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MARKET SIGHT LINES

Looking Forward to 2023: Insights as We Prepare Our 2023 Outlook

By Michael O'Keeffe, *Chief Investment Officer*

It's December 2022, and my team and I are developing our outlook for next year, which we will publish in early January. 2022 has been all about balance. We started the year identifying balancing acts. Imbalances then kept inflation elevated and markets volatile. More recently, we've expected to find balance and some market relief. In this week's Sight|Lines, we share some insights from the work we are doing as we develop our 2023 Outlook.

THE TAKEAWAY: SOME KEY FACTORS WILL ANCHOR OUR 2023 INVESTMENT OUTLOOK

As we develop our 2023 Outlook, a few questions/topics will anchor our investment views going forward:

- Will inflation continue to cool, or will structural factors keep inflation elevated above the Federal Reserve (Fed)'s target?
- When will the Fed pause its rate hikes, and when will it pivot to lowering policy rates?
- Will interest rates go higher, lower, or be range bound, and what does that mean for the bond market?
- Will the U.S. economy experience a soft landing or enter a recession?
- Are company earnings estimates still too optimistic for next year, or will earnings erode further?

Progress with geopolitical issues lessens the risk that a geopolitical issue or event will risk our ability to find balance on a host of domestic issues.

IN DEPTH: INFLATION AND FED POLICY WILL CONTINUE TO DRIVE THE ECONOMY, EARNINGS, AND MARKETS

Let's go a little deeper. We've seen challenges in 2022 linked to inflation, driven by imbalances related to the pandemic reopening and geopolitical hotspots. Given substantial monetary and fiscal policy support to help us through the pandemic, we've had excess demand. Then, with supply chains challenged by the frictions of reopening and disruptions from the tragic war in Ukraine, supplies are more limited. Excess demand and limited supplies both contributed to elevated inflation. The course of inflation, how the Fed responds, and the related economic impact will influence market interest rates, company earnings, and markets more generally:

- Will inflation continue to cool, or will structural factors keep inflation elevated above the Fed's target?
  - We can glean from fixed income security prices the inflation rate investors expect over future periods. For example, the one-year "breakeven" rate is currently 2.28%.
  - Consumers are a bit more worried, with surveys indicating a consensus view of inflation over the next year in the 5%-7% range. As of September, the Fed projects a rate of 2.8%.

    - In addition to these forward-looking views, factors we are watching include:
        - Sticky inflation drivers like shelter costs, food, and wages; and
        - Oil prices, inflation signals in Purchasing Managers Indexes, supply chain pressures, and employment.
- When will the Fed pause its rate hikes, and when will it pivot to lowering policy rates?
    - The current fed funds rate is 3.75%-4.00%, and futures markets imply a related peak of 4.9%. So, investors are expecting another almost 1.0% in rate hikes. The futures market is also signaling the timing of the next Fed rate cut: fourth quarter 2023.
    - We regularly assess Fed commentary, including Fed statements, press conferences, meeting minutes, and speeches. While the message has consistently signaled a commitment to higher rates, Fed Chair Jerome Powell recently said, “The time for moderating the pace of interest rate increases may come as soon as the December meeting,” indicating the central bank is considering a slowdown in rate hikes.
- Will interest rates go higher, lower, or be range bound, and what does that mean for the bond market?
    - The fed funds rate drives short-term rates, which have been elevated. The 90-day Treasury bill yield now sits at 4.31%. Longer-term rates reflect market expectations for future fed funds rates. The 10-year Treasury yield is 3.59%, after a peak of 4.24%. Recent declines mean market participants may believe the Fed will slow or cease rate hikes.
- Will the U.S. economy experience a soft landing or enter a recession?
    - Recession or not, the hawkish Fed policy has slowed the economy. The consensus forecast for year-over-year 2023 GDP growth is 0.4%, positive but muted.
    - We are monitoring real personal income less transfers, employment, real consumer spending, retail sales, and industrial production as key inputs to economic growth. We expect the consumer to remain active, drawing on a solid foundation of excess savings and a strong job market.
    - Risks include higher rates, housing/equity market weakness, and eroding consumer confidence.
- Are company earnings estimates still too optimistic for next year, or will earnings erode further?
    - While earnings growth forecasts have fallen over 2022, they remain positive, with forecasts of 5.2% for calendar year 2022 and 5.7% for 2023. As industry analysts process Fed policy and economic growth changes, we’re watching for further erosion in earnings growth forecasts.

CONCLUSION

As we move toward the end of 2022, we’re getting ready to publish our outlook for 2023 in early January. When we look back at this year, we’re reminded that 2022 has been all about balance: balancing acts, imbalances, and finding balance. As we look forward, we see a handful of key factors that will continue to anchor our outlook, like inflation, Fed policy, interest rates, economic activity, and earnings. We look forward to sharing our 2023 Outlook next month.

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