CS MCKEE MARKET OUTLOOK | 4Q 2022

Declining Inflation Offers Hope of a Fed Pivot

HIGHLIGHTS
FROM THE QUARTER

US Midterm elections resulted in split government with Republicans controlling the House while Democrats remained in control of the Senate and Executive branches. The gridlock in government will make for contentious negotiations in 2023, namely increasing the debt ceiling which is expected to occur in July according to the CRFB.

Band of Japan Governor Kuroda surprised financial markets late in 2022 by lifting the trading ceiling on 10yr JGBs to 0.5% from 0.25%. The move knocked global bond yields higher and strengthened the Yen to the USD significantly. The Bank of Japan claimed the move was to "improve market functioning" but traders anticipate a further exit by Japan from years of yield curve control and rounds of quantitative easing.

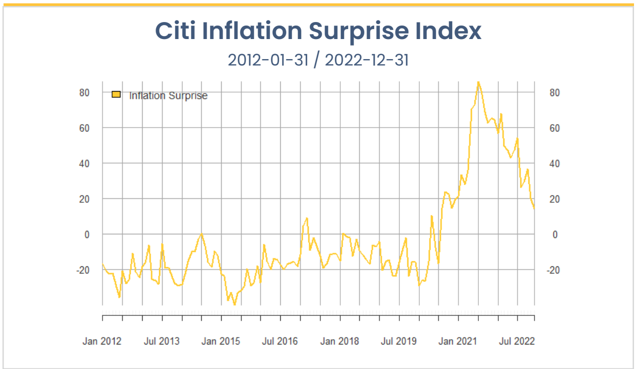
Xi Jinping made a quick about-face on China's zero-COVID policy of stringent lockdowns and testing resulting in a massive surge in hospitalizations and deaths. The rapid reopening of China will likely result in a quick dip in economic activity as the country battles COVID infections, but stronger growth on the other side of the wave.

Congress approved a $1.7T annual budget days before the US government was shutdown providing a boost to defense spending and funding to support Ukrainian efforts in their war with Russia.

2022 closed with mixed economic signals of declining inflation, even tighter labor markets, and increasingly hawkish central banks. Financial markets swung higher and lower on each data surprise which supported both bull and bear cases for the year ahead. The conflicting messages are setting the stage for a turbulent first half of 2023 with investors debating whether inflation will cool quickly enough for the Fed to loosen monetary policy and hopefully evade a well anticipated recession.

Weaker than expected CPI reports in November and December boosted hopes of an earlier dovish pivot by the Fed sending risky asset values higher. Economist's expectations for November looked for a 6.5% annual increase in Core CPI, but a surprising 0.2% downside miss led to one of the strongest historical rallies of 5.54% for the S&P 500 and sent market forecasts for the Fed Funds Rate plummeting lower.

Actual Inflation Trending Lower Than Expected:

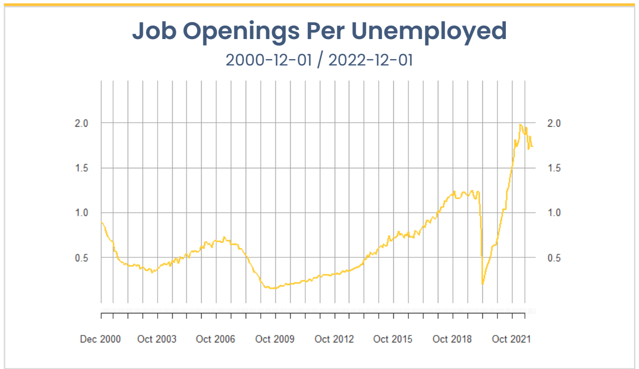


> We anticipate a greater than normal probability of recession and an associated deceleration of price growth.

LABOR MARKET DATA CONTINUES TO SUGGEST COMPANIES ARE STRUGGLING TO FILL POSITIONS

Three weeks after the CPI report, a strong payrolls report complicated the Fed's outlook as wages initially appeared to expand by 5.1% annually. November's spike in wage growth was revised lower in December to 4.8%, but still well above the Fed's preferred range of 3% to 3.5%. Further labor market data – such as the quits rate and job openings – continue to suggest that companies are struggling to fill positions and negotiating power is still with workers.

Negotiating Power Still Favors Workers:



Declining Inflation Offers Hope of a Fed Pivot

PORTFOLIO POSITIONING

Callable agency debt remained the largest risk exposure within our fixed income portfolios at nearly 38% of the total allocation. The overweight to the agency sector of +36% was funded by significant underweights to nominal US Treasuries (-36%) and mortgage-backed securities (-8%). Within the credit sector, the approximately +4% overweight continues to favor higher-quality and more liquid debt in anticipation of continued volatility. Overall portfolio duration ranged between neutral and slightly short for the quarter. We anticipate interest rates to remain range bound in the near term as recession worries compete against a persistently hawkish Fed, keeping bond yields fluctuating higher and lower.

Interest rates rose during most of 2022, with the yield on the 10-year treasury rising from 1.63% to 3.88%. Our high quality, fundamental equity strategies outperformed for the year and the 4th quarter, as the overpriced leaders of the past 12-years and speculative growth-at-any-price stocks underperformed in the rising rate environment. We are maintaining our cyclical value tilt because the spread in valuations between value and growth stocks is still above historical norms, and the Federal Reserve has reaffirmed their hawkish stance on interest rates in order to rein in inflation. We believe growth-at-any-price stocks will continue to underperform under these circumstances.

THE FED'S MONETARY POLICY PATH REMAIN MORE DOVISH THAN RECENT COMMUNICATIONS

Following both the November CPI and payroll report, the FOMC closed out 2022 by slowing their tightening pace to +50bps in December, taking the upper bound of the Fed Funds Rate to 4.50%. Prior to this most recent hike, the committee had increased interest rates by 75bps four times in a row starting in June in an effort to front-load tightening and "make-up" for their initial slow response to rising inflation. Furthermore, the FOMC showed the median dot climb to 5.125% in 2023 before anticipated rate cuts later 2024.

With financial conditions fluctuating around restrictive territory and many segments of the yield curve inverted, market-based expectations of the path of monetary policy remain more dovish than the Fed's recent communications. Currently, Fed Fund futures imply a peak rate just under five percent in June 2023 before eventually falling to 4.375 by January 2024. Why the difference between what the market expects and the Fed? There are three likely explanations: 1) the economy will fall into a recession in 2023 bringing prices down faster than expected; 2) the market believes the Fed will eventually relent regardless of the inflation level if growth concerns deteriorate further; or 3) the inflationary surge will ultimately prove "transitory" and quickly return to the two-percent growth region.

A GREATER THAN NORMAL PROBABILITY OF RECESSION AND AN ASSOCIATED DECELERATION OF PRICE GROWTH

Of these three possible outcomes, we anticipate a greater than normal probability of recession and an associated deceleration of price growth. Reliable recession indicators such an inversion of the Near-Term Forward Spread and decline in building permits support our view of this risk.

Additionally, we also expect the Fed to remain committed to tighter monetary policy if inflation remains high while growth falters. Fed communication since mid-2022 has been overly hawkish as the committee looks to regain their credibility. Under each of these scenarios, we envision volatile financial markets through at least the first half of the year.

In view of our less than rosy outlook, we remain cautious in our multi-asset strategies with higher-than-normal cash levels and an underweight to equities. As of December 31st, the asset mix stood at 59% equities, 39% fixed income, and 2% cash. The Asset Allocation Committee made a tactical decision during the quarter to invest an additional 2% cash into stocks when the S&P 500 hit the 3600 area. Further advances or declines in risky assets will continue to be driven by the inflation evolution and the Fed's reaction to the data.

INFLATION WILL REMAIN AT THE TOP OF INVESTOR'S CONCERNS THIS YEAR

We suspect that market pricing of a quick Fed pivot is a bit optimistic and expect the FOMC to remain steadfast in their commitment to bring inflation lower. While we forecast inflation to decline substantially in 2023, core price growth is likely to remain well above the Fed's two-percent target with "sticky" components of the CPI and PCE Price Index remaining strong. The current gap between market expectations and the FOMC for the Fed Funds Rate is setting the stage for an abrupt repricing in financial markets if Chairman Powell stands his ground in the fight against inflation. Inflation will remain at the top of investor's concerns for 2023 with markets swinging higher and lower depending on incoming data. A rapid deceleration of price growth would allow the Fed to downshift to looser monetary policy, while persistent inflation well above two percent will keep the central bank pursuing higher interest rates.