# Monthly Market Views

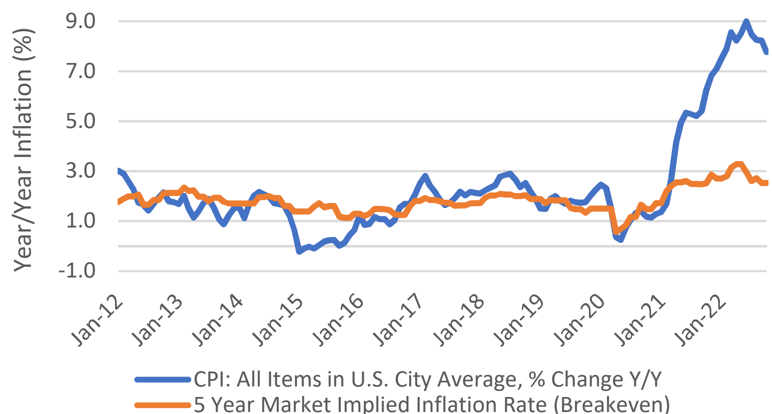
International Private Banking Division

DECEMBER 2022

**As we approach the new year, we wanted to use this month's letter to outline the themes which we expect to be important factors in next year's market performance.**

### What will inflation be in December 2023?

After nearly 40 years of subdued inflation in the United States, the past two years have seen substantial inflationary pressure (Exhibit 1[1] – Blue Line). Inflation has been broad based, and has been fueled by a number of factors. These have included ongoing supply chain issues, worker shortages during the covid-19 recovery; and commodity price spikes following Russia's invasion of Ukraine.

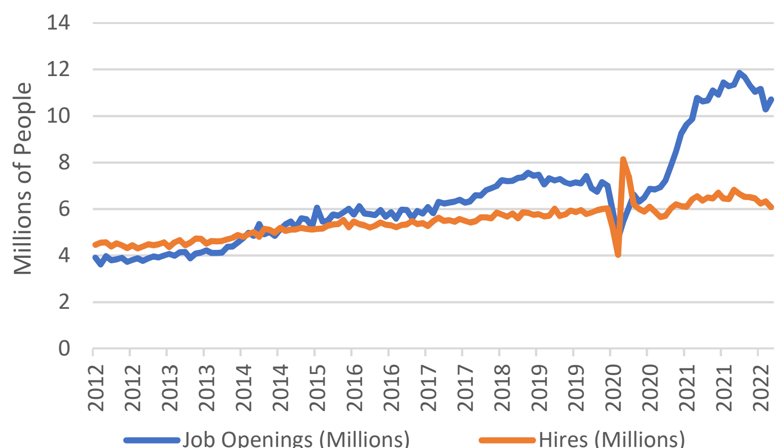



To address these inflationary pressures, the US Federal Reserve (US Fed) has been tightening financial policy since early 2022 by raising interest rates, and allowing some balance sheet assets to roll-off. Monetary policy always works with a multi-month lag, so rate hikes from early Spring may not be felt until late Summer. As we approach 2023 however, it does appear that these efforts are working.

One of the more dangerous inflationary signals are future inflation expectations, which can provide a signal about a potential for an inflation spiral. An inflationary spiral is the process on self-sustaining inflation; with businesses raise prices, and employees demand raises, and on and on. Since peaking in May 2022 at 3.3%, the market-implied annual inflation for the next 5 years, has begun to drop precipitously (Exhibit 1 – Orange Line). Putting all these factors together, it is very possible that inflation drops to around 4% by the end of 2023.

### What will happen to employment in 2023?

In a typical monetary cycle, the Federal Reserve's rate increases tend to increase unemployment as the economy slows[2]. However, the current cycle is unique in the scale of the availability of jobs. There are currently 4+ million more job openings in the economy than there are jobs being filled (Exhibit 2- Blue Line[3]).

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[1] Consumer Price Index for All Urban Consumers: All Items in U.S. City Average, Percent Change from Year Ago, Monthly, Seasonally

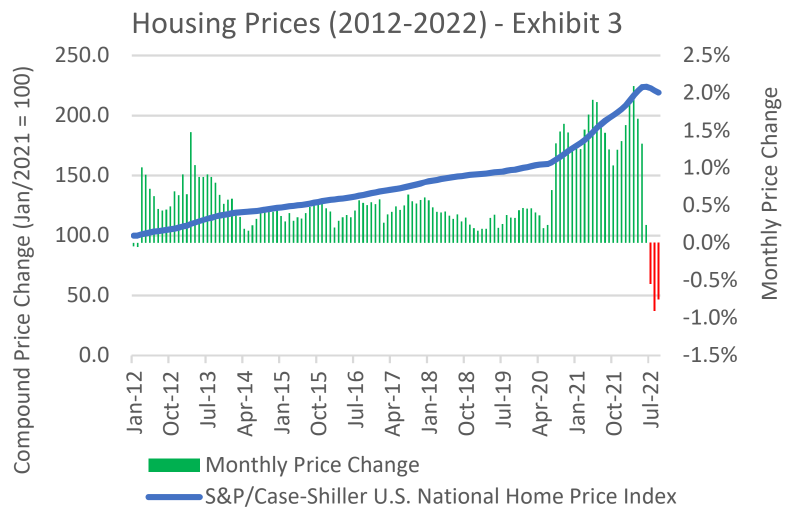
[2] U.S. Bureau of Labor Statistics, All Employees, Total Nonfarm [PAYEMS], https://fred.stlouisfed.org/series/PAYEMS,

[3] U.S. Bureau of Labor Statistics, Job Openings: Total Nonfarm [JTSJOL], https://fred.stlouisfed.org/series/JTSJOL

As the economy slows in 2023, the first casualties will be these job openings. While unemployment will likely rise, it is unlikely to approach anywhere near the levels of the 2007-2009 or 2020 recessions. An unemployment rate of 4-5% by December 2023 is our base case scenario.

**What will happen to the US housing market in 2023?**

One of the US Federal Reserve's primary goals when raising interest rates is to slow the housing market[4]; A major growth conduit for the US economy. Since the US Fed started the current tightening cycle, mortgage rates have risen from around 3.25% in January 2022 to around 6.50% by December 2022. This has had the effect of significantly slowing the pace of home-purchasing, as potential buyers have increasingly chosen to sit on the sideline.

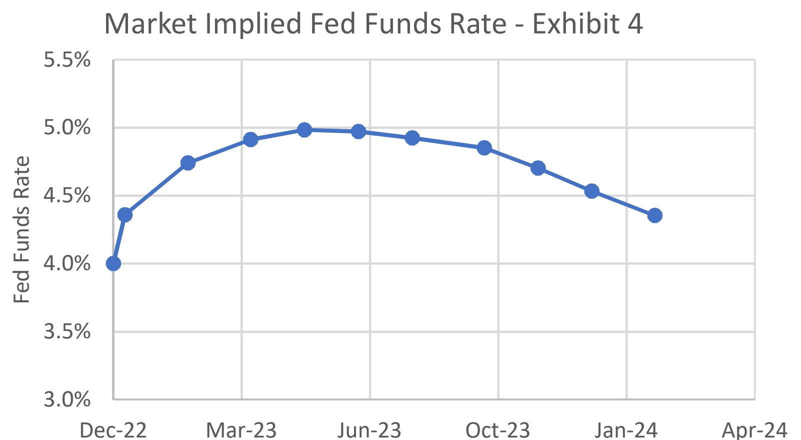



The slow-down of home purchases has led to an increase in active inventory; as there have been more homes listed than sold. The level of inventory is likely to increase further in 2023, due to a record number of under-construction homes scheduled to hit the market over the next year.

The overall effect of this dynamic has already begun to negatively affect housing prices (Exhibit 3[5]). With the S&P/Case Shiller Price Index posting negative price growth for the past 3 months, after nearly a decade of positive growth. Going forward, while we do not believe we will see a downturn anywhere as major as 2007-2011, our base case is that both average housing prices and rental rates are likely to turn modestly negative in 2023.

**When will the US Federal Reserve stop raising rates?**

Fixed income markets are currently estimating another 1.0% of Fed Funds rate hikes, with a terminal rate of around 5.0% by May 2023 (Exhibit 4[6]). Going a bit deeper into market expectations – Markets are pricing in a 0.50% hike in December 2022, followed by two 0.25% hikes in February & May 2023.




While there is no guarantee that this will come to fruition, the current path of economic news appears to largely coincide with this outlook. Based on our previously mentioned expectations of a slowdown in inflation and job openings, along with a decline in housing prices; our base case is a cessation to US Fed hiking by mid-2023 at a terminal rate of around 5.0-5.5%.

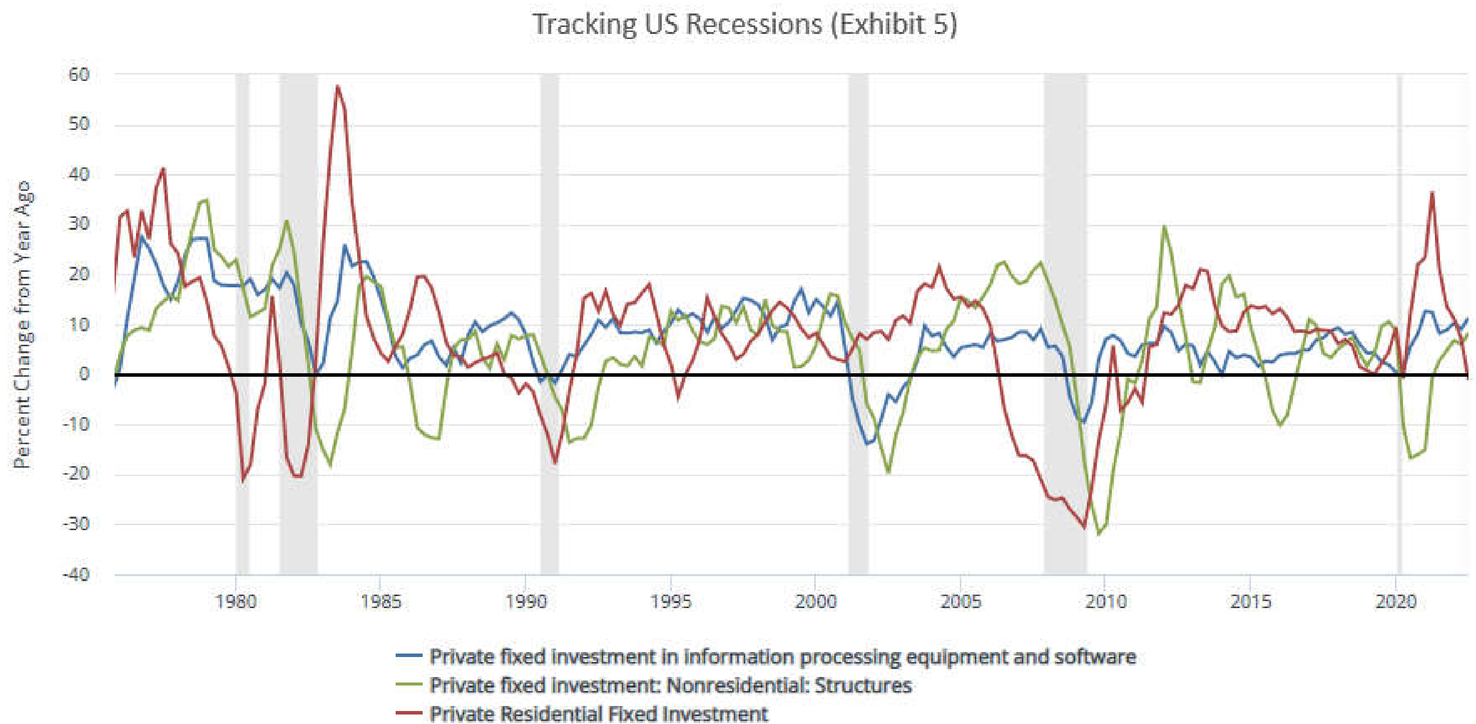
[4] https://www.federalreserve.gov/monetarypolicy/monetary-policy-what-are-its-goals-how-does-it-work.htm
[5] S&P/Case-Shiller U.S. National Home Price Index, Index Jan 2021=100, Monthly, Seasonally Adjusted
[6] Bloomberg Terminal, as of 12-5-2022

**Will the US economy enter a recession in 2023?**

The US economy is entering 2023 on fairly strong footing. This is especially true for consumption, which represents nearly 70% of economic activity. The largest recessionary indicator currently flashing warning signs is housing, which is the Fed's primary target when tightening financial conditions.

The typical pattern in US recessions is characterized in Exhibit 5[7], based on a sequential slowdown of three major economic components of Gross Domestic Product (GDP).

1) A slowdown in Residential investment (Red)
2) Followed by a slowdown in Equipment/software investment (Blue)
3) Followed by a slowdown in Non-residential investment (Green)




While the covid-19 induced 2020 recession didn't follow this pattern due to lockdowns, most recessions over the past 40+ years have. The potential slowdown we're facing in 2023 is more likely than not to follow this pattern. Based on the current economic trajectory, especially the dichotomy between a downturn in housing and a resilient consumption environment; our base case is either a light recession in 2023 or a near miss.

[7] U.S. Bureau of Economic Analysis, Gross Domestic Product [GDP], retrieved from FRED, Federal Reserve Bank of St. Louis (https://fred.stlouisfed.org/graph/?g=XdYD)

**Economic Overview**

| | GDP Forecast (2022) | GDP Forecast (2023) | Inflation Forecast (2022) | Inflation Forecast (2023) | Currency vs. USD | IG Credit Downgrade |
|---|---|---|---|---|---|---|
| Argentina | 4.4% | 1% | 73% | 93% | -39.3% | N/A |
| Brazil | 2.7% | 1% | 9% | 5% | 6.0% | N/A |
| Chile | 2.1% | -1% | 12% | 8% | -4.8% | Low |
| Mexico | 2.5% | 1% | 8% | 6% | 3.8% | Medium |
| Peru | 2.8% | 3% | 8% | 5% | 3.8% | Low |
| Uruguay | 5.2% | 3% | 9% | 7% | 13.7% | High |
| Israel | 5.6% | 3% | 4% | 3% | -8.9% | Very Low |
| USA | 1.8% | 0% | 8% | 4% | 9.9% | Very Low |

*Data Source: Bloomberg Terminal, as of December 5, 2022*

**COVID-19 Overview**

| | Vaccine Doses / Population | Total Cases | Total Cases/ Population | Last 30 Day Growth Rate |
|---|---|---|---|---|
| Argentina | 230% | 9,739,856 | 20.46% | 0% |
| Brazil | 221% | 35,337,546 | 16.32% | 1% |
| Chile | 311% | 4,937,047 | 24.69% | 1% |
| Mexico | 159% | 7,132,792 | 5.42% | 0% |
| Peru | 247% | 4,300,576 | 12.65% | 2% |
| Uruguay | 244% | 993,875 | 27.78% | 0% |
| Israel | 212% | 4,727,313 | 54.97% | 0% |
| USA | 187% | 98,972,375 | 30.17% | 1% |

*Data Source: Bloomberg Terminal, as of December 5, 2022*

**Chief Investment Officer, IPB**
Alex Polshikov
+1-212-551-8297
APolshikov@IDBNY.com

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