February 14, 2023

Economic Forecast Grid Update
Fed Funds Rate Higher For Longer Despite Market Pushback

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With inflation stubbornly above Federal Reserve expectations and a remarkably tight labor market, the Fed remains committed to a further rise in rates in order to reinstate price stability. In fact, January's stronger-than-expected jobs report showing a gain of 517,000 payrolls offers the Fed a green light to entirely focus on reining in inflation with the mandate of full employment seemingly met. The solid pace of hiring also highlights the minimal impact 425 basis points (bps) of tightening over the past year has had on closing the gap between labor supply and demand, which should further embolden the Fed to continue – unapologetically – to a significantly higher level of rates.

Inflation has eased off recent peak levels, yet the modest improvement is hardly convincing that a longer-term downward trajectory is taking hold. The underlying components tell a more complicated story where housing and core services costs, excluding shelter, are still pushing higher. This, coupled with lingering supply-side limitations, which the Fed has no control over, means that Committee-assessed risks remain to the "upside" and price pressures are likely to remain above the Fed's target throughout 2023.

While the rate of ascent in the federal funds rate has shifted back to "just" 25bps, the ultimate peak is still likely to be well beyond current expectations. Federal Reserve Chairman Jerome Powell himself has reiterated the need for significantly "more work" to be done. Additionally, should inflation remain uncomfortably high as the Fed nears a terminal level or a "sufficiently restrictive" level of policy, rates may also need to remain elevated for longer than currently expected. The Fed has said higher rates, the question remains, how much higher and for how long? The answers will depend on inflation.

Despite policy makers reiterating an unwavering focus on slowing inflation with more rate hikes on deck, a disconnect continues to widen between the central bank's commitment to higher rates and the market's trust in the Fed's resolve to continue increasing rates as economic conditions slow. Investors continue to bet on a rate cut sooner than later as the possibility of recession looms, while Committee members insist a period of pain is a necessary evil to ensure the inflation dragon is slain. In other words, recessionary conditions, while not a forgone conclusion, will not deter the Fed, but offer evidence earlier policy initiatives are having the intended effect of slowing the economy to ensure price stability.

If such an uncomfortable realization of "higher for longer" is priced into market expectations, a replay of last year's rally in longer rates remains a possibility. The long end, however, will struggle to keep up with the Fed as policy intentionally undermines consumption and investment, leaving an ongoing inversion up and down the term structure throughout the year. Sustainable downward momentum on the longer end will only return once the market anticipates the Fed is at or nearing the terminal rate and inflation has established a meaningful downward trajectory toward the Fed's 2% target. Inflation may have peaked, but the Fed is asking a different question: how long

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will inflation remain elevated? The answer will determine the pathway for policy and ultimately the depth and duration of the recession or slowdown (see chart on page 3).

While inflation does not need to reach the Committee's 2% target before the Fed backs off its aggressive policy initiatives, the Committee is well aware that the risk of curtailing inflation-taming action too soon is sufficiently larger than overshooting. The former would potentially allow inflation to become permanently entrenched in the economy. The Fed made a policy mistake at the start of the cycle by holding on to transitory language and crisis-level accommodation well beyond what was appropriate. Policy makers will not risk making a second mistake on the back end by taking its foot off the brake before victory over inflation is ensured.

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	Q2 2022	Q3 2022	Q4 2022	Q1 2023	Q2 2023	Q3 2023	Q4 2023	Q1 2024	Q2 2024	Annual Rate 2022	2023	2024
Growth indicators												
GDP, QoQ %	***-0.6%***	***3.2%***	***2.9%***	**-0.6%**	**-1.8%**	**0.3%**	**-0.9%**	1.4%	1.8%	***1.0%***	**-0.7%**	**1.6%**
Consumer Spending, %	*2.0%*	*2.3%*	*2.1%*	-0.8%	0.1%	1.5%	1.2%	1.5%	1.6%	*1.9%*	0.5%	1.6%
Fixed Investment, %	*-5.0%*	*-3.5%*	*-6.7%*	-2.5%	-1.3%	-0.8%	0.0%	0.5%	0.8%	*-2.6%*	-1.1%	0.7%
Housing Starts, k, end of quarter, yr end	*1,575*	*1,465*	*1,382*	1,350	1,300	1,475	1,525	1,585	1,630	*1,382*	1,525	1,630
Unemployment Rate, %, qrt avg, yr end	*4.8%*	*3.7%*	*3.8%*	3.9%	4.4%	5.0%	5.2%	5.5%	5.6%	*3.8%*	5.2%	5.6%
Nonfarm Payrolls, k, qrt avg, ann avg	***293***	***269***	***223***	**200**	**-100**	**-50**	**100**	**150**	**150**	***296***	**38**	**150**
Inflation indicators, YoY%, yr end												
PCE	*7.0%*	*6.3%*	*5.0%*	4.6%	3.8%	3.6%	3.2%	3.0%	2.8%	*5.0%*	3.2%	2.8%
Core PCE	*5.0%*	*5.2%*	*4.4%*	4.2%	4.0%	3.8%	3.5%	3.2%	3.2%	*4.4%*	3.5%	3.2%
PPI	*11.2%*	*8.5%*	*6.2%*	6.0%	5.0%	4.8%	4.2%	3.9%	3.2%	*6.2%*	4.2%	3.2%
Interest rate, %, end of quarter, yr end												
FF	***1.75***	***3.25***	***4.50***	**5.00**	**5.50**	**6.00**	**6.00**	**5.50**	**5.50**	***4.50***	**6.00**	**5.50**
3month UST bills	*1.67*	*3.27*	*4.37*	4.95	5.45	5.95	5.85	5.40	5.40	*4.37*	5.85	5.40
2yr UST notes	*2.96*	*4.28*	*4.43*	4.77	5.07	4.67	4.17	3.67	3.65	*4.43*	4.17	3.65
5yr UST notes	*3.04*	*4.09*	*4.01*	4.14	3.89	3.64	3.39	3.14	3.04	*4.01*	3.39	3.04
10yr UST notes	***3.02***	***3.83***	***3.88***	**3.80**	**4.00**	**3.80**	**3.75**	**3.50**	**3.50**	***3.88***	**3.75**	**3.50**
30yr UST bonds	*3.19*	*3.78*	*3.97*	3.90	4.05	3.85	3.70	3.65	3.40	*3.97*	3.70	3.40
3mon to 2s spread bps	***129***	***101***	***6***	**-18**	**-38**	**-128**	**-168**	**-173**	**-175**	***6***	**-168**	**-175**
3mon to 10s Spread bps	***135***	***56***	***-50***	**-115**	**-145**	**-215**	**-210**	**-190**	**-190**	***-50***	**-210**	**-190**
2s to 10s Spread bps	***6***	***-45***	***-55***	**-97**	**-107**	**-87**	**-42**	**-17**	**-15**	***-55***	**-42**	**-15**

Actual data in red (Source: Boomberg) | GDP figures shown as annual change

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