quarter. The irony of the outlook is that inflation will slow only if economic activity wanes. However, economic activity will not wane unless long-term interest rates move higher and remain there for a while, which, in turn, will not happen unless short-term interest rates are expected to remain higher for longer as well.

[1] *See the next section of this outlook update for more details; "Implications of an Inverted Yield Curve."*

Of course, in late September, the Bureau of Economic Analysis will release initial results of the comprehensive updates of the National Economic Accounts, including revisions of GDP and related components from the first quarter of 2013 through the first quarter of 2023. The revisions may show a far different picture of economic activity in recent years, which could alter the outlook for the economy as well.

Finally, some analysts pointed to the uptick in the unemployment rate to 3.8 percent in August from 3.5 percent in July as a sign that monetary policy is finally having an adverse effect on the economy. Such an interpretation may be premature, given that the August increase in the unemployment rate was due to a sharp increase in labor force participation (more workers looking for jobs), rather than jobs lost. It may be that some of the workers who left the labor force during the pandemic were forced to return because of the spike in the cost of living. It will be interesting to see if they found jobs and what happened to the unemployment rate in September (scheduled to be released in early October).

Based on my understanding of how the Bureau of Labor Statistics treats labor stoppages, the UAW strike will not have a meaningful impact on the unemployment rate unless the targeted companies go out of business. Striking workers are still considered employed until they are not. Whether the strike will impact nonfarm payroll data will depend on its timing. The UAW strike most likely will have very little impact on the September data but could be more of an issue in the October payroll data if the UAW is still on strike during the week that includes the 12th of the month.

Implications of an Inverted Yield Curve

Whenever I wrote about the yield curve in my previous job, my administrative assistant at the time told me that her eyes would glaze over reading it. With that endorsement in mind, I will attempt to write about the yield curve without causing your eyes to glaze over. The yield curve is, essentially, the term structure of interest rates for debt obligations of equal credit quality. For this purpose, U.S. Treasury yields are typically used to depict the term structure because the Treasury offers debt obligations at several different maturities, ranging from one month to 30 years, all backed by the same full faith and credit of the United States.

The yield curve provides a snapshot of yields at a particular point in time. A normally shaped Treasury yield curve is positively sloped; that is, the yield on the short-term obligation is lower than the yield on the long-term obligation. An inverted yield curve is negatively sloped; that is, the yield on the short-term obligation is higher than the yield on the long-term obligation. The questions are why should we care about the yield curve and what drives its shape?

Clearly, long-term and short-term interest rates are not mutually exclusive, since long-term rates can be expressed as an average of the current and expected future short-term interest rates. For example, if short-term interest rates are high but are expected to fall sharply in the future, then longer-term interest rates will reflect the expectation of lower future short-term rates more so than the current high rate. As a result, longer-term interest rates will be lower than the short-term rate, resulting in an inverted yield curve. This is referred to as the expectations hypothesis of the term structure of interest rates.

The yields on several maturities of Treasury obligations at the end of August, the end of July, the end of August last year, and the end of August two years ago are included in Table 2. The yield on the 3-month Treasury bill was 5.56 percent at the end of August 2023, compared to a mere 0.04 percent at the end of August 2021 (2 years ago). Indeed, since early 2022, the 3-month Treasury bill yield has climbed a whopping 550 basis points, reflecting primarily the similar increase in the Federal Reserve's federal funds rate target range - the upper limit of which is currently at 5.50 percent. On the other hand, the yield on the 10-year Treasury note was 4.17 percent at the end of August, compared to 1.28 percent two years ago. If these two yields represent the shape of the Treasury yield curve, it went from a normally shaped curve two years ago to an inverted curve late last year.

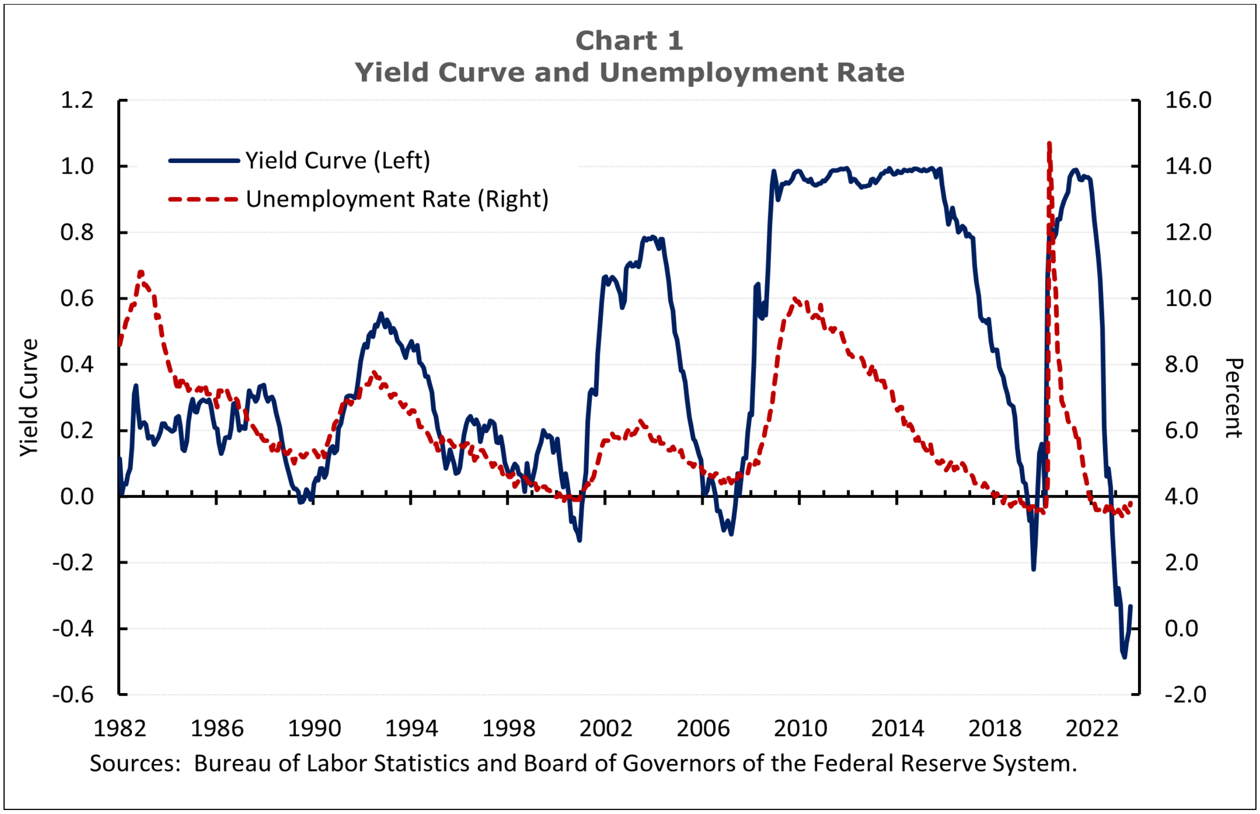
Table 2
U.S. Treasury Yield Curve
End-of-Month, Constant Maturity

Maturity	Yields			
	August 2023	Month Ago	Year Ago	2 Years Ago
3 Month	**5.56**	**5.49**	**2.72**	**0.04**
6 Month	5.54	5.53	3.15	0.06
12 Month	5.37	5.37	3.28	0.07
2 Year	4.90	4.83	3.25	0.22
5 Year	4.31	4.14	3.03	0.77
10 Year	**4.17**	**3.90**	**2.90**	**1.28**
30 Year	4.28	3.96	3.13	1.92
10-Yr less 3-Mo	**-1.39**	**-1.59**	**0.18**	**1.24**

Source: Board of Governors of the Federal Reserve System.

Most analysts consider the shape of the yield curve as a precursor of the business cycle. In particular, when the yield curve is normally shaped, the economy is expected to expand. However, when the yield curve inverts, the economy is expected to contract. Ever since the yield curve inverted late last year, the expectation has been that the U.S. economy was heading for a contraction, if not an official recession. Of course, timing the recession is always difficult. For the most part, the 550 basis point increase in short-term interest rates over the last two years was considered more than enough to slow the economy and stabilize price inflation. However, the economy continues to expand above its potential and inflation remains stubbornly elevated.

Why has the 550 basis point increase in short-term interest rates not been more effective? I think the answer rests in what has happened to long-term interest rates. For example, until very recently, the yield on the 10-year Treasury note has been slow to respond to the higher short-term rates, in large part because short-term rates were not expected to remain elevated for very long. It was not until the last few months that the yield on the 10-year Treasury note finally reflected a concession by investors that short-term interest rates may be higher for longer. If the 10-year yield remains at such an elevated level over the next few months, then the need for the Fed to hike rates further may not seem as urgent. Nevertheless, if inflation appears to be reaccelerating, which we think it might, any hesitation by the Fed to hike rates may give market participants the impression that the Fed is "behind the curve."



The contention here is that it is the relative shape of the yield curve, not just the slope, that matters. This is reflected in Chart 1, which plots the relative shape of the yield curve at the end of the month against the unemployment rate of that month over the last fifty years. In this case, the relative shape of the yield curve is defined as the 10-year Treasury note yield minus the 3-month Treasury bill yield divided by the 10-year note yield (the solid line in Chart 1). The implication is that when the yield curve is steepening, the unemployment rate (the broken line in Chart 1) is rising and, conversely, when the yield curve is flattening, the unemployment rate is falling. Unfortunately, once the yield curve inverts, the unemployment rate typically bottoms and remains near the bottom until the yield curve inversion starts to wane.

As shown in Chart 1, the yield curve inversion has started to wane in recent months, suggesting that the unemployment rate was about to move higher. In that regard, the yield on the 10-year Treasury note was 4.17 percent at the end of August 2023, compared to 1.28 percent two years ago. The upward movement in the 10-year has been far smaller and slower compared to the yield on the 3-month bill. As a result, the slope of the U.S. Treasury yield curve (10-year yield versus 3-month yield), which was normal at the end of August 2021, became markedly inverted over the last year. More recently, the inversion of the yield curve has become less severe, as the yield on the 10-year Treasury note has increased more than the yield on the 3-month Treasury bill—in August, the 10-year yield rose 27 basis points, while the 3-month yield rose on 7 basis points.

The implication is that an economic correction, if not a recession, is not too far away. My guess is that it starts late this year or early 2024. Stay tuned!■