NOVEMBER 15, 2022

ON THE RADAR

FAQs on the Markets and Economy

Is the labor market starting to slow?

Job growth remains strong, but cracks are emerging.

This October report was broadly a continuation of the strong labor growth that has been in place all year. So far in 2022, payrolls have increased by 4.7 million, far better than the average growth of 2.3 million in most good years *(see chart)*.

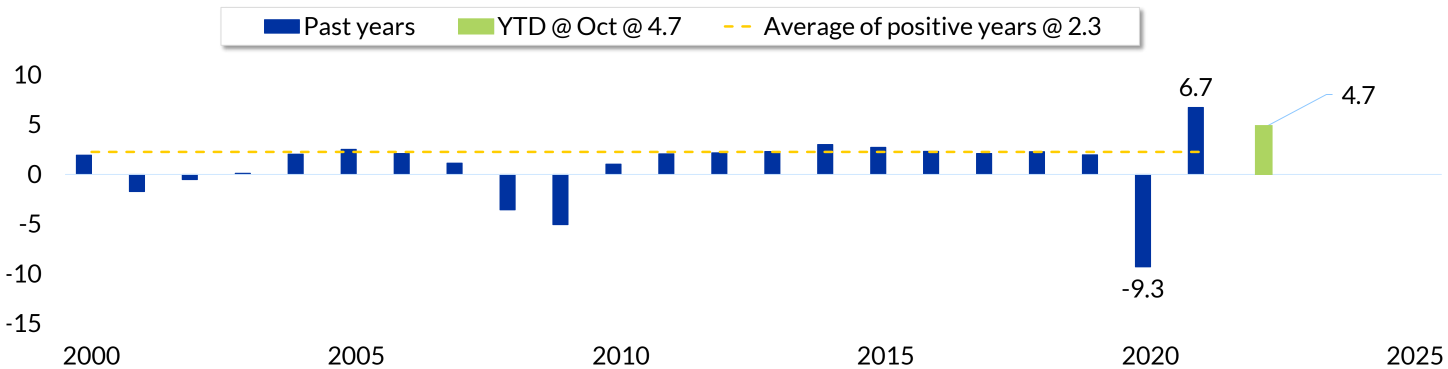
That said, the pace of employment growth is moderating, just not fast enough for the Fed. The monthly data can be volatile, so economists tend to follow a three-month trend, which shows growth has been slowing since December. Another important component of this report is wage growth, which continues to moderate. After peaking in March at 5.6%, the annual change now stands at 4.7%, and the last three months' annualized rate sits at just 3.9%. For comparison, in the year before the pandemic, it averaged 3.3%.

The persistent worker shortage has led companies to avoid layoffs (you can't fire someone you never hired), and when employees do quit, companies are quickly replacing the workers that left. But that will change as the risk of entering a recession increases due to the Fed's aggressive approach to monetary policy, domestic and global demand softening, and borrowing costs increasing. Will companies continue to hire? It is hard to know if and when that will happen. The best indicator for that is the initial weekly claims for unemployment insurance, but that has yet to budge from near-record low levels.

KEY QUESTIONS

- **What insights can be gleaned from the recent Fed meeting?**
- **What was behind last week's market rally?**
- **Are there investment opportunities in municipal bonds?**

Nonfarm Payrolls—Yearly Change
millions, seasonally adjusted



Source: Bureau of Labor Statistics, September 2022
Please note: Information is subject to change and is not a guarantee of future results.

What insights can be gleaned from the recent Fed meeting?

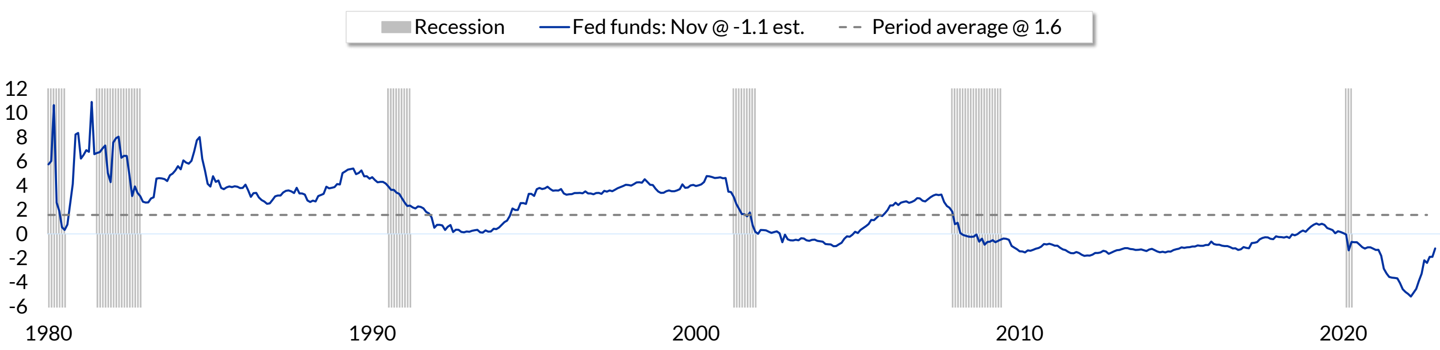
The Fed raised the federal funds rate by 75 basis points (bps) to 3.875%, which was universally expected, and they laid the groundwork for a probable drop down to a 50-bps hike at the next meeting in mid-December.

But a more hawkish tone came from Powell's press conference, where he stated that the Fed is not done tightening monetary policy. And the Fed may have to raise interest rates higher than most members thought in September when they released their interest rate forecast of a peak federal funds rate of 4.6%.

This was an important move for the Fed. It is not a dovish pivot. The Fed acknowledges that the 375-bps rate hike so far this year will cause the economy to slow and inflationary pressures to decline. It hasn't shown up in the data yet due to the lag effect monetary policy has on economic growth. The Fed is just as hawkish as it was before this meeting. The Fed still has more interest rate hikes planned for this year and next year because there is still a need (inflation-adjusted fed funds are still negative; (*see chart*). Powell stated that the slower pace should not be interpreted as signaling an imminent pause.

Inflation-Adjusted Fed Funds

%, median fed funds minus core-Personal Consumption Expenditures (PCE)



Source: Federal Reserve, Bureau of Economic Analysis, October 2022

Please note: Information is subject to change and is not a guarantee of future results.

What was behind last week's market rally?

Turmoil in cryptocurrency, uncertainty over the midterm election, and signs of moderating inflation all took turns driving wild swings in market sentiment.

By the end of the week, though, major U.S. stock indexes had rebounded in a big way from the previous week's declines, driven largely by a one-day rally on Thursday that was the strongest in two and a half years. While encouraging, we think it's still too early to signal the all-clear sign and continue to recommend caution in the near term.

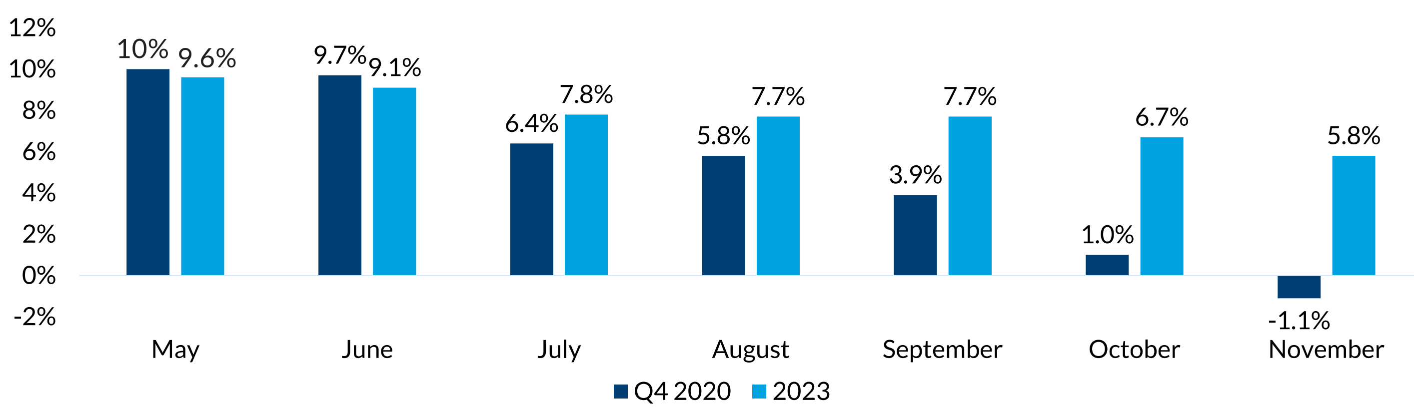
The main catalyst was the October consumer price index (CPI) report, which came in better than expected and fueled speculation the Fed could soon begin to scale back the size of interstate increases. Although signs of moderating inflation are certainly positive, one month doesn't make a trend and we don't expect policymakers to abandon their higher-for-longer narrative just yet. Inflation remains too high for comfort, and officials will want to see several consecutive months of lower readings before considering a pause.

In the meanwhile, incoming data continues to point to slowing economic momentum with higher interest rates and rising costs finally hitting Corporate America's bottom lines. With the Q3 earnings season nearly complete and tracking the lowest growth rate (2.2%) since 2020, analyst expectations for Q4 have now been revised down to -1.0%. At the end of September, analysts had forecast earnings to rise 3.9%.

Over the last couple of months, we have argued that earnings estimates would likely be revised lower to reflect the more challenging macroeconomic backdrop and rising recession risk. While earnings growth forecasts for 2023 have declined to 5.8% from about 10% since May of this year, we continue to think they remain too optimistic. In a scenario where the economy enters a mild recession next year, we would expect earnings growth to stagnate or even contract.

Relief rallies are common in bear markets. We think bottoming will be a process that could take some time to play out, and further swings in sentiment are likely as investors gain greater clarity on the outlook, particularly with rate hikes and inflation, and weigh their implications for the economy and corporate profits. In particular, we suspect further downward earnings revisions could be a catalyst for additional market declines ahead before a sustainable recovery in equity prices can begin.

Evolution of Consensus S&P Earnings Growth Estimates



Source: FactSet, November 2022

Please note: Information is subject to change and is not a guarantee of future results.

Are there investment opportunities in municipal bonds?

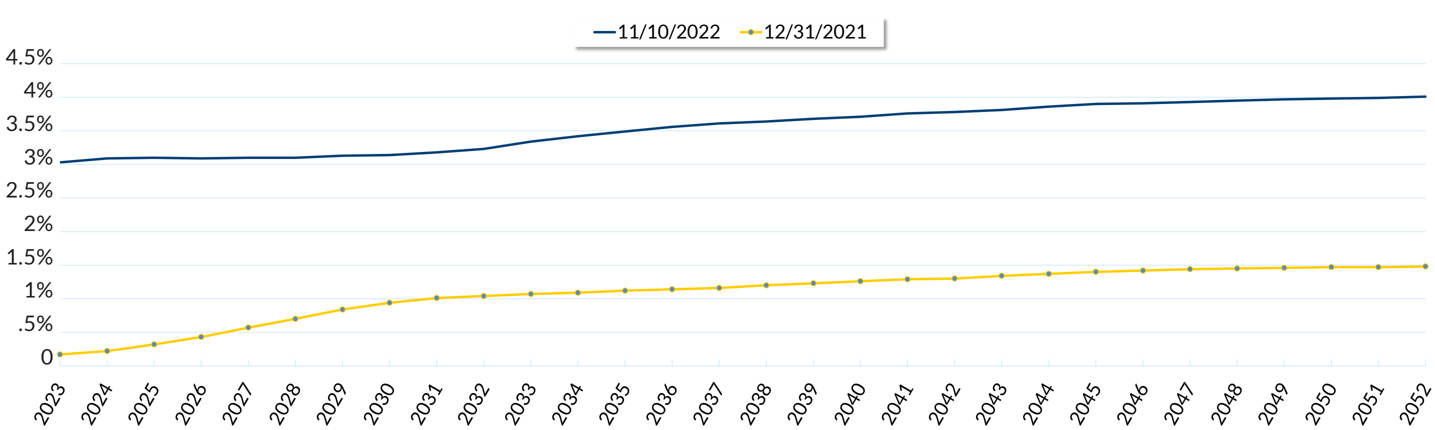
Municipal investors should consider the evolving backdrop where value opportunities continue to surface amid volatile market conditions.

Absolute yields are meaningfully higher today than at the beginning of the year, as the municipal curve has experienced a sharp rise in rates of between 250 bps and nearly 300 bps, per Bloomberg. The layering of higher municipal yields within bond portfolios not only raises overall book yield but strengthens the competitiveness of its tax-exempt cash flows. Thus, income or "coupon carry" increasingly provides a protective buffer against continued policy and recessionary uncertainty.

Relative value indicators, such as the relationship between tax-exempt yields and comparable Treasury securities, point to fair-to-attractive municipal valuations. Throughout the year, municipal fund outflows of more than $100 billion (through October) have reflected the Fed's aggressive tightening policy designed to curb excessive inflation. At the same time, constrained market issuance, given central bank uncertainty and more expensive financing terms, provided technical support that could extend into 2023, with projected reinvestment needs approximating $360 billion, per Bloomberg. Should municipal fund flows stabilize and Treasuries trade in a tighter range amid clarity around Fed policy, municipal bonds should benefit, leading to potentially attractive forward-looking returns (an observable pattern during previous tightening cycles).

Year-to-date performance has hinged mainly on the behavior of rates and less so on credit spreads. According to Bloomberg indices, A- and AA-rated 10-year bonds widened by about 40 bps and 10 bps, respectively, since the beginning of the year. Of note, spreads moved modestly over the past six months due to pockets of market demand. Despite favorable rating trends and healthy balance sheet flexibility, security and sector selection remain essential due to likely softness in the broader economy that might lead to a more pronounced weakening in revenue collections. We believe municipal bonds will play a critical role in a diversified asset allocation strategy throughout 2023, providing safety and preservation of capital for investors seeking attractive tax-exempt income.

Bloomberg AAA Yield Curve Change YTD



Source: Bloomberg, Dec. 31, 2021 — Nov. 10, 2022

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INDEX DEFINITIONS

S&P 500 Index: The S&P 500 Index, or Standard & Poor's 500 Index, is a market-capitalization-weighted index of 500 leading publicly traded companies in the U.S. It is not an exact list of the top 500 U.S. companies by market cap because there are other criteria that the index includes.

Bloomberg Barclays U.S. Corporate High Yield Bond Index measures the USD-denominated, high-yield, fixed-rate corporate bond market.

Moody's Investors Service, often referred to as Moody's, is the bond credit rating business of Moody's Corporation, representing the company's traditional line of business and its historical name. Moody's Investors Service provides international financial research on bonds issued by commercial and government entities.

CPI: A consumer price index (CPI) is a price index, i.e., the price of a weighted average market basket of consumer goods and services purchased by households. Changes in measured CPI track changes in prices over time.