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Wall Street Looks Beyond Debt Ceiling, Continues Climbing Wall of Worry

- The impact of the new debt ceiling will be minimal to the overall economy.
- Risks in markets continue to persist and we anticipate a mild recession.
- We recommend diversification as market breadth is narrow.

A debt ceiling deal was informally struck [a week ago](#) between Democratic and Republican leaders and passed a vote in the House of Representatives on Wednesday, May 31st. Finally, the Senate approved the deal in a vote Thursday, June 1st before the Treasury Department's June 5th deadline when it was scheduled to run out of funds to pay commitments such as payments on Treasury Bonds. In the end, the debate forced spending compromises including non-defense discretionary and IRS spending, and claw backs in COVID-19 aid. Additionally, some work requirements for federal aid were tightened and student loan repayments are set to resume.

Overall, the economic impact from this deal is minimal. The real hazard that faced investors was not agreeing on a bill to raise the debt ceiling, so a major risk to markets has been avoided. Investors largely looked past the disfunction in Washington and markets pushed higher despite this potentially disastrous scenario of a U.S. default. There is also a Wall Street adage markets can "climb a wall of worry." Perhaps that is what is happening because the debt ceiling isn't the only worry right now.

We aggregate economic data to gauge the risk of a near-term recession in our quarterly [chartbook](#). Currently we estimate this risk to be high and the economic data is continuing to trend downward. Last week we received more data in a manufacturing survey which showed new orders, the most forward-looking component of the survey, had a sharp decline in May. Supplier deliveries also hit its lowest levels since 2009. The Federal Reserve's rate hikes are only beginning to be felt in the economy as it generally takes 12-15 months to feel the full effect of the hikes. We saw some cracks emerge in the banking sector, but there will likely be more areas of the economy to feel the impact of high interest rates soon.

Meanwhile, the Fed continues to debate raising the Fed Funds rate even more as inflation continues to fall, albeit not at the pace that the Fed would like. Year-over-year inflation figures will fall in the next couple of months as May and June 2022 data drops off the calculation (this is known as base effects). This should be enough for the Fed to pause their rate increases, but inflation will still be above the Fed's target of 2%.

Investors are optimistic about the prospects of the Fed pausing rate hikes and inflation falling, but not pessimistic enough about the reasons for them. A Fed pause and even pivot (cutting interest rates) combined with falling inflation will likely be the product of slower economic growth and perhaps a recession. Meanwhile, S&P 500 valuation metrics such as price-to-earnings (P/E) ratios are relatively high compared to history. If you have noticed your portfolio not doing as well as major indexes, you are not alone. Major indexes weight larger companies higher, and when they do well, it can pull up the whole index. Being more diversified or avoiding large companies that have done well recently has yet to be rewarded. Lastly, Market breadth has been its weakest since 1999 by some metrics, which can be a bearish indicator.

This may appear to be a pessimistic outlook, but we are more cautious. We do think a recession over the next year is likely, but at this point we think it could be a mild recession. A strong labor market and service economy could hold up the economy as companies adjust to higher interest rates. Markets could be volatile; however, we do expect sharp market fluctuations. We reiterate our recommendation for increased diversification. Please continue working with your financial professional to help you align your portfolio with your long-term investment objectives. It is easy to get distracted by the noise and sensational headlines. Creating a financial plan that you can monitor and follow helps to avoid distractions and to stay focused on what you can control.

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A diversified portfolio does not assure a profit or protect against loss in a declining market.

Glossary

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