Citizens Market Update

September 22, 2023

- Inflation rose 0.6% in August after increasing by only 0.2% in July. Over the last 12 months, all items index increased 3.7% before seasonal adjustment – this was a larger increase than the 3.2% increase for the 12 months ending in July. The all items less food and energy index rose 4.3% over the last 12 months.
- Total nonfarm payroll employment increased by 187,000 in August, less than the average monthly gain of 271,000 over the prior 12 months, and the unemployment rate rose to 3.8%. The unemployment rate rose by 0.3% to 3.8% in August, and the number of unemployed persons increased by 514,000 to 6.4 million. Both measures are little different from a year earlier, when the unemployment rate was 3.7% and the number of unemployed persons was 6.0 million. However, in August, the labor force participation rate rose by 0.2 percentage point to 62.8%, after being flat since March.
- Since March 2022, the Fed has raised its benchmark borrowing rate 11 times to the current range of 5.25%-5.50%. The Fed did not raise rates at its September meeting, but nonetheless expects one more hike before the end of the year and also expects fewer cuts than previously indicated next year with only two cuts projected, which would put the Fed Funds rate at approximately 5.1%. The projection for the Fed Funds rate also moved higher for 2025, with the median outlook at 3.9%. We believe these projections are overly optimistic and are based on a soft-landing assumption.
- In addition to holding rates at relatively elevated levels, the Fed is continuing to reduce its bond holdings with the Fed balance sheet decreasing by approximately $815 billion since June 2022. The Fed is also allowing up to $95 billion in proceeds from maturing Treasury bonds to roll off each month, rather than reinvesting them. The Treasury is also issuing significantly higher amounts to fund fiscal deficits, both of these factors are leading to rates even higher.
- The Fed is projecting inflation to steadily cool, while the labor market remains historically strong, personal consumption remains high, and energy prices have recently increased. The Fed revised their economic growth expectations for this year, with GDP expected to increase 2.1% this year, which is more than double the June estimate, and no recession expectations. The 2024 GDP outlook was also revised up to 1.5%, from 1.1%.
- Consumers, who make up about two-thirds of all economic activity, have been resilient, spending even as savings have diminished, and credit card debt has passed the $1 trillion mark for the first time ever.
- One of the reasons we have been able to avoid recession, so far is continuous large government spending through various programs even beyond 2020 programs - 2021 American Rescue Plan, 2021 Infrastructure and Jobs Act, 2022 Inflation Reduction Act, and 2022 Chips Act. However, this on the other hand has added to the inflation.

- However, due to significant and variable lag from the monetary policy, we still haven't seen the full impact of the interest rate increases and in addition, as most of the cash infusion from fiscal stimulus is gone and student loan repayments ae starting, we expect economic conditions to slow down and lead to at least mild recession in the second quarter of 2024.

- Global markets are in similar position as Global Central Banks followed the Fed's monetary policy and US fiscal policy during the COVID lockdown and now the world is trying to play catch up by increasing interest rates.

- Rates have increased significantly to reflect Fed rate increases, particularly on the long-end of the curve, but the yield curve remains significantly inverted with the spread between the 3-month and 10-year Treasury at 1.07% and the spread between the 2-year and 10-year Treasury at 0.63%. Since the beginning of the year, the 1-year UST has increased from 5.02% to 5.46%, the 2-year UST has increased from 4.49% to 5.12%, the 5-year UST has increased from 3.91% to 4.61% and the 10-year UST has increased from 3.77% to 4.49%.

U.S. Treasury Rates						
	1-Year	2-Year	3-Year	5-Year	10-Year	2-10 Yr Spread
Current (9/21)	**5.46**	**5.12**	**4.85**	**4.61**	**4.49**	**(0.63)**
Beginning of 2023 (1/2)	5.02	4.49	4.19	3.91	3.77	(0.72)
1-Yr Prior	4.08	4.11	4.12	3.91	3.70	(0.41)
2-Yrs Prior	0.07	0.22	0.46	0.84	1.33	1.11
3-Yrs Prior	0.12	0.14	0.16	0.27	0.68	0.54
5-Yrs Prior	2.57	2.78	2.85	2.89	2.99	0.21
5-Yr Average	1.93	1.92	1.93	1.99	2.20	0.27
10-Yr Average	1.36	1.49	1.62	1.87	2.26	0.78
Current as % Above / Below 5-Yr Average	182%	166%	151%	132%	104%	-330%
Current as % Above / Below 10-Yr Average	301%	244%	199%	146%	98%	-181%

- While the recent increase in interest rates has increased the negative mark-to-market in our investment portfolio, the current MTM is negative $868 million, these values are non-economic and non-cash as these negative values pull to par as the securities mature. Our portfolio duration is much shorter today than it was a year ago, so the evaporation pace will increase.

- Lastly, our income return is stable and rising interest rates are economically beneficial as they lead to higher interest income and we have now started to realize the benefit of higher rates in our portfolio by investing the remaining portion of our maturing securities, after Ian's claims, as well as additional premiums at higher interest rates.