

ECONOMIC OUTLOOK

Summary

Positive economic data has been plentiful during the last week of January, providing further belief a soft landing may still be possible. Releases such as Q4 GDP, payrolls, ISM Services, and the Employment Cost Index (ECI) exceeded expectations. However, as we piece together the continuously changing economic jigsaw puzzle, most of this data can have different meanings based on how it's interpreted.

For example, fourth-quarter GDP beat expectations as the economy grew by 2.9%, which lifted full-year GDP growth for 2022 to 1%. This type of scenario seemed improbable just six months ago, when we experienced consecutive quarterly declines of -1.6% and -0.6%. While positive economic surprises are always welcome, the underlying data showed some flaws. For example, consumers were not as strong as expected, with spending coming in 0.8% below consensus. These high expectations caused companies to build up inventories in anticipation of a big holiday shopping season that didn't materialize. The ensuing inventory buildup accounted for nearly half of GDP growth in Q4, and a weaker consumer portends lower GDP growth expectations for 2023.

Additionally, the most recent payroll report showed 517k jobs created in January, beating expectations by 329k. And on top of that, benchmark revisions to prior data caused December to increase to 813k. That is roughly one million more employees in the workforce than were expected at the time of the payroll release. Obviously, more people employed means more people spending and contributing to the economy, which is clearly a positive sign. Although, with the Federal Reserve's belief that a strong labor market will keep inflationary pressures elevated through higher wages, they may be more inclined to continue rate hikes further than bond market investors have been anticipating.

Perhaps those wage concerns are a bit muted now, given the positive news from the ECI data. Employment cost decreased to its lowest levels since year-end 2021, suggesting the rapid wage increases seen during 2022 might now be behind us. However, that inflationary input may have been offset by the fact that ISM Services unexpectedly jumped back into expansionary territory, which would otherwise be considered an economic positive.

In short, the overall picture still remains blurry, and it will likely remain that way through the first half of the year. The future of the economy largely depends on how high the Fed takes the overnight rate. We could get some clarity if inflation, average hourly earnings, and the ECI continue to trend lower throughout the next couple of months, but each strong payroll report or elevated CPI print will only distort the image further.

Positives

The unemployment rate remains at a 50-plus-year low (3.4%)

Unit Labor Costs have declined to a two year low (1.1%)

Headline CPI declined for the third consecutive month

Negatives

Personal consumption missed expectations by 0.8% (2.1% vs. 2.9% est.)

Retail sales had their second consecutive negative month (-1.1%)

Job Openings and Labor Turnover Survey (JOLTS) job openings increased by more than 500k, to 11 million

EQUITY OUTLOOK

Summary

After a challenging year last year, the markets got off on solid footing to start for 2023. The S&P 500 rallied 6.3% in January. Historically, a strong start like that bodes well for the balance of the year, but there are certainly a number of cross currents with which to contend. The stock market advance during the month was broad in terms of style, size and geography.

Inflation had been, in our opinion, one of the primary catalysts for the market's decline but it now appears to be easing. The Federal Reserve seems to be in the final innings of their hiking cycle even though they've left open the option for further action. Stocks have responded mostly positively to Fed policy in recent weeks. This has been a welcome change, but we still need to be wary of a possible policy error or change in conditions that would alter the Fed's path.

While we remain bullish on the equity outlook for 2023, the fast start to the year may be a bit too much too fast. Macro-economic conditions are still a concern and earnings results and guidance have been less than spectacular. Investors in stocks should expect some fits and starts as the year progresses.

The reasonable equity valuations created by the multiple compression of 2022 has created a positive backdrop for long-term investors. The year could generally be a gradual stair step higher with plenty of 3% to 5% advances and declines along the way.

Positives

Fed acknowledging inflation progress

Equity valuations

Negatives

Softening economic conditions

Falling corporate earnings and guidance

FIXED INCOME OUTLOOK

Summary

The bond market kicked off the New Year with a 50 basis point (bp) rally on the 10-year Treasury note as it dropped to 3.37% in mid-January. Likewise, the 2-year Treasury note declined from 4.43% at year's end to 4.08% on January 17. With economic data coming in mostly as expected and no other major catalyst for the move, it appears that much of it was simply a rebound from late December tax loss selling. Following this powerful move, yields trended slightly higher while trading in a narrower range for the rest of the month. In all, the 2-year yield declined by 23 bps and yields from 3-years to 30-years declined by 33 bps to 40 bps. The Treasury market delivered a solid monthly return of 2.51% with intermediate-maturity bonds returning 1.60%.

Corporate bonds had a stellar month as investment-grade spreads narrowed by 13 bps on average. The sector had a monthly return of 4.01% with intermediate-maturity bonds gaining 2.52%. With a modest level of new supply to start the year, finance company bonds were the best subsector on a duration-adjusted basis. Mortgage-backed securities also outperformed Treasury notes as volatility subsided later in the month. The Bloomberg Aggregate Bond Index had its fifth-best monthly return in the past 30 years at 3.08%. Without mortgage bonds, the Government/Credit Index had a return of 3.01% while the intermediate version of that index delivered 1.87%.

Coming into this year we have a much narrower range of possibilities for the overnight rate compared to last year. Last year the Fed thought they would increase the rate by 75 bps total when they ended up increasing it by 4.25%. This year we are quite confident they will increase the overnight rate by no more than 50 bps following the February 1 increase of 25 bps. The easing of inflationary pressures and modest softening of the economy has significantly diminished the probability of much higher rates. Still, based on a handful of observations in the past 40 years, many forecasters and strategists have asserted the market is either mispriced and

longer yields have to increase, or the market is correctly anticipating a severe recession. While we do not dismiss the possibility of a mild recession this year, we think the inverted curve is properly pricing the currently elevated overnight rate with the expectation the Fed will cut rates sometime later in the year or in 2024. The Fed is then expected to get to their long-run neutral rate of 2.50% by 2026. Longer-term rates will continue to bounce around but we believe we are unlikely to break through the yields seen last fall even if the Fed holds rates steady above 5% for most of this year. Barring some exogenous shock, we may experience the longest period of curve inversion in history.

Positives

Overall inflation data is softening, particularly in the goods sector

Nearing the end of the Fed's rate hiking cycle

U.S. corporate bond spreads closer to average, but still attractive

Negatives

Fed still to increase the overnight rate in March and possibly May

The yield curve inversion to remain into 2024

Unknowns

Fed's continued efforts to reduce their balance sheet

Geopolitical tensions with China; Russia/Ukraine war