

2023 Will Feel Worse on Main Street than Wall Street

- Friday jobs data showed YoY wages falling, but with steady jobs growth and a drop in the unemployment rate.
- Is falling wage inflation without a deterioration in the labor market a win for policy makers? Perhaps, if you use Wall Street (asset markets) as a barometer.
- What about Main Street though? Inflation is near 7% and wages are starting to fall, and while job gains were strong, a closer look reveals they were lower quality, lower paying jobs.
- The Fed's design to lower inflation will eventually hurt labor markets – just look at the layoffs recently announced by large corporations. Main Street may end up consuming less, leading to declining profit margins if corporations cannot easily raise prices.
- As discussed, we see fat-tail risks on both sides of the risk distribution, which may keep volatility elevated. In the end, this is likely what a bumpy landing feels like.

Jim Caron: Welcome to 2023. Well, we're going to see what this year brings us. But the one thing I can say is judging by flows into money market funds, which are extremely high right now, it seems that people are very nervous - and probably rightly so. As we start to discuss 2023, we've talked about two fat-tail scenarios. 1) that really bad things happen in the markets and 2) that we actually get lower rates and lower inflation and all of this worrying is for naught. We have to make sure that we balance those two opportunities and risks, if you think of the opportunity as the better outcome and the risk is the worse one. We want to structure a balanced portfolio as we moved into the new year, and as I have said before, it's better to get balanced than defensive, and I think that's going to be the model for this year.

Anyway, let's start with the jobs data that we got on Friday, which showed that wages were falling but that the jobs growth rate was still very steady, where we also saw a drop also in the unemployment rate. Is this Fed Nirvana, with falling wage inflation without a deterioration in the labor market? A win for policymakers? Well, I suppose at least for now it is, but only if you use the equity and asset markets as your barometer i.e. Wall Street. But what about Main Street? If we think about inflation, it's still high, near that 7% level and wages are starting to fall despite the fact that inflation is still high. And yes, job gains are strong. But a closer look reveals that these are **lower quality and lower paying jobs** as evidenced by the drop in the **underemployment rate**, not the unemployment rate, but the underemployment rate, which is also what's known as the U6 data. This is a measure that the Bureau of Labor Statistics puts out that measures jobs relative to their skill levels.

So let's not get too pessimistic because wage growth is still elevated and inflation is falling after all. We should be happy about that. As inflation falls and people's wages are still reasonably high, purchasing power tends to go up. In addition, many see this as a sign that the Fed may take their foot off the brakes a little bit sooner. Maybe the policy rate hiking that's been going on starts to come to a halt by the end of the first quarter, early second quarter. Look the Fed's plan to lower inflation will inevitably hurt the labor markets and this is becoming apparent, just look at the many layoff announcements that we're

seeing from large corporations. Main Street knows this, feels this, and as a result, they may consume less. Given that consumption is 70% of GDP it implies slower GDP growth, slower earnings and declining profit margins, as corporations will not be able to pass along higher prices to consumers as easily as they did last year. As discussed before, we see fat-tail risks on both sides of the risk distribution which may keep volatility elevated. In the end, I suppose this is what a “bumpy landing” is supposed to feel like.

As we enter the new year, I like to say new year, same problems, but harder risks ahead. The jobs report data is still a big part of the narrative for 2023. Jobs and inflation. The December jobs data showed that jobs grew by 223,000 versus a 202,000 consensus. Average hourly wages year-over-year (YoY) fell to 4.6% from 5% and it was 5.1% in November. Average hourly earnings are still relatively high at 4.6%, but they're on their way down and this is partially what was behind the initial positive reaction in the markets, which is that inflation may start to get under control. Markets reacted very positively. In addition, the unemployment rate fell to 3.5% versus the 3.7% rate that was expected, and as I mentioned before, the underemployment rate fell to 6.5% vs 6.7% and that's extremely important. The labor force participation rate rose 0.1% to 62.3%, and this rise is attributable to the addition of 717,000 jobs gained versus losses of 278,000, based on the household survey. Look, we can't take anything away from this labor report. It was a strong number without a doubt. The drop in YoY average hourly earnings illustrates that wage inflation may actually be coming down and this is what the Fed's been trying to achieve. This is all good news, right? So what's the problem? Well here are my five major concerns.

1) The increase in jobs shows that the labor market is still tight and this keeps the Fed on high alert. 2) If we dig a little deeper, we find that despite the many layoffs in corporate America, people are able to find new jobs pretty easily. But the jobs that they're finding are lower quality as shown by the drop in the underemployment rate to 6.5% from 6.7% as just mentioned. These jobs are also paying less so as you can see in the drop-off in average hourly earnings. 3) This creates a big problem for corporate profit margins, something we're going to talk about this a lot this year. Margins are often the last shoe to drop and the reason why corporate earnings held up well in 2022, because businesses were able to pass along higher prices to consumers and keep margins high and earnings elevated. But, if people make less money, they will consume less and this will increase margin pressures lower and lower earnings. 4) With inflation near 7%, wage growth is not keeping up, falling below that 5% level. What that means is that 2023 will feel much worse than 2022 to the public in general, not just asset owners. I can't underscore this enough, as a major point that will define the political and policy narrative in 2023. Nevertheless, YoY wages at 4.6% is way above the 3% wage growth level, which would be consistent with the Fed meeting its inflation target of about 2.5%. So even though wages are coming down, they're still elevated and that still needs to be watched. 5) The jobs report likely keeps Fed policy on a mission to five and a quarter percent, as earnings decline and GDP grows below potential. That's something that we have to worry about as well.

Now, is there any good news? Well, for asset owners, yes, there is some good news, four tailwinds for asset prices as we start 2023. 1) Inflation will go from rising in 2022 to falling in 2023 and that's good news. But the real question is whether inflation actually stays anchored at low enough levels and that's what the Fed will debate. We will probably see that play out in 2H 2023, but for 1H I think we can benefit from the decline in inflation. 2) Central banks will shift from hiking to likely pausing and maybe even easing in 2023. The obvious question is at what term rate and for how long will those rates stay

low, and this is all hinging on the path of inflation. 3) The U.S. Dollar (USD) may go from strengthening robustly in 2022 to merely stabilizing in 2023, and possibly weakening by a bit. Remember a global soft landing is needed for the USD to weaken materially. Typically a stronger dollar tightens financial conditions globally. If you get a weaker dollar you get easier global financial conditions and that's really what generates a soft landing for global growth. But more likely we think the USD stabilizes and doesn't weaken. 4) China remained closed in 2022 but it may reopen in 2023. This is a wild card at this point, but could also be a tailwind for risk. That's a summary of the what I believe is the good news for asset owners and owners of capital, i.e. Wall Street.

But what about Main Street? Well, I'm afraid the news is less than good. Main Street will start to feel the reversal of economic policy largess and will participate in Wall Street's pain, albeit a year later. The markets have already been discounting many of these risks. Most forecasters have been predicting earnings to decline and perhaps a lot of that is also in the price, but consensus earnings has not really gotten there. We do look for downward revisions to earnings again, no surprise here. Now as long as the Fed doesn't hike above five and a quarter percent, which at this point I don't think they will, then I think credit spreads hold and default risks stay within forecasted ranges. This could actually be somewhat of a positive for credit, for fixed income, for bonds. Now, evaluations for risky assets will be favorable towards companies that produce high-quality earnings and can maintain margins. That's what we really want to screen for and look out for. But the bad news is that the risky and speculative assets with shaky or uncertain or non-existent cash flows will probably suffer in 2023.

Short duration and high quality assets in fixed income have reasonable yields these days. In 2022, there was no place to hide, but in 2023 you can always put your cash into the front-end and get a decent yield these days. Higher risk-free rates also mean opportunities for diversification and balancing risks and achieving better risk-adjusted returns. From a financial asset and capital perspective, seemingly, we're on better footing, but I'll always stress that the Main Street problems really are bigger and broader economic problems that will also help to influence policy and politics. This will certainly be a big part of the narrative in 2023 and ultimately, I think that Main Street is going to start to feel that pain that Wall Street felt last year. Bottom line is that perhaps this is what a bumpy landing feels like and that 2023 has fat-tail risks on both sides. We need to construct portfolios to manage those tail risks to the middle, a developing theme that I'll build upon throughout the year.

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