April 2023

Q1 2023 Commentary: Slowly moving in the right direction…

What happens when they schedule a recession and it never arrives? Since last summer when it became very apparent that the Federal Reserve would continue to raise interest rates aggressively to curb inflation, the expectation of a pending recession has loomed over investor sentiment. Also contributing to recession fears was an inverted yield curve in which short-term rates are significantly higher than long-term rates. This inversion has been in place since the middle of last year and is often a prelude to recession. This pervasive recession expectation led to extremely pessimistic investor sentiment in the second half of last year. As we noted at the time, such extreme pessimism has historically signaled that a stock market bottom is near. Extreme bearish sentiment usually precedes a higher stock market in the ensuing year. So far, so good. The stock market has rallied, albeit choppily, since October.

Under more normal circumstances, investor pessimism might be warranted. However, we are not under normal circumstances. The economy is still under the lingering influence of the covid pandemic stimulus. M2 money supply growth provides a measure of the magnitude of the stimulus. In the middle of the pandemic M2 money supply increased by 25%, a gargantuan amount. Since they started measuring money supply in 1959, money supply had only rarely increased annually by more than 10%. Those that were convinced the spike in interest rates made a recession a foregone conclusion seemed to forget about all the cash sloshing around in the system. Economic growth has been sustained because of the post covid opening and lingering economic stimulus. The initial report of first quarter growth of 1.1% matched the Atlanta Fed GDPNow website's consensus estimate. There is no recession in sight and as the economy acclimates to the new interest rate environment the threat of a severe recession recedes.

What will be critical going forward is getting inflation under control. We are getting there. Short-term rates have now been raised to the level of inflation which gets us to a restrictive monetary policy and a level that will fight inflation. Commodity prices are already down, and housing prices and rental rates are starting to fall. Still of concern are wages, which are a significant component of inflation and still rising sharply. However, job listings are coming down and wage growth is leveling off. We are keeping our eyes on the bond market which is signaling that inflation will be tamed. If inflation was expected to become entrenched at higher levels, long-term yields would be higher. However, the ten-year US treasury yield has fallen from 4.2% in November to less than 3.5% today. While long-term rates stay in their current range, our concern is only about when, and not if, inflation will get back to the Fed's 2.0% target rate.

With stable inflation comes a more stable economy and a stable economy is good for the stock market. Therefore, as we move forward, we expect the investment environment to improve. Furthermore, the federal reserve appears to be nearing a pause to its interest rate hikes which will improve investor sentiment as belief grows that interest rates have peaked. Meanwhile, as every month passes the impact of artificial monetary stimulus fades and a truly healthy economy emerges. All of these factors moving in the right direction gives us confidence in future stock market returns.