



WEALTH ADVISORS

TRUST MATTERS.

January 2023

Point of View – Economy – Markets

Important Information

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Important Information

Performance quoted is past performance and cannot guarantee comparable future results; current performance may be higher or lower.

Results shown assume the reinvestment of dividends.

An investment cannot be made directly in an index.

Investments with higher return potential carry greater risk for loss.

Investing in small companies involves greater risks not associated with investing in more established companies, such as business risk, significant stock price fluctuations and illiquidity.

Foreign securities have additional risks, including exchange rate changes, political and economic upheaval, the relative lack of information about these companies, relatively low market liquidity and the potential lack of strict financial and accounting controls and standards.

Investing in emerging markets involves greater risk than investing in more established markets such as risks relating to the relatively smaller size and lesser liquidity of these markets, high inflation rates, adverse political developments and lack of timely information.

Fluctuations in the price of gold and precious metals often dramatically affect the profitability of the companies in the gold and precious metals sector. Changes in political or economic climate for the two largest gold producers, South Africa and the former Soviet Union, may have a direct effect on the price of gold worldwide.

THE WALL STREET JOURNAL.

Markets Show More Confidence In Soft Landing

A few months ago, Wall Street rebuffed the idea that the Federal Reserve would be able to pull off a soft landing.

Now, a growing crowd is betting on exactly that happening.

... analysts and economists at a number of firms, including Goldman Sachs, BMO Wealth Management and Credit Suisse Group AG, are predicting the economy will be able to avoid a hard landing next year

Stocks are up significantly from their October lows. But the S&P 500 is still down 17% for the year, on course for its worst annual performance since the financial crisis of 2008. The stock market has typically fallen roughly 30% in recessions going back to 1929, according to Dow Jones Market Data.

BARRON'S

Buckle Up: Signs Now Point to Higher Rates And a Harder Landing

The Split-Screen Economy¹

Good news

- Still strong hiring data
- Still strong earnings estimates
- Strong GDPNow
- Oil down
- Consumers have cash
- Strong corporate balance sheets
- Strong bank capital
- Inflation is moderating

Bad news

- LEI down again
- Inverted yield curve
- Services PMI tanks
- Weak retail sales

¹ *The Wall Street Journal*, “The Split-Screen Economy”, January 7-8, 2023.

THE WALL STREET JOURNAL.

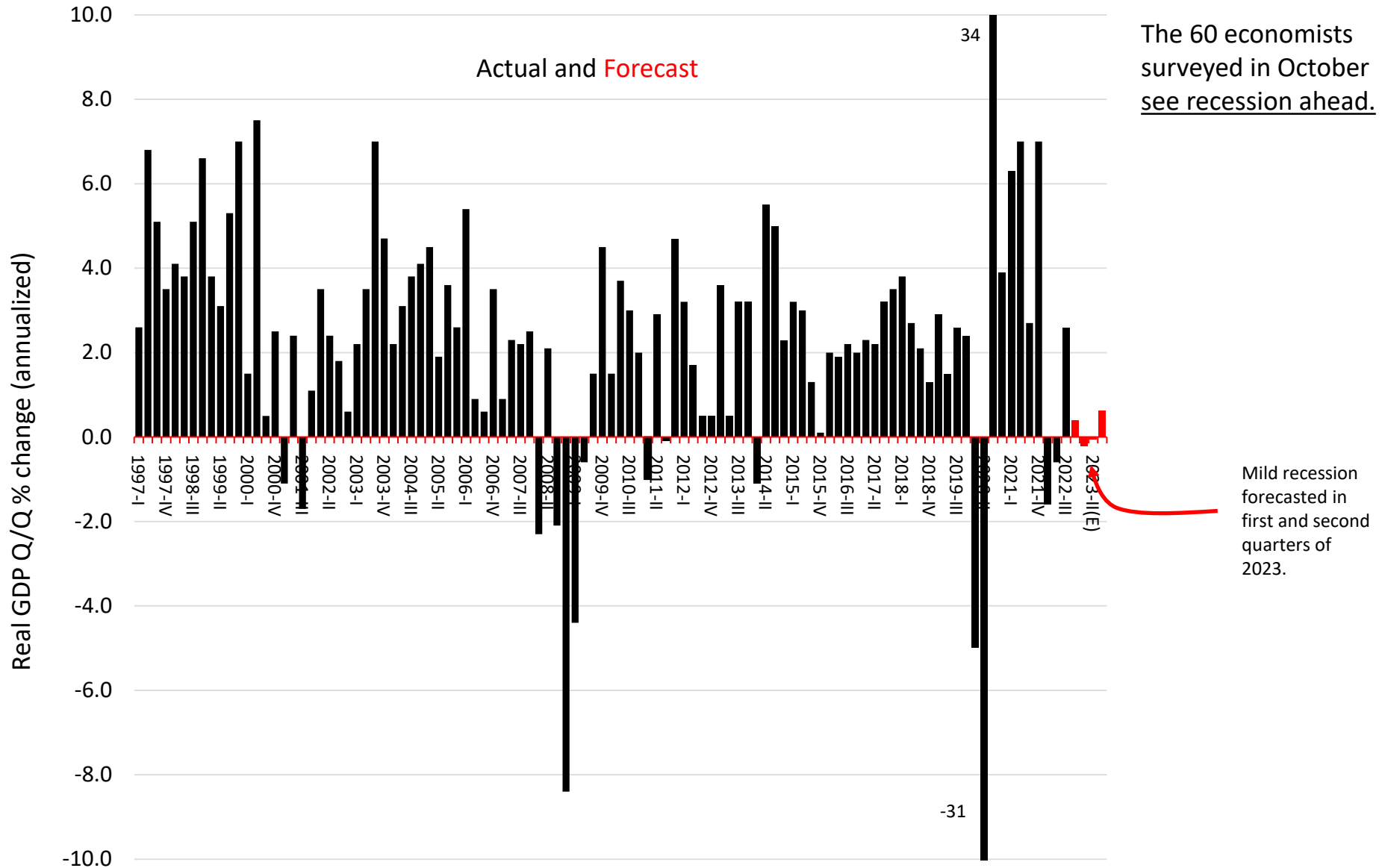
Big Banks Expect Recession and Fed Pivot

Big banks are predicting that an economic downturn is fast approaching.

More than two-thirds of the economists at 23 large financial institutions that do business directly with the Federal Reserve are betting the U.S. will have a recession in 2023. Two others are predicting a recession in 2024.

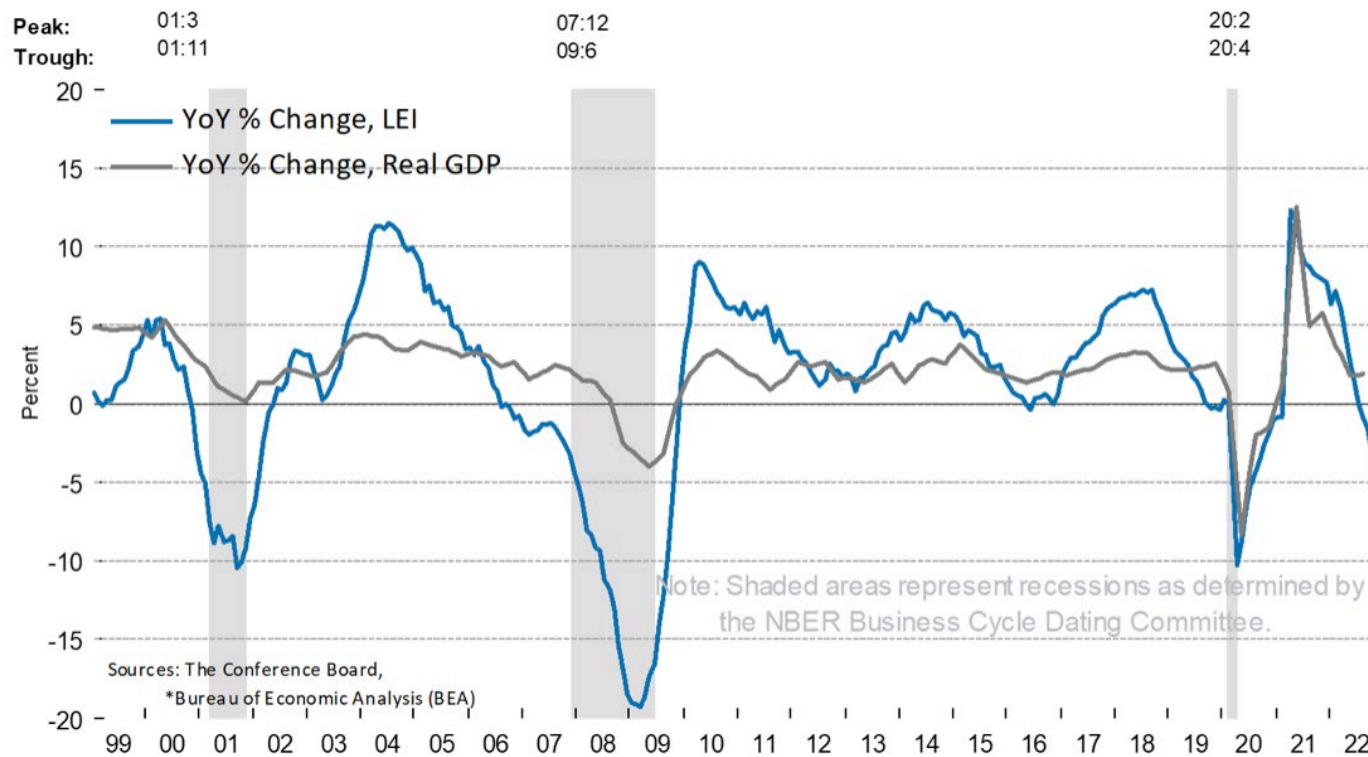
Consensus GDP forecast

GDP





U.S. index of leading economic indicators – signaling recession



“The US LEI fell sharply in November, continuing the slide it’s been on for most of 2022 after peaking in February. ... the US LEI suggests the Federal Reserve’s monetary tightening cycle is curtailing aspects of economic activity, especially housing. As a result, we project a US recession is likely to start around the beginning of 2023 and last through mid-year.”

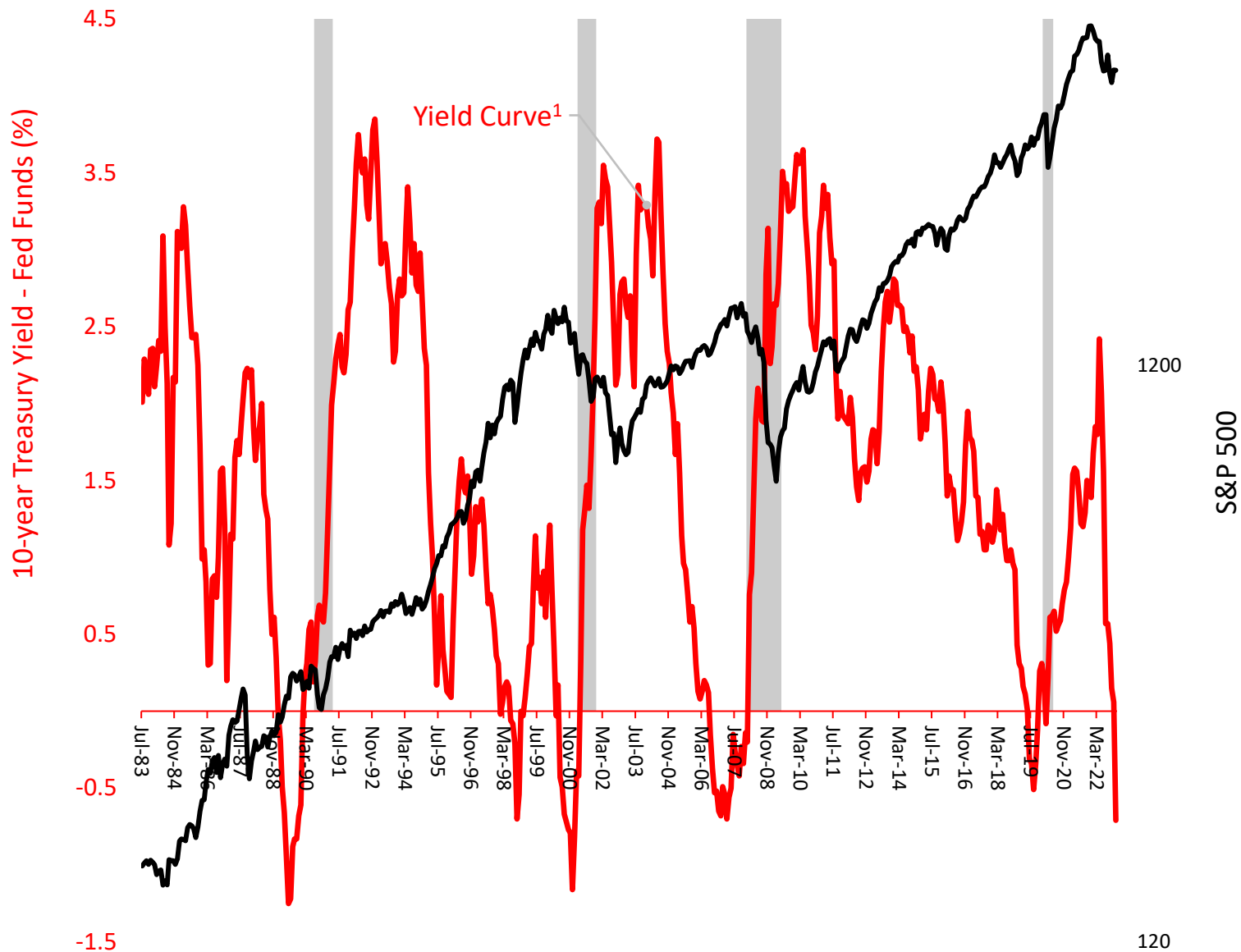
This chart shows how the LEI has definitively rolled over well in advance of the last recessions.

The Conference Board Leading Economic Index® (LEI) components: 1) average weekly hours worked, manufacturing; 2) average weekly initial unemployment claims; 3) manufacturers’ new orders – consumer goods and materials; 4) ISM index of new orders; 5) manufacturers’ new orders, nondefense capital goods; 6) building permits – new private housing units; 7) stock prices, S&P 500; 8) Leading Credit Index™; 9) interest rate spread; 10-year Treasury minus fed funds; 10) index of consumer expectations.

Source: ©The Conference Board. Data through November released December 22, 2022.

Federal Reserve policy

Yield curve vs. the S&P 500



When the yield curve has inverted the economy has usually turned down into recession with a lag of a year or more.

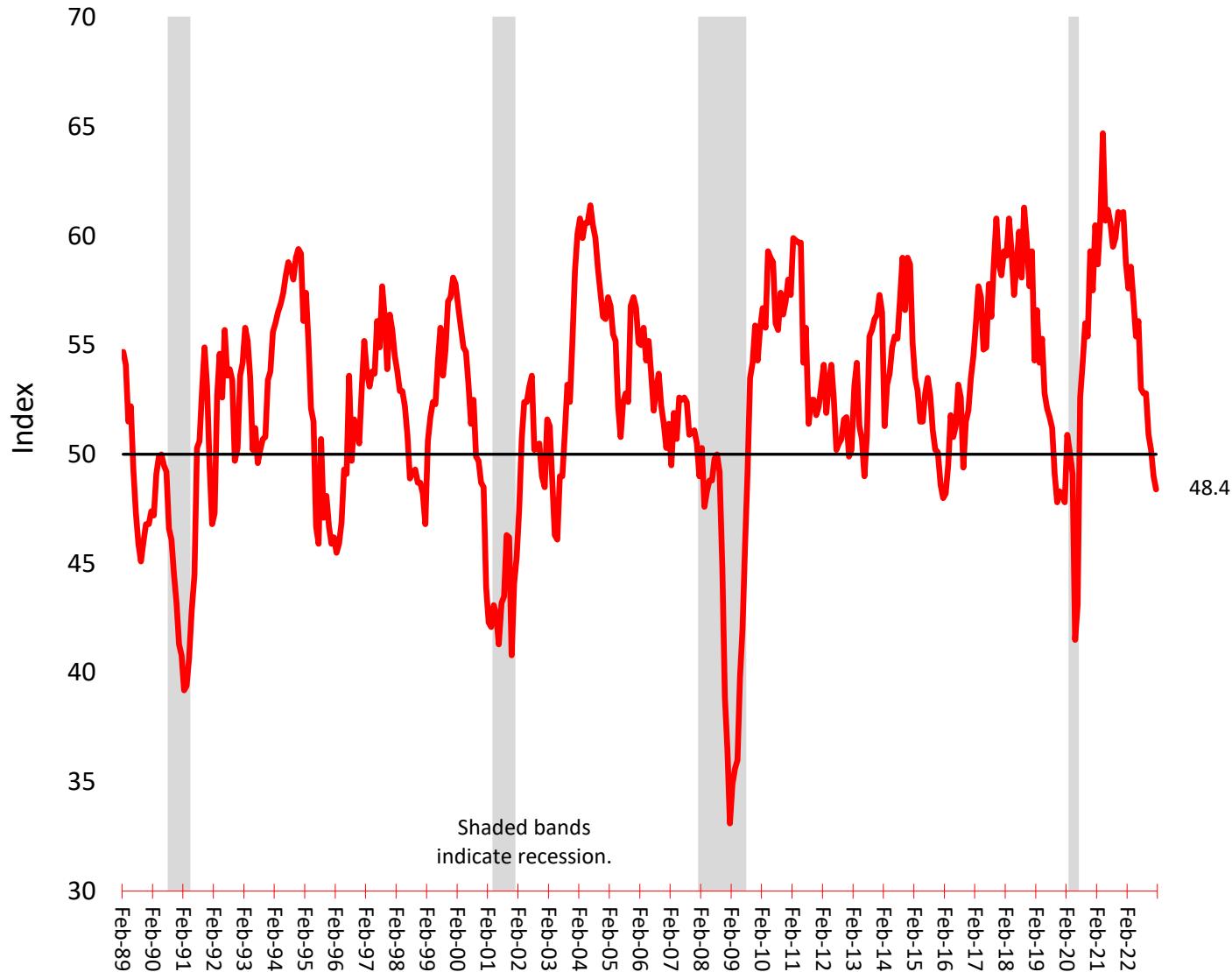
Today, the yield curve is inverted.

Sources: NBER, Federal Reserve and Standard & Poor's. Data through December 2022.

¹The interest rate on the 10-year Treasury bond (long term) minus the fed funds rate (short term).

Economic data

ISM manufacturing PMI



December at 48.4.

December new orders
45.2.

Note the historic
volatility in the
manufacturing PMI.

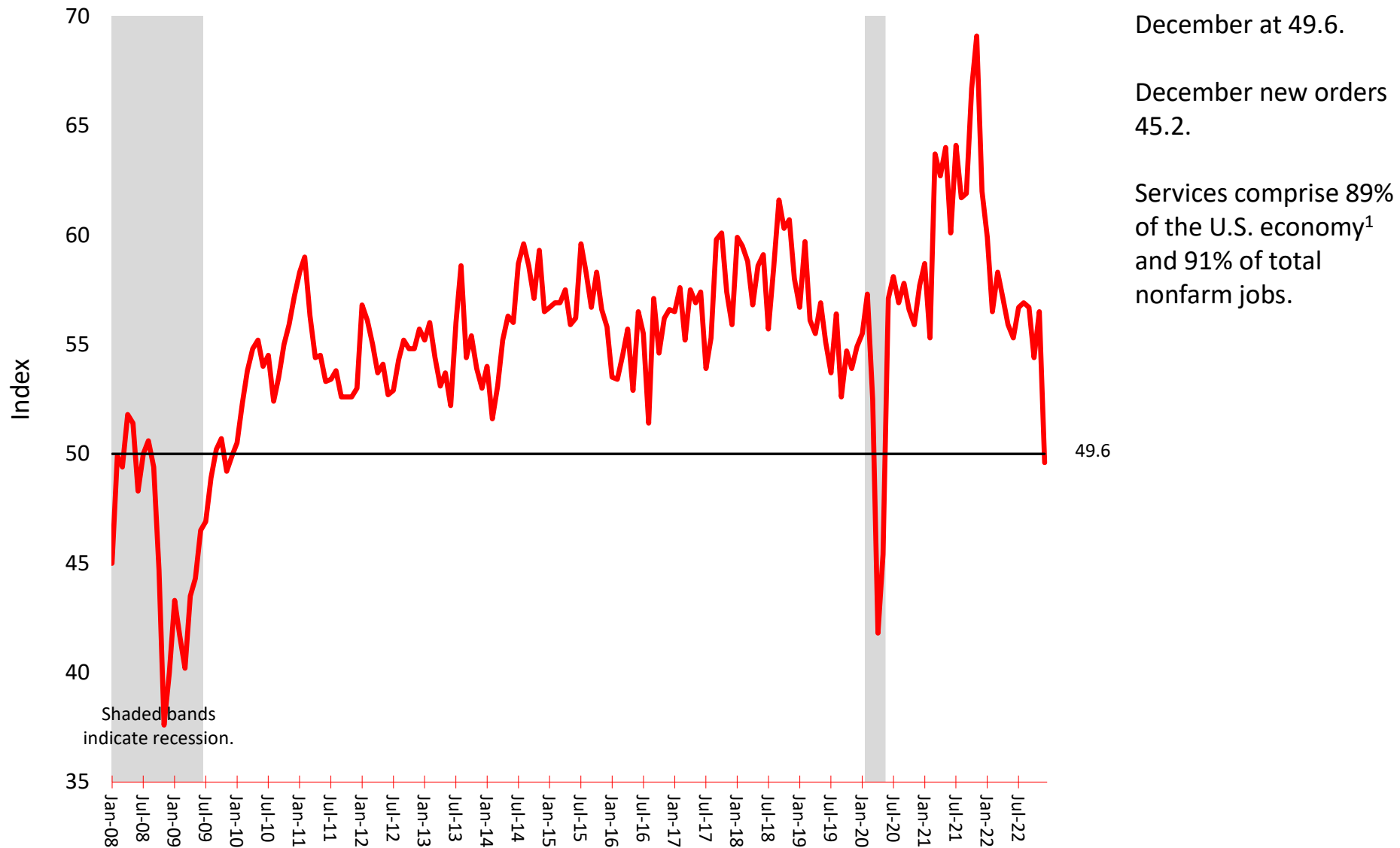
Note how this indicator
has slumped well below
50 even during periods
of strong economic
expansion, eg. 1995,
1999, 2003, 2013, 2016.

Source: Copyright 2022, Institute for Supply Management. Data through December 2022.

ISM: "A reading above 50 percent indicates that the manufacturing economy is generally expanding; below 50 percent indicates that it is generally contracting. A Manufacturing PMI® above 48.7 percent, over a period of time, generally indicates an expansion of the overall economy."

Economic data

ISM services PMI



Source: Copyright 2022, Institute for Supply Management; data through December 2022. This data series was created in 2008. ISM: "A reading above 50 percent indicates that the services sector economy is generally expanding; below 50 percent indicates that it is generally contracting." "A Services PMI® above 50.1 percent, over time, generally indicates an expansion of the overall economy." ¹Value added as a percent of GDP.

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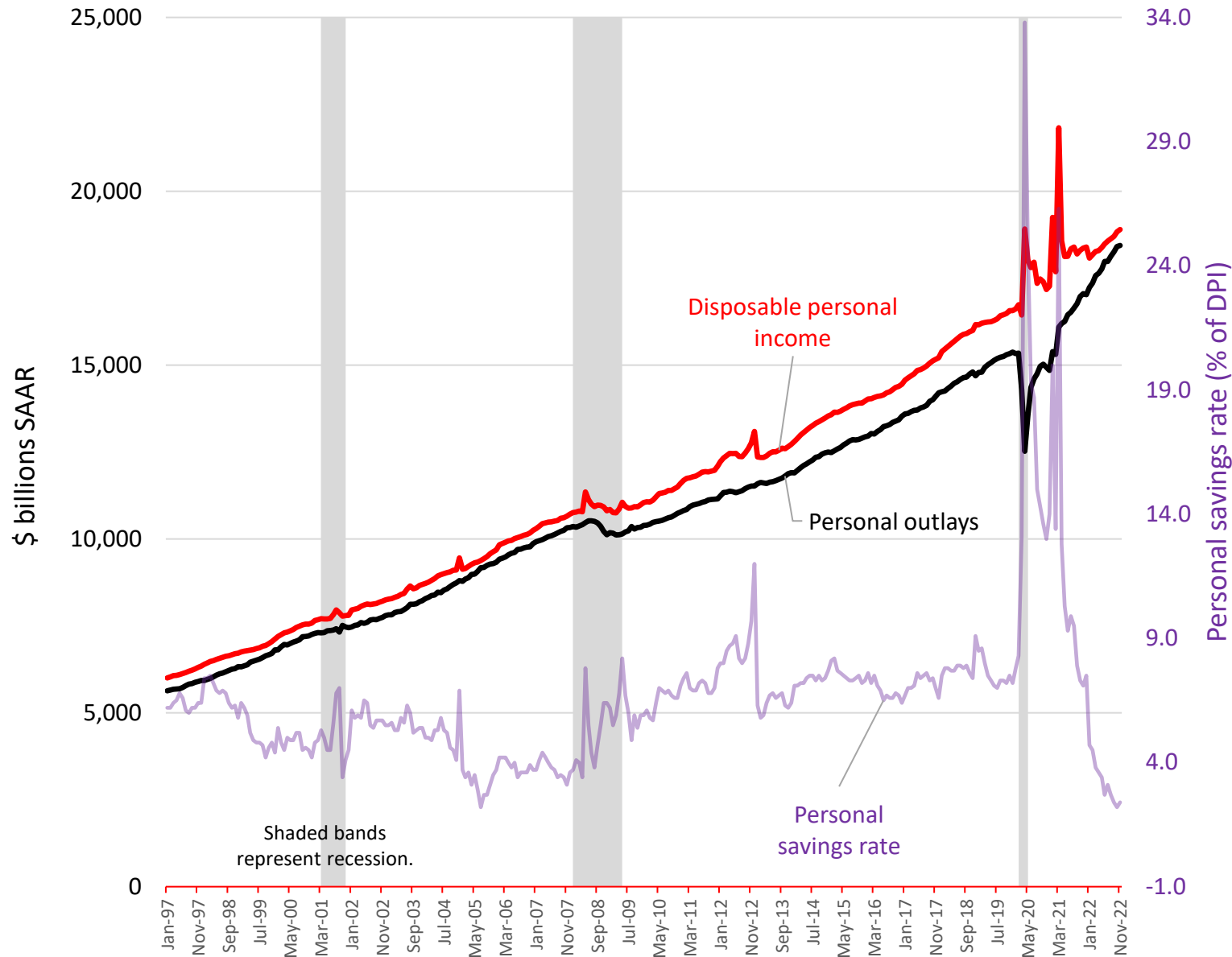
November Data Signal Slowing Economy

U.S. retail spending and manufacturing weakened in November, signs of a slowing economy as the Federal Reserve continues its battle against high inflation.

November retail sales fell 0.6% from the prior month for the biggest decline this year, the Commerce Department said Thursday. Budget-conscious shoppers pulled back sharply on holiday-related purchases, home projects and autos. Manufacturing output declined 0.6%, the first drop since June, the Fed said in a separate report.

Consumer income

Disposable personal income, spending and saving



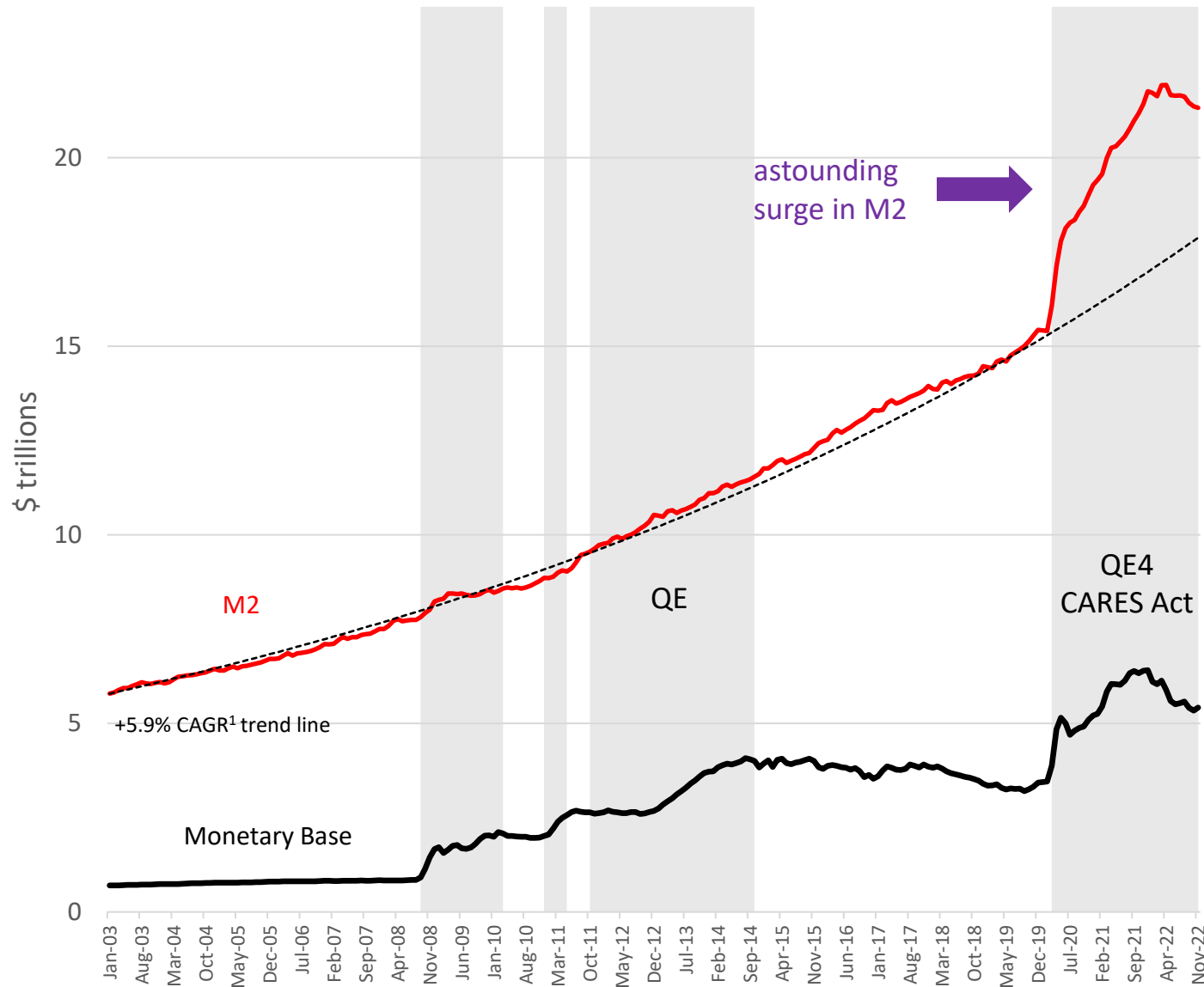
DPI up just +2.9% y/y, with the PCED up +5.5% y/y.

Personal outlays up +8.1 y/y.

The savings rate, at 2.4%, is way below pre-Covid levels.

Federal Reserve policy

The monetary base and the money supply



M2: currency held by the public plus checking, savings and money market accounts.

A quadrupling of the monetary base with QE did not affect M2 growth. The CARES Act and subsequent stimulus did ... by putting money directly into consumers' and businesses' accounts.

Monetary base: currency in circulation plus reserve balances (deposits held by banks in their accounts at the Federal reserve).

Source: Federal Reserve, statistical release H.6. Data through November 2022.

¹CAGR = compound annual growth rate.

THE WALL STREET JOURNAL.

As Savings Shrink, Spending at Risk

It is the \$1.7 trillion question for the U.S. economy: How long can the savings consumers built up during the pandemic keep their spending going?

The answer: about nine to 12 more months.

Economists estimate that headed into the third quarter of this year, households still had about \$1.2 trillion to \$1.8 trillion in “excess savings” — the amount above what they would have saved had there been no pandemic.

GDP forecast

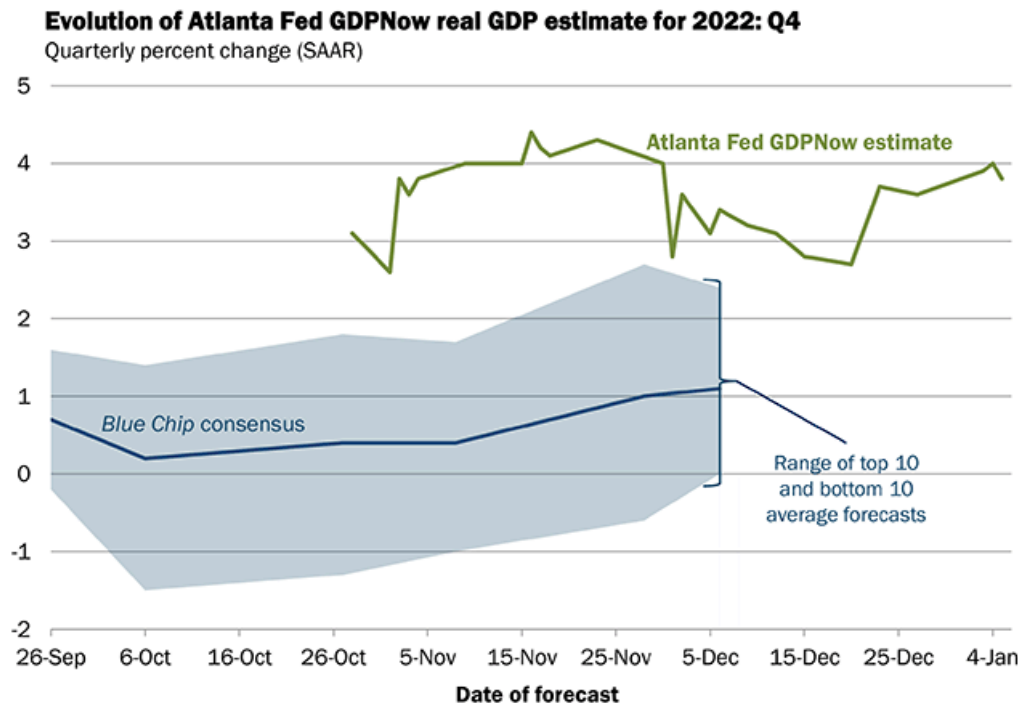
Atlanta Fed's GDPNow forecast

Latest estimate: 3.8 percent — January 5, 2023

The GDPNow model estimate for real GDP growth (seasonally adjusted annual rate) in the fourth quarter of 2022 is **3.8 percent** on January 5, down from 3.9 percent on January 3. After recent releases from the Institute for Supply Management, the US Bureau of Economic Analysis, and the US Census Bureau, the nowcasts of fourth-quarter real personal consumption expenditures growth and fourth-quarter real gross private domestic investment growth decreased from 3.6 percent and 6.1 percent, respectively, to 3.2 percent and 5.8 percent, respectively, while the nowcast of the contribution of the change in real net exports to fourth-quarter real GDP growth increased from 0.17 percentage points to 0.35 percentage points.

The next GDPNow update is **Tuesday, January 10**. Please see the "Release Dates" tab below for a list of upcoming releases.

GDPNow is much higher than Blue Chip consensus.



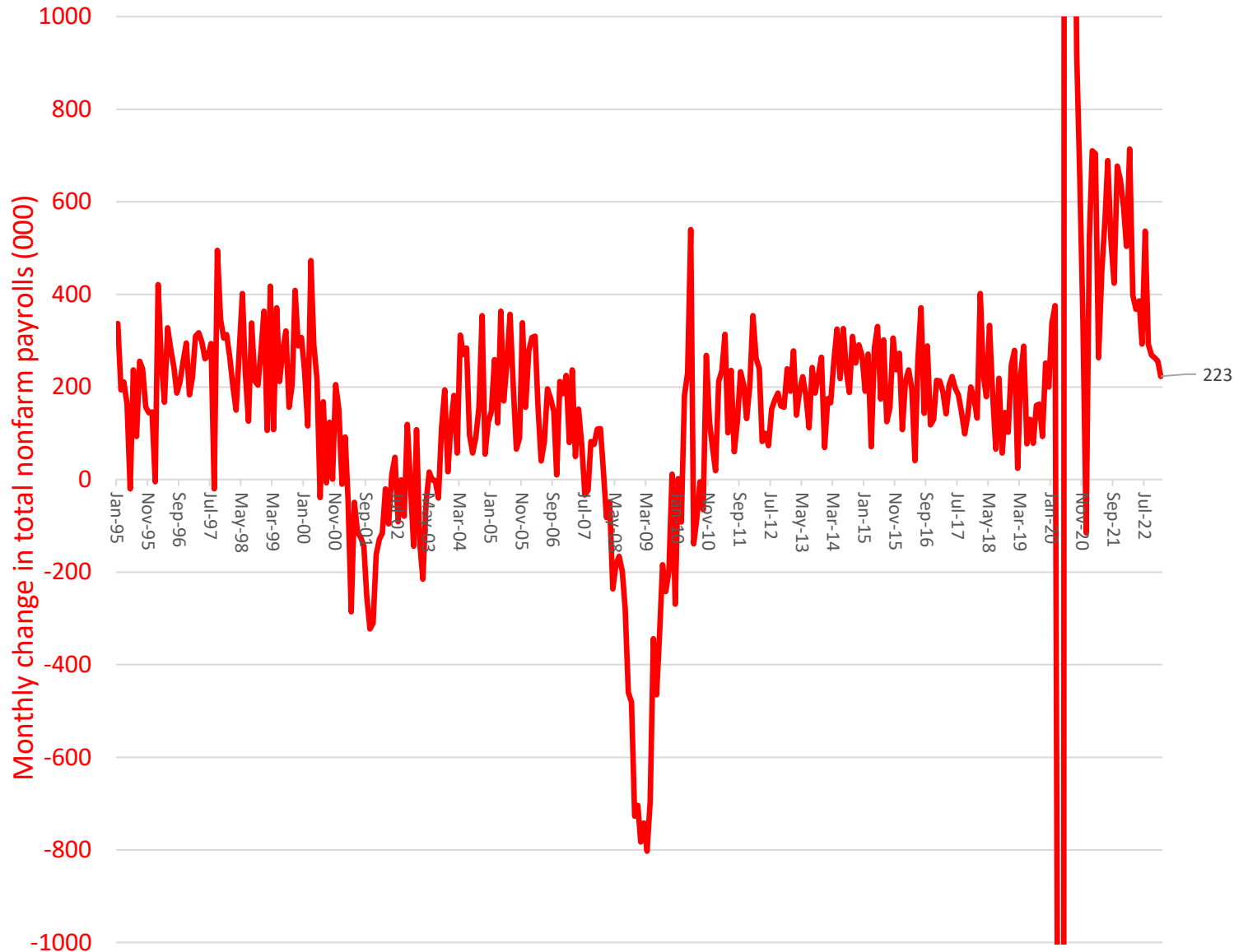
Sources: Blue Chip Economic Indicators and Blue Chip Financial Forecasts

Note: The top (bottom) 10 average forecast is an average of the highest (lowest) 10 forecasts in the Blue Chip survey.

Source: Federal Reserve Bank of Atlanta, January 5, 2023.

Economic data

Net new job formation



223,000 jobs gained in December on the establishment survey.

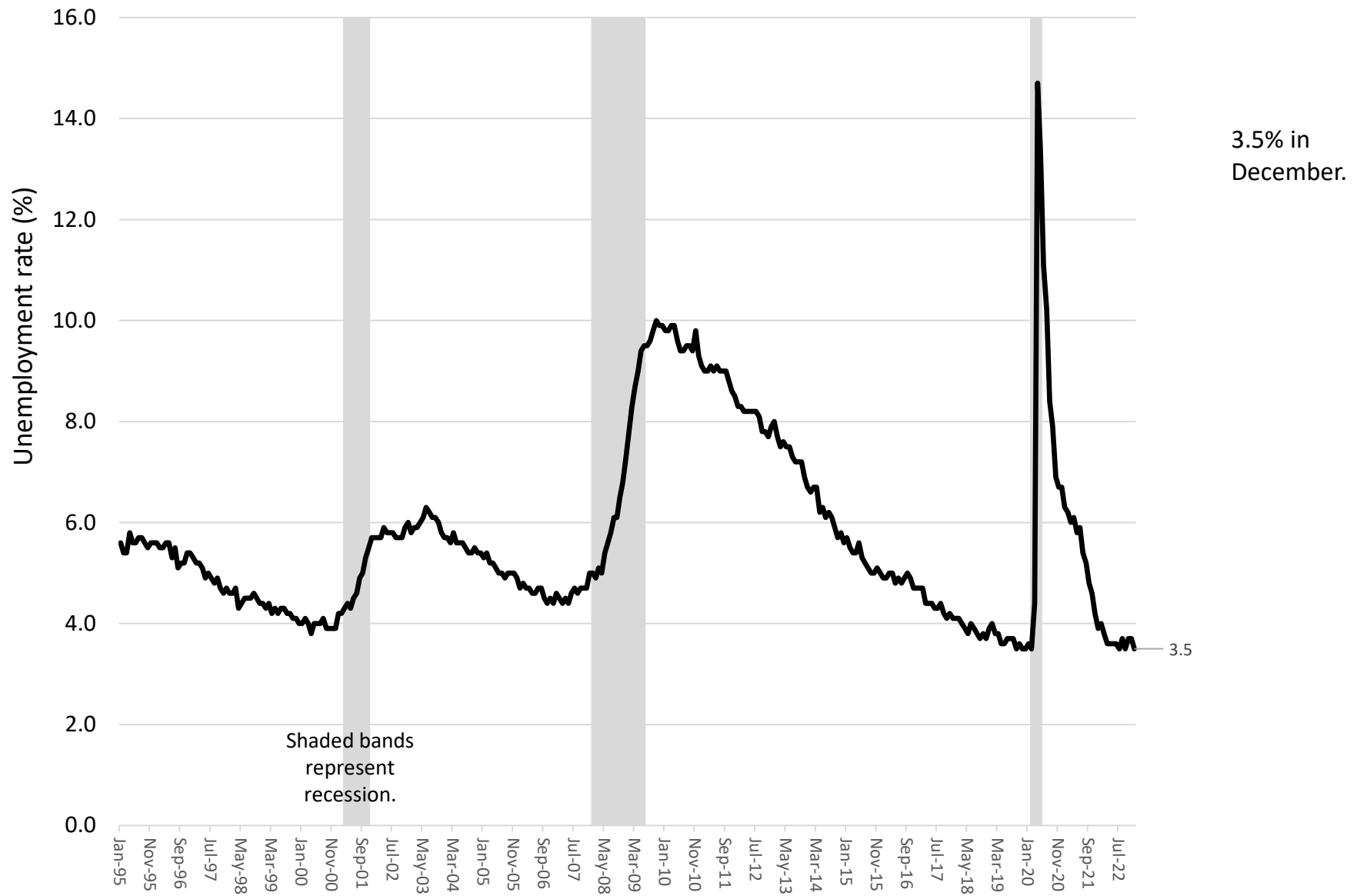
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The U.S. Is Still Hiring on All Cylinders

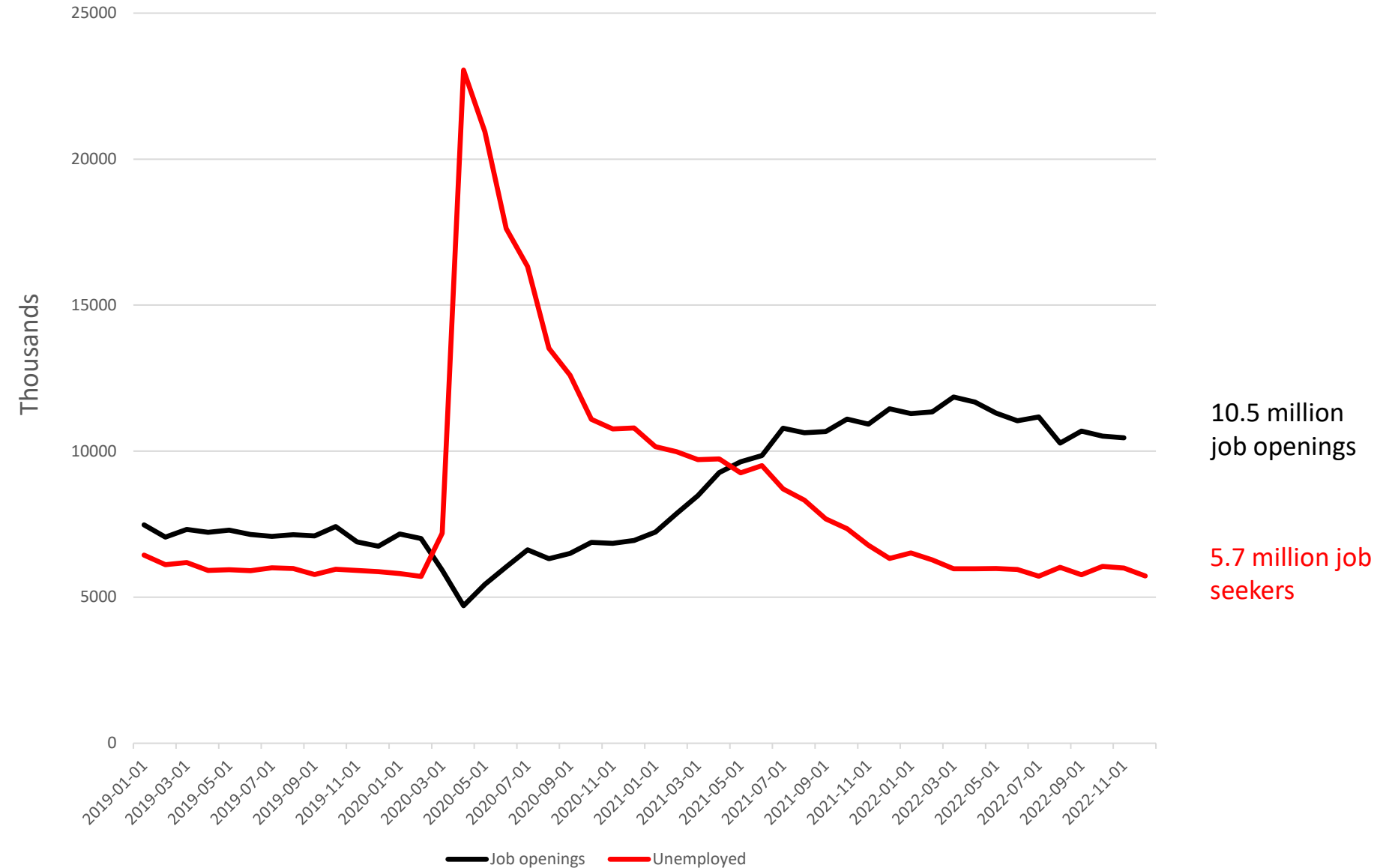
America's jobs market shows no meaningful sign of slumping despite recession fears.

The labor market is cooling. That isn't to say it isn't hot.

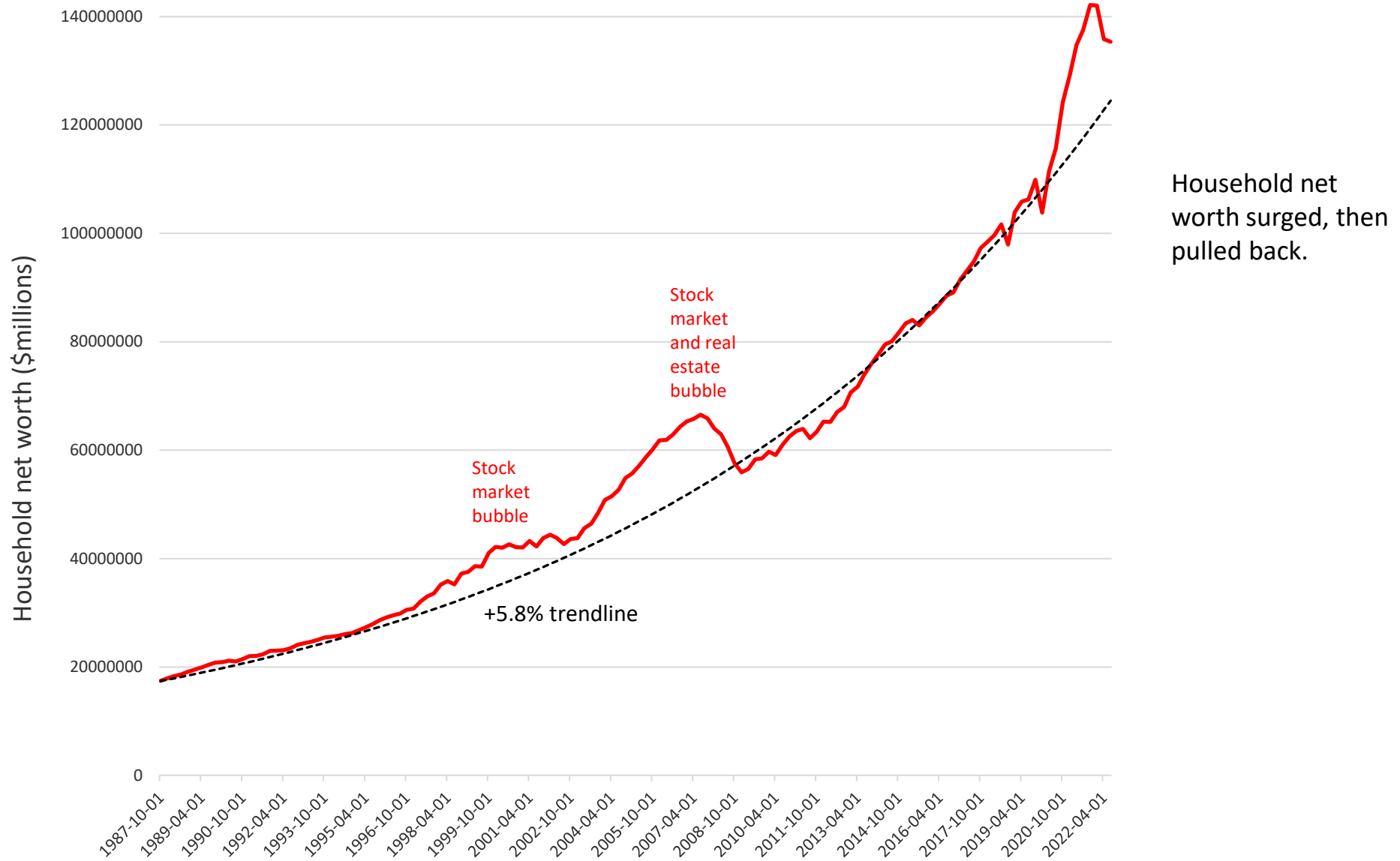
Unemployment rate



Job openings vs. unemployed job seekers

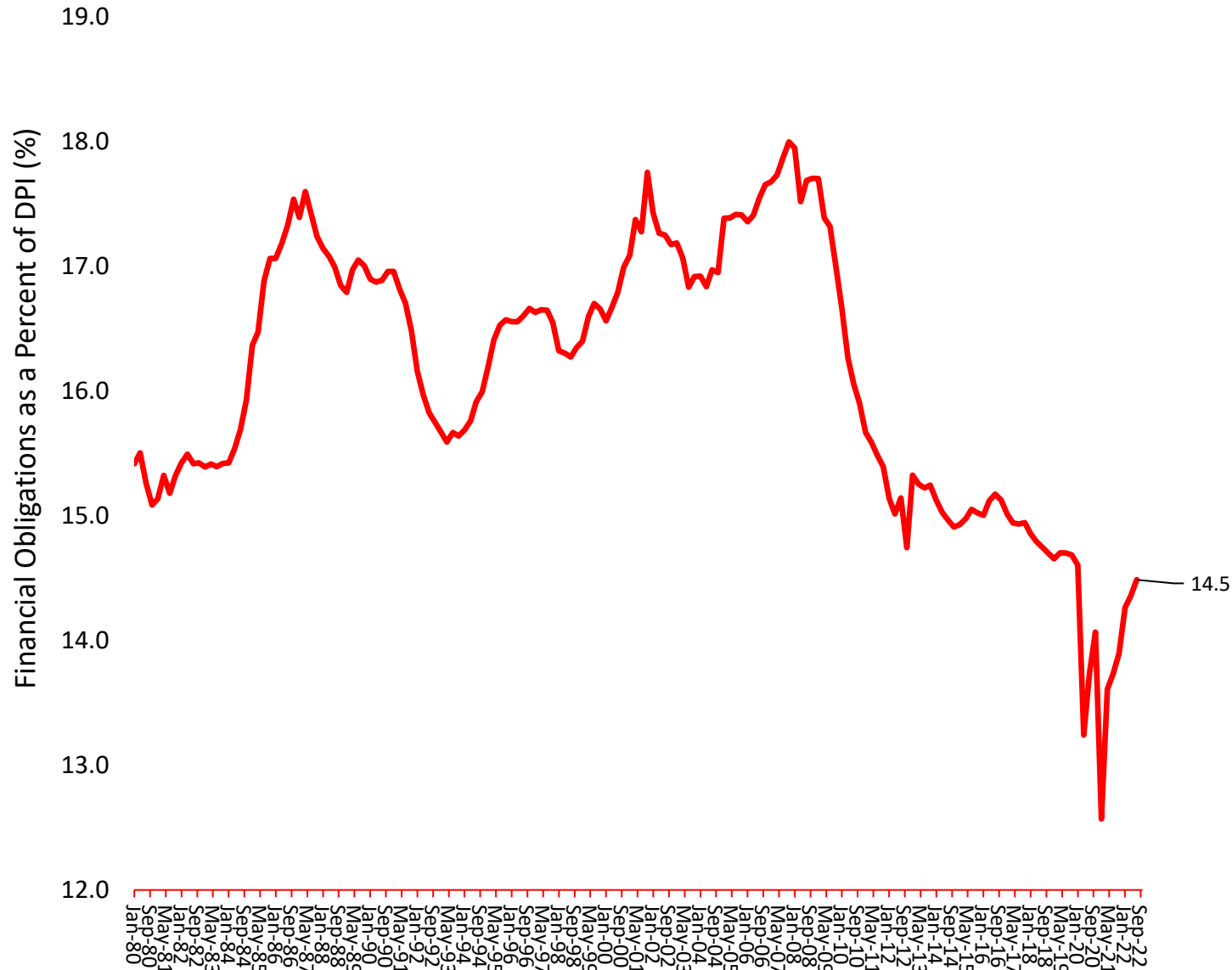


Household net worth – the wealth effect



Household balance sheets

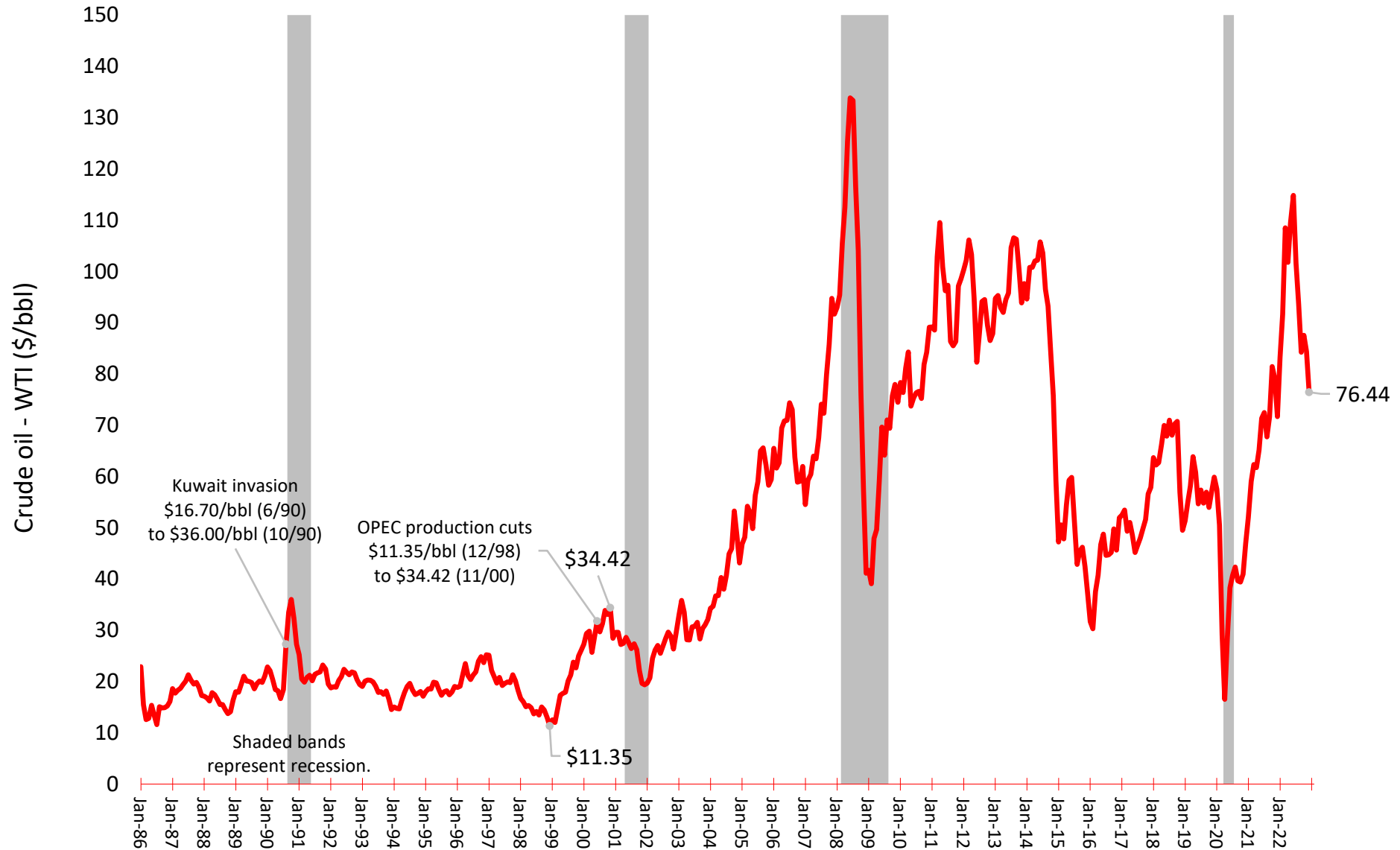
Financial obligations ratio



This measure shows that percent of monthly after-tax income that the average household pays for fixed recurring monthly obligations, such as a mortgage, car payment, utilities, real estate taxes, etc.

Oil

WTI spot crude oil prices



Source: U.S. Energy Information Agency. Data through December 2022.

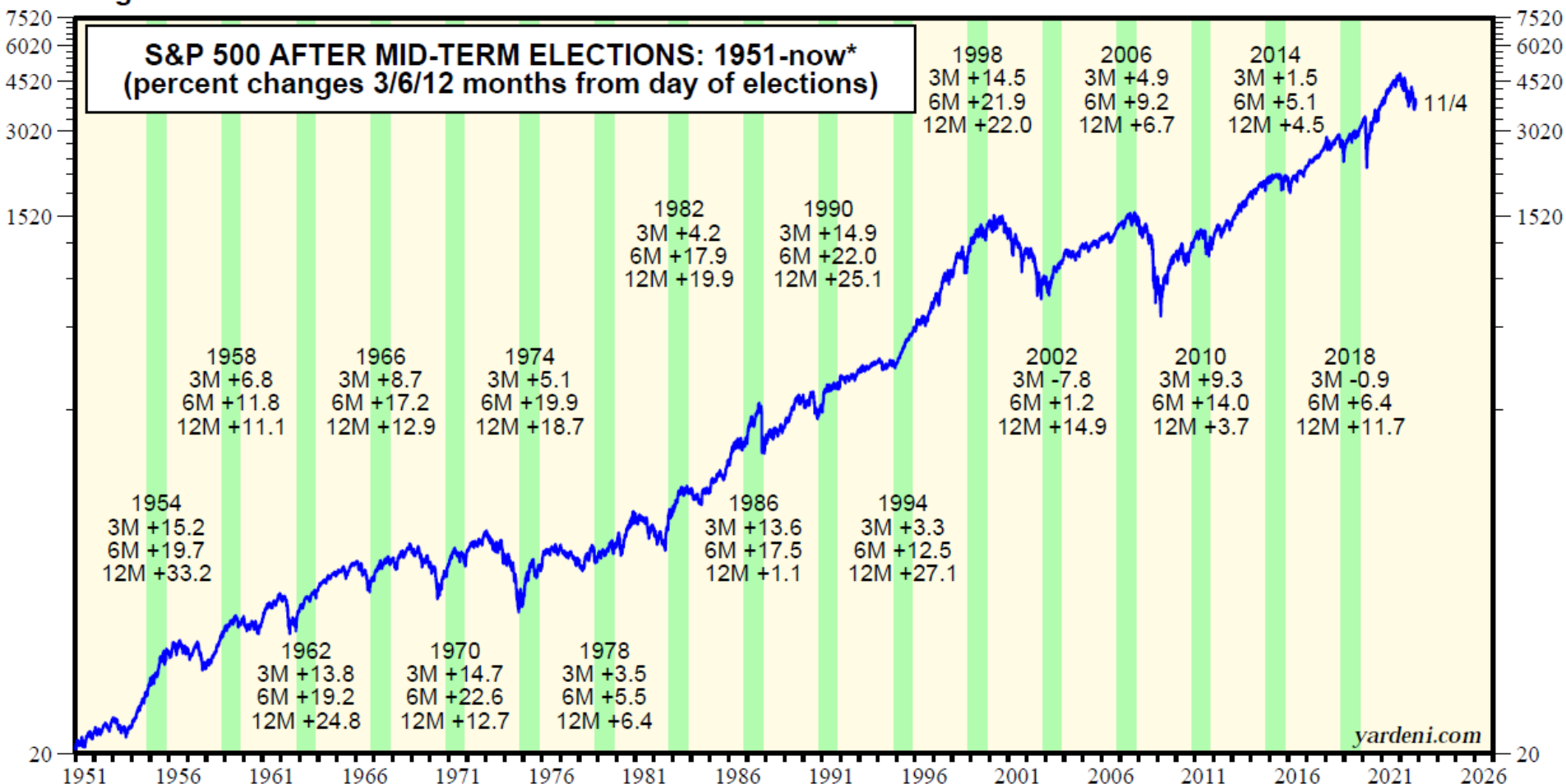
Stock Market

- bear market
- stocks vs. fed funds rate and bond yields
- 2000 bubble vs. now
- “parabolic” is normal
- skeptical of 2022/2023 earnings estimates
- What is the right P/E multiple?

Stock market

S&P 500 and mid-term elections

Figure 3.

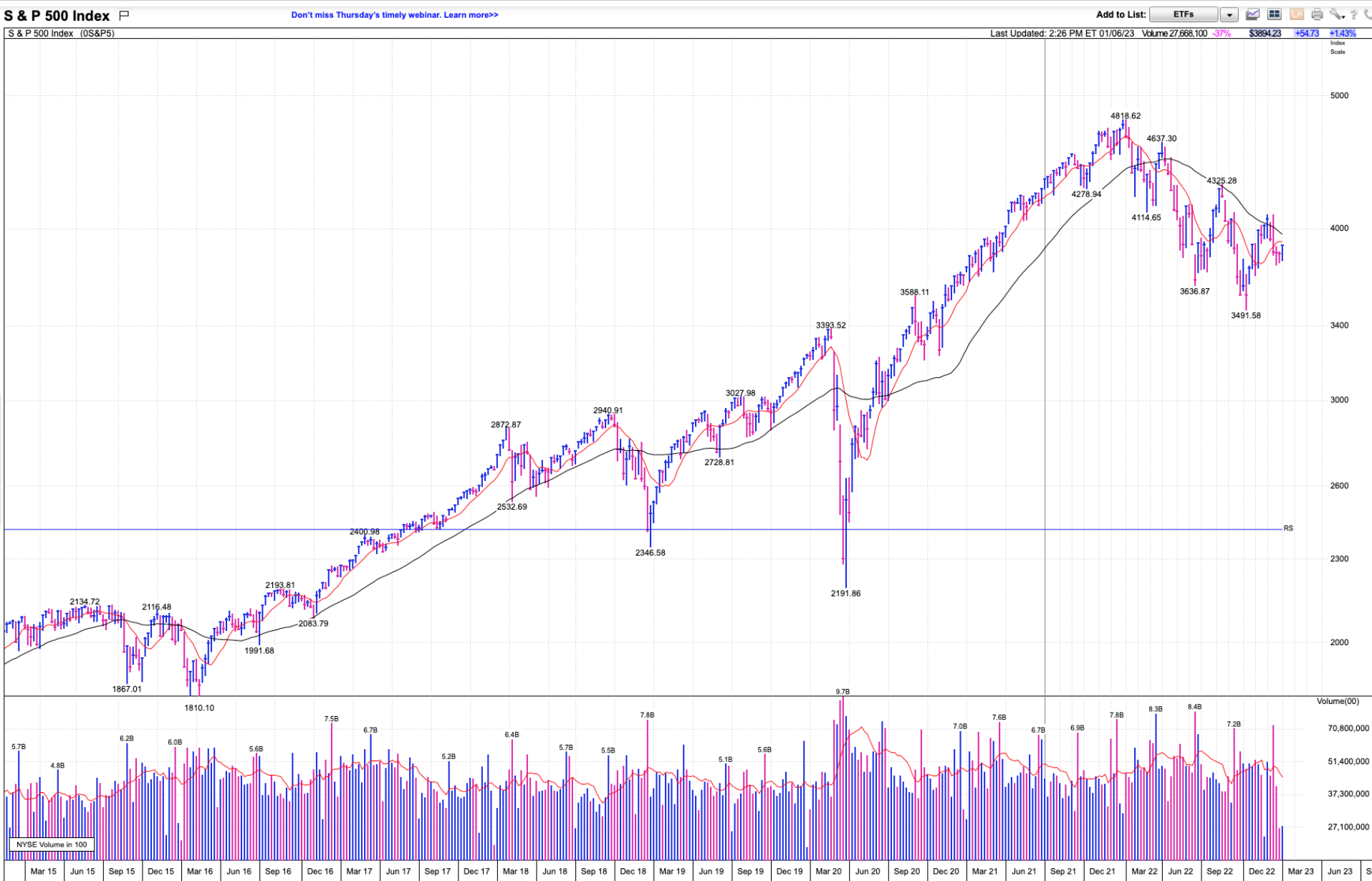


* S&P 500 up (down) during 12-month span following election day in green (red) shaded area. Prior to 1969, markets were closed on election day, therefore used "latest close" for those dates.

Source: Haver Analytics, Standard & Poor's, YRI calculations.

Stock market

S&P 500 – bear market



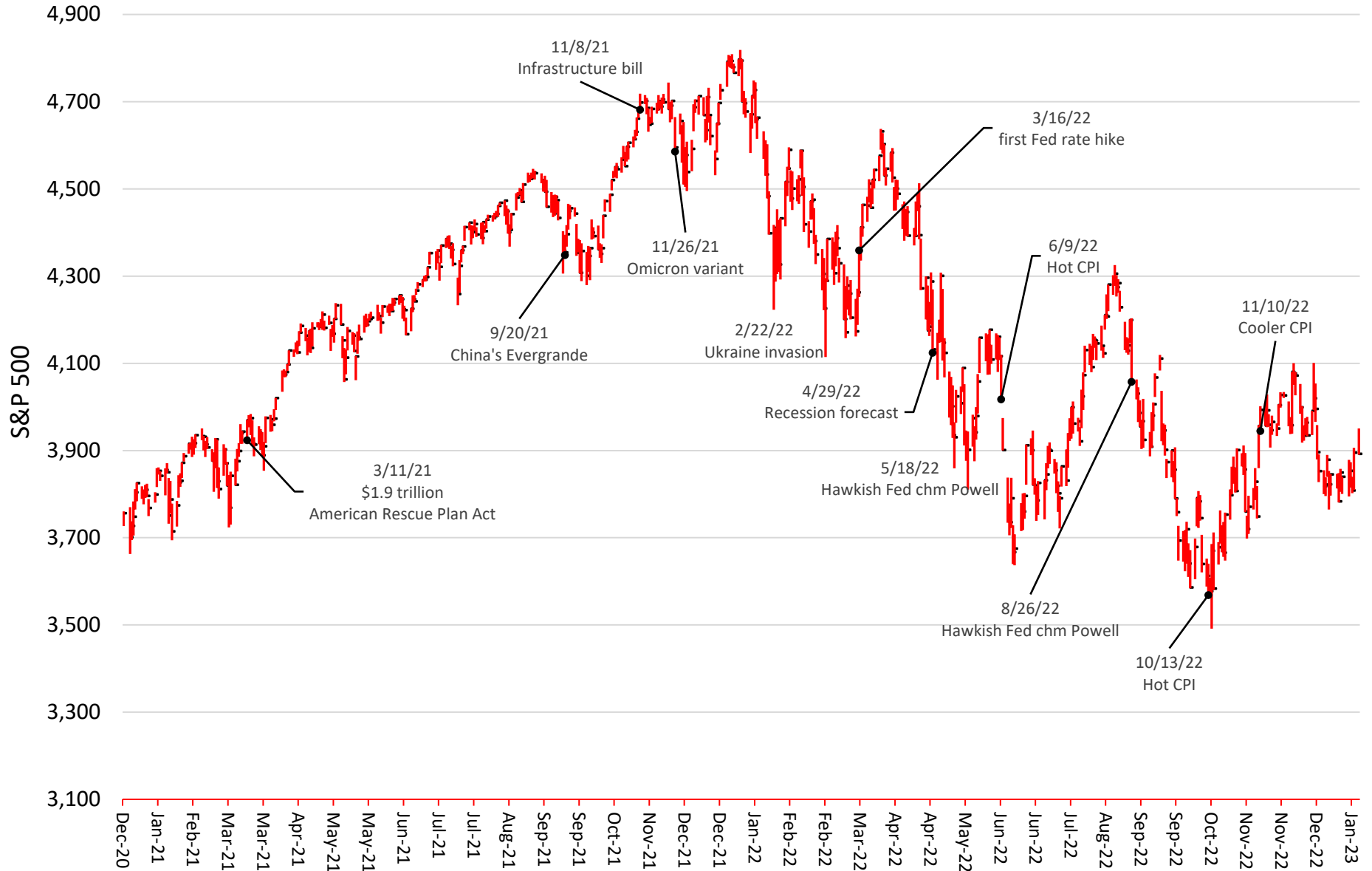
Quotes delayed 20 minutes. Ownership data provided by Refinitiv and Estimate data provided by FactSet. marketsmith@investors.com

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Source: Standard & Poor's and MarketSmith, Inc. Data through January 6, 2023.

Stock market

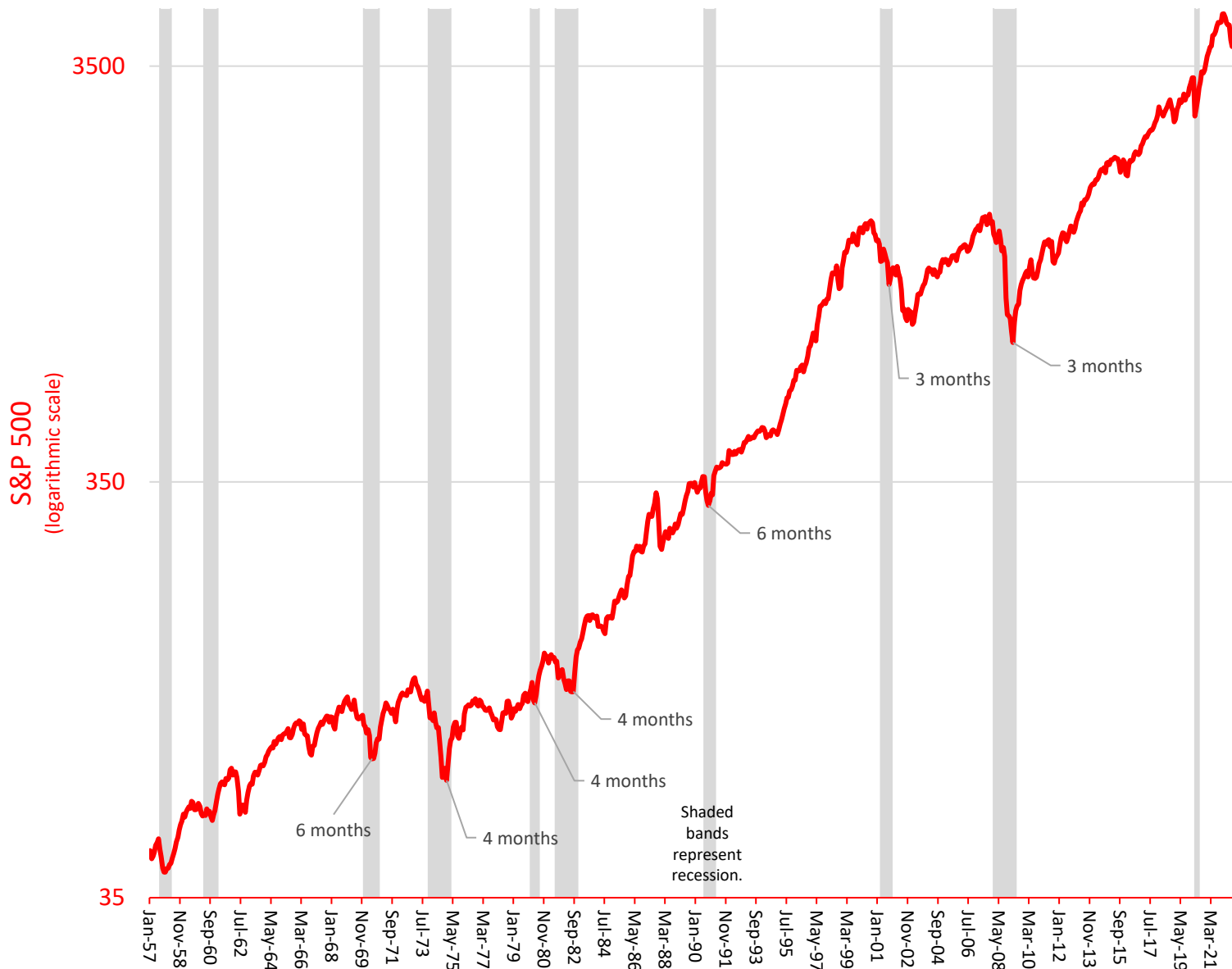
S&P 500



Source: Standard & Poor's. Data through January 9, 2023.

Stock market

S&P 500 vs. recessions



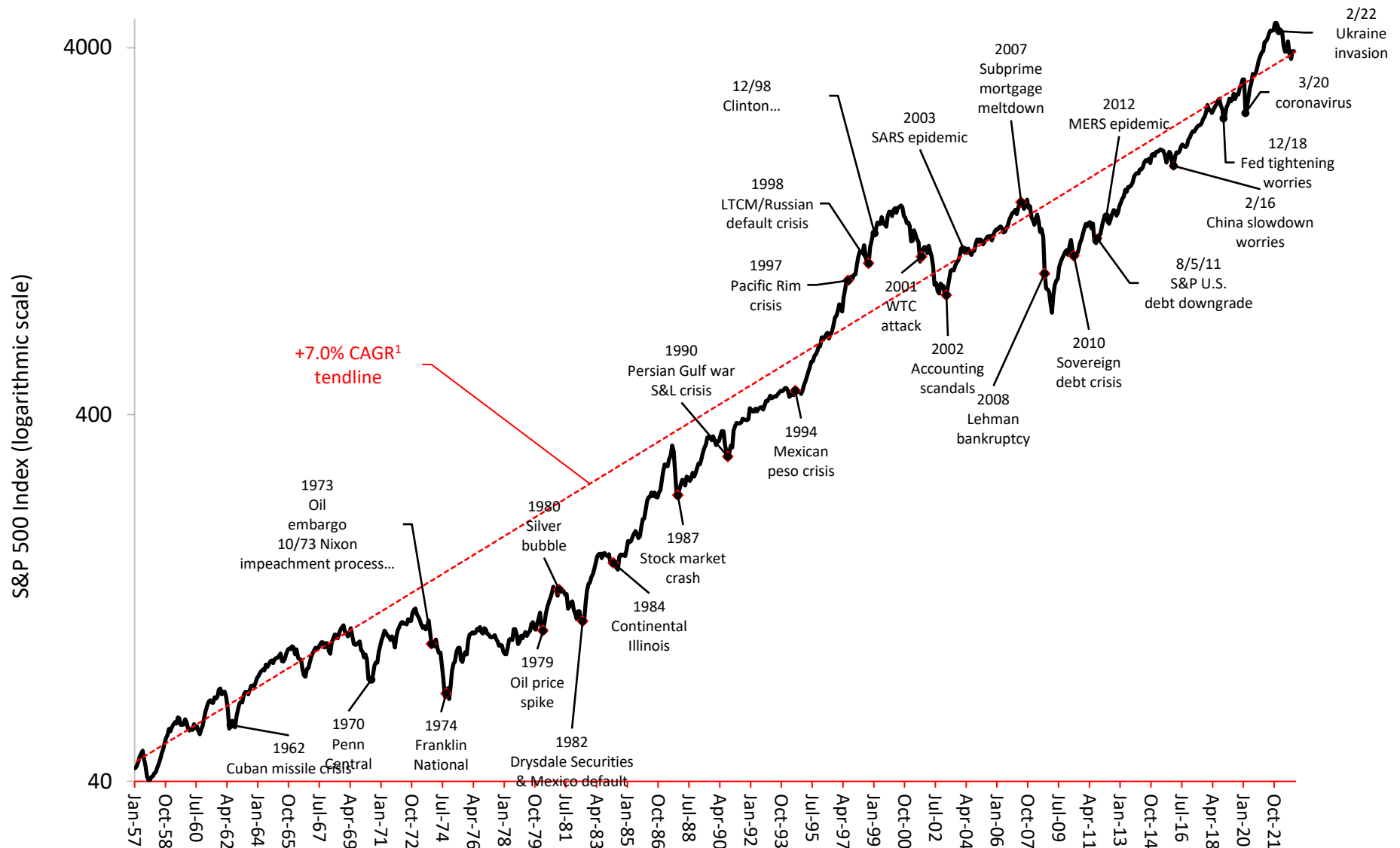
Big declines are associated with recessions.

Stocks often bottom months before recession-end.

Source: Standard and Poor's Corporation, National Bureau of Economic Research. Data through December 2022.

Stock market

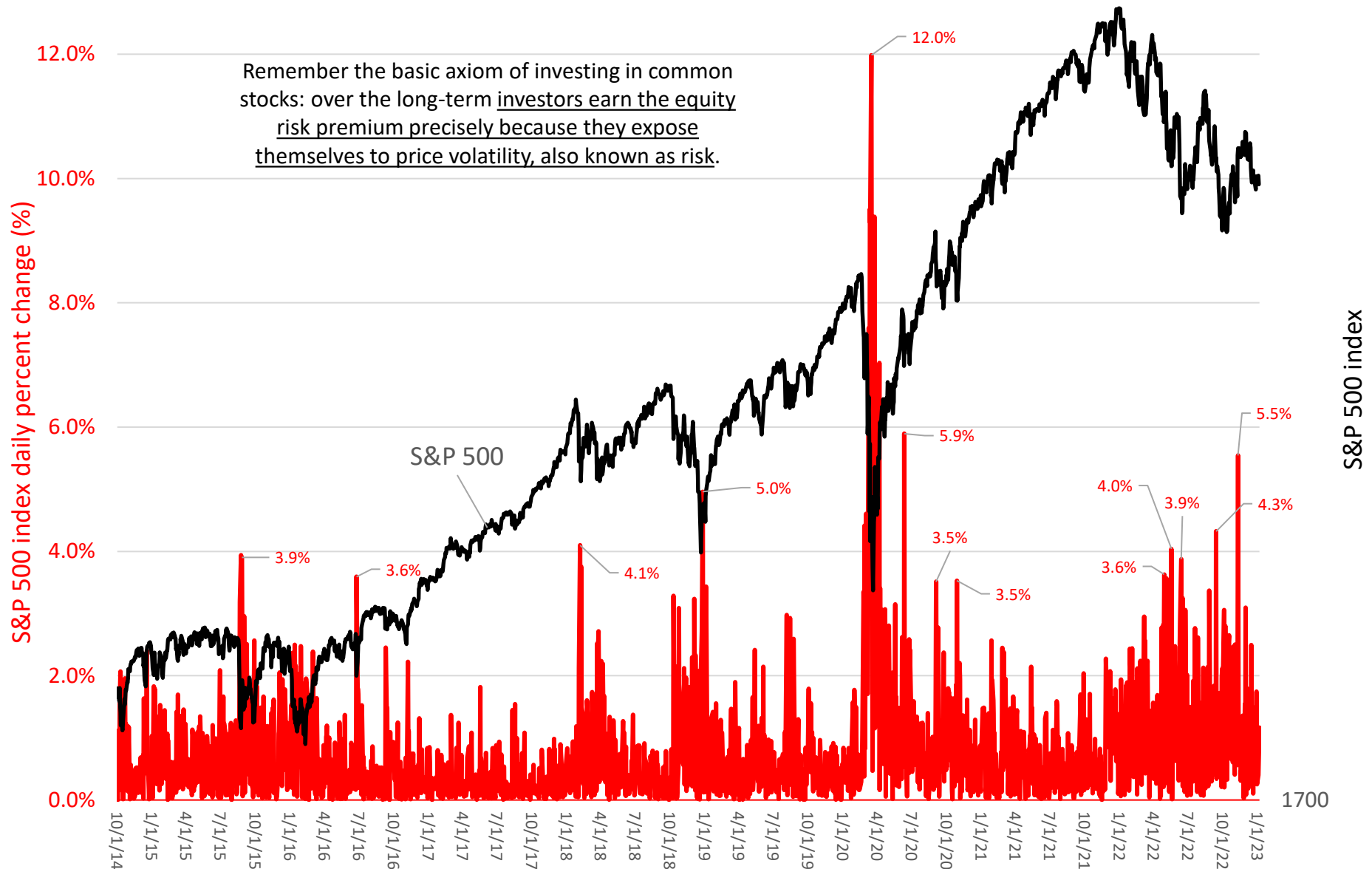
S&P 500 and crises



Source: Standard and Poor's. Data through December 2022. ¹ Compound annual growth rate.

Stock market

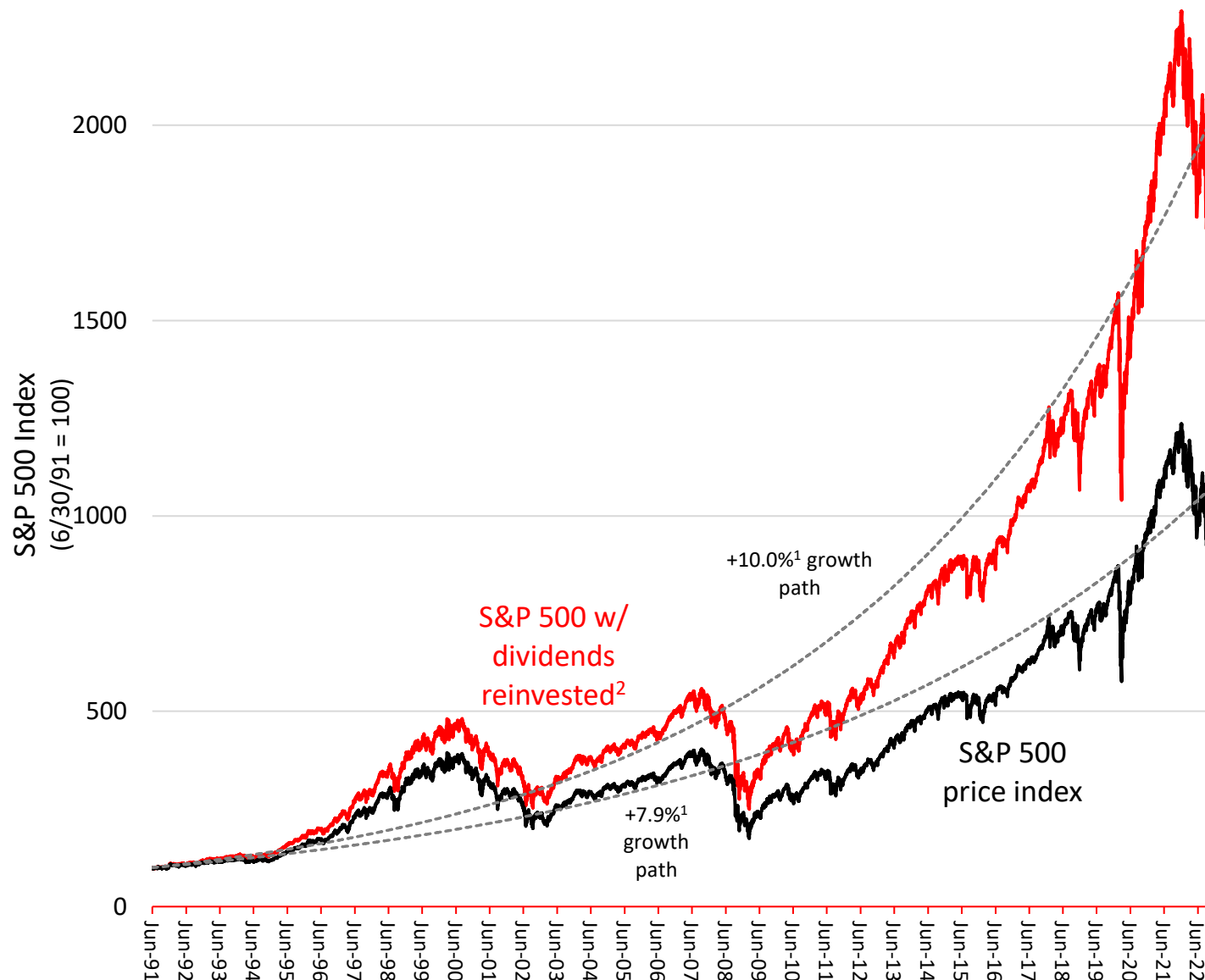
S&P 500 volatility



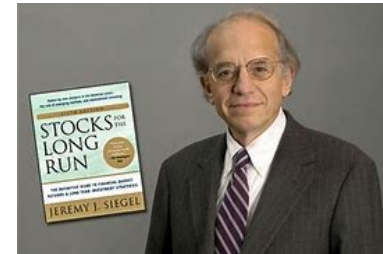
Source: Standard & Poor's, data through January 5, 2023.

Stock market arithmetic

Total return = 7.9% earnings-driven price + 2.1% dividends reinvested



+10% per year S&P 500 total return over the last 30 years is in line with the stock market's long-term returns going back to 1926, or back even further to 1871.³

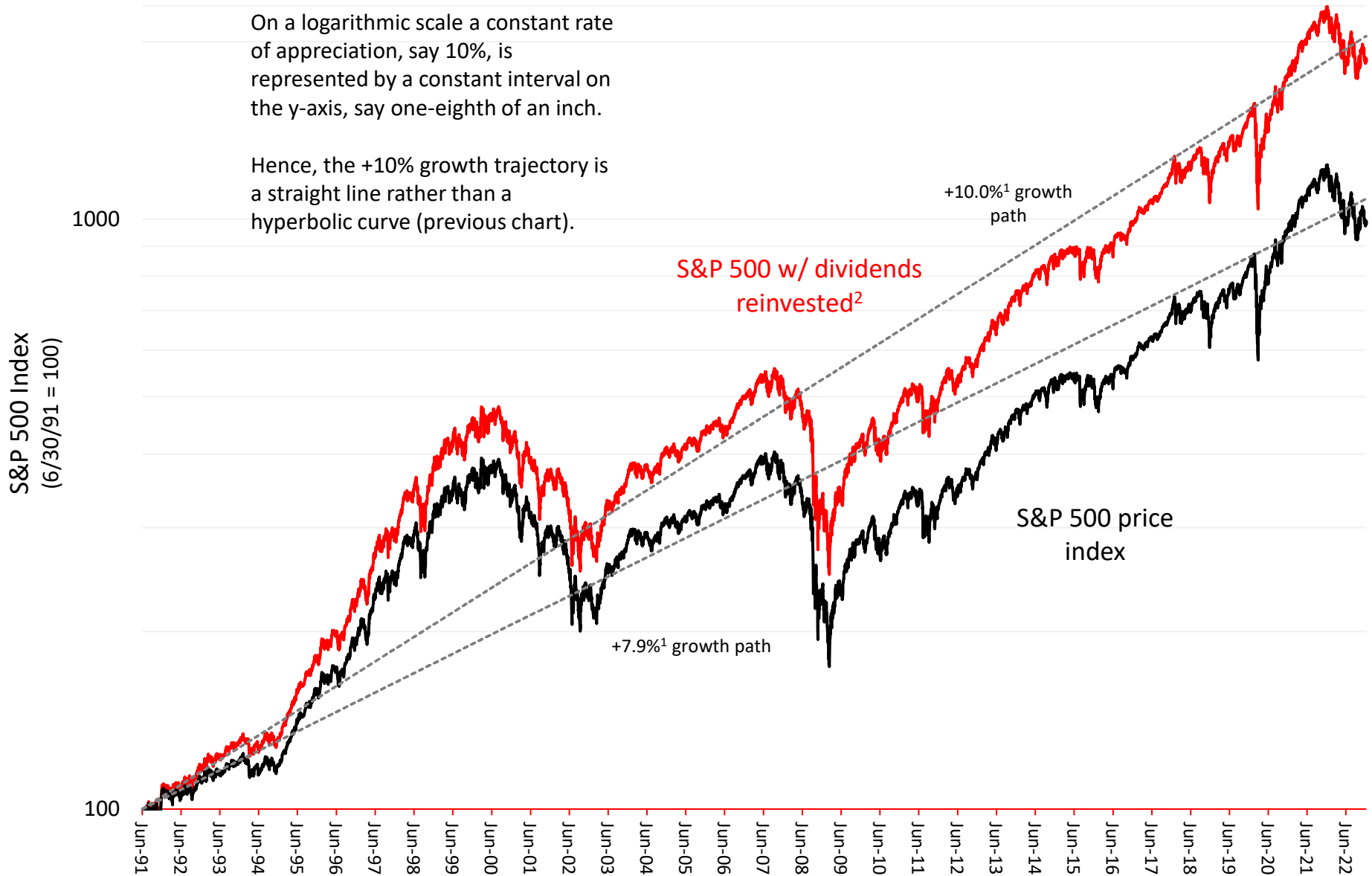


Source: Standard and Poor's. Data through January 5, 2023.¹ Compound annual growth rate. ² S&P 500 total return index.

³ per Professor Jeremy Siegel's seminal *Stocks for the Long Run*, first published in 1994.

Stock market arithmetic

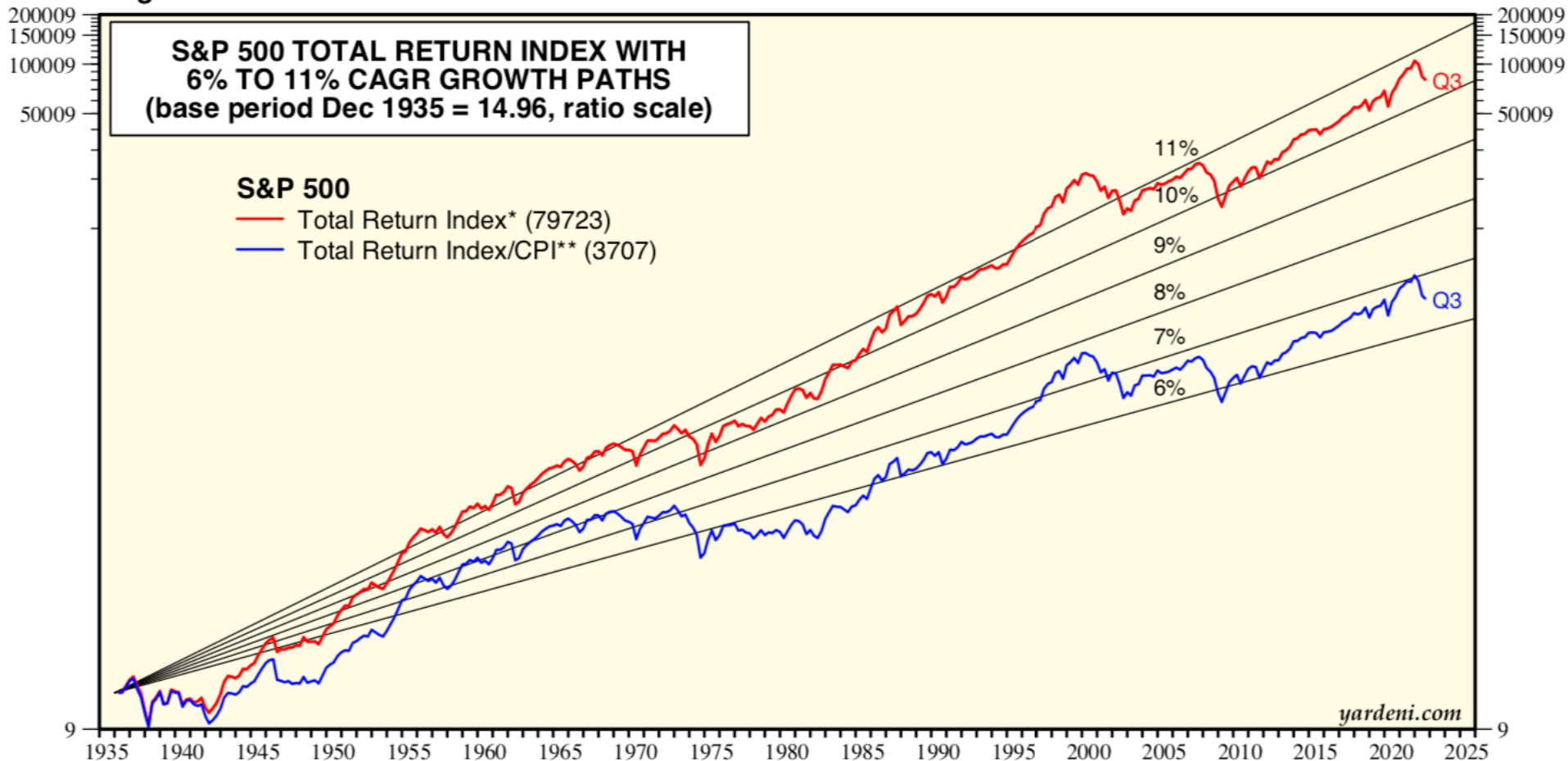
Total return = 7.9% earnings-driven price + 2.1% dividends reinvested



Source: Standard and Poor's. Data through January 5, 2023. ¹ Compound annual growth rate. ² S&P 500 total return index.

Total return and real total return

Figure 6.



* Includes reinvested dividends.

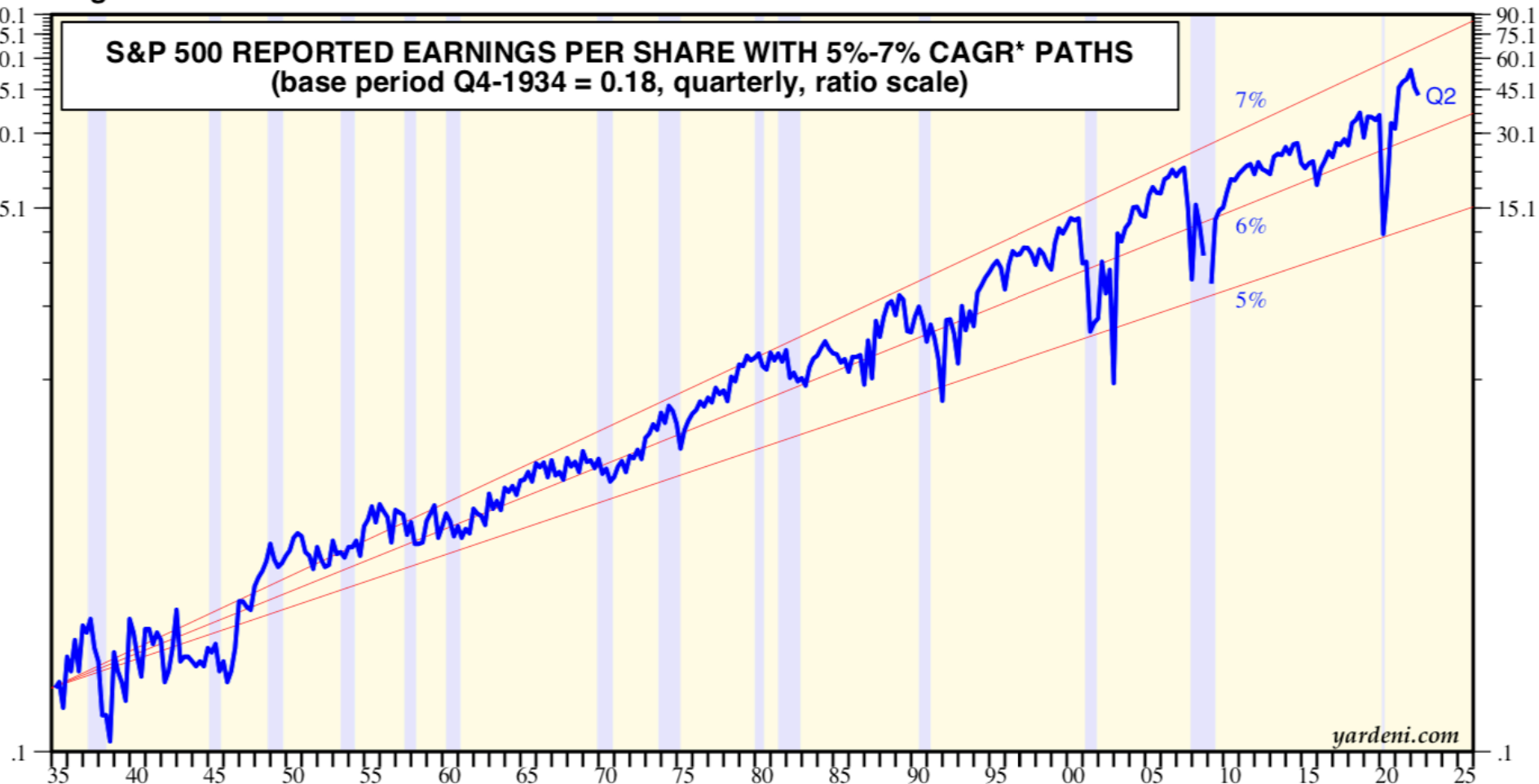
** Using last month of quarter CPI. Compounded monthly using base value.

Source: Standard & Poor's.

Stock market arithmetic

85 years of S&P 500 earnings growth

Figure 9.



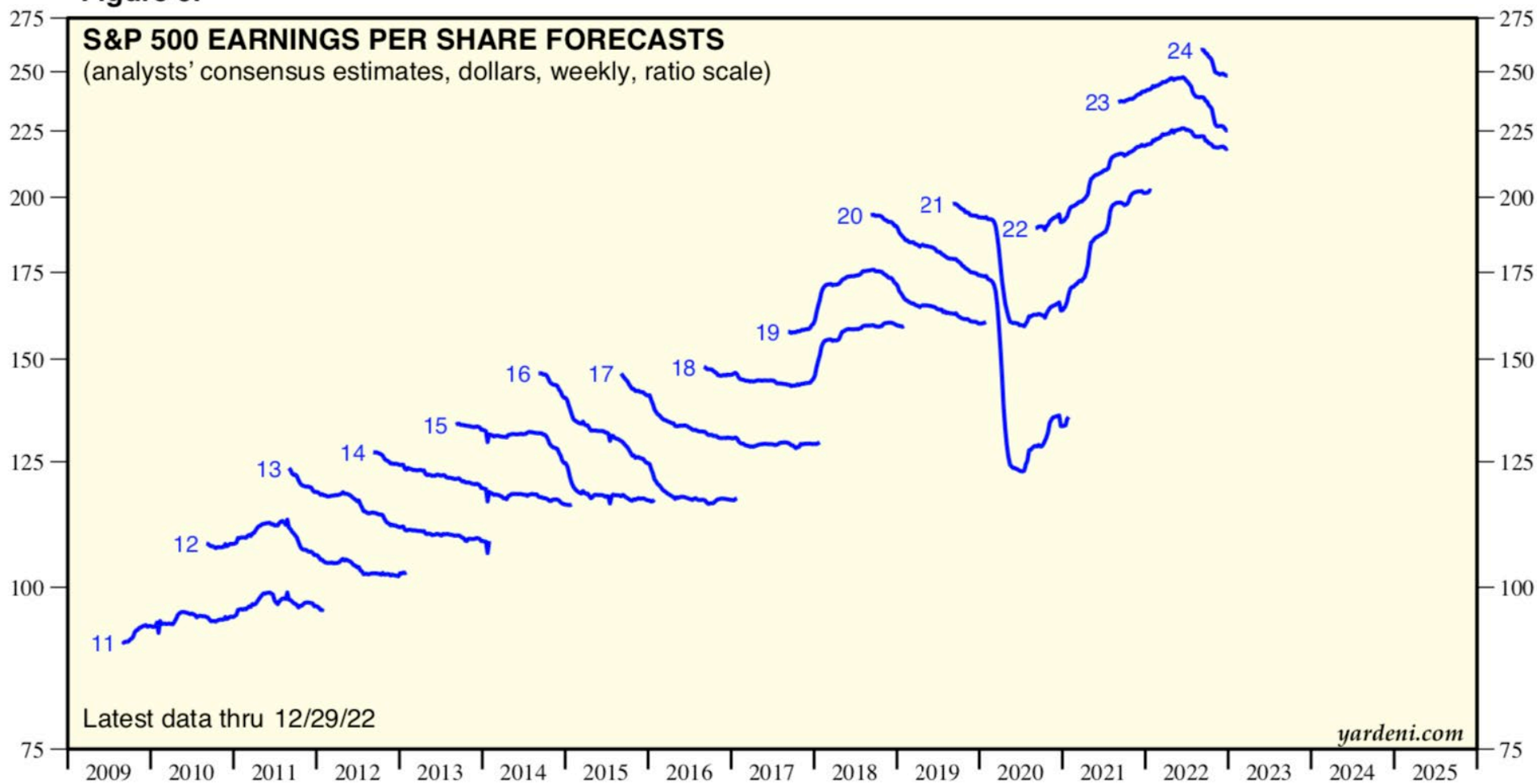
* Compounded annual growth rate from base value using monthly data. Q4-2008 not shown because of large negative value.

Note: Shaded areas denote recessions according to the National Bureau of Economic Research.

Source: Standard & Poor's.

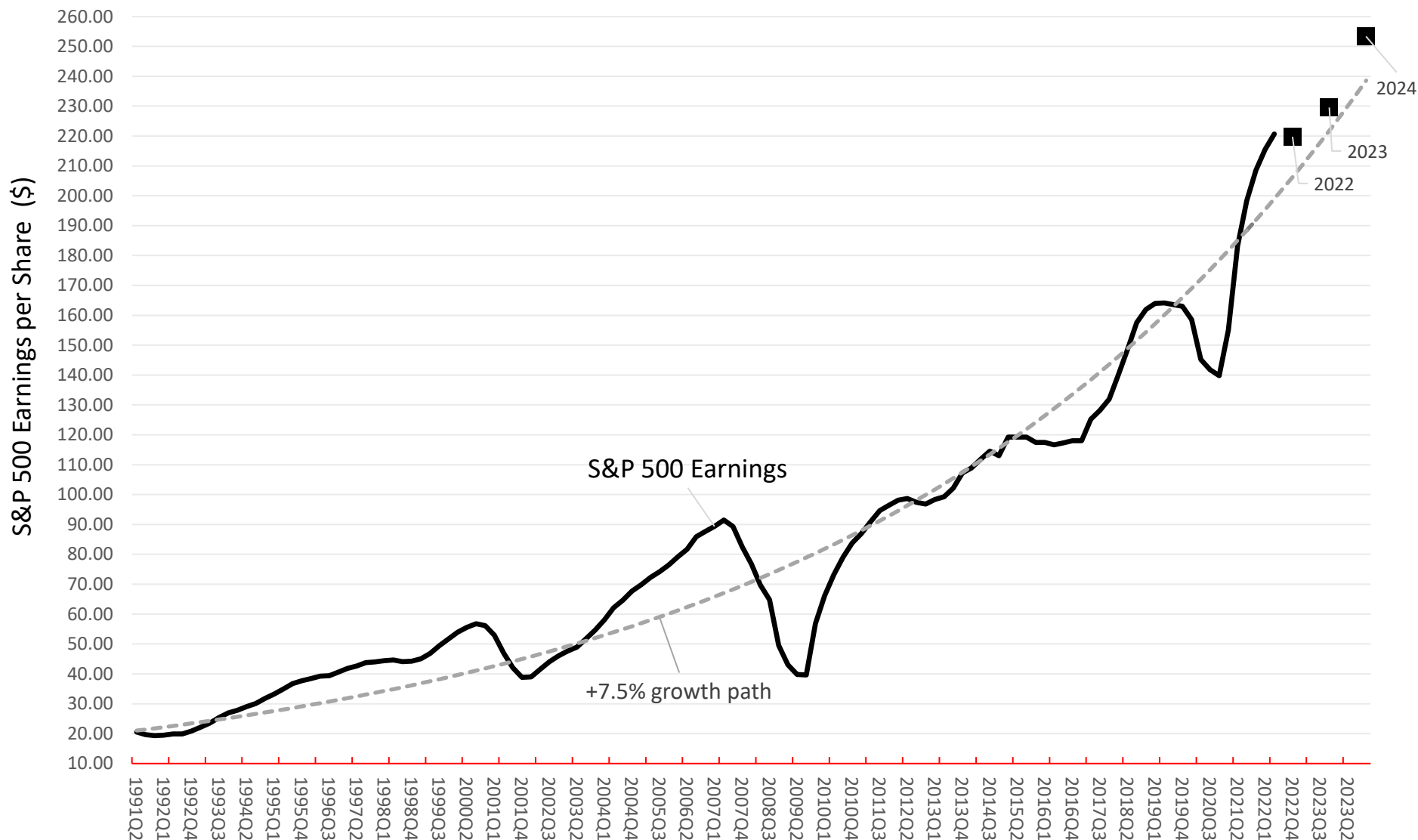
S&P earnings estimates

Figure 9.



Source: I/B/E/S data by Refinitiv.

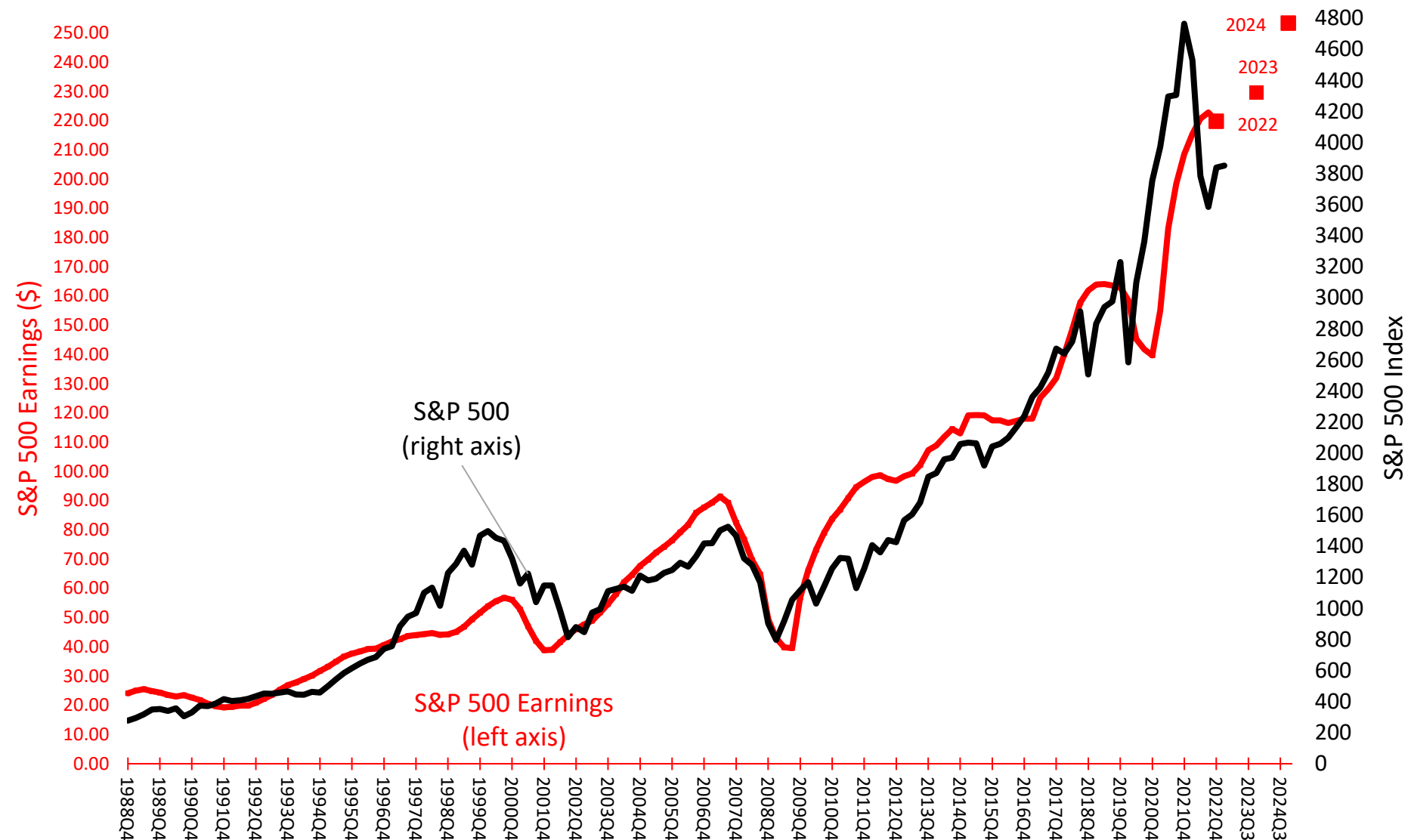
S&P 500 earnings – actual and I/B/E/S estimates



2022 (estimated), 2023 (estimated) and 2024 (estimated) bottom-up S&P 500 operating earnings per share as of January 4, 2023: for 2022(e), \$219.80; for 2023(e), \$229.52; for 2024(e), \$253.37. Sources: Yardeni Research, Inc. and Thomson Reuters I/B/E/S for actual and estimated operating earnings from 2015. Standard and Poor's for actual operating earnings data through 2014.

Valuation

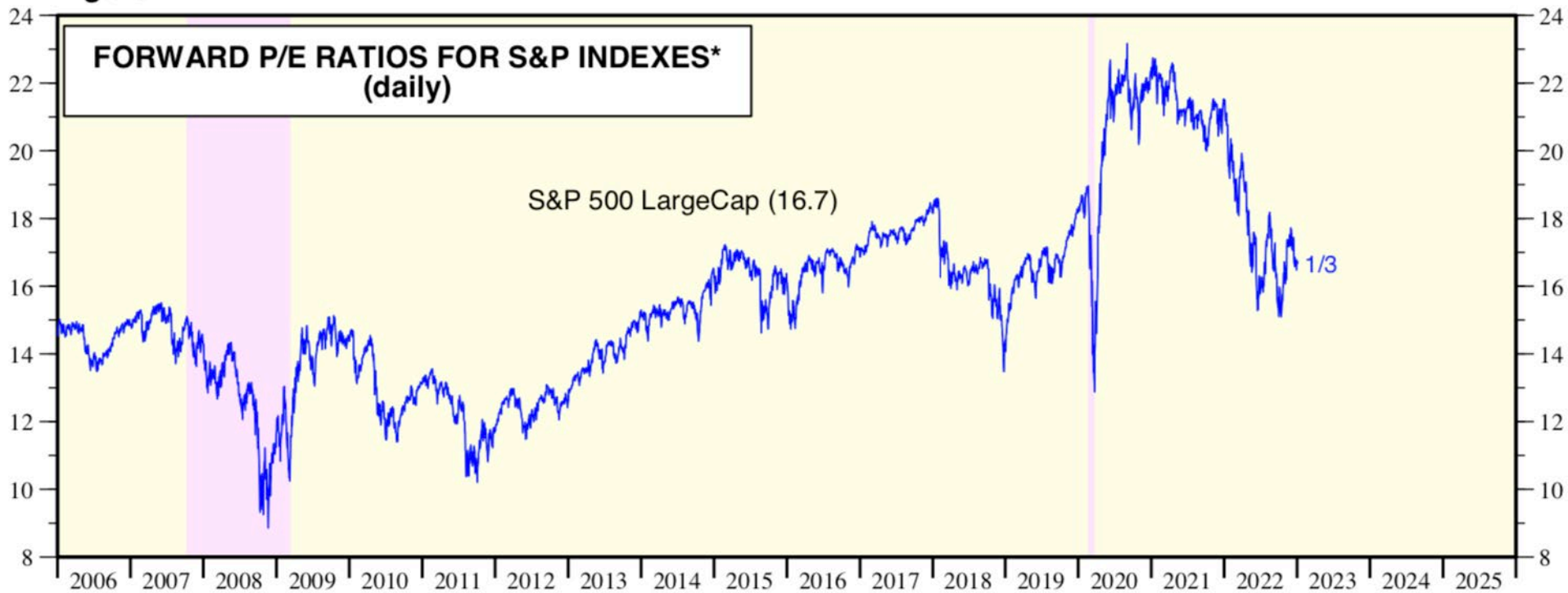
S&P 500 vs. actual and I/B/E/S estimated earnings



2022 (estimated), 2023 (estimated) and 2024 (estimated) bottom-up S&P 500 operating earnings per share as of January 4, 2023: for 2022(e), \$219.80; for 2023(e), \$229.52; for 2024(e), \$253.37. Sources: Yardeni Research, Inc. and Thomson Reuters I/B/E/S for actual and estimated operating earnings from 2015. Standard and Poor's for actual operating earnings data through 2014; index price data through January 4, 2023.

S&P 500 index forward P/E ratio

Figure 12.



Fed policy



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Fed Lifts Rates by 0.5 Point, Signals It Isn't Done

Increases are expected into spring, with cuts unlikely until 2024, even as inflation eases

The Federal Reserve approved an interest-rate increase of 0.5 percentage point and signaled plans to lift rates through the spring, though likely in smaller increments, to combat inflation.

The decision on Wednesday marked a step down after four consecutive larger increases of 0.75 point and raised the benchmark federal-funds rate to a range between 4.25% and 4.5%, a 15-year high.

Federal Reserve

Central tendency forecast

For release at 2:00 p.m., EST, December 14, 2022

Table 1. Economic projections of Federal Reserve Board members and Federal Reserve Bank presidents, under their individual assumptions of projected appropriate monetary policy, December 2022

Percent

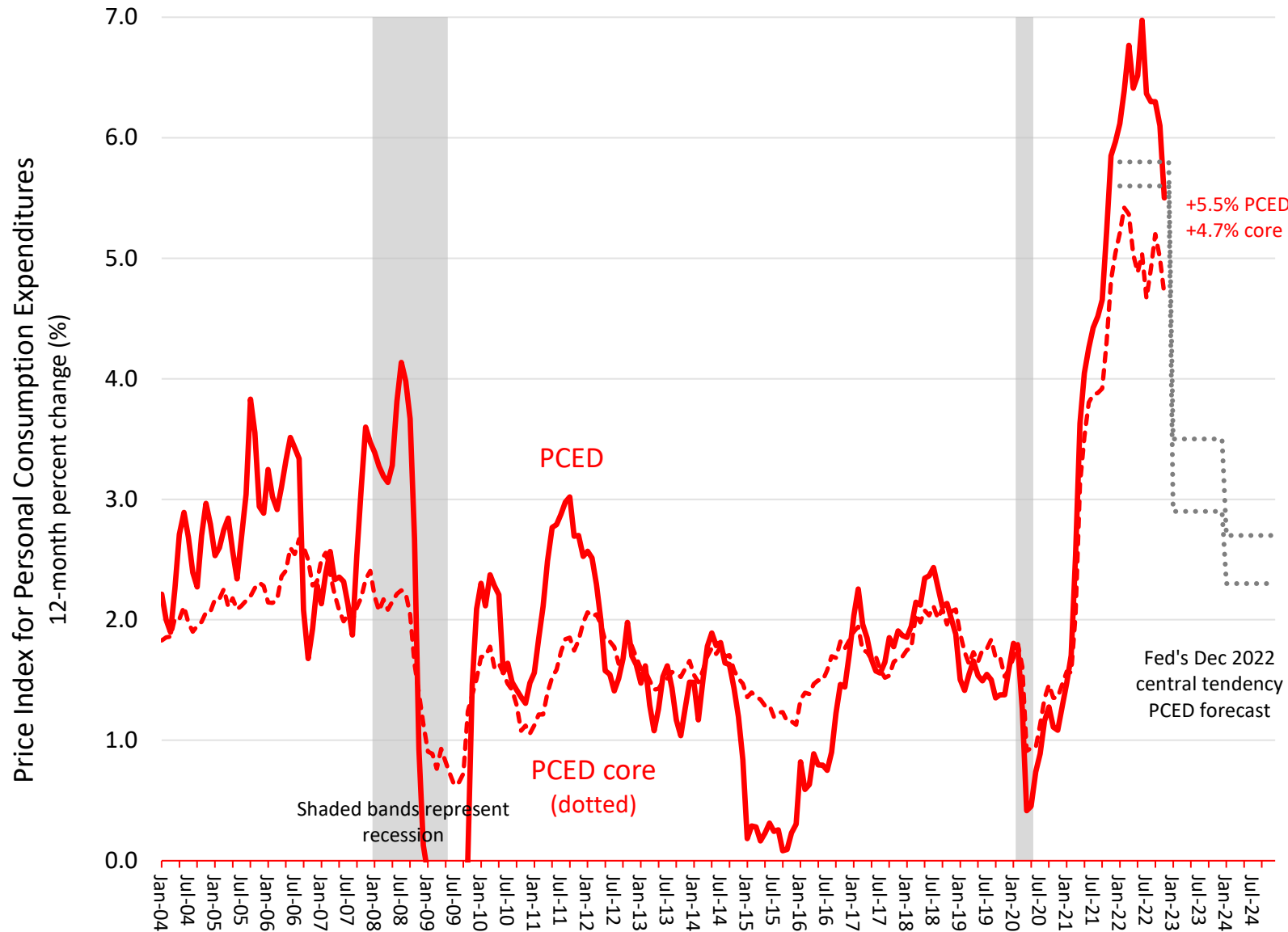
Variable	Median ¹					Central Tendency ²					Range ³				
	2022	2023	2024	2025	Longer run	2022	2023	2024	2025	Longer run	2022	2023	2024	2025	Longer run
Change in real GDP	0.5	0.5	1.6	1.8	1.8	0.4–0.5	0.4–1.0	1.3–2.0	1.6–2.0	1.7–2.0	0.2–0.5	–0.5–1.0	0.5–2.4	1.4–2.3	1.6–2.5
September projection	0.2	1.2	1.7	1.8	1.8	0.1–0.3	0.5–1.5	1.4–2.0	1.6–2.0	1.7–2.0	0.0–0.5	–0.3–1.9	1.0–2.6	1.4–2.4	1.6–2.2
Unemployment rate	3.7	4.6	4.6	4.5	4.0	3.7	4.4–4.7	4.3–4.8	4.0–4.7	3.8–4.3	3.7–3.9	4.0–5.3	4.0–5.0	3.8–4.8	3.5–4.8
September projection	3.8	4.4	4.4	4.3	4.0	3.8–3.9	4.1–4.5	4.0–4.6	4.0–4.5	3.8–4.3	3.7–4.0	3.7–5.0	3.7–4.7	3.7–4.6	3.5–4.5
PCE inflation	5.6	3.1	2.5	2.1	2.0	5.6–5.8	2.9–3.5	2.3–2.7	2.0–2.2	2.0	5.5–5.9	2.6–4.1	2.2–3.5	2.0–3.0	2.0
September projection	5.4	2.8	2.3	2.0	2.0	5.3–5.7	2.6–3.5	2.1–2.6	2.0–2.2	2.0	5.0–6.2	2.4–4.1	2.0–3.0	2.0–2.5	2.0
Core PCE inflation ⁴	4.8	3.5	2.5	2.1		4.7–4.8	3.2–3.7	2.3–2.7	2.0–2.2		4.6–5.0	3.0–3.8	2.2–3.0	2.0–3.0	
September projection	4.5	3.1	2.3	2.1		4.4–4.6	3.0–3.4	2.2–2.5	2.0–2.2		4.3–4.8	2.8–3.5	2.0–2.8	2.0–2.5	
Memo: Projected appropriate policy path															
Federal funds rate	4.4	5.1	4.1	3.1	2.5	4.4	5.1–5.4	3.9–4.9	2.6–3.9	2.3–2.5	4.4	4.9–5.6	3.1–5.6	2.4–5.6	2.3–3.3
September projection	4.4	4.6	3.9	2.9	2.5	4.1–4.4	4.4–4.9	3.4–4.4	2.4–3.4	2.3–2.5	3.9–4.6	3.9–4.9	2.6–4.6	2.4–4.6	2.3–3.0

Inflation

- Year-over-year headline PCED +5.5%, +4.7% core
- Month-over-month plunging
- M2 driving inflation
- inflation expectations (TIPS spread) falling

Inflation

PCED – headline and core



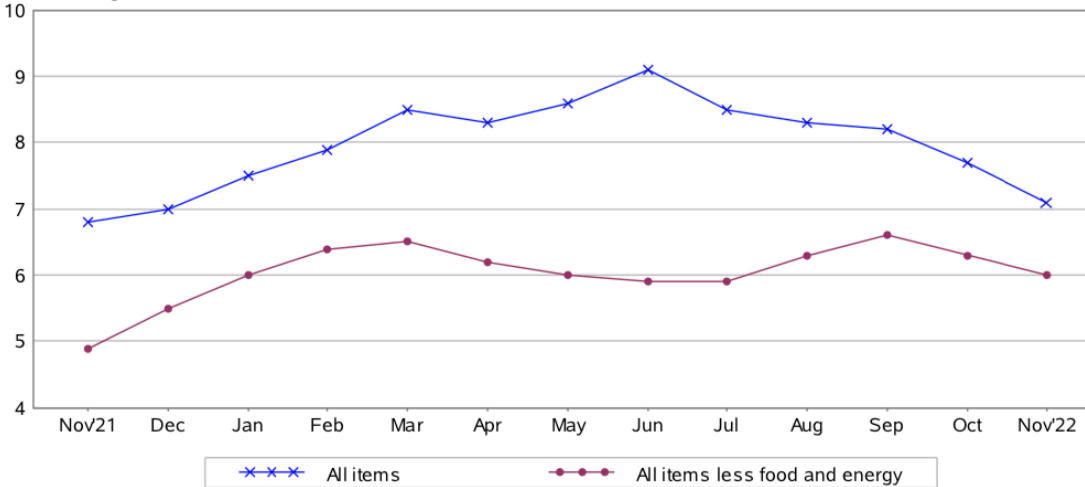
Inflation looks to have peaked, following the post-Covid surge.

Inflation

CPI – headline and core

Chart 2. 12-month percent change in CPI for All Urban Consumers (CPI-U), not seasonally adjusted, Nov. 2021 - Nov. 2022

Percent change



Up +7.1% y/y
in November.

Up +6.0% y/y
in November.

Table A. Percent changes in CPI for All Urban Consumers (CPI-U): U.S. city average

	Seasonally adjusted changes from preceding month							Un- adjusted 12-mos. ended Nov. 2022
	May 2022	Jun. 2022	Jul. 2022	Aug. 2022	Sep. 2022	Oct. 2022	Nov. 2022	
All items.....	1.0	1.3	0.0	0.1	0.4	0.4	0.1	7.1
Food.....	1.2	1.0	1.1	0.8	0.8	0.6	0.5	10.6
Food at home.....	1.4	1.0	1.3	0.7	0.7	0.4	0.5	12.0
Food away from home ¹	0.7	0.9	0.7	0.9	0.9	0.9	0.5	8.5
Energy.....	3.9	7.5	-4.6	-5.0	-2.1	1.8	-1.6	13.1
Energy commodities.....	4.5	10.4	-7.6	-10.1	-4.7	4.4	-2.0	12.2
Gasoline (all types).....	4.1	11.2	-7.7	-10.6	-4.9	4.0	-2.0	10.1
Fuel oil ¹	16.9	-1.2	-11.0	-5.9	-2.7	19.8	1.7	65.7
Energy services.....	3.0	3.5	0.1	2.1	1.1	-1.2	-1.1	14.2
Electricity.....	1.3	1.7	1.6	1.5	0.4	0.1	-0.2	13.7
Utility (piped) gas service.....	8.0	8.2	-3.6	3.5	2.9	-4.6	-3.5	15.5
All items less food and energy.....	0.6	0.7	0.3	0.6	0.6	0.3	0.2	6.0
Commodities less food and energy								
commodities.....	0.7	0.8	0.2	0.5	0.0	-0.4	-0.5	3.7
New vehicles.....	1.0	0.7	0.6	0.8	0.7	0.4	0.0	7.2
Used cars and trucks.....	1.8	1.6	-0.4	-0.1	-1.1	-2.4	-2.9	-3.3
Apparel.....	0.7	0.8	-0.1	0.2	-0.3	-0.7	0.2	3.6
Medical care commodities ¹	0.3	0.4	0.6	0.2	-0.1	0.0	0.2	3.1
Services less energy services.....	0.6	0.7	0.4	0.6	0.8	0.5	0.4	6.8
Shelter.....	0.6	0.6	0.5	0.7	0.7	0.8	0.6	7.1
Transportation services.....	1.3	2.1	-0.5	0.5	1.9	0.8	-0.1	14.2
Medical care services.....	0.4	0.7	0.4	0.8	1.0	-0.6	-0.7	4.4

¹ Not seasonally adjusted.

Source: BLS. Data through November 2022.

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What if Inflation Suddenly Dropped and No One Noticed

Maybe we should start the new year with some good news: Inflation has fallen dramatically.

No, that's not a prediction; it's a fact. With one month remaining in 2022 (in terms of available data), inflation in the second half of the year has run vastly lower than in the first half. In fact—and this is astonishing— it's almost back down to the Federal Reserve's 2% target. Even more astonishing, hardly anyone seems to have noticed.

As mentioned, the CPI inflation rate over the past 12 months has been an alarming 7.1%. But the U.S. economy got there by averaging an appalling 10.6% annualized inflation rate over the first seven months and a mere 2.5% over the last five. The PCE price index tells a similar story, though a somewhat less dramatic one. The 5.5% inflation rate over the past 12 months came from a 7.8% rate over the first seven months followed by a 2.4% rate over the last five.

Inflation

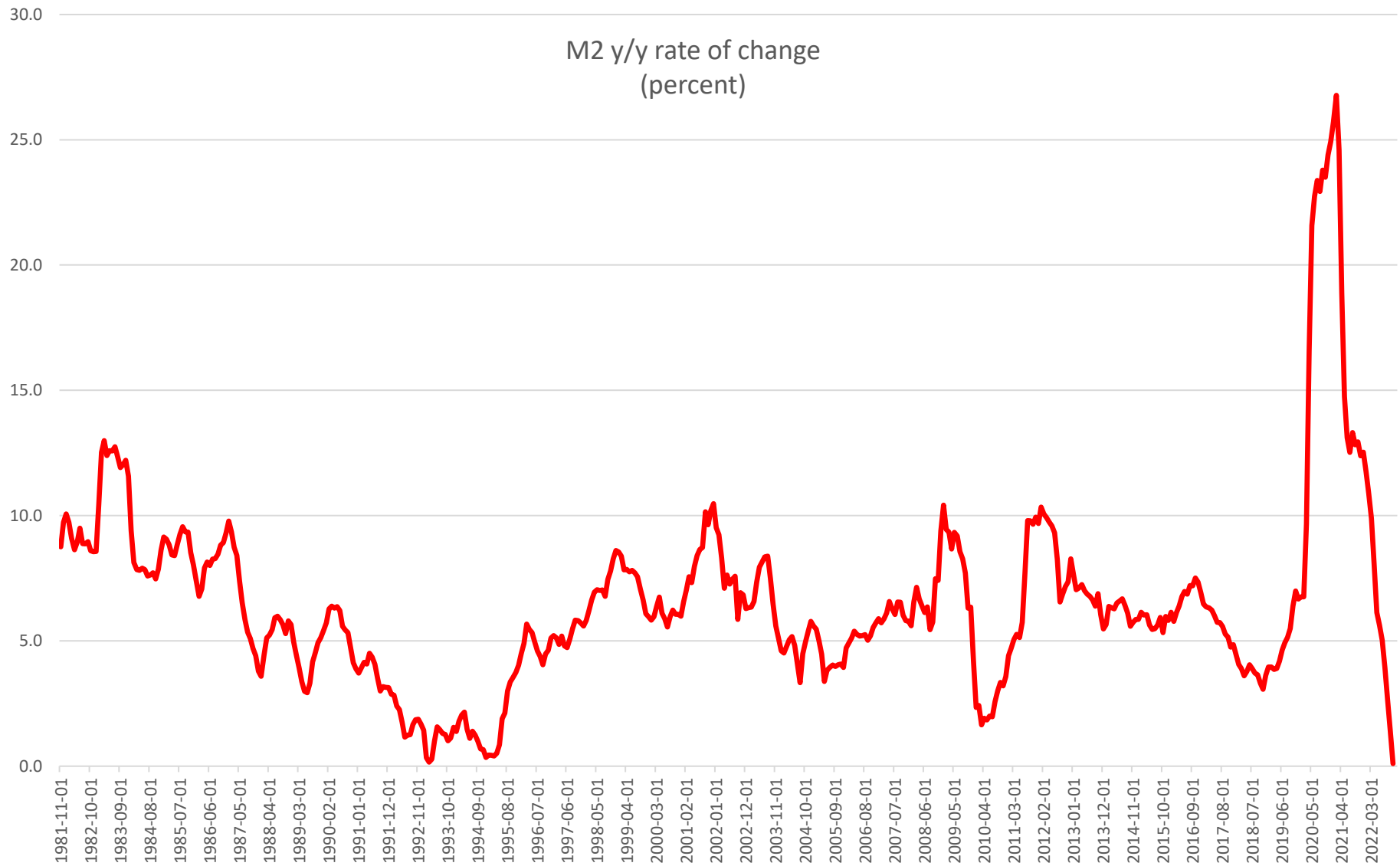
PCED – monthly rate of change annualized



Source: Federal Reserve Bank of St. Louis. Data through November 2022.

Federal Reserve policy

The money supply – y/y rate of change



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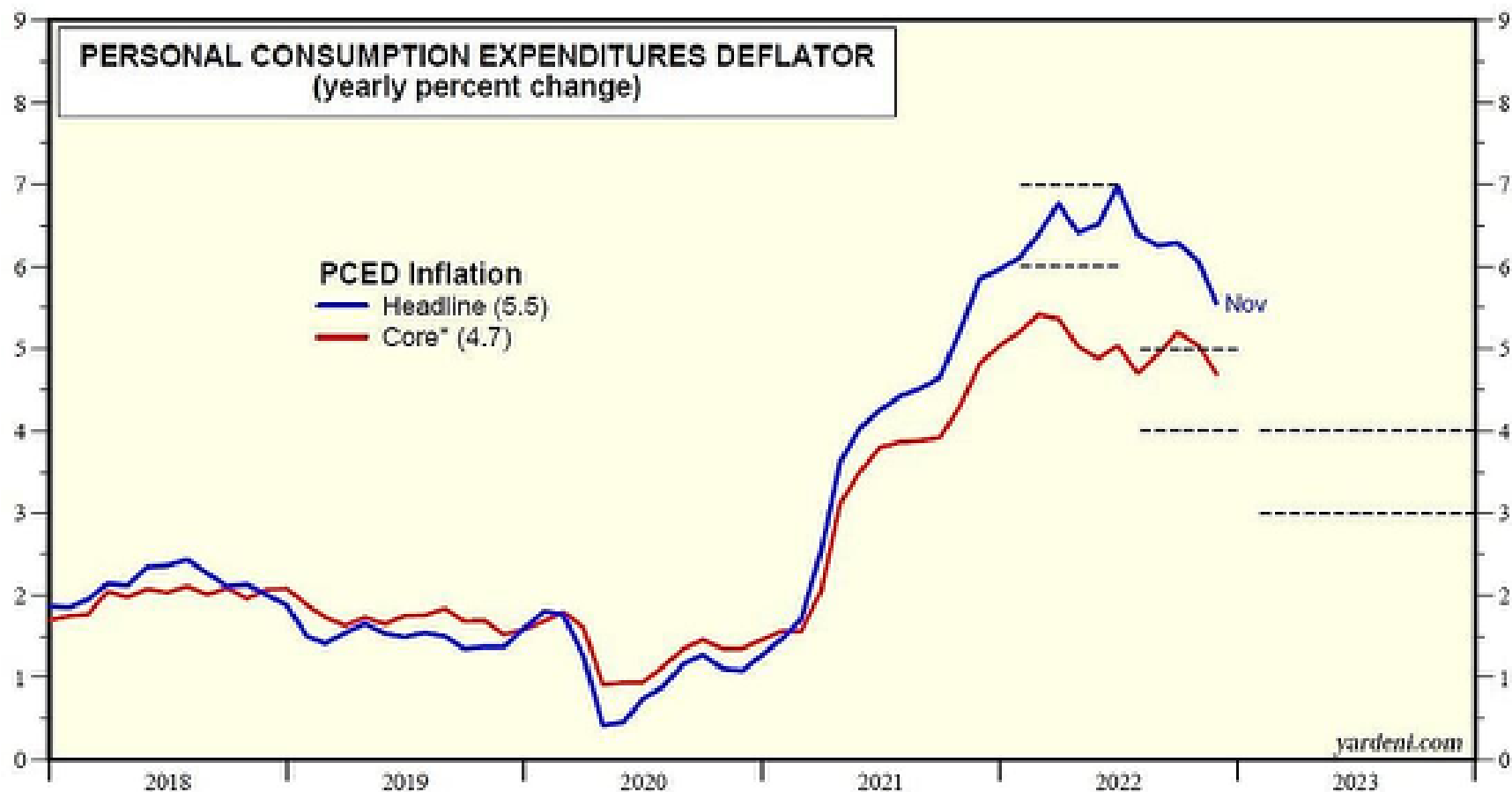
Why Inflation Is on the Way Down

Yet the relationship between money-supply growth, as measured by M2 and subsequent inflation has been statistically near-perfect in the pandemic era, with a 13-month lag. Year-over-year M2 growth began to accelerate during the pandemic recession in April 2020, and core inflation started to accelerate 13 months later, in May 2021. M2 growth peaked at a history making, off-the-charts 27% in February 2021, and core CPI peaked 13 months later, in March 2022. Both M2 growth and core CPI have been falling every month since their respective peaks.

Experience is proving, 40 years after Friedman taught Volcker, that inflation is still a monetary phenomenon.

If the relationship with inflation continues, core inflation will be at only 2.3% in 13 months, in June 2023.

Ed Yardeni's inflation forecast



* Excluding food & energy.

Note: Dashed ranges are YRI forecasts for headline PCED inflation rate.

Source: Bureau of Economic Analysis.

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JPMorgan Chase's decomposition of the CPI leads it to project headline inflation falling from 8.2% this past September to 3.2% next September. UBS, using a similar exercise, sees it hitting 2% by December of next year. Inflation-linked bonds and derivatives have reached a similar conclusion, projecting headline inflation of 2.9% a year from now, according to Intercontinental Exchange.

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Housing Costs Appear Poised to Ease

The end is in sight for one of the biggest sources of inflation. Surging housing costs helped keep inflation high this year but have likely already swung into reverse, economists say. The signal comes from private-sector indexes of rents on new leases, which tend to lead the consumer-price index measures by a little less than a year, said Alan Detmeister, economist at UBS.

“Last year we saw huge increases in these market rent measures in June, July and August, but they’re now coming in at or below their prepandemic pace,” he said. “That suggests we should now be past the peak for monthly CPI rent increases.” As a result, he predicted, inflation could be below the Federal Reserve’s 2% target by 2024.

Inflation

Inflation expectations

Inflation expectations

Median one-, three-, and five-year ahead expected inflation rate

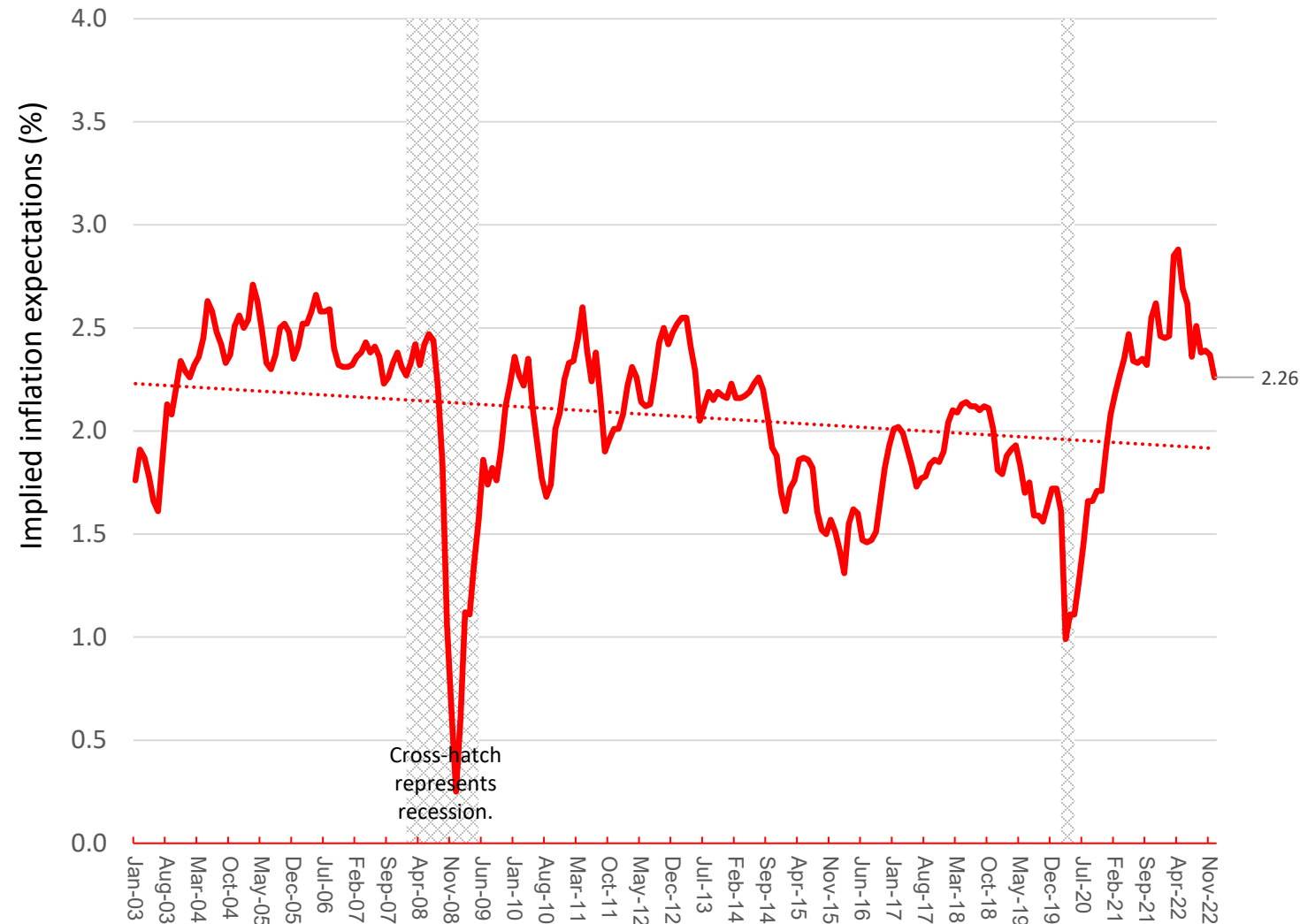


Consumers expect substantially moderating inflation.

Inflation

Inflation expectations

U.S. Treasury Bond Yield minus TIPS Yield
10-year Maturity



The difference between the nominal 10-year Treasury bond yield and the TIPS yield gives the market's opinion for a 10-year inflation forecast.

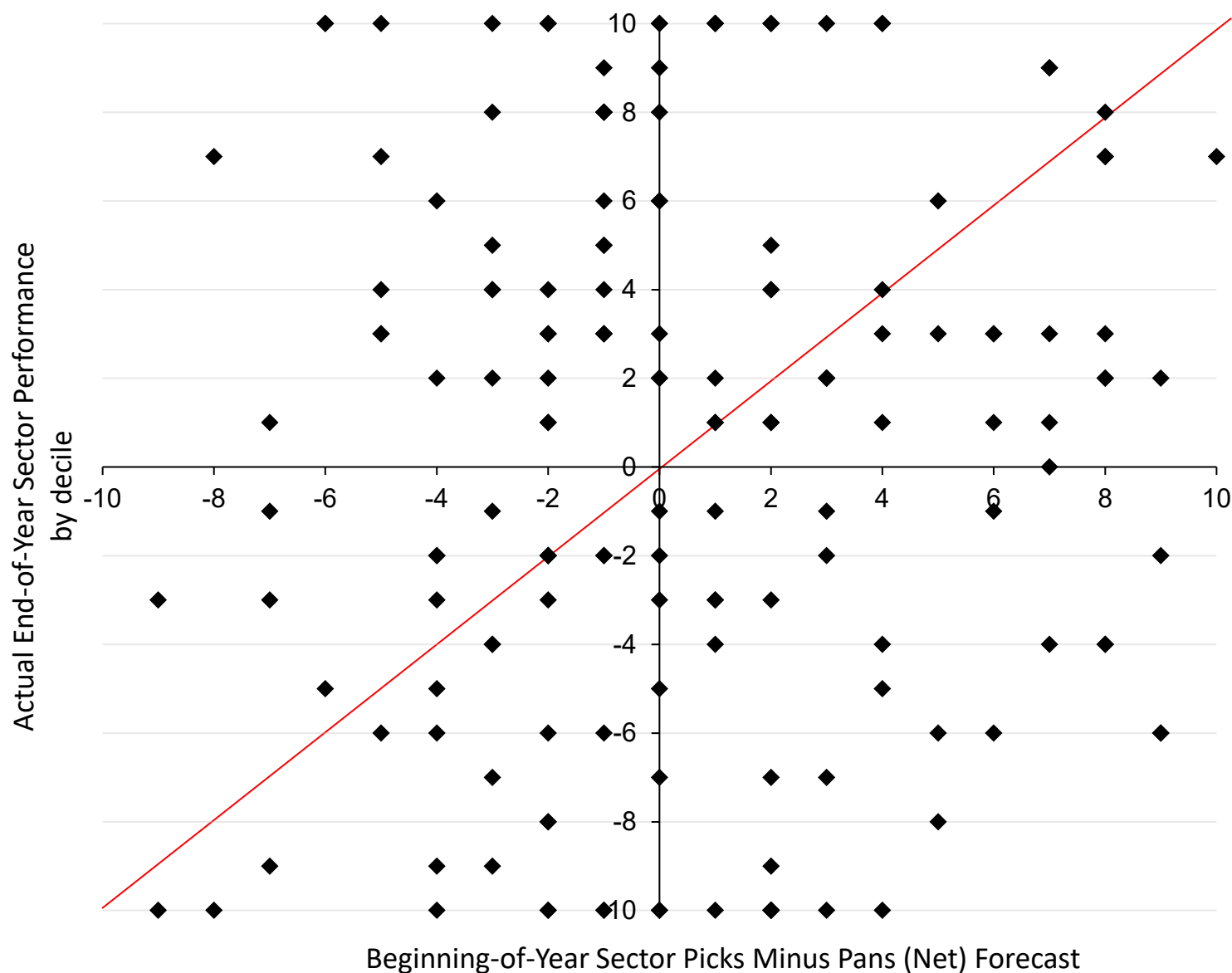
It had been trending lower for 15 years but has moved higher post-Covid.

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An Investor's Guide to Deflating Inflation Fears

Fortunately, the stock market overall has outpaced moderate rises in the cost of living. From 1927 through 2020, according to Dimensional, U.S. stocks as a whole outperformed inflation by an average of 4.9 percentage points annually in years when rises in the cost of living were above the median. If your stock portfolio is already well diversified, it should be able to keep pace with modestly rising prices.

Summary of Wall Street's sector calls 2007-2021



Strategists are no better than throwing darts.

If the strategists surveyed, collectively, were able to systematically give valuable sector picking advice, then these data points would lie along the indicated approximate 45-degree angle: sectors with high net picks would correspondingly perform relatively highly and sectors with negative net picks would perform relatively negatively. These data look pretty random.

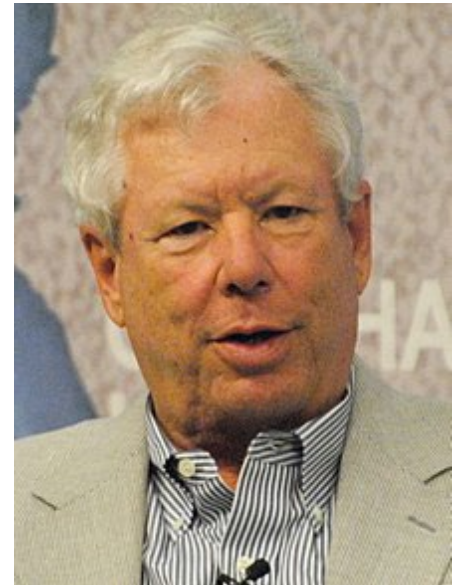
BARRON'S

Barron's: What investment opportunities should investors look for after the pandemic?

Richard Thaler: It's not knowable. That's exactly the sort of thing we pride ourselves in not doing – trying to forecast what the world is going to look like six months from now or a year from now. For individual investors, the best strategy is benign neglect. Create a sensible long-term portfolio, and then ignore it.

Barron's: What elements of behavioral economics do you find particularly relevant now?

Richard Thaler: ... Well, one of the interesting things we observed in the past six months is a big increase in retail investing at the level of individual securities.. My opinion is, for individual investors to be doing that is a fool's errand. The world has conspired to make them overconfident now because the market's been going up pretty steadily, and it has been going up fast in the segment of the market that retail investors have been most attracted to. So, it's very easy to think that you've figured this stuff out. If you think you've figured it out right now, think again.



Richard H. Thaler
Nobel prize winner for
behavioral economics

Modern Portfolio Theory = Asset Allocation

Modern portfolio theory was introduced by Harry Markowitz with his paper “Portfolio Selection,” which appeared in the 1952 *Journal of Finance*.

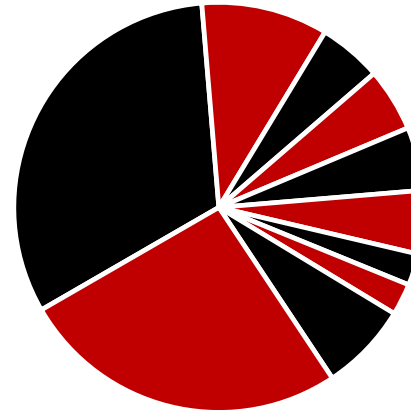
Thirty-eight years later, he shared a Nobel Prize with Merton Miller and William Sharpe for what has become a broad theory for portfolio selection.

Modern Portfolio Theory

Diversify

Optimize

Rebalance



Asset allocation and diversification do not guarantee a profit or eliminate the risk of loss.
Source: Riskglossary.com

Important Information

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The opinions expressed are those of the author, are based on current market conditions and are subject to change without notice.

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