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# Economic & Market Outlook

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After a yearlong bear market marked by high inflation and several failed market rallies, central bankers around the globe may be closer to ending their aggressive tightening polices as the economy slows and inflation dissipates.

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## GLOBAL ECONOMY

- Certain sectors of the U.S. economy are already in recession. Housing is in decline as the combination of sharply higher prices and 7%+ mortgage rates are taking potential buyers out of the market. Homebuilder activity has slowed dramatically. Sellers of existing homes are also pulling their homes off the market, keeping inventory in this sector relatively constrained. Unlike the situation prior to the great financial crisis of 2007–2009, there is no discernible inventory glut in housing, which should allow the decline to be relatively mild.
- Other sectors of the economy continued to show growth at the start of the fourth quarter. Consumer spending is being bolstered by jobs and wage growth as well as the drawdown of excess savings built up during the coronavirus pandemic. Capital spending, particularly on technology equipment, grew in the third quarter but is slowing as businesses assess the impact of higher interest rates on overall economic growth. While growth will be challenged moving into 2023 as monetary and fiscal policies remain tight, the lack of notable excess inventory buildup within the economy should prevent a deep economic downturn.
- Inflation rates in the United States appear to have peaked but are declining at too slow a rate for the Federal Reserve (Fed) to take its foot off the brake at this time. Stickiness in rental and health care inflation is masking the improvement being seen in certain goods sectors. In a service-driven economy, wage inflation will be watched most closely for signs of either improvement or potential entrenchment of price pressures.
- Europe has experienced positive economic growth so far in 2022, as the reopening of the economy has helped revive tourism and other service industries that benefit the southern-tier countries. The easing of supply chain constraints has helped industrial sectors return closer to pre-pandemic production levels. Tighter monetary policies plus dramatic increases in energy prices, which will likely remain at high levels into the winter, should lead to recession in a number of European economies in 2023.
- Economic growth in China slowed to 3.9% during the third quarter and will be constrained going into 2023 by high debt levels in the property sector, continued trade frictions with the United States and the maintenance of zero-COVID policies, which restrict mobility and impact production. The country appears to be looking inward as President Xi Jinping has effectively consolidated power, and there is likely enough domestic demand to prevent growth from declining too much from current levels. However, it will be difficult to point to China as the leader of global growth and the inevitable usurper of global domination over the next few years.

## MONETARY POLICY

- To fight generationally high and stubborn inflation, the Fed has engineered a dramatic tightening of monetary policy this year, which has taken the federal funds rate from basically zero at the beginning of the year to 4.0% with the recent rate increase of 75 basis points (bps) announced at the beginning of the month. After another 50–75 bps rate increase expected at the December meeting, Fed officials are beginning to give signals that they are willing to hold off on further rate increases to better assess the lagged impact of monetary tightening on the economy. Of course, the end of monetary tightening will be dependent on tangible progress in lowering the inflation rate moving into next year.
- The European Central Bank (ECB) has not been as aggressive as the Fed in normalizing rates primarily due to the more severe effect higher energy prices are expected to have on its economies. During the recent meeting when the ECB tightened by 75 bps to 1.50%, there were three dissenters in the voting bloc that preferred a rate increase of only 50 bps. In addition to the Bank of Canada recently surprising markets with only a 50 bps rate increase, there are growing signs that

global central bankers, who generally only have an inflation mandate, are beginning to worry more about the economic damage that can be done by tightening too aggressively into an already slowing economy.

» The Bank of Japan continues to flaunt the global tightening trends by keeping its policy rate at zero and controlling rates at the short- to intermediate-maturity levels. These policies have caused the Japanese yen to plummet and inflation to rise, but Japanese officials have been seeking sustained inflation for nearly 20 years so expect no change to this central bank policy as they rely on their finance ministry to control currency depreciation and prevent excessive capital outflows.

» The People's Bank of China (PBOC) has always had greater flexibility to ease than the developed market central banks as its policy rates were never brought down to zero. However, PBOC officials have used this flexibility judiciously as they look to control the depreciation of the Chinese renminbi.

## BOND MARKETS

» The anticipated gradual decline in inflation rates should suggest a near-term end to Fed rate increases and an end to the advance in yields across the maturity spectrum. The 10-year U.S. Treasury Note yield is expected to stop increasing when it gets to the 4.50% level, although the continued inversion of the yield curve may be signaling a peak being formed at early November levels should the economy indeed be on the precipice of recession. Yields at current levels are now much more competitive with equities and could be considered attractive assuming the inflation rate quickly moves down to 4% or lower.

» High-yield bond spreads to like-maturity government bonds have widened as concerns grow about an oncoming recession and subsequent increase in default risk. However, spreads have not widened to levels hit during past recessions, but they have widened enough to provide very attractive real yields when adjusted for inflation.

» Emerging market debt would benefit greatly from an end to the strong U.S. dollar appreciation seen over the past few years. Yields are attractive in the asset class, but credit risk is more palpable as several emerging economies are struggling with growth and growing trade deficits.

## EQUITY MARKETS

» Although interest rates are likely to increase a little more before monetary tightening ends, the valuation contraction portion of the bear market is likely complete with the focus turning to earnings. Third quarter earnings slowed but did not collapse as many industries were able to maintain most of their margins by passing along cost increases to consumers. Input costs for materials are beginning to come down with wage growth at least stabilizing, so unit demand for goods and services will be the most important driver of earnings growth in the coming quarters. Slower growth, but not a decrease in overall demand, should prevent any sharp decline in earnings and a break below the mid-October lows.

» Developed international markets are less expensive than those in the United States, as they tend to be more heavily weighted toward the cyclical sectors. The severe energy price increases seen in many of these countries are likely to have more of an impact on their economies. A positive offset to this concern is that a large majority of companies in the asset class are multinationals whose earnings will benefit from still positive U.S. demand and the beneficial impact of currency translation on their earnings.

» Emerging markets equity performance will continue to be dominated by China and the concerning policy developments that are impacting

virtually the entire Asian region. Now that President Xi has effectively consolidated power within the government, expect some market-friendly monetary and fiscal policies that could somewhat offset the effects of further mobility restrictions and ongoing trade friction with the United States.

## COMMODITIES & CURRENCIES

- Oil prices appear to have settled into a trading range buffered on one side by the global economic slowdown, which should rein in demand, and on the other by the specter of further supply restrictions in a volatile geopolitical environment. Less volatile energy prices will help ease global inflationary concerns.
- Industrial and agricultural commodities have also stabilized somewhat after the pandemic and war-induced supply and demand shocks. Russia is intimating that it may restrict the export of Ukrainian wheat, so investors must be prepared for the continued weaponization of energy and food products, as the war has apparently turned from one of aggression to attrition as Ukraine has provided surprisingly stiff resistance.
- Gold and other precious metals have performed poorly in a strong Fed tightening environment and have not provided the traditional inflation hedge expected of these investments. The prospective end of monetary tightening may relieve some of the selling pressure if the global economy is able to avoid a deep recession.
- The U.S. dollar may be merely experiencing a brief respite from its sharp year-to-date advance against most currencies. But as the Fed appears to be near the end of its rate increase policies, the greenback should settle into a rather narrow trading range for the remainder of the year.

## WHAT THIS MEANS FOR INVESTORS

There are growing, albeit somewhat anecdotal, indications that the Fed and other central banks may be near the end of their respective tightening cycles as the economy slows and inflation dissipates. This sentiment has helped propel rallies in this yearlong bear market, but the advances have ultimately fizzled as inflation rates have remained higher than expected and central bankers have been forced to be even more aggressive in raising rates.

While policymakers would like to soften demand somewhat and loosen labor markets, the inherent strength and resiliency of the U.S. economy is making this difficult to achieve. But continued consumer spending growth should allow for the general maintenance of profit margins and any shortfall in earnings to be relatively mild.



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