INVESTMENT MANAGEMENT

Economic & market outlook

Second quarter 2023

Fewer job openings, less hiring ahead

Higher interest rates and tighter lending likely to take their toll

During the past year, many have commented on the strength of the U.S. job market. In fact, its resiliency to a year of Fed rate hikes was one of the first quarter's biggest surprises. But that may be coming to an end in the second quarter, when there could be even more broad-based layoffs.

The job market's resiliency so far has been good for workers. Moreover, it also has buoyed the U.S. economy, driving consumer spending beyond even what we would normally see in an expansion.

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Gross domestic product (GDP) numbers reflect this economic growth, standing at 2.6% in the last quarter of 2022 and an estimated 2.5% to 3% in the first quarter of this year. These figures are not what you would expect, given that the Fed has raised the Federal Funds rate from near-zero just a year ago to the current range of 4.75% to 5%, as of the March FOMC meeting.

Consumers, businesses being hit from all directions

But all this apparent economic success has come at a cost.

High wages in the services sector, in particular, have kept inflation at three times the Federal Reserve's 2% target. In fact, the biggest surprise for the Fed has likely been the stickiness of month-to-month inflation numbers.

Meanwhile, as the Fed has raised rates in an attempt to combat inflation, consumers and businesses have been hit with a double whammy: They're grappling with not only high prices but also more expensive borrowing.

Although it has taken longer than expected for these rate hikes to trickle through the economy and impact the job market—that may now be coming, possibly as soon as the second quarter. This could mean more broad-based layoffs.

Companies are now contending with not only higher borrowing costs but also tighter bank lending standards. This combination will likely cause companies to reduce both the number of job openings and hiring in general. As a result, we'll see lower U.S. job growth.

We're already seeing jobs taking a hit in some industries like construction, which tends to be sensitive to interest rates. There have also been more layoffs in the technology sector, including large companies like Meta and Amazon.

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Banks making lending standards stricter

A less robust job market won't be the only thing negatively impacting economic growth in the second quarter. The recent turmoil in the financial services industry will continue to tighten lending standards. In other words, not only will loans be more expensive for consumers and businesses, they'll also be harder to get.

Financial markets anticipate these tighter lending standards to have a dampening effect on the U.S. economy that is equivalent to one or two more Fed rate hikes. And this assessment is likely correct.

Companies' outlooks for the future will be key

The surprisingly strong GDP figures in the first quarter could mean that this season's corporate earnings may actually exceed expectations because the economy grew more than the market expected.

As always, the pace of a company's earnings growth is important. However, this earnings season especially, what companies plan to do for the remainder of the year is perhaps more important than how they performed to date. One particularly important question is how they are protecting earnings from the impact of higher interest rates, higher wage costs and tighter lending standards.

Companies' comments on consumer spending also will be telling. I suspect they will be paying close attention to middle- and higher-income consumers, as lower-income consumers' spending has already declined.

What this means for your investments

These factors all mean that there is still a lot of risk associated with the equity markets, particularly in U.S. stocks. By contrast, high-grade bonds—including government securities and highly rated corporate bonds—still have relatively high yields and provide better protection during severe slowdowns in the economy.

International equities are still looking better than U.S. equities right now, and that's true for both emerging markets and developed economies. For instance, Chinese equity markets are up higher than even U.S. equity markets, as of the time of this writing.

That said, the impact of China's pandemic reopening has been somewhat of a disappointment for commodities. It was expected to increase energy demand, which would push up commodity prices, but we're not seeing that. In fact, oil prices are coming down.

That's because, as China is managing its reopening, it's being careful not to overstimulate the economy.

In other words, they don't want to have the same inflation problems that the U.S. and U.K. have had.

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