2023 Midyear Update

A Healthy Outlook Despite Negative Headlines

As we enter the second half of the year, we've had several shocks. Inflation is still too high, even as the Federal Reserve (Fed) has continued to raise interest rates in repeated attempts to combat rising prices. We just resolved the debt ceiling confrontation, which could have rattled the economy and the global financial system. The war in Ukraine grinds on, and the U.S. relationship with China remains a wild card. Even though we dodged the debt ceiling bullet, a recession is still widely expected. Looking at the headlines, you might expect the economy and markets to be in bad shape.

On the contrary, though, the news is surprisingly good when you look at economic data. Job growth remains strong, and the labor market is still very tight. Consumers are still shopping despite a lack of confidence caused by the headlines. Businesses, driven by consumer demand and the labor shortage, continue to hire as much as they can and invest when they can't. In other words, despite the headlines, the economy is still chugging along.

This is the big picture for the rest of 2023. Now let's dive into the details.

By the Numbers: 2023 Year-End Expectations

Inflation	GDP growth	Fed funds rate	U.S. Treasury 10-year yield	S&P 500
3%–4%	1%–2%	5%	3.75%	4,200

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Economic Fundamentals

Financial markets are ratifying the good economic news as well. The S&P 500 was up almost 10 percent through May, and the Nasdaq was up much more. If financial markets look ahead, as they tend to, this should give us some comfort that the recent solid performance will continue.

A solid performance, however, is not guaranteed. With so much in flux, what does the rest of the year hold? As always, the answer is to look at the fundamentals, not the headlines. The foundations of the economy—consumers and businesses—are solid. The weak areas are not as weak as headlines would suggest, but we can expect growth to slow through the rest of the year. Slow growth is still growth, however, and that likely will continue through the end of the year.

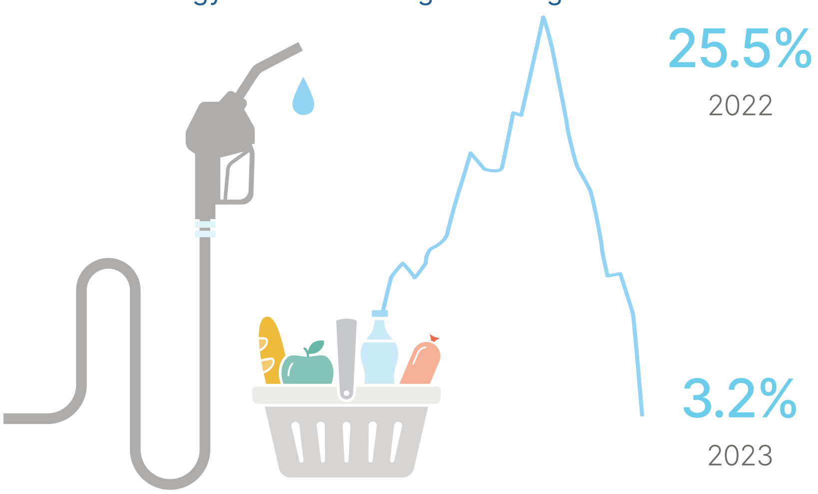
Job growth

With so much momentum in place, the economy will likely keep growing through the rest of the year. Job growth has been strong and should stay that way given the high number of vacancies. At the current job growth rate of about 300,000 per month over the past six months, and with more than 10 million jobs unfilled, even if job growth slows somewhat, the economy will keep growing. This is the key to the outlook for the rest of the year.

Consumer spending

When employment opportunities increase, confidence and spending stay high. Confidence is down from its peak but is still above levels from the mid-2010s, as well as those from 2007. With people working and feeling good, consumers will keep the economy moving through 2023. For businesses to keep serving those customers, however, they need to hire. This is proving difficult in the current climate. The thing to watch going forward will be consumer spending. Although it remains healthy, interest rate-sensitive segments such as housing or autos will show signs if higher rates are starting to slow growth. So far, the trend remains positive, but the higher the Fed hikes rates, the greater the risk over time.

Food and Energy Prices Trending in the Right Direction



Food and energy inflation approaching the Fed's long-term target of

2%

Gasoline prices are

20%

lower than they were a year ago

Source: Bureau of Labor Statistics, Haver Analytics

Inflation

As we analyze the current state of the economy, the main area of concern is inflation and monetary policy. Although inflation is down from the peak, it is still much too high—and recent data suggests it may be starting to increase again. Given this fact, the Fed, which was widely expected to cut rates this year, is now expected to either keep them stable or hike even further. With the effects of prior rate increases still filtering through the economy, this could be a rising headwind through the rest of the year.

Financial Markets

As noted, there has been a good start to the year, but will a slowing-but-growing economy be enough to keep markets rising? That depends on two things: how companies can navigate the slowdown and how interest rates move.

Earnings

If company earnings drop on a slowing economy, the market should pull back. That shouldn't be the case here because earnings are still expected to grow at a healthy rate through 2023, and, as discussed earlier, the economy should support that. So, the risks are really about valuations (the prices investors are willing to pay for those earnings). Here, we can do some analysis.

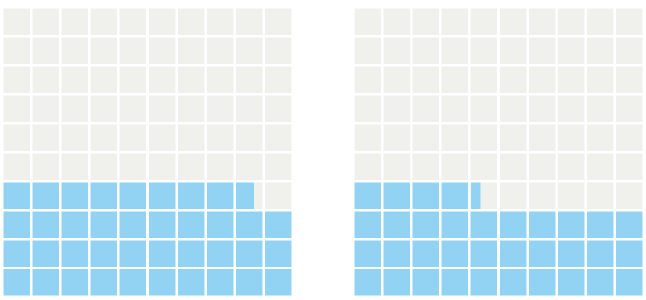
Valuations

In theory, valuations should vary with interest rates. Higher rates generally mean lower valuations. Looking at history, this inverse relationship holds true in the real data. When we look at valuations, therefore, we need to look at interest rates. If rates hold, so should current valuations, and if rates rise further, valuations may decline.

Although the Fed is now expected to continue raising rates, those increases are already priced into the market. Rates would need to rise more than expected to cause additional market declines. On the contrary, it appears rate increases may be stabilizing as economic growth slows. One such sign comes from the yield on the 10-year U.S. Treasury note. Despite a recent spike at the end of last year, the rate has declined since then and remained under 4 percent. If rates stay in this range, so should valuations—and so will markets.

In addition to these effects of Fed policy, rising earnings from a growing economy will offset any potential declines and will provide an opportunity for growth during the second half of the year. Just as with the economy, much of the damage to markets has been done, so the second half of the year will likely be positive as well.

10-Year Treasury Yield



3.87%
Year-end 2022

3.42%
April 28, 2023

The drop in yields helped support bond prices.

What About Those Headlines?

It was a tough start to the year, with the news affecting expectations more than the actual economy. The headlines screamed about inflation, politics, and bank failures, even as the economy chugged along.

Bank failures

The first half of the year saw the first wave of major bank failures in some time. Silicon Valley Bank, Signature Bank, and others collapsed suddenly, seemingly out of nowhere. The headlines hinted at fears of a new financial crisis. Indeed, the risks seemed real. Rising rates eroded banks' capital bases, leaving them less solvent even as deposits fled from the riskiest banks. Although only a couple of banks went down, more seemed vulnerable. Another 2008 seemed possible.

The system will survive and be stronger after the elimination of the weakest members. What caused the 2008 crisis was a sudden collapse in confidence, which threatened the system as a whole. In 2023, the government has laid the groundwork to resolve the problems with systemic risk. Although we are likely to see more individual bank failures, we won't see a rerun of 2008.

The 7 Largest Failures in History

Source: Bankrate

Interest rates, politics, and inflation

As we enter the second half of the year, despite the headlines and rate increases, the economic fundamentals remain sound. Longer-term interest rates have pulled back and show signs of stabilizing. Politics, at least the threat of default due to a debt ceiling crisis, is off the table for the year. Even the headline risks—inflation and war—are showing signs of stabilizing and may get better. Much of the damage is likely in the past, and the downside risk for the second half is largely already incorporated. That is not to say there is no risk, but existing risks are unlikely to keep knocking markets down.

During the second half of the year, growth will likely slow, but it will keep going. The Fed will keep raising rates, but perhaps more slowly than expected. That combination should keep the economy and the markets on a positive trajectory. It probably won't be a great finish to the year, but if we get more slow growth, which is what we expect, a win will still be a win.