

## ECONOMIC OUTLOOK

### *Summary*

It may be a new year, but it's still the same old messaging from the Federal Reserve. The recently released minutes from their December meeting indicated the labor market remains too strong and the potential for elevated inflation continues. They also stressed the risk of market participants ignoring their warnings about keeping an overnight rate that is restrictive "for some time", which could lead to financial conditions loosening too much.

However, despite their hawkish rhetoric, that is exactly what's unfolding. Market based expectations for the overnight rate remain well below the Fed's predictions. This suggests the Fed will not push rates as high as they have indicated, and additionally, will cut rates several times by year end. While it might prove accurate, this could potentially be a case of wishful thinking by market participants. If the Fed holds true to their word it's likely the stress of higher rates in the economy could send us into a mild recession or worse. On the other hand, if the Fed follows the rate path the market is projecting, there remains the possibility of a soft landing.

While a soft landing didn't seem likely during the first half of 2022, when we had consecutive quarters of negative GDP growth just as rate hikes were getting under way, it has rejoined the conversation. Despite the Fed hiking at an unprecedented pace throughout the second half of the year, we experienced 3.2% GDP growth in the third quarter, and are on pace for 3.8% in the fourth quarter (according to GDPNow). In addition, the labor market remained strong in December as the labor force participation rate ticked higher, and the unemployment rate hit a cycle low of 3.5%. Most importantly, we have seen a string of four consecutive months with decreasing core Personal Consumption Expenditures (PCE) price index, the Fed's preferred inflation metric.

Still, that doesn't mean the economy is out of the woods. For example, December also brought with it both manufacturing and service Purchasing Managers Indexes (PMI) that have moved below 50, a sign of a contracting economy. Interest sensitive areas of the economy continue to struggle, and retail sales have been negative for two of the last three months.

As the Fed approaches the late stages of its rate hiking cycle, it is likely to become much more data dependent moving forward. That makes monitoring every economic data point, specifically those regarding inflation, consumption and employment, more critical as we navigate the next several months.

### *Positives*

The final revision to third quarter GDP increased by 0.3% (to 3.2%)

The unemployment rate fell to a 53-year low (3.469%)

The Conference Board (CB) Consumer Confidence Index reached its highest level in 7 months (108.3)

### *Negatives*

Average hourly earnings year-over-year declined by 0.5% (to 4.6%)

Retail sales declined by -0.6% in November (est. -0.2%)

Pending home sales year-over-year were down nearly 40%

## EQUITY OUTLOOK

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### *Summary*

2022 was a rough year for equity investors. The S&P 500 closed the month of December down 5.8% bringing the total losses for the year to 18.1%. Growth stocks for the most part underperformed value stocks throughout the year. The Russell 1000 Growth Index dropped another 7.7% in December, down 29.1% for the year. In contrast, the Russell 1000 Value Index lost 4.0% and 7.6% respectively.

As we move into 2023, it's important to note it would be unlikely for the market to finish lower in consecutive calendar years. That hasn't happened in over 20 years and has only happened twice in the last 50 years. Also, as we have mentioned in previous publications, many of the troubles that have pressured the stock market are now showing reasons for optimism. The pandemic, while currently raging in China, has largely faded as a market concern. Inflation is still high, but it has likely peaked and has been falling faster than expected for a couple of months. Inflation is far from the Fed's ultimate target, but evidence it might be headed towards those levels may cause the Fed to pause its rate hiking campaign at some point in the coming months. This will be very welcome news for equity markets given inflation, it could be argued, was the most impactful cause of the stock market's decline. The Russia/Ukraine war continues. It is very hard to provide an outlook for a crisis relying so heavily on someone as unpredictable as Vladimir Putin.

Corporate earnings remained rather resilient in 2022 but are likely to weaken through this year. Executives are clearly

preparing for an economic slowdown. Still, equity valuations by most traditional measures, look attractive even given a forecast for modestly lower earnings. 2023 is likely to be a good year for equity investors. Many strategists believe the markets will be choppy early on but finish higher with positive returns coming in the second half of the year. Don't be surprised though, if the markets anticipate the positive changes and rally sooner.

### *Positives*

Inflation continues to moderate

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Equity valuations

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Warmer weather in Europe easing energy concerns

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### *Negatives*

Falling corporate earnings

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Recession potential

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### *Unknowns*

Federal Reserve – when do they pause and pivot

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## FIXED INCOME OUTLOOK

### *Summary*

The bond market was unable to follow up November's historically strong monthly return as it lost ground again in December. Hopes of another positive month were dashed mid-month after the Fed increased the overnight rate by another 50 basis points (bps). While this was smaller than the four previous hikes of 75 bps, the messaging was clear that more increases should be expected and investors should not expect a reversal of policy in 2023. Yields increased across the curve as this hawkish tone combined with generally stronger-than-expected economic and inflation data. The 2-year Treasury note rose by 12 bps to 4.43% and the 10-year increased 27 bps to 3.88%. The Bloomberg Aggregate Bond Index had a monthly return of -0.45% while their Government/Credit Index delivered -0.48%. Without longer maturity bonds, the Intermediate Government/Credit Index was -0.18%. That made nine months of negative returns compared to only three months of positive for 2022. Volatility also remained elevated as for each month of the year, the high-to-low trading range for the 10-year Treasury note was above the long-run average.

Fortunately, credit spreads were able to hold onto the tighter levels reached in November allowing corporate bonds to deliver better, or slightly less negative, returns for the month. Intermediate investment-grade corporate bonds delivered a return of -0.07% with industrial companies trailing at -0.21% but financial company bond returns were actually positive at 0.08%. For the year, the Bloomberg Aggregate Bond Index had a return of -13.01% while their Government/Credit Index delivered -13.58%. The Intermediate Government/Credit Index was -8.23%. The magnitude of these returns is about four times the previous worse year of 1994.

With no meeting in January, the Fed is widely expected to again increase the overnight rate by 25 bps in February with an outside chance of 50 bps. By June, expectations are they will have increased by a total of 75 bps to a range of 5.00% to 5.25%. A lot can happen between now and then, but if they do increase by this amount and the economy is not significantly impaired, shorter maturity bond yields will likely increase modestly from current levels and should drag longer yields higher as well. But if the economy shows signs of slowing and inflationary pressures continue to ease, the Fed might not

increase rates at all after the February meeting. In that case, yields could trend modestly lower on anticipation of cuts late in the year or early in 2024. We are prone to lean toward the second of these scenarios and look for bonds to have solidly-positive returns for the year. Barring a severe recession, credit spreads could narrow further as well, allowing corporate bonds to outperform Treasury debt.

### *Positives*

Without the impact of housing, inflation data is already weakening Long-run inflation expectations remain anchored

Investment-grade yields reached 15-year highs

U.S. corporate bond yields still attractive with spreads near long-run average

### *Negatives*

Fed remains committed to squashing inflation. This is their "Volker Moment"

Overnight rate to increase further and could remain elevated the entire year

The yield curve is already near historical inversion levels

### *Unknowns*

Fed's ability to reduce their balance sheet and the impact on market liquidity

Resolution of the Russia/Ukraine war and its impact on inflation going forward