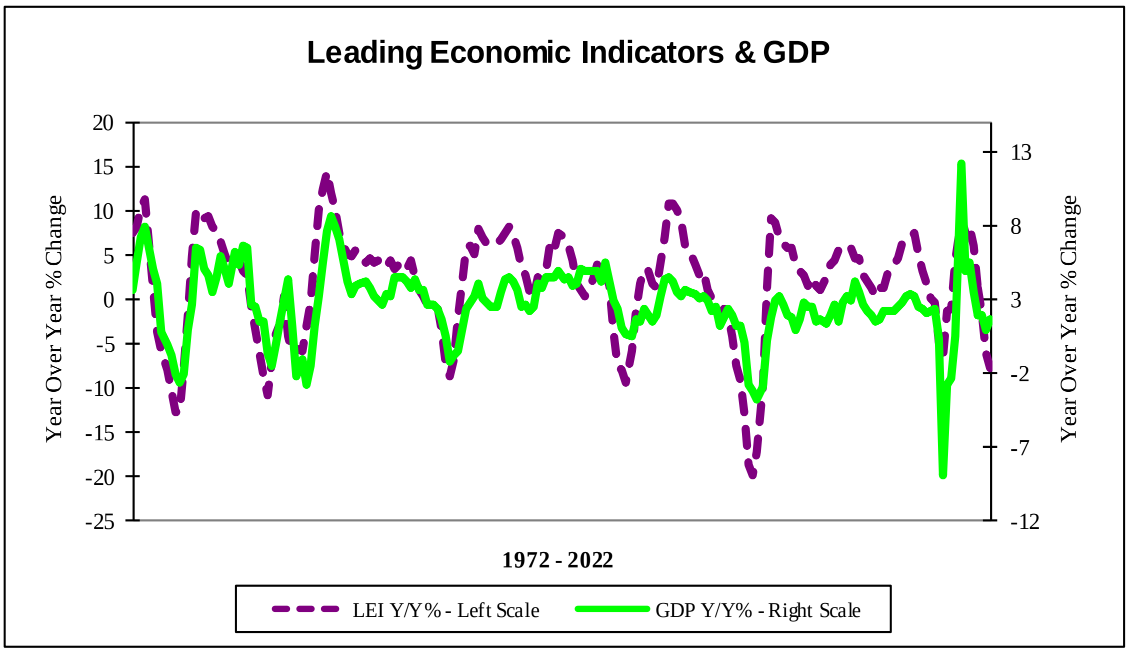
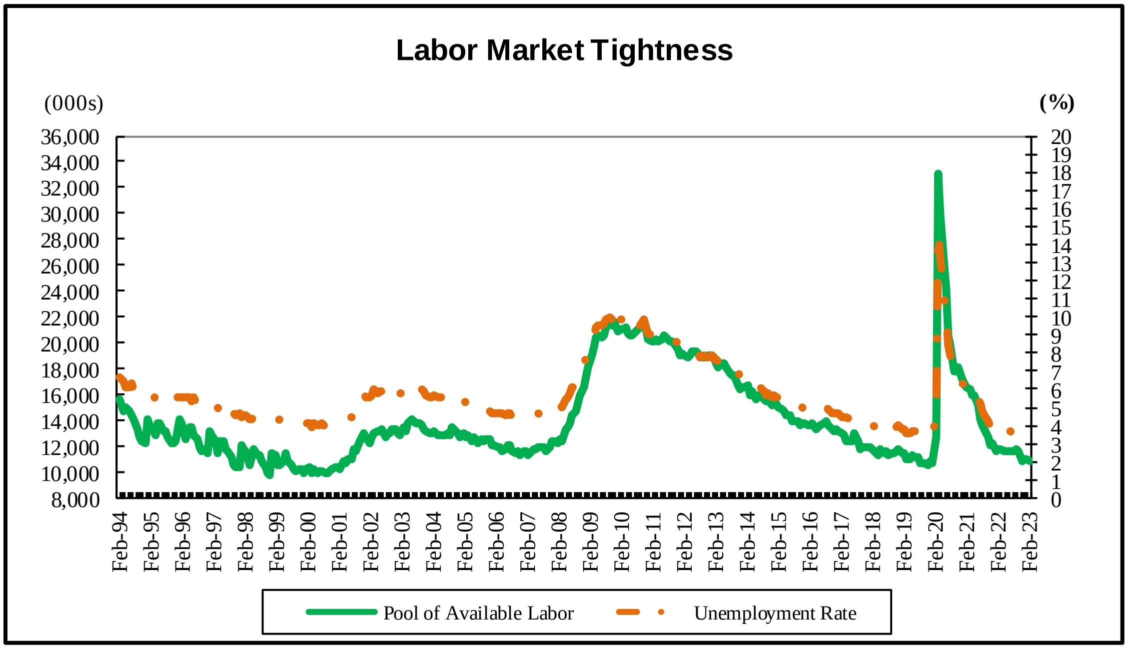
SAMCO Capital

April 30, 2023

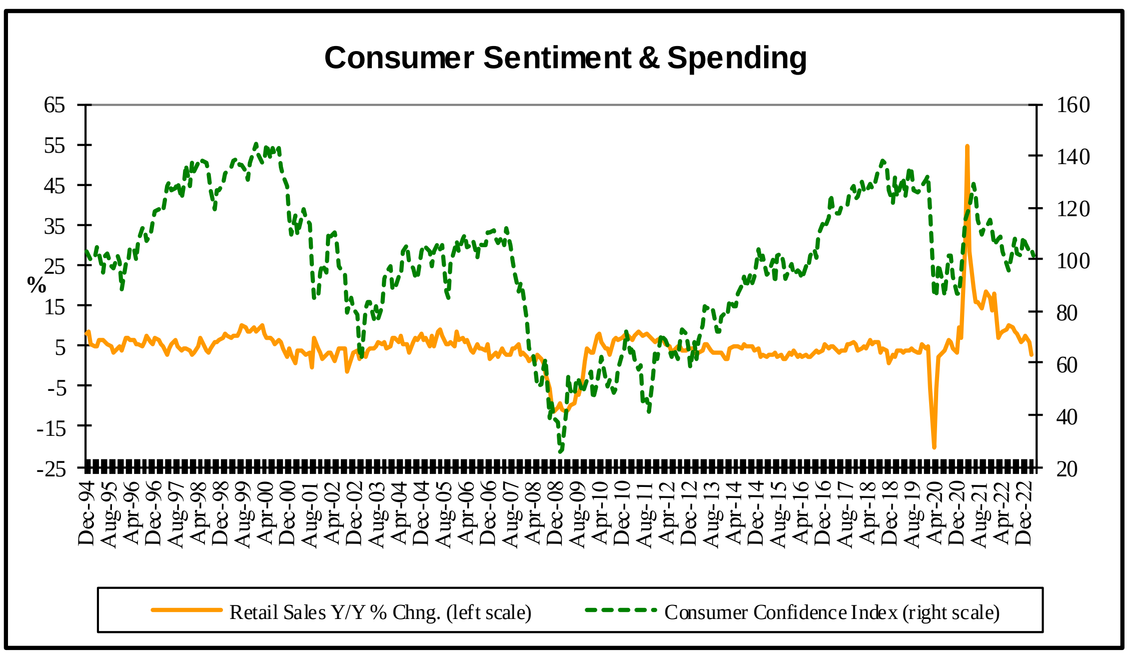
After a strong start to the year, the economy ended the first quarter of 2023 on a down note. The first estimate of GDP for the quarter ending on March 31 came in at a below consensus estimate of 1.1%, largely due to an outsized decline in inventory accumulation. Strong consumer spending at the start of the year was the main driver of growth, while recent data has revealed signs of cooling economic activity. On the other hand, overall progress on inflation remains slow. While the headline Consumer Price Index (CPI) declined to a year-over-year rate of 5.00% from 6.00% in February, a large part of the decline can be attributed to the base year effect. In March of 2022, the base year, CPI jumped higher as energy and agriculture prices spiked in the aftermath of Russia's invasion of Ukraine. The latest core CPI gauge, which excludes food and energy rose another 0.4% in March pushing the year-over-year rate up a tick to 5.6%. It certainly appears that the Fed still has some work to do to reach its inflation goal of 2%.



By historical standards, the labor market remains strong, but there are tentative signs it has begun to loosen up. Both large and small business surveys – the Institute for Supply Management (ISM) and the National Federation of Independent Businesses (NFIB) – show less hiring. The ADP Employment Change Report falling below consensus estimates, and initial and continuing claims for unemployment benefits inching up, add to tell-tale signs that the labor market may be starting to cool. On the other hand, a fairly significant decline in job openings in the Job Openings and Layoff Turnover Survey did little to correct the imbalance of demand and supply. The bottom line is that the labor market is still too tight for the Fed, which fears that a strong labor market could re-ignite consumer spending and inflation.



Consumer spending, another pillar of economic activity, also showed signs of gradually losing momentum at the end of the first quarter. Inflation outpacing the growth in income and higher financing costs is starting to bear on consumers. Then there are headlines about the banking sector stress and the potential it could lead banks to tighten access to credit, which could cause further moderation in spending.



Fed officials have welcomed signs that their aggressive monetary policy tightening is beginning to catch traction. The FOMC is widely expected to raise the targeted fed funds range up by 25 basis points to 5.00% to 5.25%. Some committee members are getting cautious and concerned about over-tightening. How much further policy tightening, if any, is needed and how long policy will need to stay restrictive will depend on economic and financial developments. Quantitative tightening is expected to stay in place for some time as the Bank Term Funding Program (BTFP) appears to have been successful in providing some stability to the banking system. With the expectation of some tightening of credit conditions, and the lagging impact of previous tightening still in the pipeline, the Fed appears to have moved closer to the end of its tightening journey. Still, if inflation remains sticky, it could be a while before they reverse course and start to lower the fed funds rate.

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