The Northern Trust Institute

The Weekly Five

Answering Your Questions on the Fed, Inflation and the Debt Ceiling

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As investors process abundant information from earnings and economic releases this week, we also eagerly await next week's policy decisions from the Federal Reserve and the European Central Bank. We expect more hawkish rhetoric, even as risk-asset markets increasingly suggest we are closer to the end of the global tightening cycle.

We held our quarterly Market Insights webinar this week and were grateful for the chance to share views, but most importantly to hear from our clients. Here are the most common questions from our call:

What is the outlook for inflation?

Inflation is falling and may continue to decline quickly as we progress through the year, an outlook supported by the data. Looking at the key components and drivers, we observe relief nearly all around. Energy prices, transportation costs and supply chain pressures have moderated. Shipping costs are down to pre-pandemic levels.

The biggest item in the inflation basket is shelter, and housing prices have turned down in response to higher interest rates. We anticipate further disinflation in this area. The real-time declines in home prices, along with the decline in rental inflation, take time to work their way through to the consumer price index data, but we expect to see the impact later in 2023.

Further, this aggressive Fed tightening cycle has resulted in the first outright year-over-year decline in money supply in at least 70 years. This is another encouraging sign for inflation moderation, particularly for those who subscribe to Milton Friedman's belief that inflation "is always and everywhere a monetary phenomenon."

We are also listening to corporate management teams during the fourth-quarter earnings conference calls: Pricing power appears to be diminished — in some cases quite dramatically — from the ease with which companies had been passing on higher costs (and then some) to consumers. Finally, we have survey data from small businesses that indicate pricing headwinds. This is perhaps not surprising given the backdrop: Households have become more frugal amid negative real wage gains and diminished savings. **Our chief economist Carl Tannenbaum and his team believe we will see inflation fall to between 2-3% by year end, near the Fed's 2% policy target.**

Will the tight labor market force the Fed to be more aggressive?

As we consider the December jobs report reflecting 200,000 jobs created during the month, it is worth noting that economists estimate that a gain of 80,000 to 100,000 is sufficient to keep unemployment steady. We have seen a growing slate of companies announcing layoffs, starting with big tech but now including financial services, and even industrials. It is likely that peak jobs growth is behind us, but we are not calling for a jobs recession.

We do expect the unemployment rate to rise to 4.5%, slightly below the Fed's forecast of 4.6%, and equating to roughly 1 million Americans losing employment. That will be painful for some households and will serve to put a damper on wage inflation. As demand for labor softens, we foresee supply increasing as more workers come off the sidelines, excess savings diminish and we continue to see immigration climb.

This colors the outlook for inflation but also portends slower growth, given that the U.S. consumer drives growth in the U.S. economy. **The wild card in everyone's forecast — including the Fed's — is the labor market. With unemployment low and jobs plentiful, wages are likely to keep upward pressure on service-sector inflation.**

What do you expect the Fed to do with these circumstances?

We have noted many times that this period is one in which professional forecasters, economists and Federal Open Market Committee members have needed to be humble. Coming out of an unprecedented pandemic, econometric models and conventional forecasting tools have proved woefully inadequate in predicting the future.

In the past, the FOMC placed great confidence in, and emphasis on, its economic forecast. Monetary policy was aligned not with today's data, but with the prospective future conditions. If the forecast was for lower inflation and lower growth in the future, the committee historically was able to moderate interest-rate policy accordingly. This time was different. There is very little confidence in models and much more of a "believe your eyes" framework at play for the Fed as well as for our own strategists and economists.

We all need to see, in real time, inflation falling toward the Fed target before we can have any confidence that a change in stance will be wise. We all have a mosaic of real-time data to digest, and the good news is that the data support the premise that inflation has peaked and will continue to abate. The open question is how fast, to what level and whether the Fed will be satisfied at the pace and that destination.

It is our view that inflation will fall toward the 2% target by the end of the year. The Fed also projects inflation to fall toward that target by the end of 2023. We anticipate another 25-basis point increase in the Fed's policy interest rate target next week as well as an additional move in March, beyond which the Fed will hold to that plateau for the balance of the year.

Even as the pace of rate hikes steps down to 25 basis points from larger increases in 2022, we expect the rhetoric to remain very hawkish. Without a marked economic downturn, we see it as unlikely that the Fed will begin to ease this year. **The Fed certainly wants to maintain credibility with investors and signal its continued resolve to fight inflation. Investors have increasingly priced in rate cuts for 2023, which we think is far too optimistic.**

What are financial markets signaling now?

While financial-market signals are interesting and should not be ignored, they can frequently confuse investors. Today, there are some seemingly contradictory signals being seen among asset classes. Starting with the interest rate market — the U.S. Treasury market — we see a continued inversion of the yield curve, or the difference between shorter-maturity Treasuries and longer-dated bonds. Historically, yield curve inversions have been harbingers of recession. The two-to 10-year Treasury yield curve has been inverted since last July, and typically leads an economic downturn by six to 24 months. This is worth watching.

But meanwhile, other indicators are showing signs of optimism. Both investment-grade and high-yield credit spreads have narrowed in the past several months, indicating a growing willingness on the part of investors to take credit risk. This is not typical of investors who anticipate a meaningful economic downturn and indicates an awareness that today's corporations may be in a stronger position to withstand economic stress. Most took advantage of the extremely low rate environment before 2022 to refinance and extend the maturity of their debt.

And of course, we have had a remarkable rally in risk assets around the world from fourth-quarter lows, showing that investors expect, at worst, a short and shallow economic downturn. Investors' sanguine outlook conforms to our own. **Much of the improvement in credit spreads and market levels we anticipated for 2023 has been pulled forward into only the past 3**

weeks, leaving us with the caveat that returns for the remainder of the year could be relatively benign, but the remaining uncertainties may deliver more volatility.

How worried should we be about the debt ceiling debacle?

This is a serious situation. The U.S. Treasury ran out of room to incrementally borrow last week, and the reservoir of "extraordinary measures" allowing continued government spending will be exhausted sooner or later this summer. Unless lawmakers raise the debt ceiling, the Treasury will be forced to prioritize payments, being careful about interest payments and social security disbursements.

This will be a drawn out process and will likely come down to the wire, as there is no incentive on either side to begin negotiations until the deadline looms more closely. While the debt limit has been raised dozens of times in the past, we worry that in this case the past may prove a poor precedent: New rules put into place during the Speaker of the House election will make the necessary consensus extremely difficult to achieve.

And while we anticipate that this will be a problem, we believe that ultimately both sides will recognize that there will be no winners in the case of an actual default. **We are several months away, of course, and we continue to monitor this situation closely. So far, there have been no indications of stress in the Treasury market that would indicate broad investor concern.**