Outlook on the United States

JUL 2023

Summary

- The mood is noticeably brighter entering the second half of 2023. The banking crises and default fears that defined last quarter are fading from view, but significant uncertainty remains.
- Pressure on regional banks—especially those unprepared for higher interest rates or those with inadequate risk management processes—could create ongoing ripples through the economy. Increased regulation will likely create a tighter lending environment, which would have negative implications for the country as a whole.
- The Federal Reserve remains focused on taming inflation, which is still far above its 2% target. A pause in rate hikes this quarter is possible, but the longer-term trajectory remains largely unclear.
- The labor market does show signs of softening. A declining quit rate and increased immigration are both helping to cool wage growth, which in turn could help tame inflation, though it could take at least six months for these effects to play out.

Equity

The Federal Reserve's decision to pause rate hikes in June 2023 signaled, to some, the end of this cycle. Yet the Fed has clearly left the door open to future hikes: Almost all Federal Open Market Committee (FOMC) members concurred that future tightening would likely be necessary. As 2023 ticks over the halfway mark, despite 500 basis points (bps) of rate hikes, over US$700 billion of Quantitative Tightening, and several large bank failures, the economic story is surprisingly resilient. Core inflation continues to ease, and if anticipated shelter price deceleration does occur, price pressures will decrease further. The labor market remains strong, with the US economy adding an average of 314,000 jobs per month in 2023, and wage growth—including in the sensitive non-household services sector—has moderated. Banking stress remains a concern as the effects of tightening filter through credit markets, but the risk of a banking crisis has lessened. The debt ceiling has been navigated for now, though we have not seen the last of partisan budget battles. Outside of the United States, China's disappointing recovery from the pandemic could lead to more stimulus measures. In Europe, core inflation seems to have turned a corner, and the European Central Bank (ECB) appears to be approaching the end of its tightening cycle which could offer a reprieve to an already lethargic economy. The third quarter of 2023 is, in our view, likely to be one of continued progress in battling inflation and positioning economies for better future trends. Risks continue to the downside, but with each data release, those risks are abating.

Inflation

Core inflation is decelerating in the United States, though slower than the Fed would like. Rent prices, the stickiest and largest contributor to the Consumer Price Index (CPI), peaked at the turn of the year and there is confidence that decreases are on the horizon, as private indices like Zillow have indicated for some time. Core goods have come down rapidly in 2023, though upward surprises are occurring, as illustrated by a spike in used cars prices in May inflation data. Further upward surprises and retail strength may give the Fed reason to hike later this year. Services excluding housing and shelter—long thought to be the most wage sensitive and therefore a key variable in the inflation story—has also started decelerating. The result is that, while core

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inflation remains well above the Fed's target, core CPI has gone from a peak of 6.6% year over year in September 2022 to 5.3% year over year in May 2023, with further deceleration expected (Exhibit 1).

But as the experience of the past two years has shown, the ride down the inflation pathway will not be smooth, particularly given the strength of the labor market.

Labor Market

The baseline expectation for policymakers and the private sector was that for the inflation rate to return to target, a sustained increase in the unemployment rate would be needed. That may still happen given that inflation remains well above 2%. So far, though, hiring has shown no signs of weakness, despite indications that the labor market is softening. The ratio of job openings to unemployed people has decreased from over 2:1 in March 2022, to 1.65:1 in May 2023. An alternative indicator of labor market tightness is the rate of workers quitting their jobs, which has fallen to pre-pandemic levels, underscoring that tightness in the labor market might be easing (Exhibit 2).

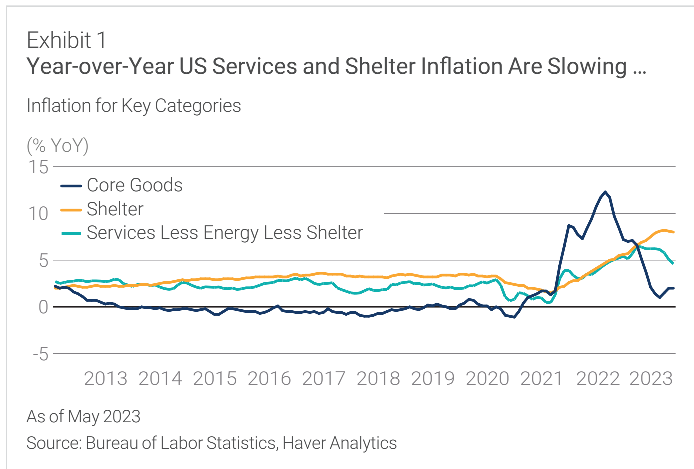
In addition, immigration rates have increased recently after slowing since 2016; estimates suggest net migration rebounded to 2017 levels last year. Increased immigration has helped solve labor shortage problems, along with an increase in the prime-age labor force as higher wages have attracted workers.

This increase in the supply of labor has helped cool wage growth which, though elevated, is consistent with a declining rate of inflation (Exhibit 3). This declining wage rate may filter through to official inflation data over the next 6–12 months, creating further downward pressure.

If these downward pressures do not materialize—or if they take longer to arrive than anticipated—the rationale for the Fed to continue hiking at the end of July (and beyond) will be stronger. Yet the biggest risk for excessive tightening will not come in the next quarter, but months from now, when inflation has fallen but remains above target. At that point, an increase in unemployment may prove necessary—and the Fed will need to decide how much pain it is willing to put the economy through to achieve its price target. The decision between a 3.5% inflation rate and a 4% unemployment rate, versus a 2.5% inflation rate and a 6% unemployment rate, will come down to how the Fed institutionally reacts to its mandate. We will be closely monitoring how Fed officials reflect on this question over the next months.

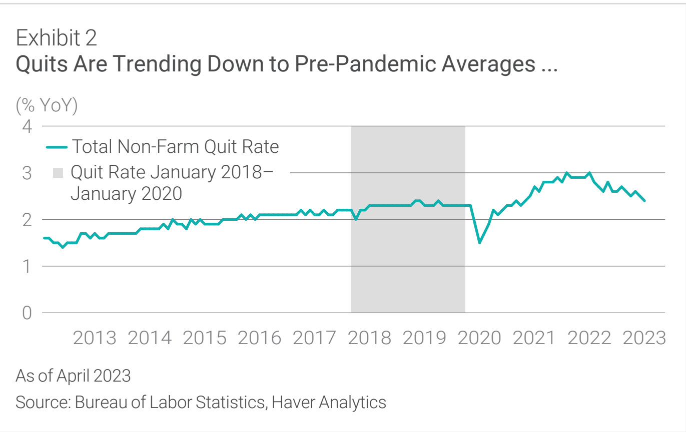
Exhibit 1
Year-over-Year US Services and Shelter Inflation Are Slowing ...

Inflation for Key Categories



As of May 2023
Source: Bureau of Labor Statistics, Haver Analytics

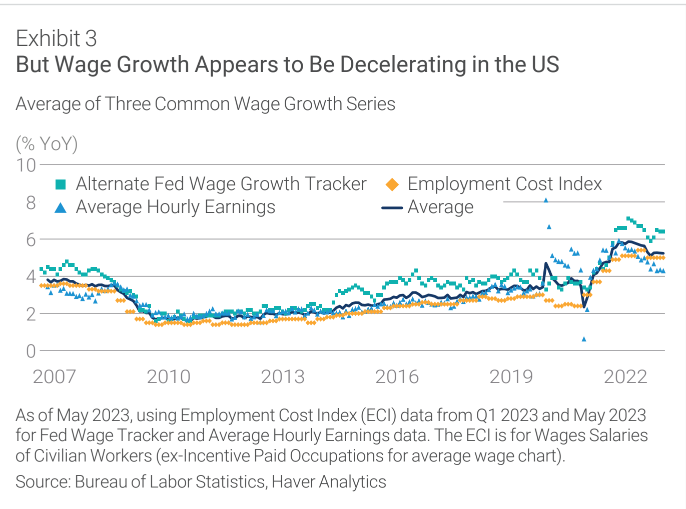
Exhibit 2
Quits Are Trending Down to Pre-Pandemic Averages ...



As of April 2023
Source: Bureau of Labor Statistics, Haver Analytics

Exhibit 3
But Wage Growth Appears to Be Decelerating in the US

Average of Three Common Wage Growth Series



As of May 2023, using Employment Cost Index (ECI) data from Q1 2023 and May 2023 for Fed Wage Tracker and Average Hourly Earnings data. The ECI is for Wages Salaries of Civilian Workers (ex-Incentive Paid Occupations for average wage chart).
Source: Bureau of Labor Statistics, Haver Analytics

Even as the labor market remains strong, there are other downside risks that will weigh not only on the Fed's decision to hike further, but on whether the United States slips into a recession.

Banking Stress and Global Weakness

Our increasingly optimistic tone is tempered by risks in the banking sector and the global economy. Our Q2 outlook was dominated by the banking sector, after the fall of Silicon Valley Bank and other regional banks. Since then, the outlook has improved but fragility remains, reflected in regional bank indices that have performed poorly in 2023. The Fed's own rationale for pausing in June was to wait for further data on this space. In other words, pressure on regional banks—especially those unprepared for higher interest rates or those with inadequate risk management processes—could create ongoing ripples through the economy.

As far as global forces impacting US growth, China's recovery from the pandemic in 2023 has been disappointing so far. High youth unemployment, at over 20%, coupled with low consumer confidence, means Chinese weakness is weighing on global growth. Lower Chinese

output impacts both emerging markets and developed markets, like Germany, that have substantial exports to China. The consequence of this weakness is that Chinese policy support is now underway, primarily through credit channels. The measures to date have targeted marginally reducing the cost of credit, but reports suggest a broader array of stimulative tools are being considered by Chinese authorities. The challenge for China's leadership is to balance the desire for growth acceleration against the risks of increased leverage. To what extent this policy support helps consumer confidence and increases output will be key to Chinese, and therefore global, growth.

The biggest geopolitical risk remains the Russian invasion of Ukraine. As Ukrainian counteroffensives are now underway, the potential for an escalation should not be discounted. Europe is already experiencing rising energy prices, which though well below 2022 peaks, will add to inflationary pressures and economic fragility—especially as the ECB has shown no inclination to halt tightening. Encouragingly though, European core prices also seem to have turned a corner, raising hopes that European inflation can settle without major increases in unemployment.

On balance, recent US economic releases have suggested that a more positive outlook is gradually emerging. The economic outlook will most likely be muted in a positive scenario, but the risk of recession appears to be receding with most forecasts now suggesting risk in 2024 rather than 2023. Yet the longer positive data is released, the less likely a recession appears to be. Several key risk factors appear to be fading in relative importance, and the Fed appears thus far to be threading the needle successfully to tame inflation without inducing recession.

Investors have demonstrated their optimism in equity, credit, and rates markets. The S&P 500 Index is now in bull market territory, although we note that the equity market advance has been disproportionately driven by a small group of stocks. For the equity rally to be sustained, we believe it will have to broaden to include more companies. Fortunately, there are many attractive opportunities in the market that have yet to deliver large price gains, giving active managers such as ourselves an attractive hunting ground to potentially generate strong returns going forward.

The preceding outlook reflects the views and analysis of Lazard's US equity teams. The following outlook reflects the views and analysis of Lazard's US fixed income team.

Debt

The second quarter of 2023 was certainly full of drama for market participants. Regional bank failures triggered a series of takeovers, with the Federal Deposit Insurance Company (FDIC) hiring BlackRock to sell the securities portfolios of Silicon Valley Bank (SVB) and Signature Bank and JP Morgan acquiring the majority of First Republic Bank's assets. Separately, fears of a potential default lingered over the markets as Congress struggled to amend debt ceiling legislation up to the last minute.

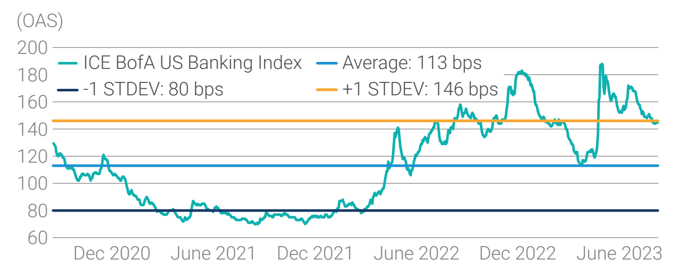
Despite the concerns above, markets weathered the storm well. Rates on 2-year Treasuries and longer maturities ended the quarter not meaningfully different than where they were at year-end; the yield spread on the US Corporate Index is nearly the same as it was at year-end as well, reflecting the pricing of stable credit markets. Still, we do not necessarily think the story is over. Although the bank failures and their repercussions seem to be less of a concern recently, some regional bank spreads continue to reflect higher risk and we would not be surprised to see further consolidation in the months ahead. Additionally, due to higher costs of funds across the sector, we expect tighter lending conditions to be an economic headwind (Exhibit 4).

The Economy Remains Strong Despite Inflation

Inflation continues to come down but remains significantly above the Federal Reserve's stated longer-run target of 2%. May's Consumer Price Index (CPI) rose 0.1% month over month and 4% year over year, which was in line with market expectations. Similarly, Core CPI, which excludes food and energy prices, increased 0.4% month over month and 5.3% year over year—also in line with expectations but nevertheless stubbornly high. Importantly, Sticky Price Core CPI remains elevated at 6% year over year (Exhibit 5). This measure is calculated based on prices for specific goods and services within CPI that are considered less susceptible to change—including medical services, rent, public transportation, and motor vehicle fees—and therefore more likely to incorporate future inflation expectations by default.

Exhibit 4
Banking Cost of Funds Will Likely Tighten Financial Conditions

(OAS)



As of 27 June 2023

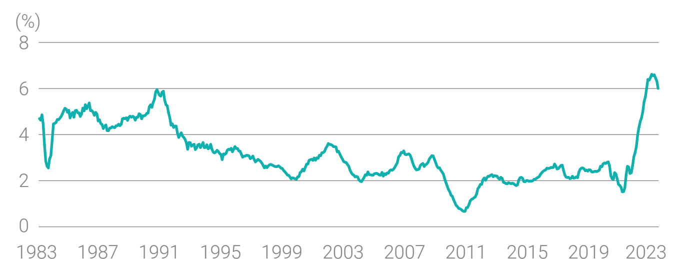
The ICE US Banking Index is a subset of the ICE BofA US Corporate Index including all securities of bank issuers. Option Adjusted Spread (OAS): 144 bps; Off Avg: 31 bps; Z Score: 0.94.

Source: Bloomberg

Exhibit 5
US Core Sticky Inflation Components Remain Elevated

Inflation for Key Categories

(%)



As of 31 May 2023

Source: Bloomberg

The Fed did pause from tightening monetary policy in their 14 June meeting but it is clear from their Summary of Economic Projections (and press conferences) that they will focus on the data and remain "strongly committed" to bringing inflation down to 2%. Markets are currently pricing in an additional rate increase but they are no longer pricing in rate cuts in 2023. Barring a black swan event or a sharp deceleration in inflation, we would expect at least one more hike of 25 basis points (bps) to be announced at the Fed's next meeting in late July and do not expect cuts this year.

As the Fed remains sharply focused on taming inflation, the underlying US economy continues to show signs of resilience. To begin, the labor market remains about as tight as it was last quarter. The U-3 Unemployment Rate is at or near multidecade lows of 3.7% and total non-farm job openings, reflecting all jobs available but not filled on the last business day of the month, are at or near multidecade highs and above pre-pandemic trends. The labor force participation rate continues to struggle, and unless productivity offsets the loss of workers, a shrinking workforce—driven by retirements and an aging Baby Boomer generation—may pose a challenge to the Fed as labor costs remain stubbornly elevated. Absent a material pickup in the participation rate or an increase in productivity, the Fed will likely have to choose between wage price inflation and slower economic growth. Finally, US Nominal Gross Domestic Product (GDP) has recovered and remains above the trendline.

Unless inflation decelerates quickly to the 2% range and stays there—or unless there is a material break in the economy that spreads to Main Street—we believe the most likely path for rate hikes is a pause after July's meeting. This means markets may have to brace for higher rates for longer, even if the yield curve indicates that the Fed could blink and change course.

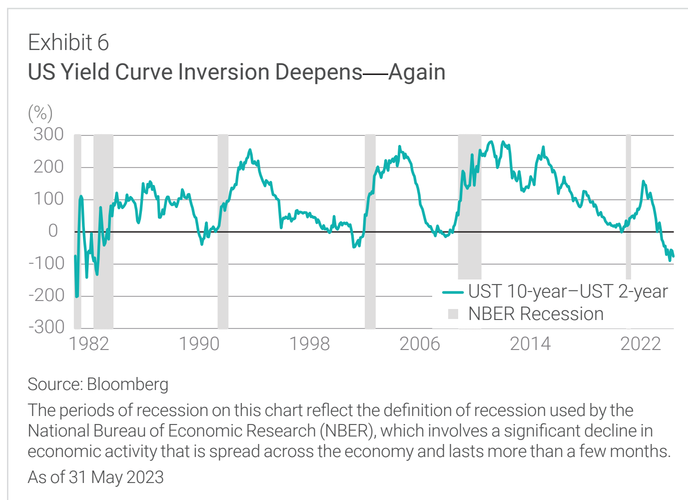


Exhibit 6

US Yield Curve Inversion Deepens—Again

Source: Bloomberg

The periods of recession on this chart reflect the definition of recession used by the National Bureau of Economic Research (NBER), which involves a significant decline in economic activity that is spread across the economy and lasts more than a few months.

As of 31 May 2023

Sparring with the Fed

The bank failures that occurred in March and the response of the yield curve show the velocity of what a Fed pivot might mean for short-term rates if accelerated cuts are anticipated. Indeed, the yield curve remains deeply inverted whether you look at 10-year versus 2-year yields or 10-year versus 3-month yields, and this inversion has historically indicated that the markets view the Fed as too restrictive (Exhibit 6). Moreover, this inversion is now back to the level from early March when SVB failed; before that, one would have to go back to 1981 to see such a large inversion.

So, what comes next? The Fed has been moving to get rates back to normal—which is a good sign, though markets may still think the Fed is too tight. Financial markets are now normalizing to the conditions that existed prior to the era of financial engineering and subsequent regulatory crackdowns. Without financial contagion, the market will likely revert to a state of differentiated outcomes that favors active alpha over passive beta. If this happens, investors may see greater dispersion among credits, which can create opportunities for above-market returns. In a higher rate environment, some companies and structures simply fare better than others, but virtually all companies tend to benefit from ultra-accommodative Fed policy—which is why you will see relatively little differentiation among credits in that environment. But beyond the current risks posed by poorly managed financials—and lower-quality, highly levered corporate balance sheets—we believe the low liquidity in the over-the-counter (OTC) fixed income markets remains a consistent material risk. Given the other risks described above, we expect higher episodic bouts of volatility in the fixed income markets.

Investment Implications

We still believe that inflation will continue to moderate as base effects and tighter monetary policy take hold. This will continue to have a profound impact on the markets, and coupled with lower liquidity, may result in intermittent periods of elevated volatility—and, by extension, potential opportunities for active managers. How much further the effects extend will almost certainly depend on the Fed's tightening trajectory, which in our view is at or near its end. We believe policymakers will have their work cut out for them as they try to tame inflation while simultaneously containing any potential systemic issues.

We remain deeply concerned about the potential for market liquidity disruptions despite our cautiously optimistic expectations for the US economy and credit fundamentals of higher quality issuers and structures. The Fed turned to its balance sheet with such force three years ago to backstop the market and alleviate a severe liquidity crisis; without the Fed, the market mechanisms for clearing on-demand transactions simply failed, and this failure has still not been addressed. As we stated last quarter, we believe the market's ability to absorb abrupt changes in investment flows remains structurally challenged. The disruptive events of March are a testament to this, as is the state of the Treasury market in recent quarters, as dealers remain reluctant to hold sizable inventory—even in the world's benchmark "risk-free" asset.

As the yield curve suggests, markets are prepared to pivot on short notice should the Fed change course in response to new data. Given the backdrop of lower growth prospects, risks in the banking system, let alone any "unknown unknowns," we expect continued volatility in markets overall.

The recent issues with SVB and Credit Suisse drive home a point we have been making for the better part of a year: Dispersion in outcomes for obligors is likely to increase as the cheap money afforded to them by capital markets dries up, especially against a backdrop of global economic uncertainty. We expect lower valuations and higher default rates in the years ahead as legacy business models and industries are scrutinized for their sustainability. With this potential risk in mind, we believe investors should continue to focus on lending to viable obligors over a long term, scrutinizing whom they are lending to and under what terms and conditions. The importance of this last part was highlighted by the zeroing-out of Credit Suisse AT1 bonds, which reminded us that yield equals risk, not return. As these times are demonstrating, investors should consider mitigating long-term liquidity risks by focusing on key security investment characteristics that institutional investors have historically relied on to protect portfolios during mark-to-market disruptions. Specifically, we believe investors should focus on securities and obligors with attributes such as:

- serving an essential economic or financial function
- issuing under standardized terms and conditions
- offering in institutional markets and institutional lot sizes
- exhibiting established transition markets that enable transactions after ratings downgrades
- qualifying for inclusion in major market indices

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