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Economic and Market Outlook

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It's Darkest Before The Dawn

To invest successfully over a lifetime does not require a stratospheric IQ, unusual business insights, or inside information. What's needed is a sound intellectual framework for making decisions and the ability to keep emotions from corroding that framework. You must supply emotional discipline.

- Warren Buffett

All financial success comes from acting on a plan. A lot of financial failure comes from reacting to the market. Long-term investment success is almost totally a function of how one emotionally handles declines in the equity market, as opposed to how one's portfolio handles them.

- *Nick Murray*

Section I. Introduction

The Oracle of Omaha expresses the true nature of being a successful investor by recognizing that emotions drive most investors into the wrong decision.

Nick Murray has been a financial services professional for more than 50 years. He is among the industry's most respected writers and speakers. He expresses the same message as Mr. Buffet, namely reacting emotionally to market declines almost guarantees long term failure.

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 possibility of a bear market crash, history shows us that over time the stock market will invariably go higher in the long term.

Section II. Inflation

The readings for inflation have begun to moderate. Currently the Consumer Price Index (CPI) is 8.3% on an annual basis, and core CPI, which excludes food and energy, is at 6.3%. Both readings are for August 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 3% so far this year have not had enough time to ripple through the economy.

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 7% today, the value of residential property is already cracking partly because the mortgage payment on a new mortgage has risen 70%. Chart #1 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 19.96% over the last year through July. Looking forward the loss of value trend should continue.

Rents are also starting to reflect this trend. Chart #2 shows an actual drop in apartment rents nationally on average over the last two months. Once again, because of calculation metrics this will not be reflected in official numbers for a few months.

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 July 2022 is down to 5.0%, which should mean an eventual reduction in demand causing inflation to ease, especially with consumers pulling back spending because of recession fears. This is in direct contrast to the great demand created when the economy first re-opened from Covid-19.

Commodities have been big contributors to inflation but that should be changing. From their respective peaks in the last year to the writing of this report, natural gas is down 26.9% (Peak 9.32, Current 6.81), crude oil is down 35.6% (119.78,77.09), lumber is down 71.1% (1464.00,423.00), copper is down 32.5% (4.89,3.30), wheat is down 32.4% (12.77,8.63) and beef is down 11.3% (22.19,19.69).

Green energy policies in the US and Europe's questionable decision in the past to become reliant on Russian energy have added to the inflation situation. The U.S. is already well on its way to increasing production levels to 12 million barrels per day (bpd). Another expected 1 million bpd increase over the next year will obliterate the current record of 12.3 million bpd set in 2019. Despite attacks on federal land use and drilling permits, the number of active U.S. oil rigs has nearly doubled from last year.

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 Ukrainian War. 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. 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 apposed to causing inflation.

Section III. <u>The Federal Reserve and Interest Rates</u>

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 0.75% at the last three meetings. This was taken as a sign that the Federal Reserve is finally starting to aggressively fight inflation and not be so far behind the curve. They also have started to let $95 billion in bonds roll off the Fed balance sheet each month. 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 are raising rates. It takes time for interest rate hikes to have its 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 4.03%, German 10-year yields 2.12%, France 10-year yields 2.73%, Italian 10-year yields 4.58% and Swiss 10-year yields 1.35%. These compare to our 3.75% 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 now have had two quarters of negative GDP but the second reading was less negative. Looking into the data of the first quarter reveals a unique fact. Many companies were double ordering during the pandemic because of the uncertainty of actually receiving inventory. When the extra inventory arrived, these companies found themselves overstocked. Orders fell off a cliff causing the negative GDP all by itself. Some of these items were seasonal. Expect discounts on many large items (Appliances, Electronics, Furniture) coming in the fall. The point is that the double ordering is a one time or "black swan" event caused by the pandemic supply chain disruptions, which brings this GDP measurement of a recession into question.

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. They collect short term deposits (savings accounts) and make long term loans. The spread on this metric is nowhere near being negative meaning banks should continue to lend.

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 has dropped 32.5% by our calculations. Copper is important because it is used across many industries.

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

We just discussed 3 different historic indicators of recession that gave us different 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 <u>no predictive value.</u>

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 <u>and</u> 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 August, the unemployment rate was 3.7% and the 12 month moving average was 3.91%. By being below the moving average this indicator is positive.

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 0.8% for August, so this indicator is barely positive. Any reading above 0 is positive. The reading is also normalizing which should relieve some inflation pressure and it also reflects less money in consumers 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 3.7% for August 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 has improved and stands at 3.98%. 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 -1.2%, 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 four of the five indicators are positive but the S&P 500 Index is 12.29% below its 40-week moving average in the recent correction. Even though the S&P 500 is below its forty week moving average this model does not give any recession warning signs because 4 of 5 indicators are still positive. 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 0.02 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 0.01.

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. <u>Market Psychology</u>

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 negative. This is reflective of the recent correction in the 20% range.

Our advance/decline line has dipped slightly below 44%, once again reflective of the recent pullback. Our model that measures the first and second derivative on price and volume is currently negative but looking like it will likely improve. We have developed this model to recognize patterns and spot buy and sell signals from reviewing years of historical data. When data looks this negative a turnaround is typically near.

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%.

Another factor not being talked about is the upcoming elections in November. Since World War II, only once did the president's party gain seats in the House. Also since WWII parties of unpopular presidents (presidents with low approval ratings-Biden August rating 38%) lose an average of 38 House seats. This would create gridlock in Washington D.C., which Wall Street always likes.

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 September 2022 was -9.9. The Empire State Manufacturing Index hit a high in July 2021 of 43 (0). September's reading improved 30 points from the previous month to -1.5. The national ISM manufacturing index remained elevated at 52.8% in August and the ISM services index is at 56.9% (above 50 is considered growth, above 55 is considered exceptional growth). 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 0.03% annualized for the third 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. Conclusion

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Corrections and bear markets alike prey on "first-and-worst" catastrophic fears, convincing investors that temporary headwinds are insurmountable. They take fortitude to fight. However, though the emotions corrections provoke feel real, the forces behind them are false.

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.

We hope this report finds you in good spirits and good health!

Scott B. Williams, CFA, CFP
Kent Stone

Chart 1

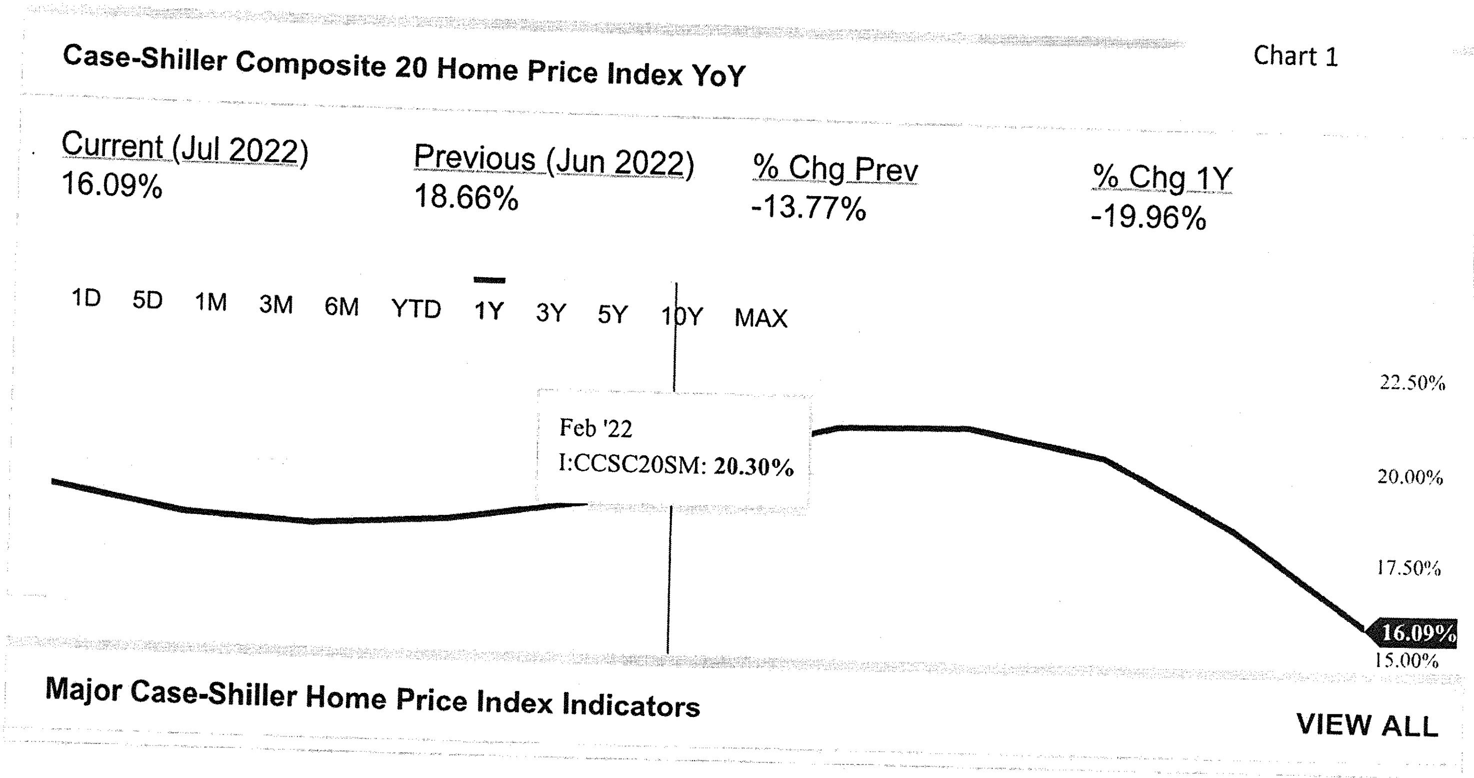
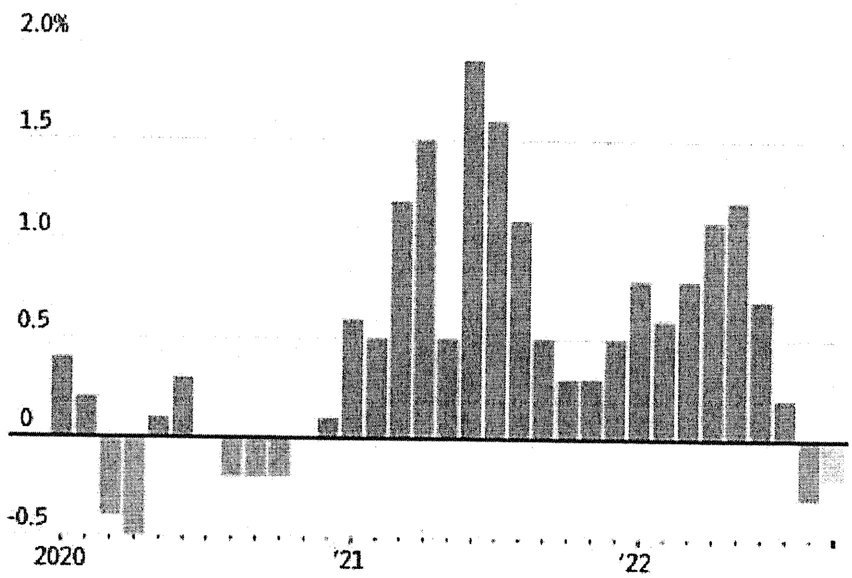


Chart 2

Monthly change in one-bedroom rent



Note: September 2022 is as of Sept. 20.
Source: CoStar

Chart 3

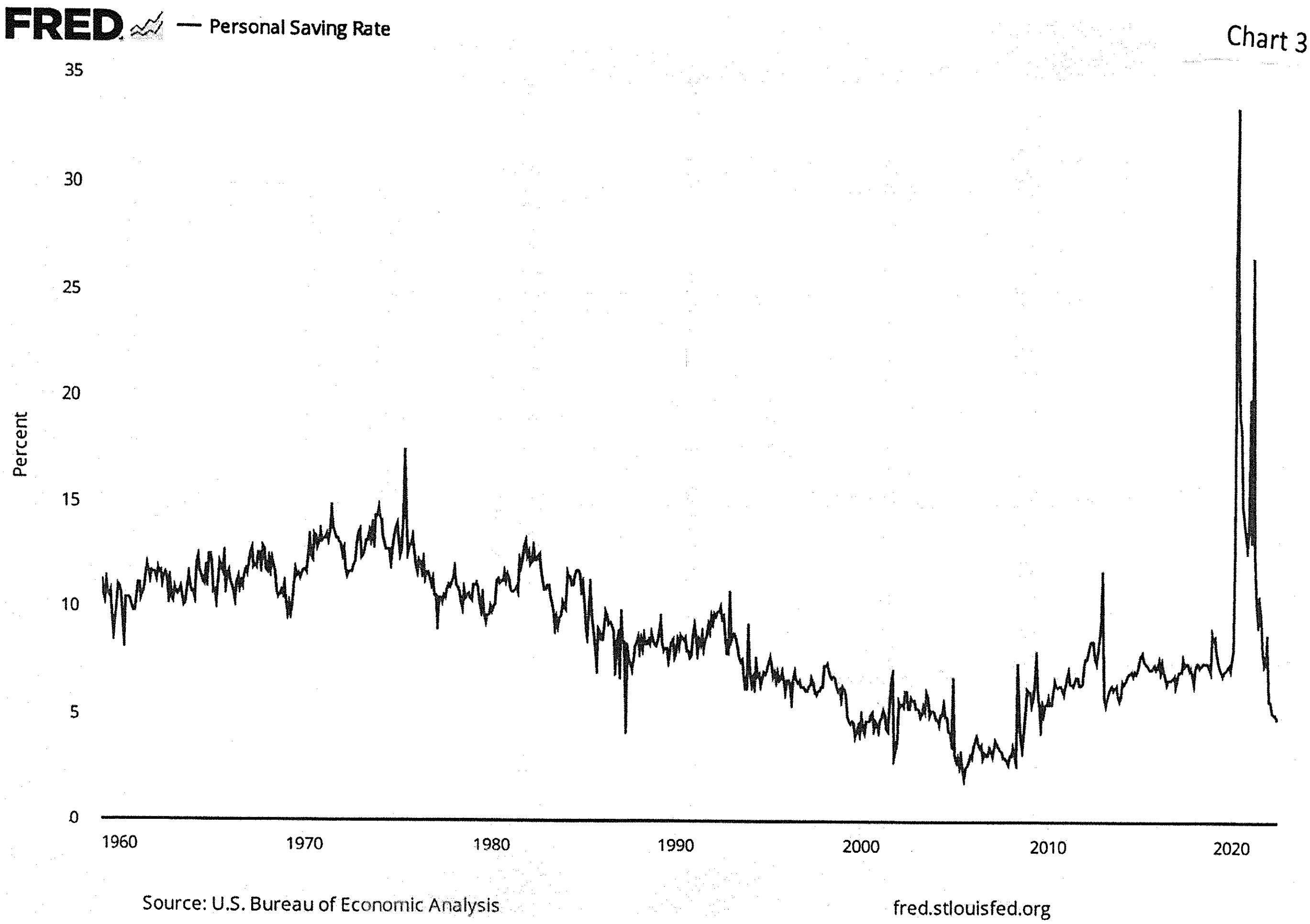


Chart 4

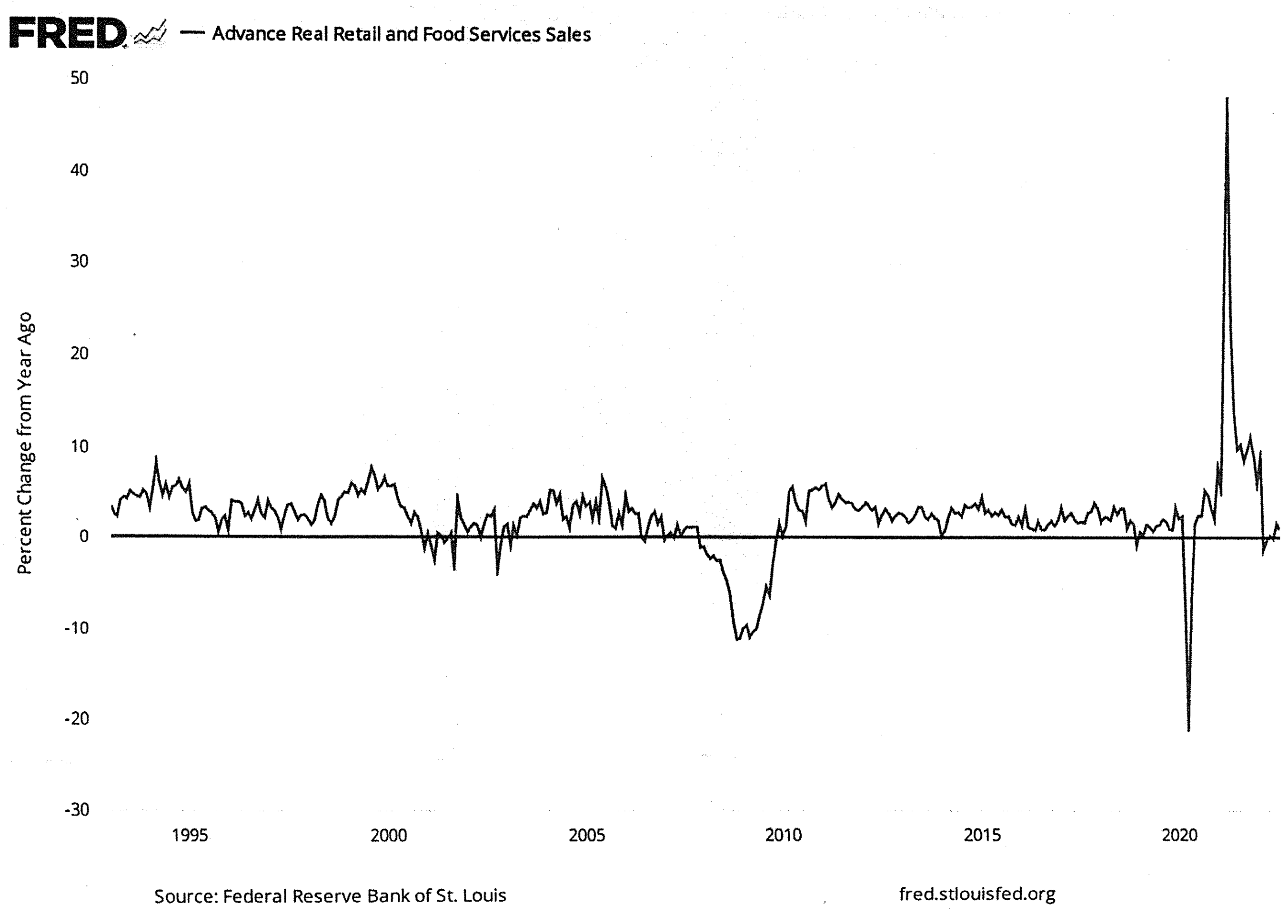
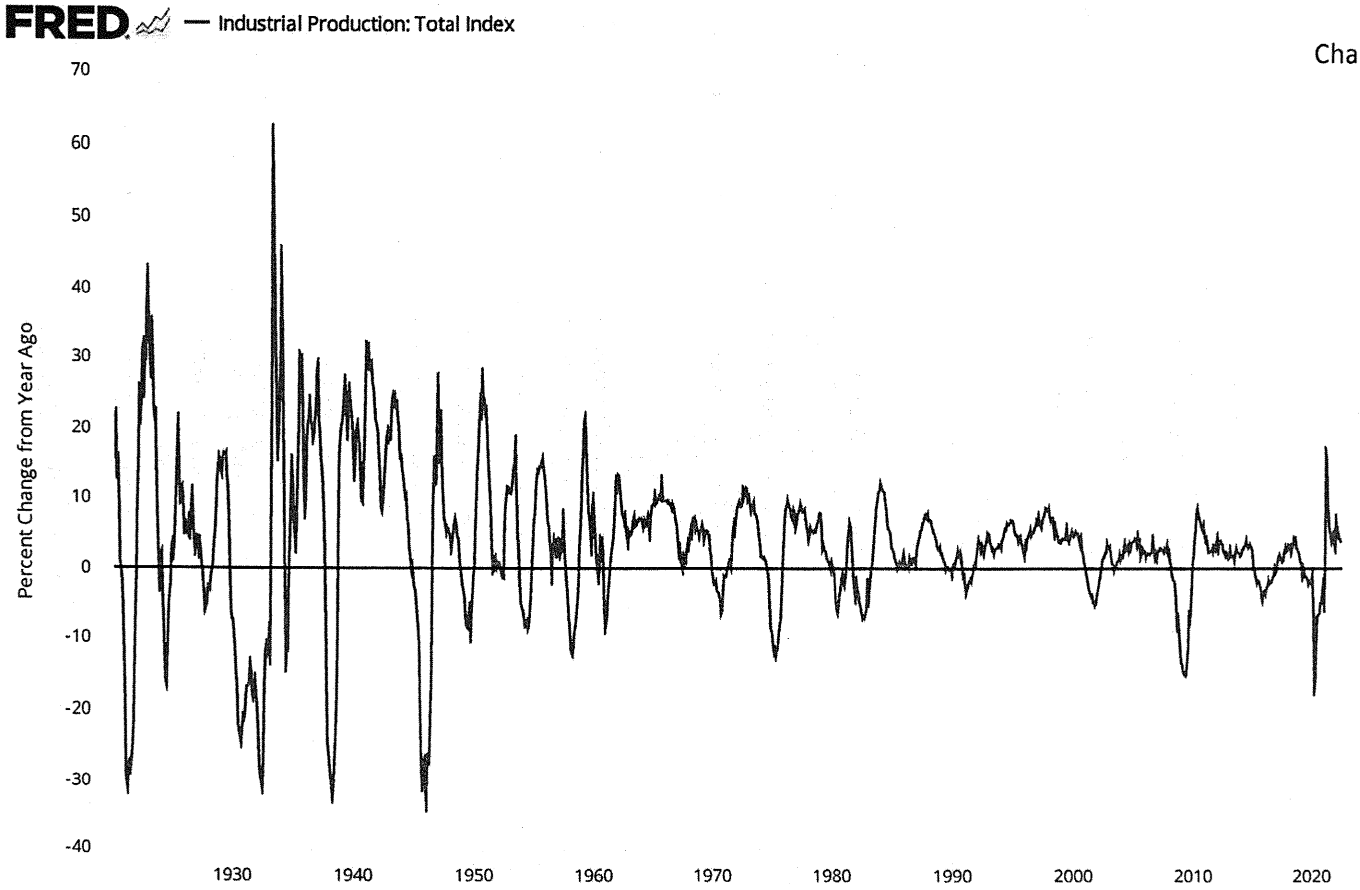


Chart 5



Source: Board of Governors of the Federal Reserve System (US) fred.stlouisfed.org

Chart 6

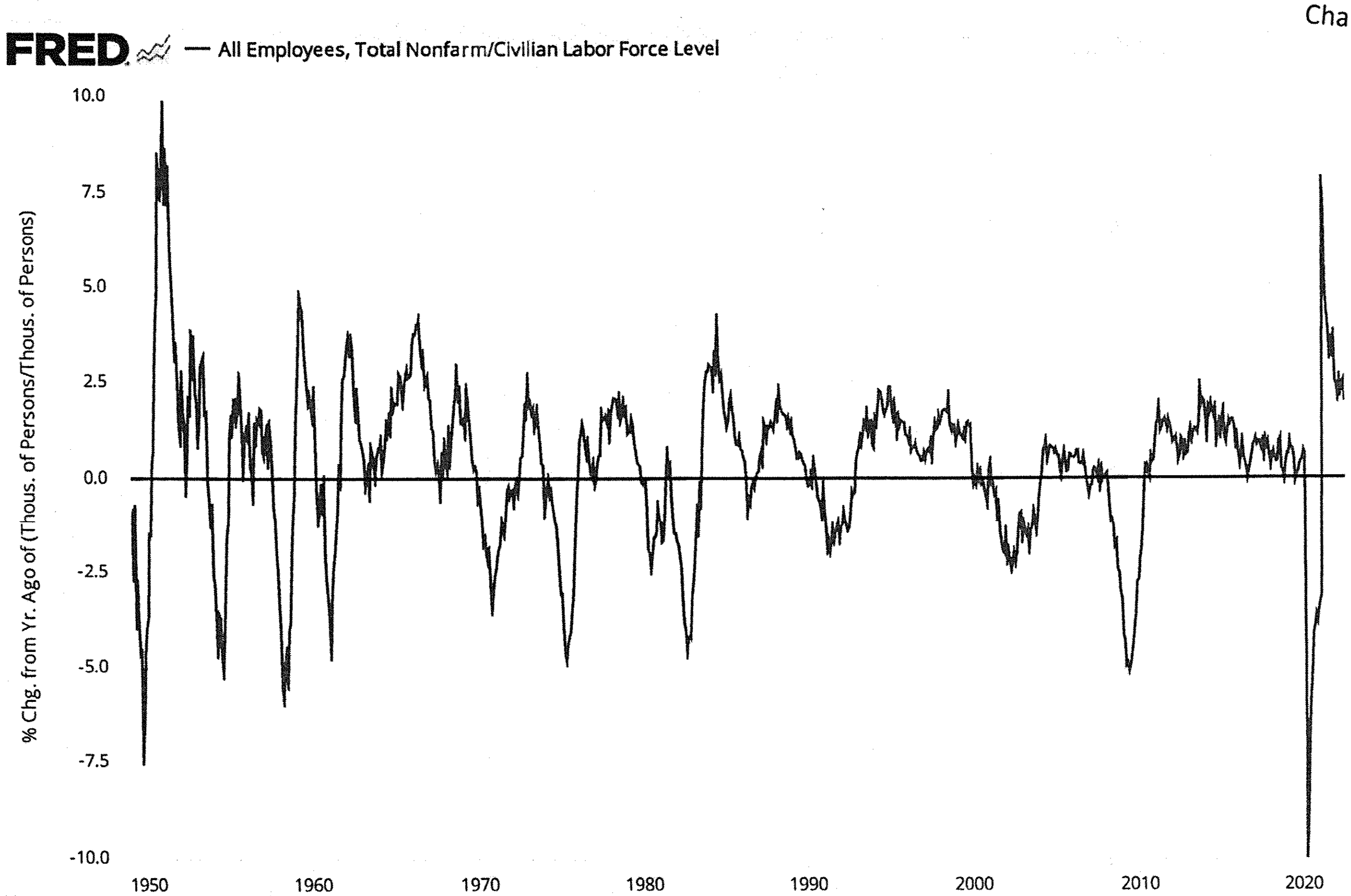


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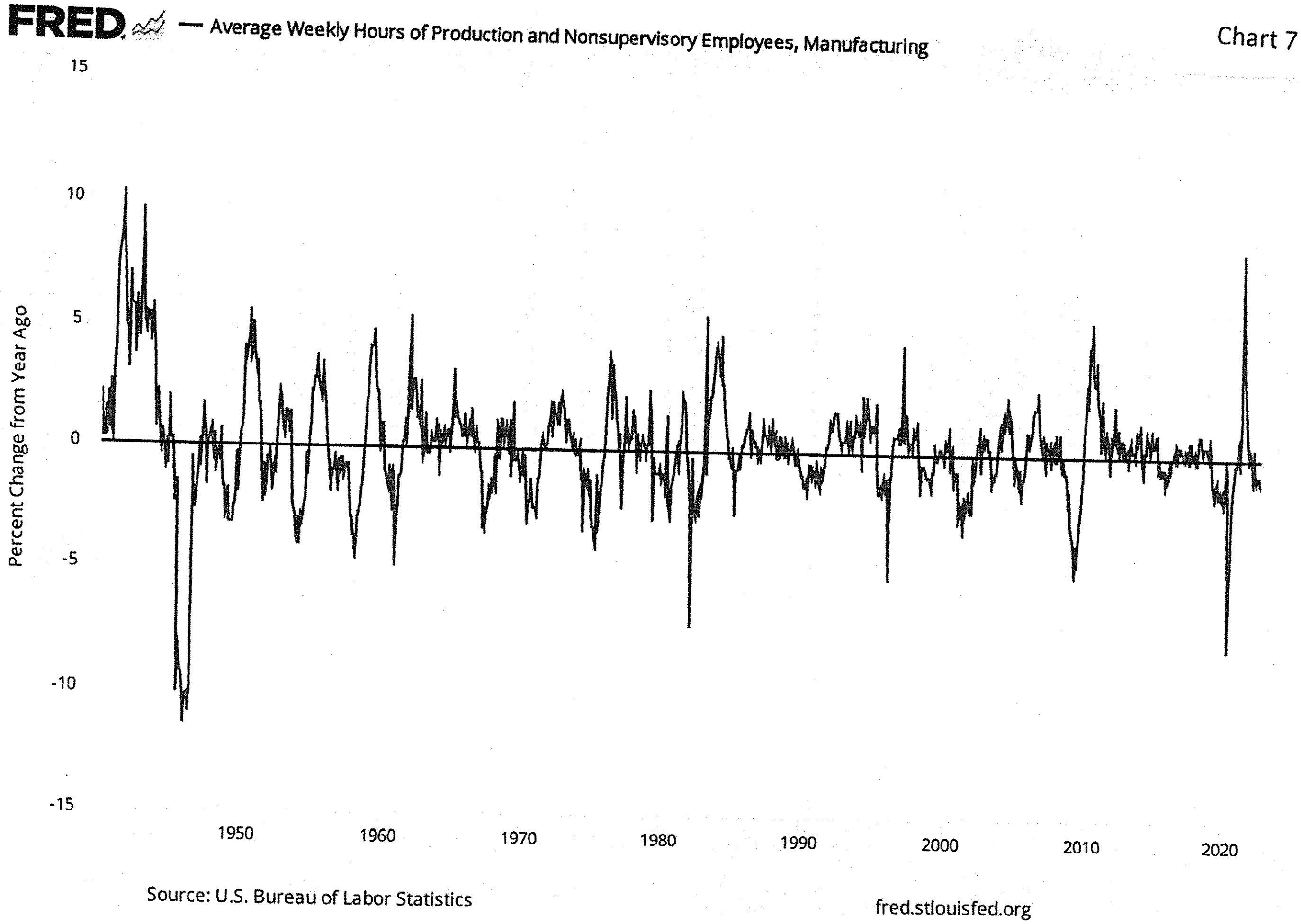
Chart 7


FRED — Average Weekly Hours of Production and Nonsupervisory Employees, Manufacturing
15
10
5
0
-5
-10
-15
Percent Change from Year Ago
1950
1960
1970
1980
1990
2000
2010
2020
Source: U.S. Bureau of Labor Statistics
fred.stlouisfed.org