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Mid-Quarter Update

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The rising tide of optimism that was evident in January is being followed by a period of uncertainty around what is ultimately required for the Federal Reserve (Fed) to complete their work. From an economic standpoint, we have characterized the current environment as one of watching and waiting. Within this context, referring to the conflict between the Fed and its program of monetary tightening against inflation, we also have asked, “Who is winning?” As usual, the picture is mixed, but right now, we have to conclude that the Fed is getting most of what it wants. We emphasize right now, for this battle is far from over and declarations of victory may be premature.

The Fed is looking for three things to develop: 1) inflation falling, 2) weakening overall demand, and 3) softening in the labor markets. Their aim is to guide the economy back to what are considered normal economic conditions. Currently, the Fed is getting the results they desire in two out of the three, the labor market being the exception. All measures of inflation are now off their highest levels and certain indicators point to weakening demand, but employment seems to be defying economic forces by reaching record lows.

High inflation robs every person in our economy of purchasing power and represents a diminishment of wealth. The ongoing health of our economy is dependent upon a stable, low rate of inflation. The Fed has set its target at 2% on the core Personal Consumption Expenditures Index. Currently running at 4.4% on a year-over-year basis, this doesn’t look too far from target. However, because it excludes volatile food and energy prices, it is a slow-moving index. There is still a lot of work to be done to reach target.

Progress toward overall weakening demand is harder to detect, especially in the light of fourth quarter 2022 Gross Domestic Product (GDP) growth of 2.9%, following a third quarter number of 3.2%. Even so, when looking at overall personal consumption expenditures, they were in steady decline over the last four months of the year to a level of -0.2% in December. Other measures such as retail sales and Purchasers Managers indexes also show weakening trends as higher costs of borrowing seem to be impacting demand. This is exactly what the Fed desires as it attempts to bring supply and demand back into balance, and thus reduce inflation.

The labor market remains strong. Of course, on an ongoing basis everyone wants full employment, but full employment implies wage growth, and the fuller employment is, the more pressure there will be for higher wages. Shockingly, the unemployment rate for January came in at 3.4%, a 54-

year low. But even in the face of a very strong labor market, wage gains moderated. For now, the prospect of a wage-price spiral is not threatened, but that is what the Fed is worried about, thus their concern about the strength of the labor market. A large part of the cost structure in an economy resides in labor, so this issue remains paramount.

Prior to release of the employment report, hopes for a soft landing were on the rise. Those hopes have been dimmed somewhat by the feeling that the strength in the labor market will force the Fed to keep interest rates higher, and for longer. As we have stated in the past, we believe the Fed will prevail and that inflation will return to target. The greatest uncertainty lies in the risk of a recession and the peril it would present to the economy and the financial markets. Quality was a valuable characteristic that benefited your portfolio in 2022. We believe 2023 will be no different, and we continue to emphasize financial stability when analyzing the securities within your portfolio.

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