



Economic Review - Third Quarter 2022

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 19 million jobs in the following 20 months. Despite a decline in gross domestic product for the first two quarters of 2022, the economy managed to add approximately 2.5 million jobs during the first six months of the year. In the third quarter alone, over 1.0 million jobs were added.

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 19 million jobs in the following 20 months. Despite a decline in gross domestic product for the first two quarters of 2022, the economy managed to add approximately 2.5 million jobs during the first six months of the year. In the third quarter alone, over 1.0 million jobs were added.

The Federal Open Market Committee (the "Committee") of the Federal Reserve held two meetings during the third quarter of 2022; one in July and one in September to discuss the additional measures being taken to support the economy, which include:

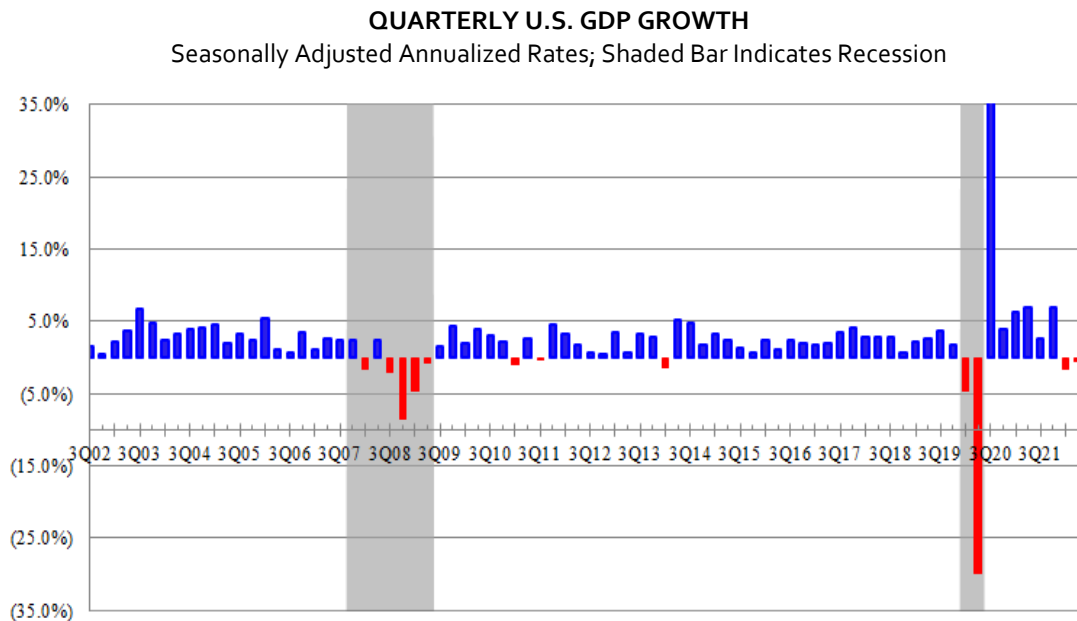
- Increasing the target range for the federal funds rate by 75 basis points in July and September; representing a total change in the target range from 1.50 percent-to-1.75 percent to 3.0 percent-to-3.25 percent.
- Signaling that additional rate increases are likely to continue throughout the year and may come in varying increments as deemed necessary to reduce inflation toward its 2.0 percent target.



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

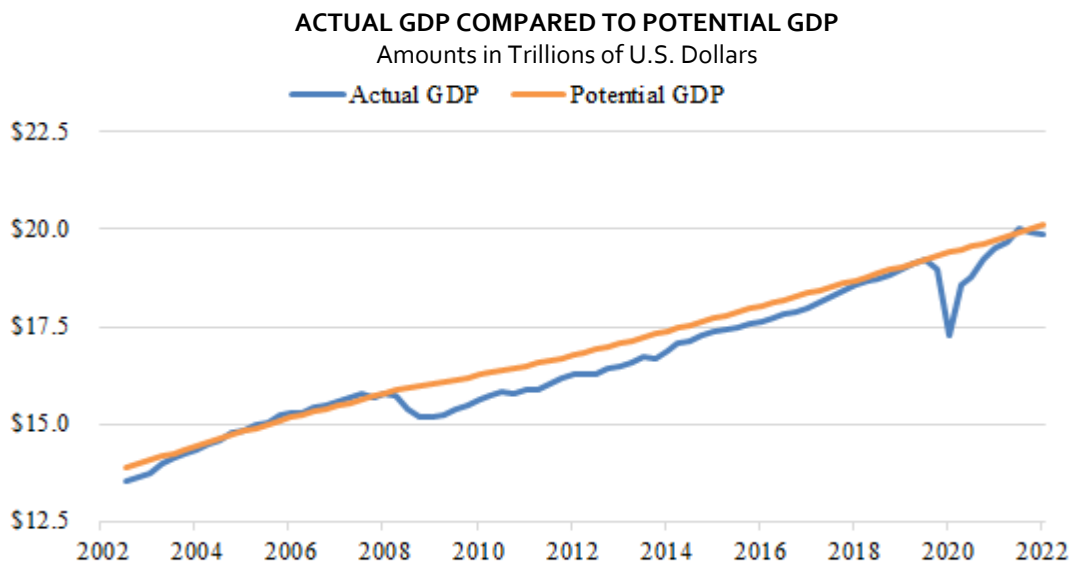
Gross Domestic Product

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 — decreased at an annual rate of 0.6 percent in the second quarter of 2022; representing the second consecutive quarterly decline in output since the recovery from the coronavirus pandemic began in the third quarter of 2020. In 2021, GDP increased by 5.7 percent for the year, compared to a 3.5 percent decline in 2020. Quarterly GDP data for the preceding 20 years is shown in the following figure.



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 \$2.1 trillion below the \$19.4 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 have brought the shortfall to \$0.21 trillion. Actual GDP and potential GDP for the past 20 years are shown in the following figure.



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

The Federal Reserve publishes estimates of GDP growth. It projects GDP to remain effectively flat in 2022, with growth of just 0.2 percent. Thereafter, it projects GDP growth rates of 1.2 percent and 1.7 percent in 2023 and 2024, respectively, before settling at 1.8 percent annual growth for the long-run.

Employment

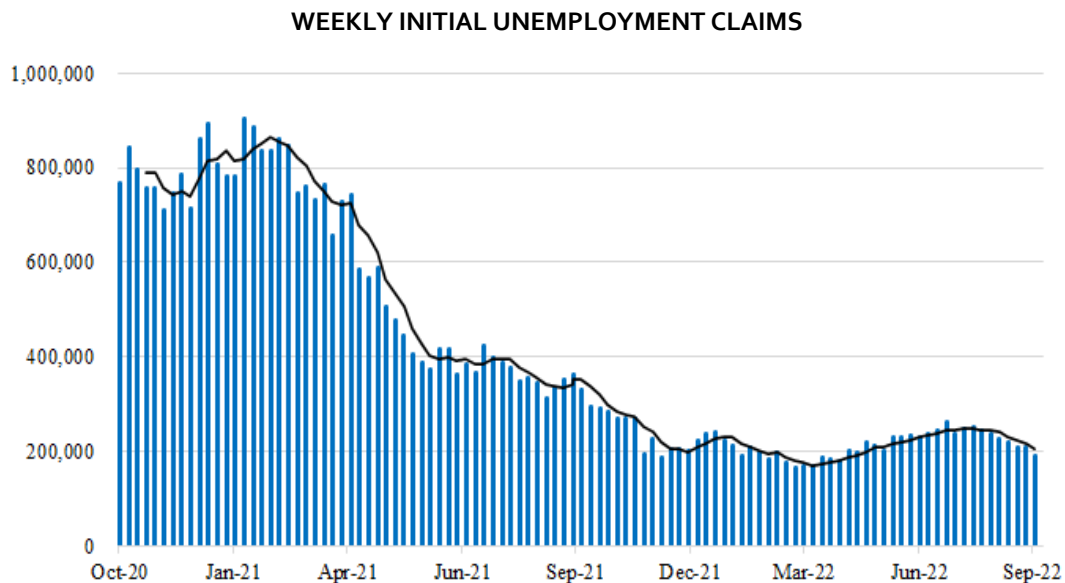
From March 2010 (the end of the 2008–2009 recession) to February 2020, 23.2 million net non-farm jobs were created.⁴ After the brief recession caused by the coronavirus pandemic eliminated ten years of job growth in just a few months, the economy returned to its pre-pandemic levels of employment in the third quarter of 2022. At the end of the third quarter of 2022, the unemployment rate was 3.5 percent, near the 53-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, reached 6.7 percent in September 2022 (its historical low since data was first collected in 1994).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, increasing modestly to an average of 232,000 throughout the third quarter of 2022 compared to an average of 206,000 throughout the first quarter.

After initial claims continued their upward trend during the first half of the third quarter, reaching an 8-month high of 261,000 (for the week ending July 16, 2022), they have reversed course and fell to a 5-month low of 190,000 for the week ending September 24, 2022. 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.



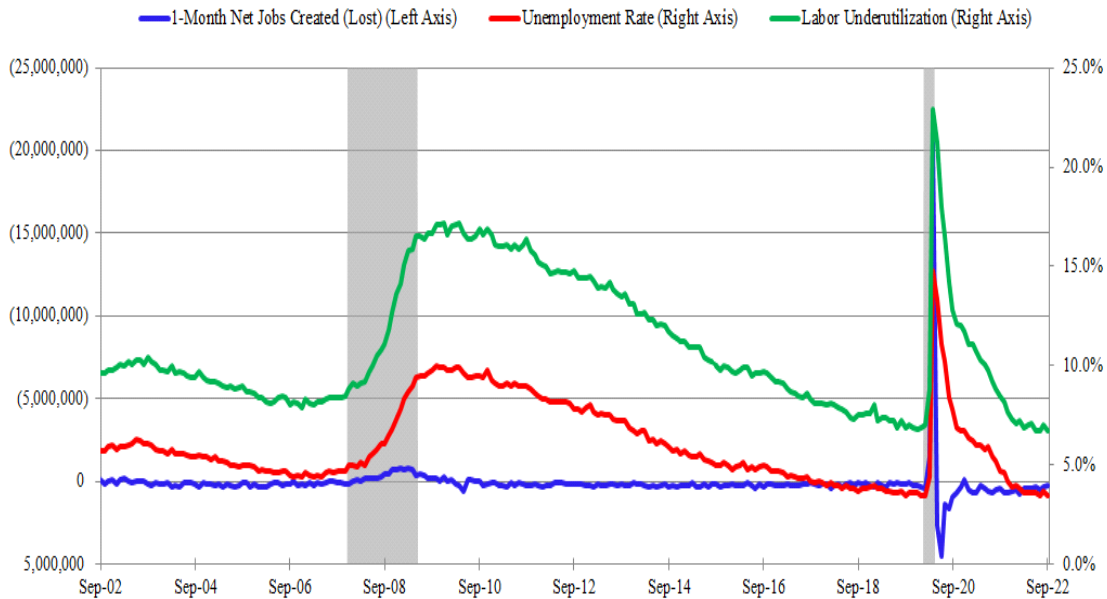
Source: Federal Reserve Bank of St. Louis.

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 continued to improve in recent quarters and is recovering well from the pandemic, there is still a large number of unfilled job openings. As of August 2022, businesses reported that there were still over 10 million job openings available, while there were only approximately 6 million unemployed people seeking work.^{6 7} In addition, over 4 million workers reportedly quit their jobs in the month of August, a level which has remained near all-time highs in previous months.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.

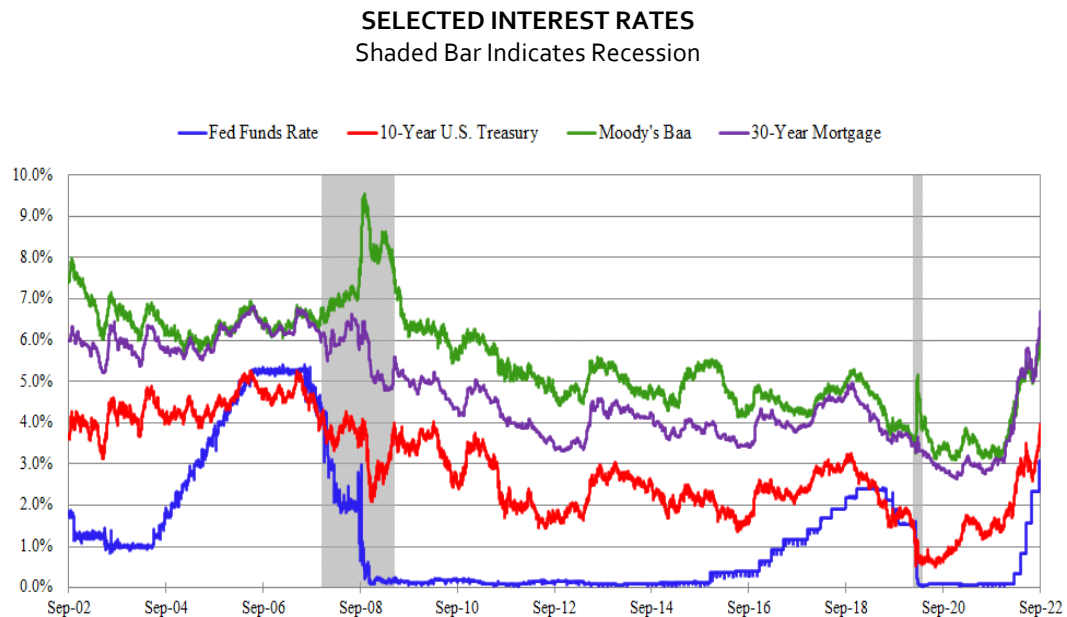
Interest Rates

Interest rates continued their broad increase during the third quarter of 2022, reaching their highest levels since well before the pandemic and the 2020 recession, as the Committee continues along the path of rate increases.

The yield on the 10-year U.S. Treasury rose 85 basis points by the end of the third quarter to 3.83 percent, which is its highest level since April 2010. The Moody's Baa rate increased by 78 basis points throughout the third quarter to 6.07 percent, a rate that hasn't been topped since April 2011.



The 30-year fixed home mortgage rate increased by 100 basis points to 6.70 percent in the third quarter as well, its highest point since July 2007. Interest rates are likely to continue to increase as the Committee executes further interest rate hikes throughout the year and likely into 2023. The past 20 years of historical interest rate data are shown in the following figure.



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

Stock Market Activity

All the major indices extended their losses for 2022 throughout the third quarter, following extensive negative returns during the second quarter. Volatility remained elevated due to concerns over persistently high inflation and how aggressive the Committee will be in its rate increases to reduce inflation. The likelihood of a recession continues to grow as the actions taken by the Committee so far have not yet brought down inflation as much as everyone had hoped, which will lead to further rate hikes and may induce a recession in order to restore price stability. In addition, there is the ongoing uncertainty surrounding the war between Russia and Ukraine.

The Russell 2000 index posted the smallest loss of all the major indices in the third quarter of 2022, favoring the performance of small-cap stocks. The NASDAQ Composite has been the worst performing index so far in 2022, as technology-based companies are particularly sensitive to rising interest rates and their effect on the valuation of future cash flows. In addition, the strengthening of the U.S. dollar throughout the year has relatively weakened the revenue these global technology companies bring in from foreign customers, which is a considerable portion of their revenue.



All major indices began the third quarter of 2022 with some positive momentum, as many investors believed inflation would soon begin to retreat to more sustainable levels following the Committee's previous actions. However, the influx of new data has suggested otherwise, and many investors fear it will take a 'hard landing' to tame inflation, which will yield steep declines in output and employment. As a result, any positive returns were swiftly extinguished and the third quarter ended with broad negative returns. Total returns for U.S. stock indices are shown in the following figure.

TOTAL RETURNS OF MAJOR U.S. STOCK INDICES

Index	Third Quarter 2022	Year to Date
S&P 500	(4.9%)	(23.9%)
Dow Jones Industrial Average	(6.2%)	(19.7%)
NASDAQ Composite (1)	(4.1%)	(32.4%)
S&P MidCap 400	(2.5%)	(21.5%)
Russell 2000	(2.2%)	(25.1%)

Note:

(1) Return represents principal only.

Inflation⁹

Inflation continued to be the most prevalent topic surrounding the U.S. economy throughout the third quarter of 2022. Although improving, the subdued global recovery from the coronavirus pandemic continues to hinder international supply chains from achieving their pre-pandemic capacity, and the Russian invasion of Ukraine has adversely affected global food and energy prices. 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). The consumer price index ("CPI") rose by 0.4 percent in the month of September alone, as well as 8.2 percent for the 12 months ending September 2022, which is a moderation from the 41-year high of 9.1 percent for the 12 months ending June 2022. The price of fuel oil continued its decline in the third quarter, but remains over 58 percent higher in September 2022 than one year prior.

Core CPI, which excludes oil and food due to their volatility, increased by 6.6 percent over the 12-month period ending September 2022, which is an increase from the 5.9 percent increase for the 12-month period ending June 2022, signaling that inflation for main goods and services remained persistent. Core CPI rose by 0.6 percent in September 2022 alone, a slight decline from 0.7 percent in June 2022. Although there is optimism that waning consumer demand, gradual improvements to the supply chain, and the actions taken by the Committee will begin to bring down inflation, it is unclear how long it will take or how damaging it will be to the economy for the Federal Reserve to get inflation back to its 2.0 percent target. The items that experienced notable price increases during the month of September include transportation services (1.9 percent), medical care services (1.0 percent), and food (0.8 percent).



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 2002, inflation had only reached 5.0 percent for a brief period in 2008, 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 elevated levels of inflation that began in the second quarter of 2021 and have continued to rise throughout the third quarter of 2022, inflation expectations are beginning to rise as well. 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 decreased sharply from 6.8 percent in June 2022 to 5.4 percent in September 2022; a positive sign that the Committee's actions are fueling some optimism that they will inevitably achieve 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 in recent months from nearly 4.0 percent to just under 3.0 percent as of September 2022.¹⁰

The Committee has continued to adjust its stance as the outlook of inflation becomes more severe than the Committee initially believed. However, the Committee has recently confirmed its intent to adjust its policies accordingly for the purpose of achieving stable prices. At its September 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 is in agreement that the target range for the federal funds rate will be between 4.0 percent and 5.0 percent throughout the rest of 2022 and for all of 2023. In 2024, there is a greater variance of projections for the target range, with a majority of the members indicating an appropriate range somewhere between 3.0 percent and 4.0 percent; however, some members believe an appropriate target range could be as low as 2.5 percent or as high as 4.75 percent. In the longer run, all of the Committee members indicate a target range somewhere between 2.0 percent and 3.0 percent is likely.¹¹

The Federal Reserve publishes estimates of personal consumption expenditures (“PCE”) inflation and Core PCE inflation. It projects inflation to begin to subside in 2022, with PCE inflation of 5.4 percent and Core PCE inflation of 4.5 percent. In the years to follow, the Federal Reserve expects inflation to retreat to more moderate levels. It projects PCE inflation of 2.8 percent and Core PCE inflation of 3.1 percent in 2023, followed by PCE and Core PCE inflation of 2.3 percent in 2024, 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.
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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 - August 2022," September 2, 2022,
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12. Ibid.