February 20, 2023

Author: Francisco Rodríguez-Castro

Does the Fed need to increase its interest rate pace faster and further?

The U.S. & Puerto Rico's economies began the year with strength, even as some predicted a recession. But as January rolled in, the consumers flexed their muscles showing strong purchasing power, and robust labor markets, with stubbornly prescient inflation proving to be a formidable foe for the Fed as it seeks to keep increasing rates to curb inflation. The CPI surprised all consensus estimates by recording 6.41%, which is 220.5% above the Fed's 2% target. While we think that the direction of the inflation numbers is heading lower, investors and regulators alike do not like the uncertainty that provides missing consensus estimates, especially inflation.

In our view, the Fed has no option but to increase rates at a faster clip, so we shall see again 50 to 75 basis points increases to curb inflation; however, the cost to investors is growing volatility.

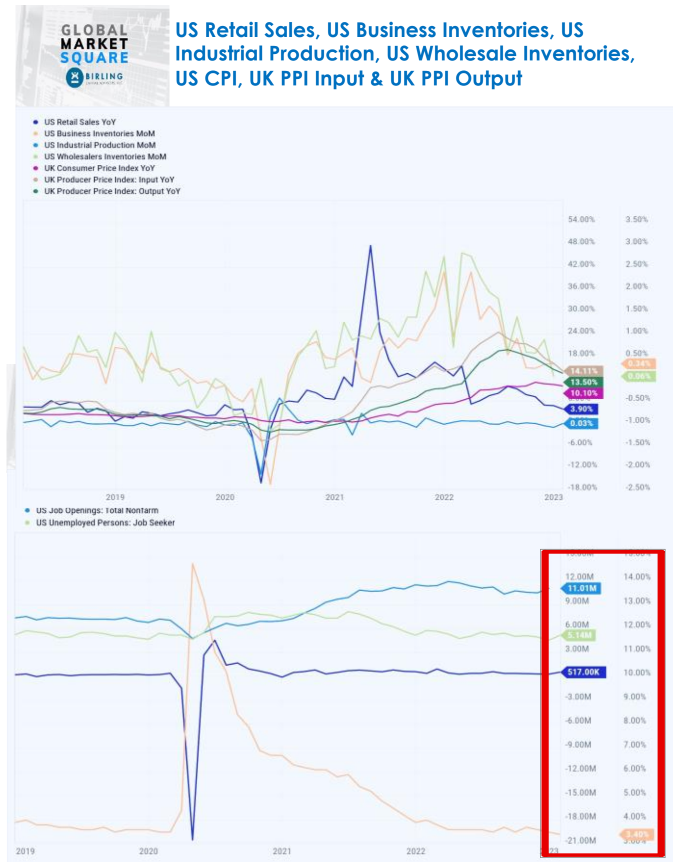
The economic data, which includes the GDPNow forecast for 1Q23, rose to 2.5%, up from 2.40%, a 4% increase. Considering the initial estimates on January 27, 2023, of 0.70%, the forecast has increased by 257.1% since then. Add to the economic news that U.S. retail sales reported their highest increase in the past two years, evidencing consumers changing their sentiment from a pessimistic to a more positive tone. Retail sales rose 2.96% ahead of the 2% consensus estimates and were led by motor vehicles, furniture, and restaurants.

Date	GDPNow 1Q23	Change
1/27/23	0.70%	Initial Forecast
2/1/23	2.10%	200.0%
2/8/23	2.20%	4.5%
2/15/23	2.40%	8.3%
2/16/23	2.50%	4.0%

Economic data and market signals have made an about-face from last year. Before these market-changing reports, the price of stocks had been rising, with tech companies leading the charge. The set of circumstances is not what one would expect from economies dealing with outsize inflation and with a Central Bank that has aggressively increased rates on eight occasions, making it the fastest pace in forty years. No one wants to ask: **Does the Fed need to increase its interest rate pace faster and further?**

Considering how the bond market has risen, for one, the U.S. Treasury 2-year note closed at 4.60%, it appears they do; however, the stock market has remained unvexed by the actions.

We share out thoughts on the challenges and opportunities on our path.

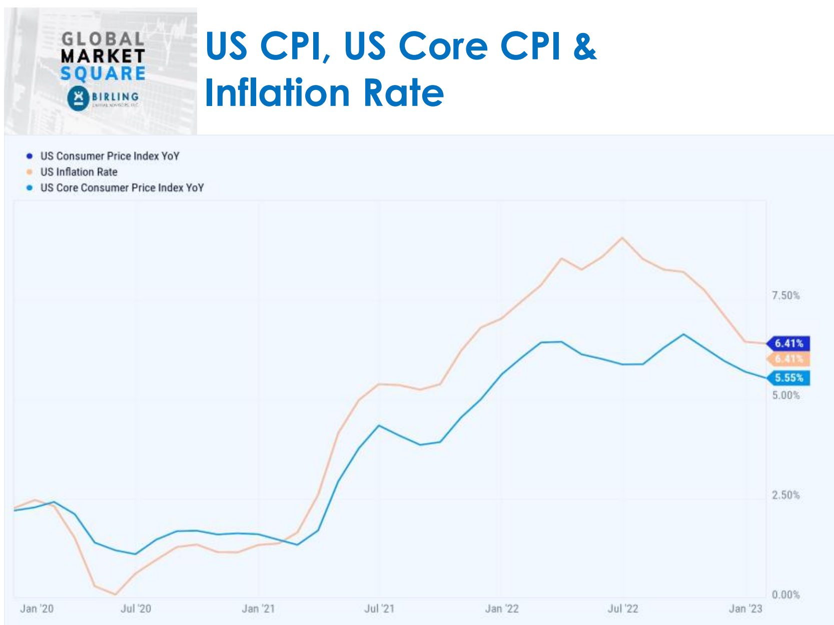


- **U.S. Retail and Food Services Sales** rose to 2.96%, compared to -1.09% last month, offsetting December's decline. A rise in auto sales, restaurants, and furniture outlets drove the increase. However, three critical nonrecurring factors may have impacted the sales report; the 8.7% cost of living increase in Social Security benefits began in January, benefiting north of 70 million consumers, as per the Social Security Administration. The other factor was the milder-than-forecasted winter weather.
- **Strong labor markets**: with U.S. Job Openings: Total Nonfarm rising to 11.01 million, up from 10.44 million last month, increasing 5.48%. The unemployment rate at 3.40%, the lowest in 50 years, coupled with the fact that there are only U.S. Unemployed Persons: Job Seekers rose 5.14 million, evidencing a deficit of 53.3% between job openings and those seeking jobs, is causing increases in wages.
- **The recession fears may have proven to be a mirage:** One key nugget of data we should all consider is that Consumer spending is north of 70% of GDP; therefore, if the consumer begins to weaken, so does the economy. As consumption has risen, the labor markets remain strong, with 11.01 job openings and the lowest unemployment in 50 years at 3.40%. With much of the discussion focused on the soft or hard landing for the U.S. economy, we believe that the

recession is just a mirage and that the economy will continue raising its GDP, powering beyond the Fed's increasing rates. Be reminded that interest rates were close to zero, and most corporations would easily absorb 6 to 7 rate increases without a problem; this creates a scenario in which the U.S. economy continues to grow even with the rate increases. The current GDPNow forecast for the first quarter of 2023 is at 2.50% GDP, and while we may experience a slower pace of economic growth, we do not see a recession taking shape.

- **Inflation is trending down at a slower pace:** higher than-forecasted Consumer Price Index reading of 6.41%; while lower than the previous month, it is higher than the forecasted range of 6.10% to 6.20%. The CPI report showed very few advances on the lowering inflation trend; this time, food, shelter, and energy rose the most. The likely reaction from the Federal Reserve Bank will be the keeping rates higher for longer than most expected, probably into early 2024. The CPI continued heading downward but slower than all consensus estimates.
  The latest inflation Nowcast for February calls for a CPI of 6.24%, Core CPI of 5.54%, PCE of 4.74%, and Core PCE of 4.29%.

  In summation, most investors consider that inflation is behind us and that the downward path shall continue at a slower pace.



- **The Federal Reserve Bank is evaluating all options:** the FOMC members are very aware of the need to soft-land the economy without repeating past mistakes that would allow inflation to rise again. In the latest increase, the Fed slowed its pace to 25 basis points from the 50 to 75 basis points it had been doing. To that end, we see the Fed increasing rates in March to 50 to 75 basis points.

Rate Increases:

- Feb. 01, 23 25 basis points
- Dec. 14, 22 50 basis points
- Nov. 02, 22 75 basis points
- Sep. 21, 22 75 basis points
- July 27, 22 75 basis points
- June 15, 22 75 basis points
- May 04, 22 50 basis points
- Mar. 16, 22 25 basis points

What should investors consider going forward?

First, check that your portfolio is well diversified and balanced between the best combination of stocks, bonds, mutual funds, ETF's, or Money Managers. Even with the solid beginning of 2023 providing substantial market gains, a rise in volatility is expected, which would likely offer selective investment opportunities. The current markets' rise, and declining volatility have been well received, particularly given that most portfolios have prepared for the worst. However, we expect volatility to reappear in the coming weeks before securing solid footing later in the year.

For now, most investors await the Fed's reaction to the slight decrease in the CPI numbers and recent inflation data and the impact on economic growth for 2023; a robust economic growth as forecasted in the GDPNow for the 1Q23 with 2.50% GDP would enormously raise the Fed's likelihood to pause rate increases. We favor neutral portfolio allocations of equity and fixed-income investments to help you adjust during this period of uncertainty.

In conclusion, we share John Maxwell's **"Seven Steps to Success":**

1) Make a commitment to grow daily.
2) Value the process more than events.
3) Don't wait for inspiration.
4) Be willing to sacrifice pleasure for opportunity.
5) Dream big.
6) Plan your priorities.
7) Give up going up.

Francisco Rodríguez-Castro
President & CEO
Birling Capital Advisors