



THE CAVU COMPASS

Monthly macroeconomic insights and market commentary provided by CAVU Securities and Piedmont Crescent Capital.

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The Surprisingly “Softish Landing”

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The Surprising “Softish Landing”

Will the Fed Pull Off a Softish Landing?

- ▲ Positive economic surprises outnumbered negative ones during the first half of 2023, giving rise to hopes the Fed might just pull off a softish landing after all.
- ▲ Real GDP growth rose at a solid 2.4% annual rate during the second quarter, and employers continued to add workers at a healthy clip. The stronger pace of growth means the economy should be better able to withstand the impact of higher interest rates.
- ▲ First half growth was bolstered by the surprising resilience of the housing market. Demand rebounded earlier this year but there were relatively few existing homes available for sale. The mismatch pulled prices higher and very quickly reversed the declines registered in the second half of last year. Builder confidence also rebounded, as buyer traffic and new home sales improved.
- ▲ The rapid uptake of major stimulus programs such as the Inflation Reduction Act and CHIPS and Science Act has also led to a surge in construction of new EV plants and semiconductor plants.
- ▲ We believe the economy’s run of good luck may be ending. Fitch’s downgrade of the US credit rating provides a needed wakeup call that the nation’s precarious fiscal position might trigger some financial market volatility later this summer and fall. The Treasury stretched its finances in the months leading up to the debt ceiling deal and will need to replenish their coffers by issuing close to \$2 trillion in securities over the next 6 months.
- ▲ We are looking for a “softish landing”, with real GDP growth averaging a 0.7% pace over the next six quarters, including back-to-back negative quarters at the end of this year and in early 2024.

The Surprising “Softish Landing”

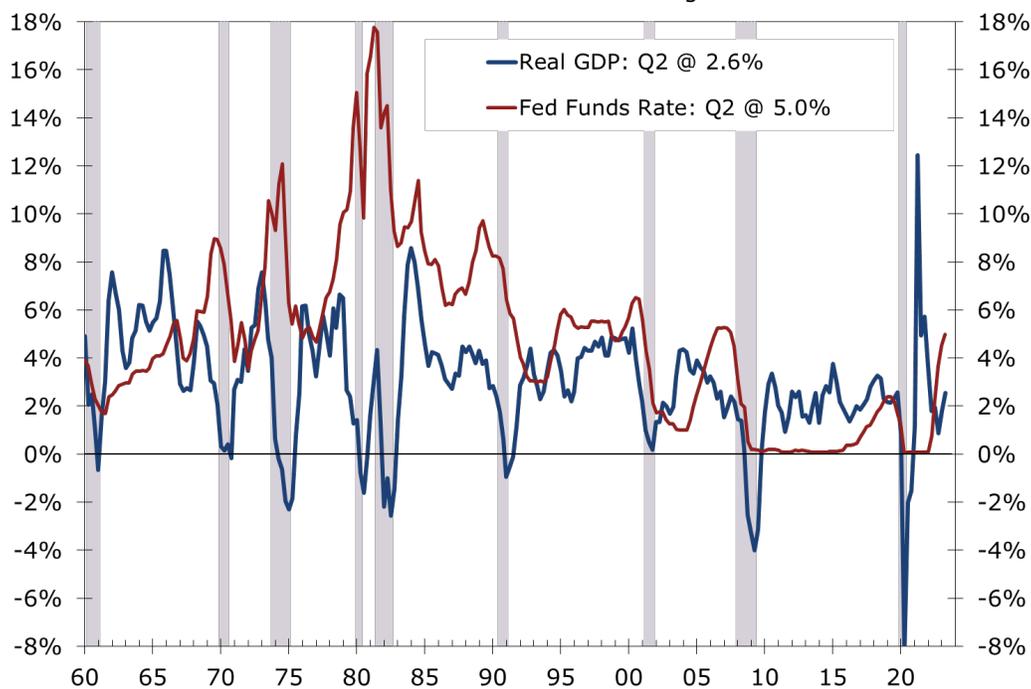
This past month’s more moderate economic data have bolstered expectations that Jay Powell might just be successful after all in pulling off the ever-elusive soft landing. After stronger than expected real GDP growth in the second quarter, even more forecasters pulled back their calls for a recession. While economic growth was stronger than expected, inflation has become less menacing and there is a growing consensus that the Federal Reserve has either finished raising interest rates or will hike the funds rate just one more time. While the odds of a soft landing have increased, we continue to believe a recession, or federal continuation of the rolling recessions experienced this past year, is the most likely course for the economy during the second half of this year and 2024.

A “soft landing” is a planned slowdown in economic growth, typically orchestrated by Federal Reserve interest rate hikes, that follows a period of strong growth. The idea is to bring economic growth back below its potential growth rate, which

is currently somewhere between 1.5% and 2%, so that the economy builds back a little slack and allows inflationary pressures to subside. If done successfully, a soft landing extends the business cycle and is sometimes referred to as “the pause that refreshes.”

Soft landings are relatively rare, difficult to pull off and even harder to sustain. Prior to the current rate hike cycle, the Fed had initiated 12 tightening cycles since 1954, where they gradually raised interest rates to break the economy’s momentum and slow or reverse a rise in inflation. In 8 of these previous cycles, the economy wound up succumbing to a recession, or a hard landing. In 4 of 12, the Fed achieved a soft landing, where economic growth slowed, the unemployment rate edged higher, and inflationary pressure eased.

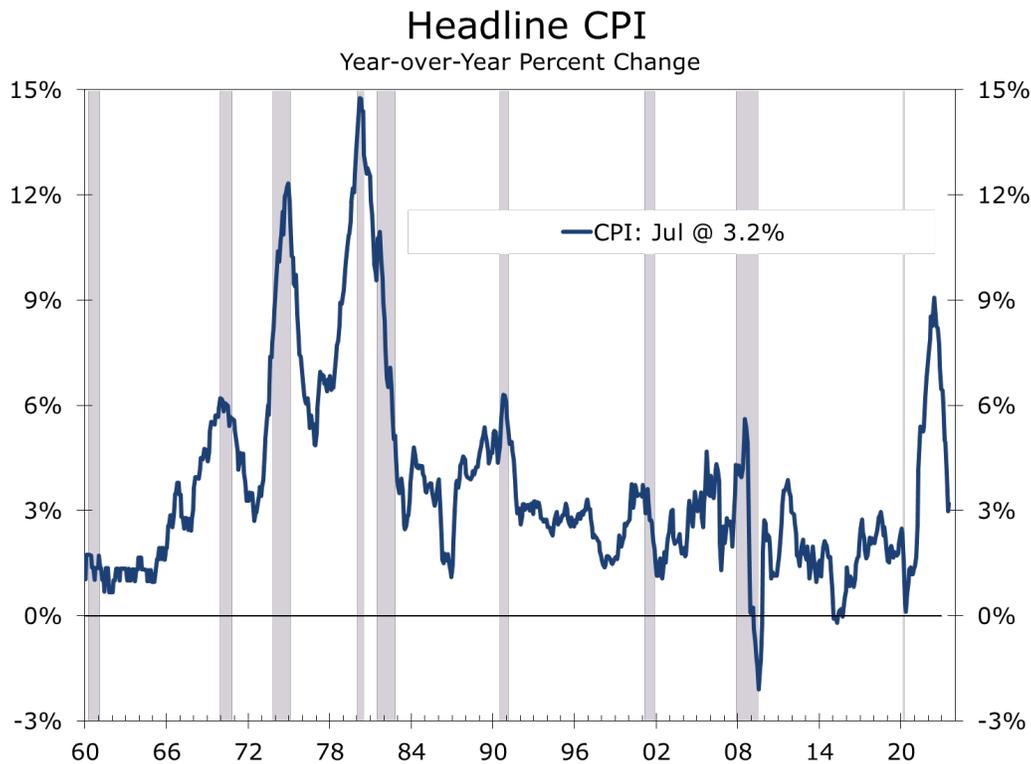
Real GDP vs Federal Funds Rate
Year-over-Year Percent Change



Source: Bureau of Economic Analysis and Federal Reserve Board

Three of the prior soft landings resulted in substantially longer economic expansions. The first was in the 1960s, when the Fed raised the federal funds rate from 3.50% in November 1964 to around 5.70% in November 1966. The rate hikes worked, with real GDP growth slowing and inflationary pressures subsiding. The Fed was able to subsequently pull rates back below 4% in May 1967. The expansion continued for another 4 years, although inflation flared back up and the Fed had to hike interest rates even higher in the late 1960s, helping send the economy into recession in 1970.

The next most notable success occurred in the mid-1980s when the economy came roaring back from the deep 1981-82 recession. That recession broke the back of the hyperinflation of the late 1970s and early 1980s, seeing the year-to-year change in the headline Consumer Price Index fall from 14.8% in March 1980 to just 2.5% by the middle of 1983. After real GDP came roaring back at a torrid 7.9% pace in 1983, the Federal Reserve initiated a series of interest rate hikes that took the federal funds rate to 11.6% in August 1984.



Source: Bureau of Labor Statistics

The Fed’s tough medicine worked, and economic growth slowed to just a 3.7% pace in the second half of 1984 and first half of 1985. That soft landing gave the expansion some breathing room, and growth continued into what became known then as the longest peacetime economic expansion on record. The long 1980s economic expansion came to abrupt end shortly after Saddam Hussein invaded Kuwait and oil prices doubled overnight. The surprise invasion of Kuwait upended what looked like another successful Fed operation, which saw the Fed raise the federal funds rate from around 6.5% in early 1988 to 9.8% in May 1989. The Fed was gradually cutting interest rates in the year and a half prior to the Kuwait crisis, as it appeared the economy was in the early stages of soft landing.

The 1990 experience reveals one of the most obvious shortcomings of soft landings. When the economy slows below its potential growth rate, there is less ability to absorb an unforeseen shock. The business cycle is never going to be repealed, however. Recessions are ultimately caused by the buildup of imbalances during the economic expansion. There were plenty of imbalances present prior to the 1990 downturn, including a vastly overbuilt commercial real estate sector and weakened financial sector, which was reeling from the collapse of the Savings & Loan industry and a handful of large bank failures.

Despite the near miss in 1990, the Fed was successful at achieving another soft landing in the mid-1990s, taking the federal funds rate from 3% to 6% between February 1994 and March 1995. The rapid increase in interest rates was not without incident, as it triggered a financial crisis in Orange County, California – whose finances were unprepared for a sudden spike in interest rates. Problems also surface in Mexico, which saw its currency plummet as it had problems servicing its debt. The economy was strong enough to withstand those exogenous events, however, and growth continued for another five years.

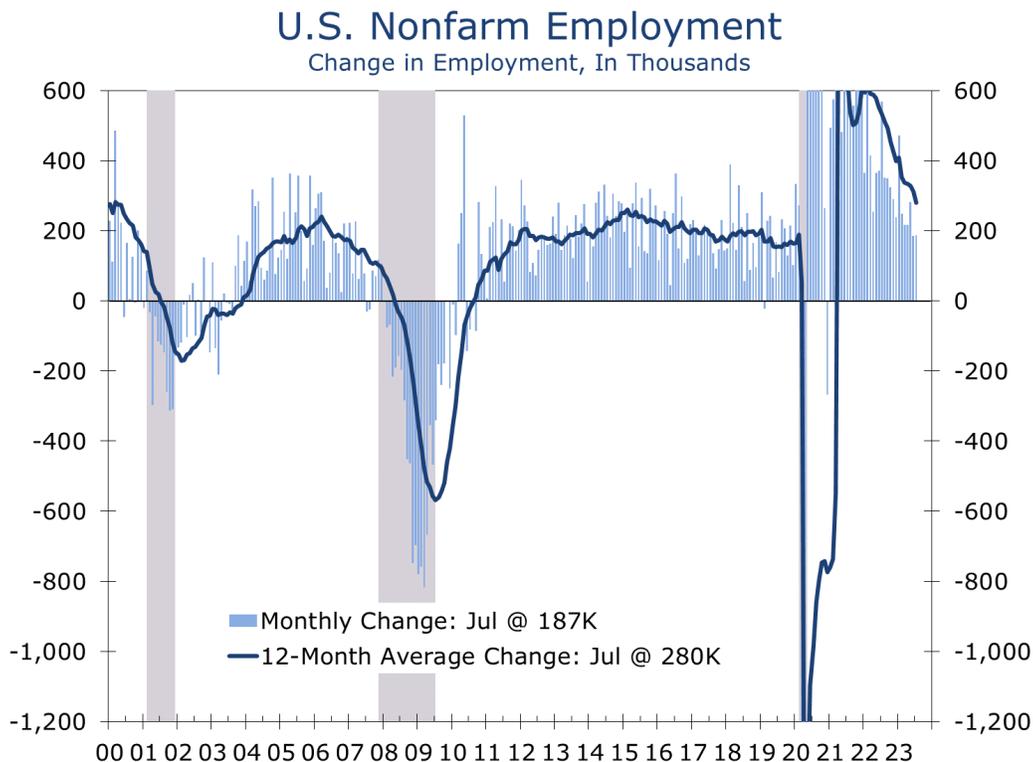
As in the decade before, the Fed appeared to have engineered another soft landing in the year 2000, only to see unforeseen events subsequently pull the economy into recession. The Fed was raising interest rates at the end of the decade, as the economy was enjoying a strong boost of growth from business investment in IT infrastructure ahead of

possible Y2K disruptions, as well as a surging stock market. The economy made it through Y2K without incident and was even weathering the selloff in the stock market reasonably well through much of 2021 before the September 11 attacks on the World Trade Center and Pentagon pulled the economy into recession.

The last time the Fed was able to pull off a soft landing was in the period just prior to the Pandemic, and whether this period qualifies as a soft landing is debatable. The Fed began to raise interest rates back in July 2017, lifting the federal funds rate from 1% to 2.4% in July 2019. The rate hikes successfully slowed the economy, and the fed began cutting rates later that year, pulling the federal funds rate back to 1.75% in February 2020. The COVID-19 Pandemic shut down the economy in March 2020, prompting the Fed to immediately cut the federal funds rate to zero. Without the pandemic, the Fed would have likely continued to gradually cut interest rates in 2020 and the expansion would have likely continued.

What does history tell us is likely to happen today? The Fed’s interest rate hikes over the past 18 months have been among the most aggressive ever, with the Fed raising interest rates from just 0.10% in March 2022 to around 5.40% currently. The 530-basis-point rise in the federal funds rate is the fastest since 1973, although the first 165 basis points essentially reverses the emergency measures put in place at the start of the pandemic – a point that is often overlooked but has played a critical role in extending the time that it has taken for higher interest rates to impact the broader economy.

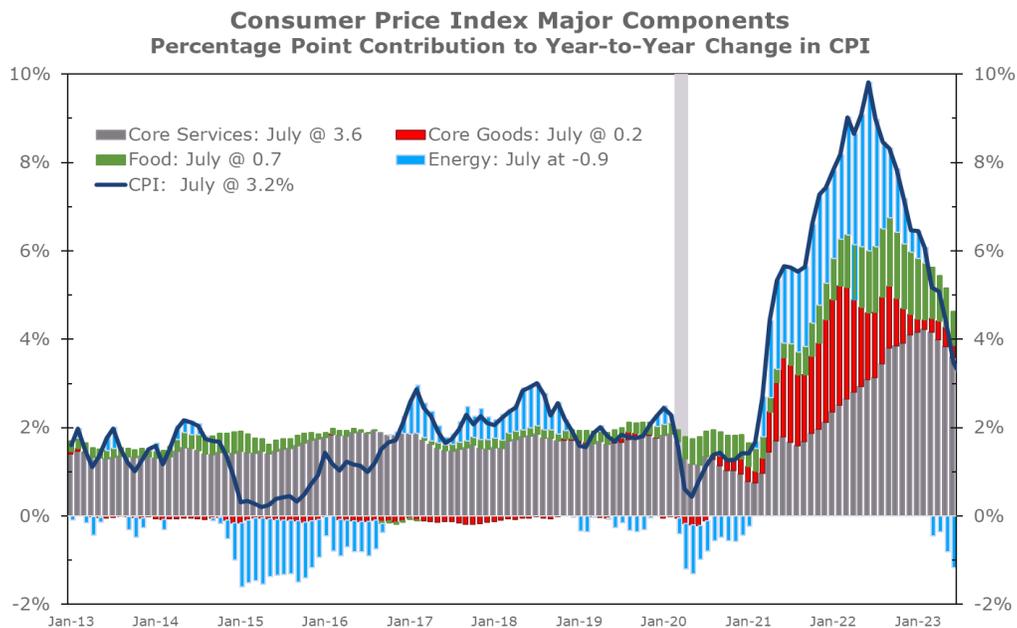
As in the 1990s, the unexpectedly rapid interest rate hikes this past year did not occur without incident, contributing to the collapse of Silicon Valley Bank and to a general pullback in bank lending. Despite these setbacks, positive surprises outnumbered negatives surprises during the first half of this year, which has bolstered hopes the economy is on the verge of a soft landing. The latest data point to support that notion has been the continued moderation in employment growth, with the latest data showing employers added a more modest 187,000 jobs in July.



Source: Bureau of Labor Statistics

We continue to believe talk of a soft landing is premature. The economy benefited from a remarkable string of positive surprises during the first half of the year that likely will not be repeated during the second half and may even be reversed. Among the more consequential surprises was that inflation eased much more quickly than expected, with the year-to-year change in the headline CPI falling from 9.1% in June 2022 to just 3.2% in July 2023.

Most of the decline in the headline CPI this past year has come from a rapid decline in energy prices, which was largely brought about by President Biden’s decision to significantly draw down the Strategic Petroleum Reserve. Gasoline prices have fallen 20% over the past year. Falling energy prices are responsible for the bulk of the 5.9-point drop in the year-to-year change in the headline CPI over the past year. The drop in energy prices has also played a major role in slowing the pace of price increases at the grocery store, as transportation costs account for a large proportion of food prices.



Source: Bureau of Labor Statistics

Unfortunately, falling energy prices have likely provided all the relief that they can. The Strategic Reserve has largely been emptied, removing that backstop. Oil prices have recently rebounded back above \$80 a barrel and gasoline and diesel prices have been edging higher. Grocery store prices are likely headed higher, as persistent drought across the U.S. and other important agricultural producing nations push prices higher. The loss of shipments from Ukraine is also tightening grain inventories and sending prices of several key products produced in the region notably higher.

There are other areas where the moderation in inflation should prove more enduring. Used car prices – another persistent problem area since the pandemic - have fallen back in recent months, as supplies of new cars have increased, and consumer demand has leveled off. Price increases for other goods have also moderated, as supply shortages have largely been alleviated. The most problematic area of inflation has been core services, which includes residential rent and owner equivalent rent. Rents are clearly moderating and will continue to slow the pace of core services prices.

Prices for services where labor makes up a large proportion of costs remain problematic, however. Wages are still rising around 4.5%, and with productivity stuck at around 1.5% or less, that pushes prices up at least 3%. Moreover,

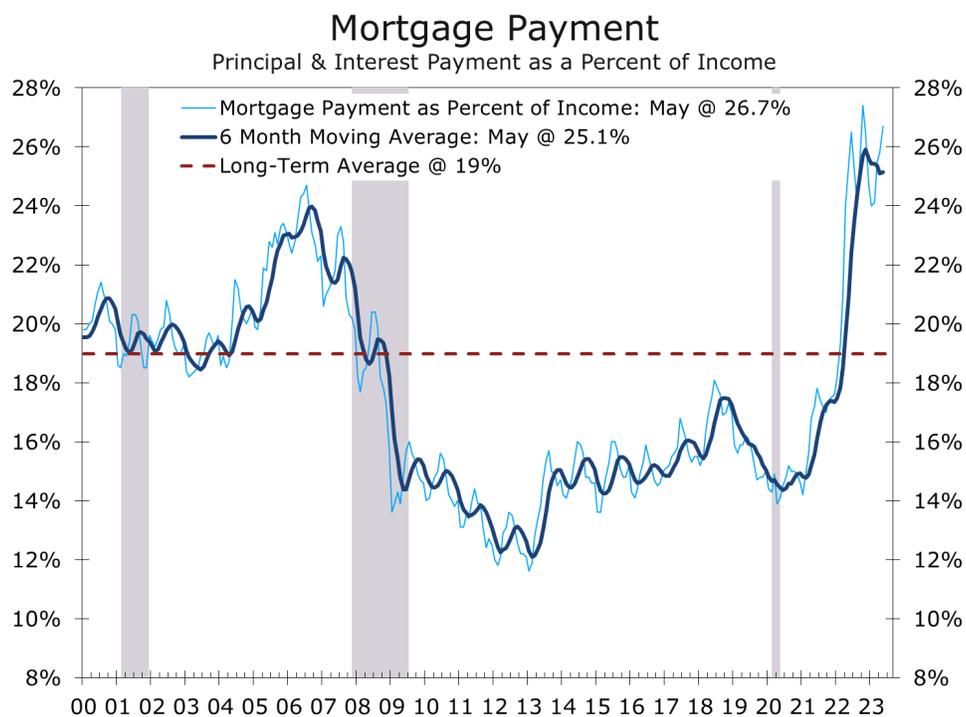
contentious labor negotiations between the United Auto Workers and major motor vehicle producers could set the stage for large pay increases in general, making it much more difficult to bring inflation back down to 2%.

The second biggest surprise of the first half of 2023 was that housing proved remarkably resilient. After mortgage rates spiked above 7% in November of last year, builders and realtors dealt with a spike in contract cancellations that pulled home sales substantially lower at the end of last year. Mortgage rates fell back to 6% in January, however, which brought many buyers back into the market, lifting new home sales in January and existing home sales in February.

The rebound in existing home sales proved short-lived. With roughly 80% of outstanding first lien mortgages fixed at 5% or less, and 60% at 4% or less, relatively few homeowners with a mortgage have been interested in selling their home and buying another with a mortgage around 7%. As a result, inventories of existing homes have remained exceptionally tight, which has completely reversed the moderation in home prices during the second half of last year.

The lack of existing homes for sale has been good news for home builders, which have seen increased buyer traffic and are enjoying stronger sales. The existing home market is more than 5 times larger than the new home market, however, which means residential investment is still a net drag on overall growth. Existing home sales provide commission income to realtors and fee income to mortgage lenders, as well as drive home improvement outlays and purchases of furniture and household appliances, all of which have been lagging.

The second half of the year looks to be even more challenging for the housing market. The combination of higher mortgage rates and rising home prices has made housing even less affordable. The latest data show that a family earning the median family income purchasing the median priced home, with a 20% down payment, will have to commit a near record 26.7% of their income to principal and interest payments. That share almost certainly rose higher in June and July when both mortgage rates and housing prices rose further. Moreover, property taxes and the cost of home insurance have spiked in the past year, reflecting higher home values and higher replacement costs.



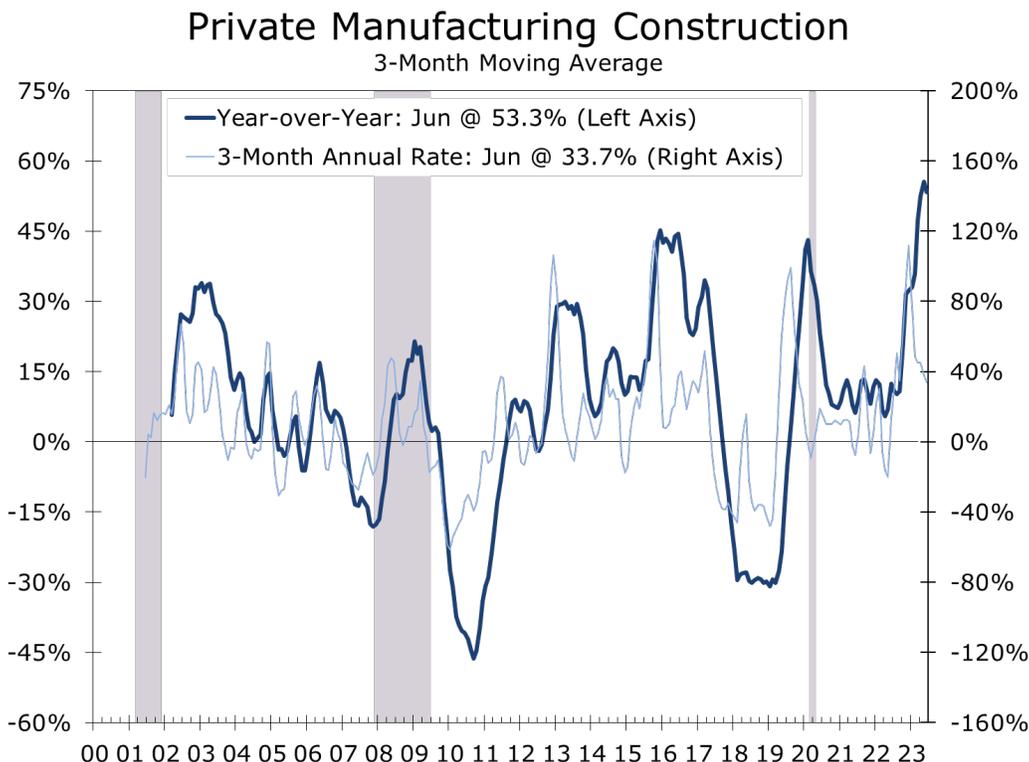
Source: National Association of Realtors

Another surprise is that higher interest rates did not take a heavier toll on household and corporate balances. Debt service costs remain relatively low for households and businesses, which has freed up more income for spending and investment. Stronger balance sheets are a holdover from the pandemic era, when record low interest rates and easier credit allowed households and businesses to refinance their debt at lower rates.

Higher interest rates are beginning to bite, however. Interest rates on car loans have risen substantially over the past year, which has slowed new and used light vehicle sales. Businesses are also having a harder time rolling over maturing debt at affordable interest rates and terms, leading to an uptick in bankruptcies and most likely some pullback in business fixed investment and staffing during the second half of this year and in 2024.

The unexpected Artificial Intelligence boom that followed the release of ChatGPT was another huge positive for the economy in the first half of 2023. The AI boom helped send stock prices higher and even led to a modest uptick in office leasing in Silicon Valley. What started as an incredibly narrow rise in share prices has broadened, which has revived consumer confidence. The AI boom has also bolstered IT equipment spending and employment. As with other booms, the initial uptake probably has a bit of hype tied to it and we expect the boost to investment and employment to fade somewhat during the second half of this year.

The last major surprise of the first half was the rapid uptake in major fiscal initiatives, particularly the Inflation Reduction Act, which is helping fuel a boom in Electric Vehicle-related infrastructure, such as EV battery plants, EV assembly plants and the production of related parts and charging stations. The CHIPS and Science Act has similarly led to a surge in semiconductor plant construction around the country. When combined with the pre-existing trend of reshoring, manufacturing construction has surged, with the latest data showing construction spending for private manufacturing facilities through the first 6 months of 2023 running a stunning 74.3% ahead of the same period 1 year ago.



Source: Census Bureau

We see the momentum giving way during the second half of the year. Customer demand for EVs has been underwhelming, which will likely lead to some slowing in EV investment. Semiconductor plant construction is also likely to moderate a bit, as credit becomes dearer and more costly.

Given the boost from fiscal stimulus it is surprising that interest rates were another area where the economy caught an unexpected break during the first half of the year. While the Federal Reserve hiked rates in line with expectations, Treasury yields were actually a little lower than expected, as the showdown over the debt ceiling meant the Treasury had to stretch their available funds a bit further than usual. The drawdown in the Treasury's General Account meant there was less Treasury issuance during the first half of the year. The Treasury will now have to rebuild their General Account, which means issuance is set to increase. Moreover, tax revenues have been coming in lower than expected while spending is rising faster than expected. The net result is the Treasury will have to raise close to \$2 trillion during the second half of this year, which will likely put some added pressure on long-term rates.

We Are Looking for a Softish Landing

While the odds of a soft landing have clearly increased, we remain more cautious. We believe a remarkably fortuitous run of economic and geopolitical events during the first half of the year have made the prospect of a soft landing appear to be closer than it is. Many of the positive surprises, such as the surprising strength in home sales, have largely run their course. Others, such as the short-term break in long-term interest rates the economy enjoyed in the run-up to debt-ceiling deal, now appear set to reverse as the Treasury refills its coffers. The Fitch downgrade of the U.S. credit rating may mark a turning point, where the economic news turns less positive.

The bulk of the improvement in the inflation data also appears to be behind us. Oil prices have recently rebounded back above \$80 a barrel, which will result in higher gasoline and diesel fuel prices. Food prices will also likely prove more problematic given the prolonged drought across much of the U.S. and renewed disruptions to shipments of key products out of Ukraine.

Recessions are ultimately caused by the buildup of imbalances in the economy and there are a few notable ones to keep an eye on. Commercial real estate is the most obvious trouble spot, with uncertainty about the demand for office space leading to a spike in office vacancy rates for class B and class C properties and a substantial drop in property prices. Other areas of commercial real estate are less troubled, but higher interest rates and higher operating costs are weighing on returns and prices.

The problems in Commercial Real Estate are weighing on the banking sector, where Moody's recently downgraded 10 regional banks and appears poised to downgrade more in coming weeks. The inverted yield curve has made bank lending less profitable at a time when many banks are now having to boost rates on money market accounts and CDs to stem the slide in deposits.

Housing affordability is another imbalance. In addition to the near record share of income needed to service principal and interest payments, property taxes and insurance costs have surged this past year. Prices will eventually have to correct, and our forecast has this correction occurring via slower price appreciation, lower interest rates, and continued moderate income growth.

One of the more glaring imbalances is the nation's persistent trillion-dollar budget deficits. Debt relative to GDP has approached levels last hit in World War II. Interest on the national debt is increasing rapidly. Deficits are like high cholesterol. Everyone knows they are bad and increase the risk of a traumatic event, but it gets a bit murkier when you

try to pinpoint just when such an event will occur. Treasury issuance is set to spike during the second half of this year, which introduces an element of risk into an economy where inflation will likely prove surprisingly persistent, and banks will also likely be scrambling to raise capital.

We are looking for a softish landing for the economy over the next few quarters, with real GDP growing at just a 0.7% annual rate between the middle of this year to the end of 2024. We also see two consecutive quarters of declining real GDP late this year and early next year, which we expect the NBER to declare as a recession.

Interest rates are expected to remain near current levels. We believe the Fed has finished with their rate hikes and that slower economic growth will limit the rise in long-term rates.

US Economic and Financial Outlook

(% change on previous period, annualized, except where noted)

	2022		2023				2024				2021 Actual	2022 Actual	2023 Forecast	2024 Forecast	2025 Forecast
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4					
Output															
Real GDP	3.2	2.6	2.0	2.4	1.1	(1.6)	(1.4)	0.4	1.8	2.1	5.7	2.1	0.2	0.7	2.5
Consumer Spending	2.3	1.0	4.2	1.6	1.0	(0.9)	(0.5)	0.5	0.8	1.1	7.9	2.8	1.5	0.5	1.7
Nonresidential Fixed Investment	6.2	4.0	0.6	7.7	(1.8)	(3.0)	(3.3)	(2.8)	(1.1)	2.3	7.4	3.8	0.9	(1.2)	2.5
Light Vehicle Sales	13.4	14.3	15.3	15.6	15.4	15.2	14.9	14.8	15.0	15.2	15.0	13.9	15.4	15.0	15.6
Industrial Production, Manufacturing	0.4	-3.6	-0.3	1.9	1.3	-2.9	-2.1	0.9	2.3	2.6	5.0	4.3	0.0	0.9	3.2
Unemployment Rate (Qtrly Avg)	3.6	3.6	3.5	3.6	3.7	3.9	4.1	4.3	4.5	4.5	3.9	3.7	3.7	4.4	4.3
Housing Market															
Housing Starts (Units, thous)	1,446	1,405	1,385	1,447	1,420	1,340	1,270	1,260	1,260	1,290	1,601	1,554	1,390	1,300	1,460
New Home Sales	583	598	638	694	670	650	640	630	640	650	771	637	595	620	700
Existing Home Sales	4,770	4,197	4,327	4,250	4,150	4,100	4,000	4,050	4,100	4,200	6,120	5,030	4,170	3,950	4,260
S&P/Case-Shiller Natl Home Prices (Yr/Yr % Change)	13.1	7.4	2.2	(0.3)	2.2	3.7	4.6	2.2	0.9	(0.1)	18.5	14.7	2.4	2.7	2.5
Inflation (Year-to-Year % Change)															
Consumer Price Index (CPI)	8.3	7.1	5.8	4.1	3.2	3.0	2.9	2.9	3.0	3.0	7.1	6.7	4.0	3.0	2.6
Core CPI	6.3	6.0	5.6	5.2	4.4	3.9	3.6	3.4	3.3	3.2	5.5	6.1	4.8	3.4	2.9
Personal Consumption Deflator	6.3	5.7	4.9	3.7	3.4	3.1	2.9	2.8	2.9	2.9	5.8	5.8	3.8	2.9	2.3
Core PCE Deflator	4.9	4.8	4.7	4.4	3.9	3.4	3.3	3.1	3.0	2.9	4.9	4.7	4.1	3.1	2.3
Employment Cost Index	5.1	5.1	4.9	4.5	4.6	4.5	4.7	4.4	4.2	4.1	3.3	4.9	4.6	4.4	3.9
Interest Rates (Quarter End and Ann Avg)															
Fed Funds Target Range	3-3.25	4.25-4.50	4.75-5.00	5-5.25	5.25-5.50	5.25-5.50	5.25-5.50	5-5.25	4.5-4.75	4.25-4.50	0-0.25	2.75	5.19	4.80	3.88
10-Year Treasury Note	3.83	3.88	3.48	3.84	4.10	4.10	3.90	3.90	3.80	3.80	1.45	2.95	3.19	3.85	3.90
Conventional Mortgage Rate (Freddie Mac)	6.70	6.42	6.32	6.71	7.00	6.90	6.70	6.60	6.40	6.30	2.95	5.34	6.63	6.50	6.10

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