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Perspective on Fourth Quarter 2022 Economic & Market Events

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It is probably a fair assumption to say that most investors are happy 2022 is now in the history books. The Russian invasion of Ukraine, the most aggressive Fed interest rate hiking policy seen since the 1970s, major China geopolitical tensions, and the doubling of mortgage rates all took their toll on financial markets. At the same time, ongoing inflation continues to undermine the financial health of lower and middle-income Americans.

Most economists are cautious about economic performance in 2023. According to a quarterly survey of professional economic forecasters conducted by the Philadelphia Fed, the consensus points to slowing growth and higher unemployment in 2023. In the first two quarters of 2023, economists expect growth will flatten (+0.2%). They anticipate a pick-up in the rate of economic expansion in the final two quarters of the year.[1]

The U.S. economy feels the effects of higher interest rates, particularly in housing, business investment, and financial assets. In the meantime, another problem with the Fed raising interest rates so much last year is that bond prices also significantly declined. When interest rates rise, the value of existing bonds decline as new, similar bonds issued with higher interest rates are made available to investors. Much of the time, when the stock market declines, the bond market rallies because bonds are seen as a safe haven during times of stock market turmoil. However, stock and bond values declined simultaneously last year as interest rates rose more significantly than anticipated.

Yet, despite the consensus of weaker economic growth and the potential for recession in the first half of the new year, there is a case to be made that the economy may fare better than expected.

The U.S. economy remains surprisingly resilient. The labor market has been healthy despite the economic slowdown in 2022, as reflected in the most recent (January 2023) employment report in which employers added a robust 517,000 jobs, and the unemployment rate stands at 3.4%, the lowest level in more than 53 years. One reason for this labor strength may be that employers are hesitant to lay off workers with fresh memories of how difficult it was to hire them coming out of the pandemic.[2]

Furthermore, the stock market is typically a leading indicator of the economy. Therefore, even if the Fed causes a recession by raising interest rates to reduce inflation, the stock market decline that has already occurred may have already partially priced in the worsening economy. Just as the stock market has declined in anticipation of a recession, it would not be surprising to see the stock market begin to recover during an economic downturn as it anticipates an eventual economic recovery.

The rebound in stocks last quarter was primarily a result of the slowing down of inflation, better-than-feared corporate profits, and growing investor relief that the descent from the summit of the rate hike cycle had begun. The fourth quarter also witnessed a change in sector leadership, with the previous market leaders, namely high-growth technology and communication services names, taking a back seat to "old economy" names.[3]

The market's performance in the year ahead may depend on the same three variables that battered stock prices for much of 2022, i.e., inflation, interest rates, and recession fears.

While these headwinds are not likely to evaporate soon, we may have already seen peak inflation. Should inflation continue to moderate, it may provide the Fed some flexibility with future rate decisions.

However, inflation may remain sticky at unacceptably elevated levels. As the Fed learned in the late 1970s, inflation is like toothpaste. Once out of the tube is difficult to put it back. Anticipate that you are going to see plenty of debate in the financial press about whether a recession will occur, and whether it will be short and shallow or longer and pronounced. For example, current forecasts from Goldman Sachs indicate a soft landing without recession while JP Morgan's Chief Economist is claiming an "economic swamp" that is shallow but takes a while from which to emerge. Two titans of Wall Street, two markedly different opinions. [4]

Even if we see lower inflation, there is no guarantee that the Fed will pivot from its current policy. As Fed Chair Powell has said, the labor market will be one of the critical determinants of future Fed behavior. In the Fed's mind, strong employment and wage growth add to inflation pressures. Moreover, Powell has repeatedly cautioned about the danger of declaring victory over inflation too soon. [5]

The question for 2023 will be, "Did the Fed go too far?" The economic impact of rate hikes implemented in 2022 may not be evident until early- to mid-2023. Many economists believe the impact of rate hikes will not reveal itself until 9-12 months later. Worries that rate increases result in a recession may weigh heavily on markets, especially in the year's first half. Investors saw in December what the overhang of a recession could do to stock prices. Whether the economy slips into a recession in 2023 is still open to debate.

2022 is a good reminder that not every year for an investor is a great success. We continue to recommend that investors remain focused on the long term without letting short-term market declines or cyclical economic downturns change their overall investment strategy. Recessions are part of the normal business cycle, and they often result in good buying opportunities for stocks. In 2023, we continue to be dedicated to our clients' success and look forward to working alongside each of you to see your goals achieved.

1. Federal Reserve Bank of Philadelphia, November 14, 2022
2. https://www.bls.gov/news.release/empsit.nr0.htm
3. https://www.cnbc.com/2022/11/11/investors-fleeing-big-tech-for-old-economy-heres-what-it-means.html
4. Marketwatch – 3 recession scenarios in 2023, 1.03.2023
5. https://apnews.com/article/federal-reserve-powell-comments-682b416097d60a09c7072b6afe734478