Ropes Wealth Examines an Economic Data Deluge & the Debt Ceiling Debate

Stock markets lost some steam this week as poor economic data, weak earnings reports, layoff announcements, and an impending debt ceiling showdown dampened spirits. Still, stocks largely remain in the green for the year while bond yields have declined in a welcome respite from 2022's value destruction.

Getting into the details, we had a first look at the regional Fed activity surveys for 2023, and it wasn't pretty. The New York Fed's Empire State manufacturing index plunged in January from -11.2 to -32.9. The Index was expected to improve to -8.6 (still negative, but less so). At -32.9, the index is at its lowest post-pandemic level and has only twice been lower in its 22-year history, in 2009 and again in 2020. The details of the report show broad-based weakness with new orders, shipments, and employment.

Housing starts posted their fourth consecutive drop in December and building permits finished the year with their third successive monthly loss. In fact, both metrics are approaching their lowest levels since June 2020, capping off the first annual decline in construction since 2009. The drop in housing starts was driven by declining construction for multifamily homes which more than offset the increase in single family homes. Also disappointing was the report this morning on existing home sales, showing a monthly decline of -1.5% to an annualized pace of 4.02 million, the slowest pace of sales since 2010. On a modestly positive note, homebuilder sentiment improved slightly in January, reflecting the move lower in mortgage rates over the past few weeks. Although the uptick in confidence may indicate that builders are starting to see better buyer demand, the wide gap between the homebuilder sentiment and housing starts and sales suggests there still may be more downside to the housing market in the months ahead.

For a sector that usually shines during the holidays, retail sales added to the uneasiness, dropping -1.1% in December. Americans cut back on spending at the height of the holiday shopping season across a range of gift categories as high borrowing costs and elevated prices diluted consumers' purchasing power despite a still tight labor market. Sales declined in clothing, electronics, online and general merchandise stores. Even dining out at bars and restaurants slowed, showing that the overall capacity of Americans to continue spending is waning.

Next week, we get our first look at Q4 2022 GDP which will be important to set the tone for 2023. Recalling the first half of 2022, GDP growth was negative, but it bounced back in Q3 with growth of 3.2%. Economists are expecting growth to be reported at 2.5% in Q4, but there are downside risks to that number which could reinforce concerns about a 2023 recession. While China's reopening and the recent downward trend for inflation have investors feeling slightly more optimistic, the data is clearly showing us that the consumer is losing steam and business investment is falling, which often portend a recession. As ominous as that sounds, it is important to remember that the magnitude of the contraction in growth matters more than the mere fact of it for investors. The stock market's precipitous decline in 2022 reflects many of these risks.

On the bright side, a catalyst for the market could be on the way in the form of a Fed slowdown or pause in interest rate hikes. Our very own Federal Reserve Bank of Boston President Susan Collins was noted this week for saying: *"Now that rates are in restrictive territory and we may — based on current indicators — be nearing the peak, I believe it is appropriate to have shifted from the initial expeditious pace of tightening to a slower pace. More measured rate adjustments in the current phase will better enable us to address the competing risks monetary policy now faces."* Collins was not alone in her assessment: Atlanta Fed Raphael Bostic, San Francisco Fed

President Patrick Harker also suggested in recent public comments that rate hikes of 25 basis points may be more appropriate now and going forward. Some even believe the Fed may wrap up their program of interest rate hikes as early as March of 2023.

I would be remiss not to mention the debt ceiling as a headwind brewing for the market in 2023. It was widely reported this week that the U.S. has hit its federal debt limit and has shifted to "extraordinary measures" to fund the government until Congress and the White House negotiate an increase. It is expected that at some point in Q3, the Treasury will exhaust those extraordinary measures and there is risk of a default on U.S. government debt and a potential government shutdown. For those of you with a good memory, there was a similar standoff back in the summer of 2011. During that debate over the debt ceiling, the S&P 500 fell from roughly 1350 in early July to approximately 1100 in the second week of August, at which point President Barack Obama reached an agreement with House Speaker John Boehner. The S&P then traded in a range and broke below 1100 in early October 2011 before beginning a recovery that saw the index rally back to 1350 in February 2012.

At this time, Congressional Republicans, especially in the House, want to force President Biden to make spending concessions by threatening not to raise the debt limit. The White House argues the debt ceiling should not be conditioned on any other action. While the prospects of a debt default are remote (even Senate Republican Leader Mitch McConnell was quoted yesterday saying that "America must never default on its debt. It never has and it never will"), there is definitely risk associated with this debt limit debate that could affect markets.

For these reasons, we are taking a careful approach to 2023 portfolio allocations, believing that while recession risk is largely priced into the market at these levels, other sideshow risks like the debt ceiling debate are still very real and worth consideration. We believe 2023 is going to be a year where a market recovery is notched back incrementally. The strength and resilience of the underlying companies in your stock holdings, combined with the yield carry of your bond holdings with interest rates now close to peaking, provide the right mix of diversification, perhaps now more important than ever, as a handful of tech companies are no longer carrying the entire market on their shoulders. While earnings reports have been mediocre so far, we are seeing the differences between companies that overextended in their growth plans and are feeling the pinch of higher inflation and interest rates, and those that planned for rainy days and have the ability to adapt to today's environment while maintaining a strong growth outlook for the future. At the end of the day, companies trade on earnings, and expectations about what those earnings will be in the future, and we are at an inflection point where earnings now hold more weight, which reflects a stabilizing and more healthy market for all of us.

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