Weekly Market Insights

January 23, 2023

The Switch is Almost Complete

Financial Markets

Last week, we wrote about the changing expectations of investors. They went from fear of an overheating economy and rising inflation to an economic downturn and earnings disappointments. Equity markets were quite volatile during the past week. The market opened on Monday with gains, adding to what had been an excellent start to the New Year, but, by Wednesday, had turned lower as a series of disappointing economic and earnings numbers were released. Before the week was over, the market had lost a significant portion of the gains for the year. Then, in a remarkable rally, the market ended the week with considerable strength.

For the week, the Dow closed down 2.70%, the S&P 500 closed down 0.66%, and the NASDAQ closed up 0.55%.

Economics

As mentioned above, the concerns of investors and analysts are now focused on a recession rather than an overheating economy and runaway inflation. The earnings and economic reports make the argument compelling. As always, we caution it is still early in the game, and these numbers can reverse.

As usual, the primary focus should be on the Fed and whether they buy into this view. Like it or not, they will decide about the direction of interest rates and play a dominant role in determining the direction of the economy. Lately, a number of Fed officials have appeared to soften their views on the fight against inflation.

While discussing government or quasi-governmental agencies, Congress will be playing an important role. We wrote about the debt ceiling last week, and nothing has changed. Investors should be aware that this happens with great frequency and has always been resolved with some degree of compromise. In this case, we see no reason to think otherwise, but we remind readers that it is always a last minute affair, which is likely to continue well into the third quarter.

We wrote earlier about earnings disappointments. As companies have reported earnings, many have not been encouraging with their forecasts for the rest of the year. These reports, along with a series of announced layoffs, have done nothing to encourage investors.

Economic releases are showing a growing weakness in the U.S. economy. Retail Sales fell 1.1% last month. While economists were expecting a month-over-month decline, the fall was greater than expected. Industrial Production also came in worse than anticipated, falling 0.7% in December. The reports are certainly disappointing, but, there can be any number of reasons for this. Two compelling reasons businesses and consumers may be pulling in their horns are: 1) concern over how aggressive the Federal Reserve will be in raising interest rates, and 2) fear over the difficult nature of U.S. politics, not the least of which are the debt ceiling and the budget. The current rancor can be encouraging to no one.

Globally, the reports from Davos, where the World Economic Forum was held last week, were surprisingly positive. Many European economic ministers were quite optimistic about the prospects for 2023, certainly more so than their U.S. counterparts. Much of Europe has had a more difficult time than the U.S. in handling inflation. Europe has suffered from very high energy costs due to the war in Ukraine. Although the war appears nowhere near over, by and large, energy prices are substantially lower than their 2022 highs. Christine Lagarde, President of the European Central Bank, along with Lael Brainard, Vice Chair of the Federal Reserve, continue to warn of declaring victory over inflation too soon.

The final argument being bandied about is the positive prospect of China's economic resurgence. This is the most tenuous of all the positive points the Europeans point to for support of a recovery. China has many economic and political problems. One of China's most lengthy and difficult problems is in real estate financing, which they haven't come close to solving. When times were flush, China embarked on a political/economic program dubbed the New Silk Road. It is not turning out as hoped. To put it simply, it is a money losing policy. This, along with some other economic changes, makes us skeptical of China's economic growth in the near future.

Conclusion

Clearly, this is not a particularly bullish paper, but nor is it bearish. What we are saying is that it is too soon to tell. Economics and finance are often like that. A few interesting things to remember—recessions can be quite shallow and not particularly damaging, and markets are anticipatory creatures. Mona Mahajan, an investment strategist with Edward Jones, points out recently in *Barron's* that markets tend to start their recovery about six months before the end of a recession.

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