

## MIDDLETON & COMPANY, INC.

### 2023 First Quarter Update

**Review:** Despite some recent market volatility, most major asset classes finished the quarter in positive territory, as markets continue to expect that the end of the rate hike cycle is near. The S&P 500 delivered a 7.5% return, slightly outpaced by developed international equities, which benefitted from a modest decline in the US dollar. Fixed income markets were also positive, as longer yields declined, with the Bloomberg Aggregate Bond Index delivering a 3.0% return for the quarter.

	1Q23	4Q22	2022
<b>S&amp;P 500</b>	7.5%	7.5%	-18.1%
<b>MSCI EAFE<sup>1,2</sup></b>	8.6%	17.4%	-14.0%
<b>MSCI Emerging Markets<sup>2</sup></b>	4.0%	9.8%	-19.7%
<b>Bloomberg U.S. Aggregate Bond</b>	3.0%	1.9%	-13.0%
<b>Bloomberg Municipal Bond</b>	2.8%	4.1%	-8.5%

<sup>1</sup> Europe, Australasia, Far East

<sup>2</sup> MSCI returns are in U.S. Dollars

### Nearing the end of the rate hike cycle. However, are cuts imminent?

As we noted in our last Investment Update, a key question heading into this year was if inflation would come down enough so that the Federal Reserve would be able to avoid having to raise the Fed Funds Rate above their projection of 5.1% for 2023. As expected, they did raise it in both the February and March meetings, which brought it to a target range of 4.75-5.0%, and they did not raise their projection of 5.1%. However, the market now expects the Fed to start **cutting** rates this summer, bringing the Fed Funds Rate to ~4% by year end. While it's not unusual for the market and Fed to have different outlooks, this particular difference of opinion could have significant implications on financial markets in the near term depending on which outlook ends up being more accurate.

As of year-end 2022, the market expected 1-2 rate cuts by the end of this year because it believed that inflation would be under control by the second half of the year. However, the recent turmoil in the banking system has led the market to now expect rate cuts to start in the summer, thinking that the Fed cannot continue its rate hike cycle if it potentially leads to more pressure on banks. The Fed's view of interest rates continues to be driven by inflation and overall macroeconomic conditions, with Chairman Powell noting that they use their financial stability tools, rather than monetary policy, to deal with banking sector issues. As the following chart shows, overall inflation peaked last summer at 9.0%, but core inflation (ex-food and energy) has been stubbornly persistent due to core services.

## Investment Update

April, 2023

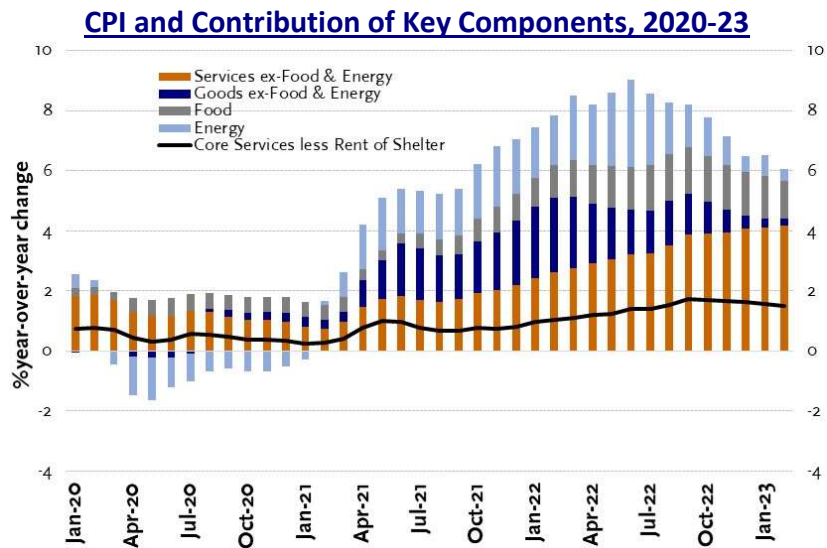
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While many people correctly note that a significant portion of core services is driven by shelter (i.e., rent) and that this component should start to decline this summer due to a lag in the data, the Fed’s predicament is that the non-shelter components of core services are also contributing a significant amount to overall inflation and not declining rapidly. As a result, the Fed did not have much choice when they decided to raise rates once again at their recent March meeting, and it is quite possible that they may need to raise at their meeting in early May.



Source: Census Bureau

**Outlook:** The US economy has been more resilient than expected to start the year, and the current estimate for real GDP growth in 2023 is now 0.8%, up from 0.3% as of our last Investment Update. The strong job market has supported consumer spending. The most recent median wage growth figure from the Atlanta Fed was 6.6% in February, similar to the level over the past year. This was higher than inflation for the first time since early 2021. While this is obviously positive for consumers and their overall financial health, it also illustrates the potential difficulty the Fed will have in driving down core service inflation, which is correlated with wages.

The recent banking turmoil will most likely lead to tighter credit conditions, which would impact consumers and businesses. It is not yet clear how much impact this will have on business investment and earnings. Although earnings estimates have declined modestly since the beginning of the year, consensus estimates still imply positive growth versus 2022.

We continue to expect international growth to be mixed. If US economic conditions worsen, it is unlikely that developed markets would be immune. It is possible that emerging markets, particularly in Asia, could outperform in such an environment due to China’s reopening from COVID, though geopolitics represent a significant wildcard.

**Strategy:** We continue to prefer quality stocks at reasonable valuations given the economic uncertainty. Volatility will likely remain elevated in both equities and fixed income due to the disconnect between what the market is assuming the Fed will do and what the Fed expects to do. As such, we believe we will have opportunities to upgrade portfolios in both equities and fixed income, as appropriate.