Market Commentary

by Chief Market Strategist
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What a Long, Strange Trip It Has Been – 2023 Market Outlook

It's been a tough year for investors. 2022 started with a Fed that pivoted from "Transitory" to "Tightening" and a war in Ukraine. Along the way, we have had: the highest inflation in four decades; double-digit losses in both stocks and bonds; interest rates rising rapidly; continued lockdowns in the world's second-biggest economy; and a slowdown in the housing market.

Add it all up, and at their worst points, total stock and bond market index funds were down nearly 25% and 17%, respectively. We've never seen a market environment like this where both stocks and bonds were down simultaneously.

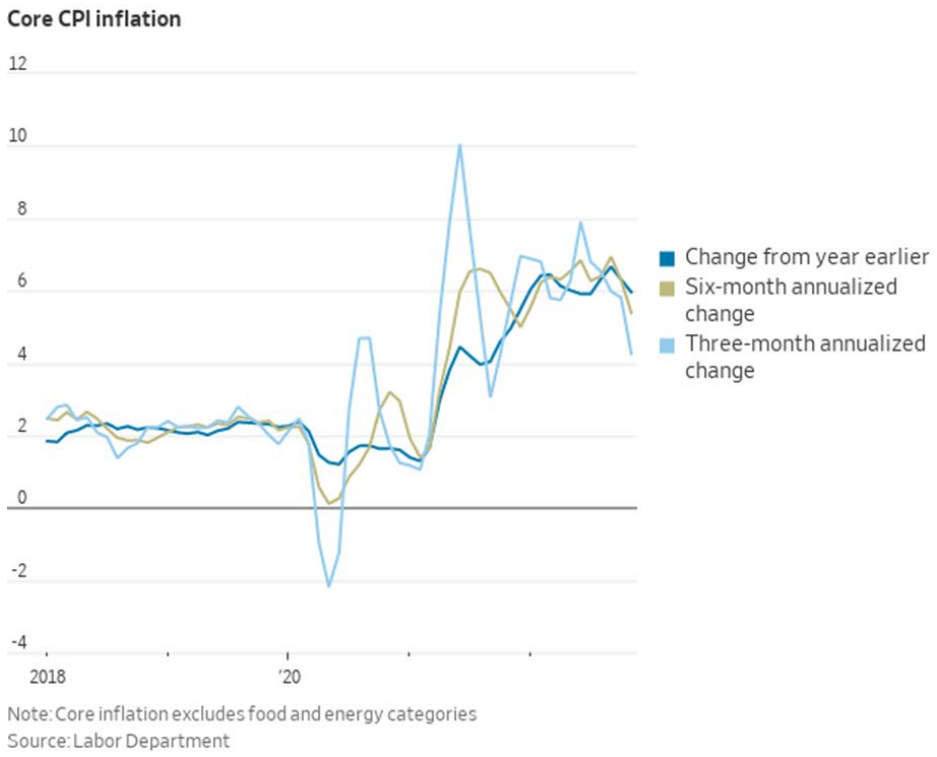
This year has been filled with ample volatility. We've had runs of down 12%, up 11%, down 20%, up 17%, down 17% from there, and now up almost 14% since mid-October.

The good news is that we will soon put the year in the rearview mirror. The bad news is that 2023 could be a bumpy ride, at least for the first few months. Weaker economic trends will likely form heading into 2023 as the Fed battles inflation, but a mild recession may help set stocks up for a better second half of the year.

The market has been in a tug-of-war between better-than-feared economic data juxtaposed with concerns about the potential for the Fed to over-tighten monetary policy and push the economy into a recession. That tug-of-war will likely continue in the first quarter of 2023 unless and until the Fed gets to their terminal Fed Funds rate.

We know that inflation is rolling over and is likely to continue. The Bureau of Labor Statistics CPI data showed consumer prices rose 7.1% in the year ending November, the lowest rate this year.

Using both three- and six-month annualized changes, shown below, it's clear that the inflation trend is heading lower for both the headline and core Consumer Price Indexes (CPI). Even the sticky shelter component of the CPI should begin to roll over—perhaps as early as the first quarter of 2023—since many real-time rental indexes (like those from Zillow, Real Page, etc.) have already decisively moved lower.

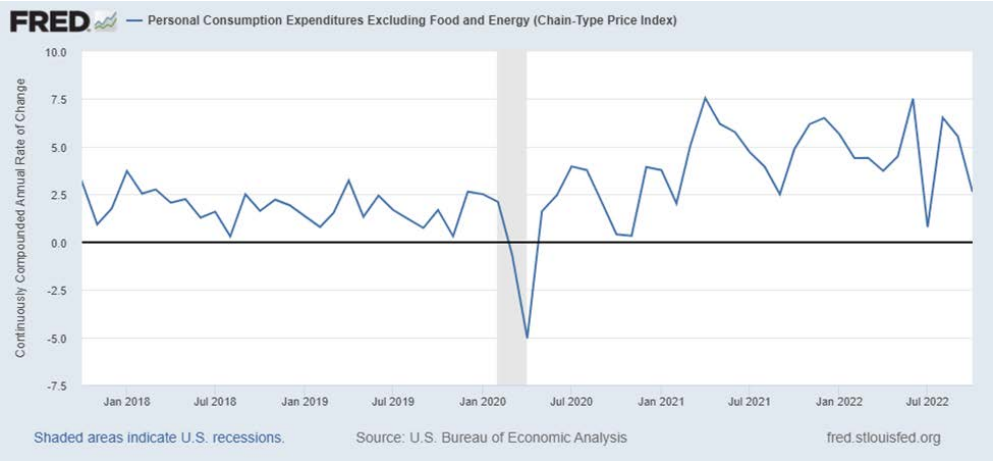


Potential Paths for YoY CPI Based on Constant MoM Changes

Month		Actual CPI YoY %	Fed Funds Rate (%)
Jun-21		*5.39*	*0.08*
Jul-21		*5.37*	*0.07*
Aug-21		*5.25*	*0.06*
Sep-21		*5.39*	*0.06*
Oct-21		*6.22*	*0.07*
Nov-21		*6.81*	*0.07*
Dec-21		*7.04*	*0.07*
Jan-22		*7.48*	*0.08*
Feb-22		*7.87*	*0.08*
Mar-22		*8.54*	*0.33*
Apr-22		*8.26*	*0.33*
May-22		*8.58*	*0.83*
Jun-22	*Peak CPI (so far):*	*9.06*	*1.58*
Jul-22		*8.52*	*2.32*
Aug-22		*8.26*	*2.32*
Sep-22		*8.20*	*3.08*
Oct-22		*7.70*	*3.83*

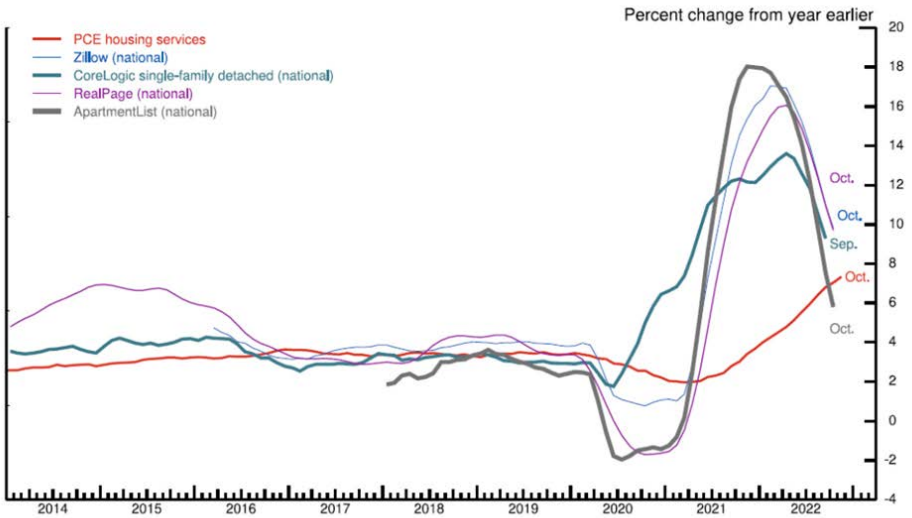
Future YoY CPI w/:	-0.1% MoM	0.0% MoM	0.1% MoM	0.2% MoM	0.3% MoM	0.4% MoM	0.5% MoM	0.6% MoM	0.7% MoM	Fed Fund Futures:
Nov-22	7.11	7.22	7.33	7.43	7.54	7.65	7.75	7.86	7.97	3.83
Dec-22	6.68	6.89	7.10	7.32	7.53	7.75	7.96	8.18	8.39	4.37
Jan-23	5.68	6.00	6.32	6.64	6.96	7.28	7.60	7.92	8.24	4.37
Feb-23	4.62	5.04	5.46	5.88	6.30	6.73	7.16	7.58	8.01	4.72
Mar-23	3.14	3.65	4.17	4.70	5.22	5.74	6.27	6.80	7.33	4.87
Apr-23	2.46	3.08	3.70	4.32	4.95	5.58	6.21	6.85	7.49	4.87
May-23	1.24	1.96	2.67	3.39	4.12	4.84	5.58	6.32	7.06	4.91
Jun-23	-0.23	0.57	1.38	2.19	3.01	3.84	4.67	5.50	6.35	4.90
Jul-23	-0.32	0.59	1.49	2.41	3.33	4.27	5.20	6.15	7.10	4.81
Aug-23	-0.38	0.62	1.63	2.65	3.68	4.72	5.77	6.82	7.89	4.81
Sep-23	-0.69	0.41	1.52	2.64	3.77	4.91	6.07	7.23	8.41	4.75
Oct-23	-1.19	0.00	1.21	2.43	3.66	4.91	6.17	7.44	8.73	4.75
Nov-23	-1.19	0.00	1.21	2.43	3.66	4.91	6.17	7.44	8.73	4.61

The Fed's preferred inflation indicator, Personal Consumption Expenditure Prices (PCE), was lower than expected. Core inflation, excluding food and energy, was only 2.6% at an annualized rate in October, far below its peak of 7.5% in June.



Encouragingly, inflation is moving down. The average rate of PCE core inflation from July to October was 3.9% versus 5.0% in the first half of this year. That step down owes largely to disruptions due to Covid easing, pent-up demand subsiding, and the end of fiscal stimulus. The full effect of the Fed's interest rate increases will be clear next year. In addition, the most recent, large declines in rental prices will show up next year in the official measures of housing costs, pushing inflation down considerably.

Figure 3. Market rents and PCE housing services inflation



Note: ApartmentList, CoreLogic, RealPage, and Zillow measure market rate rents -- that is, rents for a new lease by a new tenant. October PCE (personal consumption expenditures) data are estimates based on October data from the consumer price index. The Zillow data start in March 2016, and the ApartmentList data start in January 2018.

Source: ApartmentList; Bureau of Economic Analysis; Bureau of Labor Statistics; CoreLogic; RealPage; Zillow; staff estimates.

Inflation hit a 41-year high in mid-2022, but this is not a repeat of the persistent stagflation era of the 1970s. Among other numerous differences, during the lead-in to that era, government outlays had fueled a two-decade acceleration in the M2 money supply. In this cycle, there was only a short one-year surge in federal outlays and M2 growth. The Fed understands the distinctions; however, they have been clear in expressing a desire to avoid the fits and starts of monetary policy that characterized the era of the 1970s—which in turn fueled fits and starts of inflation.

The benign case is that the Fed can successfully bring inflation down to its symmetric 2% target without causing a significant deterioration in the unemployment rate and/or the economy more broadly. While the Fed still has more work to do, they have been able to wring a good deal of speculative excesses without crashing the financial system. Once valued at $3 trillion, the cryptocurrency market has shrunk by over two-thirds. Newly minted, disruptive technology stocks have tumbled by more than 50%, and red-hot housing prices are falling for the first time in 10 years. The full financial fallout from the Fed's inflation-fighting crusade may not be evident quite yet, as monetary policy works with long and variable lags, but so far, the progress has been more of a cooling down than a crash.

We believe that the Fed is overestimating the potential duration of inflation and under-estimating the underlying strength of the economy. If they remain truly data-dependent, we suspect the terminal rate will be seen as being too restrictive long before what has been laid out in the current Summary of Economic Projections. The Summary of Economic Projections, or SEP, represents all the FOMC participants' projections for four key economic indicators and the Federal Funds Rate. Examining the SEP opens a window into what the participants are thinking as well as how that thinking changes over time. It is important to remember that the "Dot Plot" is nothing more than a collection of the best guesses of the members of the FOMC and has not had a history of accuracy.

The U.S. treasury market yields also seem to disagree with the Fed's SEP as the yield on the two-year is down from a peak of 4.72% to 4.21%, while the 10-year yield peaked at 4.24% and currently sits at 3.47%.

> ***"The function of economic forecasting is to make astrology look respectable."***
> - John Kenneth Galbraith

The current consensus estimate for 2023 S&P 500 earnings is for growth of nearly 5%. However, that has been trimmed from nearly 10% last spring. We expect at least a quarter or two of negative year-over-year earnings, even including the Energy sector, before stabilization is possible. But we also expect the hit to earnings to be rolling in nature at the sector level.

Stocks have historically tended to bottom before earnings troughs. Keep an eye on PMIs, Housing, and the U.S. Dollar, as stabilization there would likely mean stabilization in forward earnings estimates.

Key to the outlook for the early part of 2023 is the Fed's stated goal of bringing down aggregate demand to meet supply with a restrictive policy that will slow the economy and bring inflation down sustainably. The Fed is finally leaving the 1970s and joining us in 2022. They are slowing down. That is crucial for a soft landing or a short and shallow recession. After four consecutive 75 basis point increases, the Fed raised by 50 basis points at their last meeting. The current consensus sees the Fed raising the Fed funds rate by 25 basis points at the February meeting and another 25 basis points in March. Where the Street differs from the "Dot Plot" is that the consensus sees a 25-basis point rate cut in the fourth quarter of 2023. See the data here. My view is that inflation will ease quicker than the Fed currently expects and that a pause in rate hikes should be considered.

Solid wage growth will provide income to buffer families, especially those with little savings when the full effect of the Fed rate hikes comes next year. Consumer spending is almost 70% of the U.S. economy; income is the biggest driver of spending, and the largest source of income is paychecks. Inflation is coming down, and workers are doing well.

Markets are a forward pricing mechanism and, as such, have done an efficient job of pricing in higher rates and a slower economy.

Sector Trends As of 12/7/22

			% Change				Trading Range			
Tickers	Name	Price	YTD	5-Day ↓	50-DMA	Trend	Current	OS	50-DMA	OB
XLE	Energy Select Sector	85.12	58.13	-6.62	-1.78		Neutral			
XLY	Cons. Discret. Sector	138.70	-31.76	-5.11	-2.21		Neutral			
XLF	Financial Select Sector	34.59	-10.16	-4.74	3.16		Neutral			
XLK	Technology Sector	129.60	-24.95	-4.68	2.51		Neutral			
XLC	Comm. Svcs Sector	49.40	-35.95	-4.10	0.44		Neutral			
XLRE	Real Estate Sector	38.10	-24.78	-2.91	3.99		Neutral			
XLI	Industrial Sector	99.30	-4.99	-2.38	6.30		Neutral			
XLB	Materials Select Sector	81.19	-8.95	-1.89	7.58		Overbought			
XLP	Consumer Staples Sector	76.07	0.46	-1.45	5.98		Overbought			
XLU	Utilities Select Sector	70.74	0.93	-0.97	5.63		Overbought			
XLV	Health Care Sector	138.52	-0.57	-0.36	6.13		Overbought			

We have likely seen peak inflation, peak Fed hawkishness, and peak market pessimism. When the shoeshine person, or more appropriately, the Uber driver, has changed from pitching you a hot new stock to warning about the coming recession, it has most certainly been largely factored into prices.

While we see more choppiness in markets in the first quarter, we see markets settling into a slow grind higher after that. The Fed will have reached its terminal Fed funds rate in 1Q, and investors can start reacting to incoming data without the lens of what better news will mean for Monetary Policy. Good news for the economy can become good news for markets.

We see a path to S&P 500 earnings of $230 for 2023. Using a trailing-12-month multiple of 18.5 times gets us to a yearend target of 4300. We would favor investing in a barbell approach with one end of that focused on things that we need versus things that we want, at least in the first two quarters of 2023. That would include Energy, Staples (at a reasonable price), and Health Care. On the other end of that barbell look for well-priced growth companies that have balance sheet liquidity, strong free cash flow, a solid and defensible leadership role in their sector, and have experienced significant P/E multiple contraction.

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