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INVESTMENT MANAGERS

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After a very poor year in 2022, markets got off to a very good start in 2023 despite expectations for slowing economic activity this year. Large cap stocks in the S&P 500 index gained 6.3% for the month. Small cap stocks in the Russell 2000 were up 9.8%. International stocks in the MSCI EAFE index were up 8.1% and emerging market stocks were up 7.9%. Yields for the Barclays US Aggregate Bond Index declined, leading to a strong monthly gain of 3.08%.

Economic Growth in the fourth quarter increased at an annual rate of 2.9% after adjusting for inflation according to the "advance" estimate released by the Bureau of Economic Analysis last week. This follows third quarter growth of 3.2%. Many leading economic indicators point to slow or negative growth at least through the first half of 2023 with a recession likely this year. The major factor supporting the economy right now is very low unemployment. That is expected to remain relatively low throughout the economic slowdown because of demographic trends. Hopefully that will be enough to prevent a deep recession.

Inflation continues to be the major factor affecting returns. There are signs that inflation is beginning to come down from 40-year highs, but it will take time to see significant improvement. Inflation is a comparison of current prices versus a year ago which means prices can stay at their current high levels even if the inflation rate declines. Since wages are rising at a slower rate than price levels, purchasing power has been impaired for a large portion of the population. In addition, recent legislation and executive orders appear to have exacerbated the problem causing the Fed to pursue more aggressive rate hikes.

The Fed's primary tool for combatting inflation is raising interest rates. Higher interest rates slow the economy which is adding to recession concerns. The Fed acted very aggressively last year, hoping to get inflation under control. At the beginning of 2022, the Fed Funds rate stood at 0%-0.25%. After a year of aggressive rate hikes, the Fed Funds rate is now 4.5%-4.75% as of Feb 1. Recent comments by Fed Chairman Jerome Powel left markets with the expectation that further rate increases should be expected. Over the past several years, the money supply has been significantly expanded and the federal government has spent borrowed funds at unprecedented levels. Both actions are inflationary, so the task of getting inflation under control is difficult.

The bond market seems to have shifted its primary concern to slow economic growth rather than inflation as longer-term rates have pulled back from previous highs. The yield curve is currently inverted with short-term yields higher than long-term yields. This has traditionally been a recession signal. It also implies that bond buyers expect inflation to come down. The bond market has historically been a better predictor of future economic activity than the stock market.

It has been nice to have more favorable market action this month and in the fourth quarter. However, the economic backdrop does raise concerns about stock performance in the coming months. We continue to encourage investors not to try and time the market by trading in and out. Instead, we advocate for investing according to risk tolerance.

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