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Economic and Market Outlook

December 31st, 2023

The Sun Will Come Out Tomorrow

The best way to measure your investing success is not by whether you're beating the market but by whether you've put in place a financial plan and a behavior discipline that are likely to get you where you want to go.

-Benjamin Graham

Section I. Introduction

This quote from the father of Modern Investment Theory is making the same point we find ourselves reminding our clients occasionally. Our goal for our clients is to provide for a comfortable future while attempting to minimize risk as much as is appropriate. That situation is not the same for all because of various resources and demands on their assets. Rest assured that each and every one of your portfolios is managed with Mr. Graham's sentiment as our goal.

2023 has turned out to be a good year, as we expected. The S&P 500 is up 24% as of this writing, while the Dow Jones Industrial Average has risen 13%. In addition, the Equal-Weighted S&P 500 is up 11%. As we will discuss throughout this report, many of the indicators we follow pointed to a positive outcome for the year. We will also examine what the possibilities are for 2024.

Section II. The Developing Bull Market

Just like a bear market is defined by the S&P 500 (S&P) being down by 20% or more, the most basic definition of a bull market is an upward move of 20%. Since the lows of October 2022 through December 22nd, 2023, on a closing basis, the S&P was up 32.9%. In addition, the S&P rose above the previous intermediate high of last August.

Prognosticators continue to claim that we are experiencing a “bear market rally”. This is debunked now by the fact that the Dow Jones has hit a new all-time high, the sheer definition of a bull market.

Since 1950, after gaining 20% from the bottom, the S&P continued to rise over the next 12 months 92% of the time, with an average return of 19%. That doesn't mean the market went straight up. Corrections of less than 10% are part of normal volatility.

While the earlier run in the market was somewhat concentrated in a few tech stocks, we have started to witness broader participation. Remember that the S&P 500 is a market capitalization weighted index influenced by seven mega-cap stocks. This is why the S&P outperformed by 13% versus the equal-weighted S&P for the year. But for the fourth quarter, the S&P was up 10.88% quarter to date and the Equal-Weighted S&P was up 10.75%. Since the end of last month the Russell 2000, an index of mid-cap and small-cap stocks, is up 12.43%! These returns are an indication of broader participation in the markets.

Earnings, the mother's milk of stock prices, last quarter were better than feared and estimates for next quarter have risen in each of the first two months of this quarter. This would mark the second quarter in four with earnings growing instead of shrinking.

Artificial Intelligence (AI) has only benefited a few obvious stocks to this point. But the real benefit will be for non-tech companies becoming permanently more efficient because of AI, which would coincide with a broadening out of the stock market rally. AI promises to be the next great revolution for our economy. This will not happen overnight but will provide outstanding benefits over the long term.

Section III. Inflation

The readings for inflation continue to moderate. Currently the Consumer Price Index (CPI) is up 3.1% on an annual basis, and core CPI, which excludes food and energy, is up 4.0%. Both readings are for November 2023 and lower than in our last

report. The CPI reading has leveled off after peaking in June of last year at 9.1%. The core rate actually peaked in September at 6.6%. 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, especially housing, rent and used cars. The recent efforts by the Federal Reserve to reduce inflation by raising the Fed Funds Rate by 5.25% will continue to have a delayed effect on the economy.

The Federal Reserve prefers to use a measure called the Personal Consumption Expenditures (PCE) Price Index to gauge inflation. The reading for PCE in November was 2.6% and the core rate was 3.2%. In fact, if you annualize the last 6 months the core PCE is 2.0%. Inflation in the Euro Zone even decreased to 2.4% in November.

Remember that containing inflation is not about lower prices, but about stable prices. It appears that the Fed's aggressive approach is already having some effect. The normal lag for the effect of rate hikes is 12 to 24 months. Our first hike was last March, 20 months ago.

Wages are starting to moderate as job openings drop and adjustments for increases in the minimum wage start to moderate. Wage increases 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 IV. 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 to alter their previous monetary policy path of hiking interest rates. Federal Reserve Chairman Jerome Powell held rates steady for the third time in a row at their last meeting earlier this month, but stated the committee is still data dependent, and appeared to open the door for possible rate cuts in the future. This probably does mean the Federal Reserve is done with the rate hiking cycle, a bullish sign. They also will continue to let \$95 billion in bonds roll off the Fed balance sheet each month. Shrinking the Fed balance sheet will tighten money supply which once again means lessening consumer demand. This is reflected by the fact that growth in M2 money for August year over year is now -5.88% (Chart #1). Unfortunately, congress once again keeps kicking the can down the road for government funding.

One problem we have with the Fed's recent path is the pace at which they had 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. The rapid pace and size of the rate increases have partly contributed to the gap on some bank balance sheets, causing some concern regarding the stability of the regional banks. With rates now starting to drop that concern is lessening. We view the continued pause in recent months a positive sign that the Fed is starting to let previous hikes take their full effect.

Rates in most European 10-year bonds are pulling back along with the U.S., because of a slowing global economy. The U.S. 10-year bond still remains more attractive to international investors for its yield and AA+ credit rating. The U.K. 10-year yields 3.50% (AA), German 10-year yields 1.98% (AAA), France 10-year yields 2.48% (AA), Italian 10-year yields 3.56% (BBB) and Swiss 10-year yields 0.69% (AAA). These compare to our 3.90% 10-year yield.

Section V. The Recession Model

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 tend to 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 3.64%. By being above the moving average this indicator has stayed slightly negative.

Indicator number two is represented in Chart #2. 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. Currently the reading is 0.94% for

November, so this indicator is positive. Any reading above 0 is positive. The reading is also normalizing which should relieve some inflation pressure.

Indicator number three is represented in Chart #3. This shows the year over year change in Industrial Production. This indicator has turned slightly negative. It currently sits at -0.39% for November 2023. This is not surprising given the strong GDP number from the third quarter.

For indicator number four (Chart #4), 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 -0.45%. A zero reading represents neutral therefore this indicator is negative.

Indicator number five (Chart #5) represents the Average Weekly Hours of Production and Nonsupervisory Employees-Manufacturing on a year over year percentage basis. Currently the reading is -0.49%, so this indicator is negative but is unchanged from our last report. This reflects the continued fear of the long predicted recession but also allows for an easing of inflation.

Currently four of the five indicators are negative but the S&P 500 Index has surged to be 9.09% above its 40-week moving average as of December 22nd. With the S&P 500 above its forty week moving average this model is not giving it a recession warning sign. 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 has turned slightly negative and is at -0.28 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 remained relative steady at -0.14.

In summary, the two “early warning signs” are not predicting recession at this time. We still believe that in February 2023, when our indicators predicted recession, we may have already experienced the mild recession everyone keeps predicting.

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 10 of 12 of our price/volume indicators are positive, which reflects the recent rally. The S&P has returned to 4770 and is within a percentage point from its all-time high. But that doesn't necessarily mean the end of the rally. We were here before on December 31st, 2021, when the S&P closed at 4766. All we have done is make a round trip. The market usually goes higher after that type of pattern.

Our advance/decline line has been positive for the last few months and sits at 51.5%, and is reflecting strength in comparison to recent weeks.

Our technical model measures the first and second derivative of price and volume for the market. We have developed this model to recognize patterns and spot buy and sell signals from reviewing years of historical data. This model is also providing positive signs.

The S&P was up during the 2022 Santa Claus rally, the first five days of 2023 and the month of January. Since 1950, that trifecta occurred 31 times and the following full year returns averaged nearly 18% with a 90% win ratio. As mentioned earlier, in 2023 is up 24%. We will watch this development closely going into 2024.

Section VII. The Economy

Indexes that measure manufacturing data are mixed. The Philly Fed Manufacturing Index, after turning positive in August to 10.0, pulled back to -10.5 in December of 2023. The Empire State Manufacturing Index dropped to -14.5 versus a previous reading of 9.1 in November. The national ISM manufacturing index was 46.7% in November and the ISM services index was 52.7% (above 50 is considered growth, above 55 is considered exceptional growth). All these readings reflect a softening economy and the fact that the Fed may just pull off the goldilocks soft landing scenario.

Multiple Wall Street and Federal Reserve predictions for GDP have been lowered because of elevated interest rates in 2023. In fact many are calling for a negative GDP number. But GDPNow correctly predicted GDP at 4.9% annualized for the third quarter. Their estimate for the fourth quarter is 2.3%.

Section VIII. Conclusion

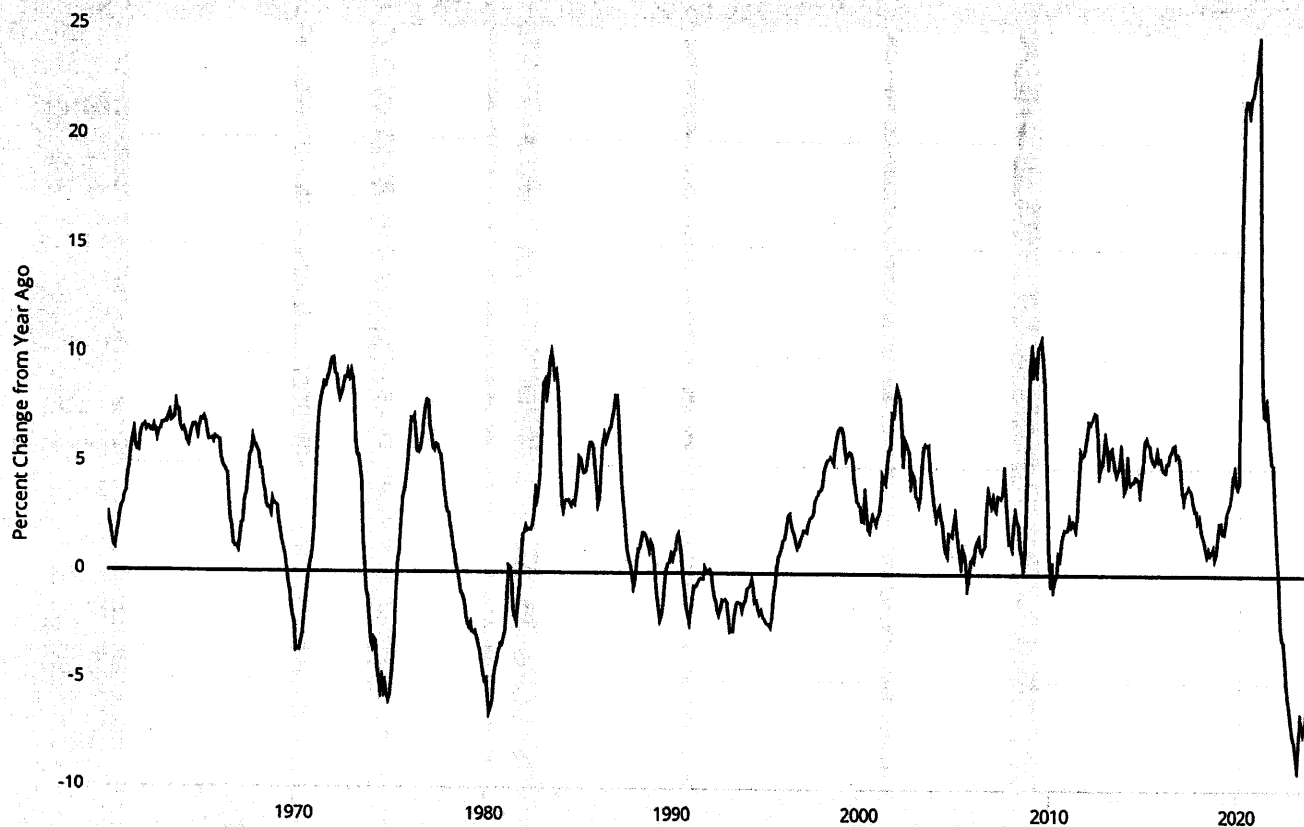
The fourth quarter was the exact opposite of the third quarter. We survived the worst two months of the year and benefited from patience in our investment themes and financial plans for the long term.

We continue to be optimistic entering the 2024. Please remember that in the short term there is always volatility and we would not be surprised by some profit taking by traders after the first of the year. But, in the long run, portfolios should continue to grow and provide for your long term goals,

Here is to a happy and prosperous New Year!

Scott B. Williams, CFA, CFP
Kent Edwin Stone

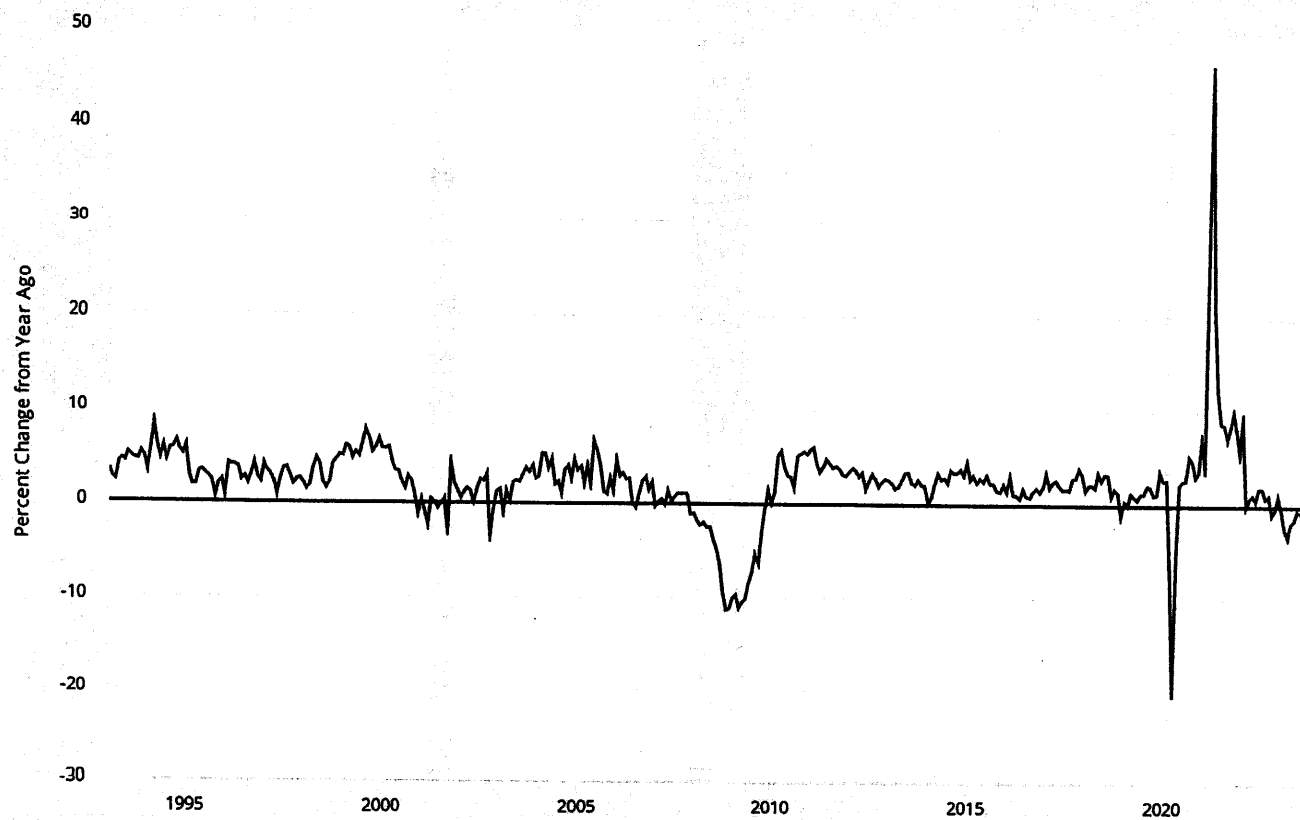
Chart 1

FRED — Real M2 Money Stock

Source: Federal Reserve Bank of St. Louis

fred.stlouisfed.org

Chart 2

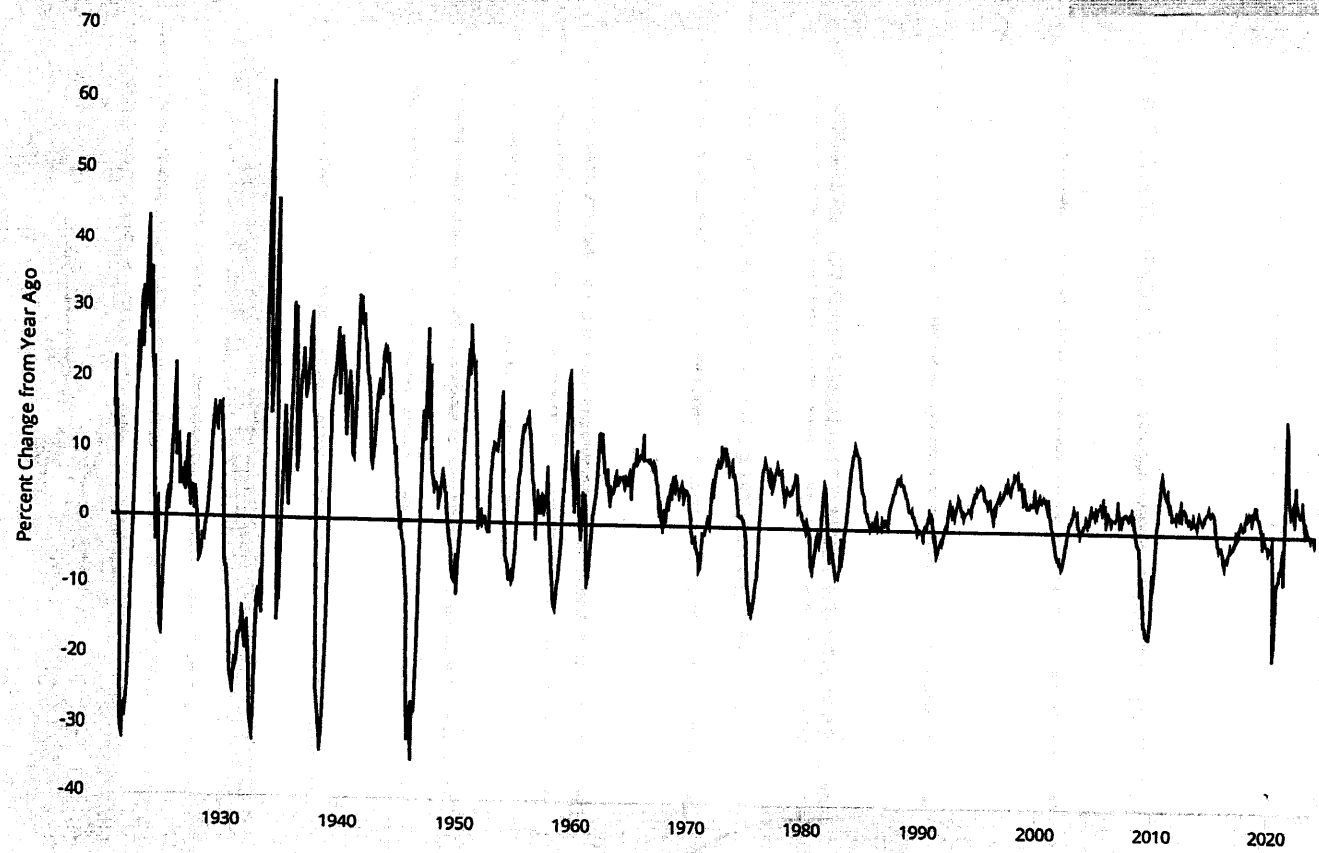
FRED — Advance Real Retail and Food Services Sales

Source: Federal Reserve Bank of St. Louis

fred.stlouisfed.org

Chart 3

FRED — Industrial Production: Total Index

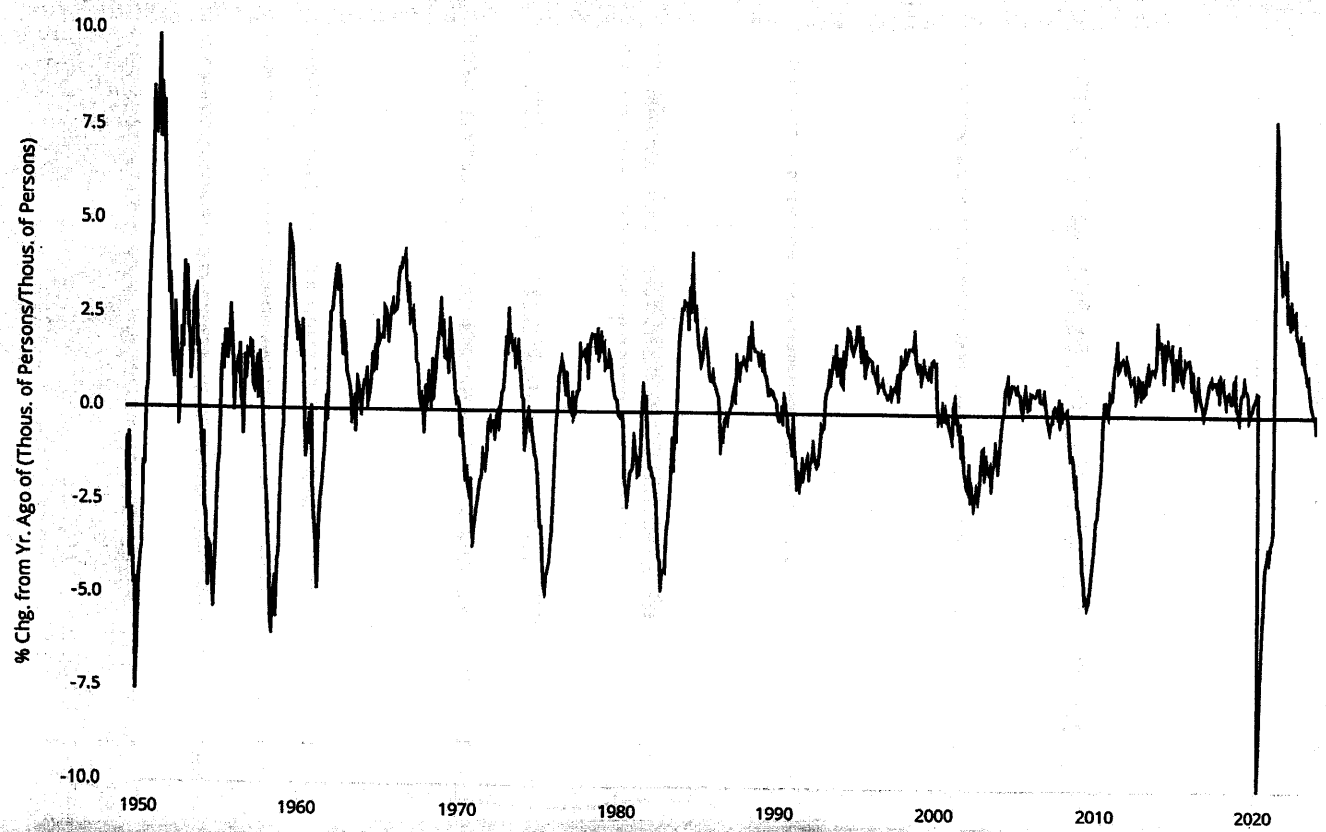


Source: Board of Governors of the Federal Reserve System (US)

fred.stlouisfed.org

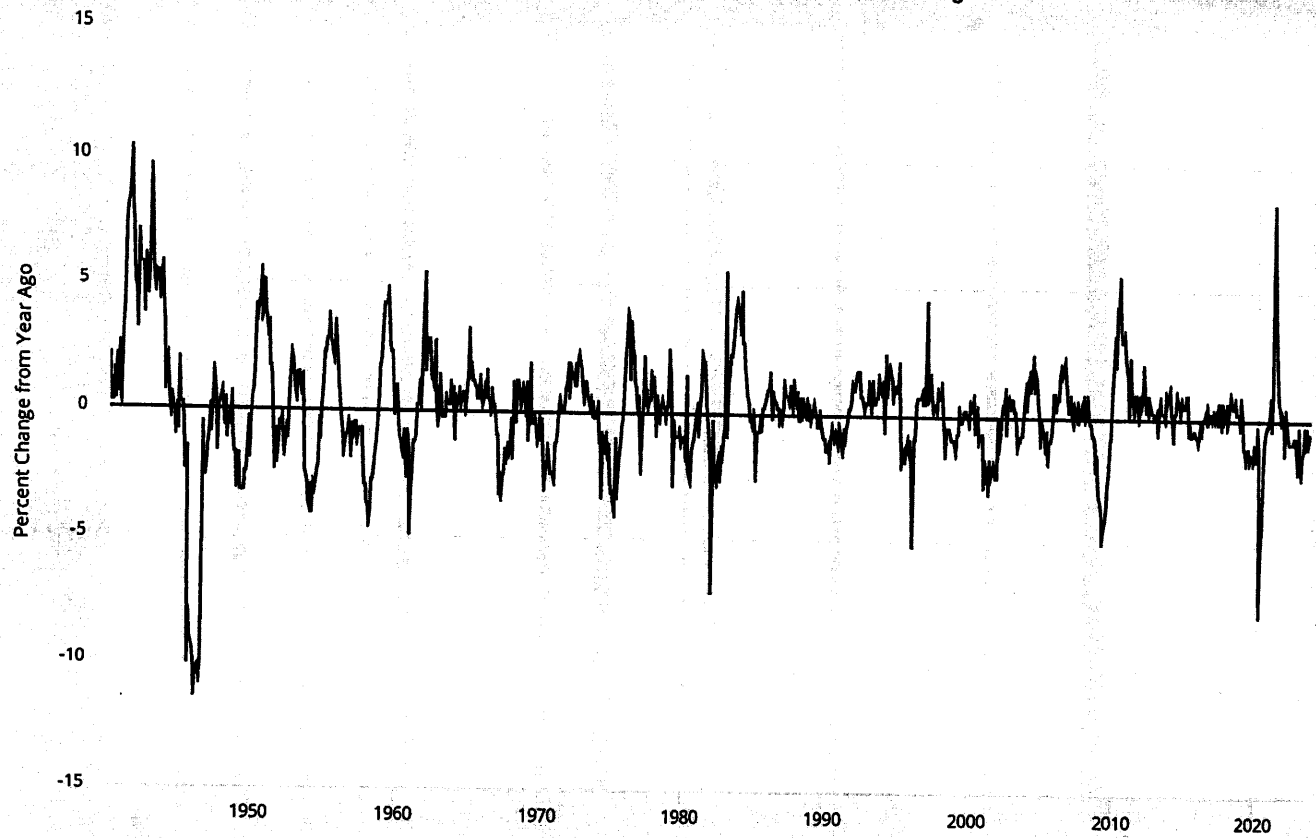
Chart 4

FRED — All Employees, Total Nonfarm/Civilian Labor Force Level



Source: U.S. Bureau of Labor Statistics

fred.stlouisfed.org



Source: U.S. Bureau of Labor Statistics

fred.stlouisfed.org