U.S. ECONOMIC & INTEREST RATE OUTLOOK

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- **Banking Stresses The Outlook**

We have, for some time, cautiously issued forecasts of slow and steady growth for the U.S. economy. Outlooks have come with one crucial caveat: they assume that nothing else goes wrong. Recent financial events have us questioning whether that condition has been breached. The failures of Silicon Valley Bank (SVB) and Signature Bank, and forced merger of Credit Suisse, have unnerved financial markets and increased recession risk.

The Federal Open Market Committee has a dual mandate of maximizing employment stabilizing prices. Those important policy goals assume the foundation of a stable financial system. While the battle against inflation is not over, the Fed must ensure it maintains the safety and soundness of—and ultimately, confidence in—the banking system. Ideally, this will be handled outside of the monetary policy process.

We expect recent banking troubles to curb credit extension, impairing growth. But the incremental deceleration will probably not be enough to place the Fed on hold. One more quarter-point hike is expected in May, followed by a long pause. Needless to say, projections are critically dependent on financial stability. Sustained activity can keep the economy out of recession, but we will closely track the accumulating risks to the outlook.

Key Economic Indicators

	2022	2023				2024				Q4 to Q4 change			Annual change		
	22:4a	23:1f	23:2f	23:3f	23:4f	24:1f	24:2f	24:3f	24:4f	2022a	2023f	2024f	2022a	2023f	2024f
Real Gross Domestic Product (% change, SAAR)	2.7	2.5	0.8	0.7	0.6	0.5	1.0	1.1	1.3	1.0	1.1	1.0	2.1	1.8	0.8
Consumer Price Index (% change, annualized)	4.2	3.8	3.2	2.8	2.6	2.5	2.3	2.1	2.0	7.1	3.1	2.1	8.0	3.9	2.3
Civilian Unemployment Rate (%, average)	3.6	3.6	3.8	4.0	4.1	4.2	4.2	4.1	4.1				3.6*	3.9*	4.2*
Federal Funds Rate	3.65	4.57	5.06	5.13	5.13	4.63	4.13	3.63	3.13				1.68*	4.97*	3.88*
2-yr. Treasury Note	4.39	4.30	4.50	4.35	4.10	3.75	3.40	3.00	2.90				2.98*	4.31*	3.26*
10-yr. Treasury Note	3.83	3.65	3.50	3.40	3.25	3.25	3.25	3.25	3.25				2.96*	3.45*	3.25*

a=actual
f=forecast
*=annual average

Influences on the Forecast

- Labor markets offered yet another pleasant surprise in February, with 311,000 jobs created. The unemployment rate rose by two-tenths to 3.6%, driven by encouraging growth in the labor force. Wages increased only 0.2% on the month, offering more hope that a wage-price spiral has been avoided. We continue to monitor weekly jobless claims, which are holding low despite reports of layoffs.

- Inflation is still not under control. The February consumer price index (CPI) weighed in at 6.0% year over year. Excluding food and energy, the CPI grew 5.5% over the same period, unchanged from the prior month. A slowdown in house prices has not yet prompted an easing of shelter cost escalation, but we still expect this to be a key element of reduced inflation over the remainder of the year. Prices are still rising briskly for core services (excluding energy and housing services).

- Retail sales cooled slightly in February, declining 0.4% from the month before after an outsized increase of 3.2% in January. Over the past year, nominal retail spending grew 6.8%, exceeding the rate of inflation and pushing up the estimate of overall growth for the first quarter. Consumers are not yet deterred.
- In a context of strong employment, high prices and resilient activity, the Federal Open Market Committee (FOMC) should raise rates without much deliberation. However, as financial stability is called into question, a case for slowing hikes became more salient. The committee settled on a hike of 25 basis points to a range of 4.75-5.00% at its March meeting.
    - Prior to SVB, futures markets expected a 50 basis point move in March and no cuts in the balance of 2023; they have quickly repriced to expect easing to begin this year.
    - The Summary of Economic Projections (SEP), including the “dot plot” rate outlook, showed that committee members see an end to hikes soon, but not cuts. The median projection was for the year 2023 to end with a policy rate of 5.00-5.25%, just 25 basis points more than today. Cuts are then forecast in 2024. The SEP reflects a committee that foresees growth that is positive but slow, and inflation that is improving but still high.
    - Asked explicitly if a soft landing remains possible, Chair Powell noted that risks are higher today, but the path to a soft landing is still open. We agree. In the best case scenario, SVB proves to be an idiosyncratic event, and economic resilience can still win the day.
    - The new, proximate risk to ongoing growth will be a tightening of credit conditions. The experience of SVB stands to make lenders more cautious and regulators more eager. While not an immediate shock, lower credit availability will limit the economy’s potential.
- Interest rates have quickly and dramatically repriced amid a flight to safety and a change in expectations of the policy rate. The full yield curve has fallen over the past month, with the most substantial repricing in the middle of the curve. In two weeks, the yield on the 2-year U.S. Treasury note fell from 5.05% to 3.76%. The yield curve inversion continues.
- Turning from immediate to near-term risks, the U.S. fiscal situation remains challenging. No earnest negotiations have begun on the debt ceiling, with the x-date at which the government runs out of capacity to issue debt still looming in the summer. The White House began the annual budget cycle with a $6.8 trillion proposal that did not include any notable cuts.

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