Halftime Report

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This holiday week carries annual significance. Most notably, it marks Independence Day when we take time to celebrate our nation's freedom. It also marks the first week of the second half of the year. Naturally, we felt that we should take the opportunity to reflect on the shift in the market dynamics over the course of the first six months of the year.

The markets entered the year on a very solemn note. The inflationary pressures of 2021 proved more stubborn than originally thought and the debt and equity markets suffered declines in 2022 which seemed to cascade throughout the year.

There are a few prominent themes that stand out in our work now that put the first half of this year in context. Inflation, by several measures, is in a fairly steady decline from 2021 highs. The Federal Reserve's restrictive policy stance seems to have helped to put the brakes on parts of our economy that were fueling pressure. However, there hasn't been much slowing of the labor market. The unemployment rate is still below 4%, even after 500 basis points of monetary tightening. Of course, we are wading through the long and variable lags to which monetarists refer when estimating the timing of the economic impact of restrictive monetary policy. However, the labor market has proven to be resilient to say the least.

This brings up the first big question of the halftime report: Is a soft landing still possible? Much of the market has been expecting a recession to begin imminently or in the next several months for two years. The yield curve has been inverted for over a year. The longer that unemployment stays low, growth remains positive, and inflation continues on its downward trajectory, the prospect for a soft landing grows from a slight possibility to potentially a strong probability.

The second half looks to be shaping up to be make or break for this tightening cycle. The market is pricing in that the Federal Reserve will halt its rate hikes in the second half of this year. However, inflation has to continue decelerating to confirm the market's view. Additionally, in a perverse irony, as the market prices in a less restrictive monetary policy, those easing financial conditions make tackling today's inflation more difficult.

The next question we have to ponder for the second half of 2023 is whether corporate America can continue to protect their profitability in this dynamic environment. Corporations have dealt with the inflationary pressures moderately well considering the velocity with which the Fed tightened policy. In the second quarter, the consensus estimate is for earnings to decline 6.8% year-over-year which would make the third consecutive quarter of declines. However, analysts expect the 2nd half of 2023 to bring with it a return to growth as flat earnings and 8% earnings growth are expected in the third and fourth quarters of this year, respectively, before accelerating to 11% growth in 2024. Reaccelerating earnings growth would be a welcomed sight for risk markets after two or possibly three consecutive quarters of earnings declines. It would indicate that inflation's impact on corporate earnings is waning.

After a first half that surprised many, we expect these two themes to remain prominent into the second half of 2023. As these themes unfold, the performance of risk markets, compared to today's prices, will depend largely on how these two themes develop in the 3rd and 4th quarters.

Source: Factset