U.S. ECONOMIC & INTEREST RATE OUTLOOK

IN THIS ISSUE

- **A New Phase of Recovery**

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The fierce downturn of 2020 and rapid recovery of 2021 are in the past. This year will feature more moderate growth, amid policy normalization. Projecting how much of each we will get in the balance of 2022 is no easy task.

Monetary policy has entered a tightening cycle. A review of the Fed's history shows that soft landings are possible, but require a favorable economic context. The U.S. economy has a great deal of momentum supported by elevated savings, a need for businesses to rebuild inventories, a broad return to work, and renewed investment.

Risks to the recovery are evident in all directions, be they a renewed COVID surge, uncontrolled inflation, high energy prices or other spillovers from the Russia-Ukraine war. But we expect activity to persevere.

We take the Fed at their word that they will fight inflation with every tool available. We expect them to succeed, but it will take several quarters for the price level to settle.

Key Economic Indicators

	2022				2023				Q4 to Q4 change		Annual change	
	22:1f	22:2f	22:3f	22:4f	23:1f	23:2f	23:3f	23:4f	2022f	2023f	2022f	2023f
Real Gross Domestic Product (% change, SAAR)	1.0	3.8	3.6	2.4	2.5	2.5	2.5	2.6	2.7	2.5	3.5	2.7
Consumer Price Index (% change, annualized)	8.5	8.5	3.8	3.0	2.5	2.3	2.2	2.1	5.9	2.3	4.7	3.0
Civilian Unemployment Rate (%, average)	3.8	3.6	3.5	3.4	3.4	3.4	3.4	3.4			3.6*	3.4*
Federal Funds Rate	0.17	0.74	1.34	1.83	2.38	2.63	2.63	2.63			1.02*	2.57*
2-yr. Treasury Note	1.46	2.52	2.71	2.90	2.95	2.97	2.97	2.97			2.39*	2.96*
10-yr. Treasury Note	1.95	2.70	2.85	3.00	3.00	3.00	3.00	3.00			2.63*	3.00*

a=actual
f=forecast
*=annual average

Influences on the Forecast

- After starting a rate hiking cycle in March, the governors of the Federal Reserve have signaled that further movements will happen in larger increments. Persistently elevated inflation has made action more urgent. We now expect that the May 4 meeting will result in a 50 basis point increase in interest rates. Tightening will continue through the first quarter of 2023, leading to a terminal rate range of 2.50-2.75%.
- Minutes of the Fed's March meeting reflected a plan to reduce the Fed's balance sheet. Bonds will be allowed to mature without principal reinvestment at a pace of $95 billion per month ($60 of U.S. Treasuries + $35 of mortgage-backed securities), after a three-month phase-in period. This is a faster pace than seen in the last reduction in 2017,

but today's recovery is faster, and today's balance sheet much larger. The rundown is likely to be announced in the May meeting and begin soon thereafter.

- Interest rates have ascended upward as the Fed's rate and balance sheet intentions have become clear, in a context of high inflation and continued growth. The U.S. 10-year Treasury yield reached a three-year high this month and may yet move higher. The long end of the curve did invert briefly, with the yield on 2-year Treasuries exceeding the 10-year for two days, but we do not believe that is a clear signal of a pending recession.
- Employment gains continue, with another with 431,000 jobs created in March; this brought the unemployment rate down to 3.6%. Payrolls remain 1.6 million workers shy of their February 2020 peak, a gap that can certainly be closed this year as gains continue. Labor force participation rates continue to rise, now reaching their 2019 levels across most demographics.
    - March's employment report indicated that average hourly earnings grew 5.6% year over year, leveling off at a high rate but not spiraling out of control. Wages increased 6.7% for production and nonsupervisory workers, suggesting that the more significant wage gains continue to accrue to lower-paid workers..
- The March reading of the Consumer Price Index (CPI) showed inflation of 8.5% from a year before, unsurprisingly led by increases in food and energy costs. However, core inflation (excluding food and energy) grew at a more moderate pace, with prices in hot sectors like used cars and durable goods contracting over the past month. The Fed's preferred measure, the deflator on core personal consumption expenditures, grew 5.4% in February, far ahead of its 2% target, affirming the case for rapid hikes.
- The first quarter's estimate of economic growth to be published at the end of the month will likely be slow, complicated by COVID-19 infections at the start of the year. With cases low, restrictions eased and offices reopened, the second quarter is poised to feature buoyant consumer spending despite higher prices. Inventory rebuilding will be a significant and unpredictable driver of the recovery, as elevated cases and renewed COVID-19 lockdowns in Asia will impair imports.
- Mortgage rates have reached levels not seen in a decade. Mortgage application activity is falling amid lower housing affordability and fewer refinancing opportunities. Cooler house price growth will not be a bad outcome, after intense appreciation during the COVID recovery.

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