

01.24.23 | INVESTMENT MANAGEMENT

12/31/2022 Focal Point: Will the Markets Get Rear Ended by the Lagging Economy?

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Most drivers will recognize this situation. You are in stop-and-go traffic. Sure, the brake lights in front of you are flashing red, and you are slowly pressing your own brake pedal. Suddenly, you realize the car in front of you is actually stopping. Brake lights don't get brighter, but you see the rear bumper looming larger. So, you slam on your brakes too, stopping short and avoiding a crash. But where do you look next? The rearview mirror to see if the car behind you was alert enough, or if you're about to be rear ended. You hold your breath for the next few seconds, bracing for impact, but hoping it will be avoided.

This is basically the situation the Fed and the markets find themselves in with the economy. The Fed started 2022 in traffic, paying attention to the "transitory" brake lights of the car in front. But it quickly had to adjust to inflation staying more persistent (thanks to Russia/Ukraine/energy) and "slam on the brakes" in the form of 4 straight 75 bps rate hikes, wrapped into an overall increase in Fed Funds from 0% to 4.25%. The poor market performance in 2022, especially for 60/40, is analogous to the discomfort of your own car screeching to a halt. But the car is now stopped, and thanks to improved valuation, it is braced. If one's own car is stopped, the consequences of an accident are reduced, though not eliminated.

The markets, and the Fed, are now at the point of looking in the rear-view mirror. Was the quick, uncomfortable stop of 2022 all there is, or will the Fed's rapid pace of interest rate increases cause the economy to slow precipitously, and for the markets to get "rear ended"? There will be consequences to the Fed's rate hike campaign. Borrowing rates, from mortgages to cars to credit cards to business, are up, and thus, activity will be restrained. It takes six to twelve months for rate hikes to flow through to the economic data, and thus, the economy is only part way through digesting the rapid rate hikes.

The good news is that markets are "braced" for a possible crash. The speed of the car is slower, or in this case, valuation is better prepared than a year ago. Also, bonds (the seatbelt) are better equipped to help diverse portfolios if there is an accident. For the economy, while it seems like the idea of inflation slowing without a recession is more dream than reality,

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the nature of the Covid recovery was one of excess demand and restricted supply, as opposed to over investment. Much of what we have seen is prices (inflation) adjusting for temporary supply/demand imbalances, many of which are correcting (or have corrected).

The markets are concerned that by focusing too much on the backward-looking data of inflation and unemployment, the Fed has gone too far already by raising rates so quickly that a recession in 2023 is possible. But the recent "pivot" rally in Q4 was driven by the Fed itself acknowledging the risk of this lagging data, and indicating they are aware of the need to slow the pace of rate hikes and see how 2022's moves play out in 2023's economy. The risk is that economies, like cars, have inertia, and it takes time for momentum to shift. Plus, when there is a sudden braking (in traffic or in the markets), something can get broken. This has generated the recession fears that weighed on the market for the second half of 2022 and are an overhang into 2023.

Offsetting this gloomy outcome is the potential for a "positive" surprise from China abandoning its Zero Covid policy. While most of the world reaped the benefits of higher growth and lower inflation from re-opening in 2021, China stuck with its restrictive lockdowns, thus reducing growth and causing supply chain issues through 2022. But its sudden abandonment of these restrictions could allow for both a boost to growth AND disinflation benefits of smoother supply chains. After a year of "negative" surprises, a positive one such as this would be beneficial.

Therefore, the focal point entering 2023, is after stopping short in 2022, *will the markets get rear ended by the lagging economy?* Or will the quick stop be all there is, and the car (markets) start moving forward again with the flow of traffic (the economy). Markets could remain volatile, as each piece of economic data is parsed for its impact on Fed policy, as well as signs that the economy is stabilizing or deteriorating

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-The BofA Merrill Lynch US Emerging Markets External Sovereign Index tracks the performance of US dollar emerging markets sovereign debt publicly issued in the US and eurobond markets.

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