THE YEAR AHEAD - IS A SOFT LANDING POSSIBLE?

Introduction

The battle lines have been drawn on interest rate predictions for 2023. Based on falling Treasury yields during the first week of the year, the financial markets are signaling that the Federal Reserve will not raise interest rates much further - and may actually lower rates later in the year to avoid or dampen the impact of a recession. The Fed on the other hand has communicated that it remains committed to raising interest rates to keep inflation under control. Fed officials are worried that the financial markets are incorrectly interpreting their decision to raise rates more slowly (50 basis points in December) as a sign that recent interest rate hikes are enough to curb inflation. However, Jerome Powell, the Fed Chair recently declared, “We have more work to do.” So... what will happen?

Recent History

Back in March of 2021, financial market participants became worried about higher inflation due to two primary factors: a shortage of goods created by COVID induced supply chain disruptions and unmet demand caused by too much COVID relief funds being pumped into the economy by the Federal Government. Despite this, as pointed out in a 2022 Pearl Creek Advisors market update, the Federal Reserve in early and mid-2021 voiced no concern over inflation and even communicated that it had no intent of raising interest rates until well into 2023. So, it kept rates low through most of 2021. As a result, tax-exempt borrowers enjoyed record low interest rates. But as 2021 drew to a close, the Fed realized its mistake and even admitted that it was too late in recognizing the potential for inflation, helping create the highest inflation levels in over 40 years.

As a result, the Fed had to play catch-up during 2022 with record interest rate hikes with the Federal Funds Rate going from 0.25% in late 2021 to its current level of 4.50%. This was aided by never-before-seen four straight 75 basis point rate hikes. The Fed has made it very clear that it is determined to keep inflation from becoming embedded in the economy. Despite this continued refrain, the markets kept thinking that the Fed would cave in and stop raising rates. Throughout 2022 the markets would cling to any economic news that might hint at a slowing economy or lower inflation to rationalize a cessation of interest rate hikes, causing the markets to rally. A Fed representative would then splash cold water on that expectation, and the markets would fall. We saw this dynamic play out multiple times during 2022, causing much of the volatility in the stock and bond markets during the past year as interest rates continued to rise.

The Desire for a Soft Landing

Unlike in 2021 when the Fed missed the mark, the Fed seemed to get it right in 2022. So, will the Fed get it right in 2023? In 2023, the Fed will be aiming for what economists call a “soft landing” - getting the economy to a more healthy inflation rate of 2% to 3% while maintaining positive GDP growth, thus avoiding a recession. This is very difficult to pull off and has been done very rarely when coming out of periods of high inflation.

As with any landing, pulling back too early or too late spells trouble. If the Fed pulls back too early (stops raising interest rates, which is what the financial markets desire), inflation could become entrenched in the economy with no landing in sight. If the Fed pulls back too late (keeps interest rates too high for too long), the economy slows down too fast and crashes. Thereby creating a recession which will weaken the labor market, causing workers to earn less and to possibly lose their jobs.

So, pursuing a loose monetary policy (not raising rates high enough or lowering rates) too soon will create systemic and embedded inflation, which is very bad for the economy, especially for lower-paid workers whose income will not keep up with the cost of living. Pursuing a tight monetary policy for too long (raising interest rates too much) creates a recession. This would also be bad for the economy as well and bad for workers in general because of layoffs and high unemployment. Both scenarios feed on themselves and are difficult to get out of once they occur.

Labor Costs Continue to Befuddle the Experts

A contributor to the recent rise in the rate of inflation has been the cost of labor due to two straight years of record-setting payroll growth. However, in December, employers added only 223,000 jobs, the smallest monthly gain in over 2 years. In addition, hourly earnings in December were up 4.6% from the previous year, the narrowest increase in 18 months. So, some market participants believe this signals lower wage growth. If so, this would be good news for the Fed as it tries to lower inflation. It could also be good news for many employers who are having difficulty finding people to fill jobs.

However, December also saw the unemployment rate drop to just under 3.5%, the lowest level in over 50 years. This is basically full employment, which would continue to put upward pressure on wages. So depending on what you want to take away from the December’s Jobs Report, you either believe higher than normal wage growth is subsiding or wage growth will continue at a lower, but still higher than normal level. The financial markets seem to believe the former and the Fed the latter.

To complicate matters further, the Federal Trade Commission recently announced that it is going to make it illegal for employers to include noncompete clauses in employment contracts, which by their calculations, could increase employee earnings annually by as much as $296 billion (see insert). This would obviously put more upward pressure on wages.

Will A Soft Landing Occur in 2023?

As the Fed threads the needle in trying to bring down the rate of inflation without dumping the U.S. economy into a recession, it must decide when to stop raising interest rates. With the Fed Funds Rate currently at 4.5%, many economists predict that the Fed will raise rates another 75 to 100 basis points, taking the Fed Funds Rate to 5.25% to 5.50% by mid-2023. Will this be enough to curb inflation? If so, will this allow the economy to slow down at a healthy rate or crash into a recession?

There is no shortage of opinions on this issue. Last week, during a Global Economic Outlook webinar put on by one of Wall Street's most respected firms, two economists who have worked together for years disagreed on the probability of the U.S. economy going into a recession. One put the odds at 35% that the U.S. economy would go into a recession in 2023 with the other putting the odds at 70%. With that, let's just say that the chances of a soft landing are 50/50, which is better than what most people would have predicted six months ago. Many believe that the current low unemployment rate will help the Fed achieve a soft landing.

Where Are Long-Term Interest Rates Headed?

If the Fed does raise interest rates another 100 basis points, short term treasury notes will follow. However, just because short term rates go up does not mean that long-term rates will follow. We currently have an inverted yield curve with the 1-year Treasury yielding 4.70 and the 30-year Treasury yielding 3.67, down from nearly 4% from a few weeks ago. And with the 30-year tax-exempt MMD index trading at the same level as 30-year treasuries, the 30-year borrowing rate for AAA rated entities is around 3.65%.

Because most market participants believe the Fed will stop raising rates halfway through 2023, most predictions see a slight increase in long-term rates for the first half of 2023 with long-term taxable rates going back to current levels later in the year, thereby creating an even more inverted yield curve.

What About Tax-Exempt Rates?

As pointed out in almost every Pearl Creek market update, in addition to Treasury rates, cash inflows and outflows from tax-exempt mutual funds also impact long-term tax-exempt rates. And because 2022 was a record year for cash outflows, doubling the next worse year, long-term tax-exempt municipal bonds underperformed taxable equivalents, meaning that borrowing rates for non-profits in 2022 rose more than borrowing rates for their for-profit peers. And that impact was even more negative for lower rated and non-rated credits. Credit spreads for non-rated 501©3 entities doubled during 2022, creating much higher borrowing costs relative to the tax-exempt MMD index. On a recently completed $50 million BB+ rated tax-exempt bond transaction for a non-profit senior living organization the 30-year interest rate was 6.5%, almost twice the borrowing costs from a year ago, which was closer to 3.50%.

So, in 2023, assuming that some of that cash comes back into tax-exempt mutual funds, rates for non-profit borrowers, especially lower rated and non-rated credits, should be slightly lower at the end of 2023 than presently, even if the Fed does continue to raise interest rates another 75 to 100 basis points.

Noncompete clauses, which typically bar employees from joining a competitor for a period after they quit, now impact one in five American workers. Long associated with higher-paid managers, the clauses have also been imposed on lower-wage workers. For example, the FTC recently brought a case against one well known company who required low-wage security guards to sign contracts that barred them for two years from working for a competing firm within a 100-mile radius of where they had been stationed. Working for close to minimum wage, these employees would have to pay a $100,000 fine if they violated the noncompete clause. And these types of contracts have become more common.

If the FTC moves forward on this initiative, companies would have to rescind noncompete requirements they impose on workers and let employees know about the change. The FTC believes that noncompete clauses suppress wages, restrain new business formation and hurt the ability of companies to hire workers they need to grow. FTC Chair Lina Khan said "This is bad for competition. It is bad for business dynamism. It is bad for innovation."

The U.S. Chamber of Commerce, a pro-corporate trade group, said it may challenge the proposal if adopted.