1Q23 Economic Summary

2023 started much the same way as 2022 ended, with all eyes on inflation and the Fed. However, focus quickly shifted in March as the banking system took center stage after the collapse of two large U.S. regional banks set-off fears of a banking meltdown. Federal regulators stepped in quickly and announced emergency measures to ease depositors' fears and shore up confidence in the banking system. The measures included the extension of FDIC insurance to all depositors of the failed banks as well as the creation of the Federal Reserve's Bank Term Funding Program, which will provide additional funding to banks through collateralized loans secured by U.S. Treasury and agency securities. These moves helped to somewhat allay U.S. banking fears, but the global banking industry was dealt another blow soon thereafter with the collapse of Credit Suisse, Switzerland's second largest bank. Credit Suisse had been battered by years of scandals and losses, but the final blow came after the bank's top backer, Saudi National Bank, said it would not provide the bank with additional funding. Credit Suisse's shares plummeted on the news, prompting Switzerland to step in and orchestrate a last-minute takeover of the bank by its rival, UBS. While the rescue helped to avert a global banking meltdown, some jitters remain about the stability of the banking sector.

Despite the turbulence caused by the banking debacle, U.S. equity and bond markets rose during the quarter. Wall Street largely shrugged off the crisis, choosing instead to focus on the impact the disruption will have on the Fed's policy path. Investor optimism over expectations that the Fed's hiking cycle is nearing an end led stock prices higher and yields lower. The yield curve inversion steepened during the quarter as yields on the long-end of the curve declined more than those on the short-end, leading to increased concerns that the U.S. economy is heading toward recession.

Thus far, U.S. economic data has proven resilient to the recession chatter. U.S. GDP is expected to have grown about 2% during the first quarter, as the stronger-than-expected labor market enabled consumers to keep spending despite rising prices. Consumer spending unexpectedly surged in January as Americans not only shelled out for necessities but continued to make up for time lost during the pandemic by splurging on restaurants, travel and other experiences. Momentum slowed in the latter part of the quarter as consumers became more discerning in their spending patterns, but household demand for services remained healthy. While consumers continued to spend, business investment slowed during the quarter as higher borrowing costs caused companies to reassess their purchasing plans. Housing market activity also slowed. High mortgage rates not only dampened demand but also limited the supply of homes coming to market as homeowners with existing low-rate mortgages were reluctant to sell. Given the lack of inventory, home prices remained elevated, further crimping housing affordability.

The labor market remains a source of strength for the U.S. economy. The U.S. added over 1 million jobs during the quarter, and the unemployment rate remained near a historic low at 3.5% in March. While labor demand continued to substantially exceed supply, improvements in the imbalance began to emerge. Though still elevated, quits rates and job openings declined during the quarter, and the overall labor force participation rate increased as more prime-aged workers returned to the labor force. In addition, even though higher wages continue to add to inflation, the pace of wage growth appears to be slowing. These are positive signs that the Fed's restrictive monetary policy is beginning to cool the white-hot labor market; however, the deceleration is not fast enough for the Fed.

U.S. inflation data accelerated at the beginning of the year but showed hints of moderating in March. Prices for goods stabilized as supply chains normalized and gasoline prices came down. In addition, the rise in shelter costs slowed. However, core services inflation remained stubbornly high. Ongoing price pressures in the labor-intensive service industry remain a key concern for the Fed and underscore the Committee's belief that more cooling in the labor market is needed to get inflation under control.

As such, the Fed's tightening campaign continued in the first quarter. After raising rates by the expected 25 basis points in February, the Fed's policy path became much less certain in March. Reaccelerating job and spending growth in January and February coupled with hotter inflation readings led markets to begin pricing in a strong possibility of a 50 basis point hike in March. However, the regional banking crisis reversed those expectations and introduced the possibility of a Fed pause. In the end, the Fed opted to raise the federal funds rate by 25 basis points at the March FOMC meeting, resulting in a target range of 4.75%-5.00%. Participants acknowledged that the developments in the banking sector would likely lead to tighter credit conditions for households and businesses, which could weigh on economic activity, hiring and inflation. However, they believed that still-too-high inflation coupled with the tight labor market outweighed these risks and warranted the additional hike. In addition, the Fed kept its median estimate for the 2023 terminal fed funds rate unchanged at 5.125%, signaling expectations that an additional 25 basis point hike is in the pipeline.

The Fed's goal remains to slow the labor market enough to cool inflation without tipping the economy into recession. However, the recent banking system stress adds to the difficulty of achieving a "soft landing." Heightened fears of a recession have caused bond traders to start pricing in rate cuts later this year. This expectation that the Fed is on the verge of reversing course is in stark contrast to the Fed's forecast and Chair Powell's higher-for-longer message. These conflicting views add to the uncertainty facing markets in 2023. Only time will tell which side will prevail.

Any opinions herein, including forecasts, reflect our judgment as of this date and are subject to change.

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