NORTHERN TRUST

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U.S. ECONOMIC & INTEREST RATE OUTLOOK

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- **Don't Count Your Chickens**

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Last year, we spent a fair amount of time pushing back against a prevailing negative consensus. Sentiment measures were low, recession fears were high, risk assets tumbled, and dislocations in the economy felt overwhelming. We took solace in the ongoing strength of employment and consumption. Thus far, they are still holding up.

We are starting the year with some momentum in the economic data. The beginnings of the elusive soft landing have taken shape. But now we find ourselves rebutting enthusiasm. It is far too soon to say the economy has conquered its many prevailing risks.

The COVID recovery cycle has offered many lessons in humility. Inflation could yet rise again; layoffs could yet gather more steam; a wide assortment of idiosyncratic events could yet derail the recovery. But the domestic economy is starting the year in a position to avoid recession.

Key Economic Indicators

	2022				2023				Q4 to Q4 change		Annual change	
	22:1a	22:2a	22:3a	22:4a	23:1f	23:2f	23:3f	23:4f	2022a	2023f	2022a	2023f
Real Gross Domestic Product (% change, SAAR)	-1.6	-0.6	3.2	2.9	1.5	0.5	0.2	0.6	1.0	0.6	2.1	1.3
Consumer Price Index (% change, annualized)	9.2	10.5	5.7	3.1	2.9	2.8	2.6	2.5	7.1	2.7	8.0	3.7
Civilian Unemployment Rate (%, average)	3.8	3.6	3.6	3.6	3.5	3.7	3.9	4.0			3.6*	3.8*
Federal Funds Rate	0.12	0.77	2.19	3.65	4.57	5.06	5.13	5.13			1.68*	4.97*
2-yr. Treasury Note	1.44	2.72	3.38	4.39	4.35	4.20	4.20	4.20			2.98*	4.24*
10-yr. Treasury Note	1.95	2.93	3.11	3.83	3.60	3.75	4.00	3.80			2.96*	3.79*

a=actual
f=forecast
*=annual average

Influences on the Forecast

- Labor markets have held their strength, with payrolls growing by a shocking 517,000 in January, and the unemployment rate falling to 3.4%. Average hourly wage gains fell to 4.4% over the past 12 months, an encouraging but puzzling development in the battle against inflation. Rising unemployment is a reliable recession indicator, and it is not yet showing stress.

- In the fourth quarter of 2022, gross domestic product (GDP) grew at an annualized rate of 2.9%. Making up for the decline in the first half, the economy grew 2.1% for the full year, in line with its long-run average growth rate. Coming quarters are likely to feature slower consumer spending as savings are depleted and job losses materialize. Unpredictable shifts in inventories and trade also complicate the quarterly forecast, but a slower year overall is a safe expectation.

- Inflation is trending down, but unevenly. In January, the consumer price index (CPI) gained 6.4% from the year before. The monthly gain of 0.5%, or 0.4% excluding food and energy, were discouraging movements upward. A rise in gasoline prices led the energy category up, and shelter costs have not yet begun to retreat. A monthly decline in used car prices is unlikely to sustain, based on more timely wholesale price measures. Meanwhile, the Fed's preferred measure, the deflator on core personal consumption expenditures (PCE), fell to 4.4% in December from 5.2% just three months prior. While inflation is down from the most worrying levels seen last year, the battle is far from won.
- At its February meeting, the Federal Open Market Committee continued its rate-hiking program, raising the Fed Funds Rate by 25 basis points to a range of 4.50-4.75%. The accompanying statement removed a list of specific inflationary risks and called for "ongoing increases" to the policy rate. In the subsequent press conference, Chair Jerome Powell mentioned "a couple more" hikes to come.
    - Given opportunities to push back against easier financial conditions, Powell and other Fed officials have given consistently balanced answers, in contrast to the more hawkish tone that was the norm in 2022.
    - We anticipate two more hikes of 25 basis points each at the FOMC's March and May meetings, followed by a pause lasting into 2024. Additional hikes cannot be ruled out if more evidence emerges of persistent inflation or other economic reheating.
- Financial conditions indices, which aggregate activity and funding across equities, debt, and bank lending, are showing an easier start to the year. However, much of the decline has come from lower volatility in equity and bond markets, which is not assured to continue. The past year brought several cycles of tightening and easing; conditions can change quickly.
- Nationwide house prices peaked in summer 2022. Higher interest rates then brought the residential real estate market to a much slower level of activity. However, mortgage interest rates have edged down from their peak of over 7%, and mortgage purchase applications have started to climb. The market is adapting to an environment of higher rates.
- Debates about lifting the debt ceiling many months in advance of actual stress are a precursor to a year of fiscal gridlock. Opposition in Congress will preclude most new spending and all new tax proposals. However, funding the government will be contentious. The risks of a debt ceiling breach and a government shutdown are on the radar, and any resolution is unlikely to come until the 11th hour.

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