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Monthly Market Commentary
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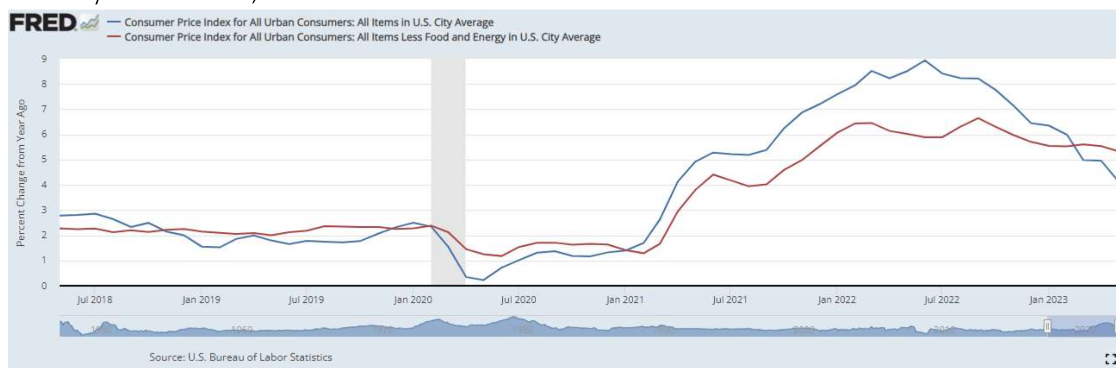
This month we will focus on why we believe the Federal Reserve continues to raise interest rates, whether or not we're in a recession, and why we continue to be very cautious (and skeptical) about the upward trajectory of the markets in 2023.

Commentary Summary

- The Fed raised interest rates initially to combat inflation. While the Fed's inflation target has not been met, inflation seems to be trending lower. I believe that the Fed is likely to continue raising interest rates not because of inflation but because of a tight labor market that may be more difficult and normalize. A tight labor market means workers can command higher wages, which also pressures inflation but can be much harder to reverse (imagine your reaction if someone wanted to cut your pay!). Instead of focusing on inflation, I am choosing to focus more on jobs reports and unemployment as a barometer for future interest rate hikes.
- A lot of clients are asking about when the US will enter a recession as a result of rising rates. This is a hotly debated topic among very smart people. In my view, we don't know. The US economy is very large, very diverse, and despite what the news may tell you, is *still* the strongest on earth. Parts of the economy may have already been through a recession, others may be in a recession now, and yet others are doing just fine. I think defining a recession in this climate is too difficult and it's more important to simply stay flexible.
- The stock market has finally been on an upswing after 18 months of significant volatility but if you peel back the layers, I believe that all is far from well. I think investors are exhausted by the volatility and are overly optimistic. The market's uptick is concentrated in a few large tech companies (it lacks breadth), there are signs of pressure in corporate earnings and profit margins, and the bond market is definitely pointing to future stress. We are happy the markets are doing well but continue to treat this market with a healthy dose of skepticism.

The Federal Reserve will likely continue raising rates, but now for different reasons

The pace at which the Fed has raised rates to combat inflation is the fastest pace in 50 years. The chart of the core Consumer Price Index (CPI) from the St. Louis Federal Reserve conveys an obvious trend: inflation was flat for many years, it spiked dramatically in 2021-2022, and now its started to recede.



Source: St Louis Federal Reserve, US Bureau of Labor Statistics

The June meeting marked the first pause in many months, but it is expected that the Fed will raise interest rates by 0.25% in July, along with another hike sometime this year. At first glance, it may be because the Fed wants to be sure that inflation is being solved, but I think there's more to the picture.

I read a compelling paper co-written by former Fed chair Ben Bernanke (the very chairman who steered the US through the 2008/2009 Financial Crisis).[2] The paper illustrated that the early inflation spike was driven by supply chain problems. The supply chain has mostly normalized, and shocks have proved to be largely temporary. If inflation was initially caused by supply chain problems, and if inflation is trending lower from 8.9% to 5.3%, why is the Fed continuing to hike rates?

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Bernanke believes that the bogey now is low unemployment and a tight labor market that is far from normal. If the current Fed is listening to their former chairman, I imagine it's following these indicators in setting their interest rate policy:

1) Unemployment rate. Unemployment needs to increase from the current level of 3.6%. An unemployment rate below 4% is very low and not indicative of a normal job market. There are 11.5 million job openings and 6.0 million unemployed persons, or only ~0.6 unemployed per job posting.[3] This unusually low rate is the product of an abnormal job market.
2) The Job Openings and Labor Turnover Survey (JOLTS). Published by the Economic Policy Institute, JOLTS conveys the number of job openings, how many workers were hired, how many quit, how many laid off, and other separations (like deaths or retirement). The latest reading is still nearly 30% over pre-pandemic levels, so a downward pace would be helpful in creating a more balanced labor market.
3) Jobless claims for unemployment benefits. While listed last, I believe this is the most important reading, and unfortunately I believe that jobless claims would need to increase for the labor market to find balance.

To summarize my takeaways from Bernanke's paper, a further drop in CPI likely won't get the Fed to stop cutting rates. A tight labor market poses more danger and if allowed to persist, it could provide a continuous source of inflation. Because of this, I believe the labor market indicators will play a bigger role in the current Federal Reserve rate-setting committee decisions.

Why aren't we in a recession? Or are we?

The interest rate hikes over the past year did a lot of damage to the stock and bond markets. However, both the economy and jobs market have turned out to be less sensitive to interest rates, leading to an ongoing debate about when there will be a recession, how bad it will be, or if we're in one already. When I'm asked about a recession, my answer is "yes, and no". According to the most popular and general definition which uses GDP, the US economy has shrunk for the past two quarters.[4] When measuring manufacturing output via the ISM Manufacturing survey, we find that this component of the economy has contracted for eight straight months.[4] When you break down the US economy by sector, the US economy has experienced a "rolling recession" of sorts meaning that different sectors are taking turns going through stress. 2022 was broadly a recession for technology and communication services companies, then basic materials (aforementioned manufacturing), followed by financial services (regional banks in 2023), consumer goods (several big-box retailers that are under stress or have gone bankrupt), and now real estate (particularly commercial real estate), and healthcare (some hospitals overspend during COVID and are having trouble paying their debts). Complicating matters further, some of those sectors that previously experienced contractions are now in expansionary mode. Are you confused yet?

So why hasn't the economy been more sensitive to rate hikes and why hasn't a "recession" been worse or more broadly defined? I would point to several areas:

1) Interest rates may have risen but the numerous households and businesses that locked in low interest rate mortgages and loans for many years or even decades, made current rate hikes irrelevant.
2) Households accumulated significant savings during the pandemic, and they took a long time to run through. This is important for strengthening an economy that is heavily dependent on consumer spending.
3) Many workers across many industries enjoyed large raises (both hourly and salary) that outpaced even inflation.
4) Rebounding stock and bond markets helped with the "wealth effect" meaning that when people's investments are rising in value, they're more likely to spend because they feel richer.

Finally, the US economy is not only the largest, but also the broadest, most diverse, and most sophisticated. Historical interest rate conditions and a pandemic put kinks in a lot of things and predicting a recession for a complex machine like the US economy is challenging. In my view, the outlook is more balanced. In some ways, it's possible that the economy feels the pain in stages yet in other ways it's also possible that interest rate hikes are only now starting to trickle through the economy and the impact of a broad recession haven't started yet. The outlook is simply too uncertain, and so I view the market upswing with skepticism.

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We're not out of the woods. The markets might be too optimistic, so expect volatility

In my view, we may be experiencing one of the most challenging traits of the latter stages of economic cycles: investors have been slogging through 18 months of market volatility and are desperate to find reasons to invest cash. It's tempting to think that better markets are ahead but I advocate staying cautious.

The markets lack both depth and conviction and instead are being pushed upward by a few, very large companies.
The traditional view of the S&P 500 is "market-cap weighted". The bigger the company, the greater the influence it has over the broader index. The S&P 500 closed at 4,411 on July 6 and is up +16% YTD, but this is mainly influenced by a few very large tech companies. If you look at the S&P 500 with each company weighted equally, then the YTD performance is +5.7% meaning that the majority of companies aren't doing nearly as well. The lack of breadth is concerning. The latest sensation seems to be that artificial intelligence will bring a transformational wave of growth and productivity and that once again, Communication Services and Information Technology are immune from an economic slowdown. This perception is overshadowing declining profits and margins for many other companies.

I think that the market valuation is reflecting a "best case" scenario that hasn't materialized yet.
I'm worried that the markets believe inflation will miraculously resolve itself (particularly the services sector), that corporate growth will hold, and that corporate earnings expectations stay level or increase, and that unemployment rises but doesn't cause stress elsewhere. Basically current market prices imply that lot of improvement will to occur with virtually no negative surprises.

The US Treasury yield curve remains very inverted, which historically has been an accurate predictor of recessions.
The US Treasury yield curve has been flashing a recession warning sign for a year. We've discussed this before, but the difference in interest rates between the 2-year US Treasury bond and the 10-year US Treasury bond is currently negative. In normal markets, investors should earn a higher interest rate on 10-year Treasuries than on 2-year Treasuries because of the higher risk that comes from a longer maturity bond. Since July 2022, the opposite has been true in what's called an "inverted yield curve". The 2-year Treasury bond is reflecting recent Federal Reserve rate hikes while the 10-year Treasury bond is saying that rates in 10 years will be lower, or that the Fed will eventually start cutting rates. The yield curve is indicating that the Fed's current rate hikes will start to bite, the economy should start slowing down, inflation will ebb, and then the Fed will cut interest rates in response to the stress caused by a recession. So why isn't the economy or the markets responding to the yield curve warning signs? As mentioned, the economy and jobs market seem to be much less sensitive to interest rates hikes than in the past and I think nobody really knows why. What I know with reasonable certainty is that the bond market is telling investors that the current level of interest rates can't last and that at some point, the Fed will need to cut rates, likely as a result of market or economic stress. Stated differently, an inverted yield curve doesn't guarantee a recession, but I think it would be a mistake to ignore it. This means I must caution clients that markets are likely to be volatile for months to come.

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Closing comments

The closest analogy I can find to current economic and market conditions is a desert. I think investors (but not necessarily our clients) are tired of trekking through an unpredictable, unforgiving, and perilous landscape for 18 months. They're looking for relief, be it cooler temperatures (lower volatility, more market certainty, or growth), a source of water (relief from rising rates), and fewer dangers (failing banks, tanking stocks, declining earnings, and shrinking profit margins). In my view, we still haven't reached an oasis, and many of the challenges we've faced over the past year have not entirely been resolved. I am happy that markets have stabilized but I am still very much on guard and focused more on risk/volatility management than upside potential. Regardless of what happens, I know that the best client outcomes are the product of meeting regularly, contacting us if you're losing sleep, having a plan (and sticking to the plan), and never making investment decisions based on emotion.

Questions and comments are welcome.

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Sources & Disclosures

[1] *St. Louis Federal Reserve*

[2] *"What Caused the U.S. Pandemic-Era Inflation?" Ben Bernanke, Olivier Blanchard. The Brookings Institution. May 23, 2023.*

[3] *Bureau of Labor Statistics*

[4] *Gross Domestic Product (GDP) measured month over month, and year over year.*

[4] *ISM Manufacturing and Wells Fargo Economics. As of July 3rd, 2023, all fifty components are in contract. Wells Fargo*

The S&P 500 Index consists of 500 stocks chosen for market size, liquidity, and industry group representation. It is a market value weighted index with each stock's weight in the Index proportionate to its market value.

US Treasury bonds are guaranteed by the full faith and credit of the U.S. Government for the timely payment of interest and principal if held to maturity.

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