Half Full or Half Empty?

February 2023

Working with countless investment professionals on Wall Street over the years, I arrived at the conclusion the fundamental difference between equity traders and bond traders is that the former group tend to see the glass as half full, while the latter group tend to see the glass as half empty. I've concluded that this relates to equity investors' eternal optimism in the markets and/or the prospects for a particular stock. Bond traders are pre-occupied with what can go wrong, resulting in the bond defaulting. It's a matter of perspective.

In some ways, the current intersection at which we find ourselves presents a similar dilemma. Inflation is a natural by-product of a growing economy; however, similar to alcohol, it is best experienced in moderation. Sustained inflation, currently running at a headline rate of 6.5% (down from July 2022's peak of 9.1%) hurts consumers as prices relentlessly march higher. Higher interest rates, which are a by-product of inflation and are the traditional tool used to combat its effects, tends to impact the business environment adversely, raising the cost of business capital, slowing economic growth, potentially to the point of an economic contraction – a.k.a. a "recession". This is the knife edge upon which the Federal Reserve finds itself. Talk of a "soft landing" gives voice to the hope that the Fed will not overstay its welcome in its mission to restrain inflation.

After a rather challenging and disquieting 2022 in the financial markets, the S&P 500 is off to its strongest start to a new year since 2009. Colloquially referred to as the "January Effect", and exacerbated by heavy tax-loss selling at the end of the year, 2023's equities' market action may be interpreted as a snap-back from an oversold state. Others are heralding the start of another bull move. I remain cautiously sanguine at this particular junction; however, timeframe becomes increasingly important. In my opinion, here are several of the larger considerations for 2023:

I. This is not a game and is certainly not a short race.

Years of "easy" money conditions and low interest rates on margin borrowing encouraged the assumption of risk. Meme stock trading, crypto-currency and day-trading, supported by mountains of cash, fueled the rise of firms such as Robinhood as financial market speculation appeared easy. Higher interest rates saw the tide ebb; more frequent (and larger?) losses are not as much fun; hence much of the speculative euphoria has dissipated!

II. We are in a new interest rate paradigm.

Responding to the inflationary tendencies fostered by supply shortages (remember hoarding paper products?), the Federal Reserve raised interest rates 8 times since March 2022. In 11 short months, short-term interest rates have risen 450 basis points. 30-year fixed mortgage rates literally doubled from 3.35%

at the beginning of the hiking cycle before settling at their current 6.35%. It is more expensive to finance major purchases today. A more obscure tool deployed to tighten financial conditions in the face of inflation, the Money Supply (as measured by M2[i]) has been declining since July. The Fed is slowly draining the well. Furthermore, we are confronting the U.S. Treasury debt ceiling and there is increasing discussion of attempting to drive the budget deficit lower toward a more balanced budget.

III. Recent economic data suggest some moderation

Recent economic data suggests there is some moderation in goods inflation and improvements in the supply chain constraints. The data also indicate that the pace of economic activity is showing signs of slowing (Industrial Production, Capacity Utilization, Existing and New Home Sales, etc.). Some of this is a function of companies working off excess inventories warehoused during the "pandemic. Despite this data, the labor picture remains strong. Non-Farm Payrolls spiked to 3x their 4-week average in the February report, pushing the Unemployment Rate to a 50-year low last month at 3.4%. More recently, highly publicized job-cuts are occurring, although the sheer number of these cuts, principally among technology companies is modest.

Do not underestimate the influence of the US Dollar. From a January 2020 low, the Dollar rallied 62% to its recent high in September 2022. Subsequently, it has retraced 50% of this rally. A weaker dollar is beneficial to exporters, making American goods less expensive in international markets. Gold tends to appreciate with a lower dollar.

IV. The Federal Reserve is intensely focused on stemming inflation.

While month-over-month headline inflation has been declining since its July 2022 peak (9.1%), the Fed is attuned to the consumer preference shift from goods to services; a sector that is highly sensitive to labor costs. With an apparently robust labor environment, the Fed is refining their focus on service sector labor inflation. In an effort to address the strength of the labor market, several theories have been advanced, including a permanent reduction in available workers due to 500,000 + Covid-related deaths; older workers opting for retirement: a significant curtailment in immigration during the pandemic: and the burgeoning "gig" economy. 2022 saw a record number of new small business filings. As long as Powell remains focused on this, interest rates will remain higher.

Inflation, once unleashed is difficult to put back in the box. Pricing roll-backs are an anathema to business. Inflation readings are likely to persist, albeit at lower levels than 2022 headlines. Rolling 12-month readings will necessarily improve as the extraordinary 8%+ levels of 2022 begin dropping off the calculation. Nevertheless, Powell and the FOMC are adamant about not repeating the early-easing mistake of the 1970s, so the bias is to remain higher/tighter for longer.

Most importantly, all of these Fed actions (rate hikes and M2) take time to cascade through the economy before they manifest, in some cases as much as 12-18 months from their inception Over-reacting to shorter-term data points runs the risk of compromising and complicating previous actions.

V. Geopolitics remain a HUGE uncertainty.

Russia, Ukraine, China, South Korea, Taiwan, to name the more obvious…. As we have observed, the Geopolitical landscape can literally change overnight with massive implications for the global economy – food stocks, energy, military defense, digital communications, etc.

Notwithstanding Congressional hyperbole, Defense spending remains a priority. The recent Chinese Balloon event underscores some of the myopia existent in the military. Similarly, reliance on off-shore supply chains is a vulnerability that is under close examination and ON-shoring efforts are underway with bi-partisan Government support. Artificial Intelligence is a central lynch-pin in our future and the U.S is determined to regain its leadership role as the technological innovator even as the U.S. invokes protectionist policies to guard against the theft of our technology by other nations. A.I, along with robotics, will be key elements in raising U.S. worker productivity - a vital objective to maintain economic growth given the constraints on the labor force today. With Covid only just in the rearview mirror, and on-going determination to develop effective therapeutics for a range of chronic diseases, the biomedical industry will remain of interest to investors as a sector with great promise.

As all of these various elements unfold, the degree of uncertainty prevents divining the likely impact, timeframe or magnitude of their combined effects with any confidence. Our experience suggests 2023 will be anything but a straight line. Our expectation is for interest rates to settle at somewhat higher levels with the equity markets generally offering modest returns as the market consolidates, digesting and acclimating to a new paradigm and eventually resuming their upward trajectory

It is during periods such as this when the benefit of a disciplined approach to wealth management pays dividends. Utilizing Wealthcare's "Comfort Zone" provides an objective metric of one's status relative to their longer-term goals; a welcome reassurance in the face of conflicting short-term information.

All the best,

Jim

James W. Graves
Managing Director

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[i] M2 is an official measure of all bank deposits, currency, CDs, Money Market Funds. In other words, all the cash out there. https://www.federalreserve.gov/releases/h6/current/default.htm