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Reasons for Cautious Optimism

By Mike Skoric

As we near the close of the second quarter, there are several reasons for optimism as it relates to major asset class returns for 2023. Just as 2022 was a "perfect storm" type of year where both stocks and bonds suffered double-digit losses, 2023 will possibly be the exact opposite. The good news can be seen across many areas – better than expected corporate earnings, slowing inflation, strong equity market returns, and continued momentum.

We have now seen a long string of generally favorable inflation readings that show that prices are meaningfully and persistently falling. The most recent annual CPI release for May 2023 shows inflation at 4%, which was the lowest level in over two years and down from over 9% in June 2022. Still keeping inflation fairly high is shelter costs which have a 30% weight in the CPI. However, this is also the category with the biggest reporting lag time and given that we know that rent growth year-to-date has significantly decelerated, we expect this category to soon be a major disinflationary factor. With that being the case and assuming all other categories will largely maintain current trends/levels – we can be optimistic that the Federal Reserve will be successful in getting to or at least close to its target inflation level of 2% by the end of 2023.

This will allow the Fed to stop the long and aggressive cycle of interest rate hikes. At the most recent Federal Open Market Committee meeting on June 14th, there was no increase in the Fed Funds Rate for the first time in over a year. While the Fed has made it clear that this is more likely just a pause rather than a pivot, recent data indicates that we are likely at the end or very close to the end of this interest rate cycle with possibly just one more rate hike later in the year. Looking forward to the possibility of lower rates, we can be especially bullish on bonds where prices have an inverse relationship to interest rates. And with respect to equities, there is a long history of better performance with low and/or falling interest rates. This makes for not only lower financing costs for individuals and businesses, but also allows for more attractive equity valuations as discounting future corporate cash flows with lower discount rates results in theoretically higher stock prices.

As markets are usually forward-looking in nature, we have seen stocks rise in recent months, which is certainly in anticipation of these developments. After experiencing the longest bear market since 1948 the S&P 500 has finally entered a new bull market, meaning that it is up over 20% from the lows in October of 2022. We were also encouraged with corporate earnings. Although earnings for the first quarter of 2023 were negative, they were still meaningfully better than expected. This, coupled with low unemployment and solid consumer spending trends, offers a reason to be positive on the prospects for the Fed to achieve the aspirational "soft landing." The summer months will likely provide more clarity, but the goal of increasing interest rates to slow inflation while keeping the economy out of a recession may soon come to fruition.

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