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Economic & Market Outlook

DECEMBER 2022

Despite the persistency of inflation and the magnitude of rate increases in 2022, the economy has generally remained resilient, buoyed by the inherent strength of the U.S. consumer and a strong labor market.

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GLOBAL ECONOMY

- Although the housing market is in a mild recession, all other parts of the U.S. economy are showing enough strength to produce growth for the overall economy as 2022 comes to an end. Consumers are using their savings and increasing their debt levels to an extent to fuel what should be a rather robust holiday spending season. The major driver of consumer spending continues to be jobs and wage growth. Businesses are indicating greater caution around spending in the various purchasing managers' surveys, but the actual spend on technology and other capital projects continues to grow in the fourth quarter.
- The October inflation report showed initial signs of a distinct slowing and in some cases an outright decline in certain goods and some services prices. Shelter inflation has remained uncomfortably high, but a reported fall in housing prices should begin to work its way into lower inflation rates in this sector as well. Energy prices will continue to be an inflation wild card due to the potential for further geopolitically driven supply constraints. Continued monthly progress in reducing inflation should forestall more aggressive monetary tightening thus allowing a slowing of the economy as opposed to a recession.
- Broader economic reopening and some easing in supply constraints have allowed European economies to avoid recession despite sharply higher energy prices. Monetary tightening and continued high natural gas prices will be difficult for economies in the region to overcome in 2023, but weaker currencies and still positive global growth should help their important export sectors and keep any overall economic recession rather shallow.
- Ill-conceived and harshly implemented "zero-COVID" policies in China have sparked surprisingly large public protests, which may convince the government to somewhat relax the more severe lockdown restrictions. While Chinese officials are poised to assist the beleaguered property sector, economic growth will continue to slow into 2023 with Grodomestic product growth forecasts in the low to mid-3% range.

MONETARY POLICY

- In a speech at the end of November, Federal Reserve (Fed) Chair Jerome Powell indicated a slowing in the magnitude of rate increases at the Fed's upcoming Federal Open Market Committee meeting, which markets are interpreting as the beginning of the end of the monetary tightening cycle. Expect a federal funds rate increase of 50 basis points (bps) at this month's meeting followed by another 25-bps rate increase in January. These two increases will bring the upper end of the range to 4.75%, which is likely the terminal rate at which the Fed stops tightening given the steady improvement expected in the inflation rate over the coming months.
- The European Central Bank and Bank of England have both been slower than the Fed in hiking rates, as their economies have been much more adversely impacted by the rise in energy prices. Both central banks have officially acknowledged the need to continue raising rates to battle inflation, but the recent decisions regarding rate hikes were not unanimous, with several governors growing more concerned that overly restrictive monetary policies can worsen any impending recession.
- Stronger signals the Fed may be close to the end of its tightening cycle has removed some pressure on the Bank of Japan to join the 2022 global tightening initiative as the Japanese yen has regained roughly 10% of its sharp year-to-date losses against the U.S. dollar over the past month. The Japanese central bank remains focused on achieving sustained inflation of roughly 2% and on controlling any increase in longer-term yields.
- The People's Bank of China maintains greater monetary policy flexibility to ease rates to help support economic growth and may become more emboldened to ease should the U.S. dollar continue to give back its gains. For now, the central bank will rely on its fiscal policy counterparts to provide the needed assistance in a slowing but still reasonably strong domestic economy.

BOND MARKETS

- The U.S. Treasury yield curve is now inverted across nearly the entire maturity spectrum in a sign the bond market believes the Fed may be tightening too much and is near the end of its tightening initiative. With economic growth expected to be comfortably positive in this quarter and next and the Fed still increasing rates at the short end of the curve for at least the next few months, intermediate-term rates should move higher with the 10-year U.S. Treasury Note yield again approaching and breaking through 4.0% early in the new year.
- An important offset to the inverted yield curve as a recessionary signal is the continued relaxation in high-yield bond spreads to same maturity Treasurys. The spreads are below the 20-year average and with rates having risen across the curve, the yields in this sector have become much more attractive to investors in a slowing but still positive economic growth environment.
- Yields are also attractive in the emerging markets debt space, but the economic forecasts in some of these countries are more tenuous. A major support to the asset class will be an expected end to U.S. dollar appreciation as the Fed slows and then stops rate increases in the near future.

EQUITY MARKETS

- With two distinct bear market rallies crushed by moves to lower lows over the spring and early fall, it is difficult to have complete confidence that the sharp rally off the mid-October lows is truly signaling the end of this bear market. As the year-to-date decline in equities has been primarily, if not solely, driven by interest rate increases that appear to be nearing an end, attention will now focus on the impact inflation and the rate increases have had on corporate earnings. Margins should contract somewhat as wages remain high, but other input costs are coming down with overall inflation, which should prevent substantial deterioration. Unit demand will be watched most closely over the coming months. Early indications around the holiday season are positive as consumers are responding to promotional discounting as retailers look to clear excess inventory.
- Despite the more severe impact on their economies from energy price increases, developed international equity markets have generally outperformed those in the United States this year when viewed in their local currencies. However, U.S. dollar strength through most of the year has totally offset this relative outperformance for unhedged U.S. dollar-based investors. Although most of the large cap companies in Europe and Japan are multinational in their scope of sales, deteriorating domestic conditions should pressure sales and margins somewhat in 2023.
- Emerging markets equity performance over the coming months will be largely dependent on the outlook in China and officials' willingness to relax draconian COVID-19 restrictions. Greater mobility liberalization will boost China's domestic economy and unleash a demand for energy and other commodities that will help the commodity-driven economies of the Latin American countries. A stable to declining U.S. dollar will also be helpful for markets in this asset class.

COMMODITIES & CURRENCIES

- Concerns around Chinese demand and since unfounded rumors of a possible OPEC+ supply increase caused downside volatility in oil prices in November. But positive global growth and the apparent desire of Russia to weaponize energy in its conflict with Western nations should cause oil and other energy prices to trend higher over the winter.
- Growing indications that the Fed may be near the end of its tightening policies have helped gold break its nine-month downtrend although

further price appreciation would be dependent upon the unlikely pivot of the central bank toward lower rates.

» The recent rally in global equity markets has been highly correlated with a decline in the U.S. dollar against other major currencies. It is difficult to forecast further substantial declines moving into 2023 given relative economic strength and level of rates which favor the United States. But the Fed being close to done tightening while other central banks catch up should prevent any damaging further appreciation in the greenback.

WHAT THIS MEANS FOR INVESTORS

» While 2022 has been all about inflation and the central bank response, 2023 equity and fixed-income returns will be driven by the ultimate impact prices and rate increases have on the global economy. The odds of a soft economic landing in the United States and Europe are narrowing given the persistency of inflation and the magnitude of rate increases, but the inherent strength of the U.S. consumer and labor economy should keep any recession short and shallow and arguably largely priced into equity markets at current levels.

» Interest rates should be close to topping out in this current cycle and have allowed bonds to become much more attractive for investors and viable competitors to equities when constructing portfolios. At these levels of rates, equities are likely fairly valued, but strong stock-picking skills will be at a greater premium in trying to avoid companies most vulnerable to significant earnings deterioration or valuation multiple contraction. The environment may continue to favor lower-multiple value stocks, which have performed relatively well so far this year.