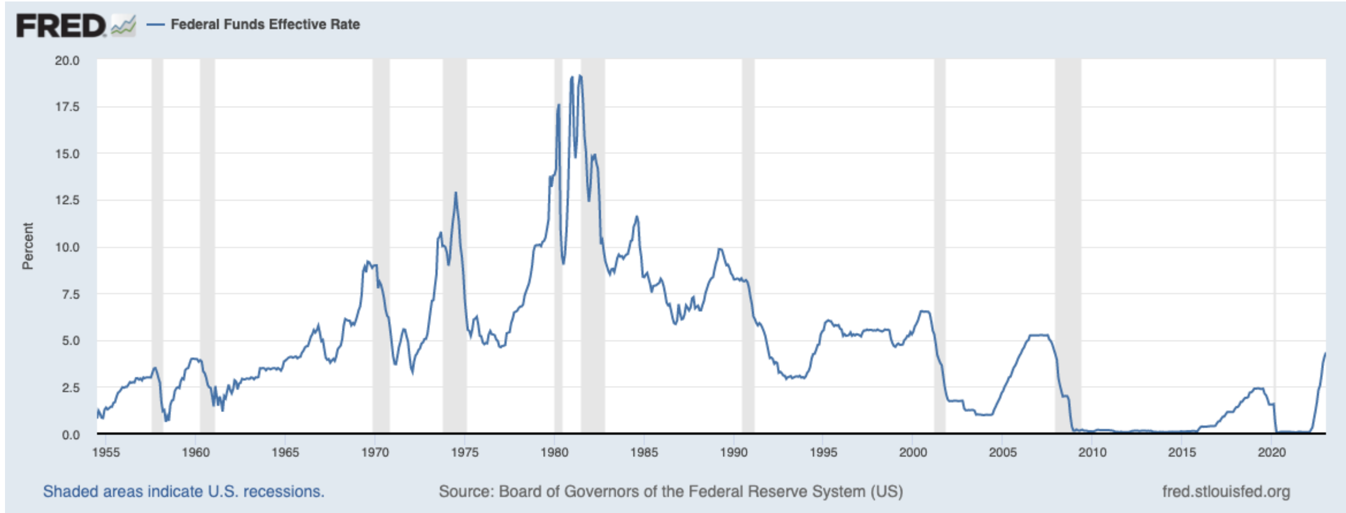
We are now halfway through the first quarter in 2023 and inflation remains the primary economic concern for the markets and investors. Its effects are causing central banks to raise rates and potentially slow the economy into a recession. Russia's invasion of Ukraine continues to drive higher food and commodity prices. Though oil and gas prices receded from their highs earlier in 2022, the war is still causing significant disruptions to supply and raising risks worldwide. In addition, tensions with China remain elevated, with increasing fears related to China's vow to reclaim Taiwan by any means. Finally, disruptions related to the COVID pandemic have not been completely resolved. All of this economic and geopolitical uncertainty created significant turbulence in both equity and fixed income markets. The Fed pushed interest rates higher at an unprecedented pace in order to cool inflation, sending market interest rates for all sorts of loans including homes, autos, credit cards and business debt up substantially. Looking at US stock and bond prices, the S&P 500 fell 19.4% in 2022 while the S&P U.S. Mortgage-Backed Securities Index declined 11.37% through year-end. Sharp selloffs in the bond and stock markets ceased and even reversed modestly so far this year, but the markets remain well below their levels from a year ago. In addition, housing prices are starting to show signs of pressure. The slide in many asset prices is global. The list of assets that did not suffer significantly in 2022 is short, with the US dollar (up almost 8.0% in 2022) being among the most prominent.

Year-over-year percentage change in the Consumer Price Index • Source: Bureau of Labor Statistics • By The New York Times

The Federal Reserve reacted aggressively to rising inflation, raising rates at the fastest pace in decades. The Fed Funds target rate is currently in a range of 4.50-4.75% following the January meeting. Market expectations are mixed for this year. According to the CME Group's FedWatch tool, a small percentage of interest rate traders expect the target Fed Funds rate to fall 25 bps by year-end 2023, but the majority (roughly 85%) are expecting increases of 25-75 bps from current rates before any softening occurs. Our assumption is that the Fed Funds target rate will rise another 50-75 bps and then hold through the end the year, except if a recession occurs in 2023, in which case rates may be cut slightly. Inflation seems to be moderating, but it remains high, and we believe the Fed will remain vigilant until it is sure inflation is back to the preferred level of near 2.0%. This could take a while, as we agree with some market prognosticators who feel that inflation will fall this year but remain stubbornly high, around 4% annually, for longer than expected. Some of the factors driving inflation are not as influenceable by interest rates, such as the Russia-Ukraine conflict, China's COVID policies, and general supply chain issues. Also, employment stayed very robust, although it may be starting to show signs of cooling off a bit. Lastly all messaging from the Fed is that they are still mainly concerned with the high level of inflation and plan to continue to be aggressive in combating it with additional rate increases for the foreseeable future.




Mortgage rates also skyrocketed in 2022. According to Freddie Mac, after falling below 2.7% in August of 2021, the national average for 30-year fixed rate mortgages climbed to almost 7.1% in November 2022, the highest level in 20 years. However, rates fell considerably in the last few months, declining almost 100 bps to 6.12% as of the week of February 9th according to Freddie Mac. “While our 2023 forecast anticipates ongoing inflation causing upward pressure on rates, recent favorable data has helped to pull mortgage rates down,” said Jiayi Xu, Realtor.com economist. “As the economy weathers the easing in inflation, mortgage rates may continue to fluctuate in the short term, within the 6% to 7% range that we have seen over the past five months.” Earlier in the year, economists and agencies like Freddie Mac predicted rates could rise as high as 7.50%. While Federal reserve interest rate hikes are one of the factors determining mortgage rates, investor activity in the bond market also helps to decide the direction in which mortgage rates move. In times of market chaos investors sometimes seek U.S. Treasury and mortgage bonds. Also, Treasury and mortgage bond yields are much more attractive today than in 2021. When demand for bonds rises so do prices, which lead mortgage rates to fall. We would also point out that there is currently a very large spread between short-term Fed rates and mortgage rates. Usually, they’re closely aligned leaving open the possibility that Fed rates continue to rise while mortgage rates don’t or rise less in the future.