

All I Want for Christmas ... Is a Fed Pause (in 2023)

'Tis the season for our annual tradition! Again, we challenged ourselves to determine what could be the single-most important catalyst that drives markets higher in the New Year and put it atop our wish list for Santa Claus.

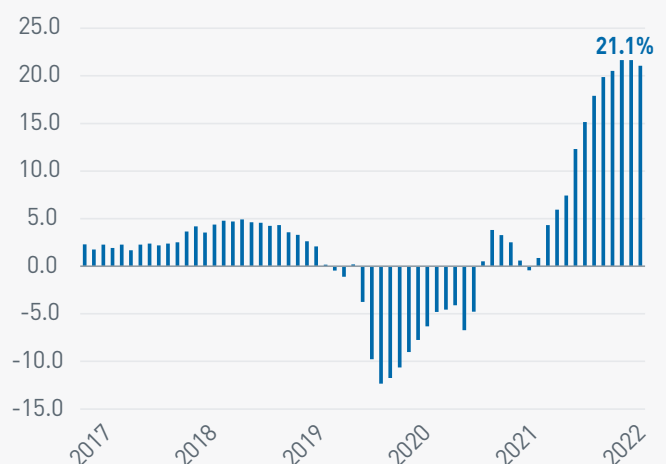


Our Christmas wish last year was supply chain normalization. We must have been on Santa's naughty list because instead we got a big lump of coal! While inventory levels increased throughout the year, it was due to inventory building by retailers rather than meaningful improvement in supply chains (Figure 1).

With 2022 effectively done and dusted, we have only seen incremental evidence of supply chain normalization. In fact, we expect supply chain challenges will continue to be a dominant headwind in 2023. Although China's zero-COVID policy — the single-largest driver of supply chain disruptions since the onset of the pandemic — was recently relaxed, the country will not return to pre-pandemic conditions overnight, and neither will supply chains. Looking ahead to 2023, we believe there is another market catalyst that matters even more. Topping our Christmas wish list this year is...drumroll, please... **a pause in fed fund rate hikes by the Federal Reserve (Fed)!**

Figure 1. Change in Inventories Held by Retailers, Seasonally Adjusted (YoY %)

Retailer inventories spiked from COVID-19 resurgence, now finally rolling over



As of 10/31/2022. Source: Bloomberg, L.P.

Do They Know It's Christmas?

Much to our chagrin, the Fed remains in the driver's seat of Santa's market sleigh. Amid a tumultuous global macroeconomic backdrop and 40-year-high inflation, the Fed embarked on an aggressive policy tightening campaign, raising the fed funds rate from 0.00% - 0.25% at the start of the year to 4.25% - 4.50% in December. The pace and magnitude of rate hikes, combined with inflation, commodity price spikes and ongoing supply chain challenges, roiled equity and fixed income markets, sending both down by double-digits year over year. Each Consumer Price Index (CPI) report has been eagerly awaited by investors, like children on Christmas morning, hoping to see inflation decline so Fed Chair Jerome Powell can finally hit the "pause button" on rate hikes.

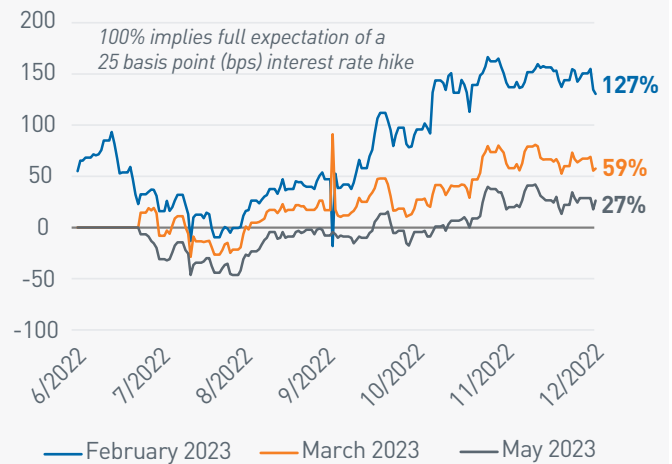
Unlike past rate hike cycles, markets have acted on anticipated Fed moves rather than waiting for an official announcement. For 2023, the market has already priced in 25 basis point (bp) increases in both February and March (Figure 2). And, although Chair Powell has reiterated to markets time and again not to expect any rate cuts in 2023, the market has already priced in 50 bps of cuts beginning in the second half of 2023! It is a frosty reminder that the Fed and markets have not been on a sleigh ride together since the Fed's policy pivot, and that the Fed's dual mandate of maximum employment and price stability does not consider the stock market.

Sadly, instead of Christmas, it feels more like Groundhog Day, as this period is eerily reminiscent of 2018 when the Fed was effectively hiking interest rates on autopilot. That year, the S&P 500® cratered nearly 20% from its high in October through Christmas Eve. Needless to say, our Christmas wish did not arrive in time to be gift-wrapped under the tree that year. But sure enough, it eventually arrived



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Figure 2. U.S. Interest Rate Probability (%)
The market's path forward is highly dependent on the Fed's rate hike expectations



As of 12/14/2022. Source: Bloomberg, L.P.

in early January 2019 — perhaps lost in the supply chain without a tracking number — as Fed Chair Powell finally indicated a pause would be forthcoming. Markets recovered, and the S&P 500 went on to generate a 31.5% total return that year.

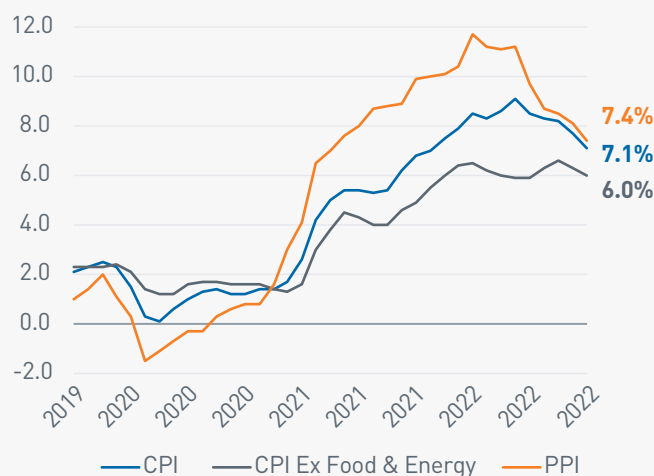
Bah, Humbug!

The Fed has not made much progress in the inflation battle, despite its generous rate hikes this year (Figure 3, page 3). Raising rates to curb inflation has been a fruitcake-less endeavor, because the Fed can only control demand, but it cannot ultimately control supply.

The world has been facing a perfect blizzard of inflationary pressures that monetary policy alone cannot fix. Intermittent lockdowns in China, the Russia-Ukraine war and U.S. dollar appreciation, among other factors, are all outside of the Fed's control, but play a large part in keeping inflation up on the rooftop. Furthermore, incorporating Fed policy changes is not as simple as flipping on the holiday lights. It takes time for higher interest rates to start to have an impact on the economy, perhaps as long as nine to 12 months.

Figure 3. U.S. CPI and PPI (%)

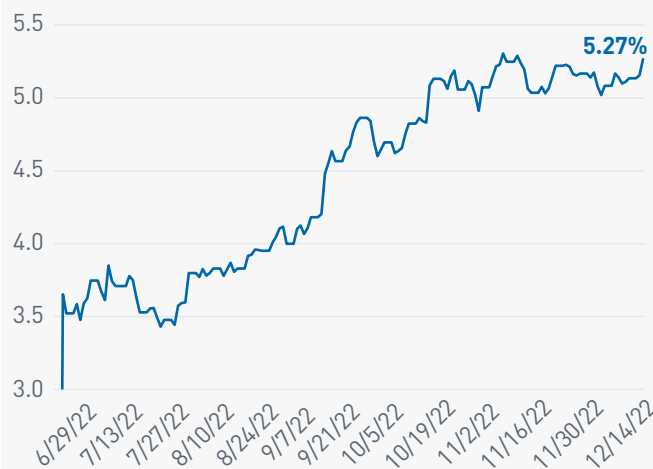
Inflation has clearly peaked, but remains at elevated levels



As of 11/30/2022. Source: Bloomberg, L.P.

Figure 4. Market Pricing of the Fed Funds Terminal Rate (%)

The destination is more important than the journey to get to the terminal rate



As of 12/14/2022. Source: Bloomberg, L.P.

That is why, we believe what matters most for markets right now is getting a line of sight to the end state of monetary policy, also referred to as the expected terminal rate (Figure 4). The terminal rate in the Fed's latest dot plot is now 5.10%, a whopping 135 bps higher than the July Fed meeting (Figure 5, page 4). Back then, it felt like Christmas in July with a terminal rate of only 3.75%, which seemed manageable from a valuation perspective. From a historical perspective, it was also substantially below "normalized" levels from past cycles. In the 30 years before the financial crisis, fed funds averaged 6.6%, but since 2007 it has averaged just 77 bps! The odds of a soft landing felt pretty good, in our view.

At 5.10%, we are deep into restrictive territory for markets, the economy and financial conditions, making the odds of a hard landing in 2023, in our view, go up and in very short order. There has never been a scenario where the Fed hiked rates to 5.10% or higher and avoided an economic contraction. However, Fed policy is still very much data-dependent, which leaves the chimney flue open, as recession is not a foregone conclusion.

The Gift that Keeps on Giving

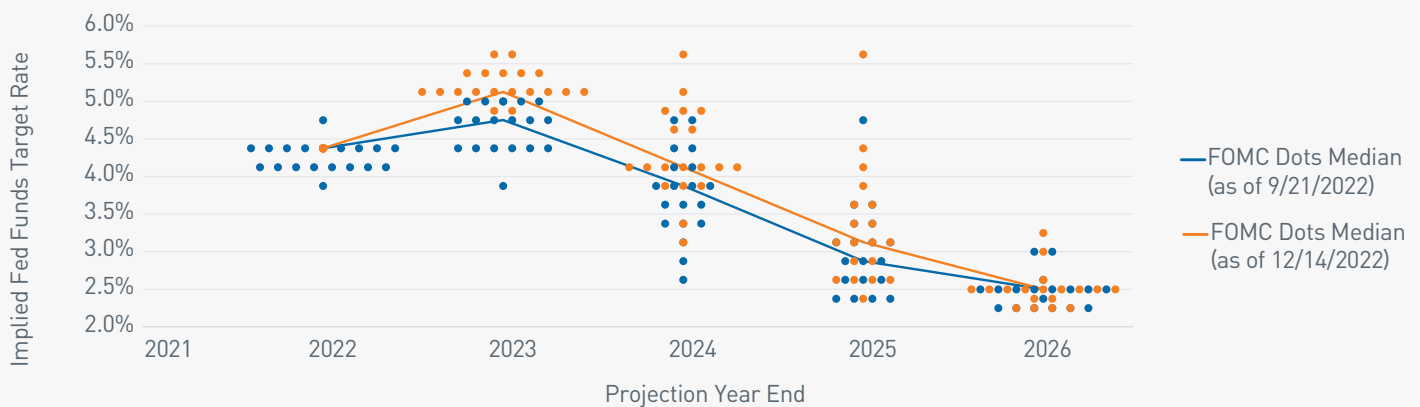
When it comes to navigating changing market and economic conditions, like Rudolph's red nose, our investment process lights the path forward. Here is our quick take on where each of our three pillars stand right now:

Business Cycle

Many economic indicators are weakening, including housing starts, new and existing home sales and Purchasing Managers indices, all of which have fallen at a rapid pace this year. In addition, the Conference Board Leading Economic Indicator Index declined 0.2% on a rolling six-month basis in November, suggesting leading indicators are showing early signs of contracting economic activity. In our view, the confluence of headwinds, including tightening monetary policy from the Fed, elevated inflation due to supply chain bottlenecks and the Russia-Ukraine conflict, will contribute to a slowing expansion of the business cycle and ultimately toward an economic contraction in 2023.

Figure 5. FOMC “Dot Plot”

Interest rate expectations shift higher and for longer



As of 12/14/2022. Source: Bloomberg, L.P.

Valuations

All major asset class valuations are back to pre-pandemic levels, primarily because prices have pulled back, whereas consensus earnings estimates have not fallen to the same degree. We believe stocks could see a further pullback as earnings weaken. Thus, not all “low” valuations should be considered cheap at this point in the cycle.

Technicals

After the first two-month rally of the year, most technical indicators remain positive as relative strength conditions are neither overbought nor oversold. The downward trendline that began with the highs of early January remains a definitive resistance level.

Happy New Year?

As of this writing, PNC Economics believes we will enter a recession beginning in second quarter 2023 with it potentially lasting through the fourth quarter. While sometimes the eternal optimist in us views the world through peppermint-colored glasses, we can point to a number of reasons why we expect this to be a mild to moderate recession in terms of magnitude, outlined below.

- **Tight labor market:** We believe businesses will be reluctant to lay off workers given the tight labor market (currently there are two openings for every one person looking for a job), making job losses limited compared to past recessions.
- **Balanced housing:** The housing market is much more balanced than it was in 2007-2008, so we do not expect it to be a significant drag on the economy.
- **Strong balance sheets:** Consumer balance sheets remain strong, with \$163 trillion in assets, and spending activity continues to be solid despite a behavioral shift from goods to services/experiences.
- **Credit resilient:** Credit markets remain resilient despite macro headwinds and the high-volatility regime. Furthermore, spreads have widened but are only back to long-term averages.
- **Ample liquidity:** Money supply has declined more than \$320 billion from the March 2022 peak but is coming off record highs. Therefore, money supply is almost \$2 trillion above its 40-year trendline.
- **Growing incomes:** As the labor market remained tight, average hourly earnings grew 5.2% for 2022.

Indices are unmanaged, not available for direct investment, and not subject to management fees, transaction costs or other types of expenses that an account may incur.

- **Capital expenditures steady:** Businesses continue to invest for the long run, with the S&P 500 marking a new all-time high in capital expenditures during the third quarter, spending more than \$236 billion.
- **Stimulus support:** Fiscal stimulus remains in the system, including:
 - *Creating Helpful Incentives to Produce Semiconductors and Science (CHIPS) Act* – This act authorized \$280 billion over the next 10 years for investment in science, technology, engineering, math programs, workforce development and other research and development.
 - *Inflation Reduction Act* – This act aims to reduce the cost of living for American families, making investments to combat climate change, reform prescription drug costs and create a minimum corporate tax.

Figure 6. Implied S&P 500 Price Level Using Earnings per Share and Forward P/E
Inflation and interest rates will have an outsized impact on earnings and valuations in 2023

NTM EPS	Hypothetical Scenario	Price to Earnings (P/E NTM)				
		15.3x	16.3x	17.3x	18.3x	19.3x
\$174	25% downside	2,651	2,825	2,999	3,172	3,346
\$209	10% downside	3,181	3,390	3,598	3,807	4,015
\$232	*NTM Consensus estimate	3,535	3,766	3,998	4,230	4,462
\$255	10% upside	3,888	4,143	4,398	4,653	4,908
\$290	25% upside	4,418	4,708	4,998	5,287	5,577

As of 12/14/2022. Source: FactSet®. FactSet® is a registered trademark of FactSet Research Systems Inc., and its affiliates.

Will the Fed be the Grinch who Stole Christmas?

Assuming we continue on a slowing but growing path (that is, the soft-landing scenario), given current interest rates and financial conditions, we believe fair value for the S&P 500 is in a range of 15.0 – 17.0 times (x) forward price-to-earnings, versus 17.4x today (Figure 6). We are not priced at recessionary valuation levels, which could translate into another 10% to 15% downside for equities. Based on what the Fed said in December, we believe investors should be prepared for more market downside.

The good news is that we expect the downside to be somewhat short-lived. With the Fed remaining firmly in the driver's seat, we expect the market to continue to anticipate and quickly price in all the Fed's tightening moves. However, as we begin to see sustained decreases in inflation and the Fed slows or pauses rate hikes, we expect valuation multiples to bounce back

like a bowl full of jelly. From our perspective, a Fed pause is almost the same as a cut in the market's view, which we believe could equate to two to three multiple points of valuation multiple expansion, all else equal.

For more details on asset allocation guidance and recommended portfolio positioning, check out our forthcoming first-quarter 2023 *Strategy Insights, The Investor's Field Guide to 2023*, which provides our investment and economic outlook, as well as portfolio positioning recommendations, for the new year.

Happy holidays! Wishing you and your families a happy, healthy and prosperous holiday season.

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