

ECONOMIC OUTLOOK

Summary

There has been significant debate as to how high the Fed will push rates this cycle and whether they will tap the brakes at the first signs of a *material* economic slowdown. However, if they are to be taken at their word, hawkish comments following the Jackson Hole symposium appear to signal rates could go higher, and stay there longer, than the market was initially anticipating. An excerpt from Chairman Jay Powell's comments put it all in context:

“Restoring price stability **will take some time** and requires using our tools **forcefully** to bring demand and supply into better balance. Reducing inflation is likely to **require a sustained period of below-trend growth**. Moreover, there will very likely be some **softening of labor market conditions**. While higher interest rates, slower growth, and softer labor market conditions will bring down inflation, they **will also bring some pain to households and businesses**. These are the unfortunate costs of reducing inflation. **But a failure to restore price stability would mean far greater pain.**”

As always, actions mean more than words. So far the Fed has backed their views with several supersized rate hikes which have initiated a slower growth environment. While there is more to be done, their recent comments are said easier against a backdrop of strong employment trends with increasing labor force participation and average hourly earnings, expanding manufacturing and services, and increasing consumer sentiment for two consecutive months.

This is not intended to paint a rosy picture of the economy. Yes, economic data has been in decline for several months, but it is not yet severe. GDP has contracted for two consecutive quarters, however, Gross Domestic Income, which should equate to the same value as GDP, is still expanding. Where the economy stands is uncertain at this time.

Nonetheless, we are in a period where, without inflation, the Fed would likely already be cutting rates to spur economic growth. So if the Fed lives up to their recent comments, things could certainly get worse before they get better. Still, it'll be much more difficult for Chairman Powell to have his ***Volcker moment** of sacrificing the economy to stop inflation once he is actually inflicting “pain to households and businesses”.

*Paul Volcker made the difficult decision to raise interest rates dramatically in an attempt to reign-in inflation. Volcker's efforts ultimately proved successful, and his decision to aggressively raise rates is referred to as the Volcker moment.

Positives

CPI and Core PCE Inflation data came in below expectations

Though still negative, second quarter GDP was revised higher by 0.3%

August payrolls remained strong (315k vs 298k est.)

Negatives

Pending home sales year-over-year are down 22.5%

U.S. labor productivity has fallen for the second consecutive month (-4.1%)

Personal income and spending both missed expectations (0.2%, 0.1%)

EQUITY OUTLOOK

Summary

Stock market investors rode a rollercoaster in August. The rally, which began in June, extended through July and into mid-August before losing steam. The selloff that followed left the S&P 500 down 4.1% for the month. Growth stocks once again absorbed the weight of the market pressure. The Russell 1000 Growth Index fell 4.7% while the Russell 1000 Value Index lost 3.0%.

In last month's Outlooks, given the elevated levels of uncertainty we questioned whether the rally off the recent lows was a textbook bear market rally. Weaker market action to close out August appears to provide evidence that this is exactly what we experienced. A retest of the lows is quickly becoming a more likely possibility.

Even if the market retests the lows, we believe the equity markets are predominately pricing in the risks associated with inflation, fed policy, supply chain, etc. Certainly volatility could and likely will persist over the coming weeks which may temporarily push the markets meaningfully lower. However, equity valuations are fairly attractive at these levels especially considering the resilience of corporate earnings to date.

It would not be surprising if the bear market momentum continues. September, after all, has historically been the worst performing calendar month based on data dating back to 1928. Buying on weakness in the coming weeks will undoubtedly be an attractive opportunity for long-term investors.

As we head into fall, even more attention will begin to focus on the mid-term elections. Over the last several cycles, mid-term election years tend to be volatile to begin with but rally in the weeks leading up to and the months that follow Election Day. By late fall, we should also have more clarity around some of the issues that have been plaguing the markets. The midterms seem likely to be the clearing event that may make way for the start of the next bull market.

Positives

Crude and gasoline prices receding

Corporate earnings resilience

Negatives

Wage inflation

Fed has no immediate plans to pivot

European energy crisis

Unknowns

Ukraine war

FIXED INCOME OUTLOOK

Summary

Following July's drop in yields and strong bond market returns, August was a jolt to investors expecting smooth sailing for their bond portfolios. Over the course of the month, various Fed officials made it known they were not in agreement with the market's belief that after hitting an overnight rate of 3.50% or 3.75% by the year's end, they would pivot and start cutting rates in the first half of 2023. Their coordinated message was that to bring down inflationary pressures and to ensure they do not return, the overnight rate will have to move high enough to suppress aggregate demand and stay there for some period of time. Late in the month, Fed Chairman Powell solidified their more aggressive posture during a brief speech delivered after their annual Jackson Hole symposium. He stated their focus is solely on inflation and there will be some pain incurred to obtain a sustained period of below-trend growth. He dashed any hopes of a Fed pivot as he said "history cautions about easing policy too early."

Given the higher for longer outlook for the overnight rate, interest rates repriced sharply higher across the curve with the 2-year Treasury note jumping 61 basis points (bps) to the highest level since 2007 at 3.49%. The 10-year note increased 54 bps to end August at 3.19%. The 30-year bond rose 28 bps to 3.29%. Even though credit spreads moved a couple bps tighter, with a longer duration as a group, corporate bonds dropped even more in value than Treasury debt. Following exceptional monthly returns in July, most of the investment grade bond indices experienced one of the top 10 worst monthly returns in the last 30 years.

Based on the futures market, there is now a 75% probability the Federal Reserve's Open Market Committee (FOMC) will increase the overnight rate by another 75 bps at their September 21 meeting. This would be the third consecutive increase of that magnitude. The market is also indicating there will be an additional 75 bps coming after that meeting but before the year's end. That would bring the Fed Funds rate to a target range of 3.75% to 4.00%. The rate cuts for the first half of 2023 have been removed and now there is just one cut priced in for the second half of the year. Given the Fed's resolve to combat inflation, our outlook for the funds rate is aligned with this forecast. The front end of the yield curve accurately reflects an overnight rate

that will move higher. As it does, the 2-year yield should move modestly higher as well. Longer maturity yields should retest the March highs, but we expect them to hold around those levels. Ultimately, the aggressive Fed action will slow aggregate demand and inflation will come back towards their target and the economy will suffer. Rates will then move lower as growth slows and the eventual rate cut looms closer. We are maintaining a neutral duration policy with an eye towards adding duration if yields move much higher. Credit spreads look attractive but we acknowledge they could move wider in sympathy with lower rated bonds if the economic environment deteriorates more rapidly than expected.

Positives

Treasury yields look attractive relative to long-run inflation expectations

U.S. yields are higher than most other developed nation's debt

Bonds now offer a decent return and increasing diversification benefits

Negatives

Fed will still be increasing the overnight rate sharply through the year's end

Some inflationary pressures will likely persist, like housing

Unknowns

Impact of accelerated balance sheet run-off

Resolution of the Russia/Ukraine war

China's intentions with Taiwan