Schroeder | Capital Management, LLC
Global Investment

Investment Review and Outlook – Winter 2023

The U.S. Economy – Growth is Slowing & Inflation is Moderating;

The recent report by the Commerce Department showed the U.S. economy is weakening, despite a still solid labor market. The gross domestic product (GDP) grew at an annual rate of 2.9% in the fourth quarter of 2022 following an expansion rate of 3.2% during the previous quarterly period. Retail sales declined in December at the sharpest pace of 2022, reflecting weaker yearend holiday spending as rising interest rates and high inflation weighed on consumer demand. Industrial production also fell sharply in December. According to the trade group, Institute for Supply Management, manufacturing activity contracted for the second straight month in December. Also, nonmanufacturing services declined well below the market forecast, the first contraction in the services sector since May 2020. The sharp spike in borrowing costs has also caused the real estate market to suffer.

On the labor front, labor market conditions remain tight. While job growth was down in December from the previous month, it remained above the consensus forecast and is yet another sign that labor market conditions remain tight as the unemployment rate fell from 3.7% to 3.5%, despite continuing layoffs not only in the technology sector but other elements within corporate America. Also, the average hourly wage climbed an annualized 3.6% in December, down from an annualized 5.0% increase recorded in November. This suggests the Federal Reserve's goal to slow wage growth in an effort to fight inflation is starting to materialize. In general, recent inflation reports, while still elevated, suggest that the Fed's efforts to slow demand and ultimately put downward pressure on prices are working and inflation is moderating. This was also validated by the 0.1% decline in the Labor Department's Consumer Price Index (CPI) for December. However, the core-CPI, excluding the volatile food and energy components, was up 0.3%, in line with the consensus forecast. On a 12-month basis, the CPI and the core-CPI were up 6.5% and 5.7%, respectively.

The Federal Reserve – Continuing Interest Rates Hikes Are Expected;

The Federal Reserve has vowed to push the federal funds rate above 5.00% by midyear 2023. This would suggest three more hikes, including an expected increase of ¼% at next week's Federal Open Market Committee meeting. There is also a consensus among senior Fed voting members that rates may need to stay above 5.00% for an extended period to effectively fight inflation.

Wall Street may not be in sync with the notion of needing three more rate increases and maintaining that level for an extended period of time. The feeling of many investors is that inflation is moderating and will be more benign in the future, given the lag effect from previous rate increases. Wall Street is betting that pricing data and the slowdown in the economy will result in a more measured pace of increases in the months to come as a result of the progress made on the inflation front. This could also help avoid the consequences of a prolonged business slowdown.

Furthermore, the investment community's desire to "go slow on future rate hikes" also underscores the current and increasing company layoffs that should eventually have a positive impact on the tight job market, increasing the unemployment rate and helping reduce inflation.

Earnings Season – Q4 2022 Reports are Reflecting the Effects of a Tighter Fed Policy:

Fourth-quarter earnings season, which got off to a mixed start, is also reflecting the effects of the Fed's tighter monetary policies. The Wall Street consensus is calling for a mid-single-digit decline in profits for the S&P 500 companies. Our sense is that the profit expectations for the first half of 2023, and perhaps further, will also be revised lower in the coming months. The health of the consumer is in question, following weak sales during the important holiday month of December. Shoppers are burning through excess savings, bolstered by past government stimulus programs, increasing their credit card balances and facing higher interest rates on their debt obligations.

Furthermore, recent uneven profit results from the banking sector also show that they are building reserves in anticipation of potentially increased loan defaults on all sides of their business: commercial and consumer loans and credit card debts. Recently, auto payment defaults were also reported to be rising. As a result of declining profitability and earnings as 2023 unfolds, there is the potential for downward pressure on valuations for S&P 500 companies.

Investment Strategy - Caution Now but Optimism During 2023:

The U.S. stock market has started 2023 on a positive note. Investors seem pleased that inflationary pressures are easing and are hoping the Federal Reserve will soon "pause" additional rate hikes. However, the environment remains unsettled. Foremost, inflation is still uncomfortably high, and the Federal Reserve has been adamant that interest rates will be rising. As a result, concerns remain that as weaker corporate profits unfold in the months ahead, a recession could materialize.

All eyes will be on the Federal Reserve in coming days and what is signaled by Chairman Powell in his comments following the expected quarter point increase in the Fed Funds rate increase during this coming week. It is important to note that while the inflation situation appears to be improving, the Fed sees its job to be stabilizing prices over the longer-term. They have suggested a goal of 2% sustainable rate of inflation. This would translate to a rate environment of relatively tight money that continues for a long period of time. As has been said, this could potentially come at the near-term expense of both corporate earnings and the overall economy.

From an investment strategy standpoint, following the recent gains in the market averages, we are continuously weighing current security valuations with the risks that exist for companies whose profit margins are impacted by lingering inflation and a weaker than expected earnings outlook.

Given the aforementioned economic and earnings headwinds, we are focused on maintaining portfolios of high-quality investment opportunities with an increasing emphasis on dividend and interest income exposure.

Wall Street does not like such uncertainty. We continue to expect market volatility in the months to come until there is more clarity in the overall economic landscape. 2023 is likely to be another up-and-down year for securities markets. However, we are optimistic that 2023 will eventually be a positive year for investment securities as we look forward to greater containment of inflation, perhaps some easing of interest rates toward the end of the year and an overall improving economy.

G. Frederick Schroeder, CFA
President and Chief Investment Officer

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