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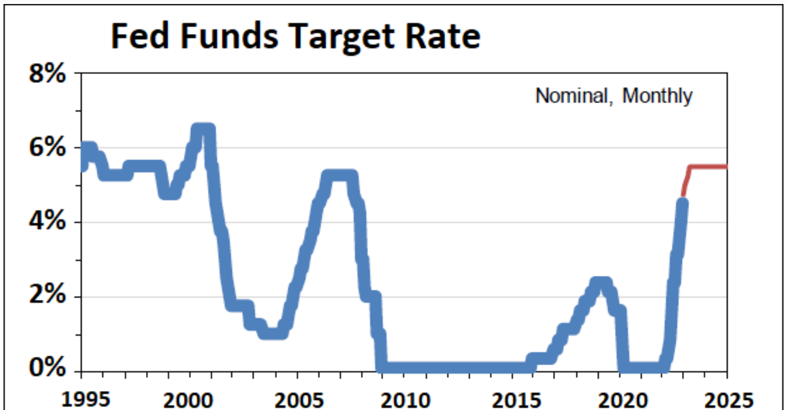
February 2023 Insights

The Long Goodbye

Federal Open Market Committee has raised rates eight times in 10 months. Many expect a quick return to ultra-easy policy. They will be disappointed. We believe Powell will stop tightening, after several more hikes but rate cuts are off the table for 2023, Likely out for 2024, and may well not come in 2025. ***Robust labor market will ward off recession, but real Gross Domestic Product trend will struggle to hit +1.5% Ahead.***



Many analysts are locked into thinking that ultra-low interest rates, like those of most of the paset few decades, are "normal." Those rates are an historical anomaly if not an abomination. With inflation likely to remain stubbornly above the Fed's target, look for an "old normal" fed funds target rate to be the standard for the next several years.

https://fred.stlouisfed.org/

Real GDP Trend to Slow to+1½%

By many measures, 2023 is off to a listless start. Housing remains sluggish: single-family starts and sales were continuing to spiral down at year-end. Regional business surveys and the Institute for Supply Management's national Purchasing Manager's Index showed continued contraction in January. Real consumption ended 2022 with the December level below the 22Q4 average.

AVALAN'S Key Takeaways:

The ultra-low interest rate environment has proven problematic for the past twenty-five years and has created a new paradigm where it has never been more important to work with a financial advisor. Please contact Avalan for a free consultation at 805. 962. 7725 or avalan@avalanwealth.com

The sole bright spot is the labor market. ***January employment data were stronger than anyone expected, even surpassing Avalan's upbeat forecasts***. The obvious inference is the Fed's campaign to reduce demand is not yet having the desired effects. Or, at minimum, that ***labor market resilience will encourage the Fed to bring more "pain."***

Many analysts looked for any escape clause in the jobs data; they settled on the trivial dip in the 12-month wage trend to +4.4%. First, even the most dovish FOMC members would struggle to call that significant. Second, as Avalan has long pointed out, wages do not cause inflation; if anything, they are a reaction to it. ***As sensible Nobel laureates say, "inflation is always and everywhere a monetary phenomenon."***

The jobs spurt puts some added momentum to early 2023. Nonetheless, Avalan believes that what we call ***"the Great Deceleration" will continue. The real GDP trend will struggle to hit +1½% in 2023. And in 2024.***

Inflation will continue to decline, but it has a long way to go to return to target. Monetary policy is not tight yet. After all these rate hikes, the real fed funds target rate is still essentially zero. Fed chairman ***Powell has pledged to "keep doing the work." The inflation data will insist he do so.*** Many analysts and the fed futures market are predicting that the FOMC will soon get over this hawkish phase. After eight rate hikes in 10 months with, they hope, maybe one more to come, they insist that the FOMC will pivot in half that time. ***Policymakers will be back to slashing rates in six months, just like the good old days.***

Avalan says, no way! The FOMC is abandoning the Zero Interest Rate Policy (ZIRP). That approach lasted three very toxic years during the pandemic. Avalan has argued that ***ultra-low rates have been problematic for the past 25 years.*** Taking half the time of that flawed ZIRP dalliance to recover means no rate cuts for quite a while. ***Avalan expects the funds target, now 4½-4¾%, to peak at 5½% or higher by this summer.***

The explosive January job results, as well as job openings that are still at near-record levels, put added upside risk on that forecast. At his news conference, ***Powell ruled out any rate cuts in 2023*** unless inflation decelerates by much more than most anticipate. ***With inflation likely remaining stubbornly high, Avalan does not expect rate cuts in 2024 either. The odds are also against any relief in 2025*.**

Bottom line: it will take at least several years for policy to return to "normal." Moreover, that will be the *"old normal" where short rates stayed clearly positive in real terms*.

Over the past three years – and the past 25 years – ZIRP has brought nothing but pain to this economy. The bad times were pretty bad: equity bubble, recession, housing bubble, Great Recession, up to this current inflation crisis. The supposed good times were… not. There is little, if any, empirical evidence that ultra-low interest rates, below 2%, did much to stimulate the real economy. Yes, they do inflate asset prices. But that only sets up the next crisis. Finally, the Fed appears to be learning this lesson.

The Bottom Line

	QUARTERLY						ANNUAL			
	22Q3	22Q4	23Q1	23Q2	23Q3	24Q1	2022	2023	2024	2025
Ann. Real Growth Rates:										
GDP	3.2%	2.9%	*1.3%*	**0.6%**	**0.7%**	**1.2%**	2.1%	1.5%	1.5%	1.7%
Final Sales (FS)	4.5	1.4	*1.1*	1	1	1	**1**	**2**	**2**	**2**
Domestic Final Sales	2.0	1.2	*1.8*	2	2	2	2	1	2	2
Consumption	2.3	2.1	**2.0**	2	2	2	**3**	**2**	**2**	**1**
Services	3.7	2.6	**2.0**	2	2	2	**5**	**2**	**2**	**2**
Fixed Investment	-3.5	-6.7	*2*	2	3	3	0	-1	3	3
Residential	-27.1	-26.7	*-8*	-8	-5	-5	-11	-15	-2	1
Nonresidential	6.2	0.7	*4*	4	4	4	4	3	4	4
Equipment	10.6	-3.8	*2*	2	2	2	4	2	2	2
Structures	-3.6	0.4	*2*	2	2	2	-7	0	2	2
Government	3.7	3.7	*1*	1	1	1	-1	2	1	1
Federal	3.7	6.2	*1*	1	1	1	-3	2	1	1
State & Local	3.7	2.3	*1*	1	1	1	1	1	1	1
Real Inventory Change	$39	$130	*$140*	$100	$75	$75	$123	$98	$75	$50
Real Non-Farm Change	56	145	**140**	100	75	75	**137**	**98**	**75**	**50**
Real Net Exports	-1269	-1232	*-1275*	-1300	-1325	-1350	-1355	-1313	-1350	-1350
Exports	15%	-1%	*-2%*	-2%	-2%	-2%	7%	1%	0%	2%
Other Indicators:										
Industrial Production	1.8%	-1.7%	*1%*	1%	1%	1%	3.9%	0.8%	1.0%	1.0%
Housing Starts(MM)	1.45	1.40	*1.45*	1.5	1.5	1.5	1.6	1.5	1.5	1.5
Unemployment Rate(%)	3.5%	3.5%	*3.6%*	3.7%	3.8%	4.0%	3.6%	3.8%	4.3%	4.4%
Ann. Growth Rates:										
Nominal GDP	7.7%	6.5%	*4%*	4%	4%	4%	**9.2%**	**5.2%**	**4.3%**	**4.5%**
Gross Dom Purchase Inflation	4.8	3.2	*3.0*	3.0	3.0	2.7	6.8	3.6	2.8	2.7
PCE Core Inflation	4.7	3.9	**3.6**	3.5	3.5	3.4	**5.0**	**3.8**	**3.3**	**2.9**
Interest Rates										
Federal Funds Rate#*	3.1%	4.0%	*5.00%*	5.50%	5.75%	5.75%	4.00%	**5.75%**	**5.75%**	**5.75%**
10-Year Treasury#	3.5	3.9	**4.0**	4.3	4.5	4.8	3.9	4.8	4.8	4.8

Quarter value=last month in qtr. § Adj. for write-offs. All $ figures in bil. † Source: Commerce
* Feds funds target the high-point of set range for forecast period

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