BLB&B Advisors, LLC
FINANCIAL GUIDANCE SINCE 1964℠

Quarterly ECONOMIC REVIEW

2ND Quarter 2023

Economic Update

Soft Landing? Hard Landing? Or No Landing?

The recent June release of May's Consumer Price Index (CPI) data showed further cooling in U.S. top-line inflation (4.0%), while, at the same time, core CPI (less food and energy prices) remains persistently high at 5.3%. Also, although U.S. unemployment in May ticked up slightly to 3.7%, it continues to hover at, or near, historically low levels. Simply put, there are still more available jobs than people to fill them.

In short, this was a mixed bag of data — offering just enough indication of a slow-down to afford the Federal Reserve some time to consider their next move.

Thus, in keeping with expectations, the Federal Reserve Open Market Committee (FOMC) opted to hold the effective Fed Funds rate steady at 5.07% during their June meeting. In its published projections, however, the FOMC upwardly revised its policy path expectations by 50bp (signaling the likelihood of another two 25bp rate hikes sometime in 2023). In addition, the FOMC:

- Raised growth projections for the balance of 2023;
- Reduced their unemployment rate expectations; and
- Upwardly revised their core PCE inflation (Personal Consumption Expenditures) forecast.

All in all, this implies a somewhat more hawkish outlook than previous statements, and slightly reduces the probability of a 'recession-less' soft landing for the U.S. economy.

In a ***soft landing*** scenario, the Fed's recent spate of rate hikes would serve to sufficiently slow the economy just enough to curb demand and rein in inflation; but not so much as to drive U.S. GDP (Gross Domestic Product) into negative territory or create a major increase in the unemployment rate.

A ***hard landing***, on the other hand, is simply another term for a recession caused by the Fed (in their efforts to tackle inflation) hitting the brakes too hard on the economy, or keeping them on for too long. What ensues is a period of negative economic growth and/or high unemployment.

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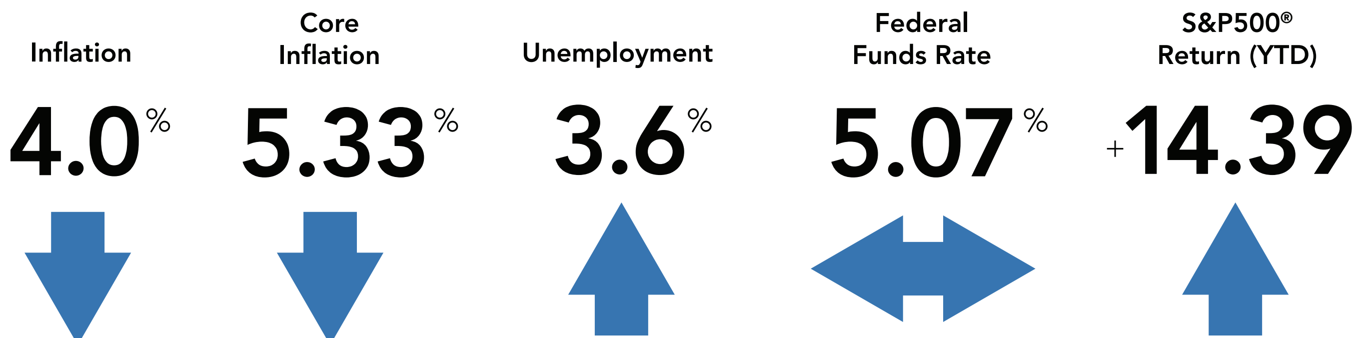

Some economists, however, continue to hold out hope for a ***no landing*** scenario. This would be a case where the economy fails to slow down, inflation remains above the Fed's 2% target, and employment numbers remain strong — causing the Fed to keep rates higher for longer. While this may sound like a desirable outcome, many experts see it as nothing more than kicking the can down the street a little longer as we wait for either a soft or hard landing to happen.

Which outcome we will end up with remains to be seen. Inflation could fall back of its own accord, considering that most COVID-related supply-side problems have been worked out and raw materials/commodity prices have declined. The recent Supreme Court ruling striking down President Biden's student loan forgiveness program, could also serve as a drag on the U.S. economy as about 40 million student loan holders will have to resume student loan repayments this fall — something they have not had to do since the start of the pandemic over three years ago.

Additionally, over the coming months, last year's peak inflationary monthly CPI readings will begin to roll off the 12-month calculation — replaced by what we expect to be lower readings which will help further drive down the inflation rate.

It should be noted that reliable past indicators of recession (i.e., an inverted yield curve, weak leading economic indicators and credit supply contraction) appear to be flashing red. Combined with the Treasury's current tight monetary policy and exceptionally high asset prices, the risk of a hard landing — while lessened — still seems to be in play.

Tight credit and high valuations

One of the key wild cards in this equation is whether or not there will be lingering economic aftershocks from the recent stresses on the U.S. banking system brought about by the successive failures of Silicon Valley Bank, Signature Bank, and First Republic. Not surprisingly, regional and community banks refocused attention on repairing their balance sheets; and as a result, further tightened their lending standards.

According to a recent report from Goldman Sachs (typically one of the more upbeat voices on Wall Street), "Banks with less than $250bn in assets account for roughly 50% of U.S. commercial and industrial lending, 60% of residential real estate lending, 80% of commercial real estate lending, and 45% of consumer lending." The resulting macroeconomic impact of tighter lending standards could therefore be highly disruptive. Goldman has therefore lowered its 2023 Q4/Q4 year-over-year GDP growth forecast by 0.3% to 1.2% — reflecting a significant downgrade to expected investment spending.[1]

Yet despite all these headwinds, the stock market has continued to steadily climb. As of the end of Q2, the S&P 500® is up nearly 15% year-to-date, with a current Shiller Cyclically Adjusted Price/Earnings (CAPE P/E) ratio of 30.69 (more than 80% higher than its historical average of 17.03).[2]

By any reasonable measurement, U.S. equity markets appear expensive — and much of this year's performance has been driven by a very small, select group of tech, consumer discretionary, and communication services stocks (e.g., NVDA, META, AAPL, TSLA and AMZN). Other sectors including energy, utilities, and consumer staples, are all generally underperforming; as are some major commodities such as oil.

A challenging global landscape

The ongoing conflict between Russia and Ukraine (not to mention the recent failed coup attempt by Wagner Group head Yevgeny Prigozhin) remains a significant cause for concern.

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As the war drags on, the potential for more economic fallout intensifies — especially Russian exports of oil and natural gas as well as Ukrainian wheat exports. Additionally, recent developments including the positioning of Russian troops and tactical nuclear weapons inside Belarus are worrisome. Any major escalation in this conflict could fracture an already fragile Russian economy, which in turn could dramatically impact global markets.

China, the world's second largest economy, is also showing signs of trouble — reporting that both industrial output and retail sales growth fell well short of forecasts in May. This looks to mark an end to the country's strong post-COVID momentum, and prompted China's central bank to immediately cut key interest rates for the first time in nearly a year. Expectations are that more cuts will likely follow.

This unexpected economic slowdown could further intensify the ongoing tensions between China and Taiwan. Not only would a ratcheting up of the dispute result in geopolitical fallout (e.g., sanctions), but keep in mind that Taiwan is also the world's leading microchip fabricator — producing 60% of the world's semiconductors and 93% of the most advanced ones.[3] Any disruption in that critical supply chain would adversely impact the global manufacture and sale of everything from smartphones and computers to automobiles, aircraft, and AI.

Looking ahead

According to the latest (May) projections from the Philadelphia Fed, they are forecasting Q2 GDP to come in somewhere around +1.0% — down slightly from the +1.3% growth in Q1, but still positive. They then see the slowdown reaching its zenith in Q4 with a 0% growth rate, followed by the start of a gradual but steady rebound in early 2024.[4] Nowhere in their analysis, however, are there any expectations for negative growth (i.e., recession). More recently, on June 29, 2023, the Bureau of Economic Analysis (BEA) issued its 3rd estimate for U.S. 1Q23 GDP — a surprising increase to +2.0 from its previous +1.3% estimate. Markets chose to interpret this upward move as another indication that, contrary to predictions from earlier this year, the U.S. economy is probably not teetering on the edge of a recession.

Based on these projections, we therefore continue to view a soft landing for the U.S. economy as the most likely outcome. Nevertheless, the economy seems poised at an inflection point — where any further unexpected economic stressors could tip us into recession.

In closing, we will simply reiterate our sentiment from last quarter's update. Our economy and markets have faced major challenges like these many times before. But in every case, the turbulence has eventually passed and the markets recovered. That is why we believe it is prudent to remain invested in a well-diversified portfolio that matches your particular risk tolerance. As always, your BLBB advisor is available to answer any questions or discuss any concerns you may have (215-643-9100).

[1] Goldman Sachs "Market Pulse," May 2023

[2] Source: https://www.multpl.com/shiller-pe

[3] "Strengthening the Global Semiconductor Supply Chain," Boston Consulting Group, April 2021

[4] "Second Quarter 2023 Survey of Professional Forecasters," Federal Reserve Bank of Philadelphia, May 2023

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The Civic 50 Greater Philadelphia provides a standard for superior corporate citizenship, and showcases how companies use their time, skills, and resources to drive social impact in their company and communities.

We're honored to receive this distinction for our continuing efforts to connect our business values to the needs of our community. For more information about this recognition please visit www.philafound.org/civic-50.

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