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MARKET SIGHT LINES

Seeking Signposts for Finding Balance: Risks All Around

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In our Outlook 2023: *Finding Balance* report and video, we discussed the idea that the first half of 2023 would remain volatile as the lag effects of tighter monetary policy take hold and we remain unsure about future policy. As we move toward midyear, we are looking for signposts for finding balance, but risks remain. In this Sight|Lines, we review a number of risks in the current environment that contribute to uncertainty and volatility.

THE TAKEAWAY: THERE ARE A NUMBER OF RISKS IN THE CURRENT ENVIRONMENT THAT MUST RESOLVE FURTHER TO ALLOW US TO FIND BALANCE

The effects of the pandemic shutdown, historically supportive monetary and fiscal policy, and reopening challenges are still being felt, including the shift to a tight monetary policy. In summary:

- The Federal Reserve (Fed) met this week and hiked rates again, signaling the possibility of a pause, but without commitment. The risk of monetary policy error remains.
- Higher rates have fueled a bank crisis this year, with First Republic Bank failing last weekend and being sold to JPMorgan Chase. Depositors and investors worry about the risk of more failures.
- The U.S. government will run out of money in early June unless a debt ceiling deal can be struck. There is a risk of the U.S. defaulting on its debt.
- We must remain mindful of increased geopolitical risks in the current environment.
- These and other factors are slowing the U.S. economy quickly. The risk of recession, and potentially deep recession, have increased.
- A slower economy means weaker earnings. These, combined with shaken animal spirits as investors consider all these issues, increase the risk of falling markets or even a retesting of recent lows.

While the risks are worrying, in many ways, the first half of 2023 has been playing out as we expected. Individuals, business leaders, and investors all feel a bit out of balance, and these risks must resolve, at least some, to allow us to find balance, which we expect later this year.

IN-DEPTH: RISKS LIKE FED POLICY, A BANK CRISIS, THE DEBT CEILING DEBATE, GEOPOLITICAL TENSIONS, AND A SLOWING ECONOMY MEANS INCREASED MARKET RISK

The pandemic shutdown shook the economy. Massive fiscal and monetary support helped with the reopening and recovery but has fueled excess demand, leading to higher inflation. A now tighter monetary policy has meant higher rates, a bank crisis, a slowing economy, and other risks and uncertainties. Going deeper:

- The Fed met this week and hiked rates again:

- The fed funds rate was increased by 0.25% for a cumulative 5% over the last year or so.
- Fed officials remain worried about sticky inflation but will watch the data going forward.
- Fed Chair Jerome Powell described Fed policy as "tight," as evidenced by interest-sensitive segments like banks, and other segments as well.
- A pause from here is possible, but officials say they don't expect rate cuts this year.
- The risk of monetary policy error remains.

- Higher rates have fueled a bank crisis this year:
  - Following two bank failures in March, First Republic Bank failed this past weekend and was sold to JPMorgan Chase.
  - Depositors and investors worry about the risk of more failures.
  - In its statement, the Fed said, "The U.S. banking system is sound and resilient."
- The U.S. government is at risk of a first-time debt default as early as June:
  - The House passed a GOP bill to raise the debt ceiling and cut spending, but Treasury Secretary Janet Yellen announced the government could run out of money in early June, leaving little time for Democrats and Republicans to negotiate a deal.
  - There is a chance a "clean bill" will be passed to increase the debt ceiling only for a short time, opening up the possibility of connecting this debate with the upcoming budget negotiations.
- Geopolitical risks remain in the current environment:
  - China continues to work to become a more relevant global economic leader, increasing competition and tensions with the U.S.
  - The tragic war in Ukraine shows no signs of de-escalation.
- U.S. economic growth is slowing quickly:
  - GDP grew 2.1% in 2022 and below trend at 1.1% annualized in the first quarter.
  - In our outlook, we forecast 2023 growth at about 0%, with the potential for a mild recession.
  - At this week's meeting, the Fed reinforced its base case view for a mild recession this year.

A slower economy means weaker earnings, which are forecast to grow only 1.0% this year, and may fall. Animal spirits have been shaken, fueling the potential for weaker markets.

CONCLUSION

We've expected the first half of 2023 to remain volatile with increased risks. So for the time being, though, we must weather the uncertainty and volatility created by these numerous risks in the environment. And as we move toward midyear, we will be looking for signposts for finding balance and more clarity on the timing of recovery in the economy and the markets.

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