Corporate Federal Credit Union

Economic Update

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THIS MONTH

- COMMENTARY
- FIXED INCOME COMMENTARY
- LABOR READINGS
- INFLATION READINGS
- ECONOMIC GROWTH READINGS

Commentary

The turn of the calendar has been a pleasant experience for investors. After a dismal year, the stock market has roared ahead in 2023. The S&P is up 6% and the NASDAQ is up 12%. Bond investors are smiling again too, with the 10-year Treasury gaining 3% in value. The main reason for the change in sentiment is the belief that the Fed hiking cycle is about to come to an end. The markets are pricing in a high probability that the Fed will be able to engineer a soft landing.

The inflation news has certainly been much improved from the peak inflation rate of 9.1% in June. The last few months have experienced sizeable declines. As of December, the year-over-year inflation rate stands at 6.5%. Falling energy and used car prices have been the major drivers of the downward trend. Despite the improvement, inflation is still a far cry from the Fed's 2% target. To get there, the labor market needs to loosen.

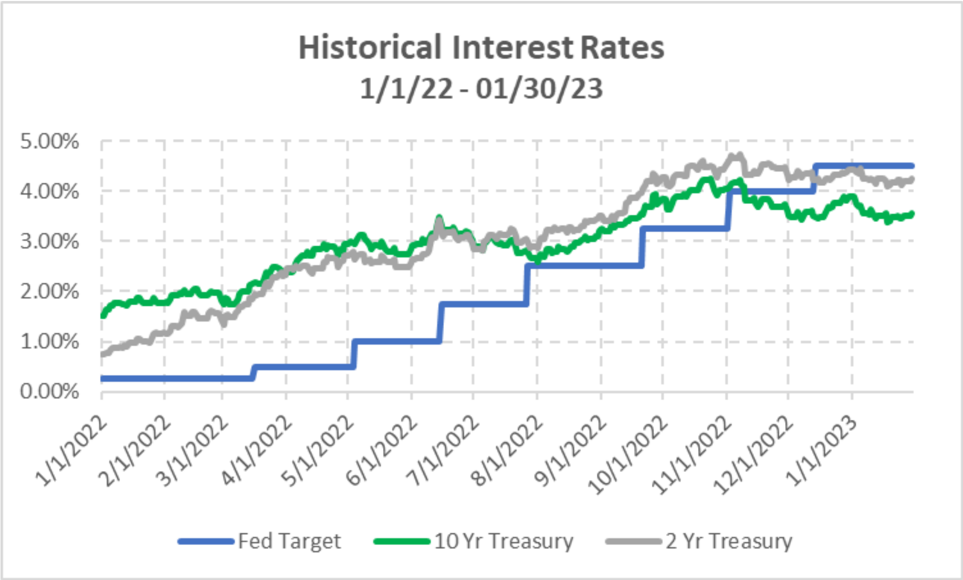
Wage growth is still running at least 1% above what would be consistent with a 2% overall inflation target. The latest payroll data shows that job growth is running about twice the pace that is needed to keep the unemployment rate steady. The number of job openings to unemployed people stands at 1.7 times versus 1.2 times in the immediate pre-pandemic period. Something must give to bring wage inflation more in line. Hopefully, this can be accomplished largely by a reduction in job openings rather than a substantial increase in unemployment. History suggests that is unlikely.

Economic growth in the fourth quarter of 2022 was higher than expected. The 2.9% annualized growth rate was a small drop from the previous quarter, but above the long-term trend growth that is closer to 2%. The details of the report show some weakness going into this year. Consumer spending was much lower than expected and decelerated from the previous quarter. Much of the gross domestic product (GDP) gain (1.5 percentage points) came from inventory buildup.

We believe that consumer spending will hold up in the first quarter of 2023. It will be buoyed by the sizeable jump in disposable income that will hit this month. The main source is from the 8.7% increase in Social Security benefits due to cost-of-living adjustments. This will provide approximately $100 billion in pre-tax income to consumers. Consumer spending should slow throughout the rest of the year as the cumulative impact of Fed hikes takes effect and the unemployment rate starts to climb. We still feel that a soft landing is the most likely scenario, with the unemployment rate peaking around 4.5% to 5.0%. We look for a mild recession to hit the economy in the latter half of the year.

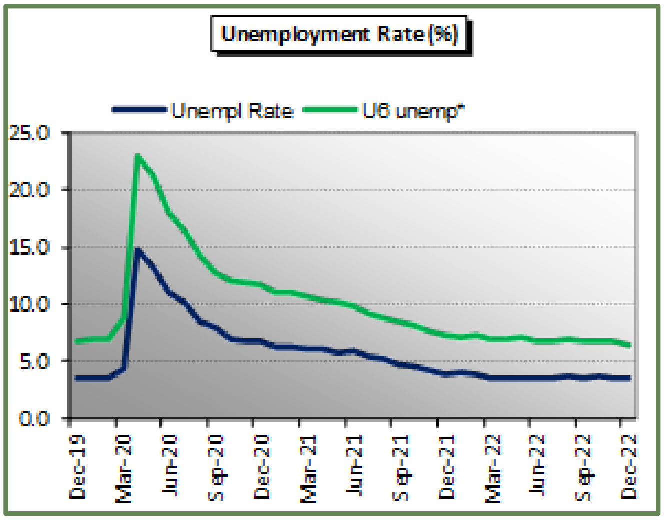
Fixed Income Outlook

Interest rates have decreased throughout most of the curve in January. Medium to longer-term Treasury rates have declined by over 30 basis points. The economic news has given the Fed cover to switch to, the more typical, 25-basis-point move at next week's meeting. Many Federal Open Market Committee (FOMC) members have already signed off that it's time to shift to a lower gear. We agree, and we expect the Fed to raise rates to 4.75% at their February 1 meeting. We expect Chairman Jerome Powell to make a hawkish statement and make it clear the Fed does not intend to convert to cutting rates any time soon. The market has a differing opinion and is pricing in rate cuts in the latter half of 2023. We doubt the market will be dissuaded by Powell's comments. We feel the market is priced at fair value right now, but believe it is prudent to add some duration, as we believe that rates have more room to fall than to increase from current levels.



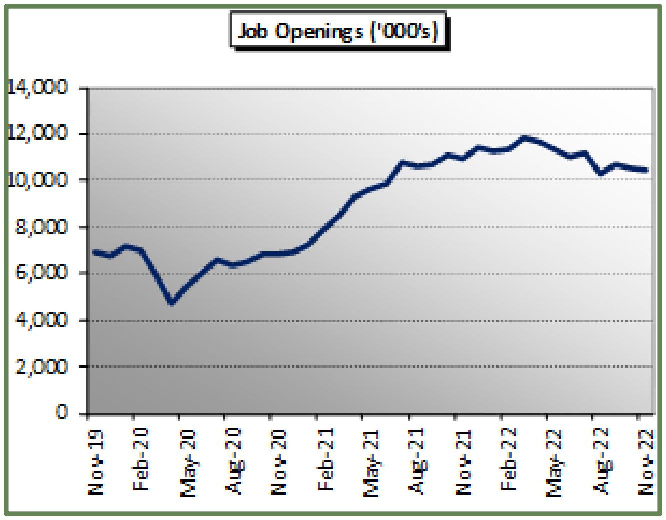
Labor Readings

(Data source: Bloomberg)



Labor Market Remains Strong

The unemployment rate fell to 3.5% in December and is back down to the lowest rate since the 1960s. The household report was very strong. It showed a significant increase in both the labor force and employment. The payroll report was also relatively strong with 223,000 jobs created in December.

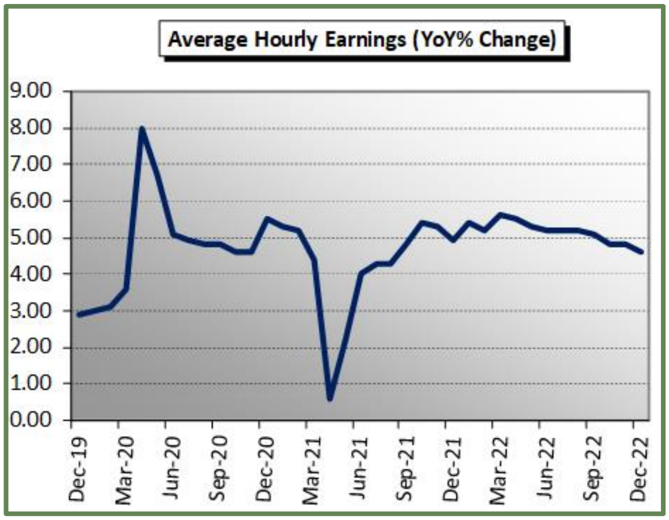


Job Openings Still Elevated

The number of job openings in November came in much higher than expected. The market was expecting a decline from the previously reported 10.3 million job openings the prior month to 10 million. Instead, the prior month was revised upwards to 10.5 million and the November result was 10.4 million openings. The ratio of job openings to unemployed people stands at 1.7 versus the 1.2 just before the COVID-19 pandemic.

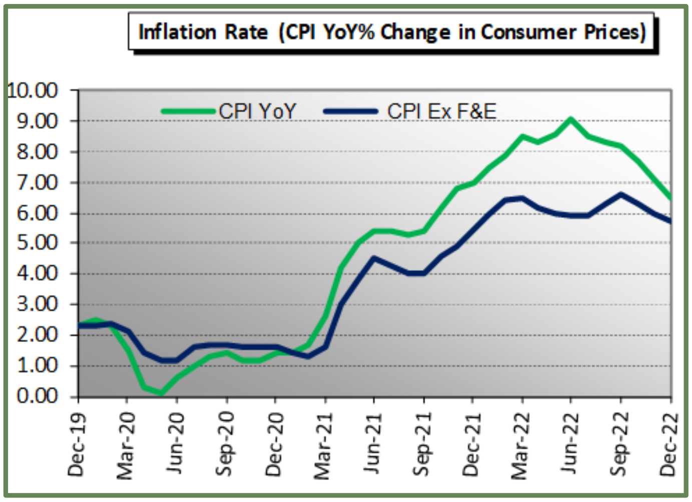
Inflation Readings

(Data source: Bloomberg)



Wage Inflation Starting to Cool

Wage inflation in December was lower than expected. The year-over-year increase was 4.6% versus an expectation of 5.0% and a gain of 4.8% in November. This was the slowest year-over-year increase since August 2021.

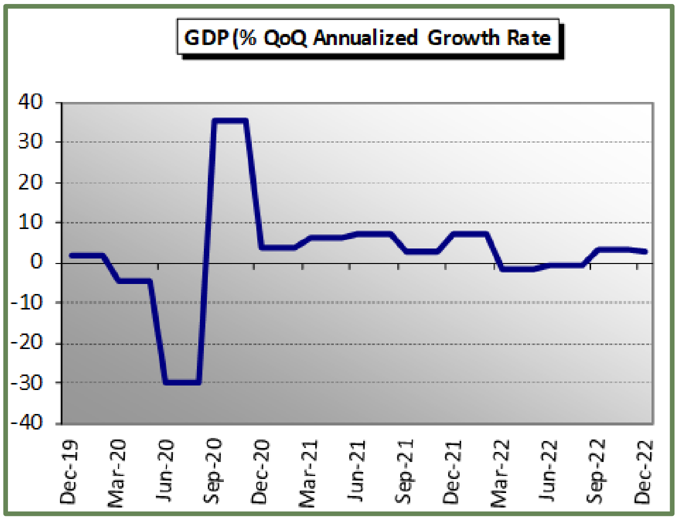


Consumer Inflation Softening

Consumer price inflation in December decreased to 6.5% from 7.1% the prior month. The "core" inflation rate decelerated to 5.7% from 6.0%. Both declines were in line with market expectations. The large gasoline price decrease was the main driver of lower headline inflation, but many other price categories are moderating.

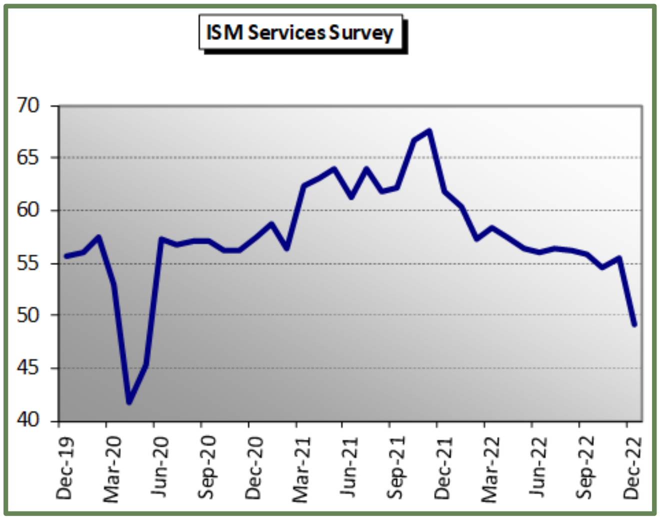
Economic Growth

(Data source: Bloomberg)



GDP Growth Slows

The advance estimate of fourth quarter GDP growth showed a slowdown to 2.9% from 3.2% in the previous quarter. The market was expecting growth of 2.6%. Despite the better-than-expected growth rate, the underlying details showed some weakness with personal consumption coming in lower than expected. Real final sales to domestic buyers hit the lowest level since the recovery began.



Services Survey Experiences Sharp Decline

The Institute for Supply Management (SM) service industry survey in December was much lower than expected and reached the lowest level since May 2020. The index fell to 49.6 versus an expectation of 55 and from 55.5 the previous month. The survey points to a contraction in the largest segment of the U.S. economy.