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**The Economy, the Markets, the Federal Reserve and the Road Ahead**

Summer feels like it is finally arriving in southern California and with it a hopefully brighter outlook for the future. Let’s look at what has happened in the last few weeks and try to ascertain what that means for the road ahead.

Last week the Federal Reserve (e.g., the Fed) hiked its interbank reserve lending tool, the Federal Funds rate by 0.25%. The markets fully expected the rate increase but what was different this time was the language the accompanying Fed policy statement contained. In the statement the Fed announced that it no longer “anticipates that some additional policy firming will be appropriate.” It also stated that the Fed will “closely monitor incoming information.”

A clear consensus has emerged that this language means that absent rising inflation, that the Fed is done raising interest rates for at least the rest of the year. Some have even said this language closely resembles the language of the Fed June 2006 statement, which marked the last rate hike of that cycle. In fact, the markets through its Fed Funds futures markets have priced in three rate cuts before this year ends and no more rate hikes. Time will tell who blinks first, the markets or the Fed.

Economically, the last few weeks have seen the release of several pieces of positive data. While first quarter GDP came in at a disappointing 1.1% annualized rate, largely due to depletion of inventories, final sales to domestic purchasers increased 2.9%, the largest increase since early 2021. This data point is one of the best predictors of future economic growth. The U.S. labor market continues to create jobs and unemployment is at a record low with 1.7 job openings for every unemployed person. Consumer spending remains strong and consumer confidence holding up. With 85% of companies reporting first quarter results average sales gains beat analysts estimates by 2% and average earnings gains beat analysts estimates by 7%. A much better showing than expected.

Let’s address the recent talk of an “impending recession.” Is a general recession possible, absolutely if the right conditions present. We have an unprecedented level of money creation in the last three years preceded by extremely low interest rates for more than a decade resulting in high inflation, high interest rates and high cash balances in the private sector. My view is that this has created an environment where sectors of the economy are experiencing recession like conditions while other sectors are not. Specifically, the “goods” side of the economy characterized by real estate, autos, and other durable goods producers that depend on financing to push sales have significantly slowed. The “services” side of the economy characterized by restaurants, travel, entertainment, and other professional services is still growing benefiting from strong consumer spending and high cash levels.

The result is that we currently have an economy that is growing slowly but growing none the less. If the economy grows, the stock market will reflect that growth by increasing in value. Historically, stock market returns have tended to be healthy following Fed rate hike pauses. Bond markets also tend to rise when interest rates top out and begin to fall. Uncertainty and risk remain in the form of still hot inflation if it were to reverse course and move higher forcing the Fed to continue increasing interest rates. Also, the current interest rate environment has put significant stress on the banking industry, particularly regional banks which may experience more failures if the Fed is forced to raise interest rates. Finally, geopolitical events such as Ukraine and China/Taiwan are always looming in the background.

My base case going forward is that the economy continues to grow at a slow pace for the next twelve months and that the stock market lows we experienced last October likely represent the bottom for this cycle. Returns going forward should be positive, but do not expect outsized performance. Volatility is still the order of the day, and a recession is likely ***if*** inflation re-asserts itself and forces the Fed to keep raising interest rates. However, longer-term the economy is positioned to continue growing and the returns from the financial markets will reflect that growth.

Attached you will find a piece by Brad McMillan, Commonwealths’ Chief Investment Officer. It presents some interesting information and analysis about what has transpired these past few weeks and what it may mean going forward. I recommend reading it to get another viewpoint.

I am always available to you via phone, zoom conference or in person. I look forward to talking with you over the next few weeks. If you have any questions or if we can be of any help, please do not hesitate to contact Linda or me.

*Certain sections of this commentary contain forward-looking statements that are based on our reasonable expectations, estimates, projections, and assumptions. Forward-looking statements are not guarantees of future performance and involve certain risks and uncertainties, which are difficult to predict. Past performance is not indicative of future results.*

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