

ECONOMIC OUTLOOK

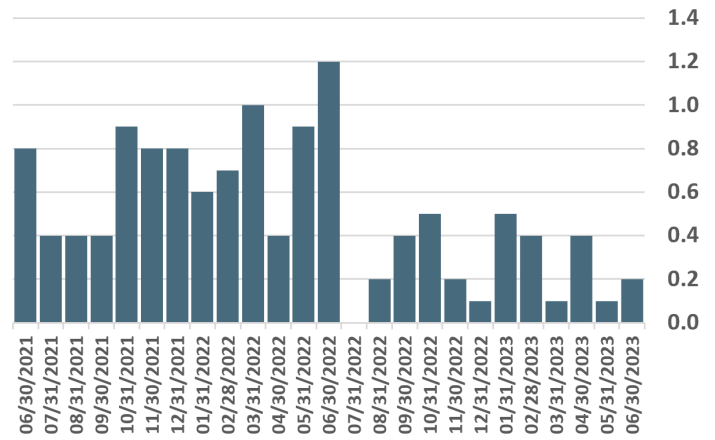
Summary

During the past year, headline Consumer Price Index (CPI) has fallen roughly six percentage points – from above 9% in June 2022 to just under 3% through June 2023. This sharp decline in inflation should not come as a surprise since it has been the Federal Reserve’s singular focus for more than a year. They’ve even implemented the fastest start to a rate-hiking cycle in history to expedite its decline. However, with inflation falling so rapidly, it’s fair to wonder if the Fed’s 2% target is now within sight.

To understand this, we need to take a quick look at the math. When referencing certain data points in year-over-year terms, each monthly value from the prior 12 months is included in the equation. When a new value is released, the oldest value is removed. With that in mind, the chart below provides a visual of monthly CPI values since June 2021 and shows how much larger they typically were compared to 2023. It makes sense then, as those larger values have been removed and replaced with smaller values, why we’ve seen a significant decline in CPI.

However, now that the June 2022 CPI data has rolled out of the equation, you can see how the task of reducing inflation further becomes more difficult. For example, with a zero value rolling off from July 2022, unless we experienced deflation in July 2023 (set to be released on Aug. 8, 2023), we will see the first uptick in inflation during the past year. Additionally, with annualized inflation through the first half of 2023 tracking at 3.4%, it’s possible that getting inflation down from 9% may have been the easy task for the Fed. Getting it from 3% to 2% could prove significantly more difficult.

Thankfully, despite all of the rate hikes, the economy is stronger than most would have envisioned. First-half GDP substantially outpaced the Fed’s projections and the job market remains strong with the unemployment rate only slightly off the cycle low. If inflation does struggle to reach 2%, it’s possible the overnight rate may remain restrictive for longer than anticipated. That may catch up with the economy eventually, but for now, a soft landing is still possible.



Positives

CPI and Producer Price Index (PPI) for June both came in lower than expectations (0.2% and 0.1% respectively)

After declining in Q1, productivity increased by 3.7% in Q2

The unemployment rate unexpectedly decreased to 3.5%

Negatives

Retail sales disappointed in June, trailing estimates by 0.3% (0.2% vs. 0.5% est.)

ISM manufacturing and services both missed expectations (46.4 and 52.7 respectively)

Revisions to nonfarm payrolls decreased the prior two months job totals by 49,000

EQUITY OUTLOOK

Summary

Equity markets continued to push higher with the S&P 500 climbing another 3.2% in July and closing the month at a 52-week high. For the second month in a row, equity performance participation was broad, across equity style, size and geography. The Russell 1000 Growth Index and Russell 1000 Value Index rose 3.4% and 3.5% respectively. All 11 economic sectors were positive for the month with energy (+7.4%) and communication services (+6.9%) leading the way. The developed MSCI EAFE Index rose 3.3% and the MSCI Emerging Markets Index gained 6.3%.

As we indicated last month, the improving market breadth has been a welcome signal for market participants. Other catalysts have been resilient consumer and labor markets as well as lower inflation which may soon lead to the end of the Fed rate-hiking cycle. Additionally, more than half of the companies in the S&P 500 have reported quarterly earnings so far with approximately 80% of them beating expectations.

From a short-term perspective, the stock market is probably overbought and may be in need of a consolidation period. The Dow Jones Industrial Average index was up 13 days in a row in July. That is the longest streak for that index since 1987. Stocks are being priced to perfection appearing as though we are going to finish the year without setback. However, that also sets the stage for something to spook the markets.

The path of least resistance has been higher for equity markets but perhaps some seasonality reminders will put a temporary freeze on the rally. August has generally been a flat month for the S&P 500 and September has been the worst performing month, on average, going back to 1945.

Higher valuations for stocks does set up the possibility of higher volatility as we move through the next few months. Some possible catalysts for a move lower include a shift higher in the projected path of inflation, poor earnings results or guidance, or a negative geopolitical event. There are countless possibilities that could surprise.

Still, the backdrop for equity markets seems to be setting up quite nicely for the intermediate and longer-term periods. Corporate fundamentals are generally strong and a soft landing looks increasingly possible. Conditions look entirely more opportunistic than most thought they would 12 or even six months ago.

Positives

Soft landing increasingly likely

Resilient corporate earnings

Market breadth continues to widen

Negatives

China recovery has fallen flat

Core inflation more stubborn

Near term equity valuations stretched

FIXED INCOME OUTLOOK

Summary

The bond market was once again held captive to oscillating economic sentiment during July. Bond yields moved sharply upward during the first few trading days as strong factory and durable goods orders set a positive tone for the economy. A surprisingly strong ADP National Employment Report cemented the Fed's late month rate increase and increased the probability of additional hikes. Then on the first Friday of the month, the U.S. Bureau of Labor Statistics (BLS) released the official government calculation of the labor market and it was weaker than expected, especially when considering the revision to the prior two months of data. A few days later the monthly inflation reports were released showing real progress towards the goal of lower inflation. By mid-month, both the 2-year and 10-year Treasury note yields had dropped more than 30 basis points (bps) as investors began to believe the Fed could soon be done with their rate-hiking cycle. That optimism faded with a series of stronger economic reports in the latter half of the month and rates began to climb again.

Late in the month the Fed followed through with a 25 bps rate increase after skipping the June meeting. This hike brought the range of the Fed Funds rate to 5.25% to 5.50%, the highest since 2001. Overall yields changed very little during the month for the 1-year to 5-year maturities. Longer yields increased as the 10-year ended 12 bps higher at 3.96% and the 30-year bond increased rising 15 bps to 4.01%. With the outlook for a Fed-induced recession fading, credit markets continued to rally with spreads on corporate bonds narrowing for the third straight month. The incremental yield on investment-grade corporate bonds is now the lowest in a year and inside the three-year-average by a few basis points. Financial company bonds continued to rebound from the Silicon Valley Bank failure and outperformed industrial company debt. Intermediate-maturity Treasury notes had a slightly positive return at 0.10% and intermediate investment-grade corporate bonds delivered 0.59%.

The real fireworks came on the last day of the month as Fitch Ratings downgraded the U.S. government from AAA to AA+. Nothing in their analysis justifying their action is new to investors of Treasury bonds. Continuing deficits, growing aggregate debt levels compared to GDP and government dysfunction have been on investors' radar for some time. With the U.S. and global

economies on much firmer footing compared to the 2011 U.S. downgrade by S&P Global Ratings, we believe the downgrade by Fitch Ratings is unlikely to put substantial pressure on Treasury yields or credit spreads. On the other hand, significant levels of new debt issuance announced by the Treasury to fund the ballooning deficit will likely continue to pressure the market and could push yields slightly higher. Combined with a modestly higher issuance of corporate bonds, buyers will need to be enticed to buy longer-maturity notes and move away from very short-term yields.

We remain comfortable with an overweight position in corporate bonds, but will consider reducing this allocation if spreads narrow further. We continue to recommend a neutral duration policy but will look for an opportunity to move slightly longer than the benchmark indexes if yields move materially above current levels.

Positives

The Fed rate-hiking cycle is likely complete.

U.S. investment-grade corporate bonds yield almost 5.5% in aggregate

Negatives

Significant issuance to fund ongoing deficits and rebuild government cash

At the margin, the U.S. government downgrade could reduce international demand

Unknowns

Impact of tighter lending standards on the economy

Russia/Ukraine war impact of commodity prices and inflation