INVESTMENT STRATEGY INSIGHTS

The Economic Report Card

April 11th, 2022

Grading the Economic Cycle

- There is room for further economic normalization, but inflation is hastening a late-cycle response from the Fed

Awaiting Marks on CPI

- Expect inflation to remain above average through 2022, though the magnitude of price pressures should begin to slow

The Fed's Inflation Fighting Project

- The Fed will likely err on the side of tighter monetary policy until inflation shows meaningful signs of subsiding

GLENMEDE

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Grading the Economic Cycle

- **In Search of Late-Cycle Signals.** Recession fears have prompted investors to seek any signs that the U.S. economy may be at or near the late stage of its current cycle. By some measures, the U.S. is showing tell-tale signs of mid-to-late cycle activity. For instance, if measured by jobless claims as a share of the civilian labor force, the domestic labor market has never been tighter. On the other hand, there are some encouraging signs on the consumer side, as household debt service costs currently remain near historical lows.
- **All Comes Down to the Fed.** It has become increasingly clear that having a thesis on the Fed's tightening path will likely be the key to forecasting the trajectory of this expansion. The Fed is trying to chase down inflation, which has historically been a late cycle phenomenon. The yield curve is recognizing this, with the spread between 2yr and 10yr Treasury yields essentially conveying that the Fed may be on course for a policy mistake at some point later this year or early next year. However, while monetary policy is already tightening, it is not yet outright tight – historically, when the fed funds rate eclipses neutral*, this has typically been a sign that recession may be near.
- **Handicapping Recession Odds.** The U.S. economy is closer to late cycle than it was just a year ago. However, it usually takes a material build up in economic excesses or deterioration in leading indicators to push the economy into a downturn. Glenmede's Recession Model projects a 3% probability of recession within the next twelve months, as it appears those excesses and leading indicators have not yet risen to concerning levels. With that said, as the Fed continues on its tightening path, this will justify close monitoring.

> *There is room for further economic normalization, but inflation is hastening a late-cycle response from the Fed*

Chart of the Week:

The late-stage economic expansion checklist is tilting cautious

⬆ Early Cycle ● Mid Cycle ✖ Late Cycle

Economic & Market Factors	April 2022	April 2021
GDP vs. Potential GDP	●	⬆
Labor Market	✖	⬆
Consumer Debt Service	⬆	⬆
Housing	●	●
Valuations	●	●
Inflation	✖	●
Yield Curve	✖	⬆
Monetary Policy	●	⬆

Source: Glenmede, FactSet Data through 4/11/2022
The table shown is a stylistic and subjective representation of Glenmede's assessment of the state of various portions/sectors of the U.S. economy, as of April 2022 and April 2021.

*Neutral refers to the level of the federal funds rate that is neither stimulative nor restrictive to the overall economy

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Awaiting Marks on CPI

- **March CPI Preview.** The March print of the U.S. Consumer Price Index (CPI) will be released this Tuesday. Consensus expectations are calling for an 8.3% annual pace of inflation which would mark the fifth straight month of new 40-year highs for CPI on a year-over-year growth basis. Contributing factors include elevated food and energy prices amid ongoing supply chain disruptions.
- **Russia/Ukraine Commodity Impact.** While Russia's invasion of Ukraine has had only a modest impact on global economic activity so far, the conflict has contributed to significant volatility in key commodities markets. Though oil prices have partially retraced their recent gains over the past week, crude options pricing implies a noteworthy likelihood that they could rise once more amid the uncertainty in eastern Europe. In addition, both Ukraine and Russia are significant exporters of other commodities, including natural gas, metals and wheat. As the war continues to rage on, the impact of disruptions could prove more acute and add additional fuel to the inflation fire.
- **Deceleration on the Horizon?** Given the waning contribution from base effects, it's possible that CPI in the U.S. may see a near-term peak over the next few months or so when measured on a year-over-year basis. There are also some nascent signs of outright deflation in some portions of the consumer spending basket. For instance, used vehicle prices, which make up 4% of the CPI, are already showing signs of falling from their highs. The Manheim Used Vehicle Value Index, which measures prices on wholesale used vehicles, declined 3.3% in March.

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The Fed's Inflation Fighting Project

- **Snippets from the Minutes.** The Federal Open Market Committee (FOMC) released the minutes from its March session last Wednesday. The possibility of a half percent rate hike in the near future appeared to gain some momentum, with the minutes mentioning that "many participants noted that one or more 50bp increases in the target range could be appropriate at future meetings." Fed funds futures are now pricing in an 85% chance of a 0.5% rate hike at the FOMC's next meeting in May.
- **Details on Balance Sheet.** The other big revelation from the FOMC minutes was general agreement among the Committee to allow up to $95 billion in Treasuries and mortgage-backed-securities roll off its balance sheet at some point over the next few months. The purpose of this action would be to reign in excess liquidity in an effort to help cool the demand side of inflationary pressures. Compared to the Fed's last orchestrated balance sheet decline during 2018/2019, the dollar value of this runoff will likely be larger this time around, though it will likely be a slower pace as a percentage of balance sheet assets.
- **Why the Fed Needs to Hit Inflation Hard.** Hot and persistent inflation runs the risk of becoming embedded into the expectations and behavior of businesses and consumers. If such economic participants begin to assume this higher inflation is here to stay, they will likely accelerate purchases so as to get ahead of the increase, further fueling the increase with their own collective demand in a self-reinforcing, momentum-like manner. The Fed's forceful pivot to tighten monetary policy is a conscious effort to avoid this scenario and attack its price stability mandate head-on.

The Fed will likely err on the side of tighter monetary policy until inflation shows meaningful signs of subsiding

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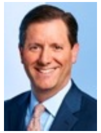

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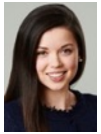

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