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COMMENTARY

February 7, 2023

Not Out of the Woods

- Equity markets started 2023 with strong performance, surprising many, including us.
- Increasing uncertainty around the Fed and corporate earnings could weigh on stocks.
- Volatility will remain as investors react to an increasingly uncertain backdrop.

Coming into 2023, we laid out a market scenario that suggested equities would be volatile and possibly weak in the first half of the year followed by a better second half. Instead of this scenario, we have seen domestic equities have one of their best starts to a year with the S&P 500 and NASDAQ Composite up 7.73% and 14.72%, respectively, through February 3. Despite the strong start to 2023, we still expect markets to struggle as investors navigate weakening economic data, a Federal Reserve (Fed) still raising interest rates, and corporate earnings, which we expect to see further downward revisions. Now is not the time to be too aggressive relative to long-term investment objectives.

The start to 2023 has been a welcome change for equity markets given the difficult 2022. The combination of hope that slowing inflation will lead the Fed to slow their rate hikes, optimism around the Chinese economic reopening, and belief that the global economy could avoid a 2023 recession have been key drivers of this rebound. However, while the equity rally has been impressive, looking underneath the headline-grabbing returns have been some signs of concern. First, economic optimism has been one market driver, however, economically sensitive commodities, such as oil, have not taken part in the rally. In fact, gold, which is a risk off commodity that usually performs well in market uncertainty, has been positive this year. Also, we have seen economic data, especially forward-looking Purchasing Managers Indices (PMIs) portray a U.S. economy teetering on the brink of a recession. Keep in mind that it usually takes the economy about 12-15 months to feel the full effects of a Fed rate hike. With the Fed only starting its rate hike cycle in March of last year and playing catchup after inflation soared, we have not yet felt the impact on the economy. The bond market is confirming this as the so called 2-10 spread, which measures the yield difference between 2-year and 10-year Treasury Bonds, is inverted and that inversion has historically been a good recession predictor.

In our [2023 Outlook] we suggested that equities would struggle in the early part of the year as the Fed's rate projections suggested that they are not done yet (the Fed's projections suggest they will raise rates from the current range of 4.50% - 4.75% to 5.00% - 5.25% by year end). These higher rates, along with the possibility of the economy falling into a recession and therefore impacting sales volumes, would likely impact profit margins and overall corporate earnings. While the consensus (via Factset) already expects earnings to rise just 2.7% in 2023 (down from an estimate of 10.7% on September 30th), we feel further downward revisions are likely. Case in point, we have seen fourth quarter earnings come in better than expected, however, first quarter earnings guidance has been poor as 37 companies reported negative guidance but only 6 indicated positive guidance. Given this uncertainty around the Fed and corporate earnings, current valuations are pretty concerning. With the price-earnings ratio (P/E) of 18.4X on 12-month forward earnings for the S&P 500, it is below the 22X at the start of 2022. However, this current P/E ratio is not reflective of higher inflation and higher interest rates that we have seen since the beginning of 2022.

As a reminder, though we still do anticipate a volatile and possibly weaker first part of 2023 for equity markets, positively, we envision much better performance for equities in the second half. The combination of lowered expectations that become easier to beat as pessimistic investors price in a potential recession that, in our opinion, will prove to be mild and a possible pivot by the Fed which may be forced to pause or even cut rates later in the year. Furthermore, despite a potential 2023 recession being the most anticipated recession in the history of our country, it is not a guarantee. In fact, if the economy is able to skirt a recession, it would also be another positive for second-half market returns.

Equity markets have performed well so far this year, surpassing our expectations. Despite this rally, now is not the time to become more aggressive in your portfolios beyond your long-term investment objectives. As we navigate mixed market signals and increasing uncertainty, please continue to work with your financial professional to make sure you are properly diversified to help mitigate market volatility. Make sure your portfolio is aligned with your long-term investment objectives.

This report is created by Cetera Investment Management LLC. For more insights and information from the team, follow @CeteraIM on Twitter.

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Glossary

The S&P 500 is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries

The NASDAQ Composite Index includes all domestic and international based common type stocks listed on The NASDAQ Stock Market. The NASDAQ Composite Index includes over 2,500 companies, spanning all 11 sector groups.