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Economic and Market Outlook

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Bye Bye, Bear

*Bull markets are born on pessimism,
grow on skepticism, mature on
optimism and die on euphoria.
-John Templeton*

Section I. Introduction

John Templeton, famous investor and a pioneer in value investing, describes what he feels is the evolution of a bull market. At the moment we feel the market is at the stage of skepticism. We will review the reasons why in the next section.

Section II. The Developing Bull Market

Just like a bear market is defined by the S&P 500 being down by 20% or more, the most basic definition of a bull market is an upward move of 20%. Since the lows of last October through June 22nd, on a closing basis, the S&P is up 22.5%. In addition, the S&P rose above the previous intermediate high of last August.

Yet many remain skeptical. CNBC brings on guests every day talking about how investors should remain defensive. A survey by Merrill Lynch of portfolio managers who usually use 65% stock / 35% bonds in their balanced portfolios during bull markets are currently recommending only 52.1% in stocks on average. Many want to point out that the market move is only because of a few stocks and the price-earnings ratio is too high at 20 times earnings. As we will discuss in more detail in our inflation coverage, the

Federal Reserve continues to fight even though inflation is reducing. On top of everything else, we are still waiting for the most predicted recession of modern times, which will also be discussed later.

The truth is that 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%. While the recent run in the market has been somewhat concentrated, an equal weighted S&P has a price earnings ratio of 15.

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.

Section III. Inflation

The readings for inflation continue to moderate. Currently the Consumer Price Index (CPI) is up 4.0% on an annual basis, and core CPI, which excludes food and energy, is up 5.3%. Both readings are for May 2023. 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 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 2.65% from July to May. That translates to a 3.18% annualized rate. This is further evidence that inflation should continue to drop. 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, 15 months ago.

Chart #2 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 April 2023 is down to 4.1%. This should mean reduced demand causing inflation to ease.

Commodities were big contributors to inflation, but that has changed. The CRB Index, which measures a basket of commodities, peaked last June at 351.25 (Chart #3). The current reading is 292.18, which is a decline of 16.82%.

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 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 paused on their current monetary policy. Federal Reserve Chairman Jerome Powell held rates steady at their last meeting, but stated the committee is still data dependent, implying they may not be done raising rates. Either way, this does mean the Federal Reserve is done or close to the end of 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 April year over year is now -9.14% (Chart #4). The recent measures to insure liquidity have ended with the agreement on the debt ceiling.

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. 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.

Rates in most European 10-year bonds are pulling back along with the U.S., because of the flight to safety caused by banking concerns. The U.S. 10-year bond still remains more attractive to international investors for its yield and AAA credit rating. The U.K. 10-year yields 4.30%, German 10-year yields 2.31%, France 10-year yields 2.84%, Italian 10-year yields 3.94% and Swiss 10-year yields 0.90%. These compare to our 3.72% 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 3.57%. By being above the moving average this indicator has stayed negative.

Indicator number two is represented in Chart #5. 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 -2.42% for March, so this indicator is 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 #6. This shows the year over year change in Industrial Production. This indicator has turned positive. It currently sits at 0.17% for May 2023. Higher production leads to greater supply which should also help inflation continue to ease.

For indicator number four (Chart #7), 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 1.11%. A zero reading represents neutral therefore this indicator is still positive.

Indicator number five (Chart #8) represents the Average Weekly Hours of Production and Nonsupervisory Employees-Manufacturing on a year over year percentage basis. Currently the reading is -1.21%, so this indicator is negative but has improved. This reflects the continued fear of the long predicted recession.

Currently three of the five indicators are negative but the S&P 500 Index has moved up and is 8.63% above its 40-week moving average. The previous week it reached 10.49% above the moving average which is another bullish signal. With the S&P 500 above its forty week moving average this model is no longer giving its 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 is at -0.06 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 9 of 12 of our price/volume indicators are positive, which is an improvement from our last report. This is reflective of the improving market after the

recent correction in the 20% range. The S&P has broken through the previous trading range from 3800 to 4200.

Our advance/decline line has been positive for the last few weeks and sits at 50.2%, once again reflective of the recent improvement. 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 S&P was up during the 2022 Santa Claus rally, the first five days of this year 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. An even rarer occurrence is to get the trifecta after a negative year like 2022. That happened 9 times since 1950 with an average return of 27% and a 100% win ratio. Six months into the year the S&P is up 12.74% making it look like this indicator will prove true.

Section VII. The Economy

Indexes that measure manufacturing data are mixed. The Philly Fed Manufacturing Index improved to -13.7 in June of 2023 but remained weak. The Empire State Manufacturing Index jumped to a positive 6.6 versus an expectation of -15.5. The national ISM manufacturing index fell to 46.9% in May and the ISM services index is at 50.3% (above 50 is considered growth, above 55 is considered exceptional growth). All these readings reflect that the Fed has had an effect on business and manufacturing but very little effect on the service economy. It also shows that we may already be coming out of a recession.

Multiple Wall Street and Federal Reserve predictions for GDP have been lowered because of the banking situation and inflation for 2023. In fact many are calling for a negative GDP number. But GDPNow currently estimates GDP at 1.9% annualized for the second quarter. These economic indicators paint a bit of a positive picture moving forward and are part of the indication to us that the bull market has legs.

Section VIII. Conclusion

One element of uncertainty has been removed since the government finally ended their kabuki dance and came to an agreement on the debt ceiling. The concern for the possibility of a banking crisis can only be healed with time. We need to keep an eye on commercial real estate for a final answer. We feel this situation will not develop into a major problem. We also believe the Fed's actions prove it is done, or almost

done, raising rates and inflation will continue to ease. It would appear that we may see blue skies ahead after a couple more minor storms.

We have grown optimistic on the markets and feel that the developing bull market will continue. Even if volatility continues 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 4th of July!

Scott B. Williams, CFA, CFP
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Chart 1

The Consumer Price Index for All Urban Consumers (CPI-U) rose 0.1 percent to 304.127 in May on a seasonally adjusted basis, after increasing 0.4 percent in April. Over the last 12 months, the all items index increased 4.0 percent before seasonal adjustment. The index for shelter was the largest contributor to the monthly all items increase, followed by an increase in the index for used cars and trucks. The food index increased 0.2 percent in May after being unchanged in the previous 2 months. The index for food at home rose 0.1 percent over the month while the index for food away from home rose 0.5 percent. The energy index, in contrast, declined 3.6 percent in May as the major energy component indexes fell. source: [U.S. Bureau of Labor Statistics](#)

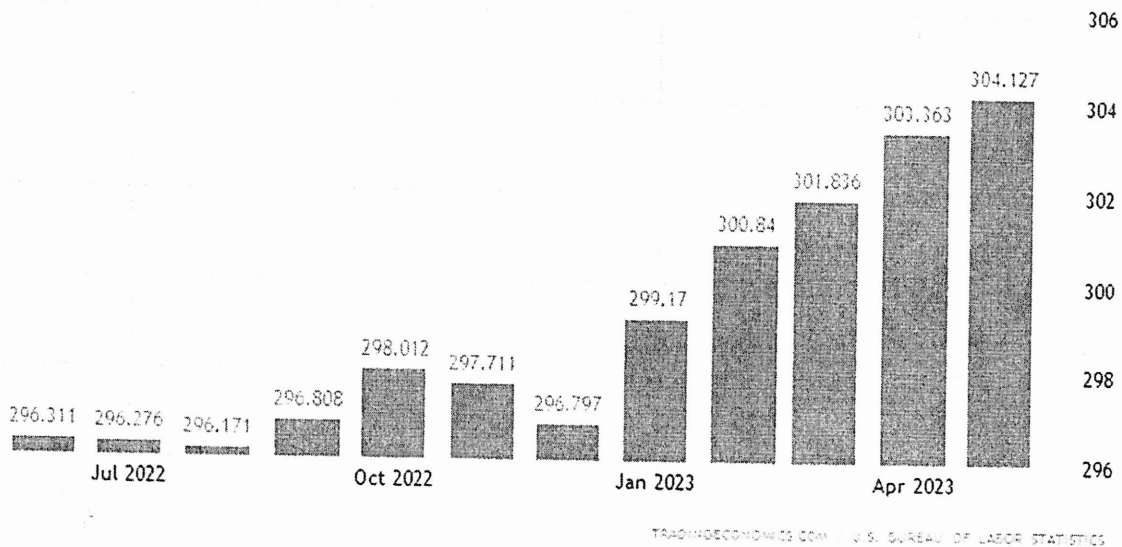


Chart 2



Source: U.S. Bureau of Economic Analysis

Chart 3

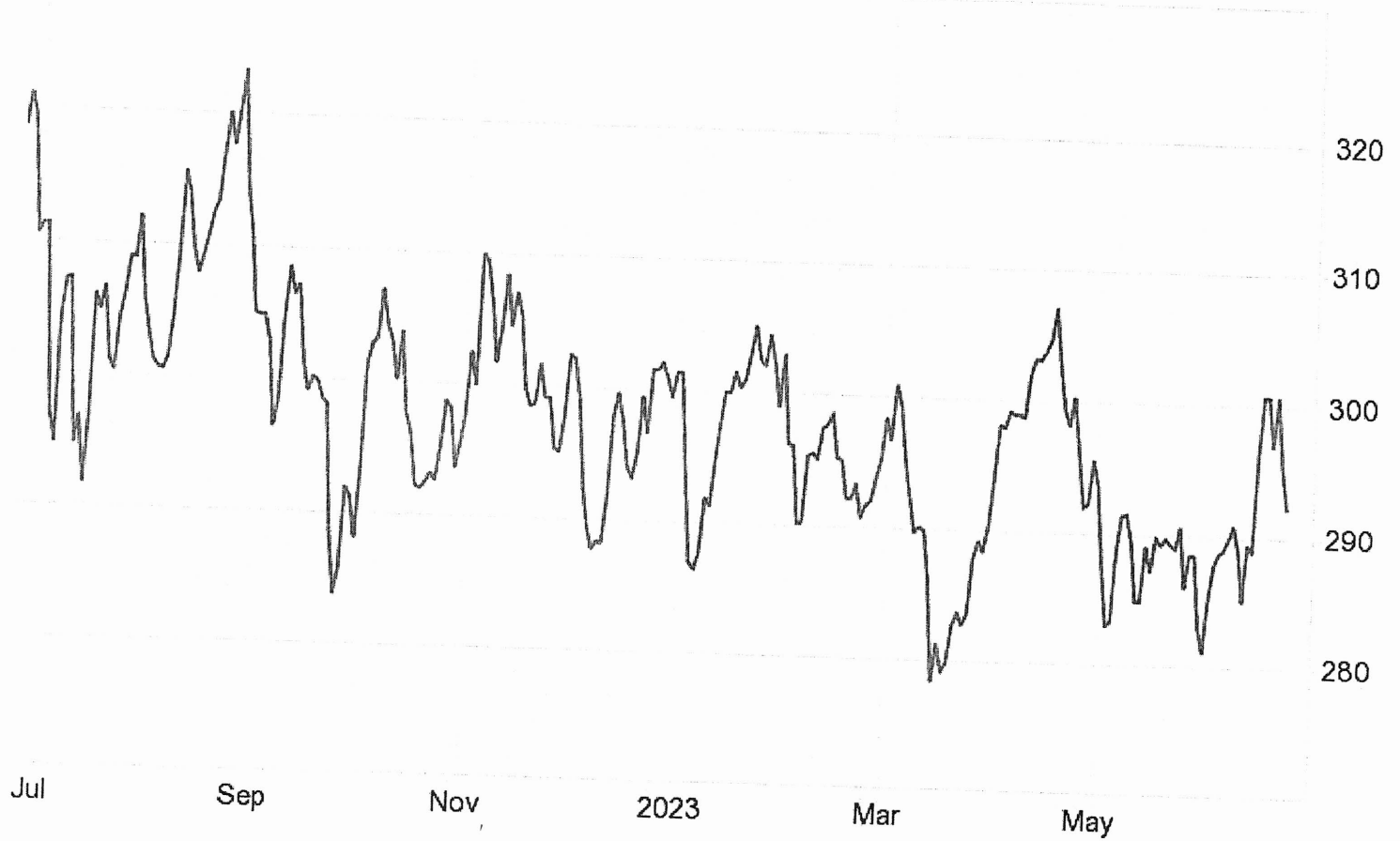
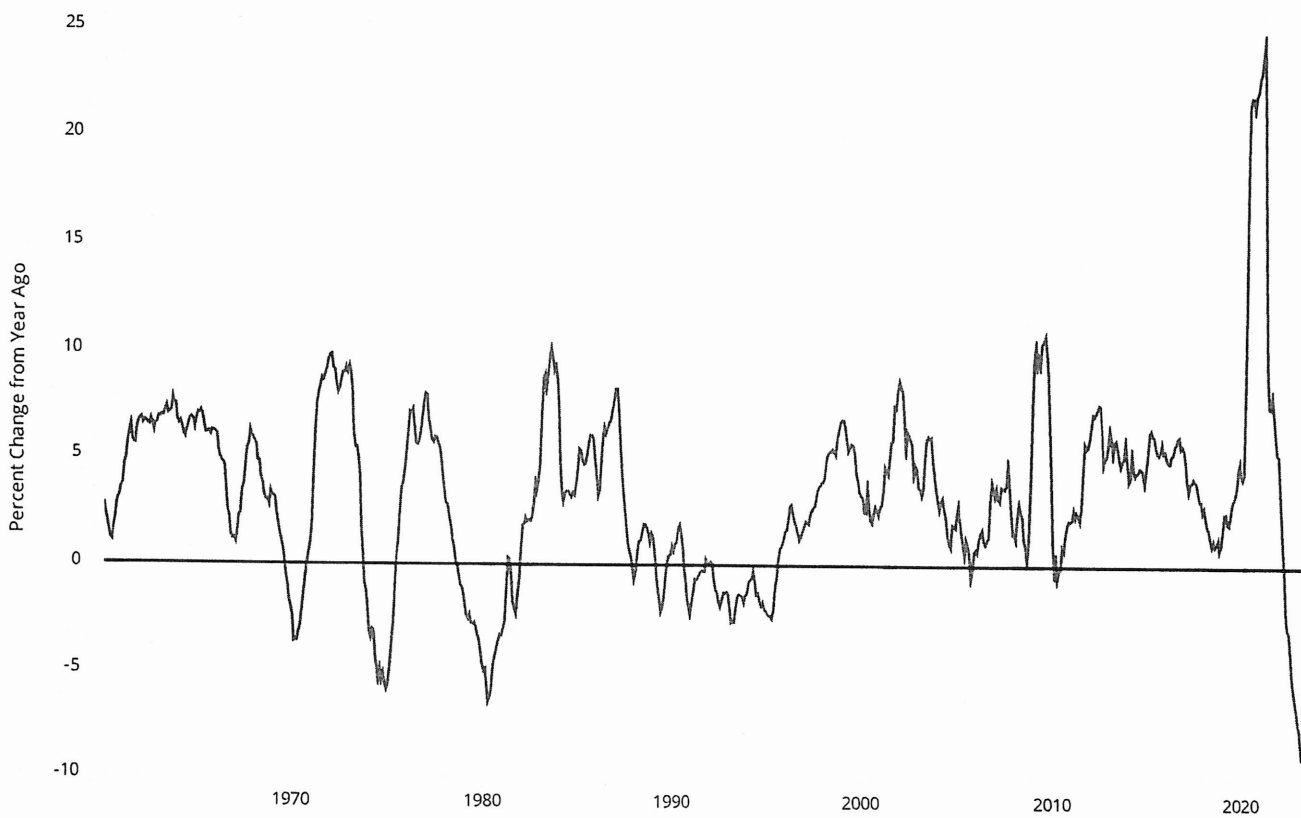


Chart 4

source: tradingeconomics.com

FRED — Real M2 Money Stock

Source: Federal Reserve Bank of St. Louis

fred.stlouisfed.org

Chart 5

FRED — Advance Real Retail and Food Services Sales

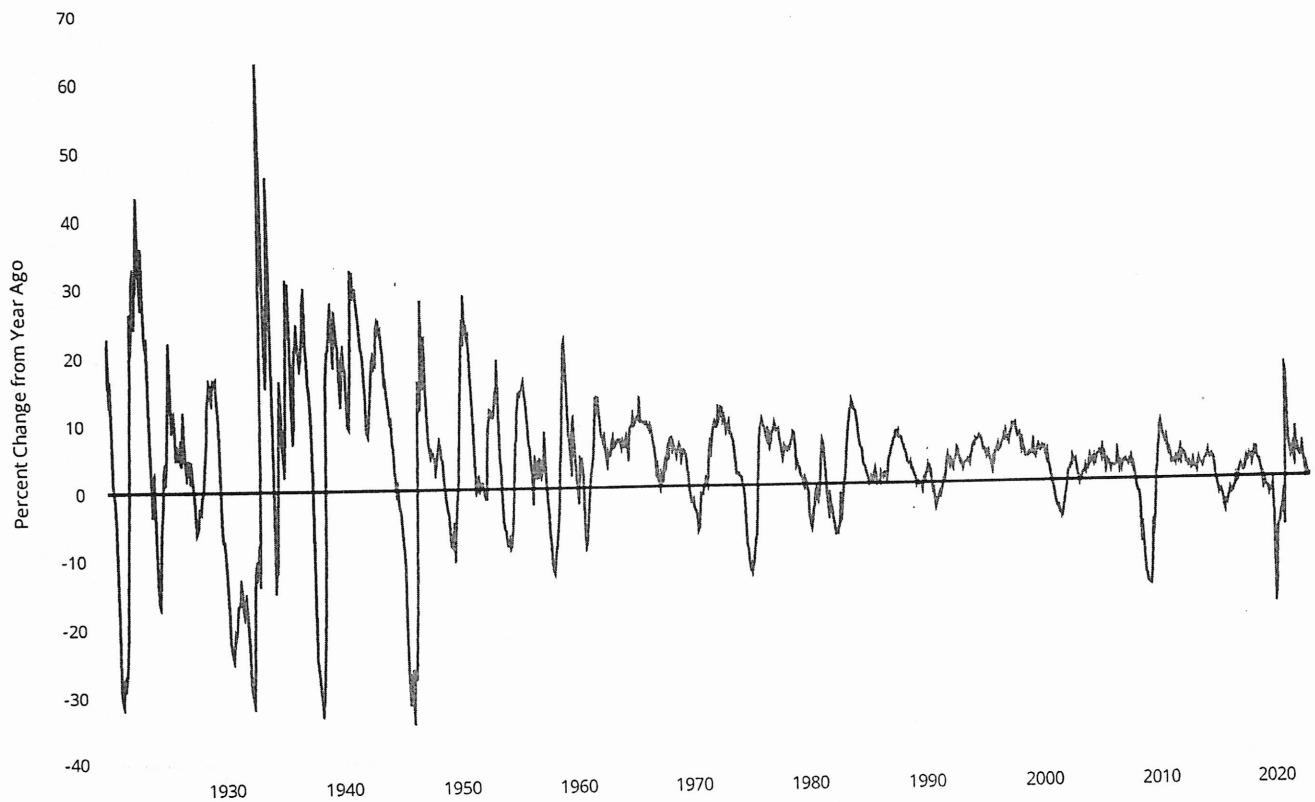


Source: Federal Reserve Bank of St. Louis

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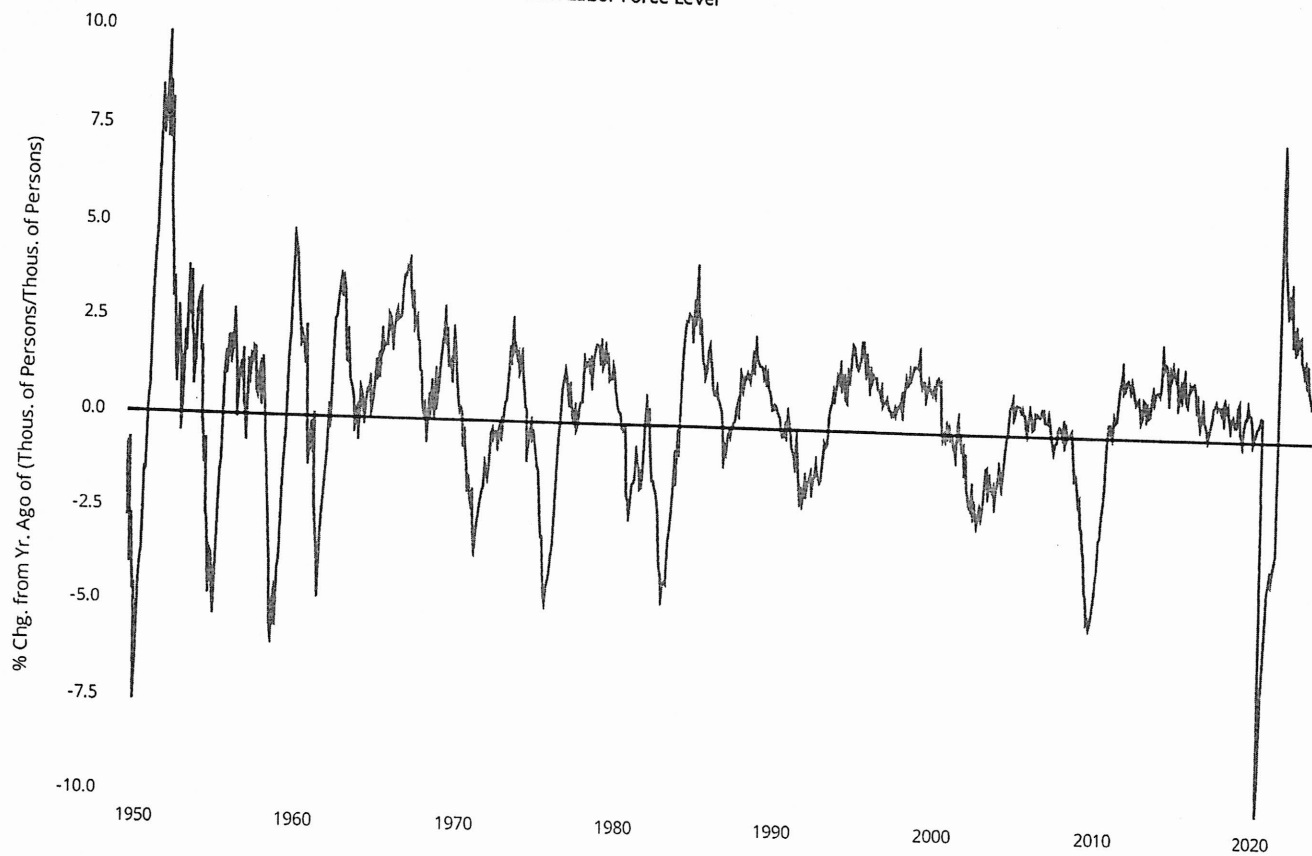
Chart 6

FRED — Industrial Production: Total Index



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

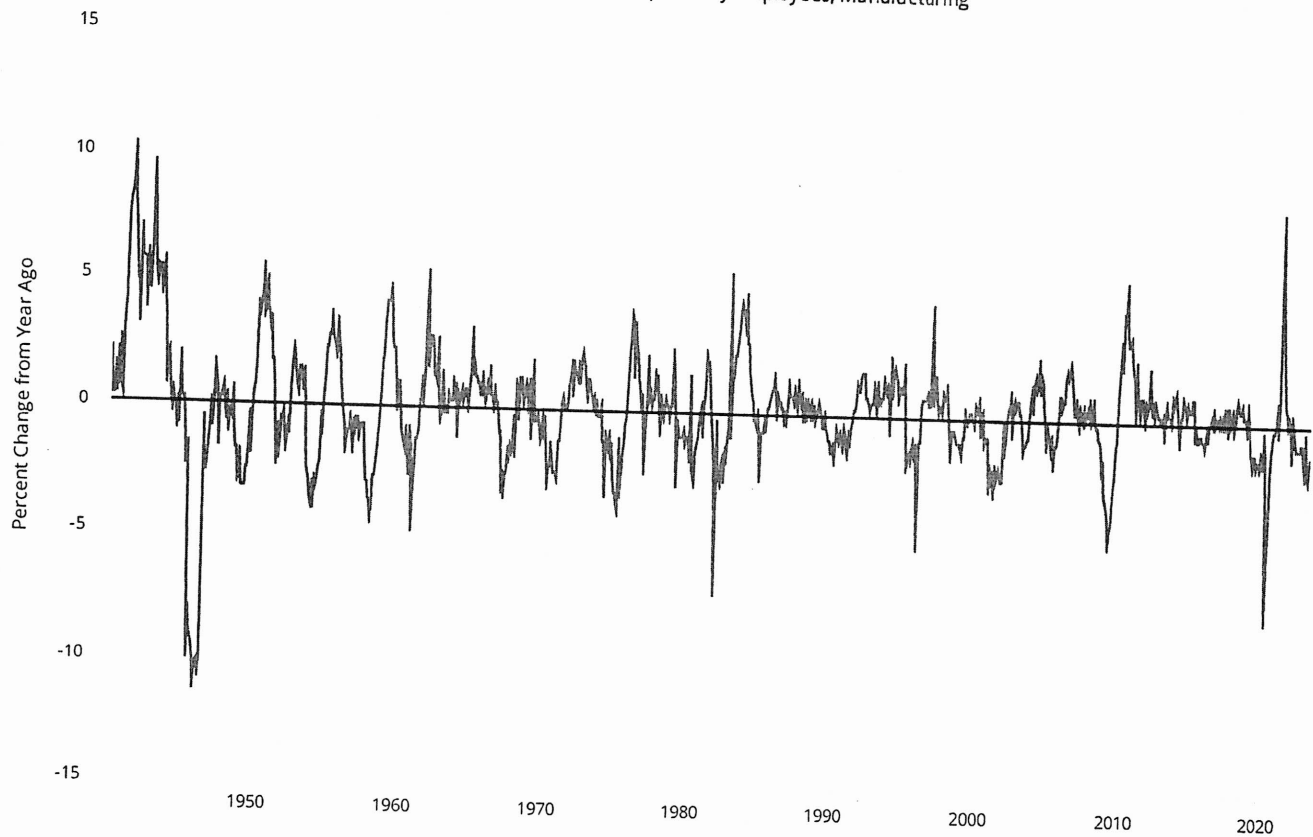
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Source: U.S. Bureau of Labor Statistics

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Chart 8



Source: U.S. Bureau of Labor Statistics

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