MILL CREEK

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March 6, 2023

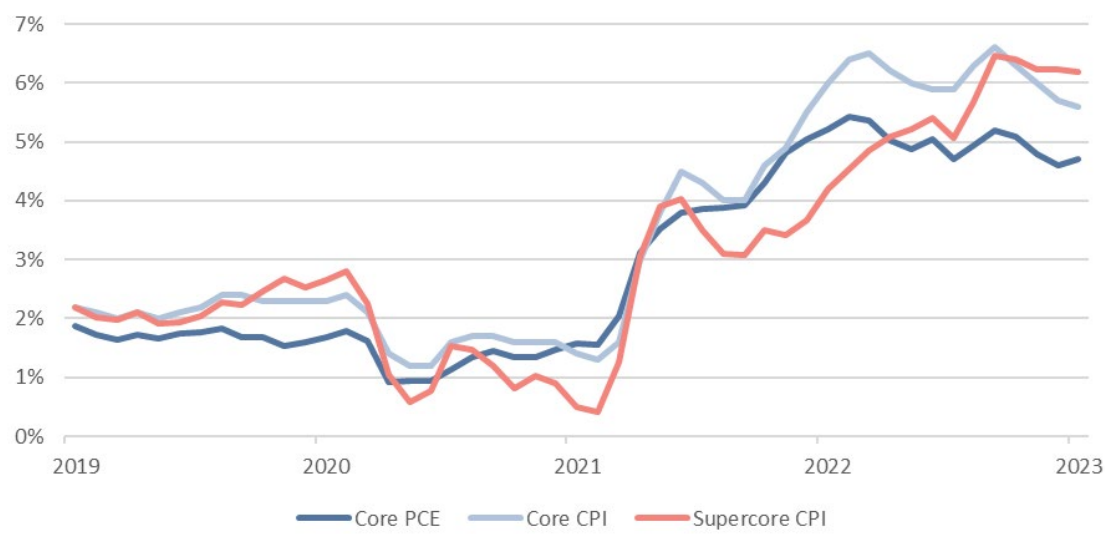
MONTHLY UPDATE

February Market Review

- Stock and bond markets retrenched in February as investors grappled with global inflation worries and a resurgent US economy. Market participants now expect the Fed Funds rate to end the year at 5.25%.
- Developed market equities (domestic and international) outperformed emerging market equities in February. Small cap equities, growth equities, and international equities have been the biggest outperformers year-to-date.
- The yields on the 10-year Treasury bond and Bloomberg Aggregate Bond Index rose to 3.9% and 4.8%, respectively.

Pivot (again?)

Fig. 1: US inflation remains stubbornly high



Source: Bloomberg, Mill Creek.

After a dovish January in which the Fed slowed rates hikes and crowed about disinflation, February's data flow made it clear that monetary policy is falling behind the curve. A growing quantity of evidence indicates another Fed pivot — this time toward hawkishness — will occur at the March FOMC meeting. For example,

1. January's core personal consumption expenditures (PCE) price index came in at an annualized pace of 7.1% - very hot,
2. The "new" inflation index Chair Powell has been focusing on – PCE excluding energy, food, and housing — showed no sign of disinflation,
3. Labor markets remain historically tight. Initial and continuing unemployment claims stay near all-time lows,
4. Retail sales rose 1.7%, beating expectations,
5. Nominal aggregate income growth jumped to 7.9% year over year and 11.7% on an annualized monthly basis for January.

In sum, the US economy has reaccelerated, inflation remains far too high (Fig. 1), and we **continue to believe** a terminal Fed funds rate between 5.5% and 6% remains likely. The market has partially caught up to our "**higher for longer**" view as market participants now expect the Fed Funds rate to be 5.25% at the end of 2023 — up from 4.5% at the beginning of the year. However, our view remains that markets are too sanguine in pricing the upside risk to Fed policy.

All that aside, if 2022 was a year dominated by interest rates, then 2023 will be a year dominated by earnings. Interest rates are currently high enough that markets can absorb a 10-Year Treasury at 4.5% or even 5% with only modest disruption, but earnings expectations have yet to price in a significant growth slowdown or recession. To put some numbers around this dynamic, a shift from 4% to 4.5% on the 10-year Treasury would not be enough to drive the S&P into negative territory for the year, all else equal. In contrast, a 15% earnings decline from current expectations implies a 10% decline in the index at year-end 2023. Accordingly, we remain positioned defensively within our stock and bond portfolios and continue to recommend allocations to private lending, real assets, absolute return, and private assets to diversify away from public stock and bond exposure.

QUICK LINKS

- House View Summary
- Private Remains Resilient Amid Tech Sector Downturn (White Paper)
- TINA Has Left the Building
- Updating Our View on Credit

This week's contributor: Michael Crook, CAIA

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