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U.S. ECONOMIC & INTEREST RATE OUTLOOK

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- **A Not-So-Fresh Start**

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The new year offers an opportunity for clean slates and new perspectives. But the economy cannot escape the echoes of the recent past. Ripple effects of COVID and the Ukraine invasion continue to impair the outlook.

The year ahead should bring more stable policy: The end of the rate-hiking cycle has been clearly signaled, and the legislative agenda will be limited. Inflation is improving, a welcome relief for consumers and businesses alike.

The outlook is predicated on nothing else going wrong. After a challenging stretch of so many disruptions, that may feel like an optimistic premise. We continue to monitor risks including the U.S. debt ceiling, escalation of the Russia-Ukraine war and volatility surrounding the reopening in China. But as long as workers keep earning and spending, the path to a soft landing remains open.

Key Economic Indicators

	2022				2023				Q4 to Q4 change		Annual change	
	22:1a	22:2a	22:3a	22:4f	23:1f	23:2f	23:3f	23:4f	2022f	2023f	2022f	2023f
Real Gross Domestic Product (% change, SAAR)	-1.6	-0.6	3.2	3.0	0.9	0.5	0.2	0.1	0.8	0.6	2.0	1.2
Consumer Price Index (% change, annualized)	9.2	10.5	5.7	4.2	3.5	2.8	2.6	2.5	7.4	2.8	8.1	4.0
Civilian Unemployment Rate (%, average)	3.8	3.6	3.6	3.7	3.9	4.0	4.2	4.3			3.7*	4.1*
Federal Funds Rate	0.17	0.82	2.24	3.69	4.57	5.06	5.13	5.13			1.73*	4.97*
2-yr. Treasury Note	1.46	2.72	3.38	4.39	4.90	4.75	4.65	4.50			2.99*	4.70*
10-yr. Treasury Note	1.95	2.93	3.10	3.83	3.70	3.90	4.00	3.80			2.95*	3.85*

a=actual
f=forecast
*=annual average

Influences on the Forecast

- At its December meeting, the Federal Open Market Committee raised the overnight Fed Funds Rate by 50 basis points to a range of 4.25-4.50%. The accompanying Summary of Economic Projections showed nearly all Committee members expecting the rate to peak at over 5% in 2023 before cuts commence in 2024.
  - We expect the Fed to end the hiking cycle in a range of 5.00-5.25%, in steady increments of 25 basis points. If inflation continues to cool, the Fed may stop short of this terminal rate, in line with the current consensus in the interest rate futures market.
- The consumer price index (CPI) for December brought more evidence of inflation falling from its 2022 highs. On a monthly basis, prices declined by 0.1%, a meaningful

shift in direction, supported by stable energy prices but impaired by high food costs. For the full year of 2022, prices rose by 6.5%. Excluding the volatile food and energy sectors, price growth measured 5.7%.

  - From a policy perspective, while the decline is encouraging, inflation measures remain unacceptably high. This softer reading appears to have supported the case for smaller rate hikes of 25 basis points, but not enough to pause yet. Sustained progress against inflation will set the stage for cuts, but likely not until 2024.
  - Healing inflation will also help to head off a recession. Nominal growth is poised to slow this year after its sustained post-pandemic rebound. Lower inflation will reduce the drag on real gross domestic product (GDP), helping to avoid a downturn.

- The December Employment Situation Summary was a capstone to a full year of growth and recovery in labor markets. Payrolls grew by 223,000, and the unemployment rate fell to 3.5%. Wage growth of 4.6% was this measure's slowest annual gain since summer 2021, an encouraging omen for the inflation outlook. The household employment survey showed significant growth after two months of decline, and labor force participation rates improved modestly. Nothing in the report was consistent with an imminent recession, nor did it offer the Fed any reason to halt tightening.
- Measures of fourth quarter 2022 economic activity have been largely favorable, and our GDP estimate has been again revised upward. The economy is starting the new year with momentum. Our recession call comes down to the state of labor markets: As long as payrolls hold up, the consumer-driven U.S. economy can avoid a contraction. We anticipate hiring to come off the boil of the past two years, reflected in a slightly rising unemployment rate forecast. Anecdotes of layoffs are cause for concern, but they have not yet been widespread enough to change the course of the economy.
- After a bruising year in equity markets, a more stable outlook will support risk appetites, allowing yields to fall moderately. With long-dated interest rates unlikely to rise, the cure for the inverted yield curve will need to come from eventual Fed rate cuts.
- The 118th U.S. Congress began contentiously in the House of Representatives. Partisan divisions are likely to preclude any major legislation, but gridlock is not always a welcome outcome, as pressing matters do not wait. The debt ceiling has already pushed the U.S. Treasury into extraordinary measures to avoid default, which will be exhausted in the summer. While markets have discounted this fiscal uncertainty the past, brinksmanship will add to the risk of volatility this year.

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