Investment Commentary

HANOVER ADVISORS

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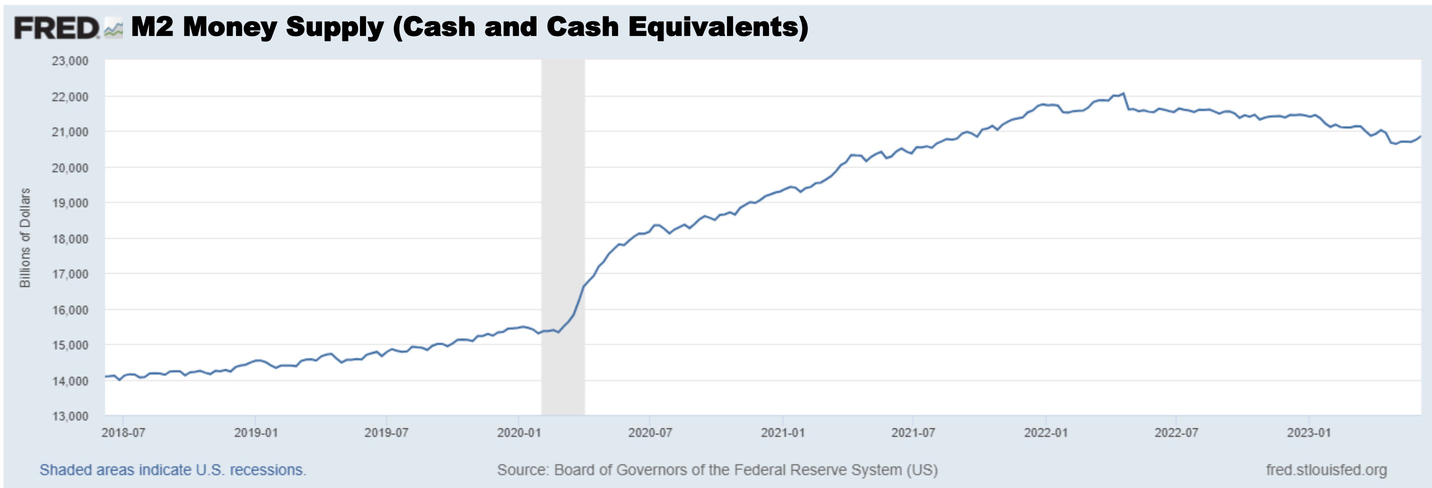
2023 Mid-Year Review: Are We Out of the Woods?

All eyes have been on the Federal Reserve, who is walking a precarious tightrope between slowing economic growth and easing, but still-high, inflation. Investors have pored over every piece of economic data trying to determine what it will mean for the Fed's thinking with regards to interest rates. The key question remains: how high will rates need to go and for how long will the Fed need to keep them there to bring inflation back down to the Fed's 2% target?

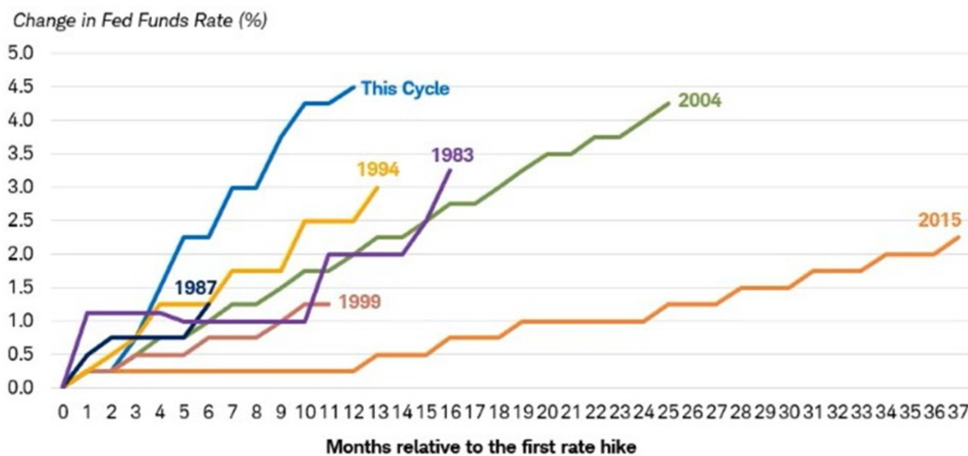
The Fed began raising rates and tightening monetary policy in March of last year. Prior to this, monetary policy, in the form of ultra-low rates and quantitative easing, was extremely accommodating. On top of that, the government's generous pandemic-era stimulus injected trillions of dollars into the economy. All told, the government's pandemic response amounted to roughly $6 trillion, more than the inflation-adjusted $4.1 trillion spent waging World War II. The M2 money supply, which tracks the amount of cash and cash equivalents in the economy, typically grows by about 4-5% annually. Average annual M2 grew by a staggering 19.1% in 2020 and 16.3% in 2021 (see graph below). This means that there was a great deal of excess money sloshing throughout the economy, which drives inflationary pressure. The Fed reiterated that inflation was "transitory" in nature, owing largely to pandemic-era spending habits and supply chain disruptions, and that the current bout of inflation would muddle its way through the economy without the need for higher rates.



Whether the Fed was right or wrong in their thinking became moot when Russia invaded Ukraine last February. The war roiled global commodity markets and caused prices of food and energy to

surge. Workers, who had additional leverage in the tight labor market, pushed for higher wages to keep pace with climbing prices, further entrenching inflationary pressures. Facing the prospect of a wage-price spiral, in which wages and prices continue to push each other up in lockstep, the Fed embarked on the most aggressive rate hike cycle in modern history, bringing rates from essentially zero to more than 5% in the span of just 14 months. Interest rates drive the modern financial system and have a far-reaching impact on everything from economic activity to stock valuations. Surging interest rates diminished the value of bonds, and the bond market, according to many measures, had the worst year in more than a century in 2022. Stocks did not fare much better. The S&P 500 ended the year down 19.44%, and the tech sector, which is more sensitive to interest rates, was down 32.5%.

Heading into 2023, uncertainty was elevated, but if anything, most of the surprises have been to the upside. Economic growth has moderated, but the resiliency of U.S. consumers and tight job market has kept recessionary fears from materializing beyond what longtime market observer Ed Yardeni has dubbed a "rolling" recession, which has seen economic contraction work its way through specific regions and industries rather than the broader economy. Inflation is trending down, and the stock market has seen a solid rebound. The S&P 500 is up 15.9% year to date, and despite ongoing volatility in the bond market, nearly every sub-class in the fixed income arena has seen positive returns. This is not to say, however, that we are out of the woods.



Inflation is indeed trending down. May's consumer-price index (CPI), a common inflation gauge, was up 4% from a year prior. That is the lowest year-over-year CPI reading in nearly two years and down substantially from the recent peak of nearly 9% seen last summer. This decline gave the Fed room to pause their rate hikes at their most recent meeting. However, much of inflation's recent retreat has been due to falling food and energy prices. The so-called "core" CPI, which excludes the volatile food and energy components, was up 5.3% year-over-year in May. Economists view core inflation as more indicative of where inflation is heading. The Fed has thus far been unable to engineer an

upturn in the unemployment rate, meaning that robust wage growth continues to drive inflationary pressure. This puts the Fed in a difficult position, running the risk of prematurely declaring victory over inflation on the one hand, and over-tightening and tipping the economy into a recession on the other.

We do expect inflation to continue to come down. The arcane method that CPI uses to calculate housing costs gives that component outsized representation, accounting for 33% of the index. CPI housing data also has a significant lag, so recent reports have seen shelter costs continue to climb, despite the downturn in the housing market. More real time data, such as the Zillow Observed Rent Index, has shown rapidly falling shelter costs. The median asking rent in the U.S. fell 0.6% in May (7.2% annualized) from a year prior, a marked slowdown from the 16.5% annual increase seen a year earlier.

As CPI data continues to catch up to recent trends, it is likely to continue declining, but it remains to be seen if bringing inflation to the Fed's 2% target will necessitate further rate hikes. The broad consensus from the markets is that we will likely see one or two additional rate hikes this year. Barring the "rolling" recession turning over into a full-blown recession, it is unlikely that we will see rate cuts this year, but the market consensus is that we will likely see cuts in 2024. This would be welcome news for the stock market, allowing the recent rally to broaden out and take pressure off earnings.

Corporate earnings proved to be resilient in the first quarter, with 79% of the companies in the S&P 500 beating estimates. Estimates for the rest of the year remain downbeat, however. Q2 earnings are projected to be down at least 5%, but things are expected to bottom out in the second half of the year before returning to positive growth. Corporate revenue has remained robust and is up about 9% year-over-year, due in no small part to inflation. Inflation and higher labor costs could squeeze profit margins and diminish earnings, but investors are forward looking, and will be likely to look beyond a potential earnings downturn, especially as things become clearer with regards to the Fed and inflation. Rate cuts would help the market's recent rally broaden out, as recent gains have been highly concentrated among a handful of mega-cap stocks.

The S&P 500 this year has been dominated by a handful of stocks, mostly in the tech sector. The top 10 performing stocks in the index represent roughly one-third of the S&P 500's gains, and the top 5 represent nearly one-quarter. These percentages are higher than even during the peak of the dot-com

bubble. This presents a great deal of concentration risk. At the end of May, only 15% of S&P 500 stocks were outperforming the overall index over the prior three months. That is the lowest percentage since 1990. The good news is that by June, that percentage had increased to 24%, a promising sign that the rally is broadening. Another piece of good news is that the relative underperformance of small - and mid-cap stocks has kept their valuations at attractive levels. These stocks are trading at about 13 -14 times forward earnings, which is within historic norms. While last year's valuations were even more attractive, small- and mid-cap stocks remain more promising than large-cap stocks, which are trading at 18-19 times forward earnings.

Amid all the uncertainty and volatility, it is looking like things may line up for a "goldilocks" scenario where the Fed achieves a soft landing, bringing inflation down without causing a recession. It must be stressed, however, that any optimism be balanced with caution. As promising as things may seem, the markets are likely to remain volatile and are highly susceptible to external shocks, particularly on the geo-political front. An escalation of the war in Ukraine, or an event as unforeseen as the initial invasion, could once again roil the commodities market, driving inflation back up and making the Fed's path even more treacherous. The turmoil in the banking sector we saw earlier in the spring may produce further stress fractures in the financial system. We remain deeply concerned about the commercial real estate market, where higher mortgage rates and devalued office space may spark another wave of bank failures. Investor sentiment may be frothy in the coming months. Optimism should be tempered by caution. On the flip side, an unexpected downturn in earnings or the "rolling" recession giving way to an outright recession would not mean it is time to exit the market. In uncertain times like this, discipline is key. Focus on your long time horizon and your personal risk tolerance, and remember, successful investing is not about trying to time the market, but rather your time in the market.

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