Market Review & Outlook

April 2023

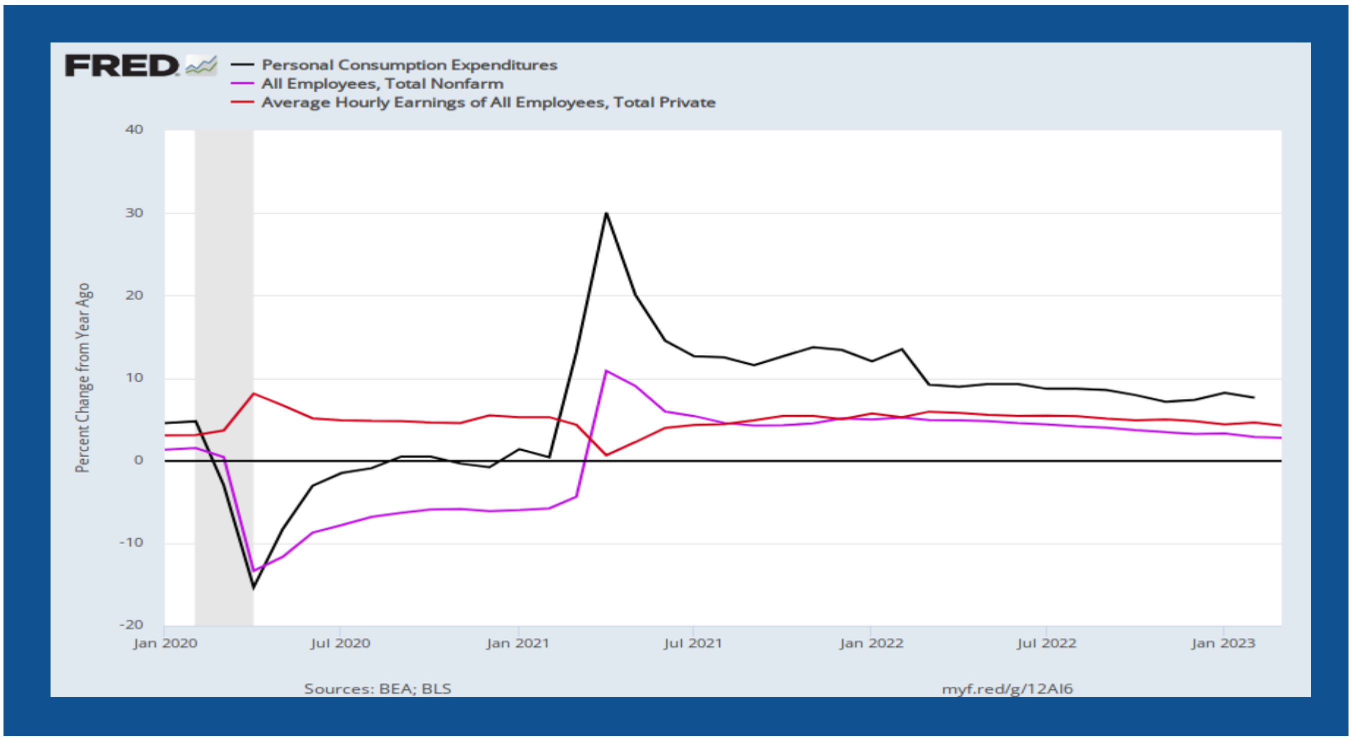
Contributors
Peter Mueller, MBA, CFP®
Steve Taddie, CBE®, CFM

The flow of headlines and opinions has been a bit more volatile than the economic data this quarter, and the US financial markets have more mirrored the data and expected Federal Reserve (Fed) policy than the headlines and opinions. For the 1st quarter, stock and bond markets gained ground as bond yields declined. Economic activity in the US has remained decent, but of course well below the Covid rebound highs, and employment while not as robust, has remained strong despite the slowing economy and rapid-fire interest rate increases by the Fed over the past year. Generally, that is good news.

We continue to see a wide disparity among economic forecasts from well-respected economists, which makes deciphering the relevance of the news flow more difficult. In addition, coming off the pandemic (cold) and rebound extremes (hot) in reported data like inflation creates some vagary in the use of "real" data. Real economic data is simply nominal (raw data) minus inflation, so volatile inflation data (which was subject to large year-end revisions) can skew the view of where the economy has been and where it is going. Better to focus on the nominal data (our choice all along) to eliminate the noise of other variables. US economic activity has slowed, and while forward estimates are fairly wide, the consensus points to lower GDP growth in the US, with well supported arguments for both no recession in 2023 or a mild recession in 2023, with outliers having much more positive and much more negative outlooks. Globally, economic forecasts for the year are also being lowered.

> "To some extent, reduced consumption is the source code behind the reduction in inflation growth we have been experiencing. ."

The strength of the US economy has been employment, as earned wages drive consumption. The graph below shows the rebound from pandemic lows in the growth of Jobs (purple line), earned income (red line), and consumption (black line). One can also clearly see the impact federal stimuli round 2 and 3 had on consumption, spiking it well above the rebound of the other two components. Historically, consumption and earned income run roughly parallel, but for borrowing which temporarily boosts consumption. At present, absent stimulus payments, consumption is falling back to more sustainable levels, and more in sync with earned income. To some extent, reduced consumption is the source code behind the reduction in inflation growth we have been experiencing.



The Fed does not want to destroy the job market nor the US economy, but it does want to dampen the ability to spend which spurs demand and instigates inflation. Historically, they have been able to do this by using monetary policy to slow the economy, which slows hiring (reducing earned income), and increases the cost of borrowing money to deter its use. **They have succeeded in making borrowed funds more expensive, but try as it might, the Fed has been unable to have a big impact on the job market, as business optimism remains somewhat high.** it's a tough job, as Fed policy creates a number of collateral issues, and there are many known and unknown variables that cloud the picture. It may well turn out to be a longer-term project than they first envisioned.

The April economic reports will capture the pre-bank crisis economic landscape, but the impact on bank lending activity is one of those collateral issues and unknown variables that will impact future business activity. The Government's response to the bank run at Silicon Valley Bank was spot on, as it addressed the issue faced by mid-tier banks and eliminated depositor risk at those failed banks. This occurrence caused a significant reallocation of deposits between banking institutions in favor of larger, "too big to fail" banks. In a fractional reserve banking system, **this deposit reallocation and increased caution amongst smaller banks will dampen small business lending, as smaller and mid-tier banks handle a large percentage of small business loans and have less deposits to lend against and less desire to take on additional risk.** This plays out across the board, and a number of economists have since reduced their economic growth expectations as a result of the changed lending landscape.

While not an extremely rosy picture, lackluster company profits in 2023 may already be baked in the cake with respect to stock prices. Expected earnings growth this year is slight, but the view forward shows earnings are expected to increase over 12% from 2023 to 2024. With PE ratios hovering just above the 15-year average, we could see stock prices increase in the second half, when 2024 earnings forecasts come into play. At the same time, as inflation growth continues to slow in terms of level and volatility, many things measured in "real" terms will normalize, and uncertainty may begin to recede, contributing to the second half 2023 story.