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AN UPDATE FROM PAUL DIETRICH

U.S. ECONOMY NOW: GLASS HALF FULL OR HALF EMPTY

While Real Gross Domestic Product (GDP) increased by +2.1% in 2022 compared with an increase of +5.9% in 2021, investors should focus on something other than the GDP report from December that came out in January.

Why? Because that report shows what was going on in the 2022 rearview mirror. You have to remember that GDP is a Lagging Economic Indicator.

Many of the December economic reports showed more Leading Economic Indicators contracting and turning into recession territory.

The ISM Manufacturing and ISM Service indexes dropped into contraction territory, signaling a slowdown that we haven't seen since the aftermath of the 2008-2009 Recession.

Retail sales fell -1.1 % in December after a -1% decline in November. Industrial production fell -0.7% in December after a -0.6% decline in November. Medium & heavy truck sales are still respectable but dropped sharply in December, down -13.5%, the second fastest drop for any month in the past twenty years. Housing starts also declined.

The good news is that the labor market still seems strong. Initial claims for unemployment insurance are still very low. But the job market is also a Lagging Economic Indicator. Jobless claims are typically at or near a bottom very close to the peak in the change of business cycles from a bull market to a bear market/ recession.

Most economists and Wall Street analysts now believe a recession will arrive sometime in the second quarter of 2023. Given recent data, it would be no surprise if we're already in a recession and the economy shrinks in the first quarter and beyond.

Let's Look At The Other December Economic Reports:

Consumption: "Real" (inflation-adjusted) retail sales outside the auto sector declined at a -2.4% annual rate in Q4. However, sales of autos and light trucks grew at a +28% rate, and basic services, which comprise most of consumer spending, should be up at a solid pace. Consumer spending on goods and services increased at a moderate +2.3% rate.

Business Investment: Analysts estimate a +4.1% growth rate for business investment, with gains in equipment and intellectual property more than offsetting a decline in commercial construction.

Home Building: Residential construction is still absorbing the pain of much higher mortgage rates, and it looks like it fell at a -24% rate.

Trade: The trade deficit shrank slightly in Q4 2022, as exports declined slower than imports.

Inventories: Inventories grew faster in Q4 than in Q3. Look for slower inventories in 2023, which should significantly drag on economic growth this year. A large percentage of the Q4 GDP growth came from inventories (which means those inventories did not sell during the holidays).

An Earnings Recession Is Here

Anyone who has taken an Economics 101 course knows that the stock market can go up or down in the short term for almost any reason—or no reason. But over a considerable length of time, the stock market always follows the long-term directional trend of the underlying economy.

If the underlying economy is expanding and going up, the stock market will also go up. If the underlying economy is contracting and going down, the stock market will also be going down.

That is why investing in bear market rallies during a downward-trending stock market is a fool's game.

According to *Ned Davis Research*, over the past 100 years, the average decline of the S&P 500 Index has been -36%, which would be considered a mild recession.

Even though the S&P 500 lost about 20% in 2022, most analysts feel that the pain of declining earnings has not been fully priced into the stock market.

Earnings projections are being revised downward at the fastest rate since 2009 when the economy was recovering from that recession.

Other analysts have warned of an earnings recession in the first half of this year, tanking stocks by another -20% or more.

We saw the plunge in tech stock earnings and the drop in the NASDAQ. Unfortunately, the market has yet to fully price in the new earnings projections.

Not all sectors have had their share of revisions yet, as more resilient parts of the market last year—like energy stocks—are now beginning to waver as firms revise earnings estimates downward.

Many analysts estimate that earnings projections by companies are still about 20% too high.

History shows that stocks will likely drop as companies continue to give lower guidance in 2023.

Against this backdrop, earnings estimates have fallen for most of last year. Yet they're still too high, according to most strategists, who expect further cuts in response to the risks of a recession, margin pressure, oil transportation dislocation, the Russian war in Ukraine, and new corporate taxes next year.

Almost all of the data points toward slowing corporate activity across the board. Very few sectors now seem immune to the slowing.

This is why investors should not be buying into the current bear market rally ['a suckers rally'] that will be ending sometime soon. The January bear market rally has been fueled by enormous tax loss selling at the end of 2022 and the buying back of those same stocks in January 2023. That process is almost over.

The S&P 500 Index fell about -20% last year as investors reacted to tightening financial conditions and began to price in some upcoming earnings pain in 2023. There may also be other headwinds that have yet to be priced into the market, such as profit margin contraction, inflation, the effects of upcoming negative GDP growth, and companies struggling with debt burdens as interest rates rise.

Consumer Spending Is Also Impacting Earnings

Slowing consumer demand will significantly impact this coming earnings season as a harbinger of recession.

U.S. economic data shows consumers lost momentum in November and December amid higher interest rates and elevated inflation.

Americans are now tapping into savings and leaning more on credit cards, raising the question of whether they'll be able to continue driving economic growth through 2023.

Job Cuts

Earnings reports will also reflect further evidence of layoffs as companies react to the slowdown in economic growth. The phenomenon is most pronounced in the tech sector, where firms are cutting jobs at a pace nearing the early days of the pandemic, as evidenced by recent announcements from Amazon, Microsoft, and Google.

Meanwhile, Facebook owner Meta Platforms Inc., Apple Inc., and Alphabet Inc. are all slowing or pausing hiring, while Taiwan Semiconductor is bracing for weaker-than-expected sales by reducing spending.

In the banking sector, Goldman Sachs, Morgan Stanley, Credit Suisse, and Barclays have already fired staff or announced that they plan to do so soon.

McDonald's Corp. is slashing corporate jobs, the first restaurant chain in the U.S. to do so despite its relatively strong sales performance in recent years.

As companies try to 'right-size' themselves, it is essential to look at earnings estimates, which are likely to be a lot more negative than currently reflected in consensus estimates.

The Debt Limit Debate

When the Republicans had control of the House and the Senate and the Trump Administration, they ran up trillion-dollar-plus deficits each year they controlled the government. The Democrats did the same thing when they held all three branches of government.

They were all spending like 'drunken sailors.'

I apologize. I didn't mean to insult drunken sailors by comparing them to Congress.

Magically, these Congressmen have all become 'fiscal conservatives' now that they have to vote to raise the debt ceiling, which is required by law.

The debate over the U.S. national debt is heating up after the federal government hit its $31.4 trillion debt ceiling in January, prompting some to call for a balanced budget—a task that would require substantial spending cuts. According to an analysis by the nonpartisan Committee for a Responsible Federal Budget (CRFB), balancing the budget over the course of a decade would require a minimum 26% cut to ALL federal spending. That figure would rise to about 85% if lawmakers avoided politically challenging reductions to spending on defense, veterans, Medicare, and Social Security.

Balancing the budget would require nearly $15 trillion in tax increases or deficit reduction and savings over a decade, which would be impossible because of political resistance by both parties to spending cuts for their favored pet projects.

To implement the spending cuts required to balance the federal budget in 10 years without additional tax revenue, the CRFB found that it would require doing one of the following:

- Eliminating virtually all defense and non-defense discretionary spending;
- Cutting Medicaid spending in half while eliminating all other mandatory spending programs aside from Social Security and Medicare;
- Eliminating all non-defense discretionary spending while ending the Medicaid program;
- Repealing all Medicaid, all income security programs, and all refundable tax credits; or,
- Discontinuing all Social Security retirement and survivors' benefits.

The hypocrisy of it all is there are no Republicans or Democrats who would vote for the above package of budget cuts to balance the budget in 10 years. They would never get re-elected.

If you still think this can be done in Washington DC, in our lifetimes, you are obviously delusional.

How Will The Debt Ceiling Legislation Be Resolved?

Since 1950, the U.S. Congress has raised the debt ceiling 78 times.

The consequences of defaulting on all of the U.S. debt and trashing the full faith and credit of the United States Government would be a global disaster. This would throw the U.S. and the world economy into a major global depression. We wouldn't be able to pay our soldiers, government workers/pensions, Social Security, Medicare, your Treasury bonds in your retirement accounts, and all foreign debt. The U.S. dollar would no longer be the world's reserve currency, and oil and commodity markets would collapse—at least for a year or so.

The stock market would also crash.

Before the final vote must be taken in June 2023, the first act of this theatrical performance will be played out by our two heroes, Kevin McCarthy and Joe Biden. They will enact a 'game of chicken' worthy of the movie, *Rebel Without A Cause*. (Only baby boomers will know what I'm talking about here.)

In the movie, two characters, Jim and Buzz, hate each other and decide to prove who is better than the other through the 'game of chicken.' In this game, the two guys have to drive their cars straight toward a cliff, and whoever jumps out of their car first is deemed "chicken" and therefore is inferior to the other person.

The suspense is killing me! Who will win—Kevin or Joe?

This is a two-act play, so in the second act of this drama, when we find out who 'blinked first,' all of the 212 Democrats in Congress will vote to raise the debt ceiling. There are estimated to be at least 50 fiscally responsible Republicans who, in the end, will vote to save the United States from economic Armageddon. Only about seven Republican votes will actually be needed to pass the bill.

Inflation Is Coming Down As The Economy Slows Into Recession

At his recent press conference, Federal Reserve Chairman Jerome Powell stated that there would be one or two more rate increases of +0.25%. That would bring the terminal rate to 5% or above.

He also stated that the Fed would not be lowering rates in 2023 to ensure that inflation was coming down to their target rate of 2%. The current inflation rate is 6.5% —over three times the 2% target rate.

What If Inflation Stays High?

Stagflation is what many economists fear. This is where inflation remains higher than wage gains, and average citizens feel like their lives and retirement investments are going backward.

This happened for 10 years in the 1970s and early 1980s.

Fed Chairman Powell outlined his concerns at his recent news conference. He said that if inflation declines stopped before reaching the Fed's target rate of 2%, the Fed would have to keep the current rates higher for longer.

He explained that higher Fed rates had already slowed housing, mortgages, bank loans, and credit card debt. Those sectors always react quickly to rate increases.

However, over half the various elements that make up the Personal Consumption Expenditures Price Index (PCE), the Fed's preferred inflation index, have remained the same for over six months.

These include wages, which, once you award them to employees, are very difficult to lower in the future. While wage increases have slowed over the past two months, they are still going up and increasing inflation.

The other area is non-housing services, like banking and financial services. Since services are primarily about people, wages are a significant element of increasing prices.

Historically, people cut back on consumer goods before they stop spending on services they often need.

We could see a plateauing inflation rate in the 4.5% to 5% range. This would still be more than double the Fed's 2% target rate.

Where Are Prices Still Rising Fastest?

The Labor Department released the most recent consumer price index, a broad measure of the price of everyday goods, including gasoline, groceries, and rents. It climbed +6.5% on an annual basis.

While the Fed is pleased with the drop in consumer inflation, the rate remains too high, and inflation in the services sector continues to climb. Wage growth is slowing but still running at 5.1% year-over-year, but still not keeping up with the current inflation rate of 6.5%.

Here is a breakdown of where Americans see prices rising the fastest year-over-year:

Food

- Eggs +49%
- Coffee +14.6%
- Cereal +16.6%

Rent

In another concerning trend that will further squeeze U.S. households, shelter costs, which account for about 40% of the core inflation increase, climbed +7.1% over the past year, the fastest increase since 1982.

Another data point that measures how much homeowners would pay in equivalent rent if they had not bought their home climbed +7.5% year-over-year. Housing costs are likely to persist well into next year before easing.

Energy

- Gas +10.1%
- Fuel Oil +65.7%
- Utilities/Gas +15.5%

Cars

- Used Cars & Trucks -3.3%
- New Cars +7.8%

Travel and Transportation

- Airline Tickets +36%

The Leading Economic Indicators Continue To Drop

A key barometer for the economy's health continues to flash a recession warning sign, indicating a downturn in the U.S. shortly.

The Conference Board's *Leading Economic Index* declined for the 10th consecutive month, falling in December by -1%. According to the *Wall Street Journal*, most economists were expecting a decline of -0.7%.

On average, the index peaks about nine months to a year ahead of a recession, according to The Conference Board. The index peaked last February 2022.

"There was widespread weakness among leading indicators in December, indicating deteriorating conditions for labor markets, manufacturing, housing construction, and financial markets in the months ahead," said Ataman Ozyildirim, The Conference Board's senior director of economics.

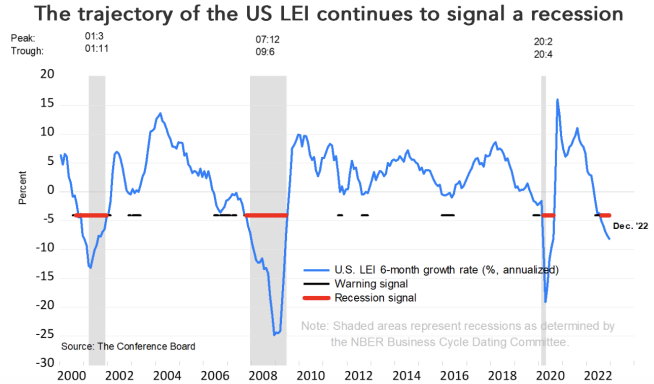
Seven of the index's 10 components declined in December, and the trajectory of the LEI continues to signal a recession, according to their report.

"Overall economic activity is likely to turn negative in the coming quarters before picking up again in the final quarter of 2023," Ozyildirim said.

The official arbiter of a recession is a panel of National Bureau of Economic Research economists, who take an array of economic indicators into consideration before making a determination — which can sometimes occur after a recession has already begun.

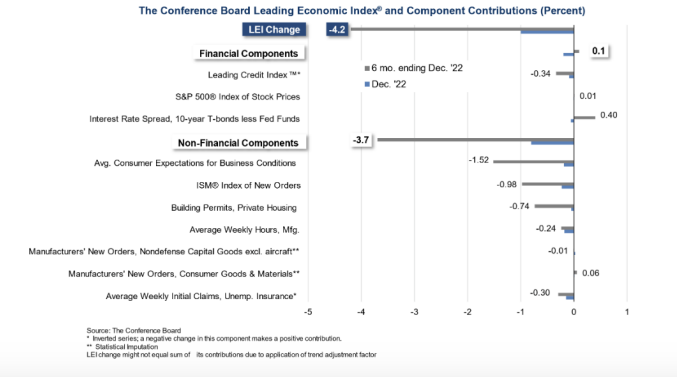
Below is The Conference Board's *U.S. Composite of Leading Economic Indicators*. It is signaling a recession, and it continues to decline.

The trajectory of the US LEI continues to signal a recession

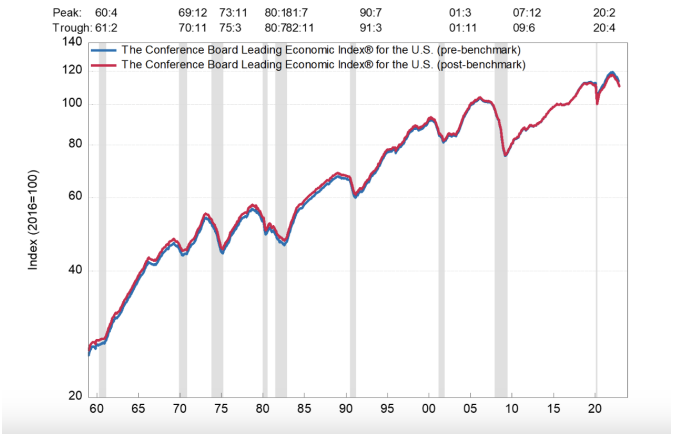


In the next chart, you can clearly see that most of the LEI components continue to contribute negatively to the Composite.

The majority of components continue to contribute negatively to the US LEI



The following chart shows how the LEI Index has declined before every recession since the 1960s, providing an early warning system for recessions.



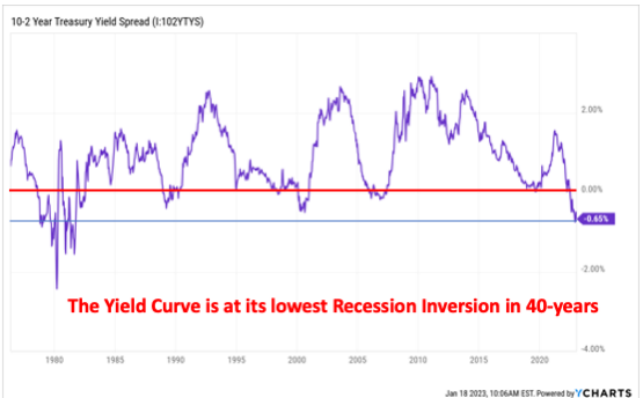
As A Leading Economic Indicator, The Yield Curve Also Has An Almost Perfect Record In Predicting Recessions

As further confirmation of an impending recession, the yield curve is a leading indicator with a near-perfect track record in predicting recessions long before they happen.

Investors watch for an inverted yield curve using the 10-year Treasury bond yield against the 2-year Treasury bond yield. The inversion of this indicator has forecast the past six recessions.

The one-year chart of the 10-year and 2-year Yield Curve as of February 1, 2023, is clearly in negative recession territory. The Yield Curve is also at its lowest inversion point in 40 years.

You can see in the chart below that the Yield Curve is now below '0' and is giving an inverted recession signal stronger than any recession since 1981-1982.



The Leading Economic Indicators Will Show Us When The Next Bull Market Is Starting

I will continue to update and publish this table in all upcoming monthly *Market Commentaries*.

The table below provides current data on the two significant composites of U.S. leading economic indicators and their composite indicator components. I've included a column to show the trailing 12-month directional trends and whether each is currently declining, plateauing, or recovering.

This updated monthly table will clearly show investors the long-term directional trends of the significant composites and individual indicator components of the leading economic indicators.

It can be your 'early warning system,' or GPS, to understand where we are currently in this bear market recession.

U.S. LEADING ECONOMIC INDICATORS (FEBRUARY 2023)

U.S. Leading Economic Indicators	Trailing 12-Month Directional Trend	Declining / Plateauing / Recovering
Conference Board Composite of Leading Economic Indicators	Recession Signal	Declining
ECRI Composite of Weekly Leading Index	Recession Signal	Declining
Major Leading Economic Indicator Components		
10 Year-3 Month Treasury Yield Spread	Directional Trend Down	Declining
US ISM Manufacturing New Orders Index	Directional Trend Down	Declining
US ISM Services New Orders Index	Directional Trend Down	Declining
S&P 500 Real Price	Directional Trend Down	Declining
US Index of Consumer Expectations	Directional Trend Down	Declining
US 4-Week Moving Average of Initial Claims for Unemployment Insurance	Directional Trend Down	Declining
US Consumer Goods New Orders	Directional Trend Down	Declining
US Construction Materials and Supplies New Orders	Directional Trend Sideways	Declining
US Manufacturing Average Weekly Hours	Directional Trend Down	Declining
US Manufacturing New Orders	Directional Trend Down	Declining
US Nondefense Capital Goods Excluding Aircraft New Orders MoM	Directional Trend Down	Declining
US Building Permits (SAAR)	Directional Trend Down	Declining
US Weekly Economic Index (NSA)	Directional Trend Down	Declining

Source: YCharts

On a personal note: As an investment manager, I have relied on this table through three previous recessions and will do so again in this upcoming fourth recession. It has never let me down.

I have been managing investment strategies for over 25 years and through three recessions, not counting the one that will start this year. I have benefited most from dispassionately focusing on data based not on the stock market but on the actual underlying U.S. and global economy. The data is what it is.

The good news is, at some point, when the U.S. leading economic indicators start to turn up again—as they always do—I expect that as I retire my defensive investment strategies and let my offensive strategies take the field once again, my investments will be worth more as the economy recovers and corporate America resumes another expansionary path.

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Paul Dietrich is focused on managing investments for private investors, retirement funds and private institutions throughout the United States. He also serves as an on-air commentator and contributes market analysis to business and financial media including *CNBC, Fox Business, Bloomberg TV, CNN, The Wall Street Journal, Yahoo! Finance, Reuters* and *The Washington Post.*

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