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March and April 2023 have revealed data that has provided clarification on the direction of inflation and the US economy that could have important implications to the stock and bond markets. These implications may indicate that market volatility and uncertainty could continue and will necessitate both patience and planning, in our view.

Commentary Summary

1) Economic data over the past 5 weeks has pointed to two conclusions: economic growth is slowing, but inflation is too. The critical question is whether the slowdown in economic growth is happening at a slower pace than the decline in inflation. If inflation declines faster than the decline in the economy, you may hear phrases like "soft landing" or "disinflation". If inflation declines slower than the decline in the economy, you'll hear heighted concerns about recessions and/or stagflation.
2) In 2022 Federal Reserve Chairman Jerome Powell said that they would hike interest rates until things break. Ernest Hemingway once wrote that things happen in two steps, "*gradually, then suddenly*". The impact of Federal Reserve rate hikes initially hit obvious things like stocks and bonds, but the impact elsewhere was less visible…until it was sudden and startling. We don't know if recent events are just the beginning or if the damage is over. Only time and patience will provide resolution, in my view.
3) I think clients have been remarkably patient and resilient, but it is understandable that people get fatigue. History tells us that the impact of Fed rate hikes can take 9 – 18 months to flow through markets and economies, and the S&P 500 doesn't find a bottom until ~6 months after the first interest rate cut, not the first hike as many may believe.[1] Past performance does not predict future returns, but if these metrics hold true this time, then we may have a long way to go before this bear removes its claws from the market, and more volatility could be likely.

The great debate: the *pace* of inflation versus economic decline

March and April have yielded important data into the analysis of whether the economy and inflation are slowing, but also which is slowing *faster*.

1) The economy is deteriorating broadly: economic indicators point to pressure in manufacturing, services, credit, and financial sectors.
   a. March ISM Manufacturing PMI fell to 46.3 versus expectations of 47.5 (above 50 is an expansion, below 50 is a contraction).[2] This is the lowest since 2009.
   b. March ISM Manufacturing New Orders fell to 44.3 versus expectations of 49.0, which is low by historical standards.[2]
   c. March ISM Services PMI fell to 51.2 vs expectations of 54.5. Above 50 is expansionary, but a level of 51.2 is below expectations, and the lowest since 2010.[2]
   d. March ISM Services New Orders fell to 52.2 versus expectations of 62.0, which is simply a giant loss of momentum.[2]
   e. Weekly jobless claims rose to 228K vs expectations of 200K, showing that the labor market is softening.[3]
2) Inflation is continuing to decelerate. Last Wednesday's Consumer Price Index (CPI) report showed that inflation increased 0.1% month over month, and 5% year over year.[4] Inflation is still increasing, but the *pace* of inflation is slowing down, and both readings were below what was expected from economists and analysts.

This debate over deteriorating economic conditions versus declining inflation is important. For a while, inflation was starting to ease while economic conditions were somewhat stable, so economists were naturally thinking that rate hikes could potentially tame inflation while not causing a recession (also called a "soft landing"). Now, inflation is easing, but economic growth is easing too. If economic growth stops or declines, and if it does so at a faster pace, that could trigger a recession, stagflation, or a host of other problems (also called a "hard landing"). Markets would like to see CPI core inflation drop below 5%, and ideally below 3.9%, and economic growth maintain some resilience. If this occurred, it should lift the burden off the Federal Reserve to not only stop interest rate hikes, but potentially also cut rates. As discussed in the March newsletter, the bond market and The Fed are an intense debate over this issue. The Federal Reserve is powerful, but the bond market is the gorilla. The Fed's published interest rate path tops off at 5.125%. The bond market currently pegs

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interest rates at 4.0%. In the bond world, this is a big disparity. To end the fight, either the bond market needs to adjust rate expectations (more rate hikes), or the Fed needs to cut rates (recession), or both.

The Federal Reserve is definitely starting to break things

Initial Federal Reserve rate hikes were reflected quickly in stock and bond prices in 2022. But the knock-on effects to the economy and other areas were not obvious and created both confusing and conflicting messages. The stress gradually built until rate hikes triggered many, unexpected events.

1) Crypto assets and other high-risk assets collapsed.
2) Two bank failures in March were the second and third largest failures in history that forced emergency Fed, US Treasury, and FDIC measures to quell contagion and systemic risks.
3) US Treasuries with maturities of 2 years experienced a statistical 13 standard deviation move in three trading days.[4] Historical precedent for this simply doesn't exist. The US Treasury market is gigantic, and anyone who as ever taken statistics likely knows that a 13 standard deviation move in *anything* is incredibly rare, let alone the US Treasury market.
4) US small-cap stocks rose 15% from January 1 through early February, then cratered 15% until recovering in mid-March.[5] Small cap stocks are historically more volatile (and have potential for greater returns) but a 15% swing in 5 weeks is also extremely unusual.
5) Commercial Real Estate posted its worst quarterly performance since the Global Financial Crisis in 2008-2009.[6]
6) The Federal Reserve maintained a consistent hawkish message of monetary tightening and rate hikes even as markets simply refused to accept or believe the Fed's conviction. For years the markets were trained to expect a "Fed Put" or rate cuts at signs of financial trouble. 2022/2023 have taught investors that the Fed truly is independent, and it can be a brutal, unforgiving teacher.

Looking back at the crash of 1987, the Tech Bubble in 2000, the 9/11 shock and recession, the Great Financial Crisis, and the pandemic, all were unprecedented, all triggered fallout side-effects that were stressful, unpredictable, and caused significant damage to markets and economics. Many significant and unexpected events have occurred that have triggered shock waves. We don't know what echo effect those shocks may have in other areas and over what time frames. Instead of stressing, watching account values, or trying to predict the next shock, I believe a more productive approach is to focus on account positioning and stress testing our existing investment strategies and adjusting accordingly. Stated differently, this is why we are here, why we have ongoing meetings, why ongoing account management matters, and why there is a balance between reward and volatility management.

Markets are resilient but we're not out of the woods, in my view

The S&P 500 has been remarkably resilient despite the headwinds and distractions. I believe that market resiliency rests on a series of mostly positive assumptions that need to be realized:

a. The bond market wins the fight with the Fed and rates are cut to 4.0% by year-end.
b. We have an economic soft landing instead of a hard landing or recession.
c. Corporate earnings season shows stability in revenue and margins.
d. No additional stress in the banking system.
e. Geopolitical tensions subside (Russia/Ukraine, China).

In both rate hike cycles from 1999 – 2000 and 2005 – 2007, bouts of optimism eventually faded and investors were left whipsawed and disappointed from 5% - 10% pullbacks. The risk/reward profile in stocks is unclear in my view, but bond prices sold off so horribly last year that it's hard to believe it could be worse in 2023. Markets can take longer to recover than many expect or have patience for, and the S&P 500 historically doesn't start to recover until after the Federal Reserve starts *cutting* rates, and presently the Fed is still hiking rates. Finally, inflation needs to continue to calm down, and at a faster pace than slowing economic growth. It is tempting to want to find diamonds in the mess of broken glass or look for renewed growth only to be potentially disappointed when the reality and complexity of the current environment overrides optimism. What's easy to forget is that the markets are forward looking, pricing in what it thinks will happen while the Fed

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mostly speaks on what is happening right now. I think it's unfair to say that market expectations are unreasonable, but I do think the market projections have been aggressive and leave room for disappointment (i.e. a pull-back).

Closing thoughts

Former Carnegie Corporation president John Gardner was quoted saying, "*History never looks like history when you're living through it*." In some ways we are living in unprecedented times, yet there are many familiarities to past periods of volatility and uncertainty. Economic and market cycles are rarely fully understood living in the moment, and it's easy to fall into the hindsight bias trap, meaning that looking backwards, someone knew it all along. We don't get to make up the conditions we want, we invest in the conditions we are given while staying humble and flexible. The good times of the past decade teach bad habits like "investing is easy", "cycles are predictable", "Warren Buffett is a washed up old man", "value stocks are dead", and "risk is always rewarded".[7] Money runs this planet and interest rates are the cost of money. When interest rates rise (or fall), the impact eventually trickles into everything. Rising rates increase the cost of money and can have far reaching, often unpredictable effects. Instead of forecasting or predicting, have a plan and stick to the plan. Stated differently, predicting rain doesn't matter, carrying an umbrella does.

Questions & comments are welcome.

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Sources & Disclosures

[1] Wells Fargo Investment Institute, JP Morgan Guide to the Markets, Factset
[2] Institute for Supply Chain Management
[3] US Department of Labor
[4] US Treasury, Thompson Reuters
[5] S&P Small-Cap 600 Index: The S&P SmallCap 600 Index consists of 600 domestic stocks chosen for market size, liquidity (bid-asked spread, ownership, share turnover and number of no trade days) and industry group representation. It is a market value-weighted index (stock price times the number of shares outstanding), with each stock's weight in the index proportionate to its market value.
[6] Wells Fargo Investment Institute, Wells Fargo Economics.
[7] David Portnoy, Barstool Sports. June 9, 2020 via Twitter.

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