Investment Environment & Outlook

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Market & Economic Environment

Excessive optimism expressed by investors during the beginning of the 4th quarter clashed head on with economic and policy reality in December as the markets faced heavy selling pressures. The declines capped a year where the S&P, Dow and NASDAQ fell the most since the 2008 Great Financial Crisis. Recession fears, slowing corporate earnings, and bond yields providing competitive risk-adjusted returns will influence stocks in 2023. Furthermore, the markets will be shaped by the state of the economy, Central Bank interest rate policy, the durability of corporate profits, and the ultimate pricing of assets.

4th QUARTER EARNINGS OUTLOOK

Anticipating a more challenging economic environment, analysts have lowered future earnings growth expectations. Since earnings drive stock prices, all eyes will focus on the banks as they start reporting 4th quarter earnings in mid-January. We will listen for commentary on credit quality, revenue trends, loan demand and observations about their customers' health.

DECEMBER LABOR MARKETS

The labor market remains healthy. The Unemployment Rate edged lower to 3.5% despite the Labor Force Participation increasing to 62.3%. Annual wage growth declined from 5.1% to 4.6%, which is a sign that tighter financial conditions are starting to impact employment conditions. While wage growth is moderating, the tight labor market is unlikely to cause the Federal Reserve to reverse course in the short term.

SPENDING BILL

The final act of the 117th Congress involved delivering a $1.7 trillion spending bill. At 4,126 pages, the bill funded a wide range of initiatives and programs, including +10% in defense spending and +5.5% in non-defense spending. Will the enormous spending package truly stimulate the economy, or will this simply add to elevated debt levels incurred from COVID-related spending? Only time will tell.

RECESSION RISKS

The Federal Reserve believes they can battle inflation and engineer a "soft landing" by avoiding a recession. Consumers and businesses have a less sanguine outlook. Elevated concerns could result in delayed spending and investment activity slowing growth further. Current economic data signal a high probability of recession. Investors should focus on the length, severity and impact of a looming recession.

CREDITWORTHINESS

Political fracture is on full display with the rancorous procedure of selecting the next Speaker of the House. Absent a quick resolution, legislative activities are ground to a halt. Political polarization raises questions about the ability to manage our fiscal affairs. Markets have looked the other way. But recall the dysfunction in 2011 leading to the unprecedented downgrade of U.S. debt. That would get the market's attention.

INFLATION

Inflation remains high but is trending downward. This should bring relief to consumers and investors. The COVID-induced fiscal and monetary policy responses distorted the global economy and financial systems. Withdrawing support and liquidity resulted in volatility across most asset classes last year. Inflation's ultimate destination in 2023 will determine the path of monetary policy and the markets.

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Interest Rate Observations

In 2022, bond investors experienced price volatility not seen in a generation due to higher rates. The traditional correlation/relationship between stocks and bonds broke down as bond prices declined along with falling stock markets. While higher interest rates allow investors to lock in higher income and reduce credit risk, the all-clear signal has not been sounded. We have discussed "Don't fight the Fed" since policy makers remain committed to maintaining higher rates for as long as necessary to combat inflation. Yet, investors continue to anticipate a policy pivot. This difference of viewpoints will shape both the equity and credit markets this year.

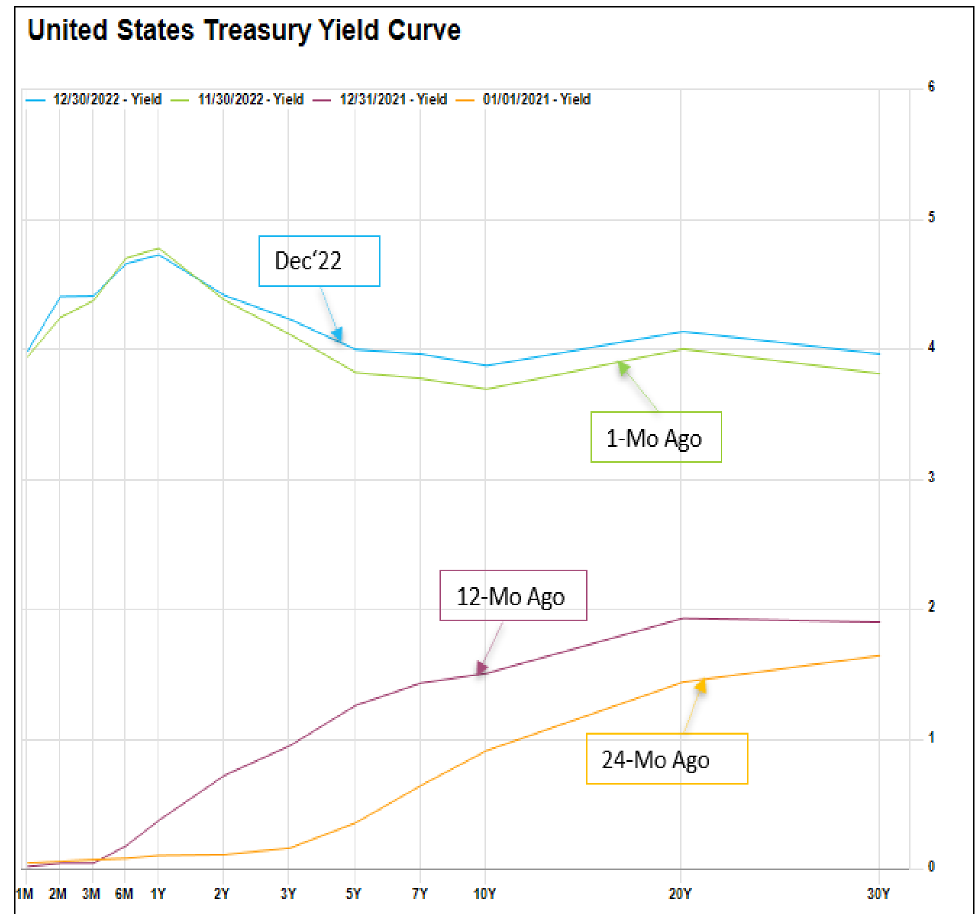
YIELD CURVE

- The FOMC raised its target rate by a total of 425 bps since March 2022, marking the fastest liftoff since 1980. The Central Bank is also projecting an additional 75 bps in rate hikes in 2023 before concluding their policy tightening cycle. Markets are expecting a peak rate of almost 5%, dramatically higher than the 2% expectation at the beginning of 2022.

- Yields rose across the curve in December. The 10yr note closed the year yielding 3.88%. The 2s10s spreads hit historic lows of -84bps in December before recovering to close the month at -56bps.

- No fixed income sectors were unscathed in 2022. The U.S. Agg Index posted its worst losses since inception and the rest of the indexes were not far behind. On the bright side, with majority of the policy tightening behind us, 2023 is setting up to be a better year for bonds.

- With mounting concerns of recession and elevated volatility levels, it is more important than ever to maintain our focus on high quality credits while managing duration and yield curve positioning at the individual account level to minimize the impact of volatility.



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