ECONOMIC OUTLOOK

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unique investment insight

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Fed Determined To Stay The Course As Markets Expect Rate Pivot

Last year started with high hopes for continued global expansion as supply chains recovered, interest rates remained low, and the pandemic receded. A year ago, the Federal Reserve still thought inflation was temporary and set short-term interest rates near 0%, but inflation turned out to be higher and more persistent than anticipated. Easy monetary policy and government aid that was crucial to support the economy during the height of the pandemic - and since the 2008 financial crisis - fueled demand as the pandemic waned and consumer spending snapped back. Exacerbating already emerging inflation was Russia's invasion of Ukraine which led to a severe energy and food crisis. Global central banks reacted to the steep rise in prices by raising rates repeatedly to try to curb growth and lower inflation. The Federal Reserve raised interest rates seven times in 2022 from near 0% to a range of 4.25% to 4.50% - the fastest pace since the 1980's - to cool the economy and combat inflation that surged to a forty year high over the summer.

At the same time, there were positive developments in 2022 in areas such as trade, employment, and wages. In an era of increasing de-globalization and bringing manufacturing closer to home, global trade reached a new high of $32 trillion. High inflation is worrisome, but the trend has been downward as supply chains ease and the aggressive Fed interest rate hikes curb demand. Commodity prices have abated with Brent crude falling from $130 a barrel in March to $76 recently, about the same level as before the invasion. In recent years, there have been significant wage gains, robust employment, and a drop in poverty. Even social security is set for a cost-of-living increase of 8.7% in 2023. Employment gains have been strong and unemployment in December was 3.5%, the same rate as in February 2020. Finally, there are $400 billion in new clean energy programs in the U.S., and billions more in funding from Europe, to cut reliance on Russian and foreign energy. Public investment is key to developing meaningful technology (e.g., internet, jet engines) and can spark inventions.

Under most scenarios, 2023 is set to be a difficult year. Major global economies such as the U.S., Europe, and China are all slowing and demand is expected to soften. China recently lifted Covid restrictions which will lift spending. War in Ukraine, rising prices, higher interest rates, and tighter monetary policy, are all weighing on consumers and businesses. Recent weakness in commodity prices is good news for the Fed in its fight to lower inflation, but also an indication of lower demand. Even though inflation in December eased for the sixth straight month to 6.5%, Fed members such as Minnesota Fed Governor Neel Kashkari are adamant that inflation should reach the Fed's target of 2% before stopping increases even if this means a recession. The reason is akin to "saving face" or losing respect – if the Fed is not able to beat inflation, then they lose credibility. Many economists are concerned that since the Fed failed to act on inflation sooner, they are over-compensating with more rate hikes in 2023 even with clear signs that inflation is moderating.

U.S. Economy

U.S. GDP expanded in the third quarter at 3.2% driven by personal consumption and spending on services. The positive GDP came after two consecutive negative quarters in the first half of the year. Unfortunately, outside of services, consumer spending on durable goods fell 0.8%. Inflation is trending lower, but is still high at 6.5% in December with the PCE price index (excludes food and energy), rising at 4.7% pace, ahead of the Fed's target of 2%. The Fed is trying to bring inflation back down to 2.0% with aggressive rate hikes and there will likely be more increases in 2023. The concern is the rate increases will slow the economy to the point of recession. With the economic data softening, the Fed lowered its GDP growth forecast for 2023 from 1.2% in September to 0.5% in December and raised the median Fed funds rate projection from 4.6% to 5.1%.

Consumer and Manufacturing

Credit card balances ended the year at $934 billion, about 15% over the last year and the highest on record. With consumer's expenses higher due to inflation and pandemic savings exhausted, credit cards were used to fill the gap. Nearly half, or 46%, rolled over debt month to month, up from 39% last year. Consumer confidence trends are subdued and consumer spending growth rates have cooled, despite low unemployment and higher wages. The University of Michigan's consumer sentiment index in December was higher month-over-month, but was still close to the lowest level in 40 years. Auto sales have recovered from pandemic lows, but the industry is still dealing with supply chain issues and now higher interest rates. In December, the Manufacturing Purchasing Managers Index contracted for the second month after 29 straight months of expansion and is at the lowest level since the beginning of the pandemic.

Employment

The U.S. labor market is losing momentum as hiring and wage growth slowed in December. Employers added 223,000 jobs according to the Labor Department, an indication of slower economic growth. On the positive side, employers added 4.5 million jobs in 2022, the second best after the 6.7 million jobs in 2021. The unemployment rate fell to 3.5%, the same level as February 2020. The labor market has been resilient in 2022 and job openings are still higher than average at 10.5 million. The pace of hiring cooled in the second half of 2022 with several large employers either laying off workers or planning cuts for 2023. Wage growth is robust with average hourly wages up 4.6% in December over last year although the rate of increase is down from the March peak of 5.6%. A recent report in the Wall Street Journal noted that small-business owners, after two years of struggling to find and keep workers in a tight labor market, are finding it easier to hire.

Real Estate

High home prices and high mortgage rates - the average rate on a 30-year fixed-rate mortgage was recently over 6% - have slowed sales. Existing home sales declined 7.7% in November from October and 35.4% since November 2021 according to the National Association of Realtors. After rising 25% over the past two years, rents are falling in some areas. Nearly 500,000 new apartment units, the most since 1986, are expected to be completed in 2023 and should help keep rents stable. Office space demand is weak with about 212 million square feet of space currently available, compared with 109 million in 2019 according to CoStar Group. The vacancy rate continues to creep up from 9.2% at the end of 2019 to 12.3% at the end of September. Part of the issue is the change to hybrid or remote office work that is lowering demand - only about 50% of workers are currently in NYC business districts on any given workday.

World Economy

Europe

After months of fearing low supplies of natural gas during the winter, a mild winter so far is lowering consumption of costly energy and helping consumers while preserving corporate margins. Economic growth in Europe slowed from 4.2% in the second quarter to 2.3% in the third quarter, as growth in consumer demand was offset by higher import prices, weak exports, and high inflation. Inflation data for Europe continues to trend in the right direction although it is still elevated. CPI in the eurozone in December was 9.2% after a 10.1% reading in November – sparking hope across Europe that inflation has peaked. December CPI in France was 6.7% over last year, down from 7.1% in November. The European Central Bank raised rates from 1.5% to 2% in December and said it would need to raise rates "significantly" higher to tame inflation. Held back by war in Ukraine, high energy and food prices, weak confidence, and tighter monetary policy, annual growth in the eurozone in 2023 is projected by the OECD to be 0.5%, after rising 3.3% in 2022.

In the U.K., the consumer price index rose 10.7% in November, a slight drop from October's 11.1%, a 41-year high. Rising prices due to higher energy costs with the war in Ukraine have hit consumers and businesses and economic growth contracted 0.3% in the third quarter. The Bank of England has hiked rates to 3.5%, the highest since 2008. Households are feeling the pinch of higher costs – consumer borrowing rose $1.8 billion in November, driven by a surge in credit card usage – a trend also apparent in the U.S.

China and Emerging Markets

In China, activity deteriorated in 2022 due to repeated lockdowns, droughts, and property sector stress. In all, GDP slowed to 3.0% and, with the exception of 2020, is the weakest pace of growth since the 1970's. Housing starts, property sales, and home prices have continued to decline with some property developers defaulting on debt. Purchasing Managers Indices for both manufacturing and service sectors fell to their lowest levels since the early days of the pandemic. With the economy reopening this year, we expect these indicators to turn positive again. Emerging markets were also hurt by higher inflation, tighter financial conditions, and lower consumer demand. India remains a bright spot with 2022 growth estimated at 6.9% by the World Bank. India's population is set to overtake China in 2023 with 1.4 billion people. After growing 5.8% in 2021, the OECD forecasts global GDP growth of 3.0% in 2022 and 2.2% in 2023, revised down from 2.8% in June. The World Bank forecasts a sharp downturn and revised their 2023 global growth forecast from 3.0% in June to 1.7% in January, citing global tight monetary policy to fight high inflation and the Russian/Ukraine war.

Commodities

Although oil prices failed to hold on to their gains after Russia invaded Ukraine, energy stocks still posted modest gains and were one of the few positive sectors in 2022. For the year, Brent was up about 10%, closing at $86 at year-end after reaching $130 in March. U.S. shale production averaged 620,000 barrels per day, short of forecasts of a million barrels per day at the beginning of the year. Headwinds to increasing production include lower quality wells (the best wells are drilled first), increased costs, and long lead-times for new drilling permits. Gold managed to end the year basically unchanged at $1,812 an ounce and rallied +11% from the November 3rd low. Gold prices were flat in U.S. dollar terms, but closed +12% against sterling, +6% against the euro, and +1% against the Swiss franc. With the stock and bond markets down double digits, gold did a good job as ballast in investment portfolios.

Investment Perspective

Higher interest rates sent global equity markets tumbling in 2022 with the steepest downturn since the financial crisis in 2008 - the S&P 500 lost 19.4% or 18.1% after dividends and the Bloomberg U.S. Aggregate Bond Index was down 13.0%. Investors at the start of 2022 were predicting that inflation would be transitory and the Fed would not raise rates aggressively. Instead, consumer demand and the war in Ukraine sent oil and commodity prices soaring while tighter monetary policy curbed interest rate sensitive investments. Low interest rates or easy monetary policy were set by the Federal Reserve after the financial crisis to revive the economy and encourage investors to buy riskier assets. Low mortgage rates also aided the housing market. As former Fed Chair Ben Bernanke explained, "Easier monetary policy, for example, raises stock prices. Higher stock prices increase the wealth of households, prompting consumers to spend more - a result known as the wealth effect." Bernanke does not address the reverse of this policy – higher rates or tighter monetary policy.

There are positive signs. Prices for goods and inflation are falling which will help consumers and businesses while lowering the probability of more large rate hikes by the Fed. Wages remain robust and unemployment is still low. Europe's economy shows signs of resilience as falling energy prices and government intervention support the economy. China is reopening after years of lockdowns and a Covid wave. This will both smooth out supply kinks and foster demand. Of course, there are also many worries including the war in Ukraine, decelerating global growth, a possible recession, rising interest rates, consumer debt, and tighter monetary policy. In addition, there are possible financial shocks such as the inability of Congress to raise the debt ceiling. The Conference Board's Leading Economic Index (LEI) has been sliding for the past nine months and fell 1.0% in November due to weaker labor markets, manufacturing, and housing.

Analysts expect S&P 500 earnings to decline -4.1% this quarter, the first loss since the height of the pandemic in 2020 according to FactSet. Bond prices dropped drastically in 2022. The yield on the 10-year Treasury ended 2022 at 3.8%, up from 1.5% at year-end 2021, and the 2-year at 4.4%. Inverted yield curves – when short-term yields are above long-term yields - are a recession warning sign and have preceded all recessions since WWII. For bonds, we favor higher quality fixed income and Treasury Inflation Protected Securities (TIPS). Equities offer the chance for longer-term growth, but are still expensive based on fundamentals such as price/sales and price/earnings. In past cycles, the stock market usually does not bottom until the Fed finishes raising rates. For sectors, we favor materials, energy, healthcare, and industrials. We still like dividend paying stocks, developed international equities, and precious metals. We look for companies with strong financials, sustainable growth, a strong competitive position, good management, and reasonable valuations. Remember that it is impossible to predict what percentage up or down the market will be on any December 31st, but equities tend to rise over long periods. In the face of falling inflation, the Fed is determined to raise rates enough to slow the economy and bring inflation to 2%. Although a majority of economists are forecasting a recession in 2023, many predict a mild downturn assuming inflation keeps falling and the Fed stops raising rates or pivots to cut rates in the second half of the year. As we brace ourselves for continued volatility, we invest for the long-term and remain vigilant.

December 31, 2022
DJIA: 33,147.25
S&P 500: 3,839.50

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