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Economic and Market Outlook

September 30th, 2023

Whistling Past the Graveyard

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

Section I. Introduction

We have kept the same quote as our last report to prove a point. 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 still 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 (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 last October through June 22^{nd}, on a closing basis, the S&P was up 22.5%. In addition, the S&P rose above the previous intermediate high of last August. But since then, the S&P has pulled back about 7% as of this writing.

So skepticism of a new bull market continues to grow. CNBC brings on guests every day talking about how investors should remain defensive. 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. The autoworkers are on strike. Student loan payments are about to kick back in. The government is once again doing its political kabuki dance over spending and shutting down. Oil and interest rates are up. On top of everything, 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%. That doesn't mean the market went straight up. Corrections of less than 10% are part of normal volatility. While the recent run in the market has been somewhat concentrated, an equal weighted S&P has a price earnings ratio of 15. 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 first 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. <u>Inflation</u>

The readings for inflation continue to moderate. Currently the Consumer Price Index (CPI) is up 3.7% on an annual basis, and core CPI, which excludes food and energy, is up 4.3%. Both readings are for August 2023 and lower than in our last report despite the rise in oil. 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.

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, 18 months ago.

Chart #1 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 2023 continues to drop and is down to 3.5%. This should mean less ability to spend, thus reducing demand, and causing inflation to ease.

Wages are starting to moderate as job openings drop and adjustments for increases in the minimum wage start to moderate. In contrast is the autoworkers strike, with their big wage increase demands. These possible wage increases could once again threaten the profitability of the auto industry, 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. <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 paused on their current monetary policy path of hiking interest rates. 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 August year over year is now -7.11% (Chart #2). Unfortunately, congress once again is debating budget cuts, with some threatening a government shutdown.

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. We view the occasional pauses 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 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 AA+ credit rating. The U.K. 10-year yields 4.33% (AA), German 10-year yields 2.81% (AAA), France 10-year yields 3.36% (AA), Italian 10-year yields 4.77% (BBB) and Swiss 10-year yields 1.07% (AAA). These compare to our 4.55% 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 August, the unemployment rate was 3.8% and the 12 month moving average was 3.58%. By being above the moving average this indicator has stayed negative.

Indicator number two is represented in Chart #3. 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 -1.19% for August, so this indicator is negative but an improvement from our last report. 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 #4. This shows the year over year change in Industrial Production. This indicator remained positive. It currently sits at 0.25% for August 2023. Higher production leads to greater supply which should also help inflation continue to ease.

For indicator number four (Chart #5), 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 0.11%. A zero reading represents neutral therefore this indicator is still positive.

Indicator number five (Chart #6) 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 continues to improve. 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 pulled back but is still 2.69% above its 40-week moving average as of September 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 surprisingly turned positive is at 0.10 currently. This could actually indicate the economy expanding. 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. <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 7 of 12 of our price/volume indicators are positive, which reflects the market pullback since our last report. This is reflective of the skepticism and the seasonality of current conditions. The S&P has returned to 4275 and is testing the high end of the previous trading range of 4200 for support.

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

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. Nine months into the year the S&P is up 8.05% after suffering through seasonally the worst 2 months of the year on average for the last 75 years making it look like this indicator still has a chance to prove true.

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 -13.5 in September of 2023. In contrast, The Empire State Manufacturing Index jumped to a positive 1.9 versus an expectation of -10.0 and a previous reading of -19.0 in August. The national ISM manufacturing index improved to 47.6% in August and the ISM services index also rose to 54.5% (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 rising interest rates and inflation for 2023. In fact many are calling for a negative GDP number. But GDPNow currently estimates GDP at 4.9% annualized for the third quarter. This is another clue that economic expansion may be underway and indicate 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

There is no doubt that the third quarter has been difficult, but not surprising. It is very typical to have periods of consolidation or correction after 20% runs in the market in the short term. A bull market never goes straight up. This time of year is notoriously known for market struggles. We are in this for the long term and three months becomes a minor blip over a five or ten year period.

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 and skepticism 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.

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

Scott B. Williams, CFA, CFP
Kent Edwin Stone

Chart 2

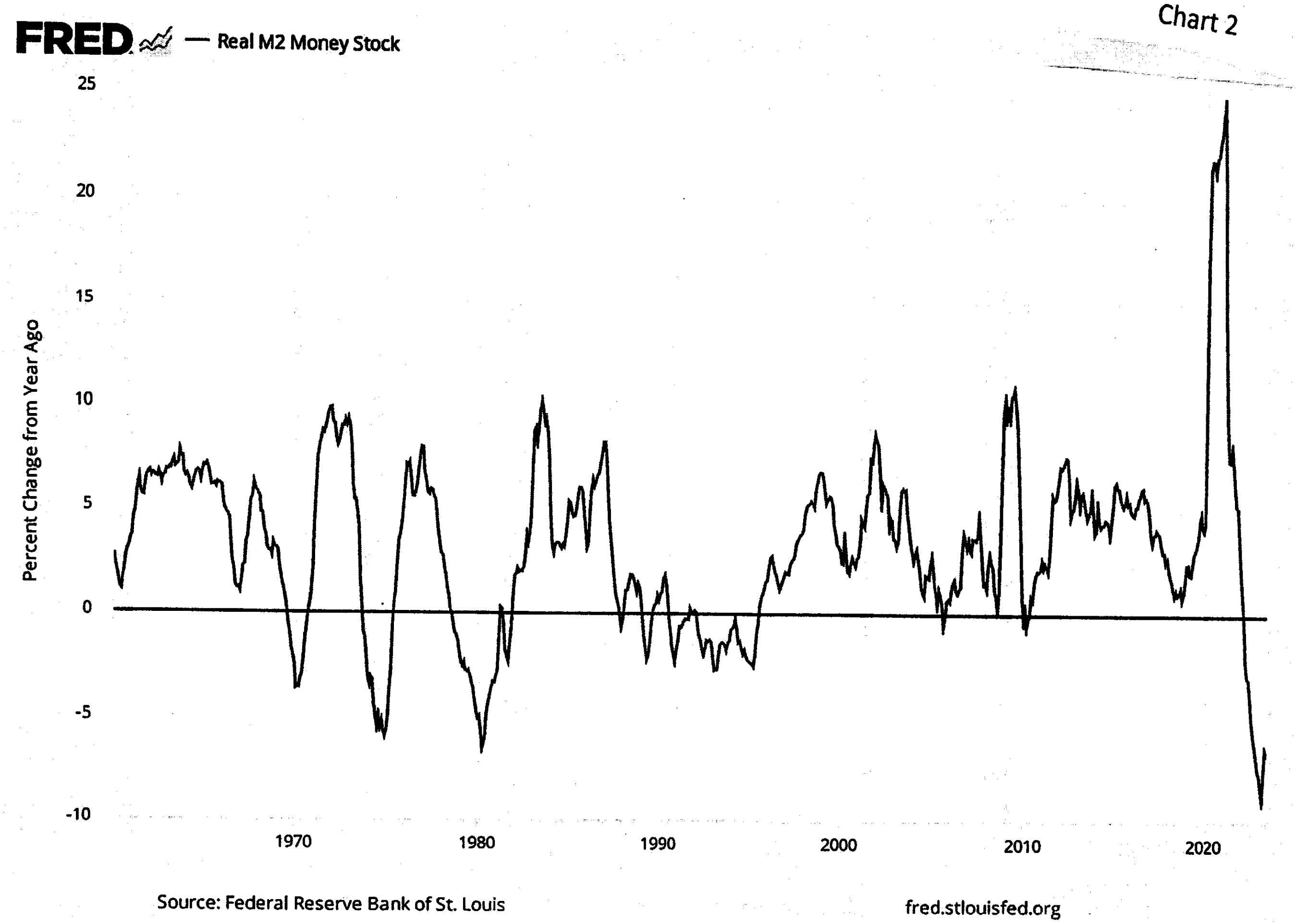
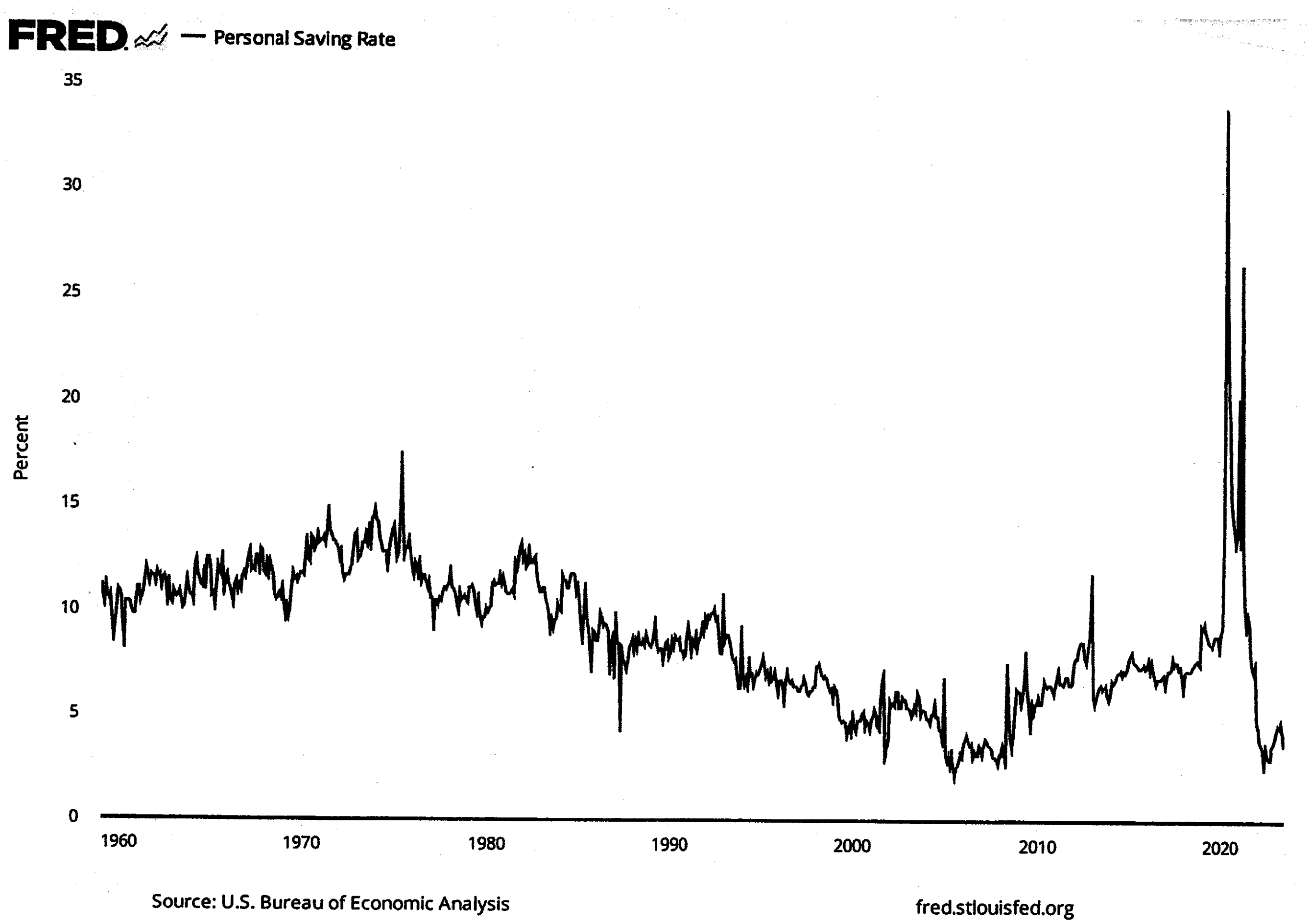


Chart 1



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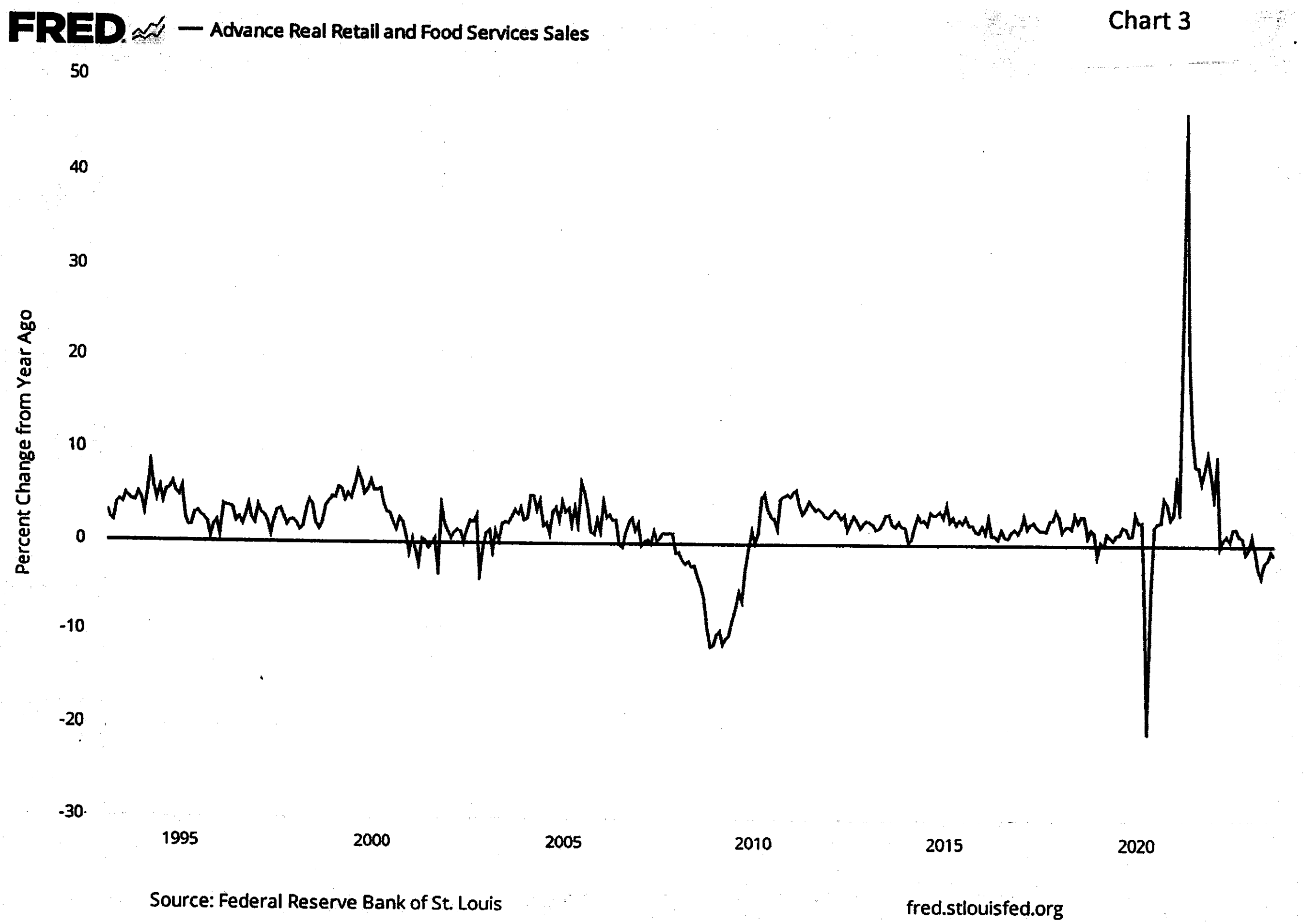

Chart 4

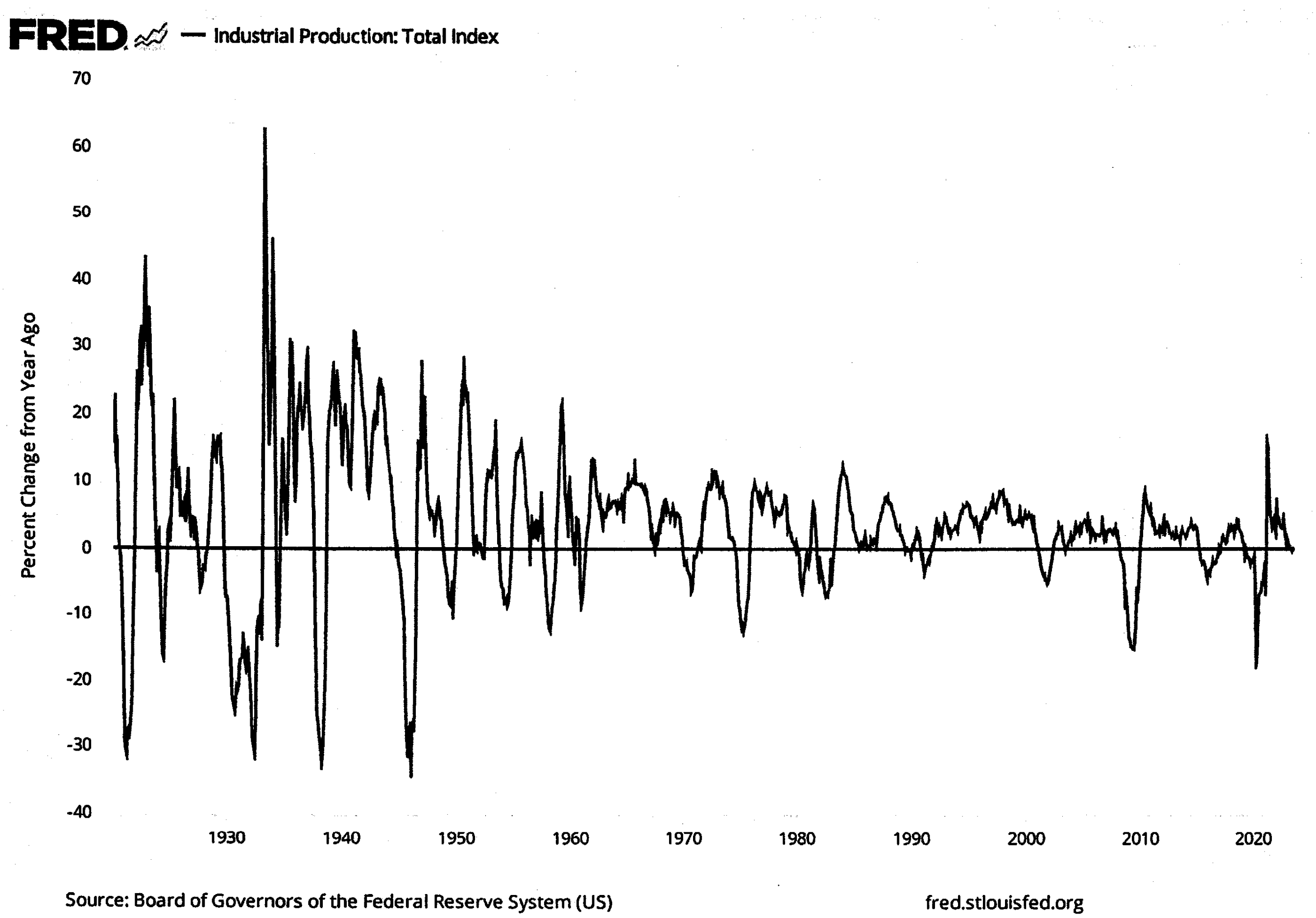

Chart 5

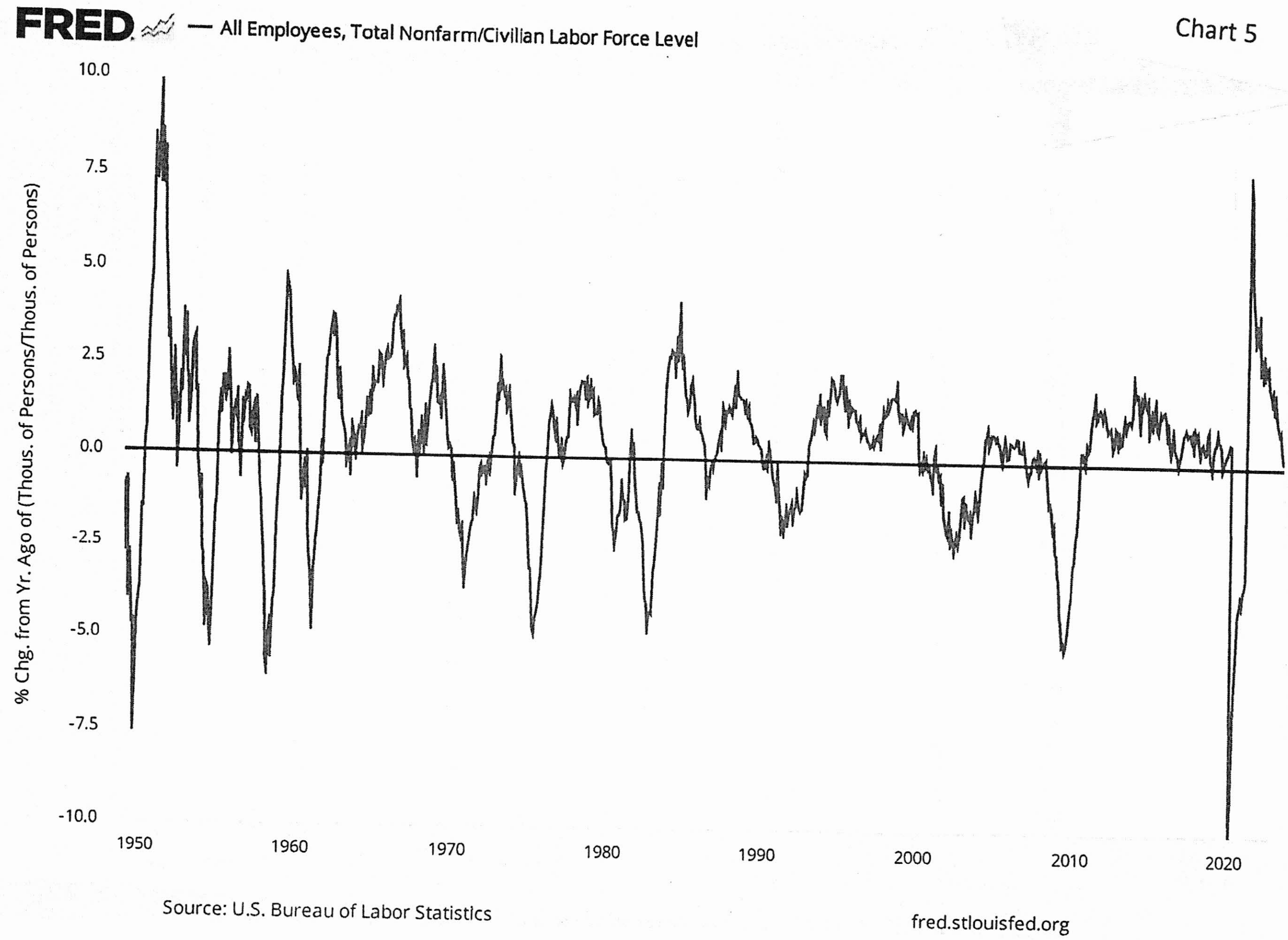

Chart 6