3 Factors That Could Drive Markets in 2023

The turn of a new year means weighing new factors that could impact markets. Investors must also remember, though, that forward-looking views come with blind spots—extraneous factors that appear without notice, creating positive and negative surprises that can help and hurt markets. Readers will recall that in 2022, Russia did not invade Ukraine until late February, making the disruptions to global commodity markets and the effects on inflation very hard to forecast on January 1st.

That being said, I do see a few macroeconomic forces likely to play key roles in the trajectory for economic growth, interest rates, inflation, earnings, and market returns in 2023. Here are three I think investors should watch closely.

1. **When and Where Will Interest Rates Peak?**

There is strong data indicating that goods inflation has peaked. Supply constraints like closed factories, higher shipping costs, and snarled supply chains have largely faded. Falling housing prices and lower prices on new rental leases indicate that the sticky “shelter and owners’ equivalent rent” component of inflation will come down. The impact of higher prices for used cars, semiconductors, and airfares appears to have run its course, and energy prices have also retreated from peaks.

That’s all-positive news. The problem today is that services inflation has not come down alongside goods inflation, and in fact may be trending in the wrong direction. A big factor driving services inflation is the tight labor market, where labor scarcity continues to drive up wages. As wages move higher, the cost of doing business rises, which filters through to higher prices charged for services. As readers can see in the chart below, categories of goods inflation (green and red lines) peaked several months ago, but services inflation (blue line) continues to trend higher.
Goods Inflation Has Peaked, But Services Inflation Remains Elevated

The inflation picture matters because it has outsized influence over the Federal Reserve’s approach to monetary policy. In 2022, the market was repeatedly wrong about inflation and projections for the fed funds terminal rate, and every shift higher drove heightened market volatility. Expectations for peak fed funds now stand at 5% to 5.25% by mid-2023, but the market may still be too optimistic about when rates will start to come down. There are plenty of historical cases of the Fed loosening too soon before the inflation battle was won, which Chairman Powell is acutely aware of.

2. Will the U.S. Enter a Recession, and Will Jobs be Lost?

On the economic front, earnings estimates are coming down and S&P 500 profit margins have peaked, which generally implies an economic slowdown is underway or very close. My preferred measure of the yield curve—which is the difference between the yield on the 3-month U.S. Treasury bond yield and the 10-year Treasury bond yield—is also inverted, which has been a strong recession signal historically as it implies unprofitable lending conditions for banks.

Yield Curve Inversions Historically Precede Economic Recessions

Supply and demand are clearly off balance in the labor market, and the Fed wants desperately to bring it back into balance. The optimistic view is that the Fed could theoretically achieve this goal by reducing the number of job openings instead of slowing the economy to the point of triggering layoffs. Whether or not they accomplish this goal will be key to watch in the new year.

3. China’s Economic Reopening – Bumpy or Smooth?

China’s economy is finishing the year with a whimper, an extension of troubles experienced throughout 2022. In November, due to continued restrictions and lockdowns associated with “zero-Covid,” China’s economy suffered...
setbacks as retail sales plummeted by 5.9% year-over-year. Unemployment in major cities rose from 5.5% in October to 5.7% in November, and the youth unemployment rate remains above 20%. Industrial production also plateaued in the month as factories were hit with the double-whammy of Covid restrictions and falling global demand. Overall, it was a bad year for China, which also likely weighed significantly on global stocks.²

But there is good reason to believe China could experience a turnaround in 2023, particularly as protests and urging from businesses has led to an easing of Covid restrictions and a shift to broader economic reopening. China appears to be following through – beginning January 8, the country will lift rules requiring foreign visitors to quarantine upon arrival, instead requiring only a negative test within the previous 48 hours. This move and others are real steps towards reopening, but it remains to be seen whether a surge in cases and deaths this winter will cause the government to snap restrictions back into place. For now, China’s government is forecasting 5% GDP growth in the new year, and many Wall Street banks and economists see the growth even higher.

**Bottom Line for Investors**

The most optimistic case for the new year involves positive outcomes for each of the three factors listed above, in my view. That means the fed funds rate would peak sometime in the summer, the U.S. may enter a mild recession where job openings fall briskly versus layoffs rising, and China resumes a full reopening and a surge in economic activity.

On the flip side, services inflation could continue to move higher, forcing the Fed to increase the terminal fed funds projection once again and lift the fed funds rate through the summer; a deeper recession could result in layoffs and a rise in the unemployment rate; and, China could restore strict Covid lockdowns and restrictions that hamstring its economy again in 2023.

Investors should look for clues throughout the year that indicate which scenarios are most likely, and make your bull or bear cases accordingly.

---


U.S. Housing Slump May Help the Fed’s Cause in 2023

The Federal Reserve desperately wants inflation to come down. A slump in the U.S. housing market may help. Following a surge of household formation in late 2020 and throughout 2021, activity in the housing market has cooled, particularly as the Federal Reserve has risen interest rates in an effort to battle soaring inflation. The surge in home prices—which saw the S&P CoreLogic Case-Shiller National Home Price Index jump 45% from January 2020 to June 2022 and apartment rents soar—has arguably now run its course. The Fed raised rates seven times in 2022, and the end of quantitative easing removed a significant source of demand on the long end of the interest rate curve. That saw mortgage rates jump from around 4% in March to 7% in the fall, with rates now having settled slightly higher than 6%. This increase results in a significant jump in median mortgage payments that homebuyers are making, to the tune of +43% from January to November 2022. The result is that buyers have left the market in droves, and sellers are holding onto properties given their locked-in low-interest rates. An easing of home prices and a plateau in new household formation has stifled home prices and also led to the supply of new apartments hitting a 40-year high, both positives in the inflation fight. Housing accounts for about 30% of the consumer price index measure of inflation, and about 1/6th of the personal-consumption expenditures index, which is the Fed’s preferred measure.¹

The End of the Negative-Yielding Bonds Era

In the aftermath of the 2008 Global Financial Crisis, central banks around the world cut interest rates to the zero bound in an effort to spur economic activity. That brought a flood of negative-yielding debt—where investors pay money to own a bond—across many developed countries in Europe. At its peak two years ago, there was $18.4 trillion of negative-yielding debt globally, a staggering figure. But the arrival of inflation has shifted the tables, with central banks around the world—even the Bank of Japan—now raising rates and bringing bond yields across the yield curve back into positive territory. The European Central Bank’s benchmark rate has climbed from -0.5% at the beginning of 2022 to 2% today. The backdrop of negative-yielding debt arguably helped fuel a years-long rally in risk assets, but now that positive yields are re-entering the market investors have more options for where to park money. The Bank of Japan remains the only developed country with negative-yielding debt, with its shorter-term notes with maturities of a year or less slightly negative.²

This New Year, Invest In...Yourself

Investors naturally think of wealth building in terms of accumulating assets and earning returns on investments in stocks, bonds, real estate, and the like. But studies show that there are also big returns to be made on a different type of investing, what economists refer to as ‘human capital.’ Beyond growth to be earned in the capital markets, there are also three categories of growth people can pursue in their own lives: professional, personal, and health. Much like we make an effort to check in on our financial lives and the performance of an investment portfolio, so too can we create stepping stones for achievement in careers, relationships, and physical and mental health. Another parallel between personal wealth and financial wealth is the need for diversification. Just as an investor
should not overcommit to a single stock or asset class, you should also not put too much time and effort into professional growth at the expense of personal and health growth. Also, just like investing, personal wealth should be framed as long-term goals with short-term checkpoints along the way.³
Mitch on the Markets – Weekly Client Commentary
December 29, 2022

ZACKS INVESTMENT MANAGEMENT, INC.
www.zacksim.com


DISCLOSURE

Past performance is no guarantee of future results. Inherent in any investment is the potential for loss.

Zacks Investment Management, Inc. is a wholly-owned subsidiary of Zacks Investment Research. Zacks Investment Management is an independent Registered Investment Advisory firm and acts as an investment manager for individuals and institutions. Zacks Investment Research is a provider of earnings data and other financial data to institutions and to individuals.

This material is being provided for informational purposes only and nothing herein constitutes investment, legal, accounting or tax advice, or a recommendation to buy, sell or hold a security. Do not act or rely upon the information and advice given in this publication without seeking the services of competent and professional legal, tax, or accounting counsel. Publication and distribution of this article is not intended to create, and the information contained herein does not constitute, an attorney-client relationship. No recommendation or advice is being given as to whether any investment or strategy is suitable for a particular investor. It should not be assumed that any investments in securities, companies, sectors or markets identified and described were or will be profitable. All information is current as of the date of herein and is subject to change without notice. Any views or opinions expressed may not reflect those of the firm as a whole.

Any projections, targets, or estimates in this report are forward looking statements and are based on the firm's research, analysis, and assumptions. Due to rapidly changing market conditions and the complexity of investment decisions, supplemental information and other sources may be required to make informed investment decisions based on your individual investment objectives and suitability specifications. All expressions of opinions are subject to change without notice. Clients should seek financial advice regarding the appropriateness of investing in any security or investment strategy discussed in this presentation.

Certain economic and market information contained herein has been obtained from published sources prepared by other parties. Zacks Investment Management does not assume any responsibility for the accuracy or completeness of such information. Further, no third party has assumed responsibility for independently verifying the information contained herein and accordingly no such persons make any representations with respect to the accuracy, completeness or reasonableness of the information provided herein. Unless otherwise indicated, market analysis and conclusions are based upon opinions or assumptions that Zacks Investment Management considers to be reasonable.

Any investment inherently involves a high degree of risk, beyond any specific risks discussed herein.

It is not possible to invest directly in an index. Investors pursuing a strategy similar to an index may experience higher or lower returns, which will be reduced by fees and expenses.

The ICE U.S. Dollar Index measures the value of the U.S. Dollar against a basket of currencies of the top six trading partners of the United States, as measured in 1973: the Euro zone, Japan, the United Kingdom, Canada,
Sweden, and Switzerland. An investor cannot directly invest in an index. The volatility of the benchmark may be materially different from the individual performance obtained by a specific investor.

Zacks Investment Management, Inc. is a wholly-owned subsidiary of Zacks Investment Research. Zacks Investment Management is an independent Registered Investment Advisory firm that acts as an investment manager for individuals and institutions. Zacks Investment Research is a provider of earnings data and other financial data to institutions and to individuals.

This material is being provided for informational purposes only and nothing herein constitutes investment, legal, accounting or tax advice, or a recommendation to buy, sell or hold a security. Do not act or rely upon the information and advice given in this publication without seeking the services of competent and professional legal, tax, or accounting counsel. Publication and distribution of this article is not intended to create, and the information contained herein does not constitute, an attorney-client relationship. No recommendation or advice is being given as to whether any investment or strategy is suitable for a particular investor. It should not be assumed that any investments in securities, companies, sectors or markets identified and described were or will be profitable. All information is current as of the date of herein and is subject to change without notice. Any views or opinions expressed may not reflect those of the firm as a whole.

Any projections, targets, or estimates in this report are forward looking statements and are based on the firm's research, analysis, and assumptions. Due to rapidly changing market conditions and the complexity of investment decisions, supplemental information and other sources may be required to make informed investment decisions based on your individual investment objectives and suitability specifications. All expressions of opinions are subject to change without notice. Clients should seek financial advice regarding the appropriateness of investing in any security or investment strategy discussed in this presentation.

Certain economic and market information contained herein has been obtained from published sources prepared by other parties. Zacks Investment Management does not assume any responsibility for the accuracy or completeness of such information. Further, no third party has assumed responsibility for independently verifying the information contained herein and accordingly no such persons make any representations with respect to the accuracy, completeness or reasonableness of the information provided herein. Unless otherwise indicated, market analysis and conclusions are based upon opinions or assumptions that Zacks Investment Management considers to be reasonable. Any investment inherently involves a high degree of risk, beyond any specific risks discussed herein.

The S&P 500 Index is a well-known, unmanaged index of the prices of 500 large-company common stocks, mainly blue-chip stocks, selected by Standard & Poor's. The S&P 500 Index assumes reinvestment of dividends but does not reflect advisory fees. The volatility of the benchmark may be materially different from the individual performance obtained by a specific investor. An investor cannot invest directly in an index.

The Russell 1000 Growth Index is a well-known, unmanaged index of the prices of 1000 large-company growth common stocks selected by Russell. The Russell 1000 Growth Index assumes reinvestment of dividends but does not reflect advisory fees. An investor cannot invest directly in an index. The volatility of the benchmark may be materially different from the individual performance obtained by a specific investor.

Nasdaq Composite Index is the market capitalization-weighted index of over 3,300 common equities listed on the Nasdaq stock exchange. The types of securities in the index include American depositary receipts, common stocks, real estate investment trusts (REITs) and tracking stocks, as well as limited partnership interests. The index includes all Nasdaq-listed stocks that are not derivatives, preferred shares, funds, exchange-traded funds (ETFs) or debenture securities. An investor cannot invest directly in an index. The volatility of the benchmark may be materially different from the individual performance obtained by a specific investor.

The Dow Jones Industrial Average measures the daily stock market movements of 30 U.S. publicly-traded companies listed on the NASDAQ or the New York Stock Exchange (NYSE). The 30 publicly-owned companies are considered leaders in the United States economy. An investor cannot directly invest in an index. The volatility of the benchmark may be materially different from the individual performance obtained by a specific investor.

The Bloomberg Global Aggregate Index is a flagship measure of global investment grade debt from twenty-four local currency markets. This multi-currency benchmark includes treasury, government-related, corporate and securitized fixed-rate bonds from both developed and emerging markets issuers. An investor cannot invest
directly in an index. The volatility of the benchmark may be materially different from the individual performance obtained by a specific investor.

The ICE Exchange-Listed Fixed & Adjustable Rate Preferred Securities Index is a modified market capitalization weighted index composed of preferred stock and securities that are functionally equivalent to preferred stock including, but not limited to, depositary preferred securities, perpetual subordinated debt and certain securities issued by banks and other financial institutions that are eligible for capital treatment with respect to such instruments akin to that received for issuance of straight preferred stock. An investor cannot invest directly in an index. The volatility of the benchmark may be materially different from the individual performance obtained by a specific investor.