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Monthly Market Commentary
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The second newsletter of 2023 comes a bit late as I wanted to navigate important economic data along with Federal Reserve policy before framing what we think clients will want to know. We build on the topics that we ended with in the last meeting: updates on geopolitical risks, inflation progress, job market updates, and Federal Reserve interest rate policy.

Commentary Summary

1) Geopolitical risks have hardly subsided. China's surveillance balloon caused a setback in US/China relations, further driving the countries apart. The Ukraine/Russia war appears to be trending to a drawn-out grind. Combined, we expect these to contribute to future volatility in markets worldwide.
2) Inflation continues to decline, but not at a consistent rate. Friday's CPI (consumer price index) report showed that prices increased +0.5% since January and +6.4% over a year ago, versus expectations of 6.1%.[1] The markets want steady inflation decline, while the reality seems to be bumpier and unpredictable. The more inflation sticks around, greater the likelihood that the Federal Reserve could keep raising rates, and that could trigger more stock and bond volatility, in our view.
3) The job market is not normalizing as expected. The markets interpret "normalization" to be rising unemployment, less job openings, and a decline in wages. On February 3, the Labor Department reported 517,000 new jobs were added and unemployment fell to a 53 year low.[2] If the job market doesn't loosen, the Federal Reserve will likely keep raising interest rates.
4) The Federal Reserve has reiterated that it will likely raise rates an additional 2 – 3 more times with a target of 5.50 – 5.75% before year end.[3] The Federal Reserve and the bond market have been playing a game of chicken since December because the bond market prices were implying 2 more hikes, leveling off, then a possible rate cut by year-end. The Federal Reserve is very powerful, but the bond market is stronger. We sided with the bond market, but it looks like the Fed will prevail for now and clients should expect more rate hikes and possibly more volatility.

Geopolitical Risks Continue

The biggest non-market "news" has been the Chinese surveillance balloon that somehow passed undetected through the US until being sighted by civilians before being down off the Atlantic coast. The incident was embarrassing for NORAD air defense, everyone in Washington naturally blamed each other, US Secretary of State Antony Blinken cancelled a summit with the Chinese, and China's message was that the US was overreacting. Per the December newsletter, China is our third largest trading partner, and our economies are closely intertwined. It is important for investors in stocks and bonds that the countries stay amicable but instead, many believe we are trending toward a modern cold war.[4] Conflict raises instability and instability can create volatility. Until this is resolved, it may be a headwind for investing.

The Ukraine/Russia war is intensifying despite western support, weapons, and sanctions. Both the Germans and Americans agreed to elevate support levels with Leopard and Abrams tanks. Meanwhile Russia seems intent to dig in and expend huge resources and lives over strategically unimportant areas, and they seem to be learning from their prior mistakes. Russia's Wagner Group continues to quietly increase Russia's sphere of influence in Africa and elsewhere, supporting the war machine. This war won't end any time soon and I believe it could have far-reaching implications for everything from oil/gas, commodities, and global stability.

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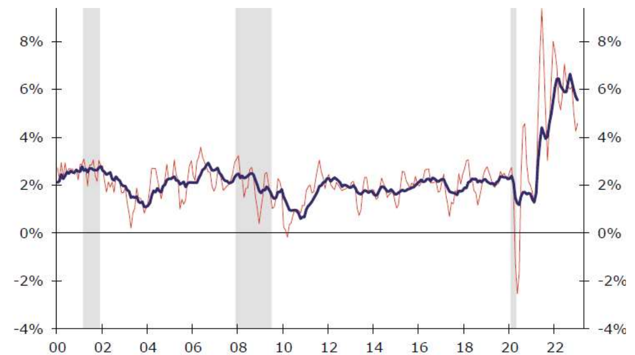
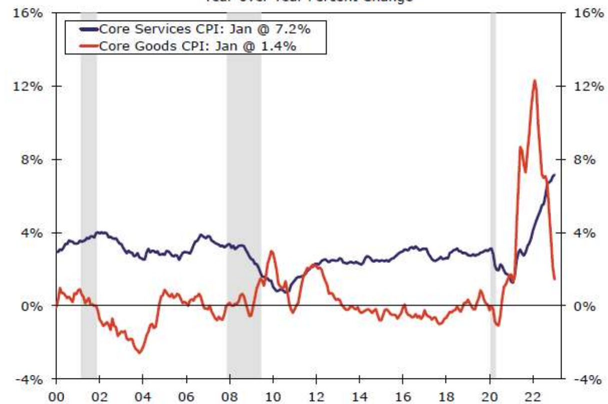
Inflation Is Not Going Quietly

Inflation seems to be grinding lower, but Friday's CPI report showed that inflation is both persistent and unpredictable. Directionally, inflation is dropping, but not at pace that is within the Federal Reserve's comfort level. It is generally accepted that inflation has fallen from the peak. In our view, prices need to decline at a *sustained* rate across broad categories from energy and food to autos and services. The US economy continues to be the largest, most diverse, and most broad economy on earth. It is doing so well that the Federal Reserve has been aggressively applying the brakes for a year with only modest effect. Until price inflation starts to consistently decline for many months, we believe that the Fed will likely continue to increase rates and we believe the process will be neither quick nor painless.



Source: U.S. Department of Labor and Wells Fargo Economics

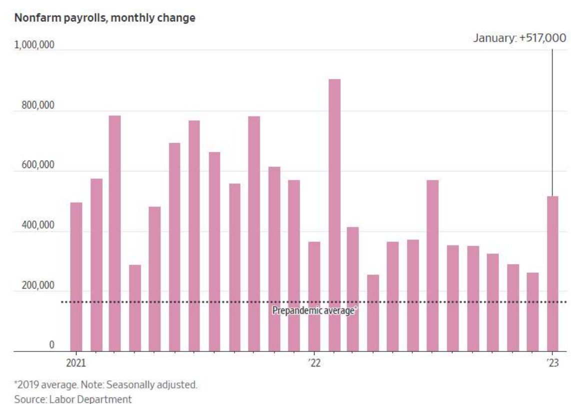
Inflation also has not deceased consistently. Prices for goods that people buy have generally decreased (red line), but prices for services (blue line) continue to increase at a stubborn pace. It is generally believed that the pandemic was an era of buying goods: TVs, cars, home updates, furniture, sporting equipment, etc. Now that the world is open, people have ventured out and are spending on services (travel, experiences, etc.). Prices for the latter don't appear to be slowing down and this is creating issues for broader inflation trends.



Source: U.S. Department of Labor and Wells Fargo Economics

Surprise! The US added 517,000 jobs in January, and unemployment fell to 3.4%

After controlling inflation, the Federal Reserve is raising interest rates to normalize the job market. For months everyone has confronted the impact of an abnormally tight labor market. Based on unemployment and job reports, it looked like the US economy was finally starting to let off the gas pedal, but January's labor report threw that out the window.



*2019 average. Note: Seasonally adjusted.
Source: Labor Department

The unemployment rate drop to 3.4% was the lowest since 1969 which is troubling because the 1970s was a decade of prolonged, persistent inflation and low unemployment until Federal Reserve chair Paul Volker crushed inflation with large rate hikes in the latter part of the decade which solved the inflation problem, but at the expense of a deep 2-year recession.[5]

Labor economists are baffled because super-cap tech and other companies are laying off tens of thousands of workers but this is being more than offset by hiring from other companies and industries. If some of the country's biggest employers are laying people off, but job market is *improving* and unemployment is *falling*, where is everybody working? In our view, the nuances of labor market dynamics don't really matter for purposes of this. The job market is not declining as expected, unemployment is not rising as necessary, and the Federal Reserve needs both to substantiate a decline in interest rate

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hikes. Until this happens, the Fed has stood firm that it will continue to hike rates and that could translate into market volatility.

More interest rate hikes are likely

By now everyone should know that interest rates determine the cost of money which is the bedrock of global commerce and pricing. When the Federal Reserve raises interest rates, it creates volatility in stocks, bonds, real estate, the price of cereal. The Federal Reserve has clearly conveyed that, among other things, inflation needs to decline, and the labor market needs to normalize. If January is an anomaly, it needs to be a big one, in our view. The bond market is the biggest, most sophisticated, and powerful market in the world. Bond market yields were implying two 0.25% interest rate hikes followed by a leveling off, then possible interest rate decline by year end. The Federal Reserve is projecting two to three 0.25% rate hikes, or even a 0.50% hike, then leveling off. The difference might seem immaterial, but it is substantial. The bond market and the Federal Reserve have had stand-offs before, and the results weren't pretty. The bond market usually prevails, but this time the Federal Reserve might have the upper hand. Instead of commentating on the fighters in the arena with an unknown outcome, I think it's best to communicate caution and patience. Clients have likely learned by now that rate hikes mean uncertainty which means volatility. As I said in January's newsletter, this is far from over in our view, and clients should expect markets to respond in unpredictable ways through at least the first half of 2023.

Closing thoughts

The conditions that caused the interest rate hikes and market volatility are far from resolved. The only difference between February 2023 and December 2022 is a few weeks on a calendar. The job market, inflation, and US economy clearly don't care what month or year it is. Some may forget that the US economy is the biggest and most diverse in the world, and there are some significant issues that will take time and patience to resolve. Quoting Federal Reserve chairman Jay Powell, *"I would say it kind of shows you why we think that this will be a process that takes a significant period of time. The labor market is extraordinarily strong."*[6] We continue to advocate that success comes from regular meetings, the importance of planning, having a strategy, and never making investment decisions based on emotion.

Questions & comments are welcome.

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Sources & Disclosures

[1] *Bureau of Labor Statistics, Wells Fargo Economics, Thompson Reuters.*
[2] *US Department of Labor, Wall Street Journal, Bloomberg*
[3] *Federal Reserve Open Market Committee meeting, February 13, 2023.*
[4] *The Economist. Week of December 30th.*
[5] *US Department of Labor*
[6] *Federal Reserve Chairman Jay Powell, Economic Club of Washington, Tuesday, February 7, 2023.*

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