

ECONOMIC OUTLOOK

Summary

On the surface, November non-farm payrolls seemed very strong – perhaps stronger than one would expect at this point in a rate-hiking cycle. The total job creation for November beat expectations by 63,000, and October gains were revised higher by an additional 23,000 jobs. Meanwhile, average hourly earnings doubled their expectations for the month (0.6% vs. 0.3% estimated), and the unemployment rate remained steady at 3.7%. In isolation, this is all positive news. However, the Fed believes that they will need to weaken the labor market in order to reduce inflation back to their target levels.

In spite of the seemingly positive news, the Fed may be pleased to see that we are starting to see some signs of cracks in the labor market. As is typically the case when fears of recession and slowing demand become embedded in the psyche of corporations, we are seeing a number of announced layoffs. While many of these announcements have come from technology companies such as Amazon, Meta, DoorDash, Intel, Microsoft and Twitter, it is not an industry-specific event. A wide range of other industries are also being impacted, with companies such as Walt Disney, Citigroup, Johnson & Johnson, Morgan Stanley and PepsiCo making similar announcements.

Additionally, when you dissect the payroll data a bit more closely, it may not be as strong as it seems. For example, while we saw job growth in excess of expectations for the month, it is important to keep in mind those expectations are at reduced levels from the growth seen earlier this year. In fact, the last time we saw fewer than the 263,000 jobs created in November was 23 months ago in December 2020 when the economy lost 115,000 jobs. Additionally, the labor force participation rate was expected to increase in November, but it actually decreased, creating a 0.2% swing. Lastly, the two-month net payroll

revisions were negative. Meaning even though October was revised higher, September jobs were revised down by a much larger margin.

This type of economic juxtaposition is becoming more commonplace. The economy clearly isn't as strong as it was coming out of the pandemic, but it also isn't weak enough to rapidly reduce inflation as the Fed would like. While the rate hikes implemented by the Fed are seemingly doing their job and starting to slow the economy, we still don't expect a "mission accomplished" type of pivot from the Fed just yet.

Positives

Core PCE for October came in 0.1% less than expectations (0.2% vs. 0.3% est.)

Third quarter GDP was revised higher by 0.1% (2.9%)

Retail sales (excluding autos) beat expectations by 0.8% (1.3% vs. 0.5% est.)

Negatives

The labor force participation rate declined by 0.1% (62.1%)

ISM Manufacturing fell into contractionary territory for the first time in 30 months (49.0)

Existing home sales had its ninth consecutive negative month (-5.94%)

EQUITY OUTLOOK

Summary

The S&P 500 rose 5.6% in November following an 8.1% rally last month. This marked the first time this year the market has advanced in back to back months. The S&P is getting ever closer to the high water mark set during the summer rally. Value stocks continued their leadership over growth, with the Russell 1000 Value Index climbing 6.2% slightly ahead of the 4.6% advance of the Russell 1000 Growth Index.

The primary focus for equity investors has been and will continue to be on Fed policy. Certainly the market will react to economic announcements or corporate news events. But even then markets are thinking about how those details will be interpreted by the Fed and the impact of policy direction. The market rally over the last several weeks was in great part due to an expectation the Fed will scale back the size of hikes in December and pause at some point in early 2023. Sound familiar? Softening Fed expectations were one of the reasons stocks prematurely rallied over the summer. The big difference between now and then is inflation is cooling off but still may not be moving at a pace fast enough to pacify the Fed.

Eventually the stock market won't be so focused on Fed policy and that day should be celebrated by investors. We

can't say when precisely that will be but we do know we are getting closer each day. December has on average been the best month for equity investors. A rally this month following the strength in October and November would certainly be a welcome signal. Volatility is almost a certainty. Regardless, equity valuations continue to support opportunity for long term investment. Happy Holidays!

Positives

Cooling inflation

Equity valuations

Negatives

European energy crisis looms

Unknowns

Federal Reserve – consistent message, inconsistent tone

FIXED INCOME OUTLOOK

Summary

After moving sharply higher during each of the previous three months, interest rates made an abrupt turn in early November shortly after touching the cycle-high closing level reached in late October. This reversal began just a few days after the Fed raised the overnight rate by 75 basis points (bps) for the fourth meeting in a row. With the Fed funds rate now at a range of 3.75%-4.00%, Fed Chairman Powell reinforced that further rate increases are still appropriate, albeit at a reduced pace. He also stated that the ultimate terminal rate of Fed Funds might be higher than the level they had previously expected and wherever they ultimately reach, investors should expect it will remain there for an extended period. Chairman Powell was clearly trying to remove investor's expectations for rate cuts in the second half of 2023. His efforts were not successful as little changed in market expectations.

Yields plunged about one week later following the release of October's inflation report on November 10. This Consumer Price Index (CPI) report showed inflation was materially lower than the consensus expectation which fueled optimism the Fed was closer to the end of their rate hiking cycle and that rate cuts will in fact be justified later next year. The 10-year Treasury note declined by a whopping 27 bps in one day and continued to trend lower for the rest of the month before ending at 3.60% (-44 bps for November). More closely following the overnight rate, the 2-year note only declined by 17 bps for the month to end at 4.31%. Risk markets responded favorably to the idea the rate increases may soon end with stocks soaring and credit spreads falling. The incremental yield on investment-grade corporate bonds relative to Treasury notes declined by 25 bps during the month. Overall, it was an outstanding month for bond investors as the Bloomberg Aggregate Bond Index had its third-best monthly return in the past 30 years.

For now, it appears there is little resistance to rates moving modestly lower on the long end of the curve as investors are looking for softer inflation reports along with weakening, or at least mixed, economic data. While we do believe that we have seen the worst of this bear market for bond investors, we are

becoming slightly more cautious and we are not convinced it will be a one-way move lower in rates. The Fed is still likely to increase the Fed Funds rate this month (50 bps) and additionally next quarter. Although the slower pace of increases will be welcomed, shorter maturity rates should still move somewhat higher when they do occur. The yield curve would have to invert further for long rates to remain unfazed and that will be hard to expect when the curve is already more inverted than any time in the past 40 years. Despite the significant rally in credit spreads, we still believe the investment-grade corporate bond market remains attractive. Barring a deep, protracted recession, credit spreads can narrow further from here.

Positives

Recent inflation data is softer than expected

Long-run inflation expectations remain anchored

U.S. corporate bond yields still attractive

Negatives

The inverted yield curve may curtail declines in long-maturity yields

Overnight rate to increase further and remain elevated well into next year

Unknowns

Impact on market liquidity as the Fed's balance sheet run-off accelerates

Resolution of the Russia/Ukraine war and escalation of hostilities with China