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Hoping for a soft landing

By Bevin Baker

2023 has undoubtedly been a year of surprises, meaning investors must be flexible with their expectations. We came into the year somber after weathering the sharp market decline in 2022. It was the first time in at least 45 years that stocks and bonds had negative returns at the end of the calendar year. To battle high inflation (according to the U.S. Bureau of Labor Statistics, the average inflation rate in 2022 was 8.0, the Federal Reserve raised interest rates seven times, which was the highest number of rate hikes in a single year since 2005.

Early this year, market growth was fueled by AI and technology names, and Europe and Japan showed stronger returns than predicted. Investors have been left wondering, “What’s next?” as we remain in an environment where it’s clear that interest rates will stay higher for longer, and inflation has slowed but has certainly not gone away.

Here are some trends to watch as we finish out 2023:

1. The economy is doing better than expected, yet there is still the question of a recession.

Many economists speculated that a recession would occur after the Federal Reserve increased rates in March 2022. Here we are, eleven hikes later, and a broad economic downturn has yet to happen. Economists wonder, will we have a recession by the end of 2024, or has a rolling recession already occurred? A rolling recession occurs when different market sectors are hit at varying times.

For example, housing experienced a downturn in early 2022 as mortgage rates climbed and affordability was threatened. The housing market has stabilized, and while inventory is still low, mortgage rates have steadied, indicating that the worst is behind us. In the third quarter of 2023, inflation has continued to ease, and economic growth has been impressive this year. However, some metrics show that economic growth is slowing, and the future remains uncertain. Regardless of whether the economy has a hard or soft landing, if we do have a broad recession, it will likely be a widely anticipated event.

2. Consumers remain resilient, which could lead to a strong market recovery.

In comparison with other global financial crises or typical recessions, the average American is spending only 9.6% of their disposable income on debt payments, which is significantly lower than we saw during previous economic upsets. The labor market has remained strong, though its strength is gradually waning. Consumer spending boosting industries such as travel and leisure is speculated, supported by an increase in real average hourly earnings. However, consumers have been eroding their savings balances and taking on more debt.

With higher energy prices and student loan repayments resuming, consumer spending will be tested in the coming months. Corporations are also in better shape than they were in previous recessions. The average interest rate coverage ratio, used to determine a company’s ability to pay interest on its outstanding debt, is stronger than in previous recessions. Business spending has also held up due in part to investments in artificial intelligence capabilities. The combination of these factors is favorable for investors during uncertain outcomes.

3. Cash is at near-record highs – a bullish signal?

Money market rates sit around a 5% yield, based on the benchmark of the 3-month treasury, a vast departure from the zero-interest rate policy we have experienced since the global financial crisis. More attractive interest rates have caused investors to gravitate toward cash and cash equivalents, to the tune of 5.6 trillion dollars, as reported by the Investment Company Institute.

However, the benefits of remaining in cash will be eroded by inflation, which still hovers at a higher-than-average rate. The upside of staying in cash will likely lessen as the Fed concludes rate increases. Historically, cash levels peak around market troughs and before market recoveries. After the global financial crisis and the COVID-19 pandemic, the S&P 500 index saw 40% or more returns during the following three months. Sitting on the sidelines can be costly when it comes to achieving long-term financial goals and knowing when to reenter the market can be challenging. Typically, when the Fed ends rate hikes, yields on cash-like investments have fallen quickly in the following 18 months. Investors may be well served to take advantage of current yields and lean into holdings still valued attractively.

4. Is a Fed pause favorable for the markets and provides an opportunity?

Going back to 1995, investing in both the stock and the bond market has led to solid returns after the last Fed rate increase. In the previous four cycles, cash has been outpaced by equities and fixed income, with the most robust returns occurring in the twelve months following the last rate hike.

Investors who wait too long to reenter the market may miss out on potential gains and risk having to buy in when prices are higher in the future. The Federal Reserve opted to pause interest rates in its September meeting and left the door open for an additional hike this year. While predictions show rate cuts next year, there will likely be only two, which is fewer than previously expected.

5. Bull markets outlast bear markets.

A bull market signifies a roughly 20% increase from recent lows, and a bear market occurs when a stock market index falls by at least 20% from recent highs. Bull markets tend to last a median of twice as long as bear markets, partially due to stock prices trending upward over time. There is also a significant difference in returns. The average bull market has a 256% gain, while the average bear market is only a 33% decline. Recoveries are not linear, and investors must keep a long-term perspective and try not to be derailed by market volatility and unsettling headlines.

In conclusion, investors are reminded that where risks exist, opportunities exist, and vice versa, and attempting to time the market is a mistake. Instead, it would be better for investors to proceed cautiously and be adaptable as 2023 ends. ■

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