TFC FINANCIAL
The Financial Counselors

MARKET UPDATE
May 25, 2023

OUR VIEW

Congress has raised the debt ceiling over a hundred times throughout history!

Debt Ceiling Battle: Ultimately, there will be an agreement, but when? And at what cost?

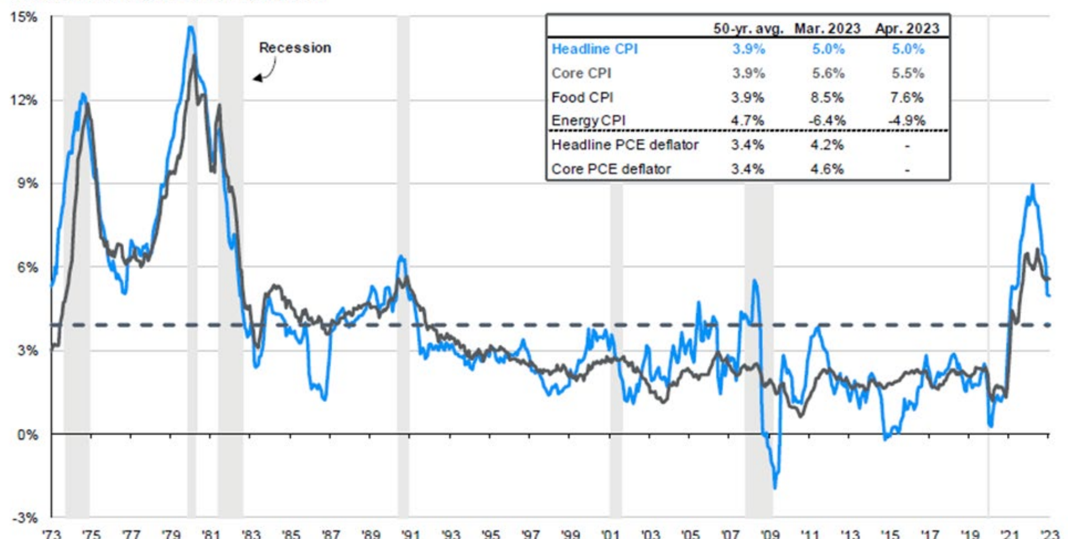
Treasury Secretary Janet Yellen has repeatedly warned Congress that June 1st is the "hard deadline" to raise the debt ceiling to avoid default. With the deadline looming, anxiety and volatility in financial markets are escalating. We thought it would be timely to share our perspectives on the headline news and beyond.

It is highly likely that there will be a resolution to the debt ceiling battle whether by June 1st or within weeks. Few may know that Congress has raised the debt ceiling over a hundred times throughout history! It should be obvious that triggering a global financial crisis and potentially deep economic recession is in no political party's best interest. Looking back to 2011 and 2013, when the same debt ceiling drama in Congress played out and seeing how investment markets reacted is useful to set expectations. Equities and other risk assets dropped sharply in the weeks approaching the default deadline and recovered in the following months. Bond markets were volatile, but paradoxically 1-to-10-year Treasury bonds rallied in both 2011 and 2013. We are expecting similar market reactions as this deadline approaches.

U.S. Economy, Inflation, Interest Rates: Is a "soft landing" possible?

U.S. GDP rose by 1.1% in the first quarter of 2023, below the consensus forecast of 2%. Recent bank turmoil, tightening credit conditions, higher interest rates, a weakening of the housing market and manufacturing sector have all contributed to a slowing economy. Taming inflation without a recession is possible, but a mild recession may not be a worst-case scenario.

Good news: inflation is declining. Headline Consumer Price Index (CPI) for April eased to 5%. While the inflation rate remains above the 2% long term target of the Federal Reserve, it is trending downward meaningfully.

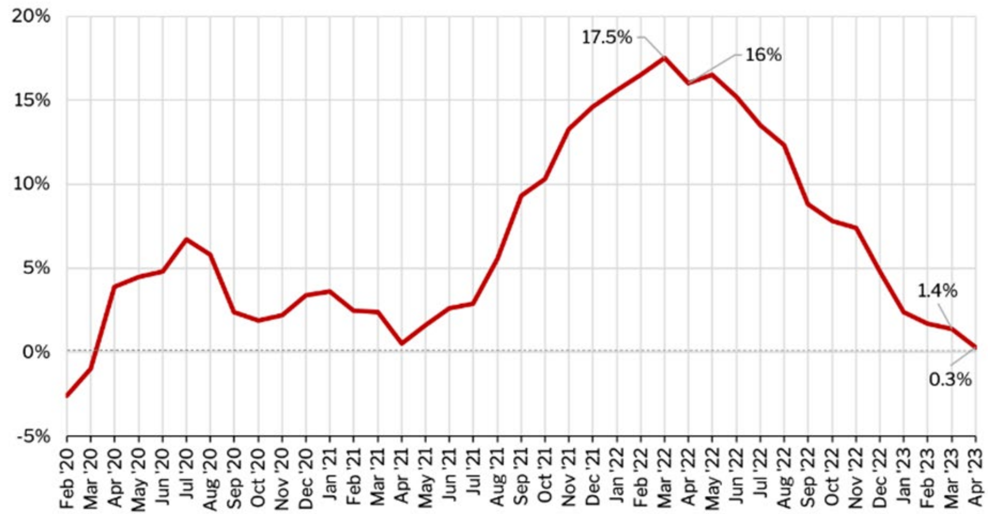


	50-yr. avg.	Mar. 2023	Apr. 2023
Headline CPI	3.9%	5.0%	5.0%
Core CPI	3.9%	5.6%	5.5%
Food CPI	3.9%	8.5%	7.6%
Energy CPI	4.7%	-6.4%	-4.9%
Headline PCE deflator	3.4%	4.2%	-
Core PCE deflator	3.4%	4.6%	-

Source: JPM Guide to the Markets as of 5/23/2023 (J.P. Morgan Asset Management)

Inflation is trending downward meaningfully.

Inflation data from sectors such as rent (tenant and owner's equivalent rent), which is 24% of Headline CPI and 40% of Core CPI, are always lagging. Recent data from RedFin shows significantly slower average rent growth in the 50 most populous U.S. cities.



Will the Federal Reserve raise interest rates again in June? Markets are currently expecting a pause. Some upcoming key data the Federal Open Market Committee members are closely tracking include Personal Consumption Expenditures (PCE), jobs reports and Producer Price Index (PPI). In any case, the Federal Reserve's interest rate hiking cycle should be near or at its end. At this point, we do not expect the Federal Reserve to lower interest rates this year unless the economy heads into a deep recession or another unexpected financial market crisis occurs and warrants an interest rate cut.

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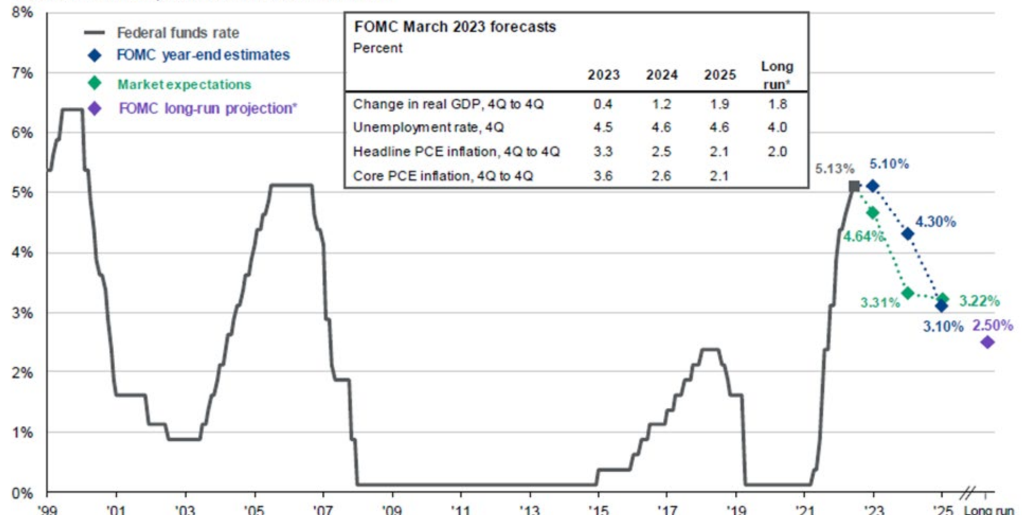

FOMC March 2023 forecasts
Percent

	2023	2024	2025	Long run*
Change in real GDP, 4Q to 4Q	0.4	1.2	1.9	1.8
Unemployment rate, 4Q	4.5	4.6	4.6	4.0
Headline PCE inflation, 4Q to 4Q	3.3	2.5	2.1	2.0
Core PCE inflation, 4Q to 4Q	3.6	2.6	2.1	

Source: JPM Guide to the Markets as of 5/23/2023 (J.P. Morgan Asset Management)

Corporate Earnings and Equity Valuations: A mixed outlook for the U.S. but better prospects overseas?

Despite slower economic growth, 77% of the S&P 500 companies which have reported Q1 earnings have exceeded analysts' expectations. Consumer spending remains strong, underpinned by a still-tight labor market, positive wage growth and the continuing post-Covid demand shift from goods to services. With our structural labor shortage, it seems unlikely that the unemployment rate would spike to high single digits from April's 3.4% rate if the economy slumps into a mild recession.

U.S. equity market valuations are not cheap, with large company stocks currently trading at approximately 18 times forward (estimated) earnings, which is above long-term average valuations. Corporate earnings and margins may be weaker and decline in the coming quarters with slowing growth and the negative impact of higher interest rates.

On a brighter note, international equity markets are offering more attractive relative and absolute valuations than U.S. stocks, particularly in Europe and Japan. A weaker U.S. dollar also boosts returns for U.S. dollar investors with (unhedged) foreign equity funds/holdings.

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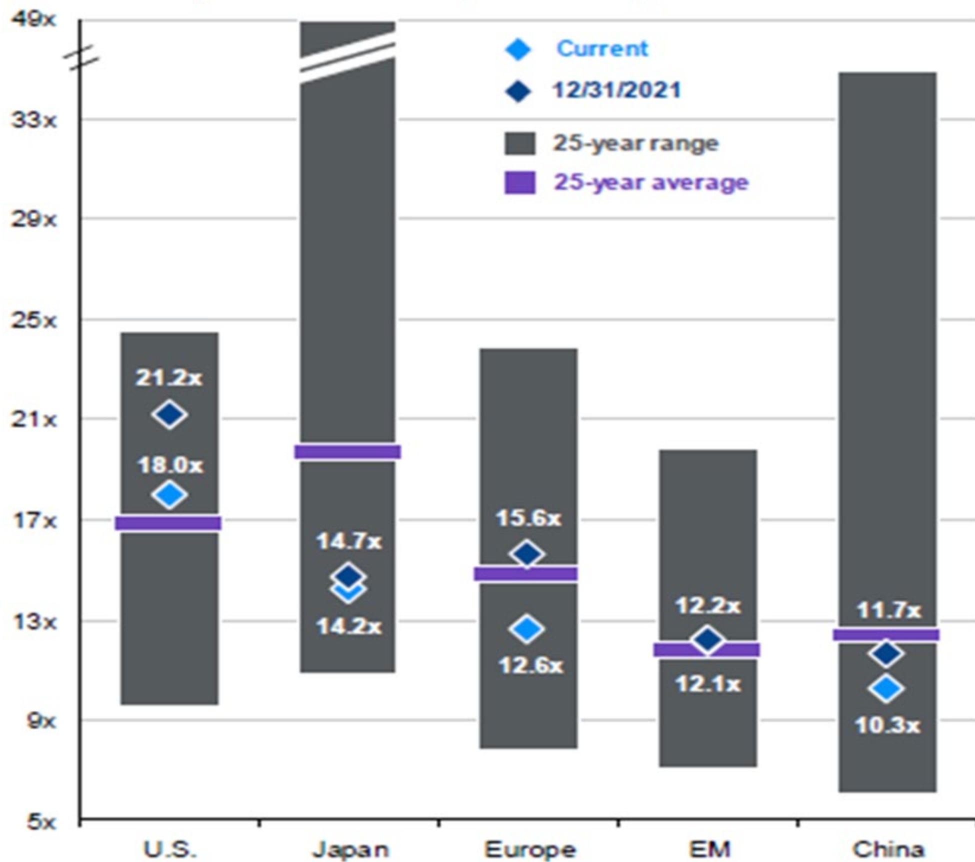


Source: JPM Guide to the Markets as of 5/23/2023 (J.P. Morgan Asset Management)

Rising geopolitical risks in emerging markets may warrant a reduction in TFC's portfolio allocation.

China, the world's second largest economy, is expected to contribute more than one-third of the world's global growth in 2023 according to the International Monetary Fund's latest projections. China's GDP grew by 4.5% in Q1 from a year ago (as reported by their National Bureau of Statistics), a hoped-for jump start to their economy since all Covid restrictions were lifted in December 2022.

In our opinion, the geopolitical risks in emerging markets (including China, the Middle East, Latin America and previously Russia) are high and unpredictable. Therefore, from an investment perspective, we remain cautious and may be reducing our allocation to emerging market funds in the future.

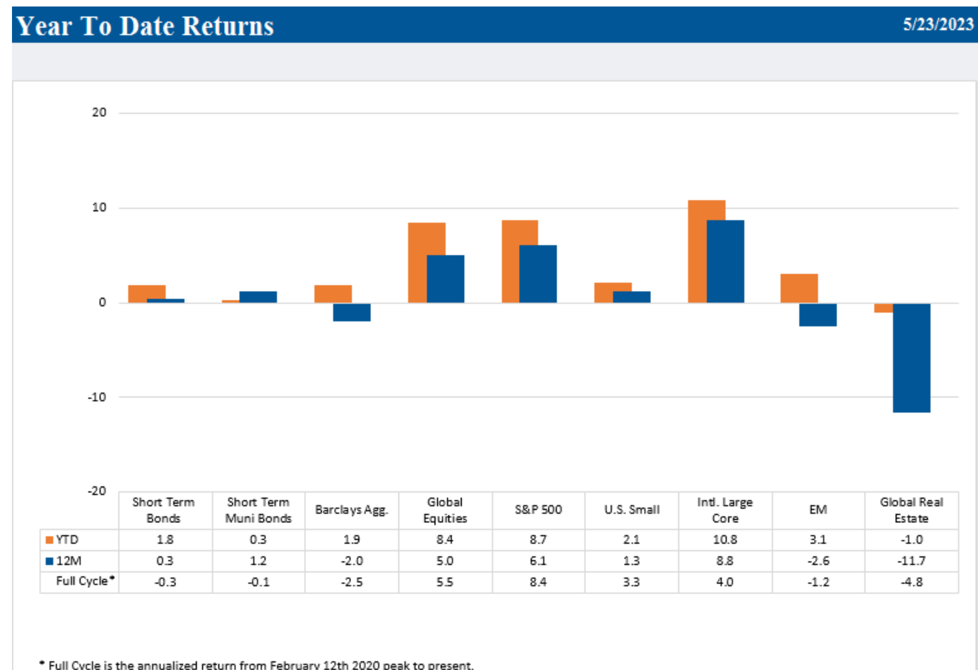
TFC Portfolio Positioning: Balanced and Diversified

With the debt ceiling stalemate dominating headlines and driving up investor fears, one's natural impulse is to take immediate action. Market timing is costly and usually counterproductive. During times like these, it is critical that we remain focused on the long-term investment time horizon and objectives of our portfolios. The fundamental principles for successful investing are balance, diversification, disciplined rebalancing and patience.

TFC's fixed income portfolios are currently allocated to shorter duration (3 year weighted average duration) high-quality bonds. In today's steeply inverted yield curve, short-term bonds provide higher yields with less interest rate risk than longer-maturities. (Note: The sharp spike this week in very short-term Treasury Bill yields is a temporary reaction to the possibility of a principal repayment deferral in the event of a U.S. debt default.)

TFC's equity portfolios are diversified globally, across industry sectors, company size and investment style (growth and value) with a strategic tilt towards quality and value. International large cap equity funds have generated over 10% in total return year-to-date, while U.S. small cap and emerging market funds have lagged. Our investments in real and other diversifying assets continue to provide inflation protection and additional portfolio income.

Portfolio diversification remains a fundamental principle for successful long-term investing.



	Short Term Bonds	Short Term Muni Bonds	Barclays Agg.	Global Equities	S&P 500	U.S. Small	Intl. Large Core	EM	Global Real Estate
YTD	1.8	0.3	1.9	8.4	8.7	2.1	10.8	3.1	-1.0
12M	0.3	1.2	-2.0	5.0	6.1	1.3	8.8	-2.6	-11.7
Full Cycle*	-0.3	-0.1	-2.5	5.5	8.4	3.3	4.0	-1.2	-4.8

* Full Cycle is the annualized return from February 12th 2020 peak to present.

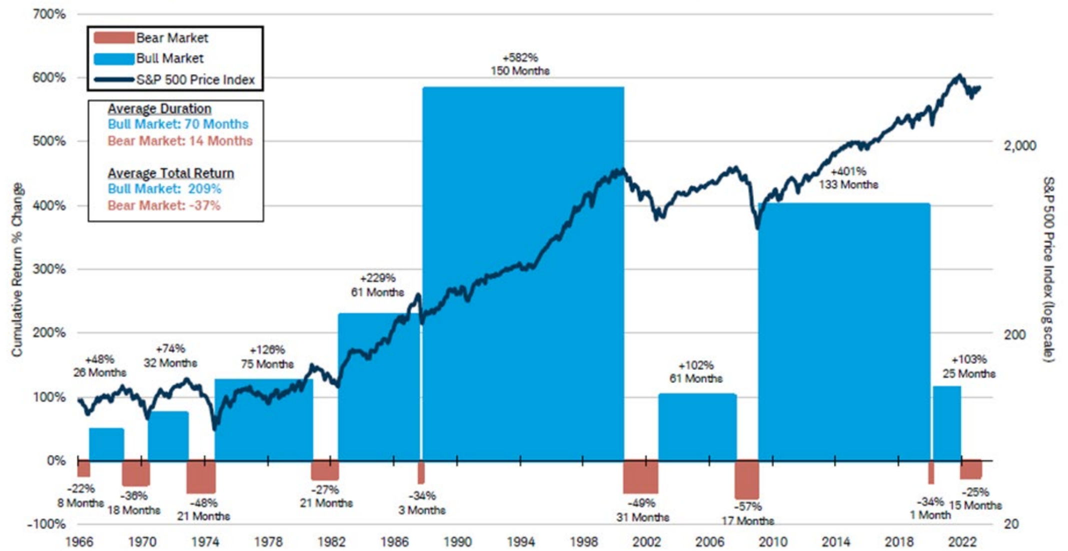
Despite near-term volatility, the long-term outlook for equities remains positive.

Market volatility will increase, and equities may fall further in the coming days and weeks if there is no agreement in Congress regarding the debt ceiling. Ultimately, there will be a resolution as the stalemate would become politically untenable if government employees and the military ranks are not paid, veterans and retirees stop receiving benefits and global financial markets are thrown into unnecessary turmoil.

The following historical bull and bear market chart reminds us to be optimistic about the medium and long-term outlook for equities.

U.S. bull and bear markets

With the S&P 500 still off its all-time high, it is notable that bull markets have generally been longer in duration and greater in magnitude than bear markets, resulting in gains over time.



Source: Bloomberg. Bull and bear markets as defined by Yardeni Research. 2022 Bear Market is showing the current trough as of 10/12/2022, but the bear market is still ongoing. Indexes are unmanaged, do not incur fees or expenses, and cannot be invested in directly. For illustrative purposes only.
Past performance is no guarantee of future results.

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Please contact your TFC Advisor or me directly if you have any questions or would like to discuss your portfolio further. Thank you.

Sincerely,

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