WATCH THE FED

The year 2022 was not a good year for the markets. The Dow Jones Industrial Average, S&P 500, and NASDAQ all had the biggest annual declines in fourteen years. Bonds, traditionally a source of stability, faired almost as poorly. A 60/40% portfolio, consisting of equity and debt, lost 17%—the worst performance in over 50 years. The primary reason for these terrible results was the rapid rise in interest rates as the Federal Reserve, recognizing that inflation was an escalating—rather than a temporary—problem, suddenly reversed course from quantitative easing to quantitative tightening.

We cannot overemphasize the importance of Fed policy, which determines the amount of money available and, hence, economic activity. Earnings are driven by the direction of economic activity and, over time, the equity markets correlate to the direction of earnings, or earnings per share. The debate among economists and strategists now seems to focus on when the Fed will ease its monetary stance and how badly earnings will be affected. We think the Federal Reserve has made it quite clear that interest rates will remain higher and monetary policy tighter for longer than most observers expect. Key to their thinking is that a monetary policy of stop-and-go, similar to that which resulted in a severe recession in the 1970s, must be avoided at all costs. As of November, wages for part-time and full-time workers were 6.2% higher than in 2021, and Chairman Powell has gone on record as saying that wage growth of 3.5% would be consistent with the Federal Reserve's 2% inflation target.

Leading Economic Indicators, published by the Conference Board, have declined year-over-year to levels consistent with the onset of recession. The Treasury yield curve is deeply inverted, while on the inflation front the ISM Backlog, the ISM Manufacturing Prices Paid, and the Chicago PMI Prices Paid indexes remain in contraction. All of these indexes lead the Consumer Price Index (CPI), which is one reason to expect the CPI to fall significantly over the next year. Earnings will follow suit.

The remarkable thing about today's economy is the strength of consumer spending, which has been fortified by government subsidies and a tight labor market. This strength is not what the Fed wants to see in its fight against inflation. We expect, therefore, that it will be difficult for the markets to mount a sustainable advance until there is tangible evidence that the Fed believes that their intended results are successful.

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