Economic outlook.

Fourth Quarter 2022

The Year Ahead: Riding on Rocky Ground

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SEI recently released its fourth-quarter Economic Outlook. A summary of the conclusions is provided below:

- Both fixed-income and equity markets chalked up big losses in 2022—almost regardless of region or style. While emerging-market equities and bonds fared relatively better, the only asset class to post a positive absolute return for the year was commodities. Investors should be prepared for more volatility in 2023.
- Price-to-earnings (PE) multiples contracted sharply in 2022. At the end of 2021, the forward PE multiple on U.S. equities was 22.5, well above the 10-year average of 18.1. At the end of 2022, the forward PE multiple had contracted to 17.1, representing a modest discount to its longer-term average.
- Although global corporate earnings estimates have eased, they do not seem consistent with the generally dour view of economists. Even a mild recession should produce an outright earnings decline of 10% or more.
- U.S. economic growth in 2022 fell well short of our expectations. An increase of just 0.7% in overall business activity now appears likely due primarily to plummeting labour-force productivity.
- In the New Year, investors will face familiar headwinds: inflation rates exceeding the targets of major central banks; interest-rate increases potentially continuing through midyear; quantitative easing shifting to quantitative tightening; and, for many countries, stagnant or recessionary economies perhaps, into 2024.
- It is not at all clear to us whether the U.S. will see a recession, although surveys of economists published by the Federal Reserve (Fed) Bank of Philadelphia, the *Wall Street Journal*, and the *National Association of Business Economics* suggest a greater than 50% chance. Wages are down in inflation-adjusted terms, the housing market is suffering a severe contraction, and job losses are up. However, the overall economy still isn't declining in a pronounced, pervasive, and persistent manner—the "three Ps" that characterise a recession.
- In terms of monetary policy, the U.S. Federal Reserve's (Fed) is expected to continue raising interest rates in 2023, with a year-end median prediction of 5.1% and a central-tendency forecast, which incorporates the majority of Federal Open Market Committee (FOMC) decision-makers, of 5.1% to 5.4%. The obvious question is whether this unexpectedly forceful approach taken by the Fed this past year and, presumably, in the year ahead, will be sufficient to bring inflation down.
- Market-implied pricing of the federal-funds rate suggests that investors and traders think that the Fed will end its tightening cycle by mid-2023, peaking at 4.8% (meaningfully below what the Fed thinks will be necessary).
- We are in the camp of the Fed's more hawkish members. If there is going to be a surprise, it may still be toward a somewhat higher federal funds in 2023, not a lower one. In our opinion, tight labour markets and a stubbornly resilient U.S. economy will keep inflation higher for longer.
- The Fed and the Bank of Canada have been mostly pushing up rates in lockstep with each other. The Bank of England has not been quite as aggressive despite the extremely high inflation rate facing the country, while the European Central Bank only recently pushed its deposit facility rate up to 2%—less than half the level of the U.S. federal-funds funds rate (Source: European Central Bank, SEI).
- We expect a move toward somewhat tighter monetary conditions than those that prevailed in 2022. When will central banks pivot in the opposite direction? We would argue there is no uniform answer.
- On the geopolitical front, the war in Ukraine looks set to drag on well into 2023 at the very least; the possibility exists for more surprises that will keep energy prices quite volatile, with current prices likely now at the low end of a wide trading range. Easing COVID restrictions in China should be good news for the global economy.

A full-length paper is available if you wish to learn more about these timely topics.

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