# Economic & Market Update

MAY 2023 OUTLOOK

The U.S. economy is slowing yet expanding, with inflation rates decreasing and housing recession stabilizing. Lower energy prices and China's growth help delay a European recession. Central banks are adjusting rates, while equity markets advance. Investors should be cautious of further tightening and consider cash as a near-term alternative to bonds.

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## Global Economy

- The U.S. economy is clearly slowing, though still expanding at the beginning of the second quarter despite the cumulative effects of higher short term interest rates and an overall tightening in financial conditions (exacerbated by the ongoing turmoil in the banking sector). Consumer spending is being fueled by continued jobs and wage growth supplemented by an ample savings cushion. Businesses are expected to grow more cautious with their capital spend in this tighter financial environment but will need to maintain inventories and capacity to serve consumer demand. The housing recession appears to be bottoming as mortgage rates have peaked, and the need for new home inventory is emboldening the construction industry.
- Progress in bringing down the inflation rate closer to the Fed's target will remain key to the economic outlook, as the biggest risk to the developing soft-landing scenario is a monetary policy error of tightening too aggressively into an already slowing economy. Headline inflation has resumed its decline after some stalling in the first quarter, although core prices excluding food and energy have been more stubborn due to still high shelter and wage inflation. Shelter price improvement appears inevitable given the housing recession, so the Fed will be looking for a decline in wage inflation, which should be evident in the April and May employment reports.
- Lower energy prices and the broader reopening of the Chinese economy have been important elements in at least delaying the highly anticipated European recession. With inflation rates in continental Europe and the UK even higher than those in the U.S., policy error risks are even more pronounced as central bankers there have only a single price stability mandate.
- The elimination of Covid-induced mobility restrictions has helped revive growth in the Chinese economy, with obvious beneficial effects on neighboring Asian economies. Ongoing trade conflicts with the U.S. and the government's support of Russia in their war with Ukraine adds a meaningful geopolitical risk element to Chinese economic growth.

## Monetary Policy

- After the 25 bps rate increase announced in the May FOMC meeting, the Fed should soon be near the end of its yearlong tightening program as confidence grows that sufficient progress is being made in reducing inflation rates. Another more ominous reason for pausing rate increases now is the growing belief that financial conditions may be tightening too much and may revive concerns around deflation should tightening lead to a hard landing recession. The most likely scenario is a pause in rate increases while maintaining rates around current levels to assess the economic impact. A pivot to lower rates this year will only happen should the economy begin to falter notably over the summer.
- The Bank of England and European Central Bank both have only a price stability mandate, and with the rates of inflation remaining high throughout Europe, these central banks are likely to continue raising rates well into the summer. However, there is less unanimity in opinion in these committees than there is at the Fed and the undesirable impact on currencies of such policy differences may force the central bankers in Europe to ultimately follow the Fed's lead.
- Projections of an abrupt end to ultra-easy monetary policy and yield curve control at the Bank of Japan under new leader Kazuo Ueda appear to have been greatly exaggerated. Ueda is adopting a more gradual approach and has initially signaled that the BOJ requires greater confidence that inflation can remain at their 2.0% target before tightening policy.
- The People's Bank of China has sufficient flexibility to decrease rates to support the economy, but will be cautious in assessing the foreign currency impacts. The central bank may continue to prefer more unorthodox measures of easing, such as decreases in reserve requirement ratios, as opposed to outright rate decreases.

## Bond Markets

- Resolution of the inverted treasury yield curve is likely to come from a combination of rising intermediate maturity rates in a slower, but still positively growing, economy with a gradual decline in short rates, as the Fed will be able to take its foot off the monetary brakes as inflation rates continue to decline.
- The municipal bond market tends to have better credit dynamics than the corporate bond market over the longer term. However, lower tax revenues in a slower growth environment, and some notable tax-induced demographic shifts, may put some near-term pressure on credits in certain states.
- Any notable spread widening in the high yield debt space has yet to occur as balance sheet fundamentals in the growing U.S. economy have remained stable. We are growing more concerned that the monetary tightening policy of the past year may be initially reflected in the below investment grade debt securities as maturities come due and corporations will need to refinance at much higher rates.

## Equity Markets

- Lower intermediate to longer maturity interest rates and the anticipated end of Fed rate increases have been important catalysts for the year-to-date advance in the equity market. Earnings were expected to decline in the first half of the year, and indeed they have according to the first quarter reports which have come in to date. But the reported earnings have generally exceeded the low bar that has been set, and we expect a return to some growth in the second half of the year given our economic outlook.
- Relief from the pressures of a rising dollar and higher energy prices have allowed European equities to generally outperform those in the U.S. as the global economy continues to grow. As central bankers in Europe are fighting a higher magnitude inflation environment, there is a greater risk of monetary policy error. But the earnings progression of European multinational companies should follow that of the U.S. and turn positive in the second half of the year.
- The lagged impact of China dropping its zero Covid policy and fully reopening the economy should begin to be felt in both economic and earnings growth through the remainder of the year. This should allow Asian emerging markets to catch up to the performance of the developed equity markets. Latin American markets will move primarily with energy prices, although Mexico should continue to be a beneficiary of the secular reshoring trend. Central and Eastern European markets will still be affected by their proximity to and ancillary involvement with the Russia/Ukraine war.

## Commodities & Currencies

- The surprise announcement of OPEC+ production cuts caused a temporary spike in crude oil, with prices quickly falling back into the trading range that has existed since the end of 2022. Concerns about global economic growth and reduced demand have so far offset any supply constraints which have yet to fully materialize. Prices are likely biased higher based on continued global demand growth, particularly from China. The potential for U.S. shale supply to significantly increase at higher price points should limit any sharp upside breakouts.
- Industrial metals have also settled into a trading range, with Chinese demand setting an upside limit with slowing growth providing an offset. There are fewer artificial supply restrictions in this space but there is a continued secular demand story (electric vehicles, emerging market demand, ...) which may bias prices higher.
- Gold prices have withstood the pressure of higher short-term interest rates and have produced strong year-to-date gains driven primarily by the banking turmoil, which may provoke greater ease at the central banks. The apparent subsiding of the pressure on banks, and isolation of the remaining troubled institutions, should cause some consolidation in the price over the coming months.

- The dollar downtrend evident late last year has settled into a rather narrow trading range with any breakout likely to be on the downside as the Fed is closer to the end of the rate tightening cycle compared to other central banks. However, as we are seeing in Japan and China with their bias towards easing, there should be a limit to any broad declines in the dollar. Any potential loss in reserve currency status appears to be in the distant future.

## What This Means for Investors

- The year-to-date advance in equity prices appears to be confirming a global economy that slows but does not collapse. Interest rates have risen to a more normal level over the past year, but a level that should not choke economic growth. Investors should be wary of further tightening now that the Fed and other central banks have achieved rate levels that would categorize current policy as contractionary. A continued decline in inflation rates towards the Fed target should soon lead to the end of fed funds rate increases. A soft landing with an economy that does not fall into recession should allow corporate earnings to resume growing, albeit at a slower rate, but would put further upward pressure on intermediate to longer maturity interest rates. Cash is a better near-term alternative to bonds given this inverted yield curve environment. Our outlook for equities is still generally positive, although some consolidation in gains may occur until clearer signals are given for the end of Fed tightening.



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