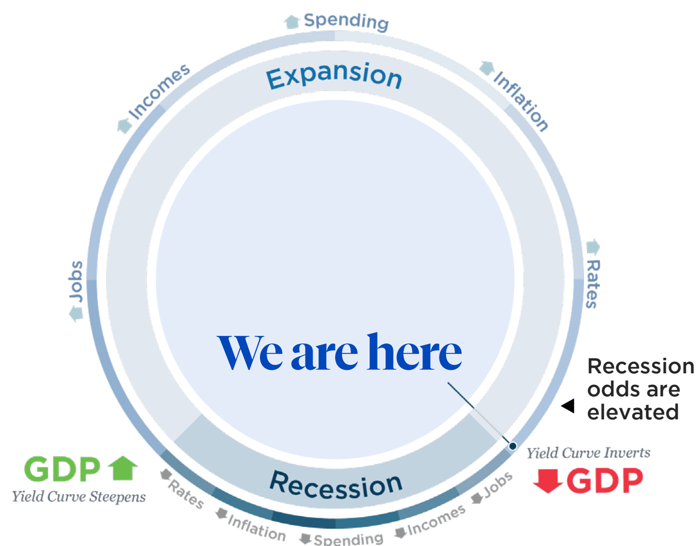
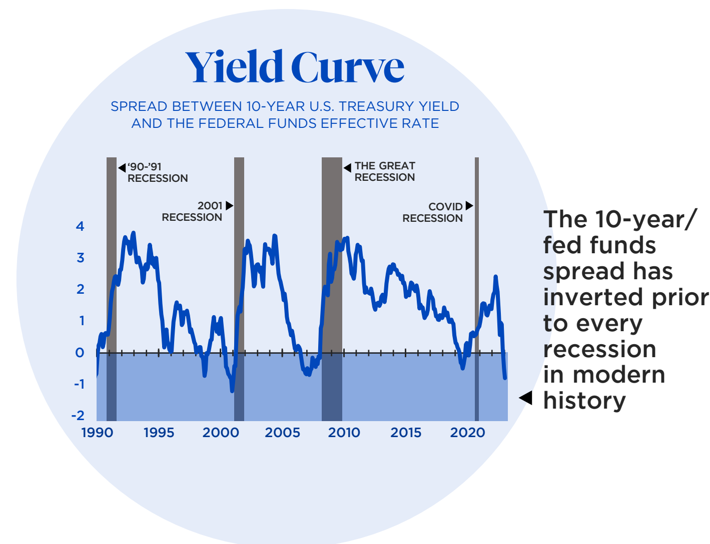
Economic & Financial Markets Monthly Review | February 2023

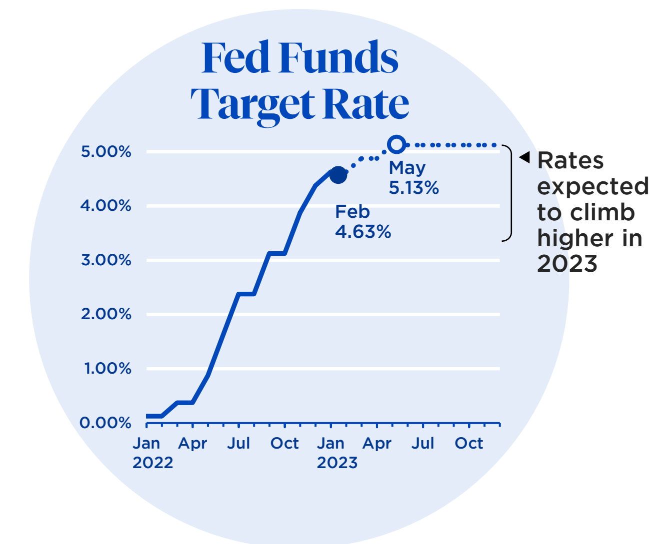
Strong data complicates Fed's goal to slow inflation

Where is the economy now?

The U.S. economy is in the late cycle period with the Fed responding to rapid inflation with a sharp tightening of monetary policy to slow domestic demand. Key leading indicators (including the yield curve) point to elevated recession risks over 2023, especially with the Fed projected to raise rates further at coming meetings.







Where we are this month

CYCLE END GETTING CLOSER

The business cycle chart is nearly in recession territory with the yield curve inversion and the housing downturn being sustained for months.

YIELD CURVE INVERSION DEEPENS

The 10-year to fed funds spread was negative by nearly a full percentage point in late January, the deepest yield curve inversion since late 2000.

TIGHTENING CYCLE NEARING ITS END

The downshift in the size of rate hikes reflects the Fed's need to more carefully calibrate policy given its now within a restrictive range.

What does this mean

- Key recession signals, including the yield curve and the Index of Leading Economic Indicators, point to a likely recession over the next year.
- While recent data suggest continued growth in the near term, our baseline forecast assumes that a moderate recession hits later in 2023.

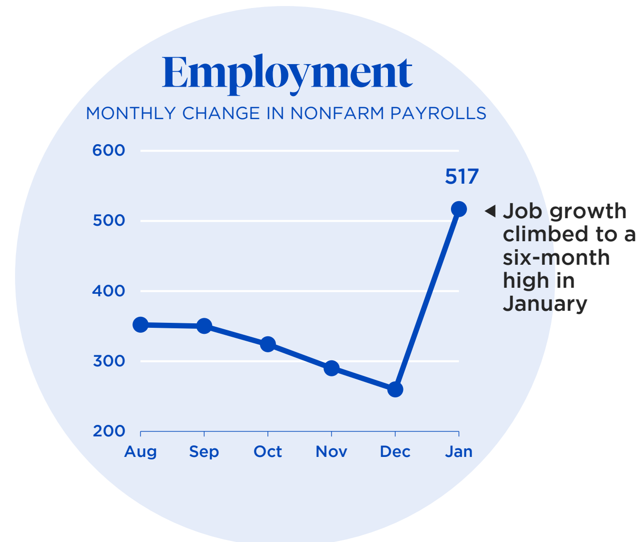
- Since at least 1962, a recession has always followed a sustained yield curve inversion that was at least this deep.
- The inversion reflects the Fed's rapid increase in the policy rate and the bond market's expectations of an ensuing economic downturn and slower inflation.

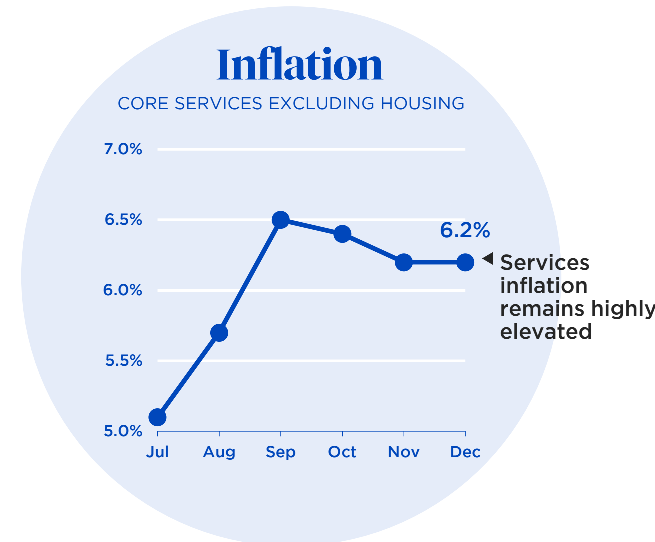
- But the tightening cycle is not complete yet. We expect the fed funds rate to rise a further 50bps by mid-year — with risks of more hikes given hot job gains and services inflation.
- Fed funds futures are pricing in rate cuts by year-end – albeit less than before the strong January employment report. We see no Fed easing until 2024.

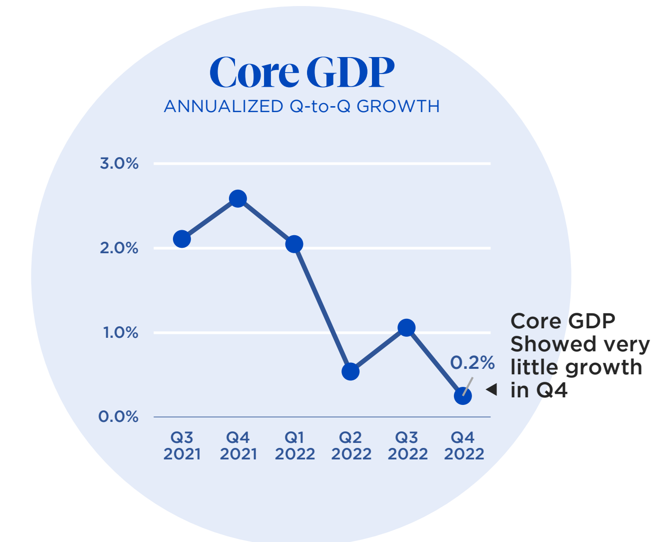
Economic Review

Labor market is too hot for the economy's own good

Job growth was stunningly strong in January and the unemployment rate fell to its lowest level since 1969. While great news under normal circumstances, it can keep services inflation elevated for longer and increases the odds of tighter monetary policy and a recession emerging sometime in the second half.







Where we are this month

BLOWOUT JOBS REPORT

Nonfarm payrolls grew by 517,000 and the unemployment rate fell to a 54-year low as demand for workers remains extremely strong.

SERVICES INFLATION REMAINS HOT

A recent favorite of Fed Chair Jerome Powell, core services inflation less housing was only slightly below its recent peak.

CORE GDP FLATLINES

Final sales to private domestic purchasers, or core GDP, slowed sharply in 2022 as consumers and businesses pulled back on their spending.

What does this mean

- Job gains were expected to continue to trend lower in January, but labor demand remained very strong, counter to the Fed's aim to cool the demand.
- The further tightening in the labor market indicates upside potential for wage gains that could lead the Fed to increase the fed funds rate above 5.0 percent over 2023.

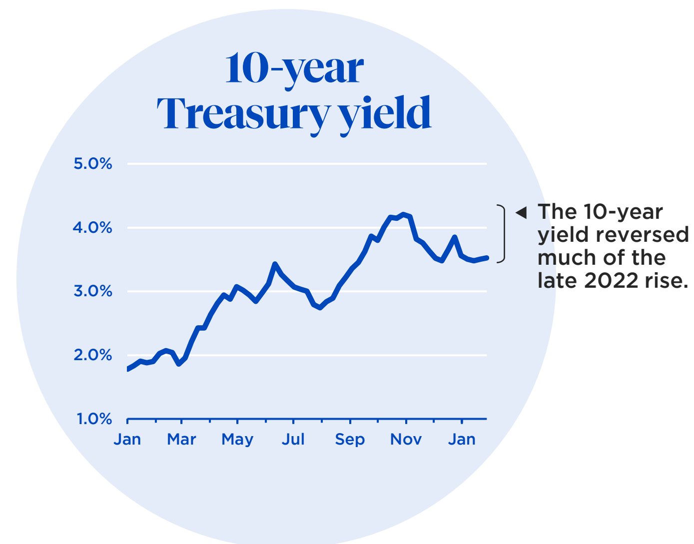
- The cooling of overall consumer inflation has come mainly from the goods side. Services inflation tends to be stickier as it is driven by rising wages and still strong consumer spending on services.
- We expect cost pressures from core services less housing to keep inflation elevated (and monetary policy restrictive) through 2023.

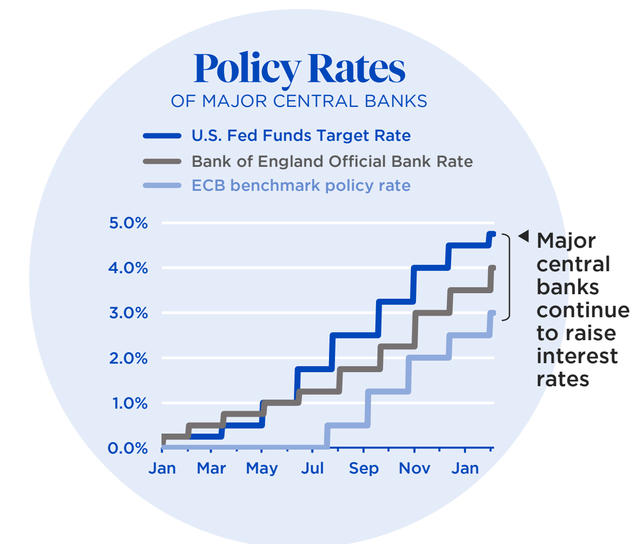
- About half of the overall 2.9 percent annualized increase in Q4 real GDP stemmed from an unwanted jump in inventories as consumer and business demand waned.
- Nearly flat core GDP growth implies little momentum heading into 2023, but strong job and income gains in January should support spending activity and growth in the near term.

Financial Market Review

Stocks rally even as central banks tighten

Optimism greeted 2023 with cooler inflation readings boosting investors' appetite for risky assets. Long treasuries erased some of last year's plunge, while equity markets posted broad-based increases. Recent central bank actions and the surprisingly strong January employment report suggest a prolonged period of restrictive policy that took some steam out of the equity market at the start of February.





Where we are this month

A NEW YEAR, A NEW MARKET

The S&P 500 index added over six percent after signs of slowing inflation and expectations that an end to the Fed tightening cycle was close.

INTEREST RATES RETREAT

The yield on the 10-year Treasury note quickly pulled back from year-end 2022 levels on elevated recession concerns for the year ahead.

CENTRAL BANKS TIGHTENING

Major central banks continued to lift interest rates higher and signaled that additional hikes are likely needed to tame inflation.

What does this mean

A new year, a new market

- Investors are more hopeful for a better 2023, with S&P 500 earnings expected to climb nine percent this year and futures showing the Fed cutting rates in the second half of 2023.
- But the market rally faltered in early February as very strong demand for workers ironically increases the odds of a hard landing should the Fed tighten more.

Interest rates retreat

- Investors favored long tenor securities with the two-year yield only modestly lower over January. However, yields across the yield curve have climbed higher after the strong employment report.
- Corporate credit spreads tightened further, extending a three-month easing of credit conditions despite looming downturn worries.

Central banks tightening

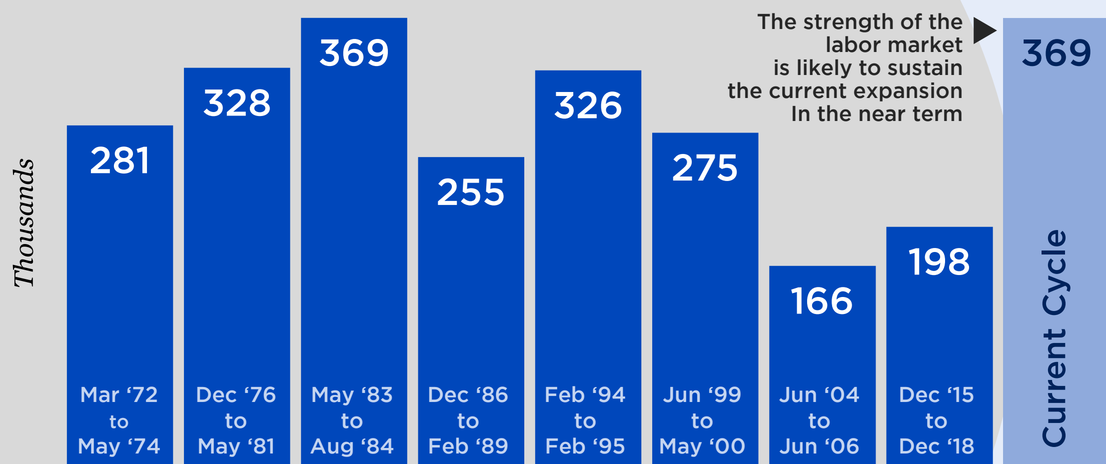
- The Fed led the way on rate hikes over 2022, but key global central banks have followed suit in response to widespread inflationary pressures.
- The brisk headwind of higher interest rates weighs on the global growth outlook for 2023, although the reopening of China and a warmer winter in Europe mitigates the worse case scenario.

Outlook

Mixed data reflect an economy in transition

The mixed economic readings at the outset of the year reflects the Covid-related crosscurrents that continue to impact the outlook. It is also likely a symptom of an economy in transition, as the numbers often diverge when the growth rate is either ramping up or winding down. In this case, the enduring strength in the labor market is offsetting weakness elsewhere as is typical in the early stages of rate hike cycles. Over time, however, the lagged effects of Fed tightening will weigh on job growth as well, reversing the positive feedback loops that are currently sustaining the household sector and, to a large degree, the broader economy. A recession may not be imminent but remains a substantial risk going forward.

Average monthly changes in nonfarm payrolls in the first year after the outset of Fed tightening cycles



Labor is too hot for the Fed

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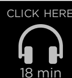

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Latest Forecast

Data as of February 2023

	2021 ACTUAL	2022 ACTUAL	2023 FORECAST	2024 FORECAST	2025 FORECAST
REAL GDP	5.9%	2.1%	0.7%	-0.3%	2.1%
UNEMPLOYMENT RATE	5.4%	3.6%	4.4%	5.3%	4.8%
INFLATION (CPI)	6.7%	7.1%	3.8%	2.6%	2.3%
TOTAL HOME SALES	6.89	5.67	4.60	5.10	5.50
S&P/CASE-SHILLER HOME PRICE INDEX	18.9%	6.2%[e]	0.0%	2.5%	3.0%
LIGHT VEHICLE SALES	14.9	13.8	14.6	15.4	16.2
FEDERAL FUNDS RATE	0.00%	4.25%	5.00%	3.50%	2.50%
5-YEAR TREASURY NOTE	1.26%	3.99%	3.70%	3.10%	2.80%
10-YEAR TREASURY NOTE	1.52%	3.88%	3.60%	3.15%	3.00%
30-YEAR FIXED-RATE MORTGAGE	3.11%	6.42%	6.30%	5.00%	4.70%
MONEY MARKET FUNDS	0.14%	2.27%	4.97%	4.09%	2.90%

[e] = Estimate

Later 2023 recession

A moderate recession should occur over the second half of 2023 with weak consumer and business activity likely to carry into early 2024.

More housing weakness

With mortgage rates high and the unemployment rate eventually rising, demand for single-family homes should remain sluggish — lowering sales, cooling prices, and limiting home construction.

Fed easing not likely until 2024

After lifting the fed funds rate to 5.00% (or higher) in the first half of 2023, we expect the Fed to maintain restrictive policy into 2024 with inflation still above-trend. This could delay the economic recovery from a projected downturn.

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Sources

Page	Topic	Source
Page 1	**Where is the economy now?**	
	Business Cycle	*Nationwide Economics*
	Yield Curve	*Bloomberg; National Bureau of Economic Research*
	Fed Funds Futures	*CME Group*
2	**Economic Review**	
	Employment	*Bureau of Labor Statistics*
	Core Services Inflation ex-housing	*Bureau of Labor Statistics*
	Core GDP	*Bureau of Economic Analysis*
3	**Financial Markets Review**	
	S&P 500	*Standard & Poor's*
	10-year Treasury yield	*Federal Reserve Board of Governors*
	Central bank policy rates	*Bloomberg*
4	**Outlook**	
	Average monthly payroll gains	*Bureau of Labor Statistics*
	Latest Forecast	*Nationwide Economics*

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