

ECONOMIC OUTLOOK

Summary

The Federal Reserve has telegraphed slow growth this year by forecasting a paltry 0.4% increase to GDP in their latest “Summary of Economic Projections.” While below-trend annual growth is not typically the objective, that type of result would likely gratify Fed officials since they have been transparent in their mission to tame inflation by slowing the economy and increasing the unemployment rate. By establishing the steepest start to a rate-hiking cycle in history, they have shown just how seriously they take that mission. However, nearly 14 months after their first hike, it appears the message has yet to reach the consumer.

Although first-quarter GDP came in below expectations (1.1% vs. 1.9% est.), it was positive almost single-handedly due to private consumption. By adding 2.48% to GDP this quarter, consumption surprised to the upside with its largest increase since the start of the rate-hiking cycle. Digging further into the details, the ratio of goods to services finally resembles pre-pandemic levels, with goods contributing a positive value to GDP for the first time in a year. If not for the 2.26% that inventories detracted from GDP, it would have been a much stronger report than anyone anticipated.

Unfortunately, the more strength shown by the consumer, the more likely inflation will remain elevated. Inflation is already decreasing at a slower pace than expected and certain data points bring pause to how quickly we might get close to a 2% target. For example, there were nearly a million jobs added to the economy in the first quarter and the unemployment rate remains near historic lows at 3.4%. Durable goods orders easily beat March expectations, and the Employment Cost Index (ECI), which includes wage data as well as benefits paid by companies, remains near 5% year-over-year. While we are likely past peak inflation, that doesn’t mean inflation is behind us.

Will 2023 GDP finish the year near the Fed’s target? That remains to be seen. The economic impact of the recent bank failures is still to be determined. As a source of lending, banks have more of a material impact on economic growth than some other sectors might. However, if the first quarter is any indication, it might come down to the consumer. Corporate earnings have been generally positive and as long as the consumer continues strong spending habits, it could reduce the expectation the Fed will cut rates.

Positives

April job growth exceeded expectations (253k vs. 185k est.)

Headline CPI in March dropped considerably (0.1%)

Factory orders had the second-highest level in the past six months (0.9%)

Negatives

ISM Manufacturing has been in contractionary territory for six consecutive months

Productivity decreased (-2.7%) while unit labor costs increased (6.3%) in Q1

Pending home sales were substantially weaker than expected in March (-5.2% vs. +0.8% est.)

EQUITY OUTLOOK

Summary

Equity markets were surprisingly docile in April especially given the number of crosscurrents impacting the economy and capital markets. The S&P 500 added 1.6% during the month and extended its year-to-date gain to 9.2%, much to the surprise of many market prognosticators expecting weaker results. April performance was also tightly bunched across styles, geography, size and economic sector with no noteworthy outliers.

We are now more than half way through earnings season and the results have largely been better than expected. Big Tech earnings have proven quite resilient with early cost-cutting efforts having a positive impact. Bank results, in light of recent events, have been mixed with larger, better-insulated money-center banks outperforming their regional bank peers. Companies more closely impacted by consumer spending have pointed towards slower activity but certainly nothing suggesting a recession is immanent at this point.

In spite of market action to begin the year, many potential concerns remain on the horizon. The debt ceiling debate is accelerating to the forefront with market-moving political posturing likely in the coming weeks. Inflation continues to moderate but is still far away from the Fed's target making the exact forward policy path uncertain. The war in Ukraine is expected to escalate, which could result in some market repercussions. Still, these issues have been largely discounted

by markets for some time and stocks have still been content to climb the wall of worry. Volatility is probable as we move through the summer but as more clarity is provided regarding these various matters stocks may very well continue to surprise on the upside.

Positives

Inflation continues to cool

Fed hinting at a pause

Aggressive cost cutting supporting corporate earnings results

Negatives

Labor markets remain tight

Regional bank concerns continue

Unknowns

2023 recession - a coin flip

FIXED INCOME OUTLOOK

Summary

Following more than a year of elevated intra-month volatility, during April the 10-year Treasury note finally traded in a high-low range that was slightly smaller than the long-run monthly average. This came despite a ramp-up in the option market's implied volatility, as measured by the Merrill Lynch Option Volatility Estimate (MOVE) index, which hit its highest level since 2009. Likewise, credit spreads also traded in a relatively narrow nine basis point (bp) range for the month following a dramatic rise, then fall in March. It seemed that bond investors were trading lightly as they weighed the turmoil in the regional banks against further Fed interest rate increases. Overall for the month there was less than 10 bps change in yields across the curve as the 2-year note ended at 4.00%, the 10-year note ended at 3.42% and the 30-year came in at 3.67%. The Bloomberg Aggregate and Intermediate Government/Credit Indexes delivered an equal return of 0.61%. Adding additional duration exposure produced only a few bps of additional return as the full duration Bloomberg Government/Credit Index returned 0.63%. With a higher-base yield and credit spreads narrowing a few bps, investment-grade corporate bond returns bested Treasury returns by 23 bps (0.77% vs. 0.54%).

With the early May rate hike, the Fed is likely done for the cycle. Their post-meeting press release no longer mentioned they anticipate some additional policy firming may be appropriate. They now indicate they will be more data dependent without an expectation for further rate increases. To reinforce the revised outlook, Chairman Powell twice reiterated that the change in the statement was meaningful. But along with the revised statement, he also repeated from past meetings that the committee does not expect to be cutting rates this year. According to the Fed Funds futures market there is a significant divergence in the market's expectations and those of the Federal Reserve's Open Market Committee (FOMC). Along with no additional increases, the market is pricing for three rate cuts this year and a fourth in January 2024.

No one knows how this crisis of confidence in the regional banking system will end, nor can we perfectly measure the

impact the tightening credit will have. But directionally, the failure of three sizable regional banks will undoubtedly impair economic growth as access to capital becomes more difficult and expensive to obtain. With inflation remaining stubbornly high and the labor market robust, much of rate cut case hinges on this weakness arising from the banking sector. While the need for rate cuts may come before year's end, we believe the Fed will risk erring in an effort to maintain some level of credibility. If they were to reverse policy quickly, they understand their forward guidance would be less impactful as a policy tool. For this reason, we believe the market has moved too far in expecting multiple rate cuts. If we are correct, the 2-year yield could climb above the 4% level and stay there for a while. Longer-maturity yields could tag along higher, but should remain less sensitive to the overnight rate. While we still believe the multiyear bear market for bond investors is over, there may be some bumps ahead.

Positives

The Fed is likely done increasing the overnight rate

U.S. corporate bond spreads are attractive but selection is critical

Negatives

The market has probably over anticipated rate cuts

Inflation statistics easing but at a slower pace

Unknowns

Resolution of regional bank concerns and deposit flight

Geopolitical tensions with China; Russia/Ukraine war

Simplifying Life