Congress Asset
Management Company, LLP

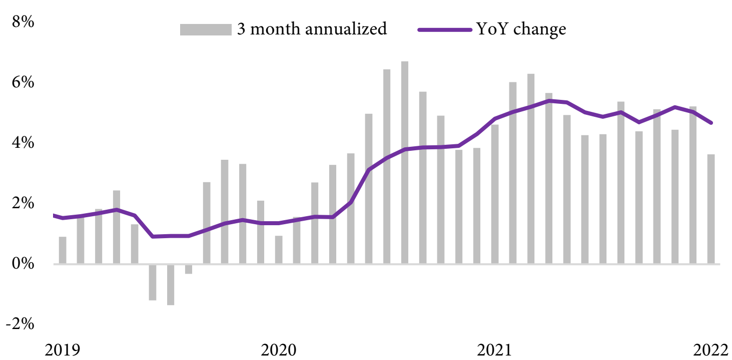
ECONOMIC AND MARKET OUTLOOK

First Quarter 2023

The financial markets were relatively calm as 2022 ended, belying the most turbulent year since the 2008 Great Financial Crisis. 2022 will be remembered as the year the pandemic-induced economic haze began to lift. The clearer view accentuated some troubling trends: the stubborn persistence of inflation, Russia's continuing aggression in Ukraine and antagonism towards the West, and the ratcheting up of tension in trade rhetoric and restrictions between the U.S. and China. Rising rates punished markets with little solace found in stocks, bonds, or alternative investments. The S&P 500 was down 19% for the year and the Bloomberg US Aggregate Index fell 13%, the first time in at least 50 years that both stocks and bonds had negative returns.

Inflation has been a major driver of market volatility and we believe it will continue to have an outsized effect on the markets and economy in 2023. The Federal Reserve (Fed) raised the federal funds rate seven times over the course of the year, a cumulative increase of 4.25%, to slow economic growth and fight rampant inflation. While the full impact of these rate hikes has yet to be felt, recent indicators suggest we are past peak inflation, a sign that the Fed's efforts may be paying off. Core Personal Consumption Expenditures (PCE), the Fed's preferred measure of inflation, has fallen in each of the last 4 months. The 3-month annualized rate in November was 3.6%, the lowest since February of 2021.

Core PCE 2019-2022

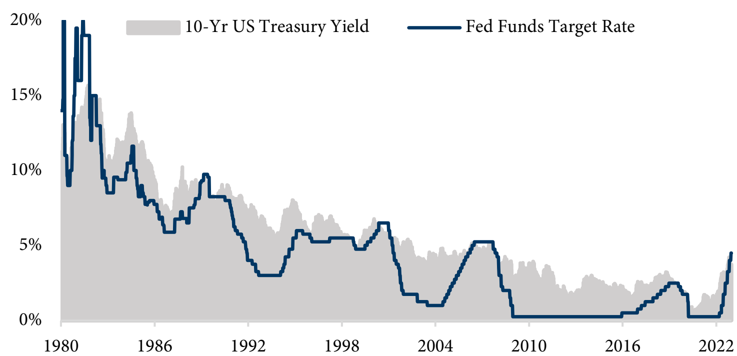


Source: U.S. Bureau of Economic Analysis as of December 2022

Consumer demand for goods and housing should continue to weaken, alleviating some cost pressures. However, the labor market remains out of sync with a shortage of workers even though wages and compensation continue to grow at an accelerated rate. The Fed would like to see the unemployment rate increase from 3.7% to over 4% to bring this back in balance, in theory easing compensation costs. Fine tuning the unemployment rate however is an inexact art, and the Fed risks damaging the American worker should they be too aggressive.

Though trending down, inflation remains high, and the Fed expects to continue raising rates in 2023. This Fed tightening cycle, like all the prior ones, is a delicate experiment – too much tightening could cause a recession, too little and inflation could resurge, wreaking its own havoc. As it stands now, the Fed Funds rate target at 4.25% is above the 3.85% 10-year US Treasury yield, a point at which tightening cycles have ended in the past. We expect this cycle will wind down early in 2023, allowing the economy to find its natural footing with less Fed intervention.

Fed Funds Target Rate & 10-Yr US Treasury 1980-2022



Source: Board of Governors of the Federal Reserve System as of December 2022

Still, the ultimate success of the Fed's experimentation remains unknown. While there are plenty of historical examples of tightening cycles that resulted in recession, the chances of a "soft" landing are buoyed by a domestic economy that continues to exhibit resiliency. Consumers and businesses are feeling the pangs of higher interest rates but generally do so from a position of strength. Consumer interest and debt burdens are low, thanks to years of low interest rates, and high levels of reserves have allowed consumers to absorb higher costs. Though businesses have seen an overall increase in debt levels, fundamentals remain healthy with low leverage, debt service, and elevated cash.

The geopolitical situation bears watching. As the Russia-Ukraine war drags on, it portends a wider conflict and highlights the fragility of the world energy markets. Western efforts to transition to sustainable wind and solar energy, neglecting traditional natural gas and oil development, have left the world vulnerable to energy price spikes and shortages. Europe has responded by refocusing its attention on nuclear power and quickly adding liquified natural gas capabilities to its roster of energy options. However, more will be needed to forestall social unrest or worse in the face of rising energy costs.

China's abrupt decision to re-open its economy should give the global economy a boost. Yet caution remains warranted as the sudden shift appears out of character, raising concerns that China's economy is teetering on recession. Re-opening is welcome but the relationship between the U.S. and China appears more fragile now than it has since 2001 when China was admitted into the World Trade Organization. The growing tension has led to increasing trade restrictions put in place by successive U.S. administrations to protect national security interests. Recently, the U.S introduced sweeping export controls to prevent Chinese companies from obtaining or manufacturing advanced computer chips. As a result, technology companies have altered sales and procurement policies to abide by U.S. demands. Other industries may end up following suit and moving production out of China or altering procurement policies.

Last year's broad sell-off reflects the lingering economic uncertainties around growth and inflation. We do not anticipate a similar experience in 2023. It was a painful year for most investors, but these watershed years can be cathartic. The zero-interest rate era is over, and the readjustment phase is well underway. Not coincidently, speculative investments that blossomed in the zero-rate era have cracked. Those, like FTX – built on manipulation, greed, and fraud – have collapsed. Fortunately, ancillary damage has been contained and the crypto correction will not be a contagion.

The bond market of 2023 should offer more stability. Last year's unprecedented interest rate rise was driven by the highest inflation levels in over 40 years. This seems unlikely to be repeated as inflation appears to be easing. Further, while bond yields have fallen recently, they remain near their highest levels in over a decade and offer investors better income prospects.

The outlook for stocks is more tenuous. Company profit margins will likely shrink as elevated costs have yet to be fully realized, but stock valuations are attractive especially if interest rates stabilize as expected. Technology stocks led the market in a low interest environment over the past few years. However, we anticipate market breadth to widen as shifting economic sands improve the prospects for other sectors, potentially altering stock market leadership in the coming year.

Overall, the risk of recession has cooled but continues to be elevated amidst tightening monetary and fiscal policy. Yet the underlying US economy has held up relatively well, especially against the backdrop of a looming global recession. While additional fiscal stimulus is unlikely with the return of a divided government, there is still a large amount of spending to be disbursed, which could provide a further tailwind. Though the broader economic outlook is uncertain, we remain confident opportunities for outsized and resilient earnings growth can be identified through bottom-up fundamental analysis. We believe a diversified portfolio of quality growth companies provides investors the best opportunity to participate in up markets and protect capital in down markets.

Investment Oversight Committee
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