QUARTERLY MARKET OUTLOOK

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2023 SECOND QUARTER OUTLOOK

Preparing to Land

At-A-Glance

The Atlanta Fed is estimating Q1 GDP growth of over 3% as we get close to quarter end.

In February, the Consumer Price Index (CPI) showed the smallest 12-month increase since September 2021, but it was still running hot at 6%.

The Federal Reserve increased interest rates by 0.50% in the first quarter, having increased rates by 0.25% in each of the first two FOMC meetings of 2023, putting the current target range at 4.75% to 5%.

Stocks started the year strong as investors anticipated a Fed pivot, and the S&P 500 was up over 10% by early February. That reversed as economic data came in stronger than expected. Higher expectations for a more aggressive Fed ensued.

Bonds also had a choppy quarter, rising, falling and rising again. Large swings were seen. In mid-March, the 2-year Treasury yield posted its biggest 3-day drop since the 1987 stock market crash.

Volatility will continue as investors digest data and anticipate the Fed's policy response. Sectors are struggling with high interest rates and rising recession risks.

Overview

Higher interest rates are starting to take their toll on the economy. We had seen their impact on home and automobile sales, but in the first quarter, it became clear that higher interest rates also hurt start-up companies and banks.

With higher interest rates clearly making their mark, recession risks are growing. Investors grapple with what type of recession we could have and discuss it in terms of a plane landing. Will a potential recession be a hard landing (deep recession)? Will it be a soft landing (mild recession)? Or will we see a goldilocks scenario, where areas of the economy enter a recession at different times?

We think the answer will be somewhere in the middle. Our base-case scenario is for a soft landing. So far, the economy has been resilient. This is evident in manufacturing, which is in contraction and already in a recession. It was one of the first sectors to benefit from the pandemic stimulus money because of a surge in goods demand, and one of the first to decline. While in contraction, it is currently a mild contraction. Additionally, the labor market is strong, with nearly two job openings for every single individual looking for work. As a consumer driven-economy, this is good news. People tend to spend money if they have a job and don't fear having to find a new job if they lose their current one.

Aware of the impact of actions to date on the economy, the Fed is also widely expected to dial back their future interest rates hikes and some even anticipate they will cut rates later in the year. This has led to more investor optimism and is hopefully the silver lining in the bad bank news that rippled through markets.

Stock markets are forward looking and anticipate future Fed moves as well as future economic growth and inflation. Large cap stocks, as represented by the S&P 500, are not cheap from a valuation perspective, but they are less expensive than they were at the start of last year. Smaller company stocks have better valuations. Earnings growth is expected to be negative in the coming months, but this could set up upside surprises later in the year.

Bond markets are also forward looking and have been volatile as bond investors try to account for what the Fed may do next. The good news is that bonds pay a lot more yield than they did a year ago and can buffer more price volatility.

Your financial professional can help you stay on track and keep focused on your personalized long-term plans, helping you navigate through market volatility.

For a more detailed look into what we are thinking and what is happening in the economy and markets, continue reading our second quarter 2023 outlook.

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Global Economy

When Rates Go Up, the Tide Goes Out

The cracks from Fed tightening started to emerge in the first quarter. Without time to raise rates gradually to determine the impact, the Fed was forced to hike them quickly, increasing the potential to break areas of the economy that had benefited from zero-interest rate policy. Some companies are reliant on cheap borrowing costs, especially startups, which can have negative cash flows in their infancies. Banks that were overexposed to such companies and didn't have a diversified base of customers saw runs on the bank as their customers moved in tandem to use cash to fund operations when their investor capital dried up. We saw higher interest rates and tighter financial conditions expose a few banks that were taking excess risks.

To make matters worse, when these banks saw large inflows of cash during easy money periods in 2020 and 2021, they invested in longer-dated bonds, which were also hurt when long-term bond yields rose (bond prices move in the opposite direction of bond yields). Short-term yields were yielding over a percent more than long-term yields in early March, a level not seen since the early 1980s. While this is not a credit risk, it is duration risk, and it is bad for banks in general because they borrow money at short-term rates and invest at long-term rates. An upward sloping yield curve helps them make profits. An inverted yield curve means the banks are pressured to give customers more interest than what they are making from their long-term investments.

It is important to note that this is different than the Great Recession when banks were largely invested in mortgage-backed derivatives where the underlying mortgages were not performing. The assets of the banks now are mostly composed of long-dated U.S. Treasuries, which if held to maturity, will be redeemable for the full principal amount. If the banks are forced to sell before maturity, however, they must sell at a discount because yields have risen. Having liquidity to meet customer demands is very important and prevents selling bonds at losses. The Fed understands this and has begun providing a program that helps banks provide this liquidity without having to sell these longer maturity assets at a loss, using them as collateral for these shorter-term loans instead.

The tide has gone out and companies that grew dependent on zero interest rates are getting washed to shore. Banks that were overexposed to these companies are in trouble, but more broadly the banks that are not in trouble are still feeling the effects of Fed policy with the inverted yield curve. It could be a good time to see how the economy is doing in this new rate environment. While companies reliant on zero interest rates are the first to wash up, other companies may do so later.

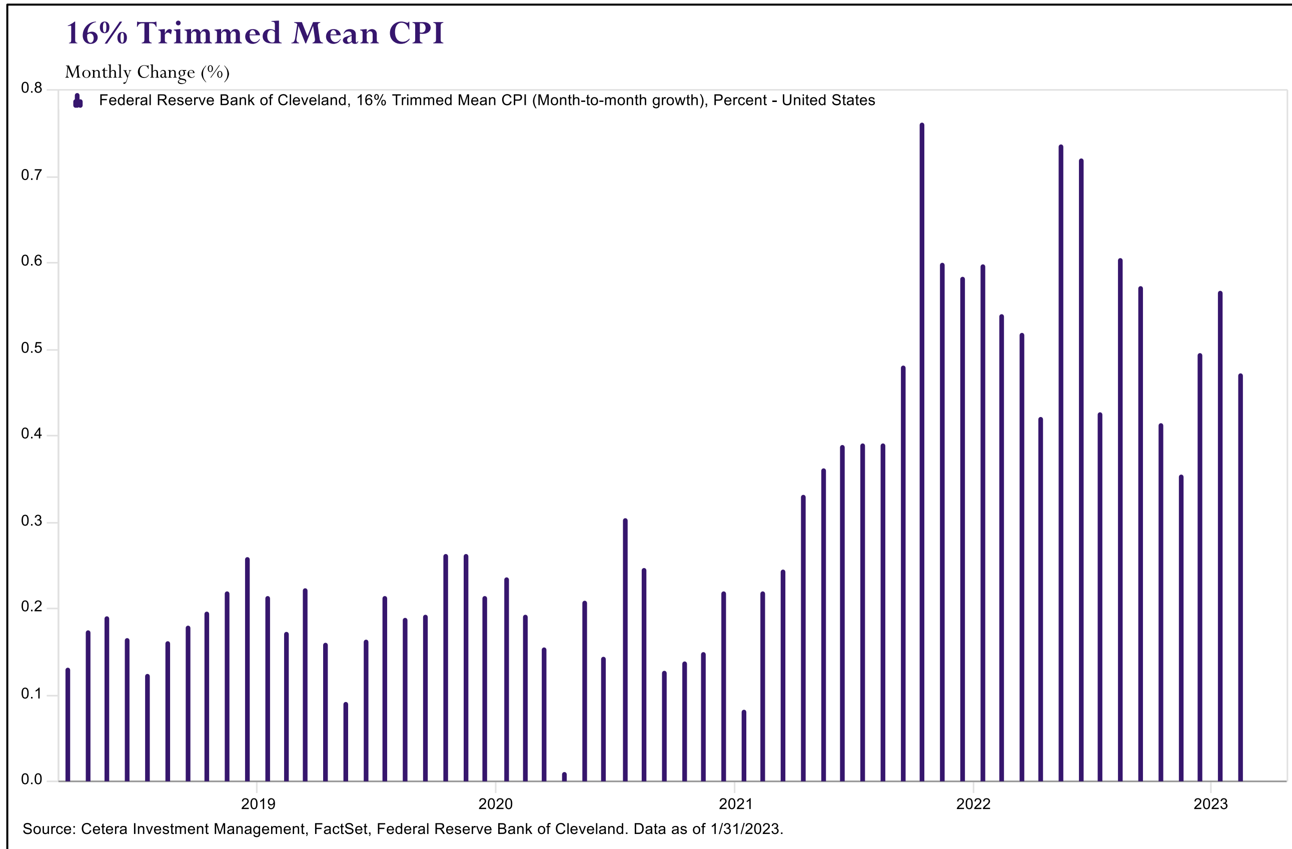
With the Fed potentially getting ready to pause interest rate hikes, investors are contemplating what damage has been done to the economy. The analogy of a plane landing is often used. Will the economy suffer a hard landing (deep recession), a soft landing (shallow recession) or will there be no landing (no recession)? We will take you through these potential scenarios, and why we still think our 2023 outlook thesis of a soft landing is intact.

The Hard Landing

The bear case of a hard landing, or deep recession, can be made due to stubbornly high inflation. After all, that is why the Fed is aggressively hiking interest rates. Inflation can be tricky to measure, and it isn't the same for everyone. We like to look at different metrics to gauge inflation, not just the headline consumer price index, which is often quoted in the media. For example, we follow the 16% trimmed mean index, which removes the top and bottom 8% of inflation categories and averages the remaining ones. It allows us to better gauge how inflation may be stripping out outliers at a broad level. As you can see in **Figure 1**, inflation on a broad basis has been rising again over the last couple of months. While this is just two data points, it is starting to look like a trend and the bear case scenario could be made that inflation isn't under control and the Fed will have to

continue to raise rates, creating collateral damage to the economy. The Fed has no choice but to hurt the economy to tame inflation.

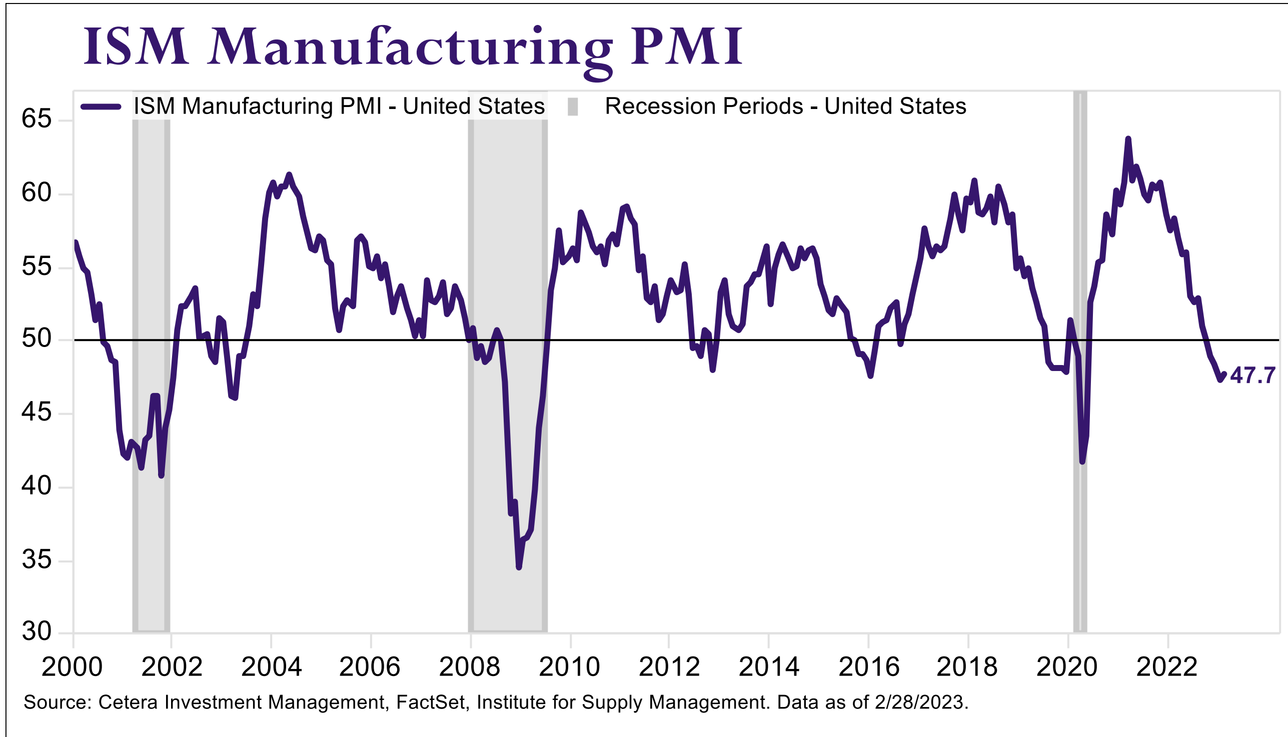
Figure 1: Broad Based Inflation



The Soft Landing

The soft-landing scenario, or middle-of-the road scenario, is that we will experience a mild recession, and it remains our thesis. While inflation is a problem, we think the Fed rate hikes are having an impact, but there is a lag. As mentioned earlier, companies that relied on zero-interest rate policies are struggling, but we think most companies are better positioned to weather the increase in borrowing costs. Many refinanced at cheap interest rates and used that opportunity to clean up their balance sheets. Homeowners did the same, as 90% of all mortgages are 30-year and 15-year fixed rate mortgages and home equity levels are coming off 50-year highs. We currently see a scenario where the Fed takes a pause soon and it is still possible rates will be cut later in the year if inflation does show improvement and economic growth slows. Meanwhile, manufacturing, which we expect to get hit first, is holding up. While in a mild contraction, it isn't doing as poorly. This sector benefited from stimulus money and the stay-at-home economy but was expected to struggle as consumers began shifting attention to the services sector. **Figure 2** shows the Institute of Supply Management Manufacturing Purchasing Managers Index. This index is based on surveys of business leaders in the manufacturing sector and is forward-looking, asking these decision makers questions about the future. Will they be hiring or laying off workers? Will they build inventory levels? You can see the index is below 50, which is signaling a contraction, but currently the index isn't as bad as many feared.

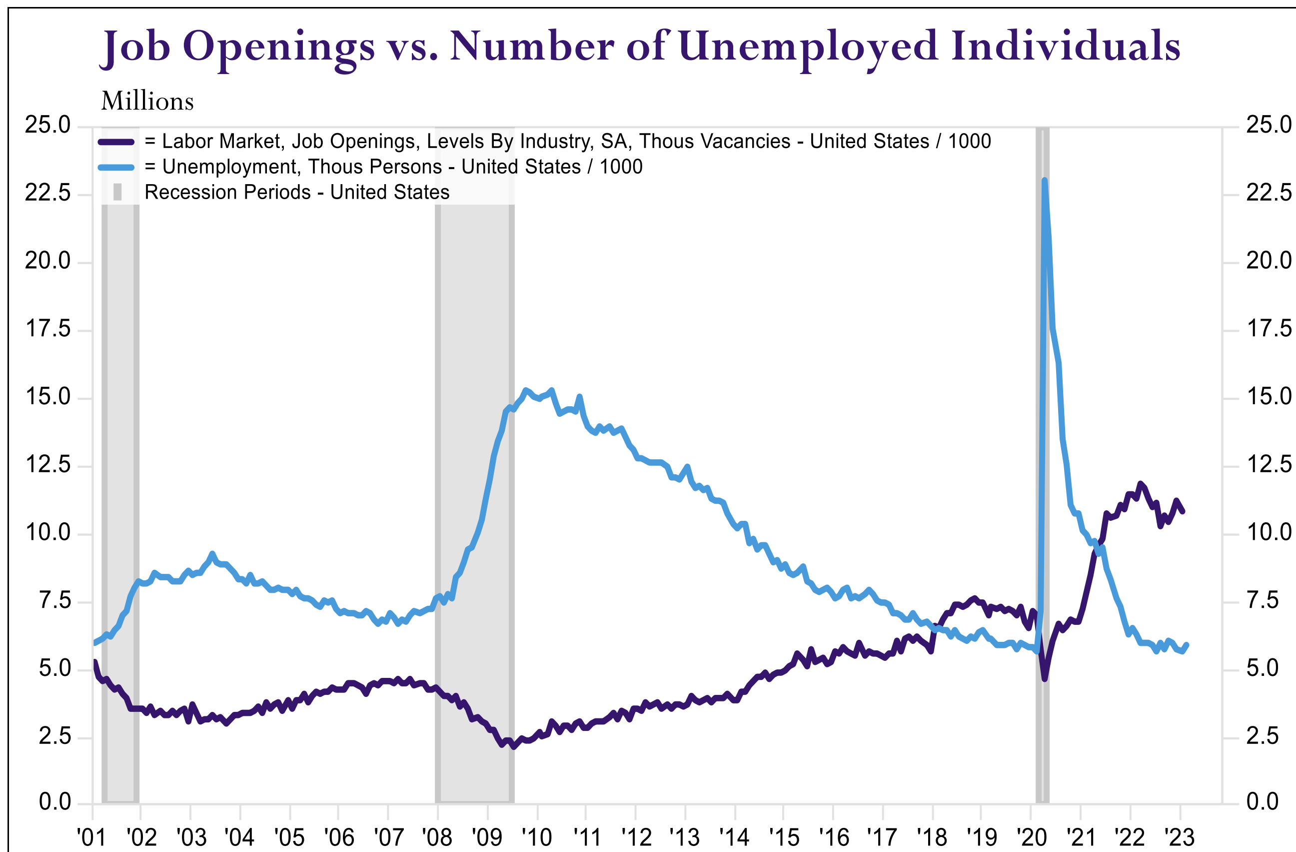
Figure 2: Economic Data Holding Up



No Landing?

The no-landing scenario is the most bullish, or goldilocks, scenario–the one with no recession at all. Proponents of this thesis often talk about a rolling recession, in which certain sectors of the economy experience a recession but the broad economy avoids one. The best argument for this scenario is the labor market. The unemployment rate was recently at 50-year lows and there are nearly 2 job openings for every job seeker, as seen in **Figure 3**. Labor market strength is undeniable, and as a consumer-driven economy, this is very positive. When consumers don't fear finding a new job if they lose their current one, they tend to spend money. While this is optimistic, we do note that these conditions can change quickly. The unemployment rate tends to come down gradually over long periods of time but can jump up dramatically when a recession happens.

Figure 3: Strong Labor Market



Source: Cetera Investment Management, FactSet, U.S. Bureau of Labor Statistics. Data as of 1/31/2023.

Global Economy: Divergence in Central Bank Policies

The global economy is expected to grow 2.2% in 2023, according to new estimates from U.K.-based economic firm Capital Economics. Eurozone growth projections were revised higher, but estimates are still negative at -0.1% and point to contraction. The U.K. is expected to contract by 0.4% and Japan by 0.1%. Emerging markets are expected to post positive growth, at 3.5%. This is all compared to the United States with a 1% expected GDP growth rate.

One of the big stories of 2023 could end up being the disparity of central bank policies around the world. China has already been cutting rates, but it is possible the Fed could pause and cut rates later in the year, while the European Central Bank continues to hike rates higher to combat higher inflation. Capital Economics estimates inflation to be 6% for the Eurozone and only 3.9% for the U.S. in 2023. Divergent central bank policies have an impact on currencies and in this scenario the U.S. dollar could weaken. This could be good for U.S. businesses that do business overseas at they would exchange other currencies for a weaker dollar, making profit off currency. This is also good for U.S. investors investing abroad. Much of investor losses in international investments over the past year can be attributed to a rising dollar. A resolution in the war in Ukraine could also benefit Europe. Many have also been awaiting the reopening of China as they loosened their COVID policies. China and even the rest of Asia could see increased economic growth due to this.

Equity Markets

The first quarter was a great reminder of how fast investor expectations can change in a Fed rate hike cycle and the volatility that can ensue. 2023 started with an equity rally. The S&P 500 climbed over 10%, as investors expected the Fed to pause and even pivot and lower interest rates later in the year. Strong economic data and aggressive signaling from the Fed changed that view and stock markets contracted accordingly. As quarter-end approached, we started to see a few bank closures in the U.S. and worries about a major bank in Switzerland, leaving investors confused at first. Was this bad news actually good news because the Fed can stop their rate hikes? Or was this just bad news? As we approached the March Fed meeting, the S&P 500 had given up nearly all its gains for the year.

Where the stock market goes from here depends a lot on what we examined in the economic section. Investors have a lot of questions...When will the Fed stop raising interest rates" Will the Fed lower interest rates? What damage has already been done to the economy? The answers to questions about actions by the Fed might be answered soon but will be influenced by inflation. The last question will take longer to answer, as there is a lag between the Fed's policies and their impact to the economy.

Meanwhile, there will be a lot of volatility as expectations shift back and forth with new economic data, Fed speeches, and headlines about companies struggling due to higher rates. As stock markets are forward-looking and anticipate what's going to happen, anticipations can change quickly with new information. In the meantime, we can gauge current expectations for corporate earnings and look at stock valuations to determine how expensive they are relative to history.

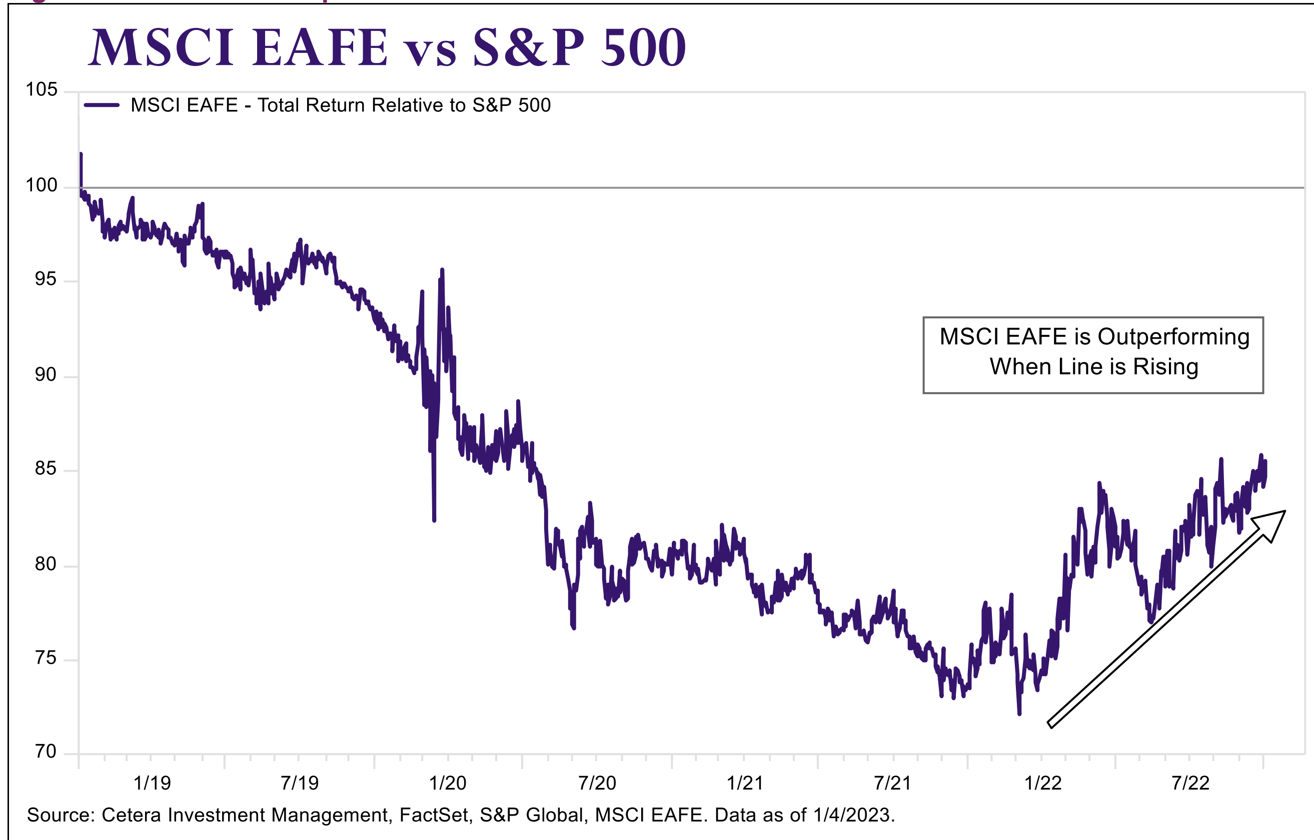
Earnings expectations have been lowered and probably will continue to be lowered for the foreseeable future. The current outlook is for single-digit negative earnings growth in the first and second quarters, with positive single-digit growth in the third and fourth quarters. For the year, earnings growth is predicted to be slightly positive. As we discussed in our 2023 Outlook, expectations are low and continue to be lowered. With our thesis of a soft-landing scenario, this could provide for upside surprises later in the year as companies increase profit margins if inflation starts to fall and the Fed pauses or even pivots and lowers rates.

Assessing whether stocks are currently cheap or expensive, we can look at price-to-earnings ratios. Stock prices relative to their earnings appear to be around their 15-year averages for S&P 500 companies. So, they don't appear cheap, but aren't expensive either. This is probably still good news, because going into this Fed rate hike cycle these stocks were trading near 15-year highs from a valuation perspective. If we move away from these larger U.S. stocks, valuations get better. Valuations of smaller companies are near 15-year lows and developed markets outside of the U.S. are below their long-term averages. Emerging market stocks have lower price-to-earnings ratios (P/Es) than those of developed countries.

The outperformance of domestic large cap stocks over the past decade can largely be attributed to a strong dollar, strong earnings growth, and lower interest rates, which benefit growth companies and especially technology companies. The S&P 500 index has a higher concentration of technology companies than smaller company indexes and international indexes. Eventually, the dollar will fall relative to other currencies, especially if there is divergence in monetary policy like we discussed in the economic section. Additionally, borrowing costs are higher now and many growth and technology companies are starting to struggle in this new environment. A case could be made for international and smaller companies to outperform the S&P 500 in the future. The war in Ukraine has increased energy prices and driven inflation, which has hurt Europe, while China's strict COVID policies have hurt Asian economies. China has recently reversed these policies and many are looking forward to the reopening of Asia, which could see the early boost that the United States experienced when it rolled back COVID restrictions. The end of the war in Ukraine is less certain, but potential peace talks could bolster optimism. If this optimism increases, U.S. investors who may have under-allocated international

market exposure, may want to reconsider their allocations moving forward. International developed markets quietly outperformed the U.S. last year despite the headwinds of a rising dollar and a war in Europe. **Figure 4**

Figure 4: International Equities



Source: Cetera Investment Management, FactSet, S&P Global, MSCI EAFE. Data as of 1/4/2023.

Fixed Income

The first quarter saw historically large moves in bond prices and yields. We discussed the inverted yield curve earlier, so let's start by expanding on that. Bonds of different yields and maturities do not move in tandem with each other and are influenced by different factors. Short-maturity bonds are influenced more by the Fed Funds Rate, while longer maturity bonds are influenced more by expectations around future economic growth and inflation. The Fed has been raising the Fed Funds Rate to slow inflation, but it also slows future economic growth expectations. As such, short-term bond yields have been rising faster than long-term bond yields to the point short-term bonds have higher yields than long-term bonds. As described earlier, this is bad for banks.

A common way to evaluate the spread between short and long maturity bonds is to look at the spread between 10-year Treasuries and 2-year Treasuries. This spread was the most inverted it has been in over 40 years the week before banking troubles arose. After of the first banking problems occurred, the 2-year Treasury yield posted its biggest three-day drop since the 1987 stock market crash, known as Black Monday. As mentioned, the 2-year Treasury yield is influenced by the Fed Funds Rate and is even used to predict where that rate will be in 12 months. The two-year yield was as high as 5.05%, then fell to 3.81% in little over a week (**Figure 5**). Investors were pricing in a Fed pivot. Case in point was during one week in mid-March, when investors went from expecting the Fed to raise rates by another 1% before year-end to then expecting the Fed to cut rates by 1% before year-end. Next, they began anticipating the Fed would cut interest rates over the course of the next

year. These are wide moves and the spread between the 10-year and 2-year Treasury yields went from -1.08% to -0.43% in a very short period.

Figure 5: 2-Year Treasury Yield

Source: Cetera Investment Management, FactSet. Data as of 3/17/2023.

As we get closer to the end of the Fed rate hike cycle, we expect more volatility. There is a lot of uncertainty around Fed policy now that inflation is still high, and the economy is starting to show cracks from higher interest rates. We just discussed the Treasury market, but credit markets are also moving.

High-yield spreads are the spread between below-investment-grade bond yields (junk bonds) over Treasury bond yields. These bond holders get an additional spread over Treasuries for taking on the extra risk of default or downgrade which is associated with investing in bonds issued by companies with less financial strength. High-yield spreads jumped from under 4% to 5.2% quickly. However, this is below levels we typically see in a recession. The last three recessions all saw this spread grow to over 10%. It should be noted that there have not been a lot of issuances of high-yield bonds recently, so demand has been low. This could artificially keep this spread lower than what we would typically see because of this supply-and-demand imbalance.

Bonds suffered their first double-digit annual loss on record last year, but the risk-and-return dynamics changed with rising bond yields. Bond prices rise when bond yields fall, so this year has started out well for bond investors holding high-quality bonds. With a potential recession on the horizon and prospects of a less aggressive Fed, high-quality bonds could continue to perform well. In addition, if yields don't move from where they currently are, bond investors could get decent yields just holding on to them. Bonds can also protect

against equity volatility. When constructing a bond portfolio, your financial professional can help you create one that suits your specific goals and objectives.

The Bottom Line

We are crossing our fingers for a smooth economic landing, but much of the impact from the Fed tightening cycle has yet to be felt and we do not know when it will stop or reverse course. Ultimately, the pace of inflation will decide that. Inflation is slowing but remains stubbornly high. We will continue to watch interest-rate-sensitive areas of the economy for more clues to future economic turbulence. There are areas in equities that look relatively cheap but large cap growth still demands a premium trading above its 15-year average price-to-earnings ratio. In fixed income, the risk-and-return relationship has changed with higher yields, as bond yields can now buffer price declines. We continue to expect a lot of volatility in both bonds and stocks. Eventually, we expect a soft landing or a mild recession. More certainty around the economy and the Fed could lead to investor enthusiasm like what we saw to start the year. Timing is difficult, as investors' enthusiasm can turn quicky, as we have already seen. They are eager to start pricing in a more accommodating Fed. Your Cetera financial professional can help you through these volatile times to keep you focused on your personal goals and objectives.

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Glossary
The S&P 500 is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

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