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Economic and Market Outlook

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Light at the End of the Tunnel

Skepticism and pessimism aren't synonymous. Skepticism calls for pessimism when optimism is excessive. But it also calls for optimism when pessimism is excessive.

- *Howard Marks*

Section I. Introduction

Our quote comes from Howard Marks, a founder of Oaktree Capital and a 50 year veteran in the investment community. The quote once again talks to the cyclicality of markets.

When the stock market falls, as it has recently, people are convinced that it will continue to fall for an extended period of time and will never recover, so they want to get out. That is a fear driven response. To be a successful investor you need patience and a long term view. While the media loves to talk about the bear market and how horrible 2023 will be, history shows us that over time the stock market will invariably go higher in the long term.

While the S&P 500 is down about 20% this year, there are many individual stocks that are down 40% to 70% already. This has led many prognosticators to predict doom for 2023. The fact is, since 1928 the S&P 500 is up for the year 72% of the time and has only been down 2 years in a row 4 times. No one can pick the bottom, but we feel confident that it is time to be skeptical of the excessive pessimism. If you were to buy a security when it is down 70% and it then takes 10 years to recover to its previous high, you would get an annualized return of 15.78% (Down 50%, 7.18% annualized).

Section II. <u>Inflation</u>

The readings for inflation have begun to moderate. Currently the Consumer Price Index (CPI) is 7.1% on an annual basis, and core CPI, which excludes food and energy, is at 6.0%. Both readings are for November 2022. The CPI reading has leveled off and the core rate actually peaked a few months back at 6.4%. This is still well above the Federal Reserve's 2% target. The problem with all these measures of inflation is that they are backward looking or lagging indicators. The recent efforts by the Federal Reserve to reduce inflation by raising the Fed Funds Rate by 4.25% so far this year have not had enough time to ripple through the economy.

The year over year inflation numbers also do not show the recent slowdown in inflation. Chart #1 is the raw data for CPI. In reality, the CPI has only risen 0.5% from June to November. Remember that inflation is not about lower prices, but about stable prices. This stability should start to appear in the annual rate in about 5 months. It appears that the Fed's aggressive approach is already having some effect.

Housing contributes roughly one third to various inflation measures and tends to be one of the greatest lagging indicators, partly because of the method of calculation. Because of rising mortgage rates the housing market may be coming to a screeching halt. With a 30 year mortgage rate rising from 3% in March to over 6.5% today, the value of residential property is already cracking partly because the mortgage payment on a new mortgage has risen 70%. Chart #2 represents the Case-Shiller Home Price Index. It shows that while the growth rate of home value is still positive, the rate of growth has dropped more than 50% to 8.6% over the last year through October. Looking forward the loss of value trend should continue.

Chart #3 is the personal savings rate for the U.S. After averaging about 7% from 2000 to 2019, it peaked in April 2020 at 33.7%, right after the beginning of the Covid-19 lockdowns. The reading for November 2022 is down to 2.4%, indicating consumers have less discretionary money to spend. This should mean reduced demand causing inflation to ease, especially with consumers also pulling back spending because of recession fears.

Commodities were big contributors to inflation but that has changed. From their respective peaks in the last year and a half to the writing of this report, natural gas is down 49.9% (Peak 9.32, Current 4.67), crude oil is down 34.5% (119.78,78.5), lumber is down 73.0% (1464.00,396.00), copper is down 21.9% (4.89,3.82), wheat is down 38.6% (12.77,7.84) and beef is down 11.3% (22.19,19.70).

The "ease" with which goods move around the world continues to improve. Most of the inflation we are experiencing is a mismatch of supply and demand caused first by Covid-19 fears and lockdowns, then continuing supply chain issues and now the war in Ukraine. Factory shutdowns caused a shortage of semiconductors, food stuffs, lumber, etc. This shortage is easing and supply is slowly rising while demand is starting to pull back as consumers brace for a possible recession.

Wages continue to rise in an effort to lure people back into the workforce, as well as adjustments for increases in the minimum wage. These wage increases will not roll back and it is unsure how much further they will need to rise, but wage increases still trail inflation so it is not the problem that many believe. Wages tend to increase in order to keep up with inflation, as opposed to causing inflation.

Section III. The Federal Reserve and Interest Rates

Because of inflation, the financial media and the Fed have become more focused on interest rates. We have been spoiled by ultra-low rates during the pandemic.

The Federal Reserve has continued with their new monetary policy. Federal Reserve Chairman Jerome Powell raised the Fed Funds rate by 0.50% at the last meeting. This might be a sign that the Federal Reserve is finally starting to moderate their rate increases and not be so far behind the curve. They also have continued to let $95 billion in bonds roll off the Fed balance sheet each month, so far reducing the balance sheet about $500 billion. Both actions will tighten money supply which once again means lessening consumer demand.

One problem we have with the Fed's current path is the pace at which they have been raising rates. It takes time for interest rate hikes to have their full effect on the economy and inflation. The economy does not turn on a dime. Wharton School Professor of Finance Jeremy Siegel, a CNBC contributor, has the same opinion. He feels the Fed is making a big mistake by not waiting to see the current effects of rate hikes along with tightening liquidity from the balance sheet run off. He criticized the Fed for its inability to recognize that inflation is easing.

Rates in most European 10-year bonds are rising along with the U.S., but the U.S. 10-year bond remains more attractive to international investors. The U.K. 10-year yields 3.66%, German 10-year yields 2.51%, France 10-year yields 3.05%, Italian 10-year yields 4.63% and Swiss 10-year yields 1.59%. These compare to our 3.88% 10-year yield. Part of this rise is contributed to a combined central bank effort to fight inflation globally.

Section IV. <u>Recession</u>

There are many different indicators that analysts follow to predict a recession. We have our own model which will be discussed in the next section. First let's review a few others.

The definition of recession:

A period of temporary economic decline during which trade and industrial activity are reduced, generally identified by a fall in GDP in two successive quarters

We had negative GDP in the first two quarters of 2022 but in the third quarter the current estimate is 3.2%. It may mean we already got through a recession by this definition. The market is always forward looking so it may be realizing we are already in a recession and about to exit one.

Some analysts like to use the yield curve as a predictor of recession. This is because it helps us understand finances and bank activity which are the lifeblood of economic growth. The problem is most media pundits look at the 2-year to 10-year yield spread, which did invert about a month ago and is barely positive now. They should be looking at the 3-month to 10 year yield because that is more indicative of how banks lend. But even that spread is now negative. The 3-month Treasury is yielding 4.17% and the 10-year is yielding 3.88%. This is another indication that we may already be in recession and working our way out.

Another historic indicator is the price of copper, or "Dr. Copper" as it is sometimes referred to. Before every recession in the last 30 years copper has entered a bear market. Recall earlier in our report that from its peak copper dropped 32.5% by our calculations. Now it is only down 21.9% so this may be yet another indication that we are actually about to come out of recession. Copper is an important indicator because it is used across many industries. An increase in price indicates an increase in manufacturing demand.

Section V. <u>The Recession Model</u>

We just discussed 3 different historic indicators of recession that gave us interesting results. As we have discussed in past reports, earnings and the economy are the true long term influences on the stock market. Recessions, or fear of recessions, are the major reason we experience corrections of more than 10%. Corrections of less than 10% are just part of normal volatility and can happen multiple times each year.

The official arbiter of recessions in the U.S. is the National Bureau of Economic Research (NBER). They determine when our economy enters and exits recessions. The problem is that usually by the time they declare the official start date of the recession the economy is probably coming out or already done with that recession, in other words no predictive value.

At Clutinger, Williams & Verhoye we have developed what we view as a recession indicator which tracks 5 data sets on a monthly basis. If 3 of the 5 indicators are negative and the S&P 500 is below its 40 week moving average, it is a very strong indication that a recession is near or may already be underway.

Indicator number one compares the current monthly unemployment rate to its 12 month moving average. As of November, the unemployment rate was 3.7% and the 12 month moving average was 3.68%. By being above the moving average this indicator has turned negative.

Indicator number two is represented in Chart #4. This represents the year over year percentage change of Advance Real Retail and Food Service Sales. This is one method to measure the strength of the consumer. As you can see, the Covid-19 shut down had a major effect on this index in early 2020. Re-opening is also having a major effect. This indicator bottomed in April 2020 at -20.2% and had recent high of 45.2% in April 2021. Currently the reading is -0.6% for November, so this indicator is barely negative. Any reading above 0 is positive. The reading is also normalizing which should relieve some inflation pressure and it also reflects less money in consumer's pockets.

Indicator number three is represented in Chart #5. This shows the year over year change in Industrial Production. This indicator bottomed in April 2020 at -16.3%. This indicator is positive. It currently sits at 2.51% for November 2022. This number improving could help lower inflation. Higher production leads to greater supply.

For indicator number four (Chart #6), we look at Total Nonfarm Payrolls divided by the Civilian Labor Force Level on a year over year percentage change basis. This indicator stands at 1.81%. A zero reading represents neutral therefore this indicator is still positive.

Indicator number five (Chart #7) represents the Average Weekly Hours of Production and Nonsupervisory Employees-Manufacturing on a year over year percentage basis. Once again, this indicator bottomed back in April 2020 at -7.69%. Currently the reading is only -1.21%, so this indicator is negative and reflects how supply chain issues have caused a slight slowdown in the economy in the last few months.

Currently three of the five indicators are negative and the S&P 500 Index is 3.91% below its 40-week moving average in the recent correction. With the S&P 500 below its forty week moving average this model is giving its first recession warning sign. The market is possibly reflecting this fact since it is forward looking and pricing in a recession already. We will be closely monitoring these indicators in the coming months.

The above indicators are only updated on a monthly basis. To offset this situation we also track two other indicators. They are both indicators that are updated more frequently (on a weekly or daily basis) and we consider them as early recession indicators. Both are somewhat volatile so we track three month moving averages. These two indicators are separate and independent of the first five and either one can indicate the possibility of recession on its own.

The first one is the Aruoba-Diebold-Scotti Business Conditions Index which is updated on a daily basis and published by the Philadelphia Federal Reserve. The 91 day moving average is at -0.11 currently. The divining line for entering and exiting recessions is -0.8.

The second indicator for recessions is the Chicago Fed Business Activity Index. It is reported weekly and the divining line for entering recessions is -0.7. The three month moving average slightly weakened and sits at 0.09.

In summary, the two "early warning signs" are not predicting recession at this time, but have weakened somewhat in the last three months.

Section VI. Market Psychology

For decades we have measured market psychology using price and volume data in the short and long term from the Dow Jones Industrial Average as well as a 17 week moving average of advancing and declining stocks on the New York Stock Exchange.

Currently 7 of 12 of our price/volume indicators are negative, which is an improvement from our last report. This is reflective of the sideways market after the recent correction in the 20% range.

Our advance/decline line has recovered slightly to 48.4%, once again reflective of the recent sideways movement. Our model that measures the first and second derivative on price and volume has recently given us a buy signal. We have developed this model to recognize patterns and spot buy and sell signals from reviewing years of historical data.

The American Association of Individual Investors conducts a weekly survey to measure bullish and bearish sentiment. The bearish reading (those who think stocks will fall over the next six months) from the September 21st survey was 60.9%. This is only the fifth time since 1987 that the reading was above 60%, the last time being March 5, 2009 or the bottom of that bear market. The average return one year later for these five events for the S&P 500 was 33%.

Section VII. <u>The Economy</u>

Indexes that measure manufacturing data have weakened. The Philly Fed Manufacturing Index hit a nearly 50 year high in April 2021 with a reading of 50.2 (0 is the line for growth or contraction). The reading for December 2022 was -13.8. The Empire State Manufacturing Index hit a high in July 2021 of 43 (0). December's reading dropped 30 points from the previous month to -11.2. The national ISM manufacturing index fell to 49.0% in November and the ISM services index is at 56.5% (above 50 is considered growth, above 55 is considered exceptional growth). They also reflect the fact that we may already be in a recession.

Multiple Wall Street and Federal Reserve predictions for GDP have been lowered because of the war in Ukraine and inflation for 2022. GDPNow currently estimates GDP at 3.7% annualized for the fourth quarter. These economic indicators paint a bit of an opaque picture moving forward and are part of the indication to us that the market could be bottoming.

Section VIII. <u>Conclusion</u>

With the recent pessimism of higher interest rates, recession fears and predictions of another down year for stocks, we agree with Howard Marks that we should become skeptical of excessive pessimism. We also know the consensus opinion going into a new year is hardly ever right.

We have been cautious on the markets and feel they are now close to a bottom with the S&P down 22% for the year at this writing. Even if we are incorrect in the short term, purchases in the near future should prove very profitable in the years ahead based on the cyclical nature of the economy and the stock market.

Happy New Year!

Scott B. Williams, CFA, CFP
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United States Consumer Price Index (CPI)

CHART 1

The consumer price inflation rate in the US eased for a fifth straight month to 7.1 percent in November 2022, the lowest since December 2021 and below market expectations of 7.3 percent. Still, the latest reading remained well above the US Federal Reserve's 2 percent target. On a monthly basis, the non-seasonally adjusted CPI edged down 0.1 percent to 297.711 points, while the seasonally adjusted index was up 0.1 percent, the least in three months and also below consensus of 0.3 percent. source: U.S. Bureau of Labor Statistics

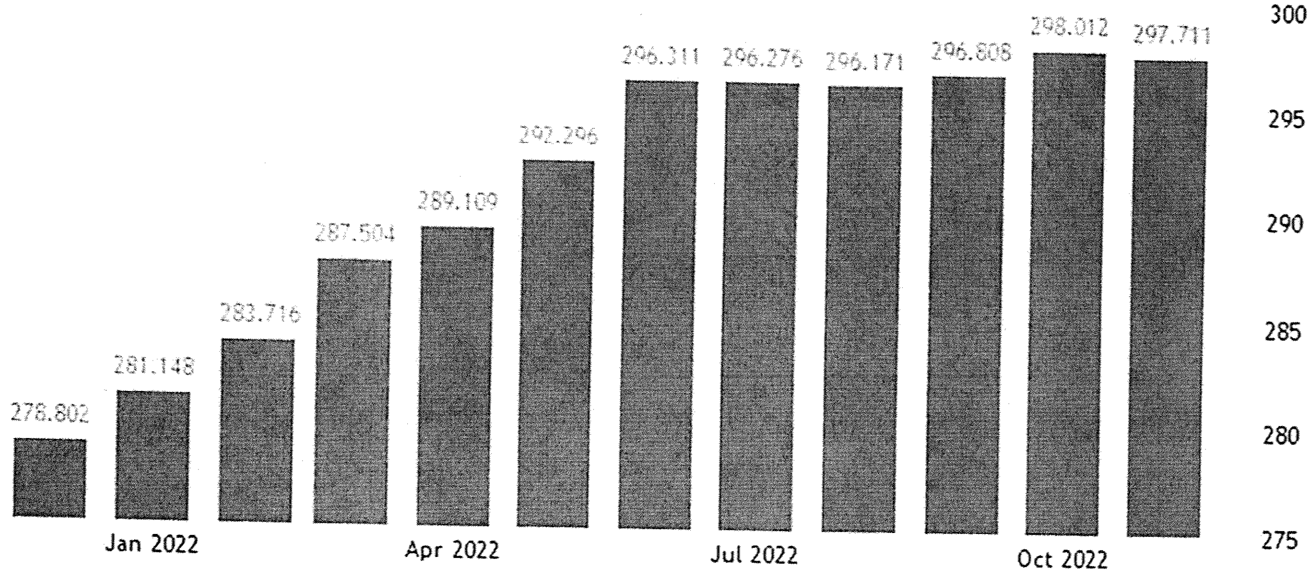
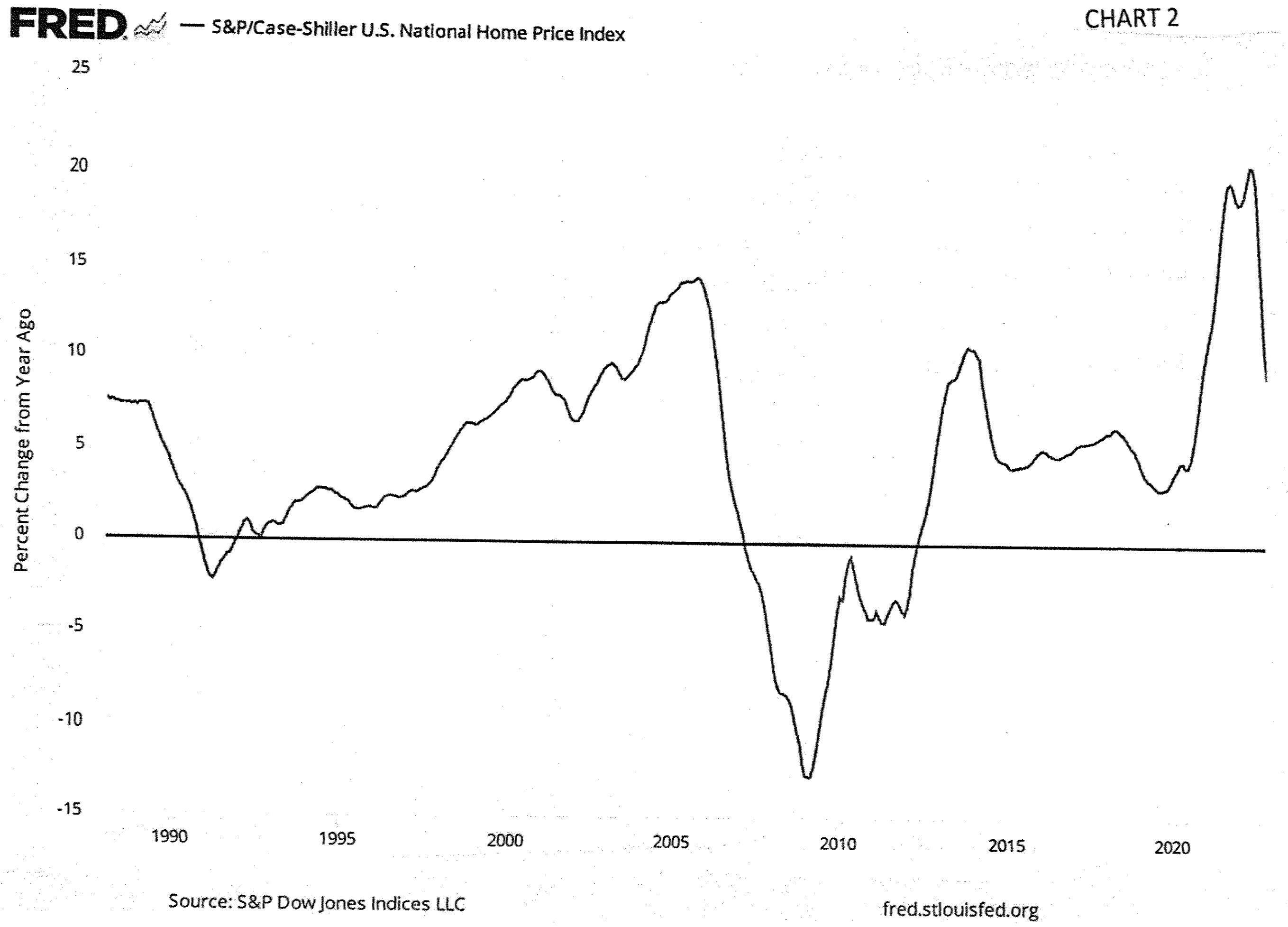


CHART 2



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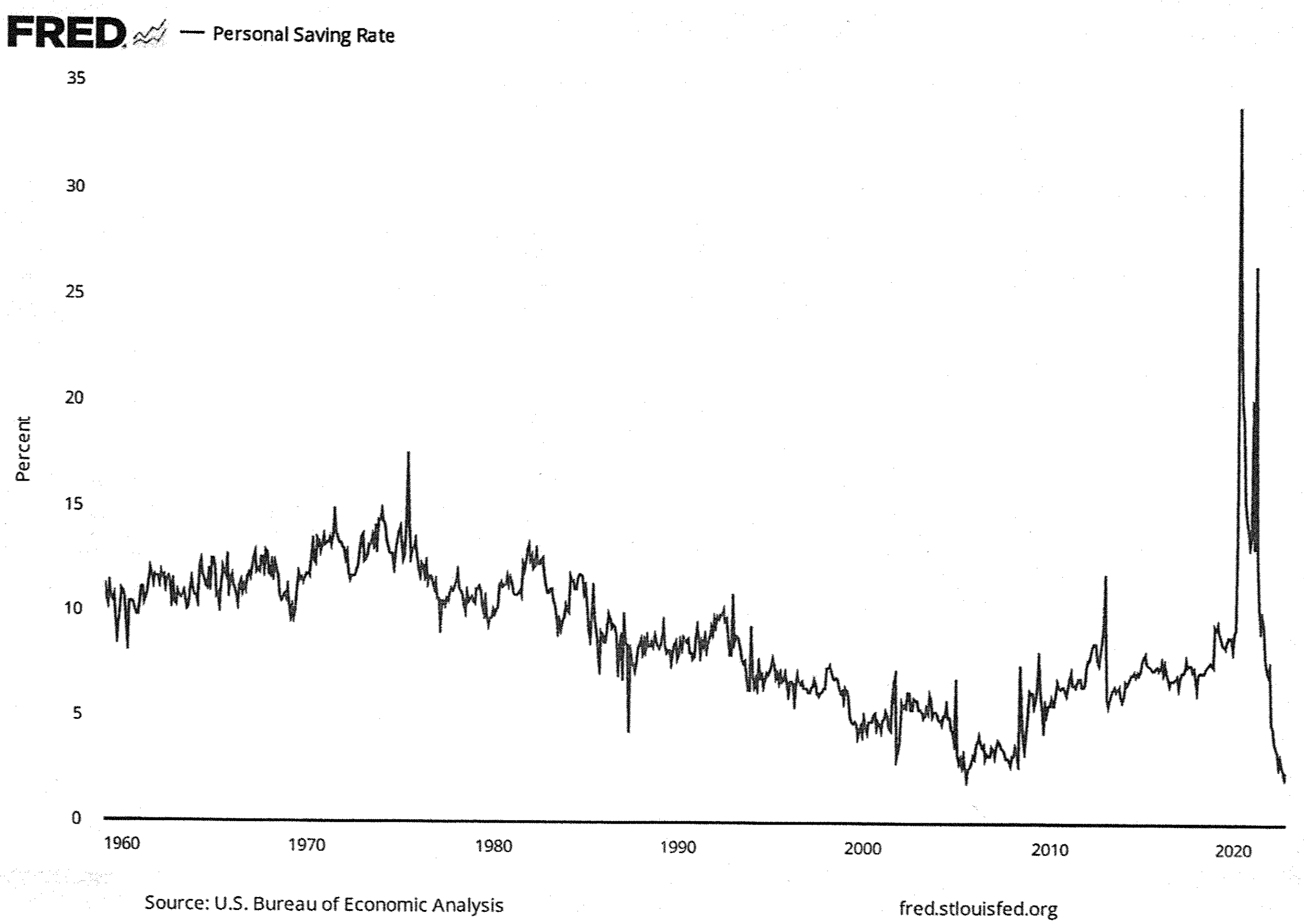

CHART 4

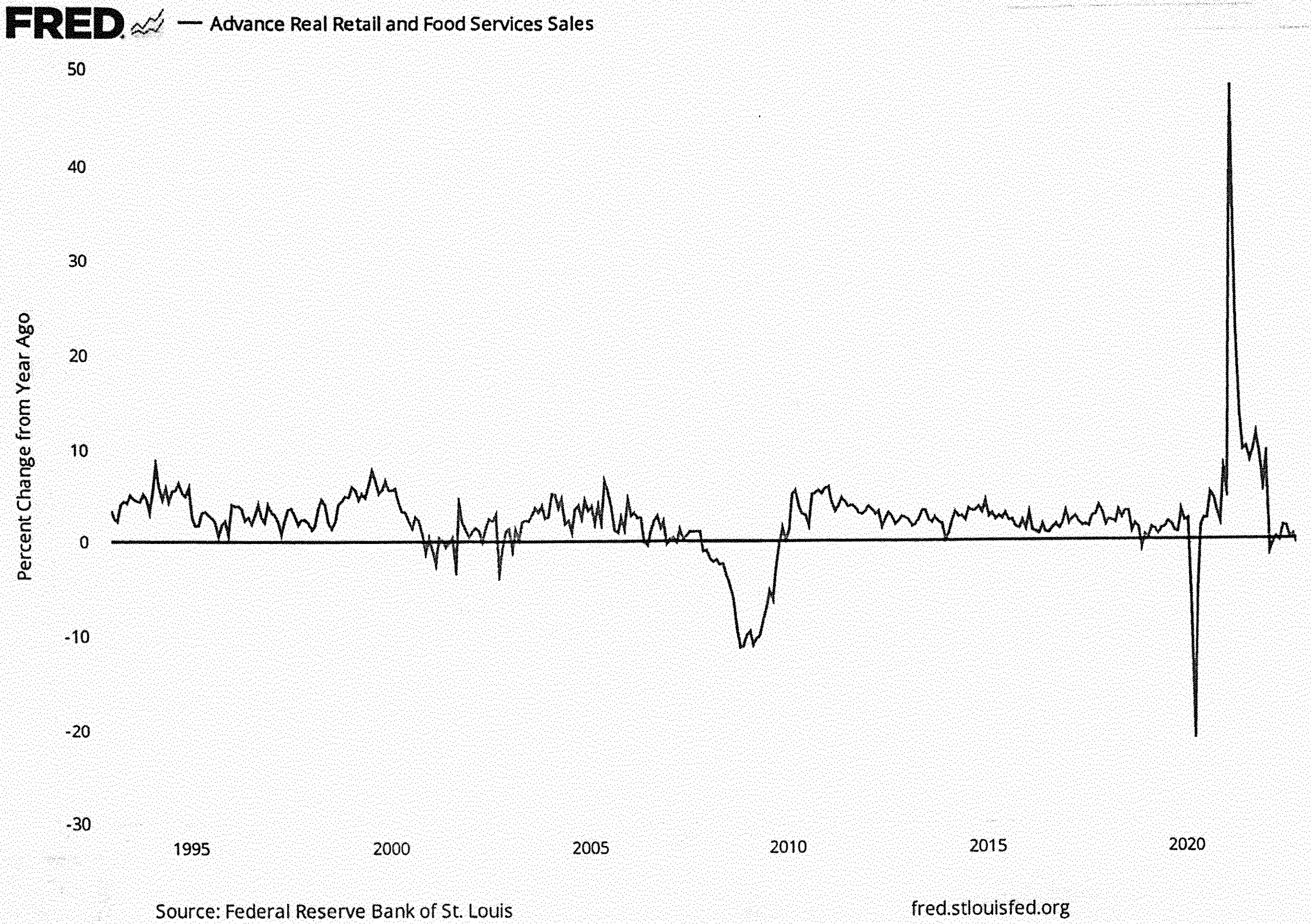

CHART 5

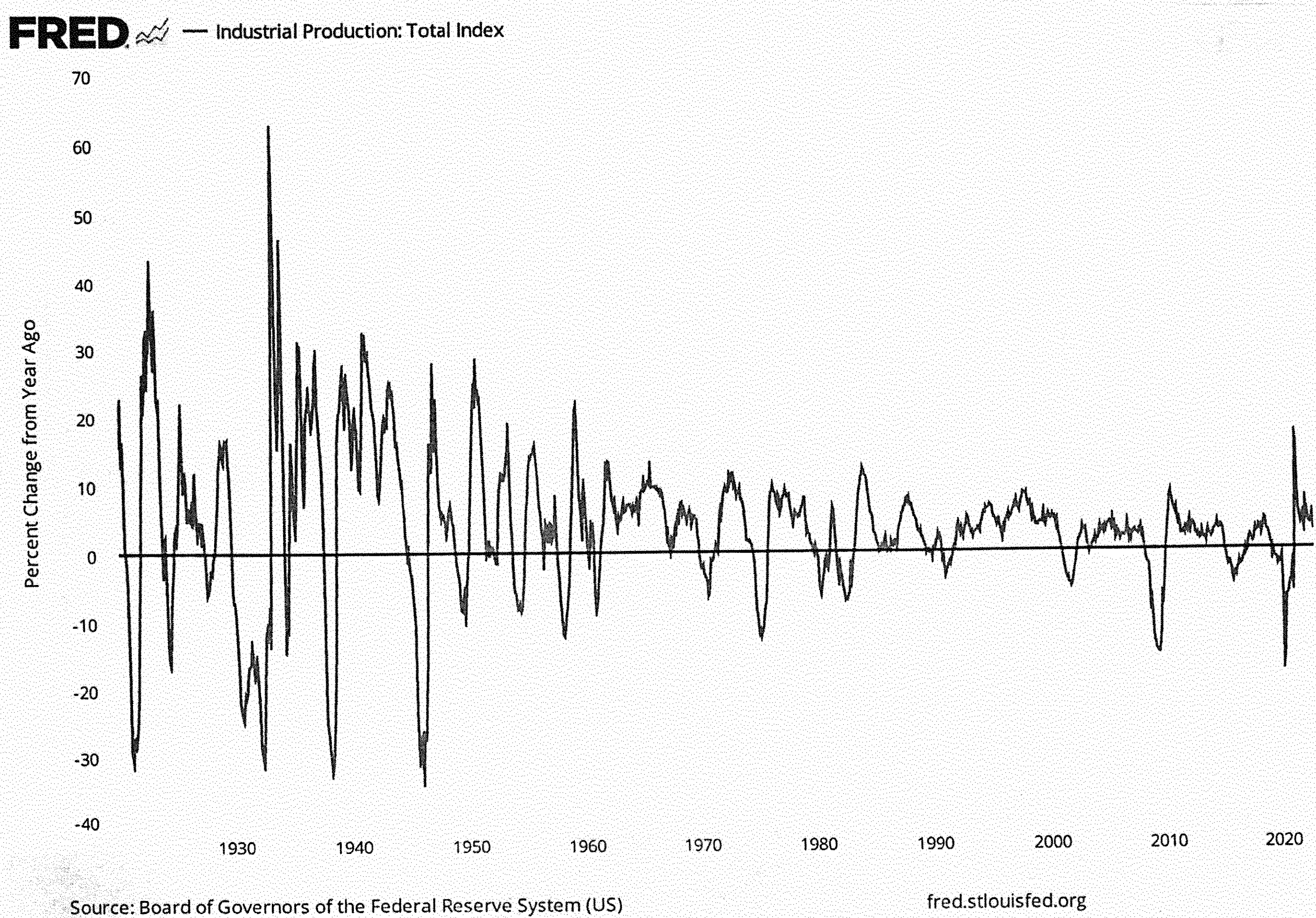

CHART 6

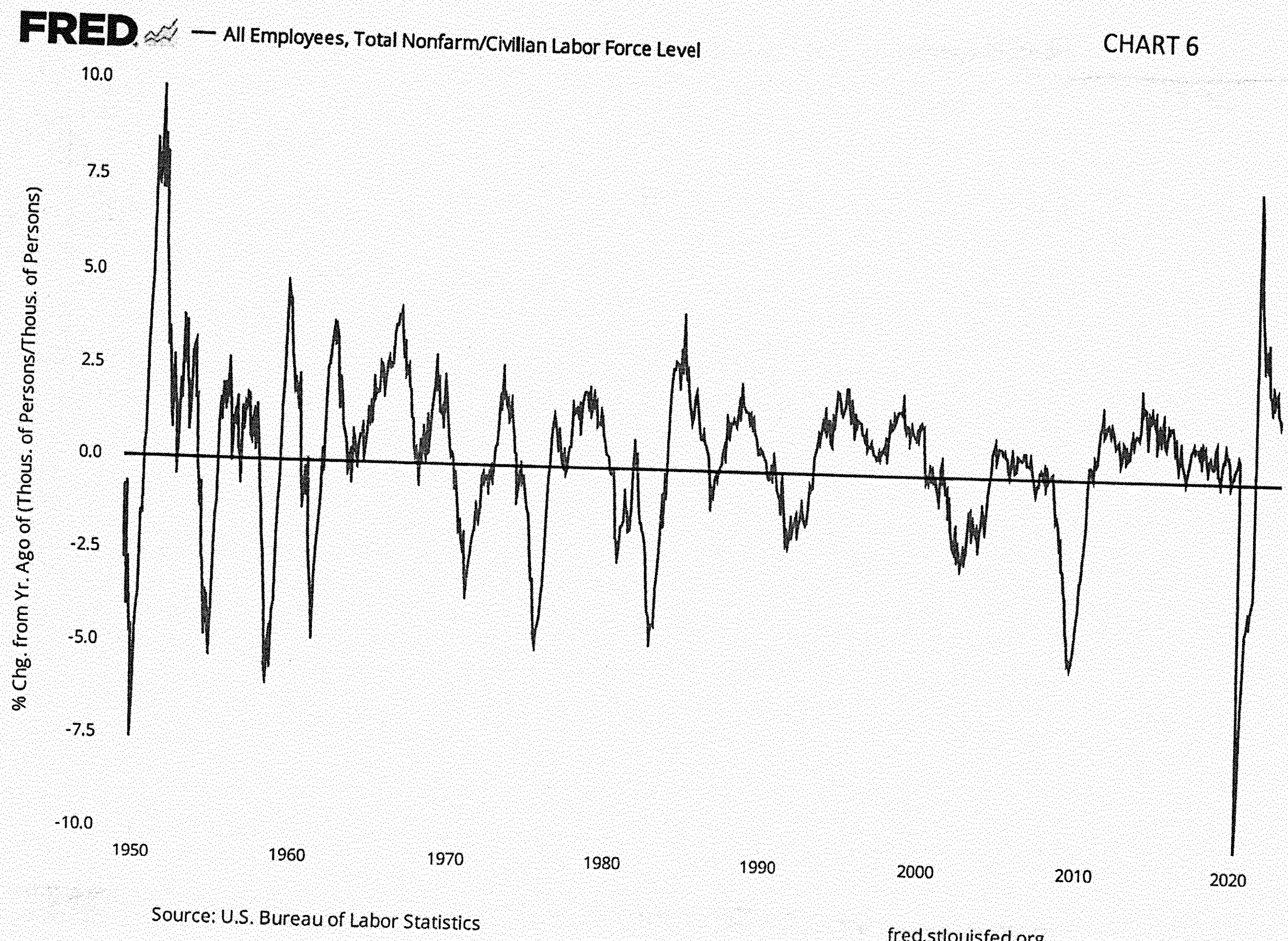

CHART 7