

# Quarterly Economic Update

Presented by:  the Legacy Group

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**In this Q4 recap:** Stocks rallied amid better-than-expected corporate earnings, increasing hopes of a slowdown in rate hikes, and indications that inflation may be moderating until retreating on renewed recession worries.

## The Quarter in Brief

The fourth quarter managed to repair some of the damage inflicted on stocks since the beginning of the year. Investor sentiment for much of the quarter rose due to a stronger-than-expected earnings season, a deceleration in inflation, and an increasing conviction that the Fed may begin scaling back on the pace of interest rate hikes. The mood, however, soured in December as recession fears were rekindled by continuing Fed hawkishness and weak economic data, sending stocks lower and paring some of the quarter's accumulated gains.

October began on a volatile note, as stocks soared in response to Britain's incoming prime minister's reversal of an earlier decision to cut taxes, a decision that had sent global markets lower at the end of September. This was soon followed by an extraordinary day in U.S. markets. An above-consensus inflation report sent stocks tumbling in early trading to levels not seen since 2020 before mounting a massive turnaround that by day's end had witnessed the Dow Jones Industrial Average surging 1,500 points from its midday low.<sup>1</sup>

The market stabilized with the start of the third-quarter earnings season, with early earnings reports calming fears of deteriorating profits and pushing Fed policy concerns into the background. Overall, earnings weren't great, but the bar was low, that most companies exceeded Wall Street's expectations. With 99% of all S&P 500 companies reporting, 70% of companies checked in with a positive earnings surprise.<sup>2</sup>

Stocks added to their gains in November on growing investor optimism for a slowdown in future rate hikes. After the Federal Open Market Committee (FOMC) announced a 75 basis point rate hike at the start of the month, stocks retreated on hawkish comments by Fed Chair Powell in his post-meeting press conference. However, markets staged a quick recovery following a cooler-than-expected inflation number that ignited a rally that lifted stocks to their biggest one-day gain in two years.<sup>3</sup>

Despite a stream of comments from multiple Fed officials that discouraged the easing-rate-hike

narrative, stocks continued to climb, boosted by upside surprises in new economic data and strong earnings from retailers. Markets received an added boost in November when Powell indicated that a slowdown in rate hikes was appropriate and may begin as early as December.

Stocks opened December by surrendering some of the earlier months' gains as recession fears dragged on investor sentiment. The Fed announced another rate hike of 50 basis points, widely expected by the market. Still, the increase in the terminal rate (i.e., the rate at which the Fed stops further rate hikes), along with weak economic data, elevated recession worries and closed the quarter and the year on a muted note.

### **The U.S. Economy**

After two straight quarters of negative growth, the U.S. economy grew by an annualized rate of 2.6% in the third quarter, owing in large part to an outsized contribution from net exports, the biggest in 42 years – a result that appears unlikely to get repeated in future quarters.<sup>4</sup>

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. Surveyed forecasters project that the fourth quarter Gross Domestic Product (GDP) annualized growth rate will decline to 1.0%. In the first two quarters of 2023, economists expect growth will flatline (+0.2%). They anticipate a pick-up in the rate of economic expansion in the final two quarters of the year.<sup>5</sup>

The U.S. economy feels the effects of higher interest rates, particularly in housing, business investment, and financial assets. At the same time, ongoing inflation continues to undermine the financial health of lower and middle-income Americans.

Consumer confidence, an essential prerequisite to spending, has been declining in recent months as Americans worry about the economy's health and financial prospects. In The Conference Board's November survey of consumers, consumer confidence ticked lower, dragged down by inflation and rising interest rates. When asked about their expectations in six months, a growing number of Americans anticipate their incomes will be lower, while a shrinking number of respondents believe their incomes will rise.<sup>6</sup>

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 November employment report in which

employers added a robust 263,000 jobs, and the unemployment rate stood at 3.7%. 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.<sup>7</sup>

Meanwhile, consumer spending power remains strong, with over \$1.5 trillion in aggregate excess savings (savings over pre-pandemic trends), albeit down from its \$2.0+ trillion peak in 2021.<sup>8</sup>

Finally, The Federal Reserve Bank of Atlanta's "GDP Now" forecasting model, which attempts to track GDP growth in real-time, estimates an annualized 4Q growth rate of 2.8% (as of December 15, 2022), which stands well above most economists' expectations.<sup>9</sup>

## Global Economic Health

Global economies continued to be challenged by the conflict between Russia and Ukraine, accelerating inflation, a tightening economic environment, and persistent sluggishness in China. The International Monetary Fund (IMF), in its latest economic forecast, projects that global economic growth in 2022 will come in at 3.2% (unchanged from its earlier July estimate) and slow in 2023 to 2.7% (a downward revision of 0.2 percentage points). The IMF calculates a 25% chance that growth may fall under two percent, with more than a third of economies likely to contract.<sup>10</sup>

The IMF has a low outlook for Europe amid high inflation and slowing growth. It projects that advanced economies in Europe will grow by just 0.6% in 2023 while emerging economies (excluding Turkey and conflict countries—Belarus, Russia, and Ukraine) will expand by 1.7%. It anticipates that more than half of Europe's nations will experience a recession.<sup>11</sup>

The outlook for the U.K. is a little better. In the Bank of England's (BoE) monetary policy report in November 2022, the BoE projected that the nation would be in recession for a prolonged period, with inflation remaining stubbornly high at about 10% until mid-2023. At that time, it may begin to moderate. Any improvement in economic performance may be further out. The BoE estimates that the U.K. economy will shrink by 0.75% in the second half of 2022. They also feel it may continue to contract through 2023 and into the first half of 2024.<sup>12</sup>

China's economy is also struggling, weighed down by persistent lockdowns resulting from its zero tolerance for COVID infections, a policy it only just reversed in December. One independent analysis forecasts that China's economy will grow by just 3.0% in 2022 and 4.3% in 2023. This is below the government's 2022 target of 5.5% growth. One notable trouble spot is the downturn in its property sector, which represents at least 20% of the country's output and nearly two-

thirds of urban Chinese household wealth. With the bust in residential prices and new developments, China's economy may feel the strain of its property issues for years to come.<sup>13</sup>

In Japan, the Bank of Japan lowered its forecast of economic growth in 2022 from 2.4% to 2.0%; for 2023, from 2.0% to 1.9%. They raised their estimate for inflation for both years.<sup>14</sup>

## QUARTERLY TIP

*If you're trying to save money or track your spending, consider using cash. Cash is real. You can see it, and you know when you're out of it. Money becomes more abstract when you use a credit or debit card, leaving you more open to financial choices you may later regret.*

### **Looking Back, Looking Forward**

The rebound in stocks last quarter was primarily a result of moderating inflation, better-than-feared corporate profits, and growing investor relief that the end of the rate hike cycle was closer to the end than the beginning. 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.

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.

But 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.

By its admission, today's Fed was late to respond to inflation. Moreover, central banks did not defeat the high inflation of the late '70s/early '80s alone. Global governments also contributed by reducing fiscal spending, which some politicians seem unwilling to do today, e.g., European subsidies to offset higher energy prices.

Even if inflation moderates, 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.

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.

MARKET INDEX	Y-T-D % CHANGE	Q4 % CHANGE	Q3 % CHANGE
DJIA	-8.78%	15.39%	-6.67%
NASDAQ	-33.10%	-1.03%	-4.11%
S&P 500	-19.44%	7.08%	-5.28%

BOND YIELD	12/31 RATE	1 MO AGO	1 YR AGO
10 YR TREASURY	3.88%	3.70%	1.51%

Sources: Wall Street Journal, December 31, 2022, Treasury.gov (Bond Yield)

The market indexes discussed are unmanaged and generally considered representative of their respective markets. Individuals cannot directly invest in unmanaged indexes. Past performance does not guarantee future results. U.S. Treasury Notes are guaranteed by the federal government as to the timely payment of principal and interest. However, if you sell a Treasury Note prior to maturity, it may be worth more or less than the original price paid.

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Composite Index is an index of all stocks (A shares and B shares) that are traded at the Shanghai Stock Exchange. The S&P/TSX Composite Index is an index of the stock (equity) prices of the largest companies on the Toronto Stock Exchange (TSX) as measured by market capitalization. The MSCI Emerging Markets Index is a float-adjusted market capitalization index consisting of indices in more than 25 emerging economies. The MSCI World Index is a free-float weighted equity index that includes developed world markets and does not include emerging markets. The CBOE Volatility Index® is a key measure of market expectations of near-term volatility conveyed by S&P 500 stock index option prices. The S&P SmallCap 600® measures the small-cap segment of the U.S. equity market. The Russell 2000 Index is a small-cap stock market index of the bottom 2,000 stocks in the Russell 3000 Index. Additional risks are associated with international investing, such as currency fluctuations, political and economic instability and differences in accounting standards. This material represents an assessment of the market environment at a specific point in time and is not intended to be a forecast of future events, or a guarantee of future results. MarketingPro, Inc. is not affiliated with any person or firm that may be providing this information to you. The publisher is not engaged in rendering legal, accounting or other professional services. If assistance is needed, the reader is advised to engage the services of a competent professional.

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