Economic Review - First Quarter 2023

The state of the general economy can help or hinder a business' prospects by influencing the demand for its goods and services. The economy also affects the availability and price of inputs such as capital and labor. The prevailing economic conditions therefore directly affect the value of a business at a specific point in time. The 128-month economic expansion from June 2009 to February 2020 was the longest since the 1850s. The COVID-19 global pandemic suddenly and severely affected economies and markets around the world, causing the U.S. economy to lose nearly 22 million jobs and go into a recession from February 2020 to April 2020, which was the shortest recession in U.S. history. After returning to growth in April 2020, the U.S. economy rapidly recovered, adding back nearly 10 million jobs in the final 8 months of 2020. Since the beginning of 2021, the U.S. economy has added back an additional 15 million jobs through the first three months of 2023, representing a cumulative gain of 25 million jobs in the 35 months since April 2020.

Summary

The state of the general economy can help or hinder a business' prospects by influencing the demand for its goods and services. The economy also affects the availability and price of inputs such as capital and labor. The prevailing economic conditions therefore directly affect the value of a business at a specific point in time. The 128-month economic expansion from June 2009 to February 2020 was the longest since the 1850s.[1] The COVID-19 global pandemic suddenly and severely affected economies and markets around the world, causing the U.S. economy to lose nearly 22 million jobs and go into a recession from February 2020 to April 2020, which was the shortest recession in U.S. history.[2] After returning to growth in April 2020, the U.S. economy rapidly recovered, adding back nearly 10 million jobs in the final 8 months of 2020. Since the beginning of 2021, the U.S. economy has added back an additional 15 million jobs through the first three months of 2023, representing a cumulative gain of 25 million jobs in the 35 months since April 2020.

The Federal Open Market Committee (the "Committee") of the Federal Reserve held two meetings during the first quarter of 2023; one in January and one in March to discuss the additional measures being taken to support the economy, which include:

- Increasing the target range for the federal funds rate by 25 basis points in January and March; representing a total change in the target range from 4.25 percent-to-4.50 percent to 4.75 percent-to-5.00 percent.

- Signaling that additional rate increases may be necessary to continue to reduce inflation toward its 2.0 percent target, although the Committee has indicated it will consider the aggregate impacts of their recent tightening of monetary policy when determining the appropriateness of future policy decisions. The Committee expects

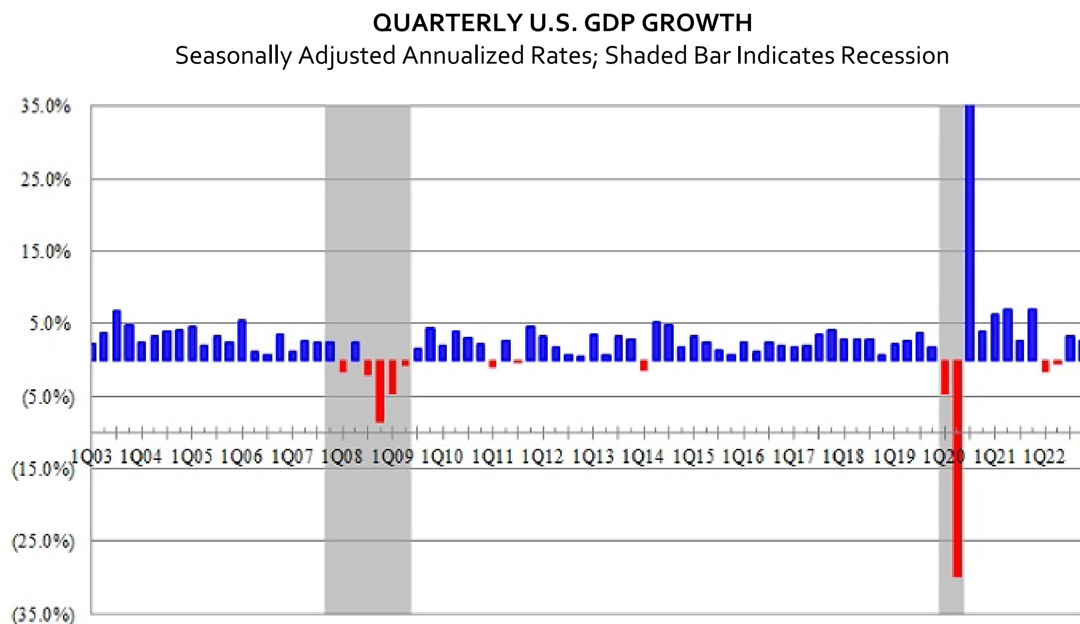
the effects of previous rate increases to be working with a lag throughout the economy.

- Continuing its reduction of the assets held on the Federal Reserve's balance sheet by $95 billion per month. [3]

Gross Domestic Product

The U.S. Bureau of Economic Analysis estimates that real gross domestic product (GDP)—the output of goods and services produced by labor and capital located in the United States — increased at an annual rate of 2.6 percent in the fourth quarter of 2022; which is the second consecutive quarter of growth following successive declines in the first and second quarters of 2022. In 2022, GDP increased by 2.1 percent for the year, compared to a 5.9 percent increase in 2021. Quarterly GDP data for the preceding 20 years is shown in the following figure.

QUARTERLY U.S. GDP GROWTH
Seasonally Adjusted Annualized Rates; Shaded Bar Indicates Recession

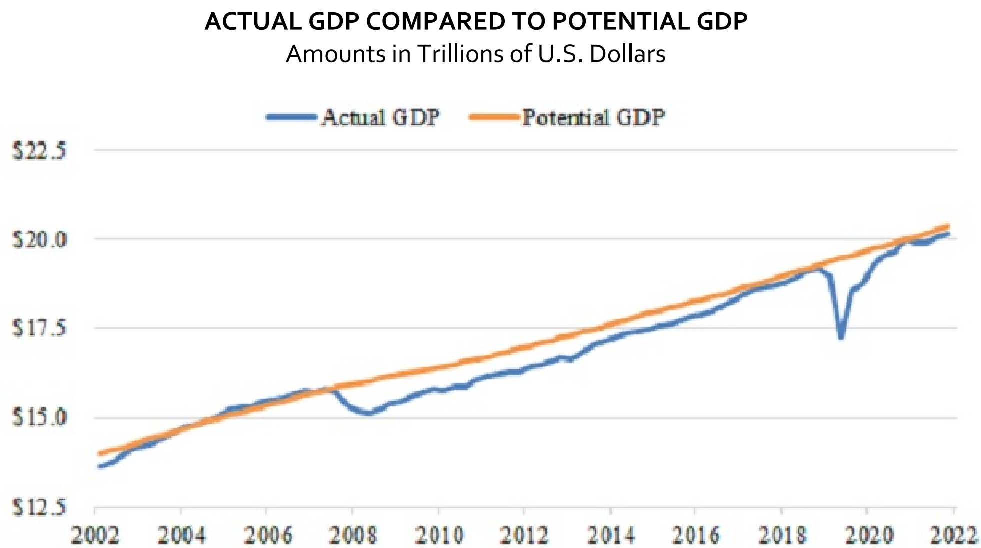


Sources: U.S. Bureau of Economic Analysis and National Bureau of Economic Research. GDP percent change is based on chained 2012 dollars.

The brief 2020 recession caused by the coronavirus pandemic resulted in real GDP in the U.S. to fall to $17.3 trillion in the first quarter of 2020, which was $2.2 trillion below the $19.5 trillion potential real GDP estimated by the Congressional Budget Office. After actual GDP briefly exceeded potential GDP in the fourth quarter of 2021, the declines in output in the first two quarters of 2022 brought upon a shortfall of $0.28 trillion between actual and potential GDP. The growth in actual GDP in the third and fourth quarters of 2022 have tightened this deficit to

$0.18 trillion. Actual GDP and potential GDP for the past 20 years are shown in the following figure.

ACTUAL GDP COMPARED TO POTENTIAL GDP
Amounts in Trillions of U.S. Dollars



Sources: U.S. Bureau of Economic Analysis and Congressional Budget Office. GDP is based on chained 2012 dollars.

The Federal Reserve projects GDP growth of just 0.4 percent for 2023. Thereafter, it projects GDP growth rates of 1.2 percent and 1.9 percent in 2024 and 2025, respectively, before settling at 1.8 percent annual growth for the long-run.

Employment

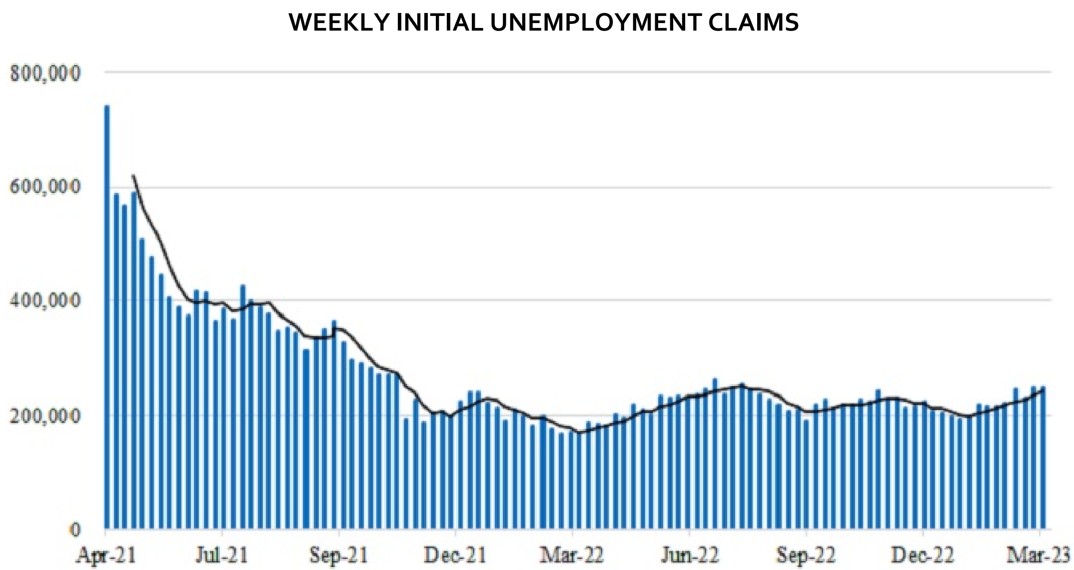
From March 2010 (the end of the 2008–2009 recession) to February 2020, 23.2 million net non-farm jobs were created.[4] After the brief recession caused by the coronavirus pandemic eliminated ten years of job growth in just a few months, the economy returned to its pre-pandemic levels of employment in June 2022. In the first quarter of 2023 alone, an additional 937,000 jobs were added. The unemployment rate reached 3.4 percent in January, matching the 54-year low of 3.4 percent in 1969. A more expansive measure of labor underutilization, including discouraged workers who have left the workforce and part-time workers who would prefer full-time work, elevated slightly from 6.5 percent in December 2022 (an all-time low since data was first collected in 1994) to 6.7 percent in March 2023.[5]

Beginning in March 2020, national, state, and local governments began instituting lockdowns that forced the closures of many businesses and restricted the free movement of citizens, and a wave of layoffs and furloughs began. Initial unemployment claims, which had averaged 218,000 per week in 2020 prior to the COVID-19 pandemic, spiked to a high of 6,648,000 for the week ending March 28, 2020. As the economy and labor market recovered, initial unemployment claims have remained

historically low, staying effectively unchanged to an average of 220,000 throughout the first quarter of 2023 compared to an average of 221,000 throughout the fourth quarter of 2022.

After initial claims fluctuated between approximately 194,000 and 216,000 for the first half of the first quarter of 2023, they peaked at 247,000 for the week ending March 18, 2023, its highest level since the week ending August 6, 2022. Initial claims ended the first quarter at 246,000 for the week ending March 25, 2023. Initial claims are still near the lower end of its historical range and continue to signal an extremely tight labor market despite recession and inflation concerns. Weekly initial unemployment claims and the four-week moving average for the past two years are shown in the following figure.

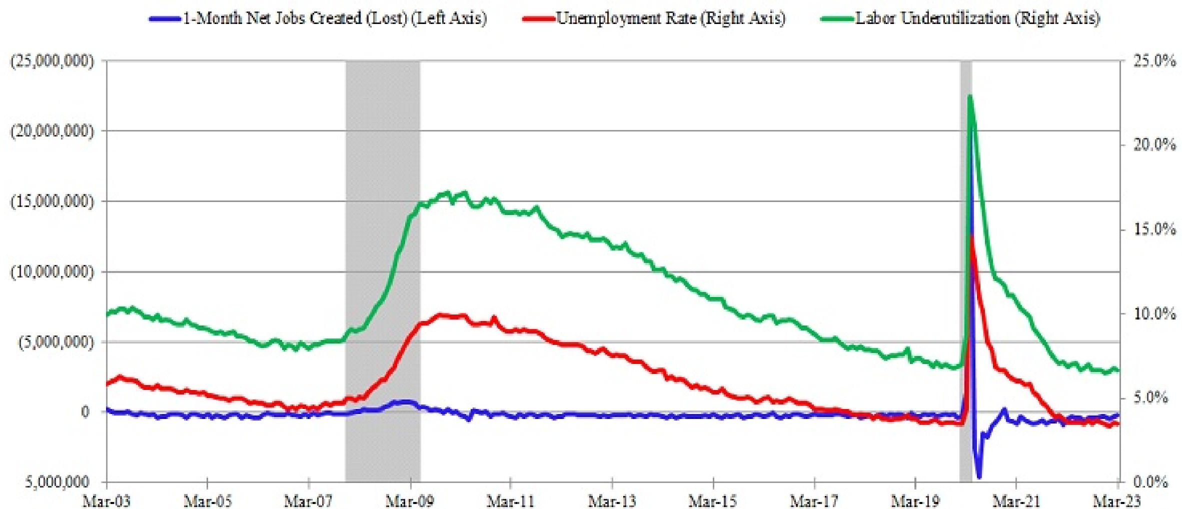
WEEKLY INITIAL UNEMPLOYMENT CLAIMS



Source: Federal Reserve Bank of St. Louis.

Unemployment and underemployment restrain economic growth as consumers are unable or hesitant to spend. The past 20 years of job creation, employment, and underemployment data are presented in the following figure.

MEASURES OF STRESS IN THE LABOR MARKET
Shaded Bar Indicates Recession



Sources: Department of Labor, Bureau of Labor Statistics, and National Bureau of Economic Research. Data represents non-farm payrolls.

While the labor market has remained strong in recent quarters, there is still a large mismatch between the number of people actively looking for work and the number of unfilled job openings. As of March 2023, while there were approximately 5.8 million unemployed people seeking work, businesses reported that there were more than 9.5 million job openings.[6,7] While this gap has narrowed in recent quarters, the surplus of job openings relative to job seekers suggests a favorable labor market for workers, and strong demand for labor from employers. In addition, nearly 4 million workers reportedly quit their jobs in the month of March, a level which has moderated somewhat over the past year, but is considered to still be historically high.[8] The higher the rate at which workers quit is generally viewed as a positive sign for the labor market, as workers will usually only quit their job if they believe they can find or have found a better job. The Committee believes that the large number of job openings relative to the number of people seeking work and workers' willingness to quit their current job indicate that labor conditions are remaining strong.

Interest Rates

Although the Committee raised the federal funds rate 50 basis points throughout the first quarter of 2023, interest rates declined (nevertheless remaining relatively high). A major reason for the divergence between the federal funds rate and longer-term interest rates is the emerging optimism that the Committee may be nearing completion of its rate increase cycle. In other words, investors believe the federal funds rate may be reaching its "terminal" level, which is the point at which inflation can continue to moderate towards the 2.0 percent target without further hindering growth.

The yield on the 10-year U.S. Treasury declined 40 basis points in the first quarter to 3.48 percent, subsiding from a 12-year high at the end of the fourth quarter of 2022. The Moody's Baa rate decreased by 28 basis points to 5.59 percent in the first quarter, while the 30-year fixed home mortgage rate declined by 10 basis points to 6.32 percent over the same period; again fueled by hopes that the Committee's tightening of monetary policy is nearing completion. Interest rates are likely to continue to closely follow the actions and outlook provided by the Committee. The past 20 years of historical interest rate data are shown in the following figure.

SELECTED INTEREST RATES
Shaded Bar Indicates Recession

Source: Federal Reserve Statistical Release H.15 (519) Selected Interest Rates.

Stock Market Activity

Following negative returns in 2022, the major indices recovered reasonably well in the first quarter of 2023, driven by positive data regarding inflation and employment, as well as hopes the Committee will pause its rate hikes in the coming months. The NASDAQ Composite was the best performing U.S. index in the first quarter of 2023, as technology-related stocks benefit the most from the prospects of interest rates stabilizing. All the other major indices posted single-digit gains during the first quarter, as the Dow Jones Industrial Average was the worst performing index of the quarter with a return of less than one percent.

Volatility declined and remained largely subdued in the first quarter of 2023, outside of a brief period of volatility in the financial sector stemming from the failures of Silicon Valley Bank and First Republic Bank. The otherwise calm period in the market is a deviation from the volatility broadly experienced in the last three years since the onset of the coronavirus pandemic. Generally positive economic data, along with the improving outlook on inflation, helped calm investors and market participants. Further, as more positive data comes in, concerns surrounding whether there will be a recession in the near

term are becoming less pervasive; both in regards to whether we will actually enter a recession, and about how impactful and long-lived one may be.

As mentioned, the NASDAQ Composite and the Dow Jones Industrial Average were the best and worst performing indices of the first quarter, respectively. The S&P 500 effectively split the difference between these two indices, benefitting from the aforementioned positive economic news that came in during the quarter. The S&P MidCap 400 and the Russell 2000 outpaced the Dow Jones Industrial Average, but lagged behind the larger cap indices that were fueled by strong returns of major technology companies; such as Meta (Facebook), Tesla, and Nvidia.

The belief that the Committee is nearing the end of its aggressive rate hike program, coupled with positive data on inflation, output, and employment, is good for all participants in the market. As a result, all the U.S. stock indices started the year with positive returns, as shown in the following figure.

TOTAL RETURNS OF MAJOR U.S. STOCK INDICES

Index	**First Quarter 2023**
S&P 500	7.5%
Dow Jones Industrial Average	0.9%
NASDAQ Composite (1)	16.8%
S&P MidCap 400	3.8%
Russell 2000	2.7%

Note:
(1) Return represents principal only.

Inflation[9]

Inflation continued to be the most prevalent topic surrounding the U.S. economy throughout the first quarter of 2023. Chairman Powell has reiterated that the Committee will utilize the appropriate tools to fulfill its dual mandate as directed by Congress, which includes stable prices (defined as 2.0 percent annual inflation). Following a year where inflation remained volatile, the 12-month change in the consumer price index ("CPI") remained stubbornly high, only declining from 7.5 percent to 6.5 percent in 2022. However, during the first quarter of 2023, CPI dropped to 5.0 percent in March, its lowest point since May 2021.

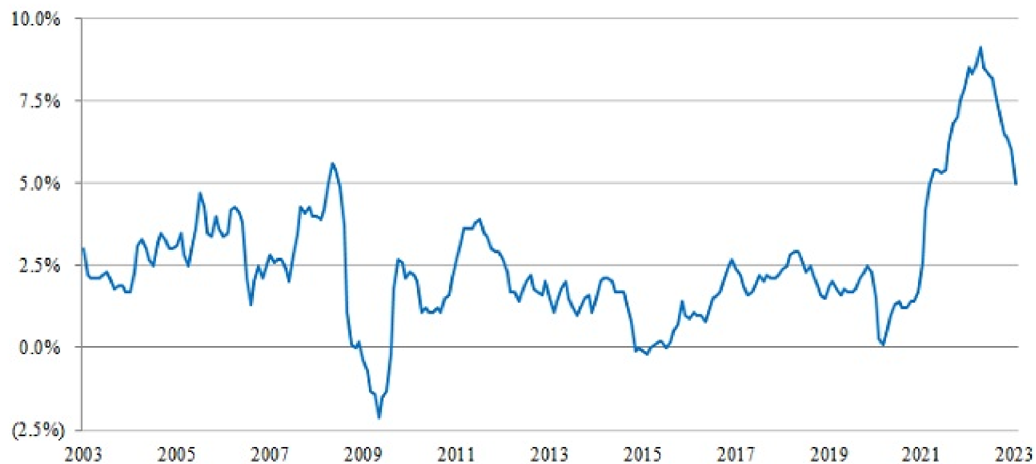
For the month of May alone, CPI increased by 0.1 percent, which benefitted from continued declines in oil prices. The price of gasoline continued its decline in the first quarter, and stands at more than 17 percent lower in March 2023 than one year prior. While the one-month change in CPI remains somewhat volatile, it is much lower than the one-month increases experienced in the first half of 2022.

Core CPI, which excludes oil and food due to their volatility, increased by 5.6 percent over the 12-month period ending March 2023, which is barely a decline from the 5.7 percent increase for the 12-month period ending December 2022, signaling that inflation for main goods and services remains high. Core CPI rose by 0.4 percent in March 2023 alone, which is unchanged from the 0.4 percent increase in December 2022.

Some of the notable items that experienced meaningful price changes in the month alone include transportation (1.4 percent), shelter (0.6 percent), and new vehicles (0.4 percent). For the 12 months ending March 2023, the price increases on transportation (13.9 percent), electricity (10.2 percent), and food (8.5 percent), were significant as well.

The last time inflation was comparable to our current environment was the early 1980s, which exhibited some of the issues being experienced today; global and political instability, as well as energy and oil shocks. However, the current inflationary environment is particularly surprising given how muted inflation had been for the past two decades. Since 2003, inflation had only reached 5.0 percent for a brief period in 2008 (a period of excessive expansion and consumption preceding the "Great Recession") and had since failed to exceed 4.0 percent until April 2021. The annual change in the CPI for the last 20 years is shown in the following figure.

ANNUAL CHANGE IN THE CPI



Source: Bureau of Labor Statistics.

As a result of the reduction in the pace of inflation in recent months, inflation expectations are beginning to reflect that optimism among consumers. The Federal Reserve monitors inflation expectations because if consumers and businesses anticipate an increase in wages and prices, they can adjust their behavior accordingly, making the expected inflation a reality. Every month, the Federal Reserve Bank of New York publishes expectations of future inflation. Prior to 2020, one-year forward-looking inflation expectations generally remained between 2.5 percent and 3.0 percent since

2015. One-year forward-looking inflation expectations have continued to decrease from a high of 6.8 percent in June 2022 to 4.7 percent in March 2023; a positive sign that the Committee's actions and incoming data are indicative of progress towards price stability. In addition, three-year forward looking inflation expectations remain elevated above the Committee's longer run 2.0 percent target, but have declined over the past year from 3.7 percent to 2.8 percent as of March 2023. [10]

The Committee has continued to adjust its stance as the outlook of inflation changes over time based on new economic data. However, the Committee has recently confirmed its intent to adjust its policies accordingly for the purpose of achieving stable prices. At its March meeting, the members of the Committee provided their outlook of the target range for the federal funds rate in the coming years. All but one member predicts that the target range for the federal funds rate will be between 5.0 percent and 5.75 percent by the end of 2023. In 2024, there is a wide variance of projections for the target range, with projections ranging from as low as 3.25 percent to as high as 5.75 percent. However, the bulk of the members see a federal funds rate in the range between 4.0 percent and 4.75 percent. In the longer run, a significant majority of the Committee members indicate a target range somewhere between 2.25 percent and 2.75 percent is appropriate. [11]

The Federal Reserve publishes estimates of personal consumption expenditures ("PCE") inflation and Core PCE inflation. It projects inflation to continue to subside in 2023, with PCE inflation of 3.3 percent and Core PCE inflation of 3.6 percent. In the years to follow, the Federal Reserve expects inflation to retreat to more moderate levels. It projects PCE and Core PCE inflation of 2.5 percent and 2.6 percent, respectively in 2024. This is followed by PCE and Core PCE inflation of 2.1 percent in 2025, supporting its belief that the Committee's policies will not allow the inflationary environment to exist long-term.[12]

Disclaimer: this article has content that is general and informational in nature. This document is not intended to be accounting, tax, legal, or investment advice. Data from third parties is believed to be reliable, but no assurance is made as to the accuracy or completeness.

Endnotes:

1. National Bureau of Economic Research. <https://www.nber.org/research/data/us-business-cycle-expansions-and-contractions>.

2. Ibid.

3. Board of Governors of the Federal Reserve System, "Plans for Reducing the Size of the Federal Reserve's Balance Sheet", May 4, 2022. <https://www.federalreserve.gov/newsevents/pressreleases/monetary20220504b.htm>.

4. Bureau of Labor Statistics. "Employment, Hours, and Earnings from the Current Employment Statistics survey (National)." <http://data.bls.gov/timeseries/CES0000000001?output_view=net_1mth>.

5. "U-6 total unemployed, plus all persons marginally attached to the labor force, plus total employed part time for economic reasons, as a percent of the civilian labor force plus all persons marginally attached to the labor force." Reported on a seasonally adjusted basis.

6. Bureau of Labor Statistics, "The Employment Situation - March 2023," April 7, 2023, <https://www.bls.gov/news.release/archives/empsit_04072023.htm>.

7. Bureau of Labor Statistics, "Job Openings and Labor Turnover - March 2023," May 2, 2023, <https://www.bls.gov/news.release/archives/jolts_05022023.htm>.

8. Ibid.

9. Bureau of Labor Statistics, "Consumer Price Index - March 2023," April 12, 2023, <https://www.bls.gov/cpi/>.

10. Federal Reserve Bank of New York, "Survey of Consumer Expectations," <https://www.newyorkfed.org/microeconomics/sce#/>.

11. Board of Governors of the Federal Reserve System, "Summary of Economic Projections," March 22, 2023, <https://www.federalreserve.gov/monetarypolicy/fomcprojtabl20230322.htm>.

12. Ibid.