WealthIQ: February/March 2023

Walking the Economic Tightrope

Executive Summary: We believe the U.S. economy continues to walk a tightrope as financial markets attempt to balance continued consumer resilience with the Federal Reserve's task of cooling inflation by raising interest rates. Recently, market behavior has seemed a bit contradictory as stronger January economic data added to inflationary concerns and the path of monetary policy.

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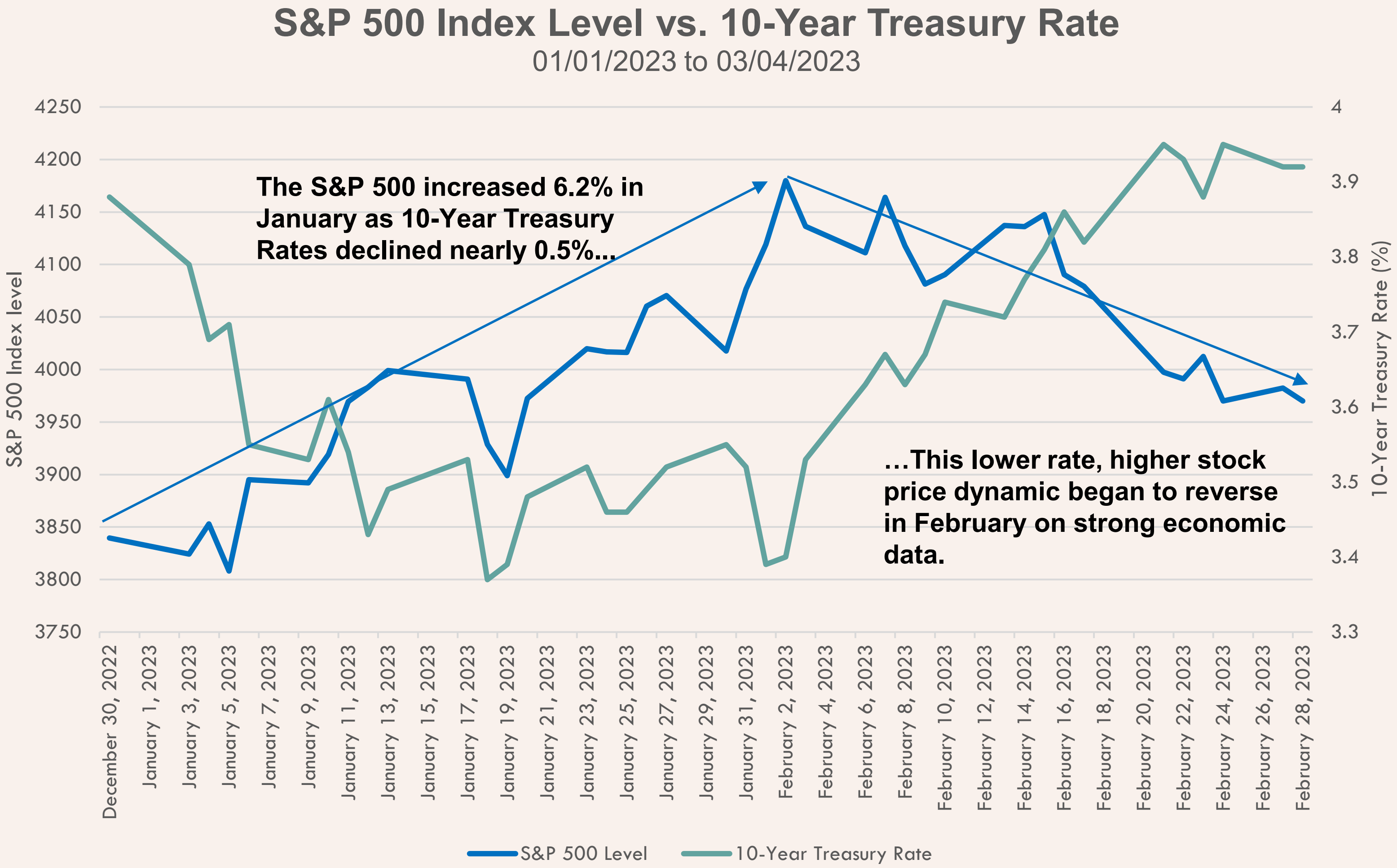
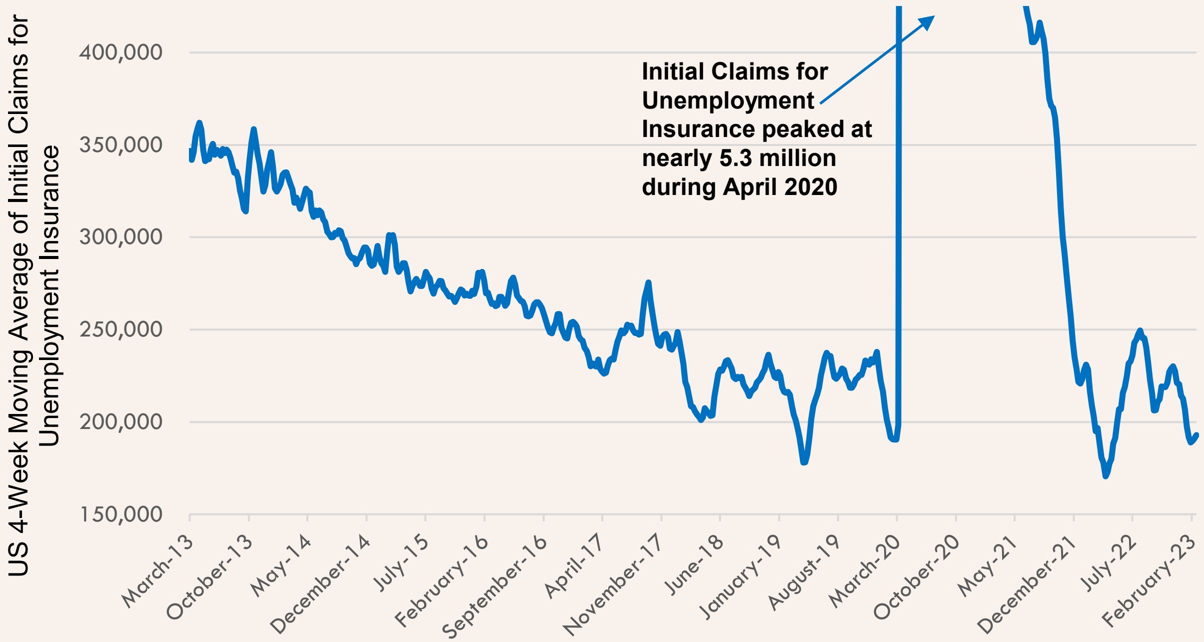
1) Stock and bond markets began the year with strong gains in January on continued hopes of moderating inflation, rate cuts i n the second half of 2023, and a 'no landing' scenario in which the economy continues its expansion without hitting a recession. Then, on February 1st, the market welcomed the Federal Reserve much-anticipated slowdown in the pace of tightening, raising the Fed Funds rate only 0.25% rather than the previous 0.75% and 0.50% hikes. However, as February progressed, economic data releases came out stronger than many had anticipated, and markets began to accept the possibility of further tightening throughout 2023.



Data Source: YCharts

2) One of the primary drivers of shifting sentiment has been better than expected January economic data (reported in February) which supports further interest rate hikes by the Federal Reserve. Perhaps most importantly, the labor market has not yet cooled the way economists may have expected. The 4-week moving average of Initial Claims for Unemployment Insurance remains low (though it has begun to trend slightly higher), while private payrolls growth surprised significantly to the upside in January.

US 4-Week Moving Average of Initial Claims for Unemployment Insurance



Change in US Nonfarm Payrolls MoM (thousands)

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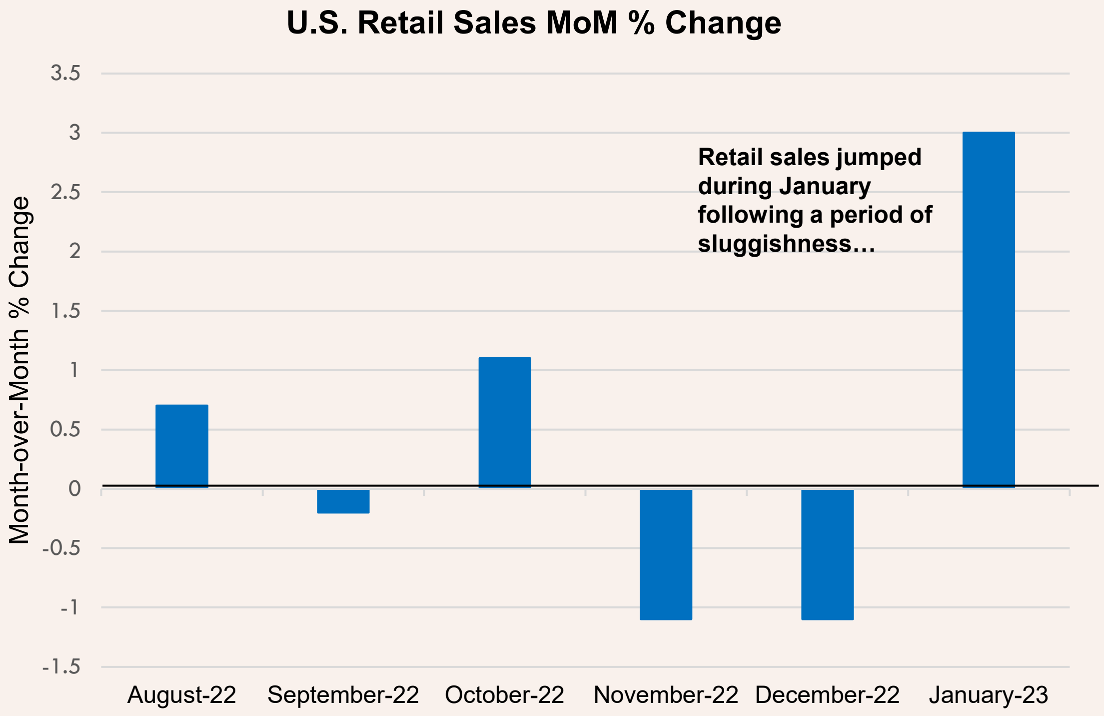
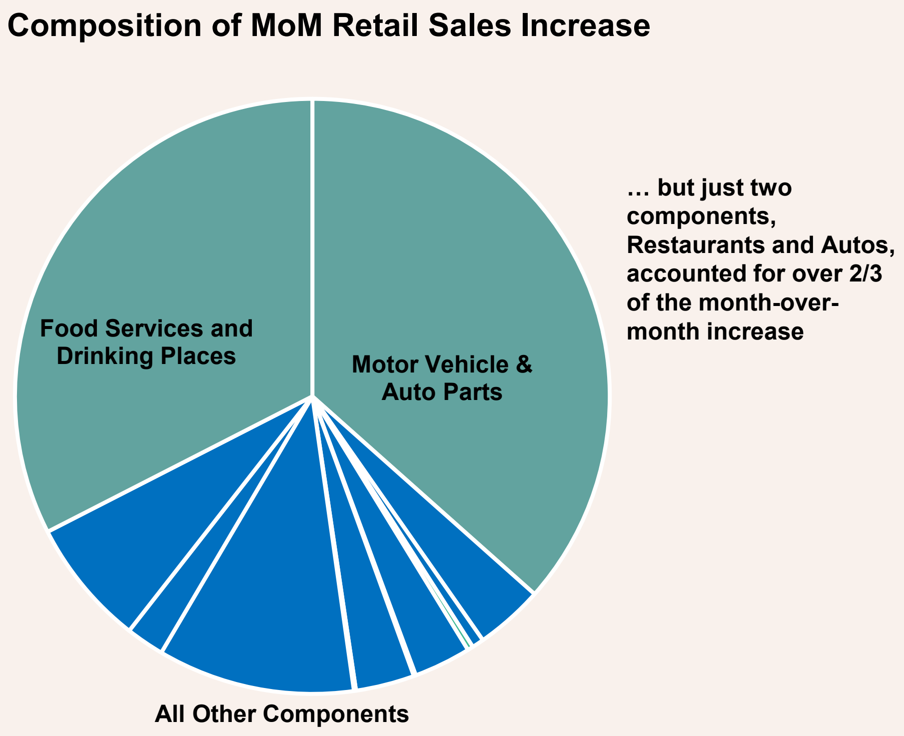
Data Source: YCharts; U.S. Department of Labor; U.S. Bureau of Labor Statistics

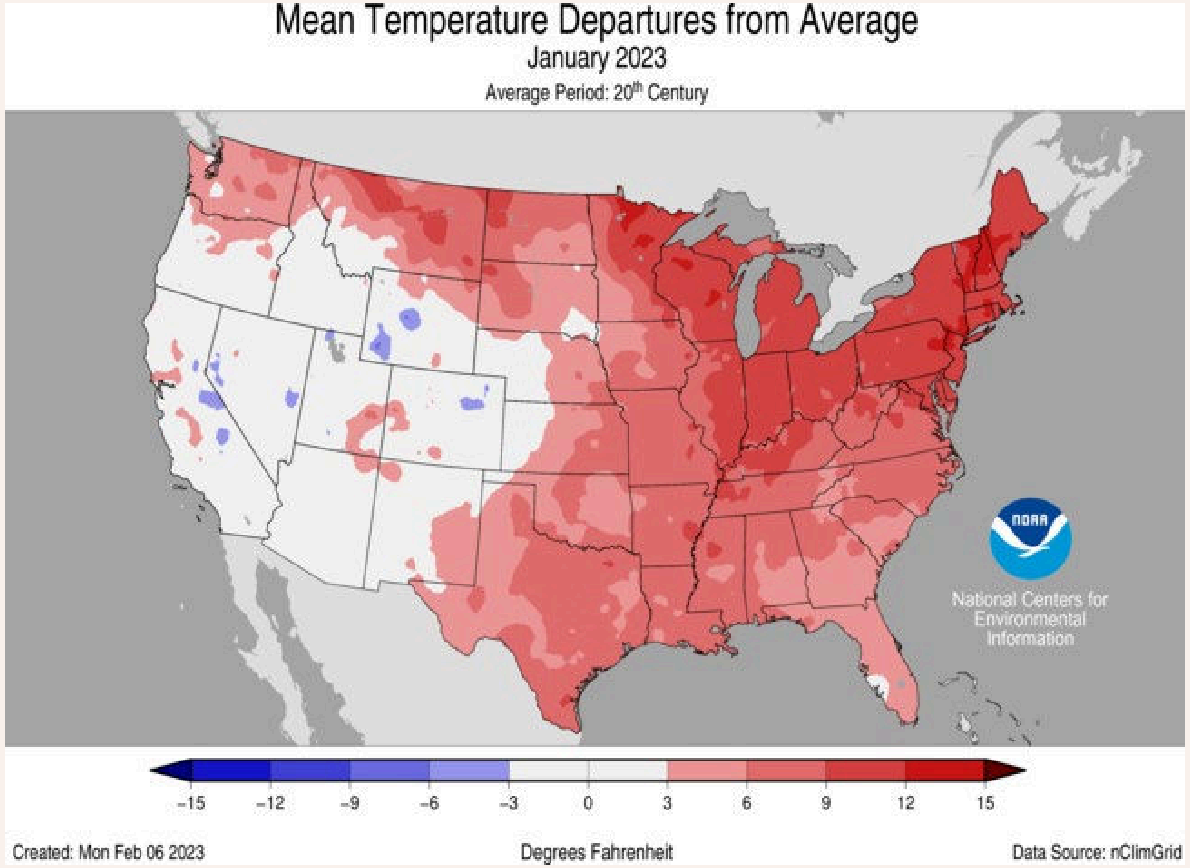
3) Retail sales also increased more than expected, and month-over-month inflation also appeared to reaccelerate in January. The chart on the left displays the month-over-month percentage increase in retail sales. The chart on the right outlines the components contributing to the increase.





Data Source: Bloomberg, L.P.

4) One thesis for why economic data came in hot during January has to do with unseasonably warm temperatures. Some economists believe these above-average January temperatures may have been a catalyst for above-expected consumer spending. With less inclement weather holding people back from shopping and travel, consumers were able to spend more freely than they historically have been able to during the first month of the year. While that may be a comforting argument against reaccelerating inflationary pressures, the reality remains that markets will need to see signs of *actual* economic cooling in the months ahead.



"The contiguous U.S. average temperature during January was 35.2°F, 5.1°F above average, ranking as the sixth warmest January on record." - NOAA

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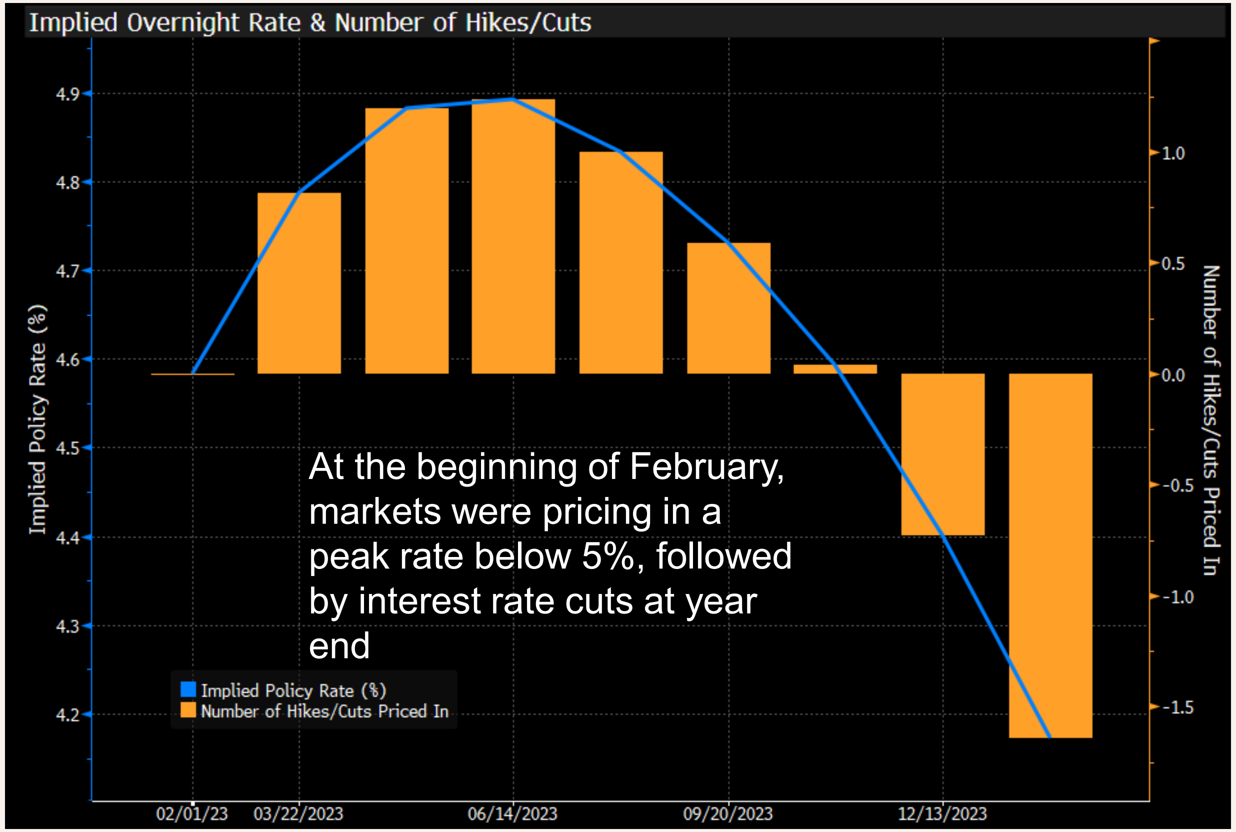
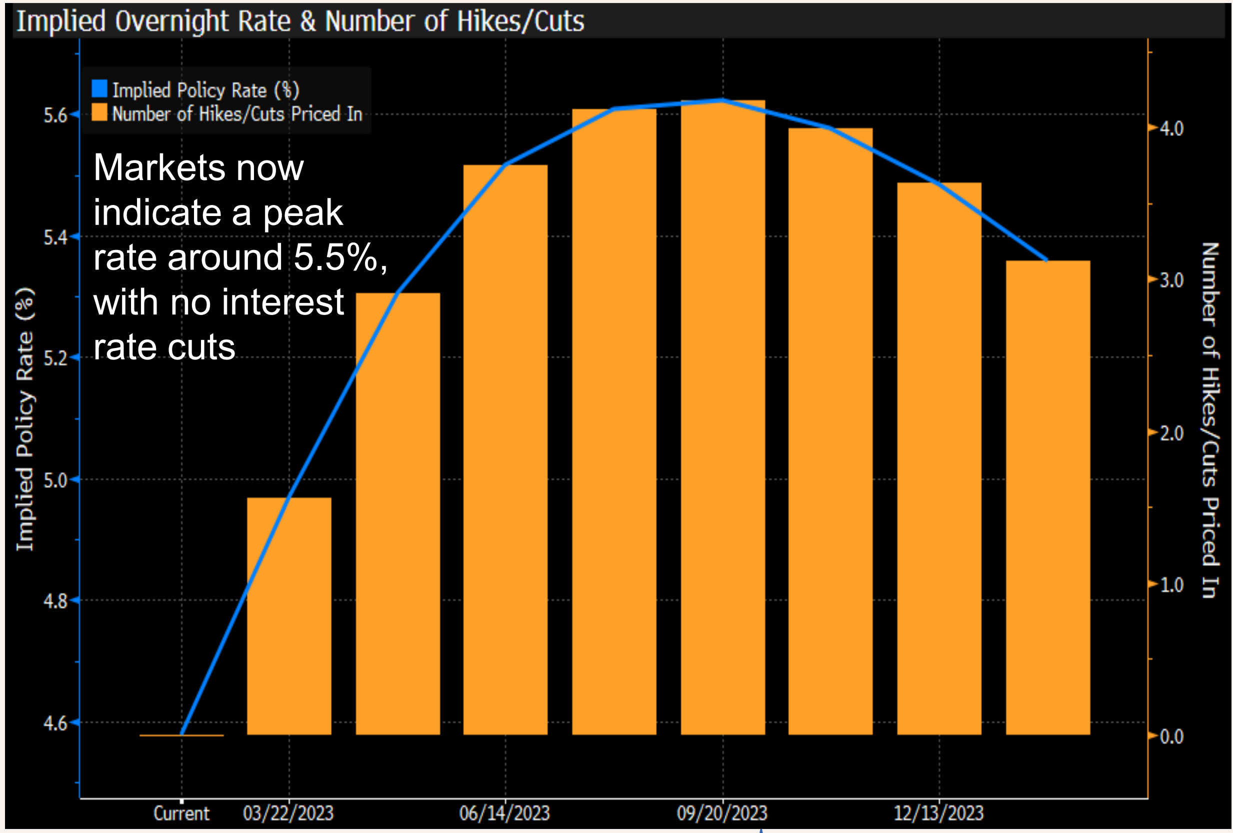
Data Source: National Oceanic and Atmospheric Administration

5) For months, markets had also been resisting Federal Reserve warnings of continued tightening in hopes of rate cuts before the end of 2023. However, it finally appears the market and the Fed are aligned- expectations of a 2023 rate cut have been priced out of futures markets. While this has driven up rates and led to the disappearance of positive year-to-date fixed income returns, we believe the continued raising of interest rates has made current fixed income yields even more attractive for investors.

Market Priced Rate Expectations a/o 02/01/2023



Market Priced Rate Expectations a/o 03/07/2023



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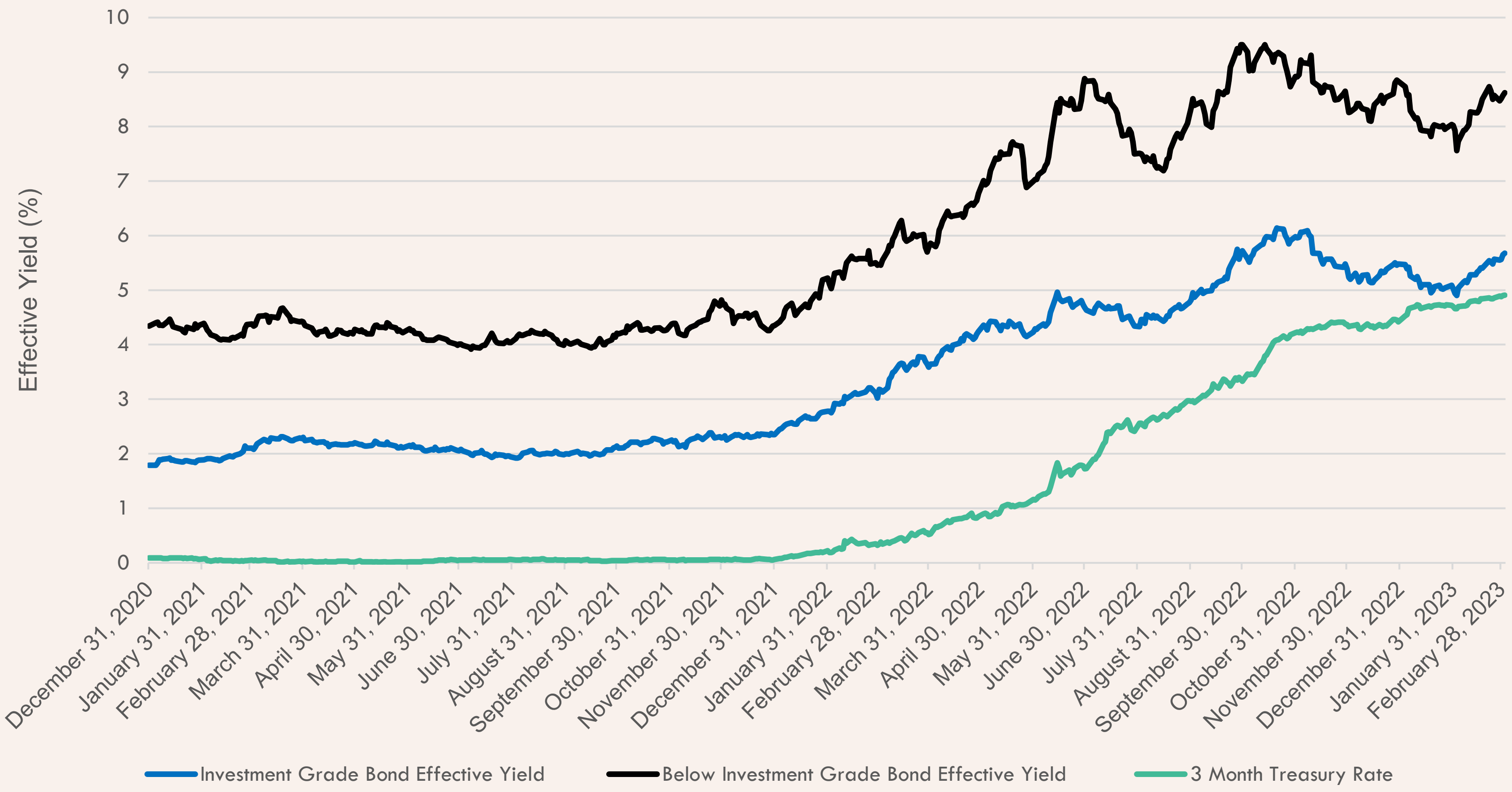
Data Source: Bloomberg, L.P.

6) Yields on 3-month treasury bills (a proxy for money market mutual funds) are approaching 5% (green line), while yields on investment grade corporate bonds are yielding over 5.5% (blue line). Bonds rated below investment grade are currently yielding in the high single digits (black line). This sizeable increase in interest rates has helped create a more attractive environment for fixed income, and sets up for more favorable conditions for investors as interest rates stabilize.

Effective Yields: 3-Month Treasury, Investment Grade Bonds, Below Investment Grade Bonds



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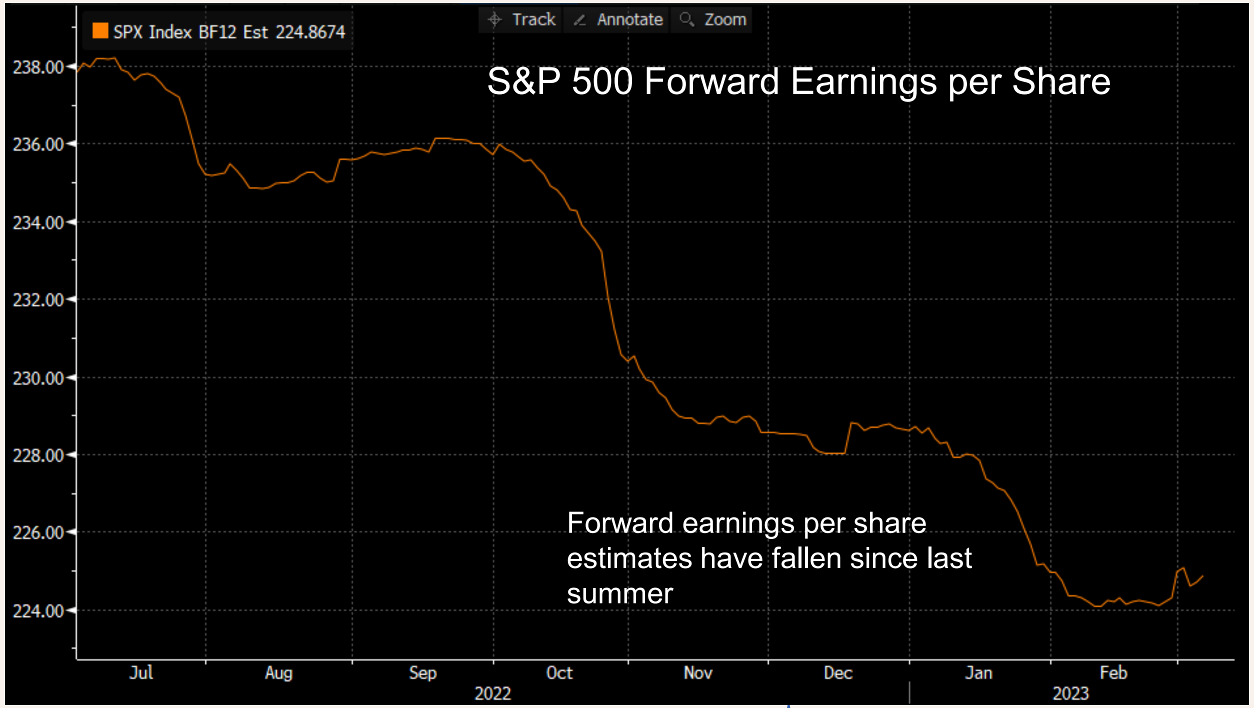
Data Source: YCharts; Investment Grade Bonds reflect ICE BoA U.S. Corporate Index, Below Investment Grade Bonds reflect ICE BoA U.S. High Yield Index

7) Equity markets have also ‘repriced’ as a result of changing interest rate expectations; however, S&P 500 performance remains year-to-date positive. In the February Federal Reserve Meeting Minutes, Federal Reserve staff stated, ‘asset valuation pressures remain notable’ and ‘the forward price-to-earnings for S&P 500 firms remained above its median value despite the decline in equity prices over the past year.’ This is a fair description of current equity market conditions, as highlighted by the chart on the left. Due to this, we believe corporate earnings per share estimates (chart, right), which have been declining since last summer, will need to begin to show signs of improvement before stocks can have a sustained rally. It remains too soon to say if the current leveling out of earnings expectations is the beginning of an improvement in earnings fundamentals or simply a temporary reprieve.



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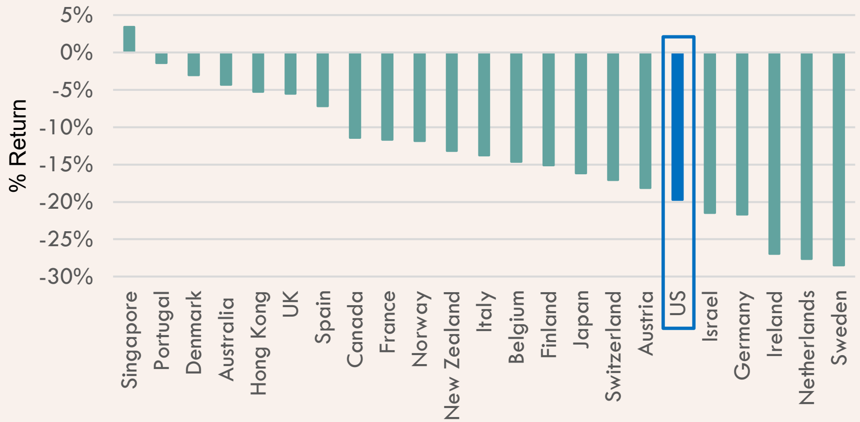
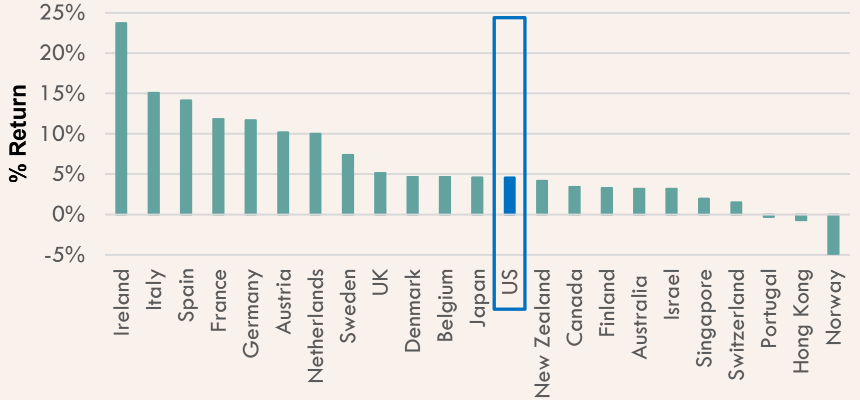
Data Source: Bloomberg, L.P.

8) Until earnings improvement is observed, market volatility will likely continue. Over the past year investors have seen large swings in monthly performance for the S&P 500 (table, right). Outside of the United States, foreign equity markets have performed well, with U.S. stock performance lagging that of other developed economies since the beginning of 2022.

% Returns 2022
Bloomberg Developed Market Equity Indexes



% Returns 2023 Year-to-Date
Bloomberg Developed Market Equity Indexes



S&P 500 Monthly Returns (%)

	2021	2022	2023
January	-1.1	-5.3	6.2
February	2.6	-3.1	-2.6
March	4.2	3.6	
April	5.2	-8.8	
May	0.5	0.0	
June	2.2	-8.4	
July	2.3	9.1	
August	2.9	-4.2	
September	-4.8	-9.3	
October	6.9	8.0	
November	-0.8	5.4	
December	4.4	-5.9	

Markets have experienced sizeable swings in monthly returns since the beginning of 2022

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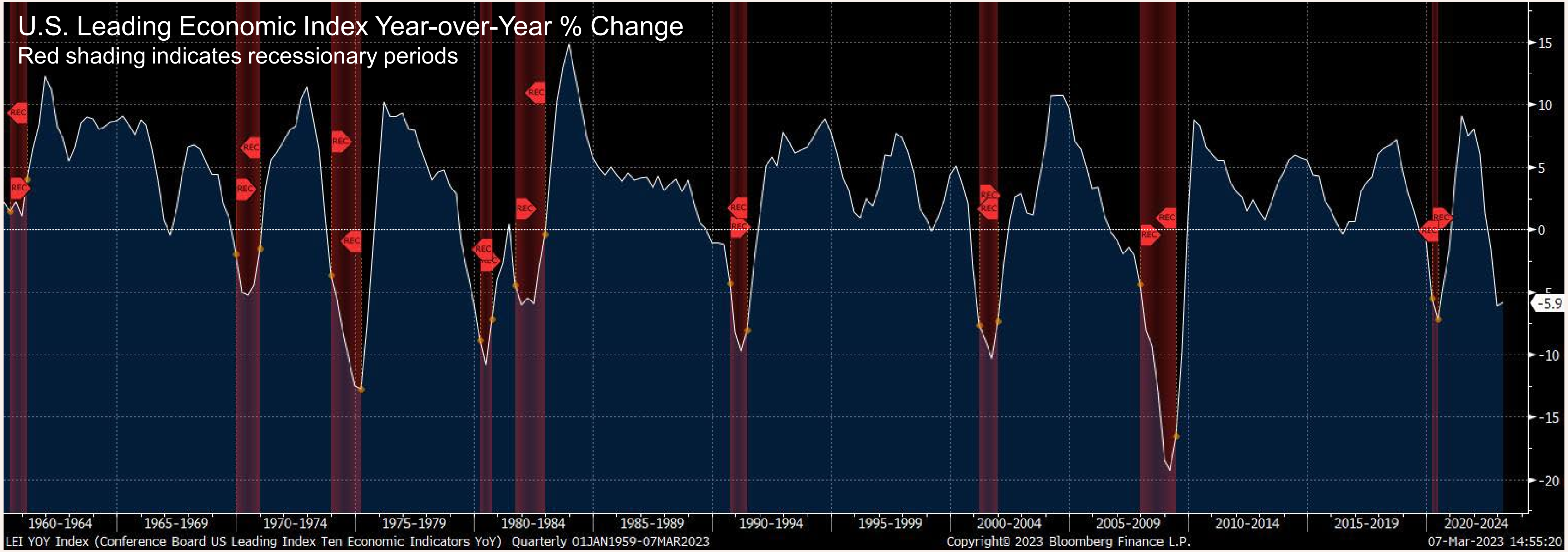
Data Source: Bloomberg, L.P.; YCharts

9) The current expansion continues to defy “normal” economic cycle expectations as our current level on the LEI (Leading Economic Indicators) is consistent with past recessions despite many other data points remaining strong. This points to the unique nature of this post-COIVD economy. For now, U.S. economic growth remains positive, albeit at a slower pace. The market's reaction function will likely continue to remain high as incoming economic and corporate data is scrutinized and assessed against potential monetary policy ramifications.



Data Source: Bloomberg, L.P.

10) Over the next serval weeks there are many data points that we believe could be consequential for near-term market behavior. While the calendar has turned to 2023, the playbook thus far remains the same- the path of inflation and the sustainability of our economic growth remain the top concerns for market participants as we continue through the year. We've included a summary of what we believe to be some of the most important upcoming meetings and economic data releases during the month.

Important Economic Data Releases for March

Data Source: Bloomberg, L.P.

Interested in sending our investment team a note? Please send an email to wealthiq@marshallfinancial.com.

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