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The Wealth Management Division of First County Bank

OUTLOOKS

March 2023

ECONOMIC OUTLOOK

Summary

After several consecutive months of declining Consumer Price Index (CPI) data, investors may be forgiven if inflation was no longer a preeminent thought. That is no longer the case as a series of data releases in February highlighted a potential inflationary rebound and increased the odds for future Fed rate hikes.

In the days following the Fed's February meeting, one in which they decided to increase the overnight rate by just 0.25%, non-farm payrolls shocked the market with a blistering 517k jobs created in January. This doubled the prior month's total and nearly tripled expectations of 189k. On top of that, an additional 71k jobs were added through the prior month's revisions, bringing the unemployment rate down to a 53-year low. In isolation, this would be a very positive development. But remember, the Fed currently prefers an increasing unemployment rate. The simple logic is that as long as the labor market remains hot, salaries could increase as companies are forced to offer more compensation to entice talent. This extra disposable income could get spent on goods and services, causing prices to rise further and leading to higher production costs and further salary requirements. This illustrates the Fed's most feared outcome of a wage-price spiral.

But just as investors were recalibrating to the likelihood of an additional Fed hike based on the payroll report, a slew of new data was released. First was the CPI, which tied for its largest value during the past seven months, at 0.5%. The following day, retail sales posted their highest monthly level since the economy reopened nearly two years ago. Next, the Producer Price Index (PPI) came in 0.3% higher than expected, and finally, year-over-year Core PCE (the Fed's preferred measure of inflation) was 0.4% above expectations. This all seems to indicate the consumer remains strong and is continuing to buy goods and services at a strong pace despite the actions taken by the Fed thus far.

Naturally, if there is a fear that inflation is rebounding, the Fed will take more action. Since they had already planned to take rates up to 5.25% in 2023, it won't be a surprise if the summary of economic projections from their upcoming March meeting now shows a number well north of that. There is a level of interest rates where, if pushed to, the economy will show serious economic consequences. Apparently, the Fed hasn't found that level yet and let's hope they never do.

Positives

Retail sales beat expectations by 1.0% (3.0% vs. 2.0% est.)

New Home Sales month-over-month beat expectations by 6.5% (7.2% vs. 0.7% est.)

Initial jobless claims have remained under 200k since the first week of the year

Negatives

ISM Manufacturing continues to decline further into contractionary territory (47.7)

4Q22 productivity missed expectations by 0.8% (1.7% vs. 2.5% est.)

Durable Goods Orders were the most negative in nearly three years (-4.5%)

EQUITY OUTLOOK

Summary

Equity markets displayed more turbulence and consolidation in February after the strong 2023 opening month. Stocks were most likely overbought from a short-term standpoint, but hotter-than-expected inflationary data and higher interest rates added additional market pressure.

One noteworthy deference from selloffs throughout 2022, growth stocks held up better than value in February. The Russell 1000 Growth Index declined 1.2% while the Russell 1000 Value Index dropped 3.5%. That's potentially a further signal the weakness last month was simply a consolidation of the outsized gains in January.

With earnings season mostly in the books, expectations moving forward were largely reset lower. Corporate executives are broadly being conservative in their guidance given the potential for slower economic activity. However, cost-cutting initiatives have been widespread and should help to mitigate the pressure on earnings. Should the Fed manage to engineer a soft landing, earning results later this year could surprise to the upside.

As we've mentioned on multiple occasions in recent months, most of the catalysts that weighed on markets last year have been easing with an exception being geopolitical risks and specifically the war in Ukraine. Market action moving forward could very well resemble the first two months of this year; generally higher with periods of sharp consolidation and volatility throughout.

Positives

Slowing pace of Fed hikes with hints at a pause

Equity valuations

Negatives

Risk of Ukraine war escalation

Declining corporate earnings and guidance

Unknowns

2023 recession

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FIXED INCOME OUTLOOK

Summary

The set up could not have been any worse for bond investors in early February. On the first day of the month, the Fed increased the overnight rate by just 25 basis points (bps) which was the smallest increase since the first hike back in March 2022. Following January's sharp move lower in yields, this was actually reassuring to investors. Most felt confident the Fed was nearing the end of the rate hiking cycle with only one final 25 bps jump coming this month, followed by rate cuts beginning late in the year. Then just two days later, the Bureau of Labor Statistics released a gangbuster jobs report showing over 500,000 new jobs created in January. This was then followed up by stronger than expected retail sales and multiple inflation reports that were stubbornly high. That confidence in the outlook for the overnight rate quickly eroded and investors began to reprice the market to reflect multiple additional rate increases and no rate cuts through this calendar year. And just like that, nearly all of January's price gains evaporated.

Overall, the 2-year Treasury note increased 62 bps to end the month at 4.82%, the highest since the summer of 2007. The 10-year rose 41 bps to end February at 3.92%, eclipsing the year end level of 3.88%, but failing to make a cycle high which was 4.24% back in October. The 2-year to 10-year curve reached a new maximum inversion at 90 bps, the highest level since the fall of 1981. The revised outlook even sent credit spreads a handful of bps wider causing investment-grade bond returns to fall even more than Treasury returns. Sorting 30 years of monthly bond market returns, you will find that January's top 10 positive return was followed up with February's bottom 10 negative return.

While disappointing recently, inflation still continues to trend lower with many categories experiencing actual deflation. The long and variable lag of monetary policy should become even more restrictive on inflationary pressures over time. Despite the continued bond market volatility, the range of possibilities for the overnight rate continues to narrow. Coming into the year, like the market, we were expecting two rate increases with a chance of a third. But contrary to the market, we were unconvinced the Fed would cut rates before the year's end. We have adjusted our outlook upward by another rate increase and now the market has come to believe cuts are unlikely as well. The bond market quickly adjusted to reflect the new outlook for the funds rate. Unless the Fed projects a more hawkish outlook at this month's meeting, there is unlikely to be a massive repricing to the upside again. From today's yields, it is difficult to script a scenario where bond returns are negative for the calendar year. We may not have reached the absolute cycle high in yields, but we believe investors are being rewarded for taking the risk of being too early.

Positives

Overall inflation data is easing, particularly in the goods sector

The Fed is likely to be at the end of the rate-hiking cycle by this summer

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

Negatives

The Fed is increasingly hawkish with recent inflation report disappointments

The yield curve likely to remain inverted well into 2024

Unknowns

The Fed's continued efforts to reduce their balance sheet

Geopolitical tensions with China; Russia/Ukraine war