WHAT COULD POSSIBLY GO WRONG?

Kevin Flanagan — Head of Fixed Income Strategy
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It's the beginning of a new year, and if there is anything perhaps different about 2023, it's that most economic/macro outlooks seem to be all on the same page. In fact, I have found it difficult to find much in the way of a contrarian viewpoint on any media outlets. To be transparent, I have to admit that I'm pretty much aligned with what is being discussed out there, but that got me thinking. What could possibly go wrong?

In my 30+ year career, I don't know if I've ever seen a more widely expected recession than what is currently being talked about and, better yet, factored into the money and bond markets. In addition, the widespread consensus that inflation has peaked and will continue to cool is also a major theme. That brings us to the "elephant in the room" for sure…the Fed, and the expectation that rate cuts will be coming to a theater near you later this year.

- Let's take the econ backdrop first. There is no doubt that "chinks in the economic armor" are becoming more prevalent. We already know about housing's woes, but manufacturing, and now service-related gauges, are in contractionary territory.

  However, the latest jobs report continued to reveal that a rather solid labor market setting still exists. While wage growth did decelerate on a year-over-year basis, the unemployment rate and better-than-expected job growth number (yet again) underscore that a crucial underpinning for the consumer remains intact. So, what if the U.S. economy manages the "soft landing" after all, avoiding a recession in the process, and real GDP stays in the plus column?

- On the inflation front, a variety of factors definitely point to further cooling, but to what point? What if inflation does remain "sticky" and stays closer to 5% than 3% or even 4%? Along those lines, could China's COVID-19 reopening ramp up demand pressures?

- The Fed seems to be on a path to at least a terminal Fed Funds Rate of 5%. But what if it ends up being more like 5 ½%?

- Perhaps, more importantly, what if the Bank of Japan's recent decision to lift its cap on the 10-year JGB yield proves to be a precursor toward its first rate hike, and the yield heads to 1% or higher?

- Arguably, those scenarios outlined above could push the Treasury 10-Year yield closer to a 5% threshold rather than the 3% (or even lower) level I've been reading about lately.

Conclusion

If 2022 taught us anything, it's that the best-laid outlooks may look good on paper, but developments can change the end results in a formidable fashion (just ask Powell & Co.). This blog post was just an exercise to think a little bit outside of the box and get out of the market's current echo chamber.

That being said, there is one key aspect to any outlook that still resonates above everything else, and that is "there is income back in fixed income!"

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DEFINITIONS

Recession : two consecutive quarters of negative GDP growth, characterized generally by a slowing economy and higher unemploymen.

Money Market : a market for highly-liquid assets generally maturing in one year or les.

Bond market : The bond market—often called the debt market, fixed-income market, or credit market—is the collective name given to all trades and issues of debt securities. Governments typically issue bonds in order to raise capital to pay down debts or fund infrastructural improvements.

Federal Reserve : The Federal Reserve System is the central banking system of the United States.

Gross domestic product (GDP) : The sum total of all goods and services produced across an economy.

Federal Funds Rate : The rate that banks that are members of the Federal Reserve system charge on overnight loans to one another. The Federal Open Market Committee sets this rate. Also referred to as the "policy rate" of the U.S. Federal Reserve.

Rate Hike : refers to an increase in the policy rate set by a central bank. In the U.S., this generally refers to the Federal Funds Target Rate.

Treasury yield : The return on investment, expressed as a percentage, on the debt obligations of the U.S. government.