

ECONOMIC OUTLOOK

Summary

As expected, the debt ceiling standoff ended just days before the so-called “X” date, which is when the government was projected to run out of funds. Now that President Biden has officially signed the bill and details are readily available, let’s consider the potential economic impact.

Congress has suspended the debt ceiling through January 2025, conceptually allowing the Treasury to borrow an unlimited amount of funds. On the surface, that could be considered an economic positive due to the potential for expansionary fiscal policy, but the details say otherwise. The most important of those details are the caps applied to discretionary spending, affecting all categories except mandatory programs such as Medicare and Social Security. Defense spending will increase by 3.3% next year (still below the current rate of inflation), while nonmilitary spending will remain flat going into 2024. Given current inflation levels, a static spending level is effectively a cut to the budget. Additionally, 2025 spending increases have been capped at only 1%. The Congressional Budget Office (CBO) projects the bill should reduce the deficit by roughly \$1.5 trillion over the next 10 years.

While a deficit reduction of roughly \$150 billion per year could be considered contractionary fiscal policy, with an overall deficit still in excess of \$1 trillion per year, it is hard to consider current fiscal policy anything but stimulative. Fiscal policy (Treasury) and monetary policy (Federal Reserve) are traditionally expected to work together to either reduce inflation or provide an economic boost. Instead, they have been in a 16-month-long tug-of-war. The actions taken by the Federal Reserve to reduce inflation have been undermined by deficit spending, which has kept economic growth stronger than expected. Not only is this likely part of the reason inflation has reduced at a slower pace than initially expected, but it also

likely contributes to the expectation the Fed will continue rate hikes by July.

While government spending and stimulus payments did contribute considerably to the inflation we are experiencing, it’s not the only reason inflation remains high. Payrolls added 144,000 more jobs than expected in May, and the overall labor market remains strong despite the slight increase in the unemployment rate. Average Hourly Earnings growth remains nearly 2% higher than its 10-year average during the 2010s. However, by reducing the deficit, Congress has at least taken the first step toward aligning fiscal and monetary policy, which should help reduce inflation further.

Positives

The second revision of 1Q23 GDP revised higher by 0.2% (1.3%)

Durable goods orders surprised to the upside (1.1% vs. -1.0% expected)

Retail sales turned positive following two consecutive negative months (0.4%)

Negatives

Core PCE inflation was higher than expected in April (0.4% vs. 0.3% expected)

ISM Manufacturing and services PMI's both surprised to the downside

The unemployment rate unexpectedly jumped 0.3% higher (3.7%)

EQUITY OUTLOOK

Summary

Large U.S. companies continued to grind higher in May with the S&P 500 adding another 0.4%. However, unlike last month, which highlighted performance was tightly bunched across styles, geography, size and economic sector, this month saw a significant divergence in stock performance. The Russell 1000 Growth Index climbed 4.6% while the Russell 1000 Value Index fell 3.9%. The Russell Midcap Index and Russell 2000 Index (small-cap) fell 2.8% and 0.9% respectively.

Perhaps even more notable was the discrepancy in performance by economic sector. Information Technology stocks rose 9.5% extending the year to date gain to 34.0%. Communication services rallied 6.2% in May and 32.8% so far in 2023. By contrast, energy, basic materials, and consumer staples declined 10.0%, 6.8%, and 6.1% respectively. The continuation of these trends brings attention to the lack of breadth displayed by this year's market rally.

The strength of the stock market has surprised many investors given the many headwinds faced early in the year. However, the rally has been fueled by very narrow leadership of a handful of large momentum stocks. Historically, this lack of breadth has been considered unhealthy and many market pundits would suggest it is unsustainable. Some suggest those stocks that have led the way have run too far too fast and need to come back to earth.

In spite of the challenges at the beginning of the year, we continue to see positive developments on several fronts. A

debt ceiling agreement has been reached, inflation is falling, and corporate earnings have held up much better than anticipated. There are still other challenges that are likely to create some volatility throughout the summer, but the market's continued anticipation of improving developments and data may very well lead to wider stock participation and overall breadth within the equity market.

Positives

Fed nearing the end of hiking cycle

Inflation continues moderate

Corporate earnings better than expected

Negatives

Market leadership is quite narrow

Labor markets remain tight

Unknowns

2023 recession

FIXED INCOME OUTLOOK

Summary

For most of May, the debt ceiling showdown commanded headlines as the potential for a default on U.S. government obligations sent the yield on some June maturity Treasury bills to more than 6%. This jump was significantly more than can be explained by any possible path of the overnight rate alone, which is usually the basis for T-bill yields. Beyond the debt negotiations, investors remained focused on the rapidly shifting outlook for the Fed Funds rate which is a significant driver of longer-maturity yields as well. After dropping 20 basis points (bps) in early May, the 2-year Treasury note increased by 77 bps reaching a high of 4.56% late in the month. While coinciding with the move in T-bill yields, this move was more likely driven by investors' reassessment of their outlook for multiple cuts in the overnight rate during the second half of the year. As measured by the futures market, investors were 50/50 on a rate cut by July and now there is an 80% probability of a rate increase priced in. As measured by the longer-dated contracts, the investors were expecting three and a half rate cuts by year's end and now that probability shows just 50% of one rate cut. These reversals came after multiple Fed board members commented that while a pause at the June meeting might be reasonable, additional firming of monetary policy may be needed.

As news of a likely debt ceiling deal spread and concern about a default faded, the June T-bill yields dropped back to the low 5%'s and the 2-year ultimately settled at 4.40%, an increase of 40 bps for the month. The 10-year increased 48 bps intra-month, before ending 22 bps higher at 3.64%. Credit spreads moved about 12 bps wider as yields increased but then reversed and ended the month just two bps higher. Intermediate investment-grade corporate bonds had a return of -0.76% for the month while intermediate-maturity Treasury notes returned a nearly identical -0.75%. Finance company bonds bested those issued by industrial companies.

With inflation on a slow-paced decline and the labor market remaining resilient, we are uncertain about the need for

additional rate increases. But without some sort of exogenous shock, we have believed the market should not be expecting multiple rate cuts this year. At some level you have to take the Fed at their word and believe they are going to try to avoid cuts at all cost in order to maintain the credibility of their forward guidance. North of 3.50%, the 10-year Treasury note looks attractive and we believe a retest of the October high yield is unlikely. We also see good relative value in corporate bonds as credit spreads also remain elevated compared to levels prior to the regional bank failures. The universe of intermediate-maturity corporate bonds now yields more than 5%, which should make a strong contribution to a balanced portfolio for multiple years.

Positives

The Fed is likely to pause in June and might be done for the cycle

U.S. corporate bond spreads are attractive but selection is critical

Negatives

With the debt limit suspended, expect significant issuance to rebuild government cash levels

Inflation statistics easing but at a slower pace

Unknowns

Impact of regional bank lending levels/constraints

Geopolitical tensions with China; Russia/Ukraine war
