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Beware the Strong Economy

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These days the "Goldilocks" economic scenario is a "soft landing", a favorite market euphemism for a mild economic slowdown instead of a full-blown recession, accompanied by a rapid decline in inflation. This scenario, with the economy "not too hot and not too cold" (just as Goldilocks preferred her porridge in the childhood fable), allows for the Fed to stop hiking rates and even start cutting sometime in the not-too-distant future.

The inverted yield curve in the bond market suggests that perhaps the outlier risk is that the economy is weaker (too cold) in the later part of this year, with the potential for an unpleasant recession forcing the Fed to cut rates more substantially. But the recent stronger economic data have some people talking about the opposite, a "no landing" scenario, which assumes minimal economic slowdown in the near term. Be careful what you wish for, because a "no landing" today could lead to a "crash landing" tomorrow if restrictive Fed policy goes further than consensus.

Data in the first quarter point to a robust economy and persistent inflation. The January jobs data released February 3 showed nonfarm payrolls increased by 517,000, dwarfing the 187,000 estimate. According to the JOLTS report, there are nearly two job openings available for every one person looking for work. On February 24, the Personal Consumption Expenditures price index (PCE – see Chart), which is a favored measure of inflation of the Fed, came in spicier than estimates both at the headline level and at the core (excluding food and energy). Consumption, spending and wages thus far in early 2023 show a strong economy and renewed concerns about inflation, and talk from the Fed has become more hawkish as well, even with hints of a possible 50 basis point rate hike in March. Beyond that, corporate earnings have held up much better than many feared. The bond markets have certainly noticed with 10Yr Treasury yields on the move from 3.39% on 2/2 to just under 4% as of this writing only three weeks later.

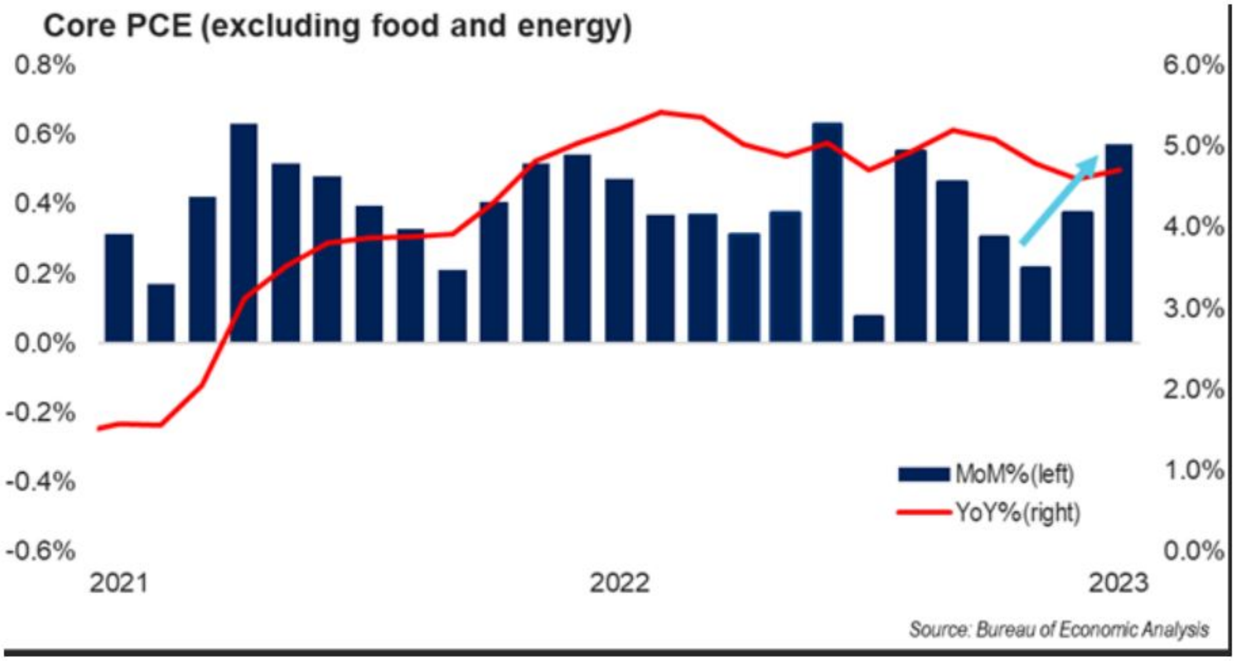

Chart 1: Personal Consumption Expenditures Price Index (Source: Courtesy of FHN Financial, sourced from Bureau of Economic Analysis)

These days investors must beware an economy that is too hot. It has been so long since we have experienced anything resembling a "normal" business cycle. With inflation in the equation, an economy's strength and resilience can ultimately prove to be its undoing. There is an old Wall Street saying that says that "an economy does not die on its own". What that means is that recessions do not usually just occur, they are the product of tighter monetary policy. Economic strength means that inflation remains a concern, which means that the Fed could be forced to raise borrowing costs much higher and for longer than anyone is talking about right now. Nobody is even thinking about 6% Fed Funds rate or more aggressive Quantitative Tightening, but remember that if forced to choose between taming inflation or preventing recession, the Fed will choose the former. The Fed has been warning the markets that taming inflation is job #1, but many have ignored the caution trying to get ahead of a Fed pivot. There is another saying that is probably the truest advice on Wall Street: "Don't Fight the Fed", and in today's world the Fed does NOT want to see high stock markets, excessively low unemployment, and strong economic activity because those conditions allow inflationary forces to build.

The odds probably still favor a "soft landing", but risks remain on both sides for an economy that is too hot or too cold. Volatility, as the markets adjust to ever changing data, could give investors opportunity. Stay tuned.

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