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FINANCIAL ADVISORY GROUP LLC

Second Quarter 2023 Economic and Market Outlook

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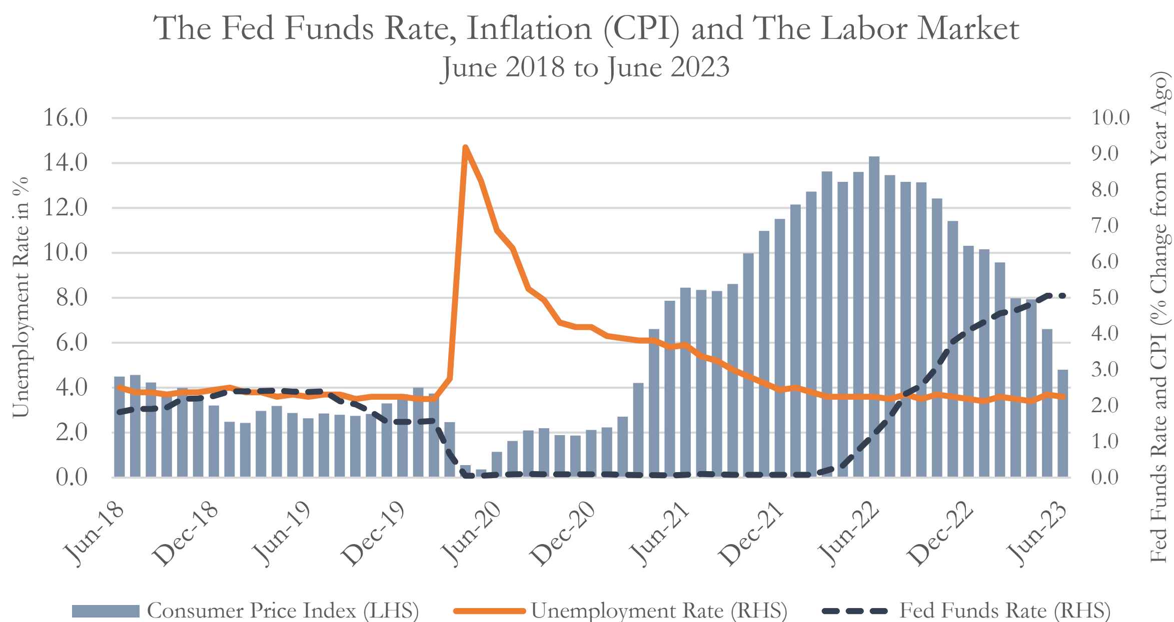
SECOND QUARTER 2023 ECONOMIC OUTLOOK

Despite fears of a recession, high-profile regional bank failures and the debt-ceiling drama, the U.S. labor market remains strong, consumer spending resilient and economic growth positive for the first half of the year, suggesting that the Fed may yet be able to engineer a rare "soft-landing."

The last time the Federal Reserve brought inflation down without causing a recession was in 1994 when Alan Greenspan and the Federal Open Market Committee (FOMC) raised its benchmark interest rate from 3.0% to 6.0%. While economic growth did slow at the time, the economy never went into reverse and the labor market held up.

Figure 1: The Federal Reserve's Efforts to Achieve Price Stability and Full Employment



Source: Source: Board of Governors of the Federal Reserve System (US), Federal Funds Effective Rate [DFF] and U.S. Bureau of Labor Statistics, Consumer Price Index for All Urban Consumers: All Items in U.S. City Average [CPIAUCSL], Unemployment Rate [UNRATE],retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/DFF, July 12, 2023.

The same may be true this time around. **Figure 1** shows that with the rapid increase in the Fed Funds Rate from 0.0% to 5.0% last year, inflation has fallen from its peak in June 2022 and is currently running at a more manageable 3.0% year-over-year pace. At the same time, the labor market recovered from its Pandemic spike in early 2020 and has remained at full employment since December 2021. While headline inflation remains above the Fed's preferred 2.0% target, it has come off of its highs and some of the underlying components of inflation, particularly housing-related costs, continue to fall. As a result, we expect that the Federal Reserve is near the end of its current rate hiking cycle as it seeks to achieve its dual mandate of price stability and full employment.

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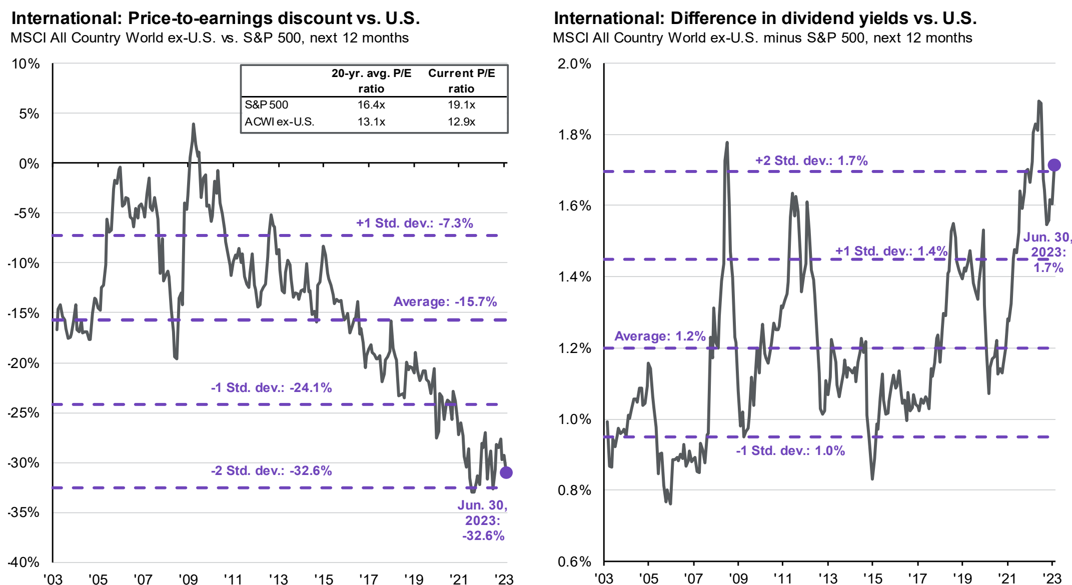
INTERNATIONAL MARKETS MAY OFFER VALUE

While economic conditions in the U.S. have improved significantly in 2023, the same cannot be said about European and Asian markets. Inflation remains high in the U.K. and Europe, although it too is coming off of its highs thanks to aggressive action taken by the Bank of England and the European Central Bank. China's GDP grew 6.3% for the 12-month period ended June 30, 2023 as the economy benefited from its post-COVID lockdown rebound, but stalled in the second quarter this year as excesses in the property market have led to moderating house prices and an investment slowdown in the sector. While economists forecast modest growth in the U.K. and Europe for 2023 and expect China to grow 5.5% this year, investor sentiment remains poor.

While the rest of the world is fighting inflation, China is facing falling prices or deflation as goods, services and producer prices are down. According to the latest figures from Trading Economics, the Chinese Consumer Price Index is flat year-over-year as of June 2023. The decline in export prices is largely the reason behind the recent weakness in Chinese growth, although on an inflation-adjusted basis, the news is not as bad as it seems.

Figure 2: International Markets Trading at Historically Attractive Valuation Levels



Source: FactSet, MSCI, Standard & Poor's, J.P. Morgan Asset Management. Guide to the Markets – U.S. Data are as of June 30, 2023.

With investor expectations so negative and valuation levels at historically attractive levels, we think international markets may offer value opportunities for long-term investors. As of June 30, 2023, the MSCI All Country World Ex-U.S. Index is trading at a 30% discount and offers a nearly 1.7% dividend advantage relative to the S&P 500 Index, which is very attractive compared to the 20-year history shown in **Figure 2**. Finally, if the decade-long U.S. dollar bull market slows, the relative outperformance of foreign currencies would also support international equity returns in U.S. dollar terms.

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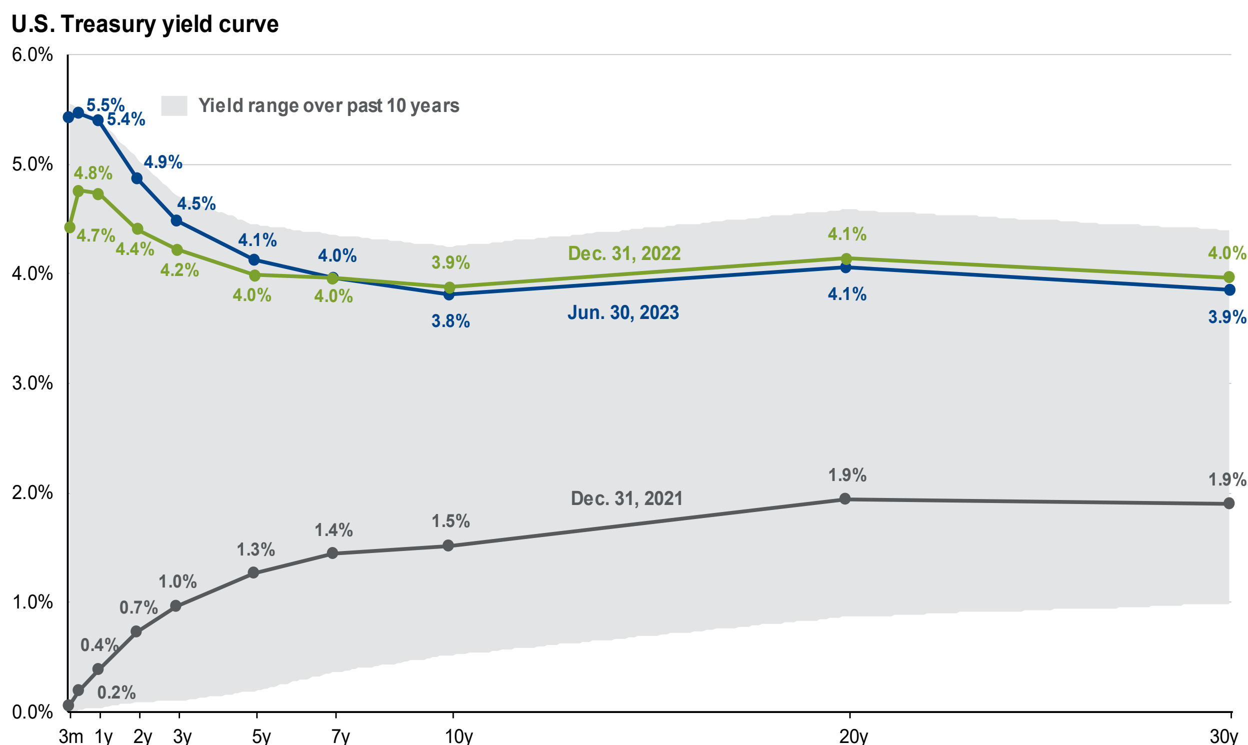
CAN THE FED ACHIEVE A SOFT LANDING?

Consumer sentiment and investor expectations remain elevated for the U.S. economy and the stock market going into the second half of the year on hopes that the Fed can achieve a so-called "soft-landing." As a result, equity markets have rebounded strongly since their lows in September 2022 and are trading at heightened valuation levels.

However, the recovery in the bond market has been more muted since yields remain elevated across the curve. As **Figure 3** illustrates, the yield curve remains at the higher-end of its 10 year range and has changed little since the start of the year despite evidence that inflation has eased and economic conditions improved at the margin. The fact that the yield curve remains inverted (3-month bills yielding more than 10-year bonds) suggests that fixed income investors remain wary of the current economic environment.

While higher current yields for bonds will provide more attractive fixed income going forward, the total return of the bond market will only improve further when and if bond yields fall. This typically occurs when investors anticipate an economic slowdown or if bonds offer an attractive alternative to the stock market. With short-term U.S. Treasury bonds offering nearly 5.0% yields and the U.S. stock market trading at historically expensive valuations, there may finally be another alternative, or at least an attractive complement, to stocks in a balanced portfolio.

Figure 3: U.S. Bond Markets Offer Attractive Yield, but Signal Caution



Source: FactSet, Federal Reserve, J.P. Morgan Asset Management. Guide to the Markets – U.S. Data are as of June 30, 2023

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OUR OUTLOOK

The mixed economic and market signals coming from the post-pandemic recovery make it difficult to forecast the future. The best example of this confusion is the fact that the most anticipated economic recession in history has yet to materialize despite the fact that "sure-fire" indicators such as the inverted yield curve have been signaling trouble for over a year. Despite that, U.S. equity markets are again approaching all-time highs, although this year they have been driven almost exclusively by a narrow set of technology companies that have benefited from the excitement surrounding the latest advances in artificial intelligence.

With the easing of inflation and the end of the current rate hiking cycle in view, we do anticipate a another shift in the yield curve, particularly at the short end as investors price in more modest inflation going forward and less aggressive monetary policy as a result. This should help bond markets recover some of their 2022 declines. In addition, if bond yields stabilize or even fall from their current levels, this could also lead to more breadth in the stock market as investors gain more confidence in the path of the economy.

Perhaps the most important lesson from the past twelve months is that the cost of market timing can be high. The impact of being out of the market even for a short time can be profound. While there were many risks on the horizon as we entered 2023 and the temptation to sell-out and go to cash to wait it out was strong, investors that remained committed to a balanced strategy benefited from a strong rebound in the stock market. History has shown that after a significant decline, markets tend to produce positive results over the following 1-year, 3-year and 5-year periods rewarding patient investors. While the economic and market outlook remains unclear, we expect the benefits of a well-balanced portfolio to show through.

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