

# Economic Outlook

Tom Fitzgerald, Fixed Income Strategies Group

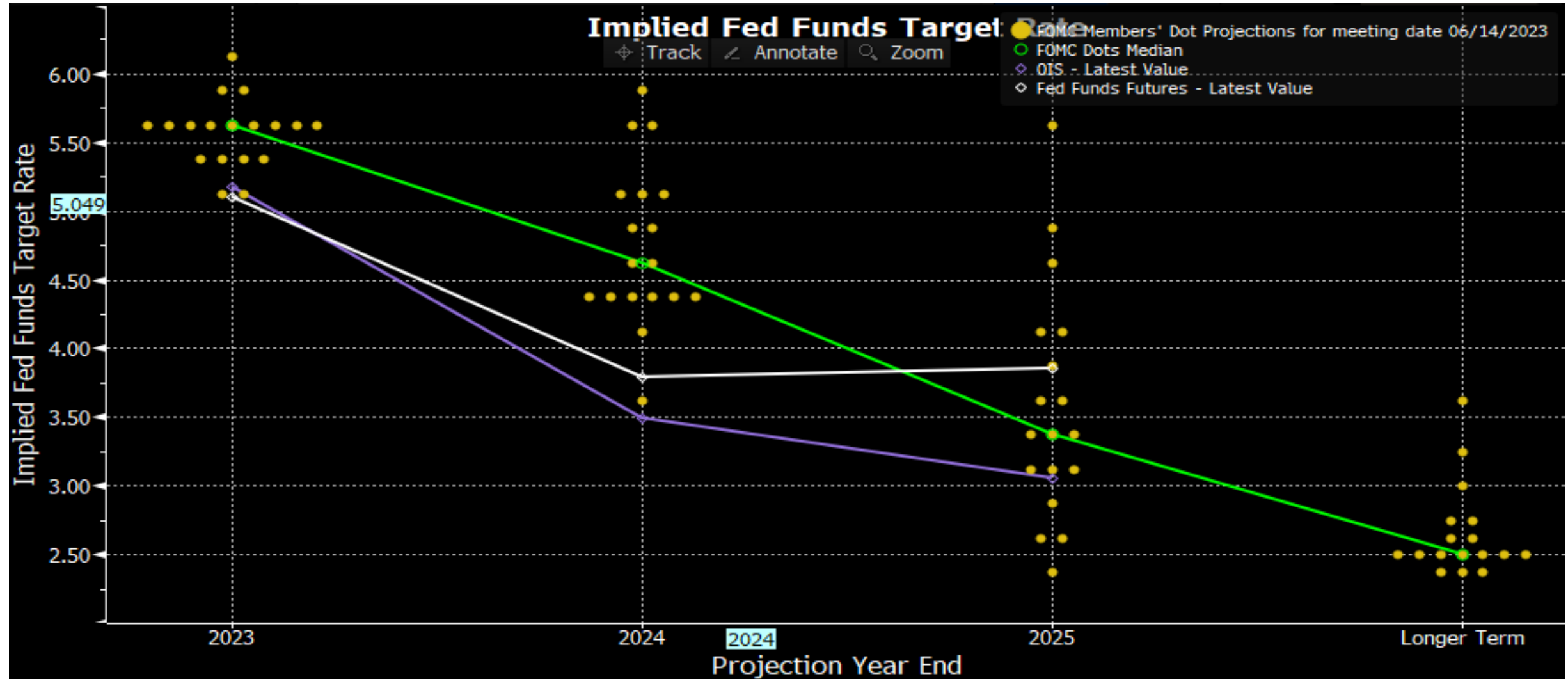
July 25, 2023

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## Is The Fed Done After Tomorrow?

- The FOMC is expected to hike another 25bps tomorrow. The question is will that be it, or is there another hike to come later this year?
- **While we think they will pause in September, the November meeting could see another rate hike if both inflation and employment readings don't show sufficient cooling.**
- Despite plenty of recent improvement in overall inflation readings, the Fed's recent concern is that core services inflation, until recently, hasn't shown much improvement this year. How that evolves through the second half of 2023 will go a long way in determining the Fed's future rate hiking posture.

## Fed's Latest Rate Projections – Hiking to 5.50% - 5.75% With 100bps in Cuts in 2024

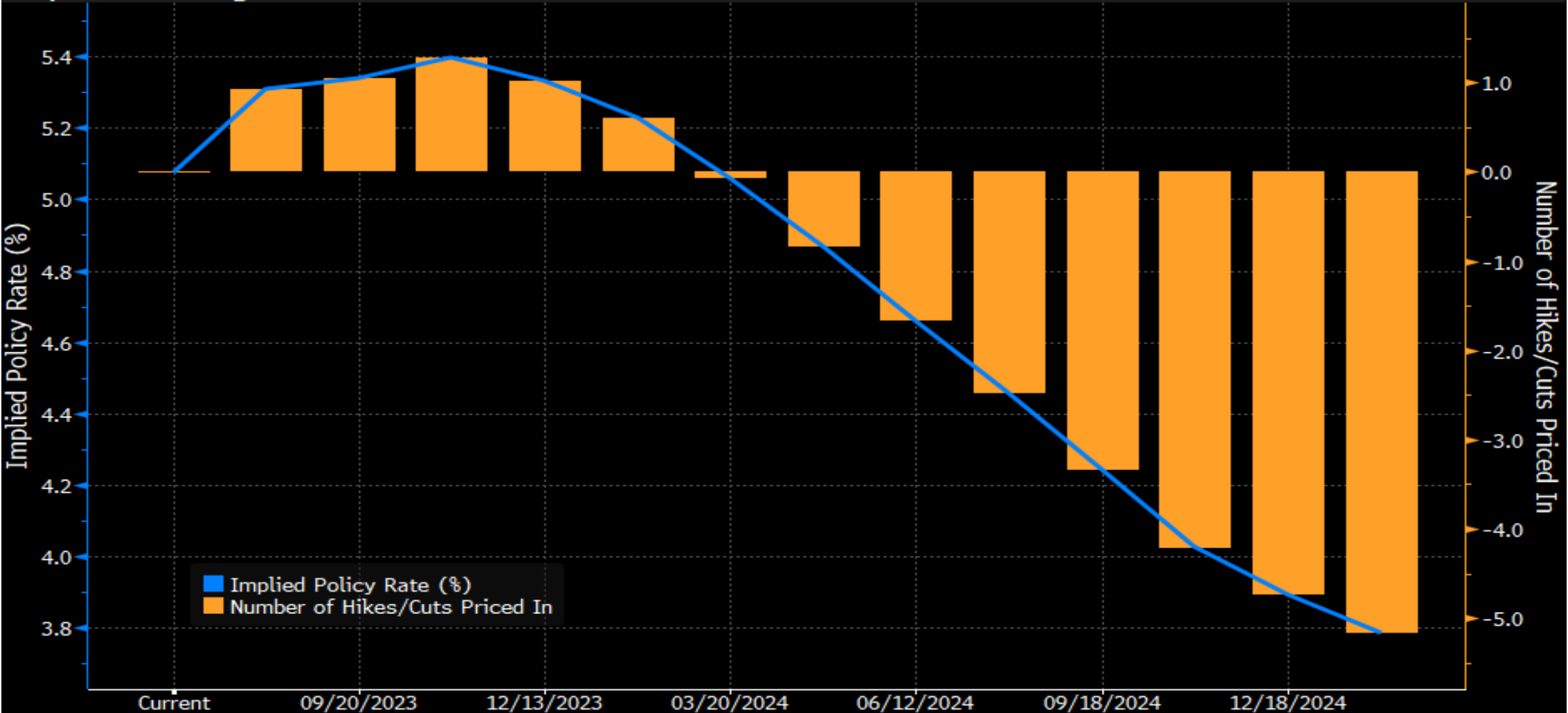




## Market's Latest Rate Projections – Hiking to 5.25% - 5.50% With 140bps in Cuts in 2024

World Interest Rate Probability: Rate Path

Implied Overnight Rate & Number of Hikes/Cuts



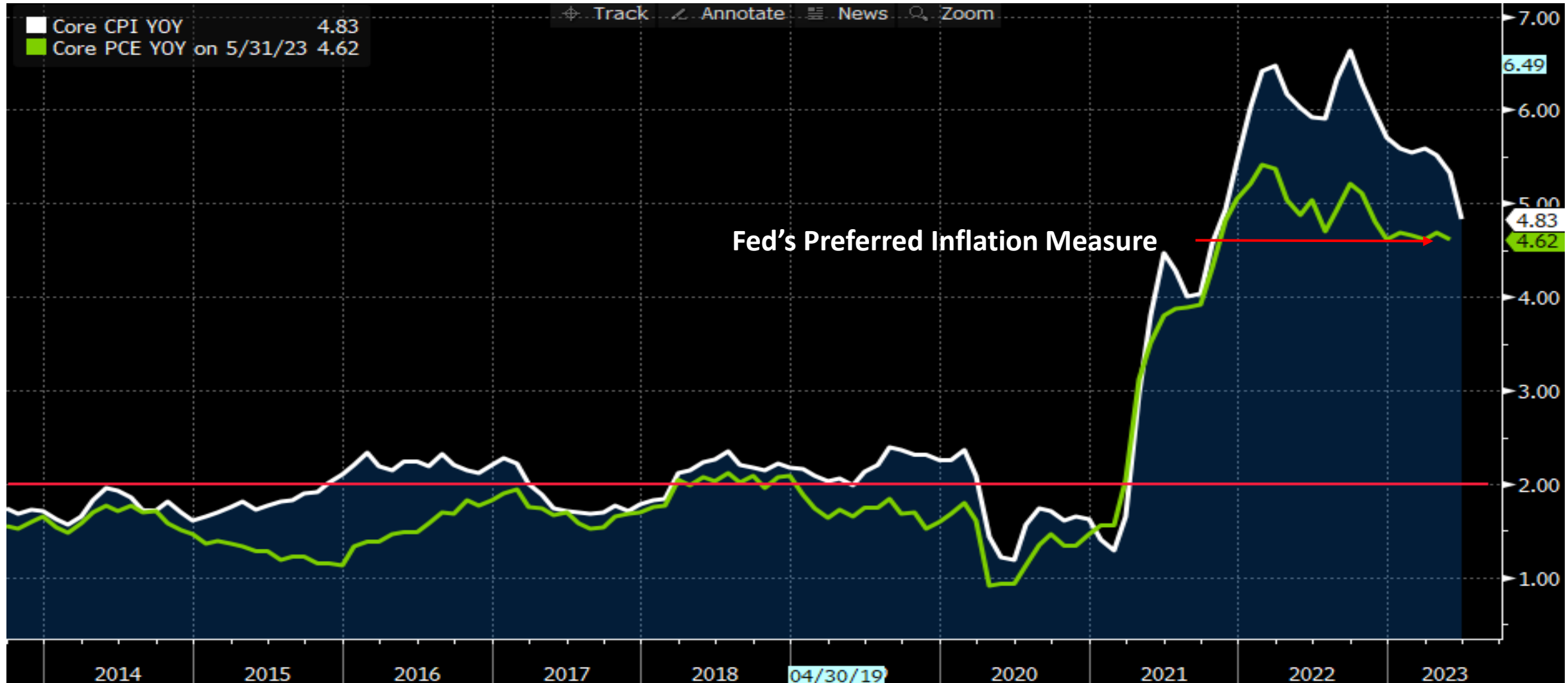
## What Does This Mean for Yields?

- The short-end of the Treasury curve has recently repriced higher in yield as it adopts somewhat to the Fed's June fed funds forecast. Fed funds futures expect the Fed to be done after tomorrow, whereas the Fed has another hike forecast for 2023. Thus, **short-end yields may rise further if the second hike starts to look likely.**
- Longer maturity Treasury yields have been climbing recently, both in response to the Fed's updated rate outlook and reflecting the resilience of the economy. We believe, however, the move from here will be more range bound due to:
  - Belief that the Fed will get inflation under control with its rate hikes.
  - The cumulative hikes, combined with the slowdown in lending stemming from the recent bank turmoil, will slow the economy. That will also ease inflationary pressures.
  - **The pre-pandemic demographic forces of an aging and slow-growth populations will eventually reassert themselves and work to keep rates suppressed.**

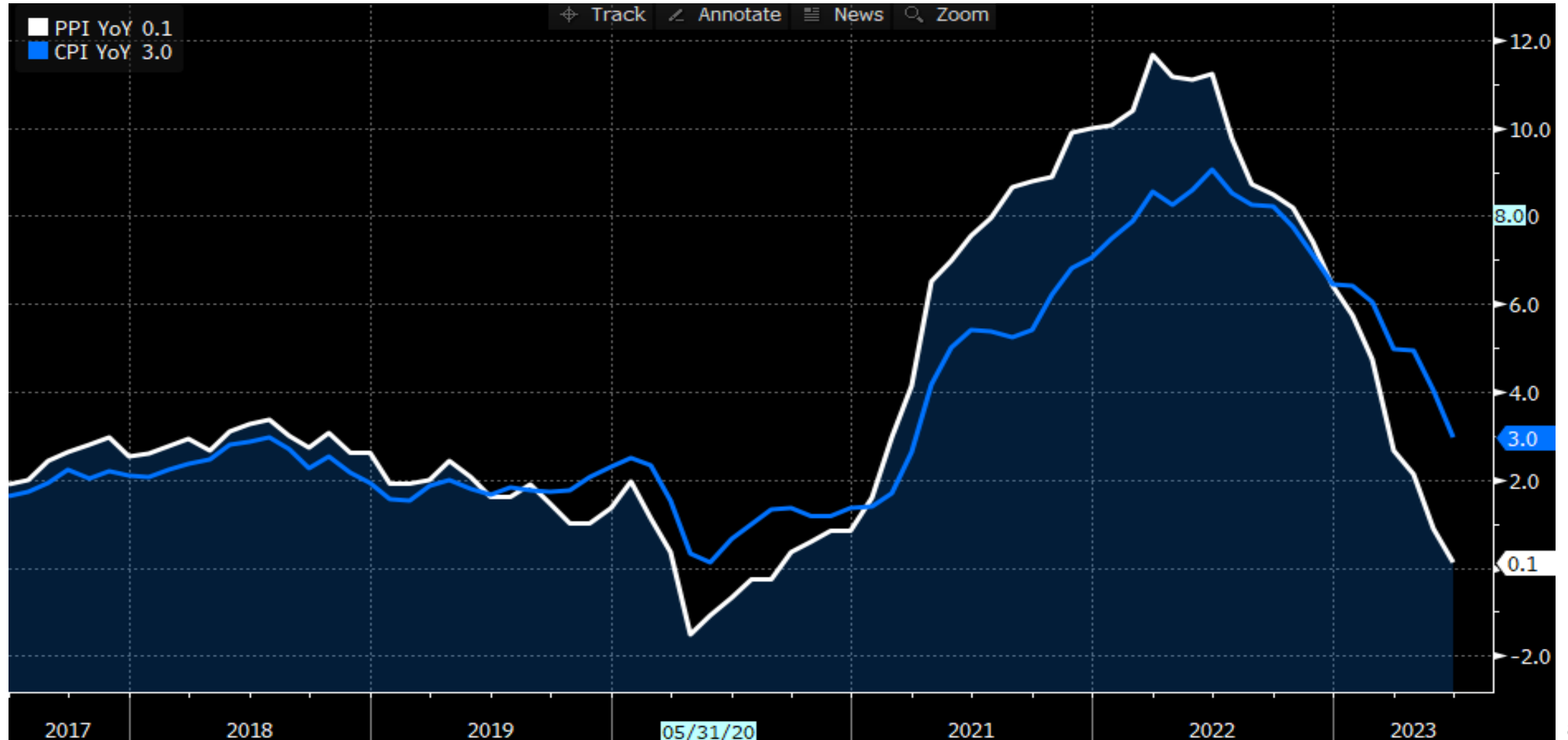
# Inflation Trends

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## Inflation Measures - Peak Inflation Is Behind Us – But Some “Stickiness” Remains

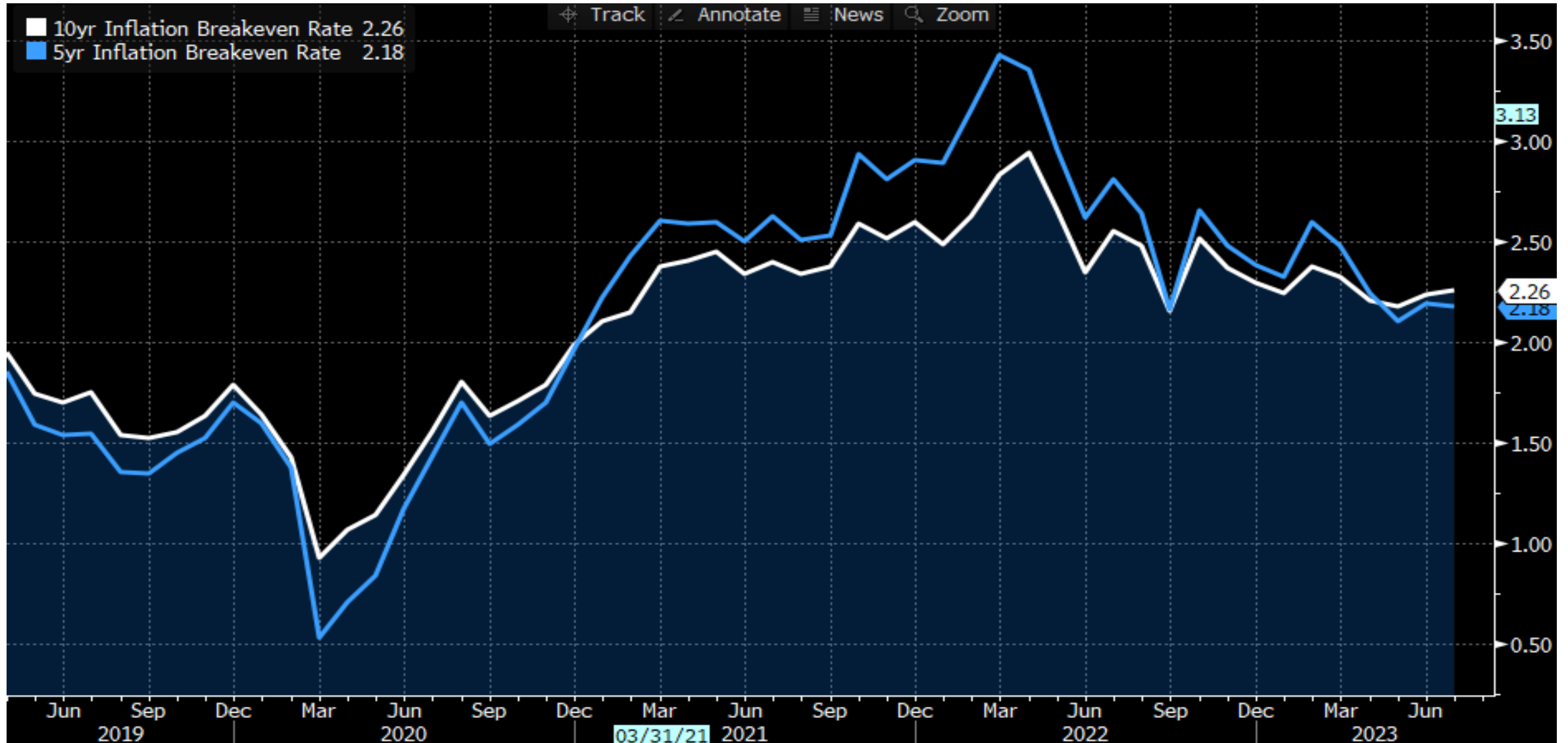


## Inflation Measures – PPI Leading CPI Lower Which Implies Continued Improvement is Likely

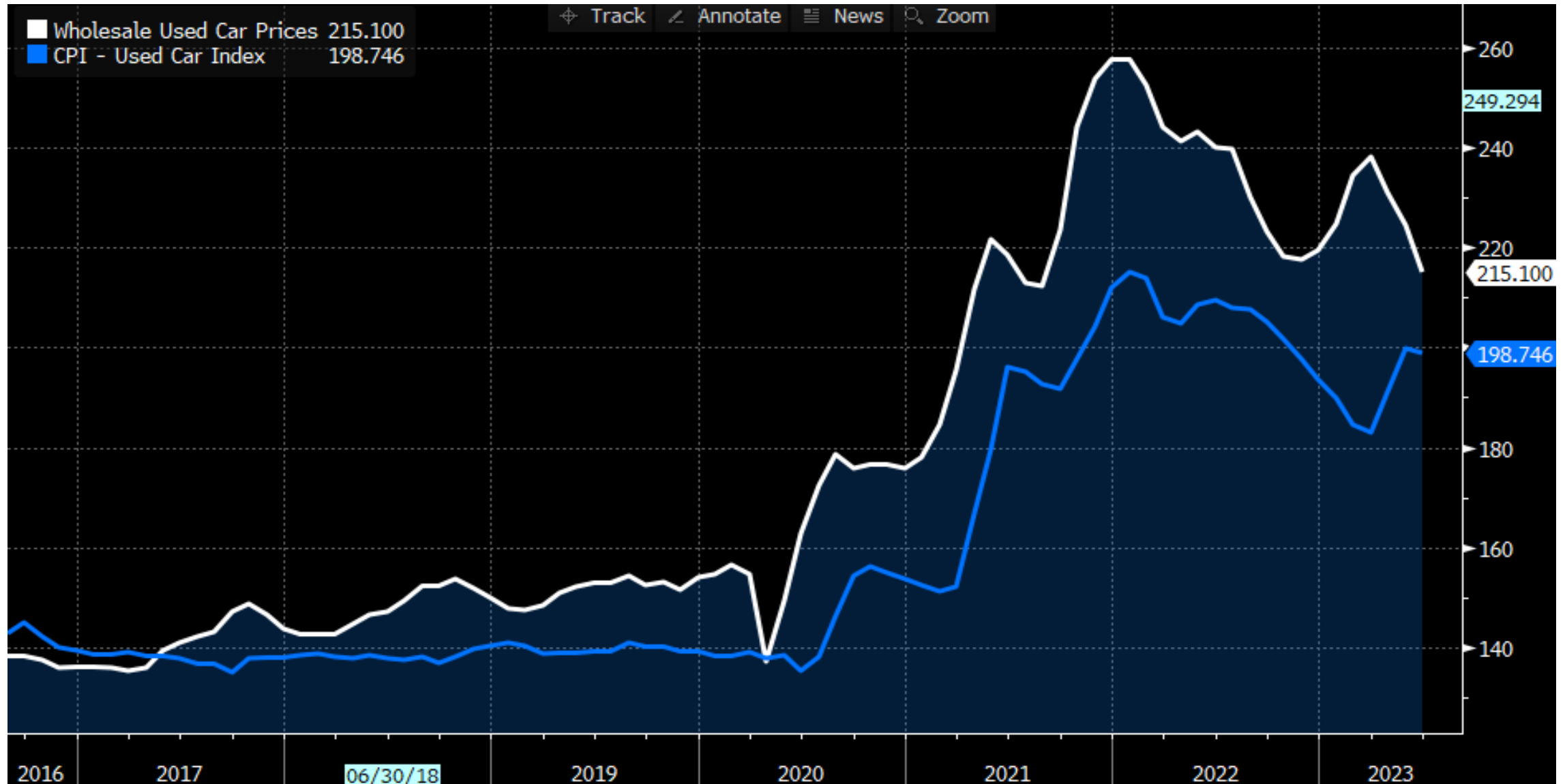




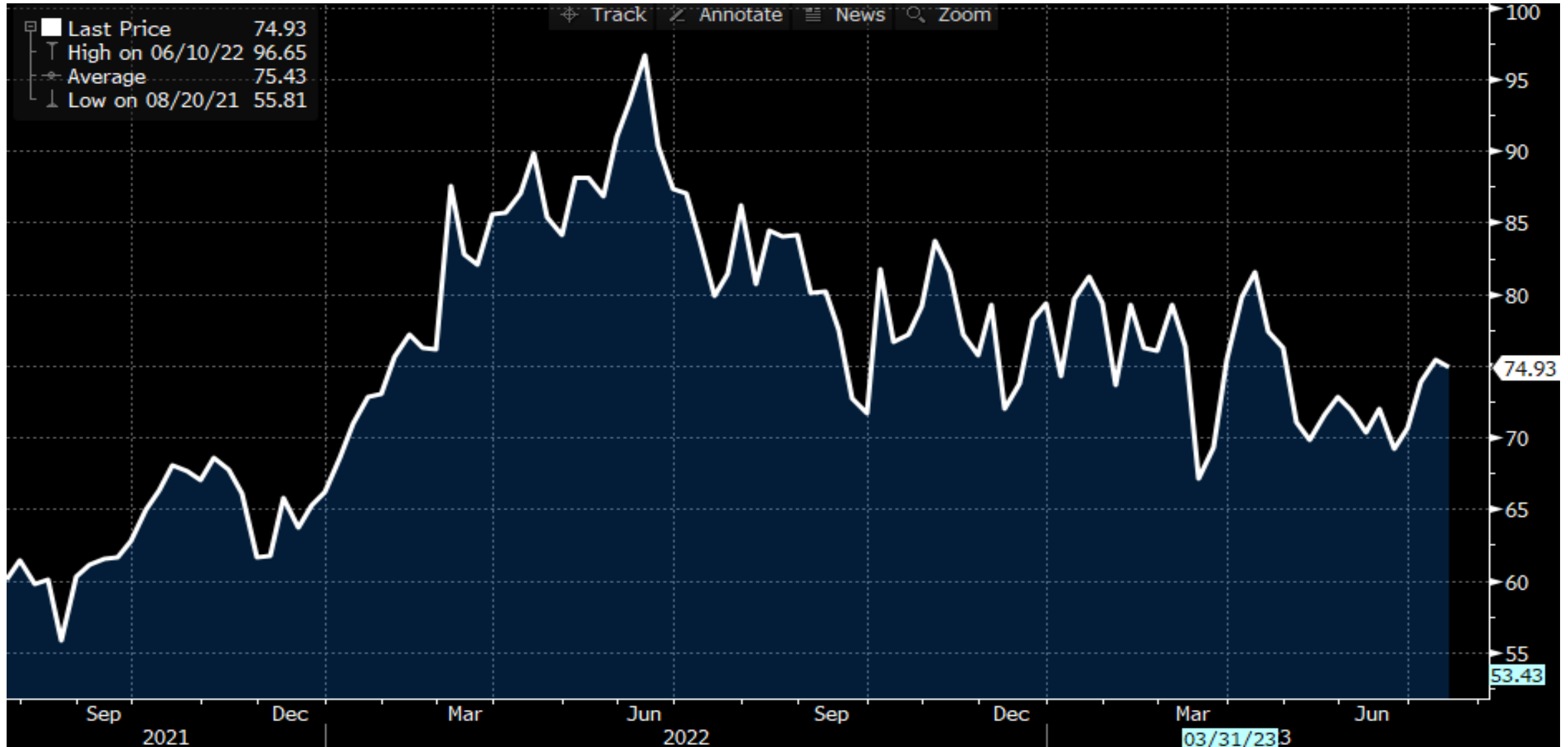
## Inflation Measures – Inflation Breakeven Rates Appear Well Behaved



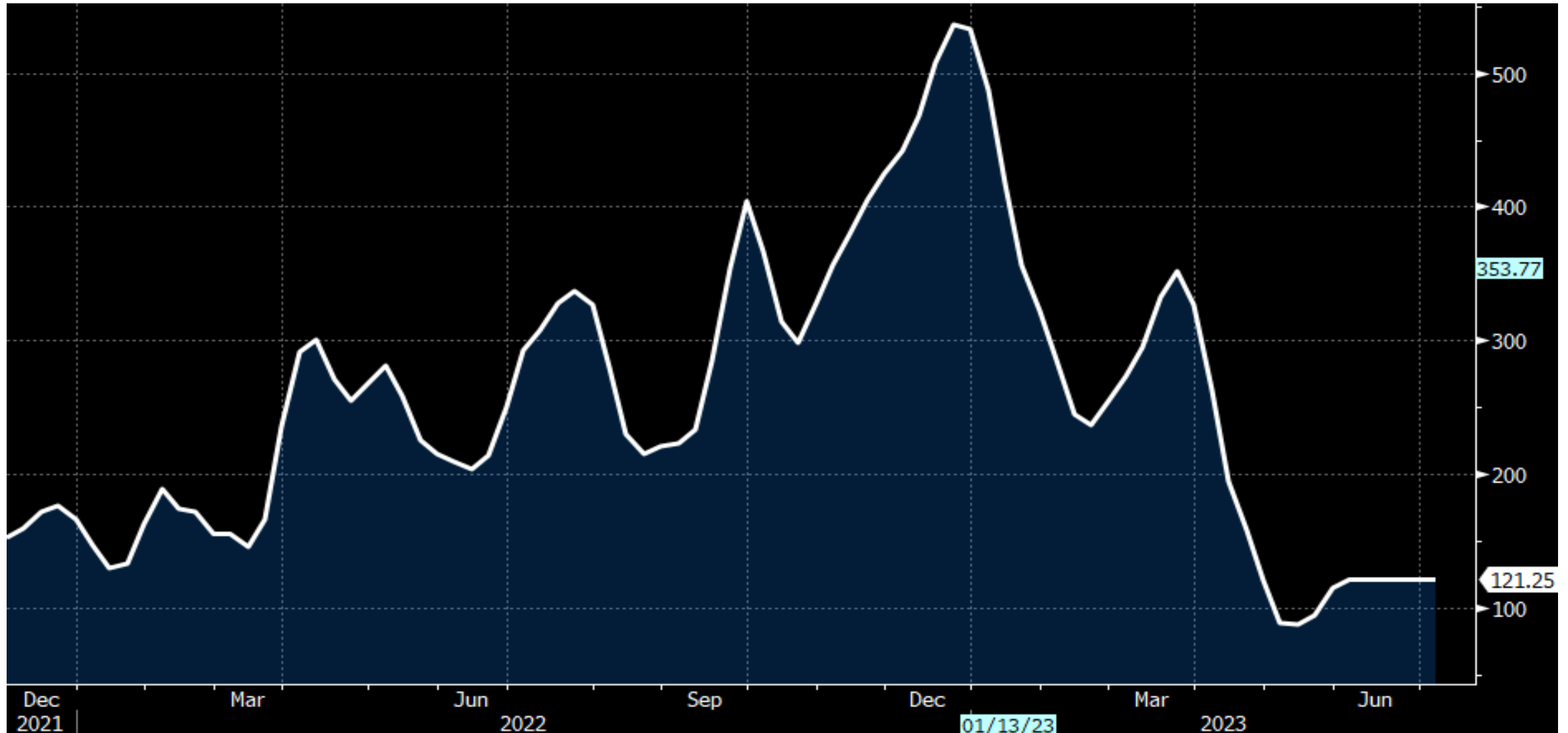
## Inflation Measures – Wholesale Used Car Prices Falling Again, Retail Should Follow



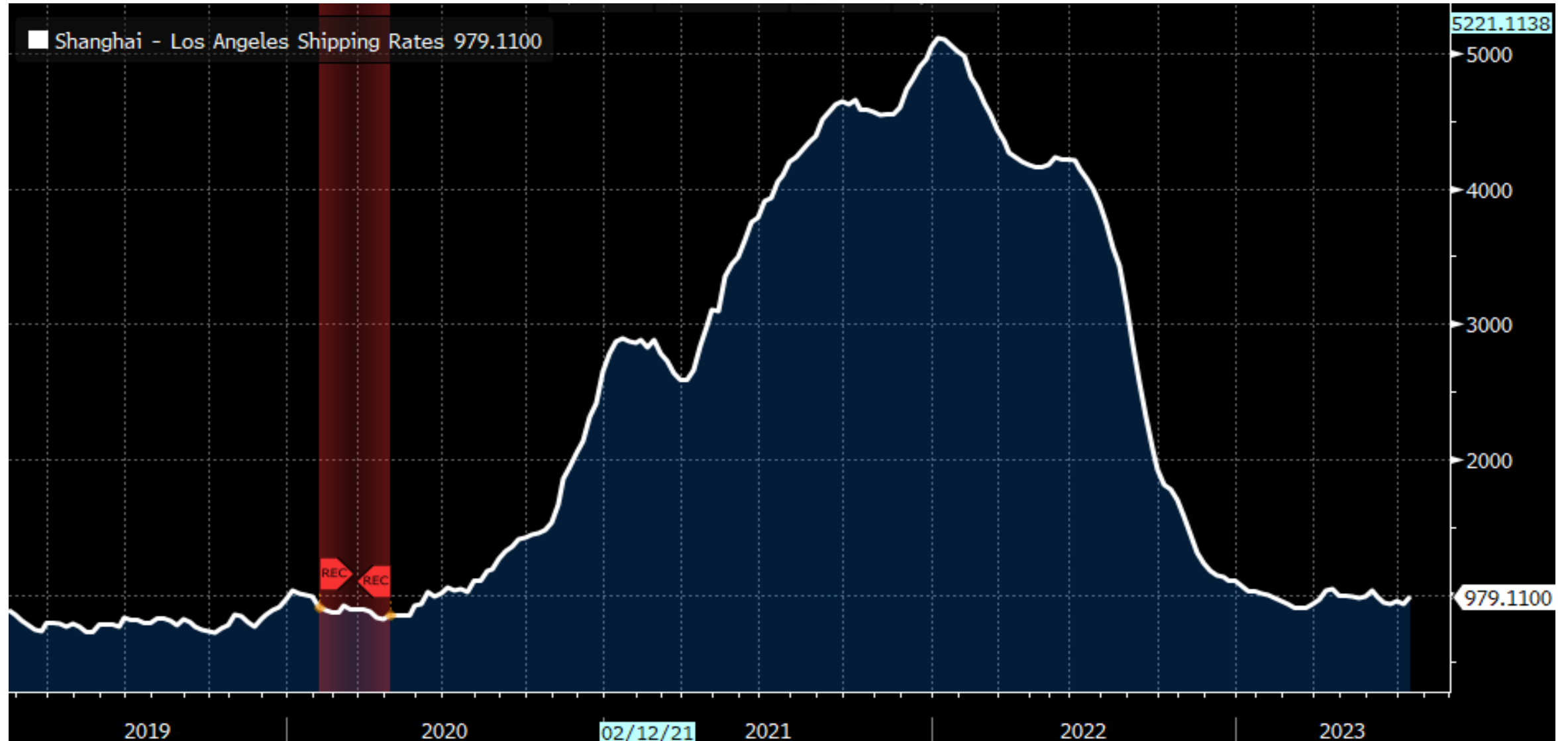
## Inflation Measures - Oil Prices Well Off June 2022 Peak



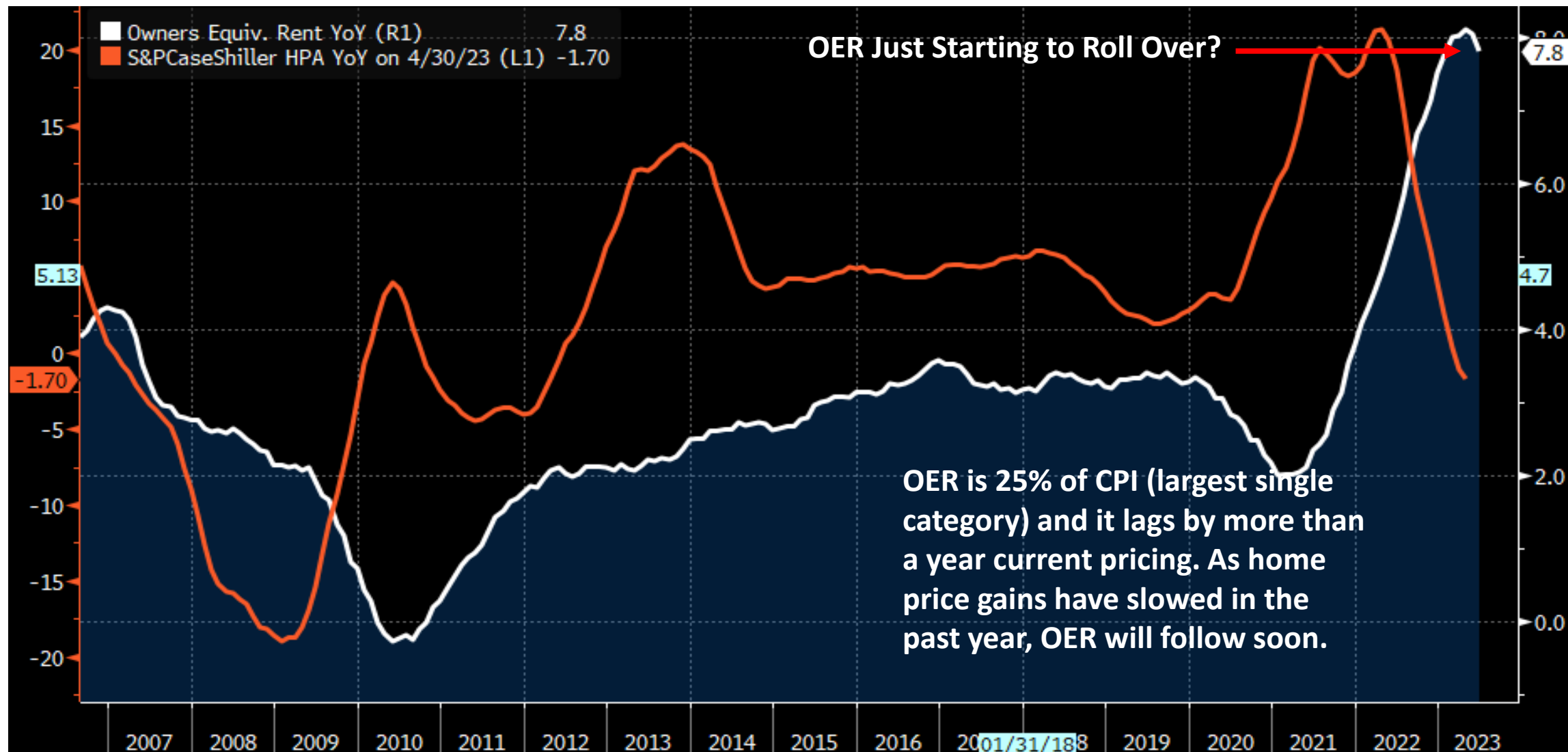
## Inflation Measures – Egg Prices Off the Highs



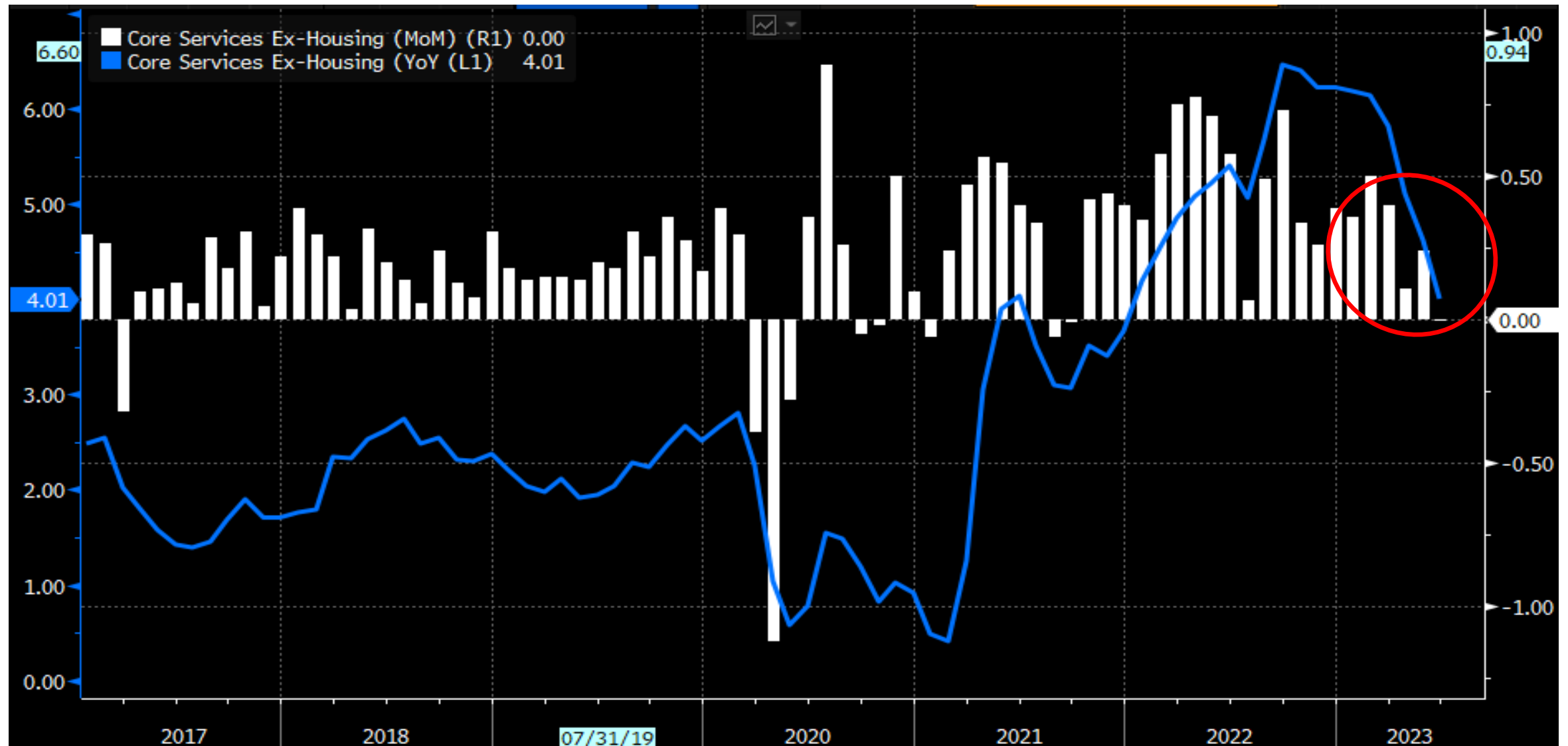
## Inflation Measures – Shipping Container Rates – Back to Pre-Pandemic Levels



## Inflation Measures – Owners Equivalent Rent Poised to Follow HPA Lower

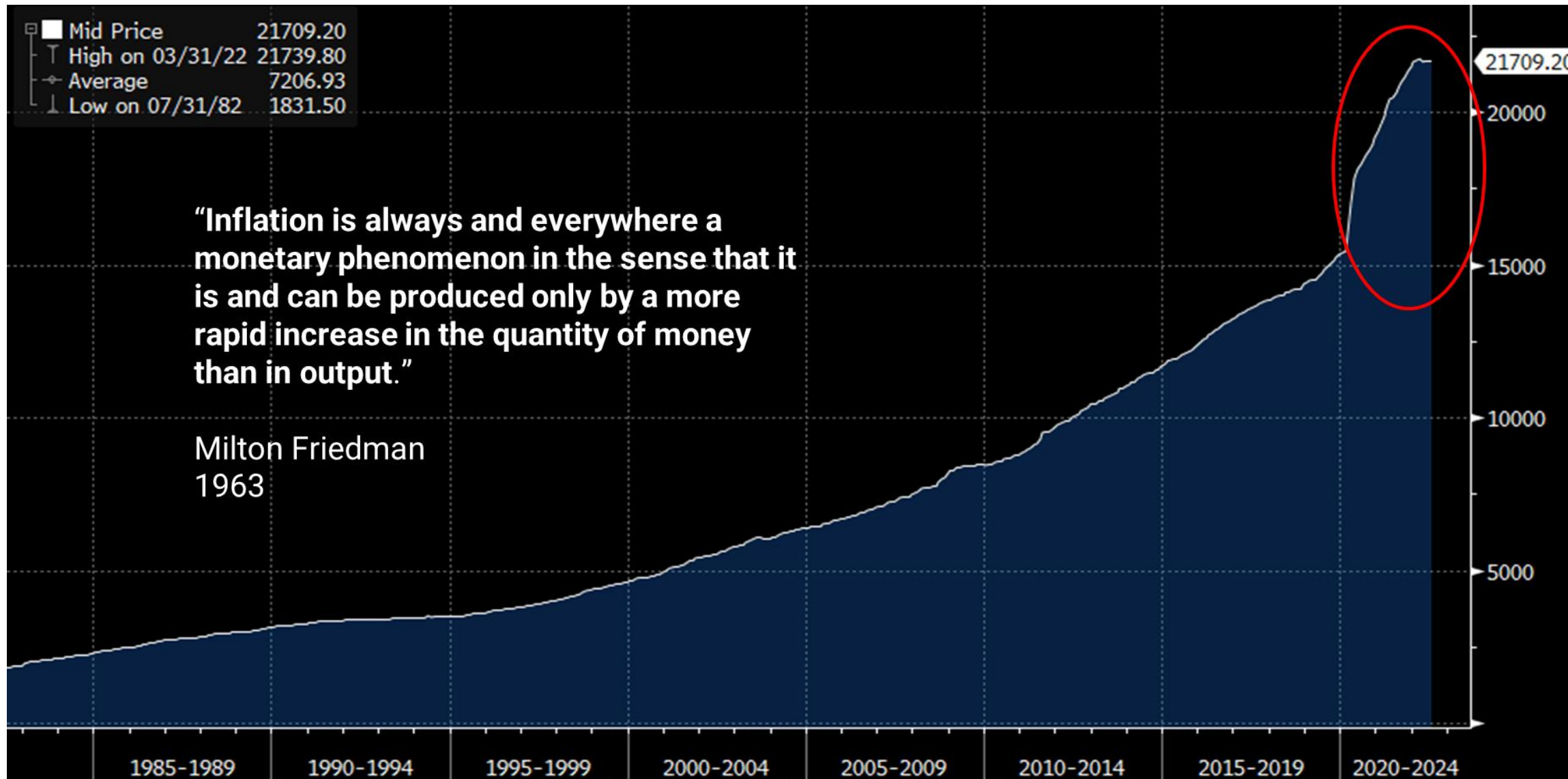


## Inflation Measures – Core Services Ex-Housing – Finally Some Recent Improvement



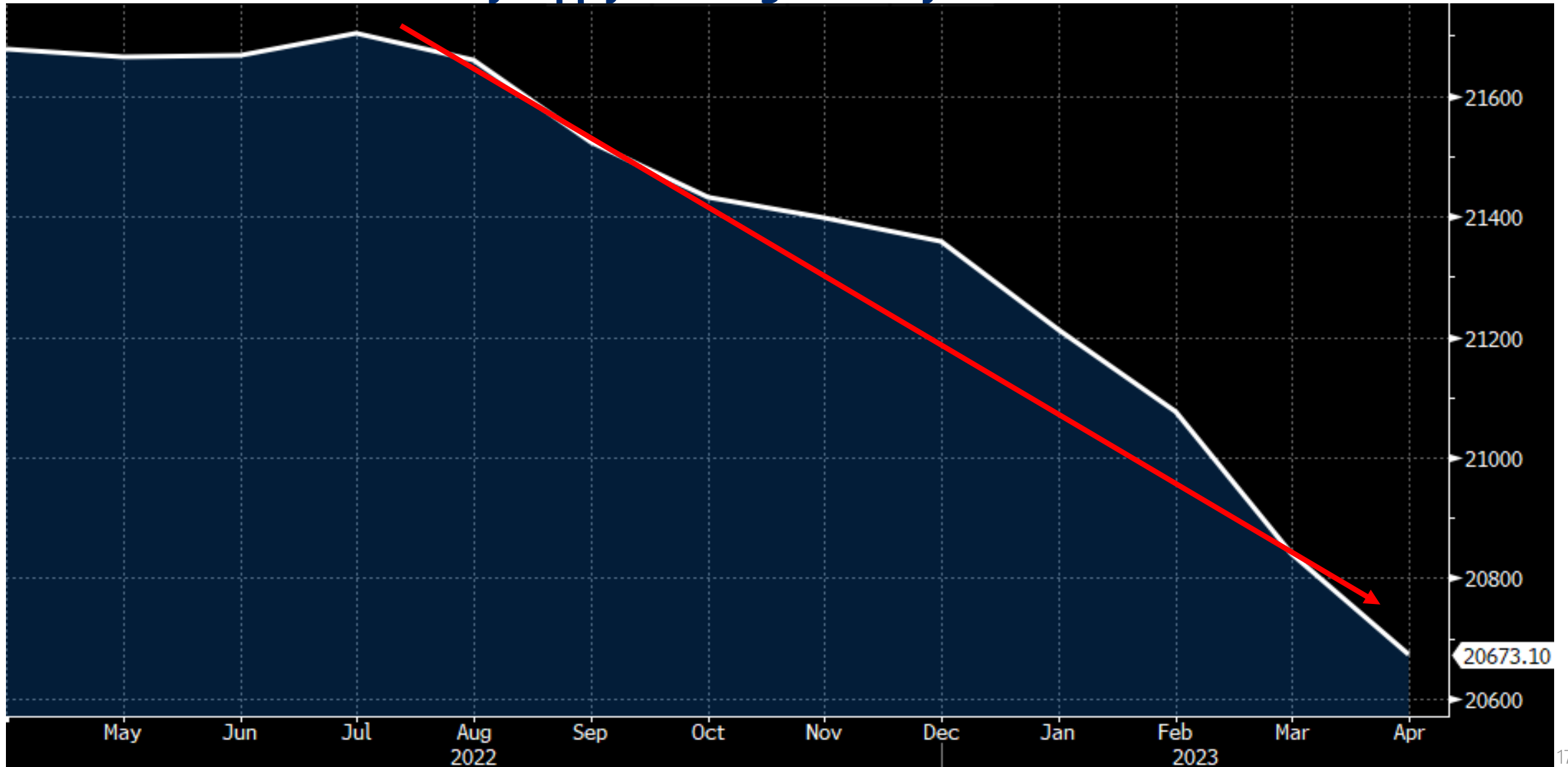


## Inflation Measures – Stimulus Easy to See in Money Supply





## Inflation Measures – Money Supply Declining Since July 2022: Precursor to Lower Inflation?



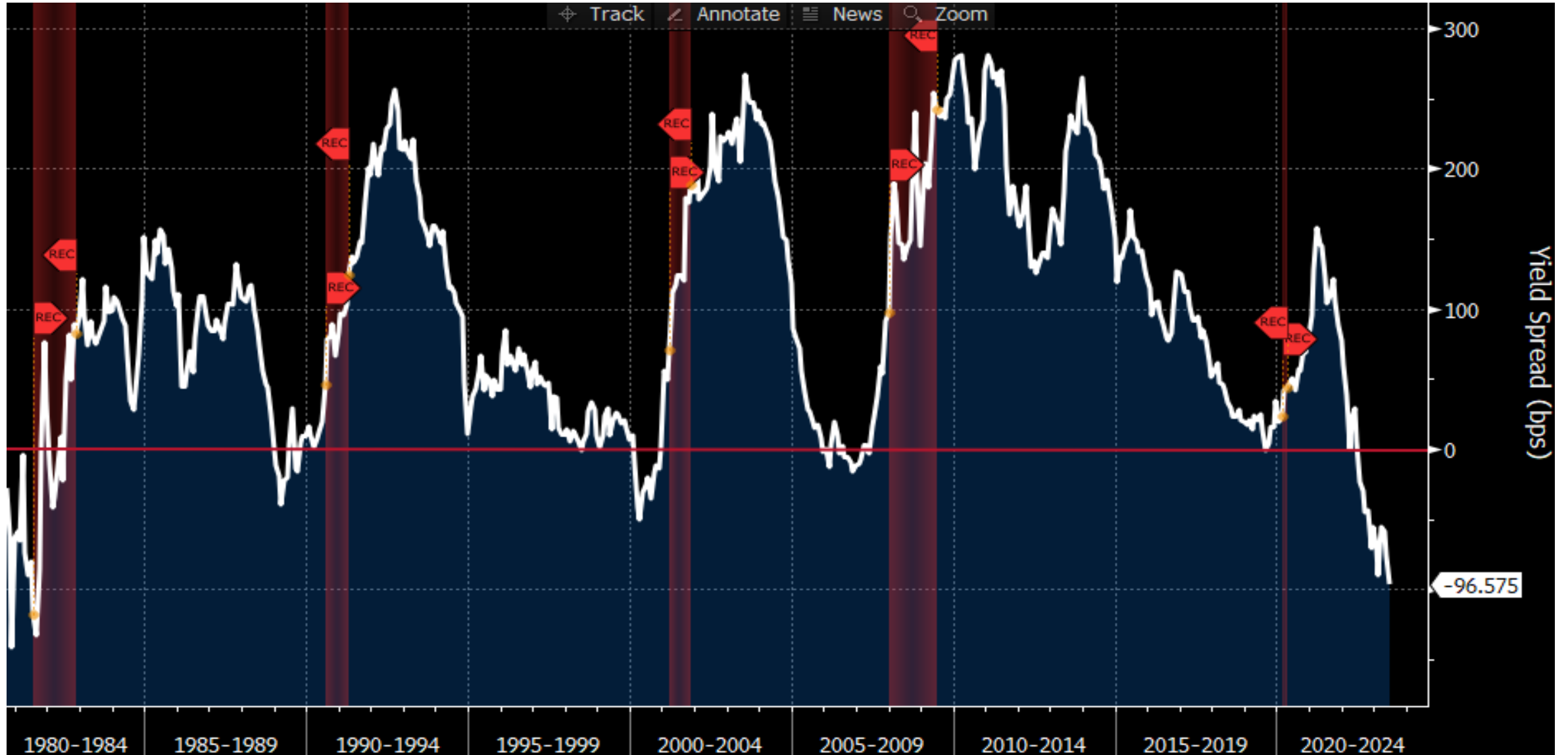
## Inflation Conclusion

- Progress on inflation has been slow, but it is moving in the right direction.
- Goods and commodity inflation has cooled significantly.
- Service inflation has been the “sticky” piece as demand shifted from goods to services.
- However, service-side inflation does seem to be plateauing, if not cooling, in recent months and that bodes well for limited future rate hikes.
- **In conclusion, it does seem like the trend towards lower inflation is in place but getting from 3% to 2% could be tough.**
- **While not wanting to “move the goalposts” of the 2% target, inflation at 8% vs. 2% was noticeable. 2% vs. 3%? Maybe not so much. Expect some change in Fed tone once we get to 3%.**

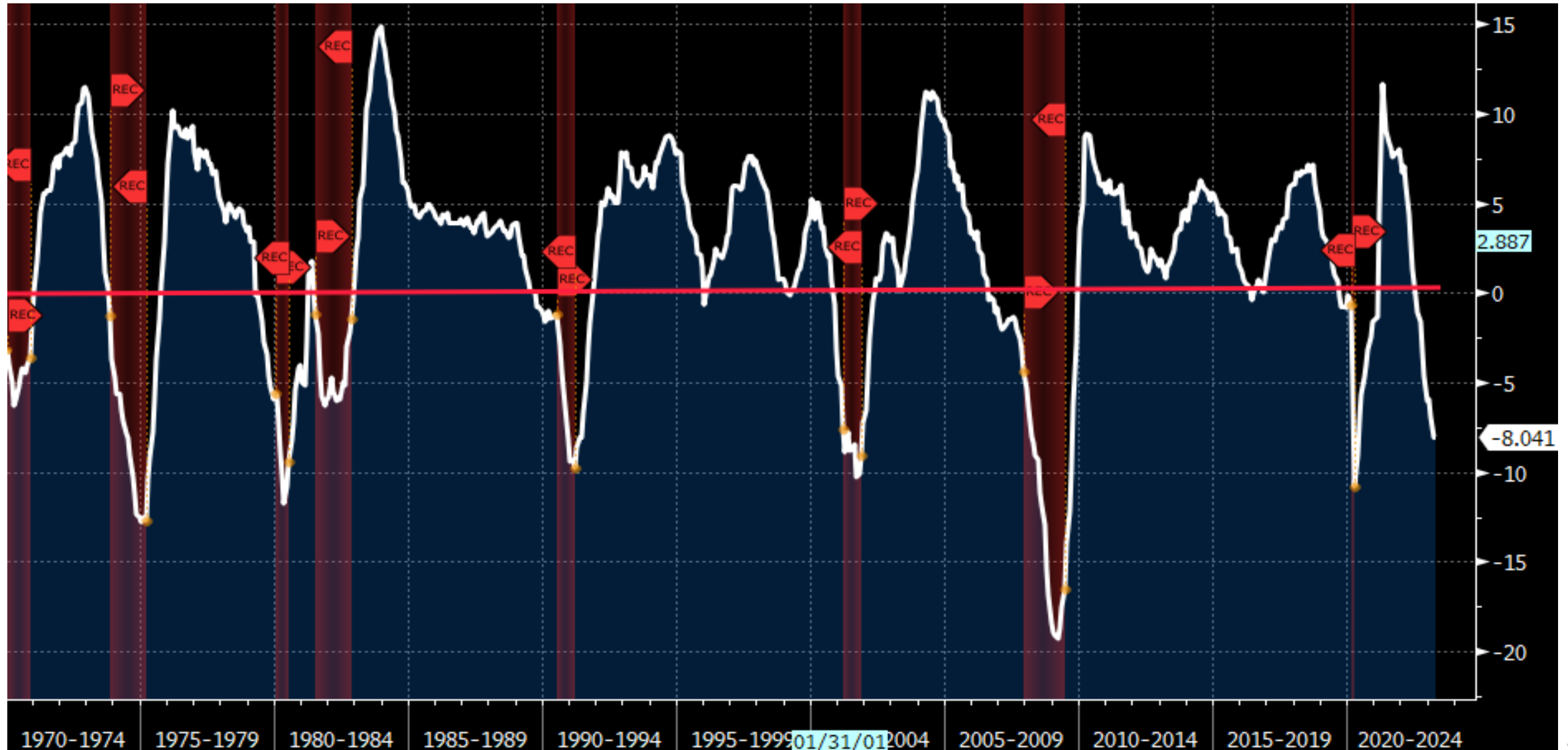
# Recession Indicators

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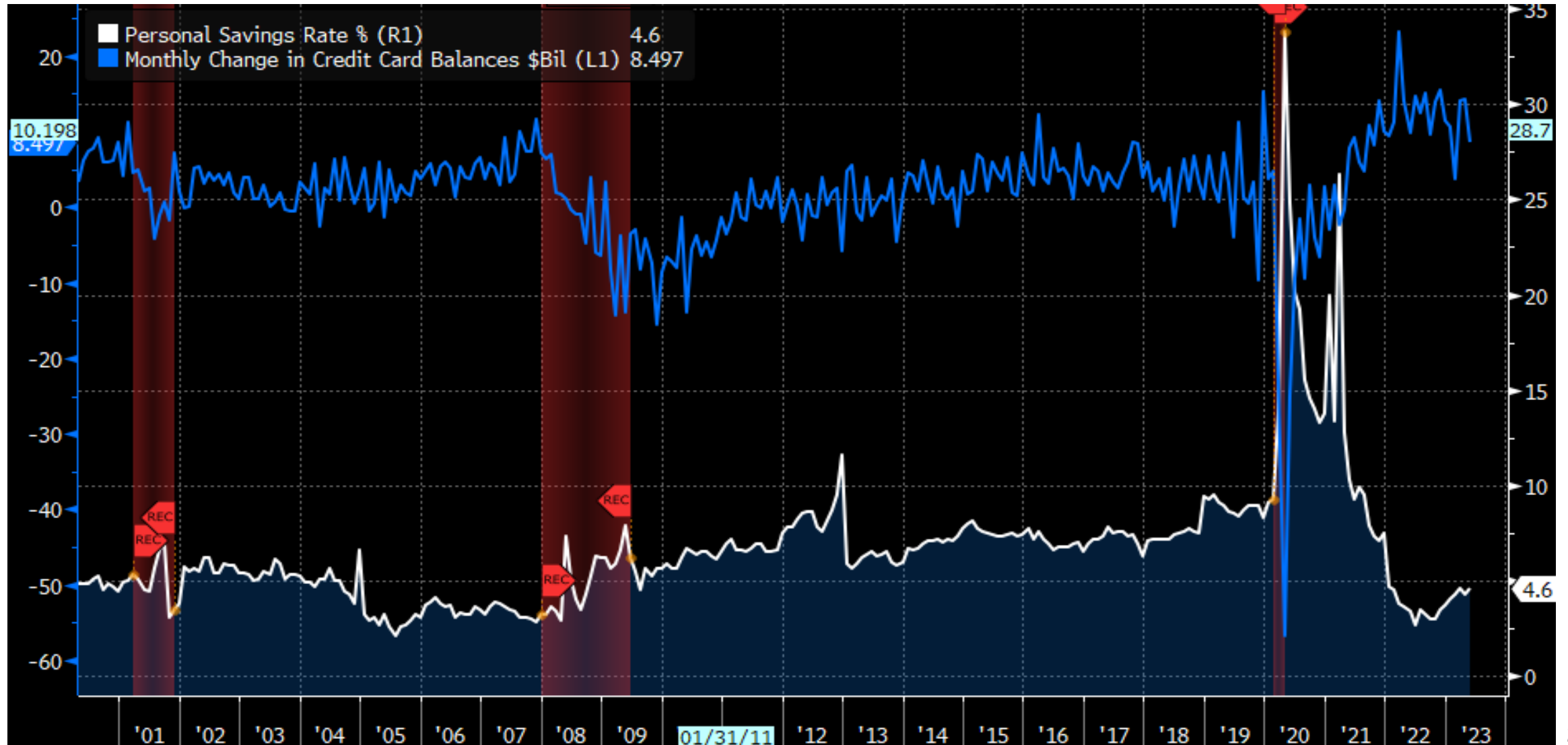
## 2Yr -10yr Treasury Spread Inverted - Clear Recession Signal



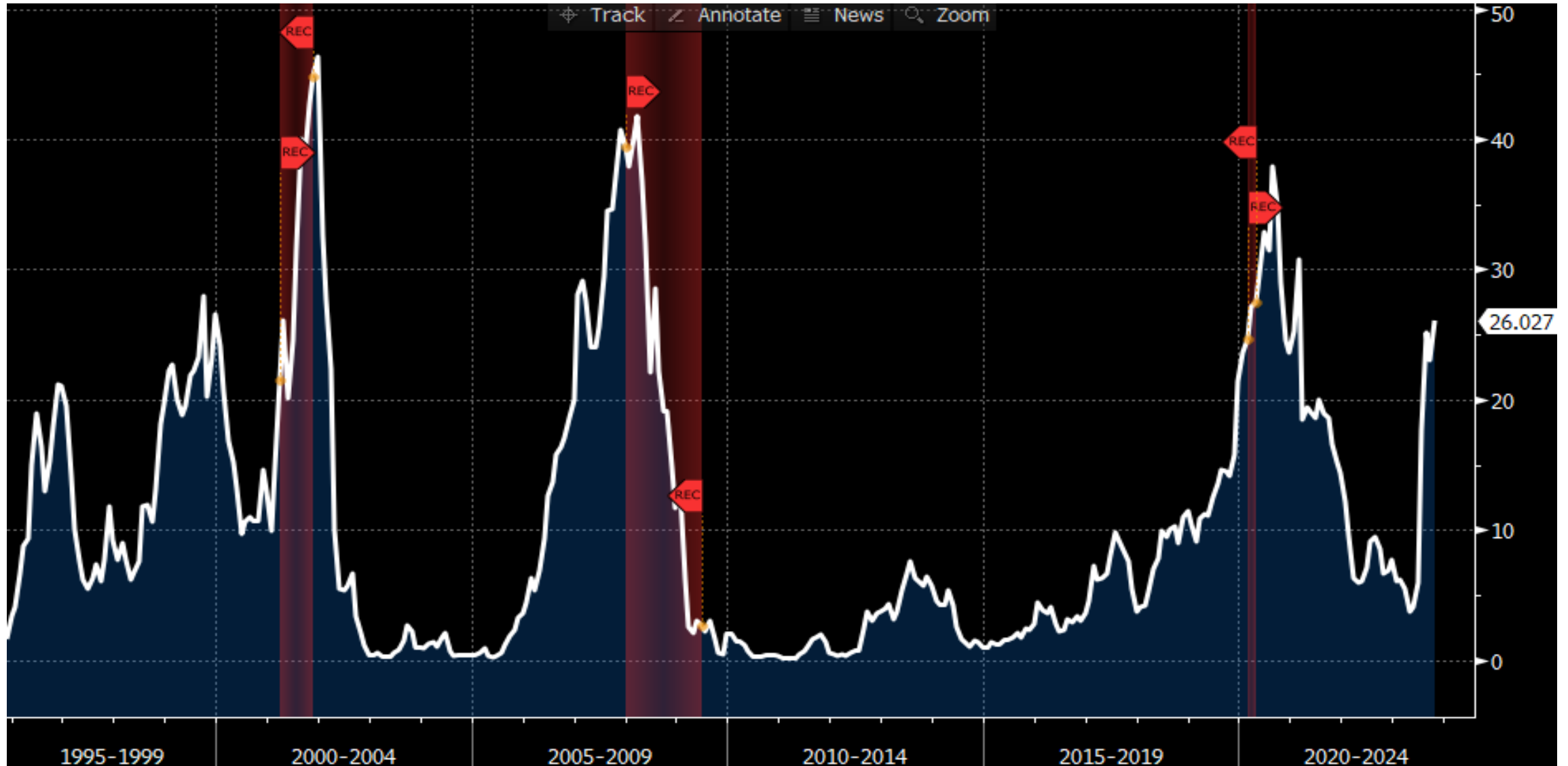
## Negative Leading Economic Indicators (YoY) Signaling Recession



## Personal Savings Rate at 14yr Low and Credit Card Balances Increasing

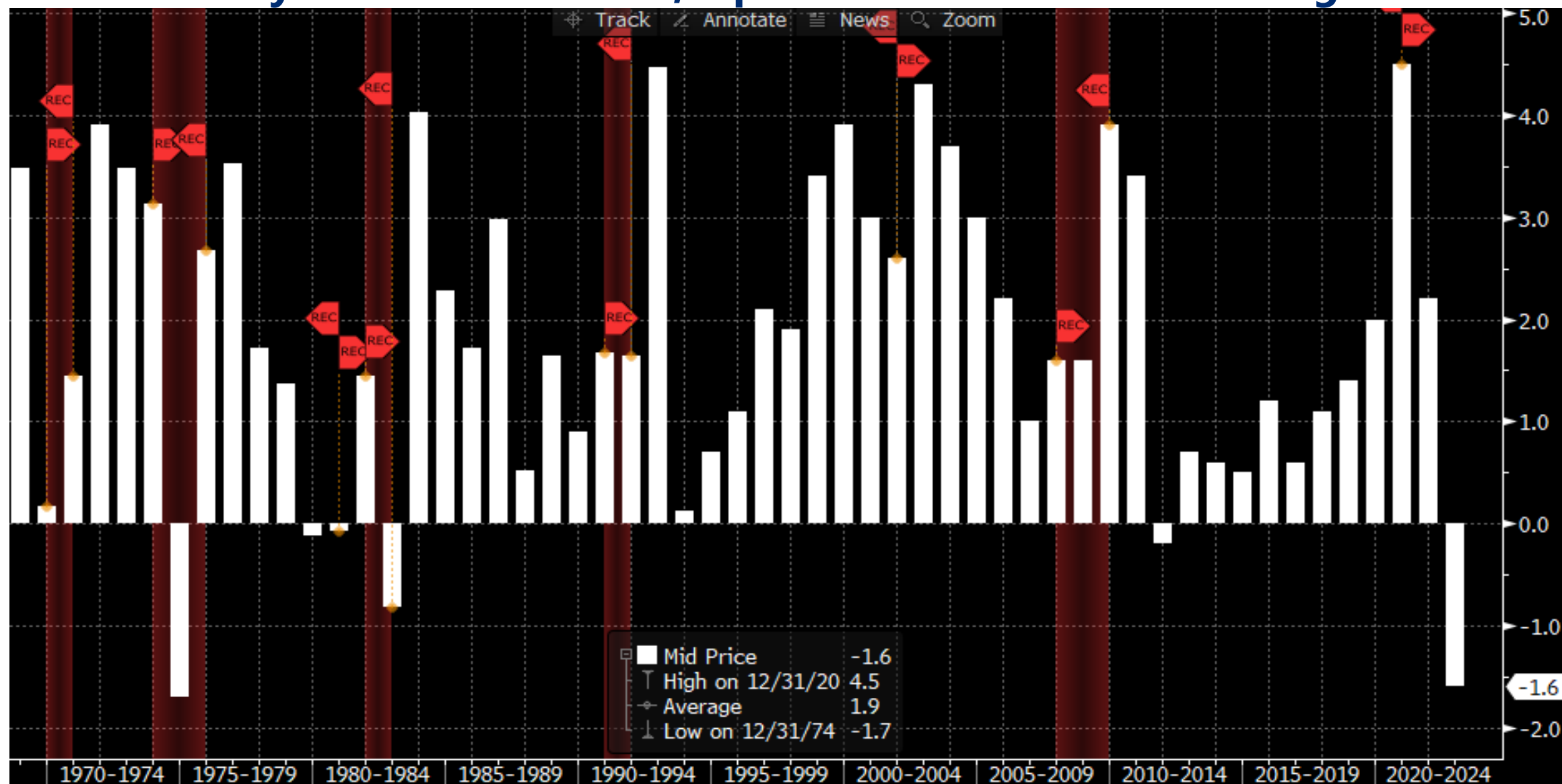


## NY Fed Recession Odds Near Previous Recession Levels





## Productivity Has suffered as Older, Experienced Workers Retired During Pandemic





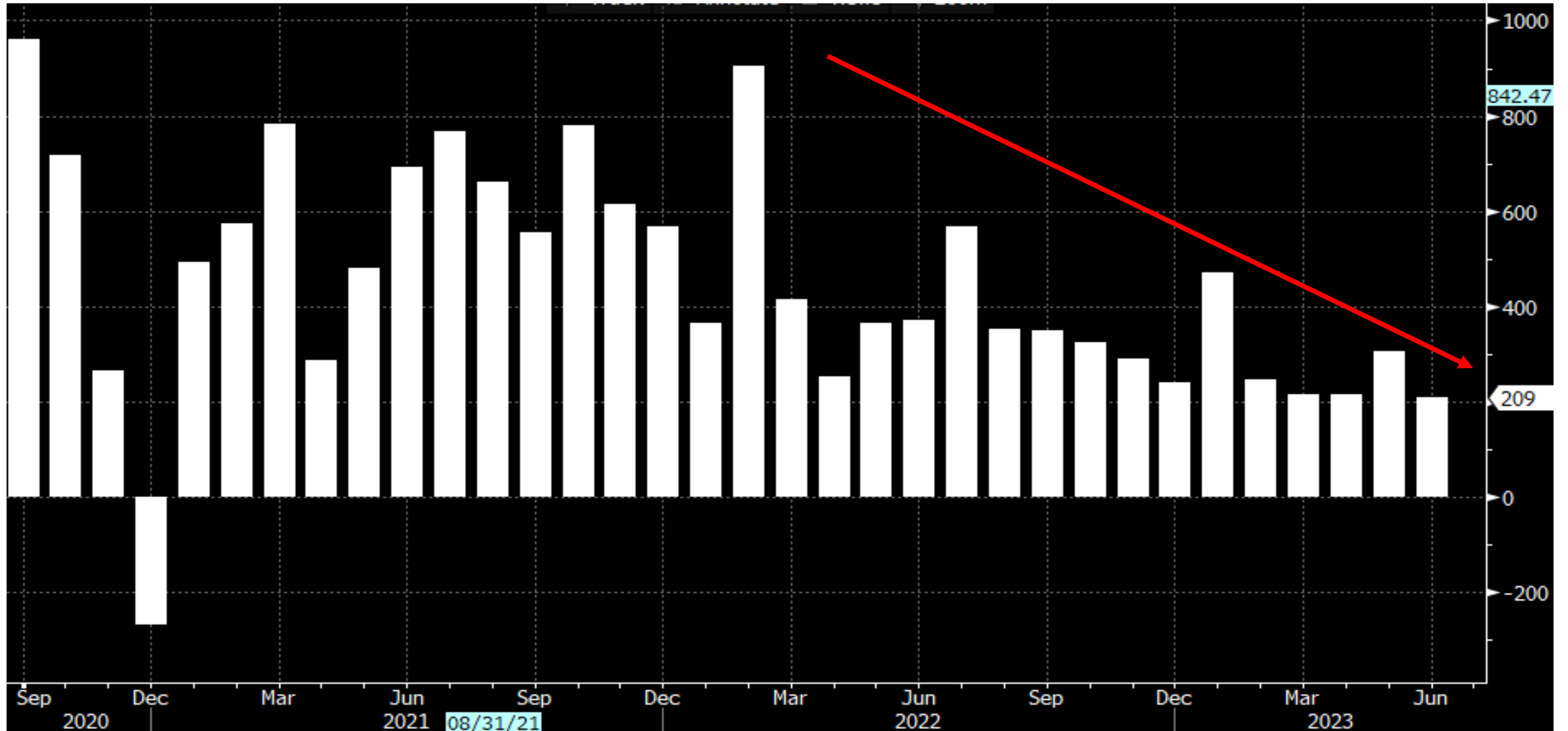
## **Recession Conclusions**

- The consumer, and the economy have proven resilient.
- While there are plenty of recession warning signals flashing, most have been flashing for awhile while the economy and the consumer maintain positive momentum.
- Will the banking crisis and the resulting tightening in financial conditions be enough to tip the balance towards recession? It's possible, and the Fed staff has forecast a mild recession later this year, although FOMC officials see a soft-landing scenario.
- Our base case is for a so-called soft landing, avoiding a recession but just barely. That said, a recession is possible later this year, or in early 2024, but it would be a relatively short and mild affair.

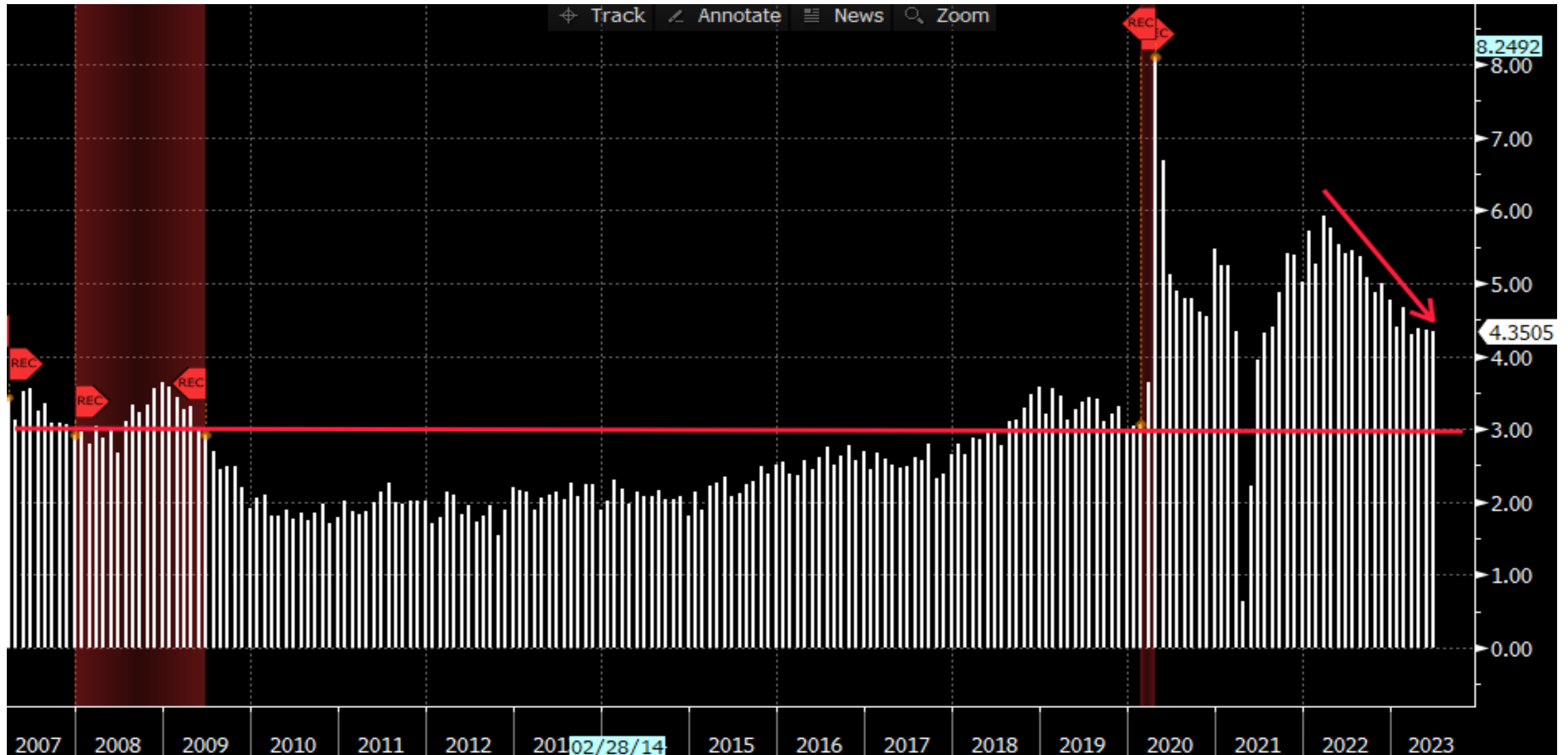
# Economic Positives

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## Job Growth, While Slowing, Remains Solid – Fed Wants This Lower

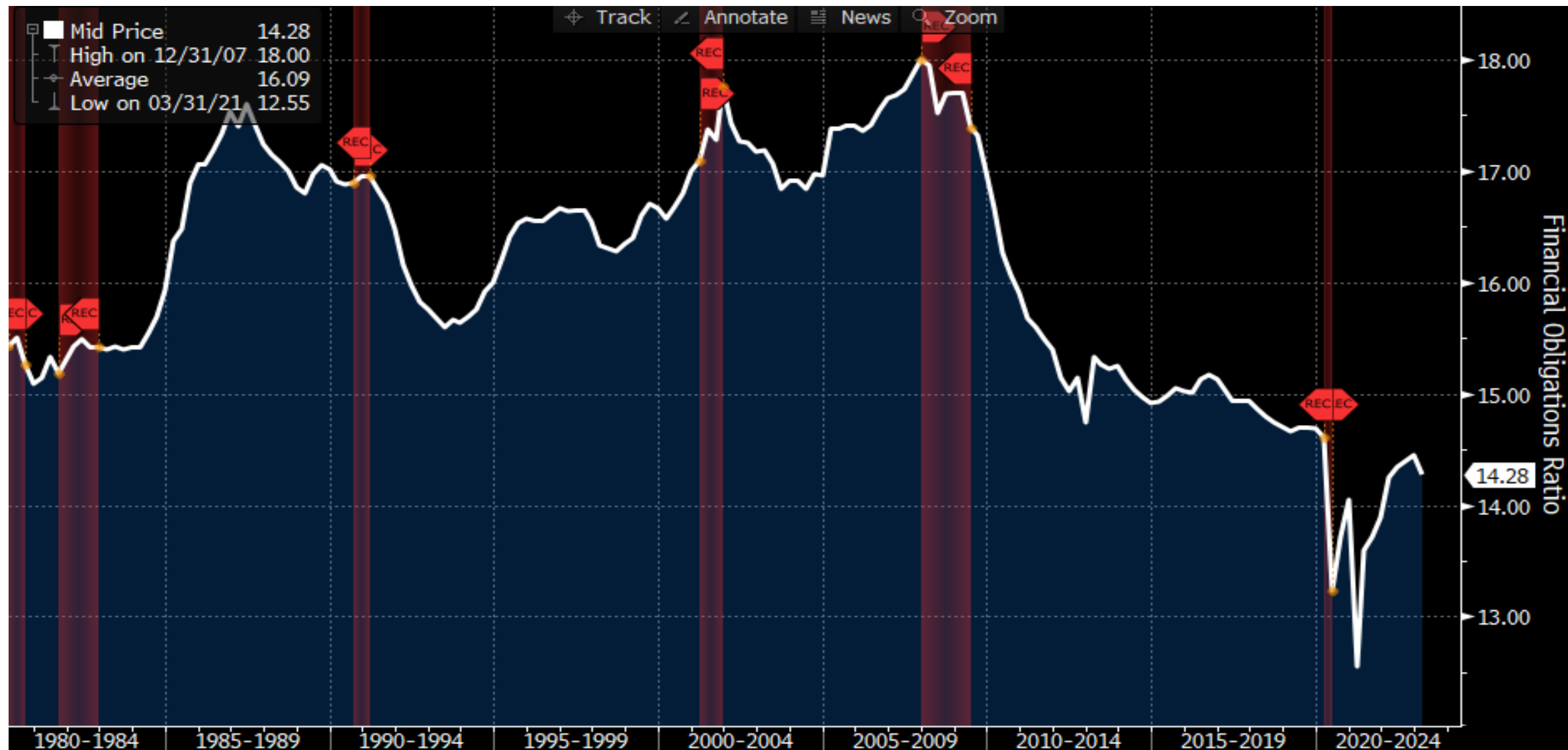


## Average Hourly Earnings Above Long-Term Average- Fed Wants This Lower

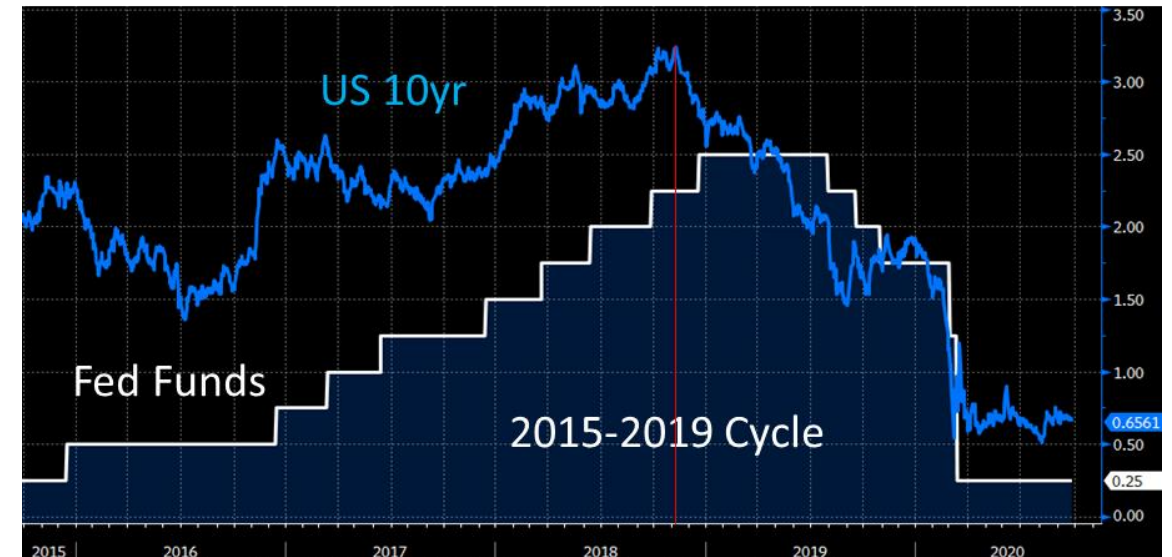
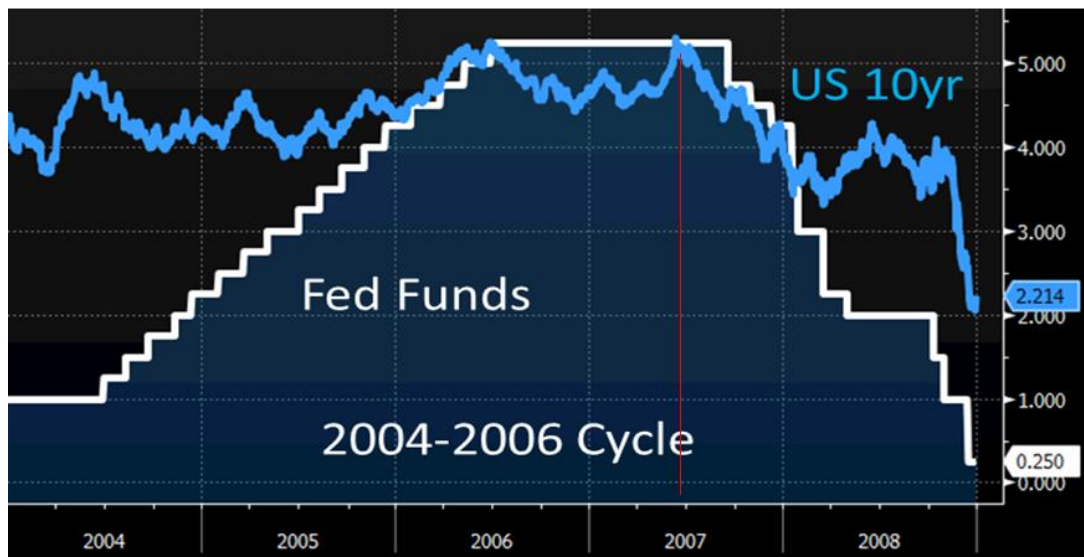
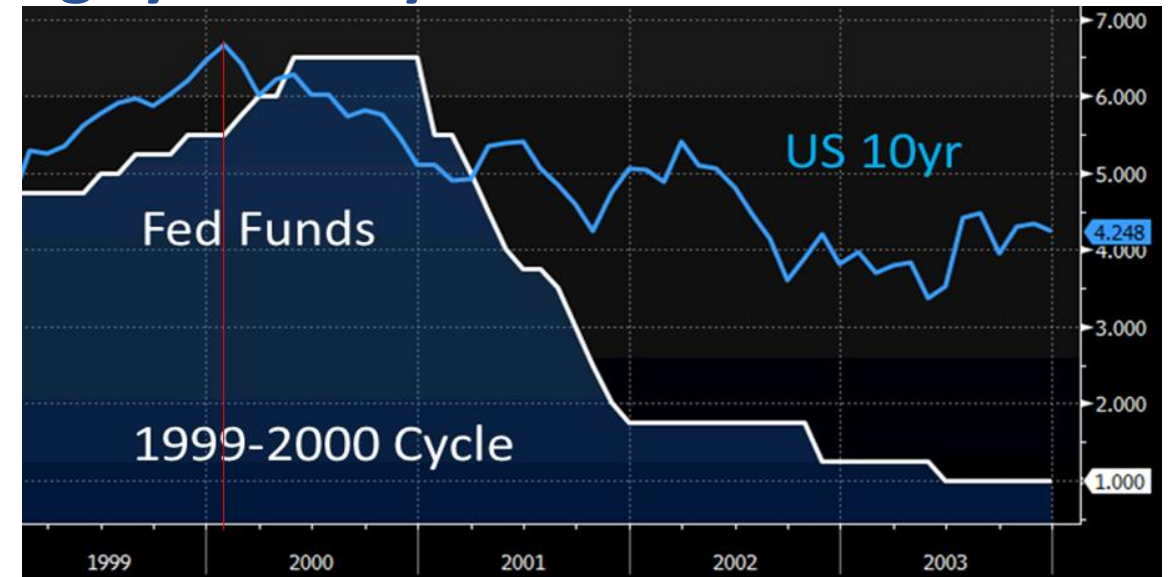
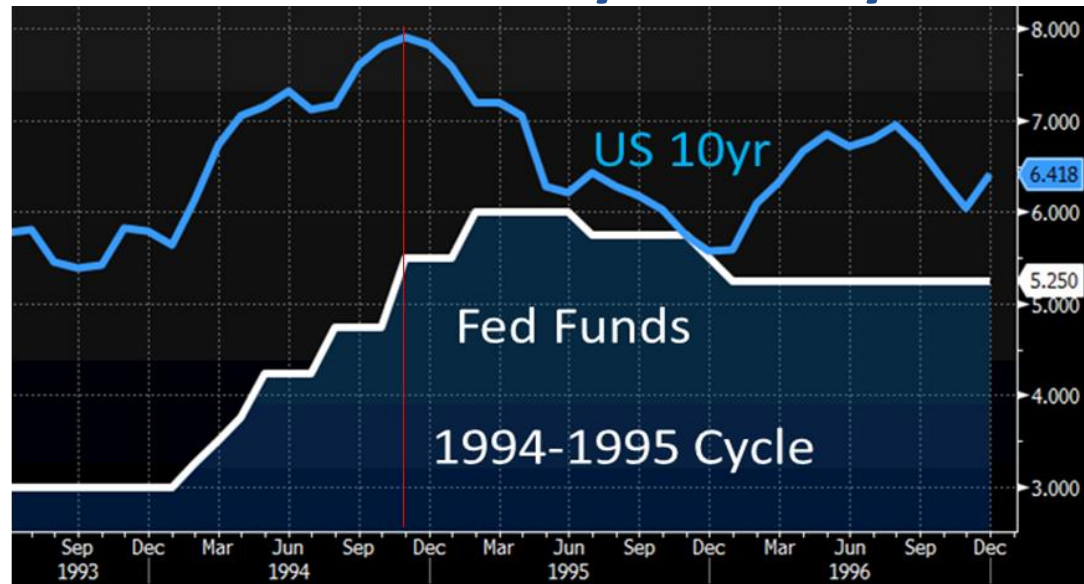




## Financial Obligations Ratio Increasing But Plenty of Spending Capacity Remains



## Fed Funds vs. 10yr Treasury in Prior Hiking Cycles – 10yr Leads Fed Funds Lower



## Fed Funds vs. 10yr Treasury Yield in Current Hiking Cycle – 10yr Patiently Waiting





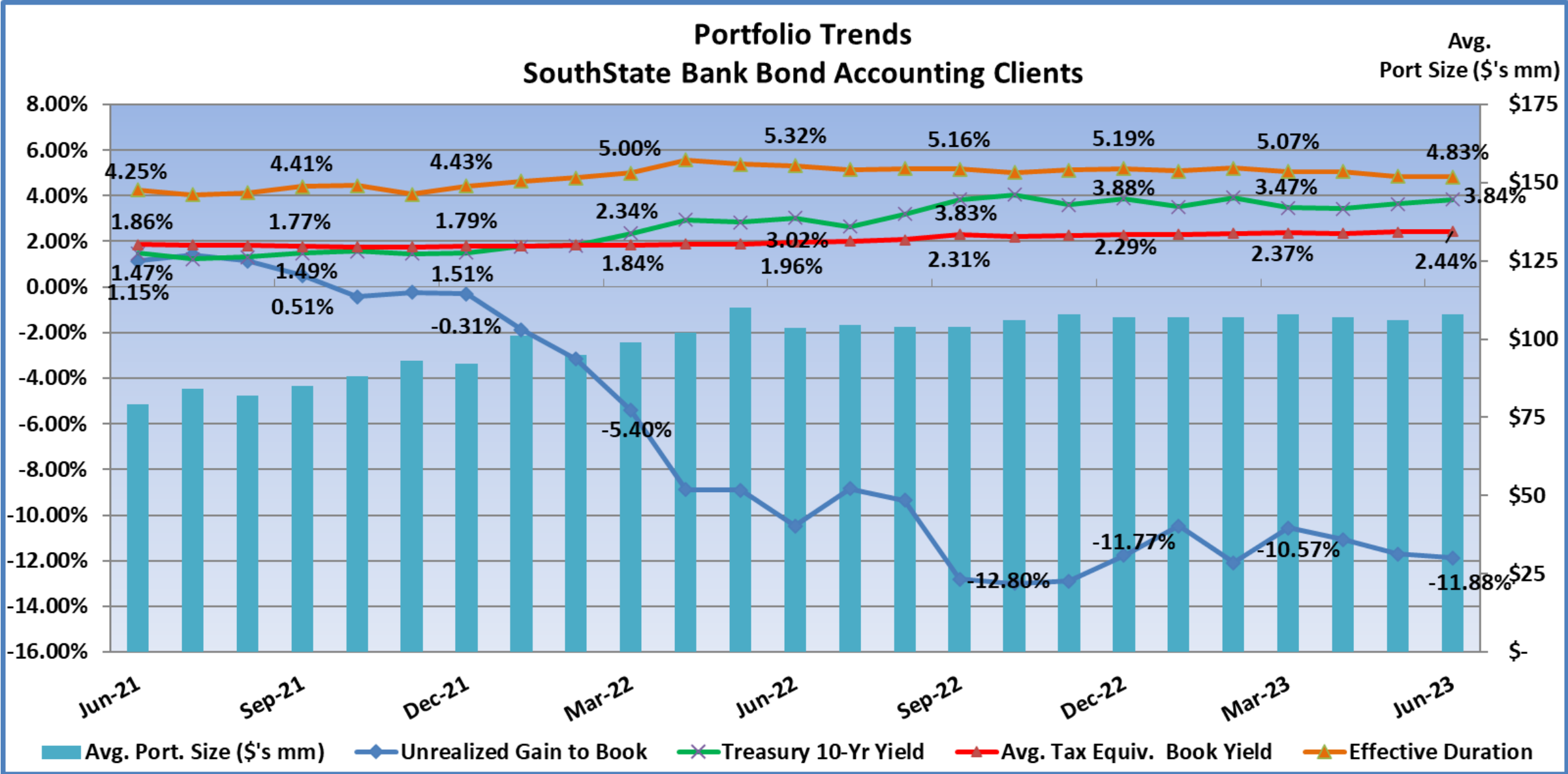
## Conclusion

- Numerous recession indicators are flashing clear warning signals, but the economy has remained resilient. Will the banking crisis tighten financial conditions enough to tip the economy into recession? Our base case is for a so-called soft landing but if a recession occurs it should be short and mild.
- Service-side inflation has been “sticky” as consumers enjoy activities unavailable during the depths of the pandemic. **This “stickiness” has eased lately but if it resurfaces it will force the Fed to consider another another rate hike later this year.**
- On the positive side, after rapid increases in 2020/21, **money supply has been decreasing for nearly a year which should dampen inflation pressures** as we move further away from the impact of the stimulus programs.
- **While not our base case, a recession is possible in the latter part of 2023, or early 2024, as lending standards tighten and the cumulative effect of rate hikes bite into consumer demand. This could shorten the Fed’s timeframe at the terminal funds rate, but we agree that rate cuts aren’t likely until 2024.**
- **Finally, from an investment perspective, when it’s obvious the Fed is done hiking, the Treasury market will anticipate this with yields moving lower before the first cut happens.**

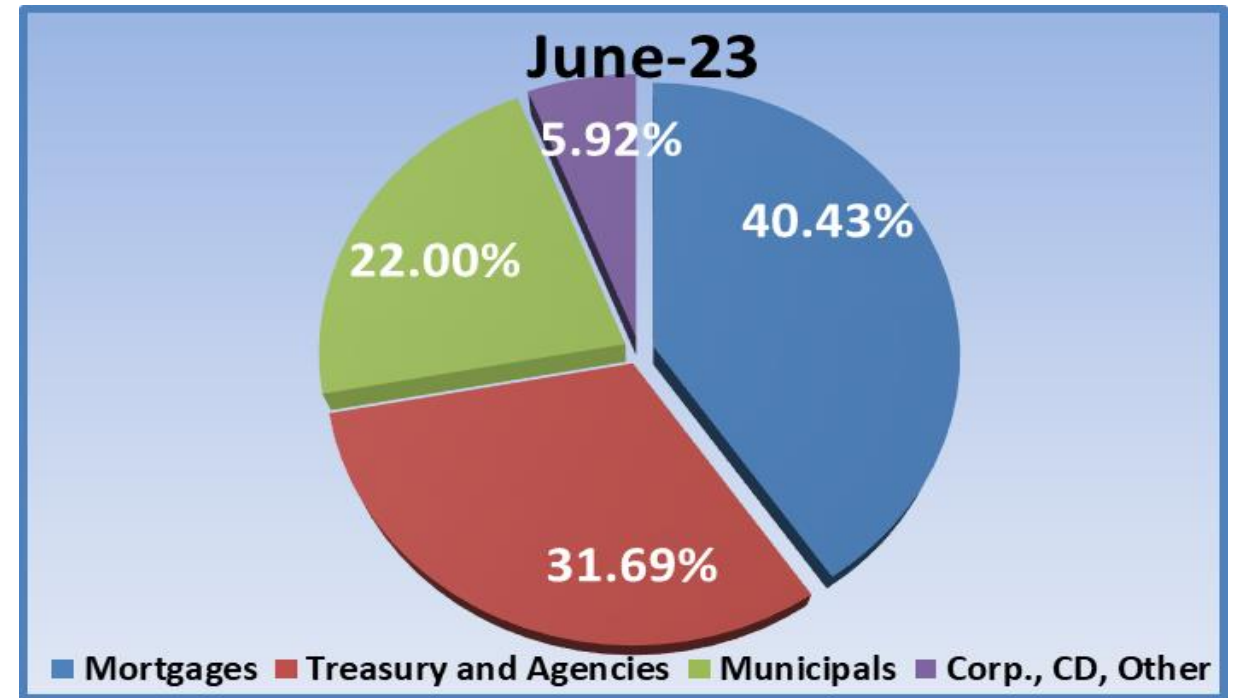
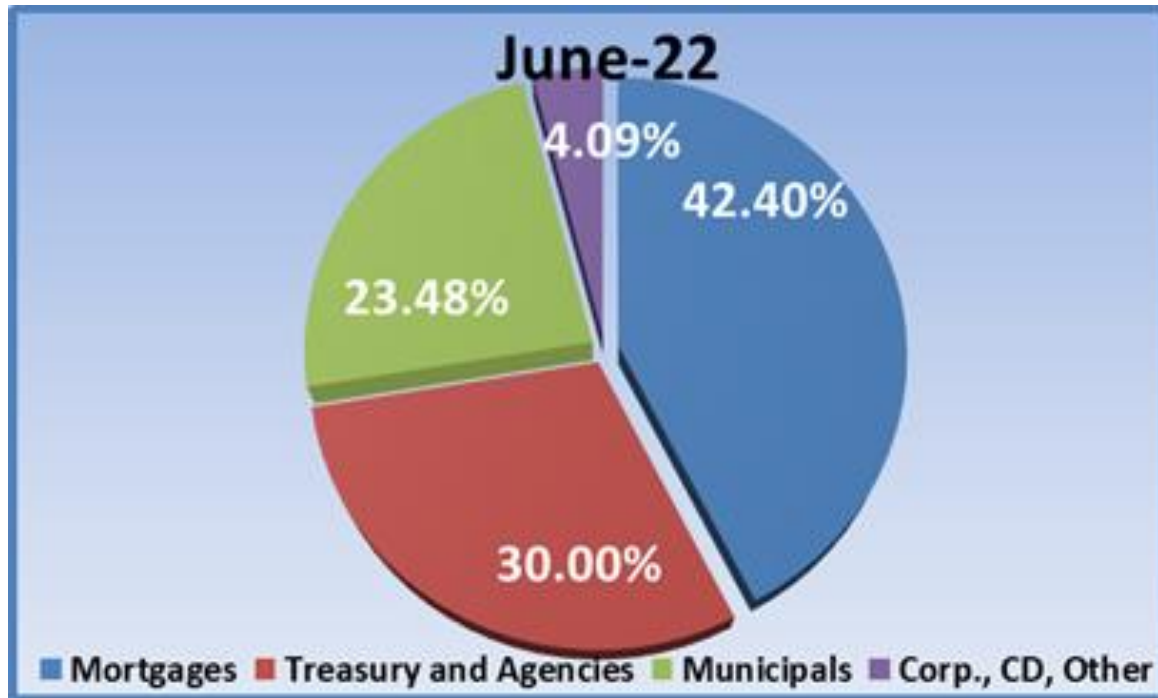


- Presently, we provide bond accounting services for approximately 130 community bank customers.
- The total par value of that group is approximately \$13.9 billion.
- What are recent trends in:
  - Performance characteristics
  - Allocation of Investments

# Bond Portfolio Trends



## Allocations Have Changed Some Over Last Year



- Modest Drop in MBS Allocations
- Modest decrease in Muni Allocations
- Modest increase in Agency/Treasury Allocations - Mostly Treasury
- Moderate increase in Other Category Allocations-Mostly CDs



## Bond Acct Group (2nd Qtr Purchases)

Portfolio Sector	Current Values			Composite Ratings  Credit Rating	Book and Market Yields						Average Life  Level (Yrs)	Interest Rate Risk  Effective Duration	Rate Risk  Convexity
	Current Par Value	Current Book Value	Current Market Value		Level Rates  BookMarket		Rates Up 1%  BookMarket		Rates Up 2%  BookMarket				
<b>FIXED:</b>	(000's)	(000's)	(000's)										
Fixed MBS	\$44,188	\$43,166	\$43,166	AAA	5.04%	5.04%	5.00%	5.75%	4.99%	6.67%	7.40	4.09%	-0.99%
Fixed CMOs	\$10,082	\$8,298	\$8,298	AAA	6.11%	6.11%	5.54%	6.49%	5.14%	6.75%	5.46	5.23%	0.05%
Treasuries	\$249,600	\$245,769	\$245,769	AAA	4.98%	4.98%	4.98%	5.98%	4.98%	6.98%	0.58	0.56%	0.01%
Agency Callables	\$20,800	\$20,734	\$20,734	AAA	5.10%	5.10%	5.10%	5.73%	5.10%	6.51%	7.43	2.92%	-0.84%
Corporates	\$1,000	\$862	\$862	A-	5.05%	5.05%	5.05%	6.00%	5.05%	6.95%	6.57	5.61%	0.37%
CDs	\$3,228	\$3,228	\$3,228	AAA	5.09%	5.09%	5.09%	6.05%	5.09%	7.05%	1.73	1.61%	0.00%
Taxable Munis	\$2,810	\$2,718	\$2,718	AA	5.08%	5.08%	5.15%	6.08%	5.15%	7.09%	11.93	8.18%	-1.10%
Munis (tax equiv.)	\$13,035	\$13,183	\$13,183	AA	4.83%	4.83%	4.97%	5.80%	4.92%	6.63%	13.45	8.10%	0.55%
<b>Total Fixed:</b>	<b>\$344,743</b>	<b>\$337,958</b>	<b>\$337,958</b>	<b>AAA</b>	<b>5.02%</b>	<b>5.02%</b>	<b>5.01%</b>	<b>5.94%</b>	<b>5.00%</b>	<b>6.90%</b>	<b>2.61</b>	<b>1.65%</b>	<b>-0.16%</b>
<b>FLOATING:</b>													
ARMs	\$501	\$502	\$502	AAA	6.75%	6.75%	7.39%	7.53%	7.95%	8.34%	9.06	0.64%	-0.49%
Corporate Floaters	\$1,000	\$1,000	\$1,000	AA	6.18%	6.18%	6.83%	7.27%	7.47%	8.36%	3.00	1.19%	0.01%
CMO Floaters	\$16,223	\$15,989	\$15,989	AAA	7.25%	7.25%	8.16%	8.22%	9.06%	9.19%	3.17	0.14%	-0.02%
SBA Floaters	\$3,581	\$3,802	\$3,802	AAA	6.63%	6.63%	7.62%	7.74%	8.57%	8.79%	7.42	0.01	0.01%
<b>Total Floating:</b>	<b>\$21,305</b>	<b>\$21,294</b>	<b>\$21,294</b>	<b>AAA</b>	<b>7.08%</b>	<b>7.08%</b>	<b>7.98%</b>	<b>8.07%</b>	<b>8.87%</b>	<b>9.06%</b>	<b>4.06</b>	<b>0.29%</b>	<b>-0.03%</b>
<b>TOTALS</b>	<b>\$366,048</b>	<b>\$359,251</b>	<b>\$359,251</b>	<b>AAA</b>	<b>5.14%</b>	<b>5.14%</b>	<b>5.19%</b>	<b>6.07%</b>	<b>5.23%</b>	<b>7.02%</b>	<b>2.70</b>	<b>1.57%</b>	<b>-0.15%</b>

# Thank You

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