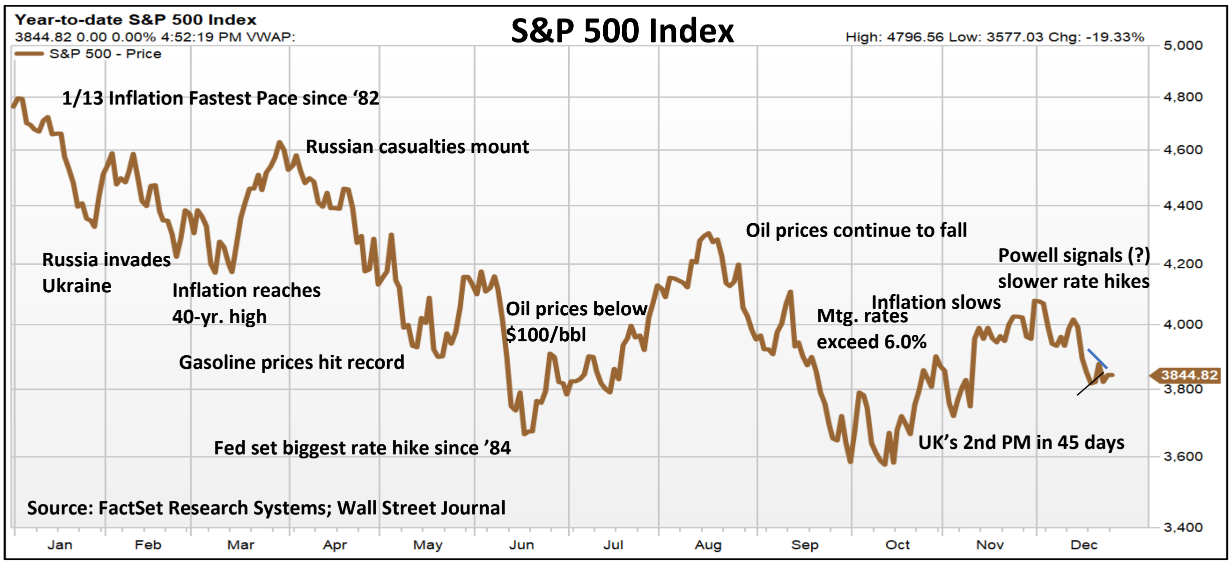
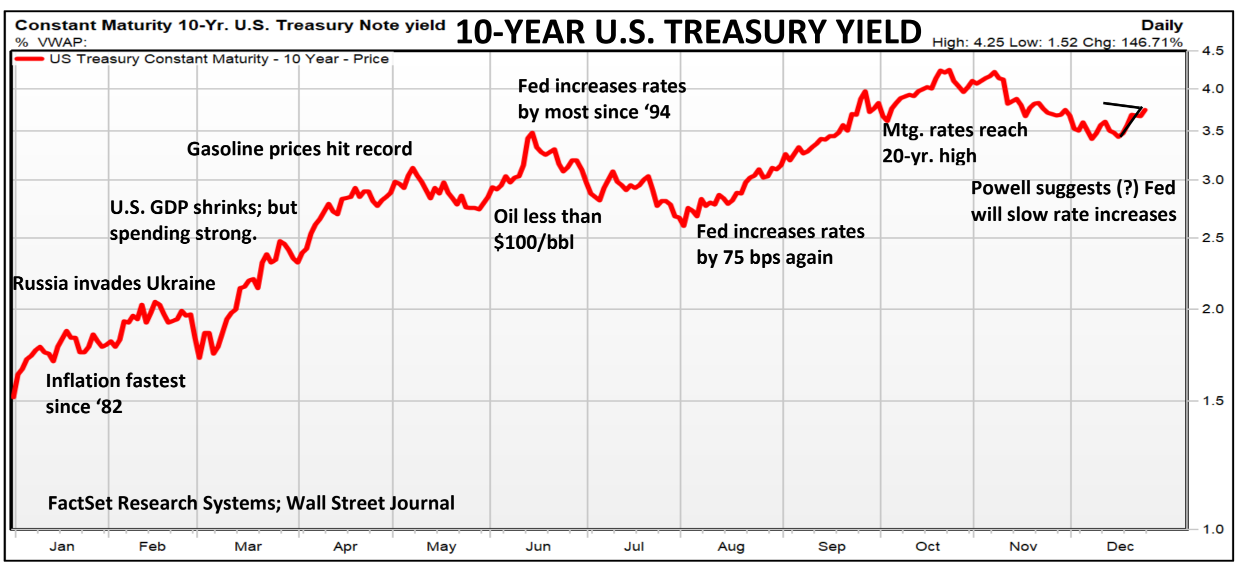
Economic & Financial Market Views – 2023

Each year is unique, shaped by circumstances, at times unforeseen!!

At this time last year as we looked forward to 2022, the U.S. economy (GDP) was growing, health conditions improving, monetary and fiscal policy stimulative, employment rising, supply chain problems easing and corporate profits growing. Despite this positive environment, our market optimism for 2022 was restrained. We anticipated that annual equity returns might, at best, be single digit rather than the average double digit returns of the previous decade. Our outlook was based on the elevated valuation of stocks, the potential for increases in inflation and interest rates, and by rising political polarization. Our concerns were on target, the results were not.

It is a humbling task and an attempt at clairvoyance to forecast the direction of financial markets six months or even a year ahead with a high degree of accuracy and consistency. That is why we continually recommend focusing on longer-term secular trends. Who, at the beginning of 2022, would have anticipated the dramatic spike in Omicron virus cases in January, the invasion of Ukraine by Russia in February, the persistence of inflation, the Fed setting its biggest rate hike since 94'[i] in June, a "nuclear winter" for digital currencies, two UK Prime Ministers in 45 days, or U.S. mortgage rates at 6.0% or higher.[ii] These events shaped the economy and financial markets in 2022 and, as stated above, were unique, and for most, unforeseen.





As we look forward to 2023, much has changed during the past twelve months. With Europe and the U.S. experiencing or anticipating economic slowdowns, weakness will be felt around the globe with economies slowing due to declining demand.

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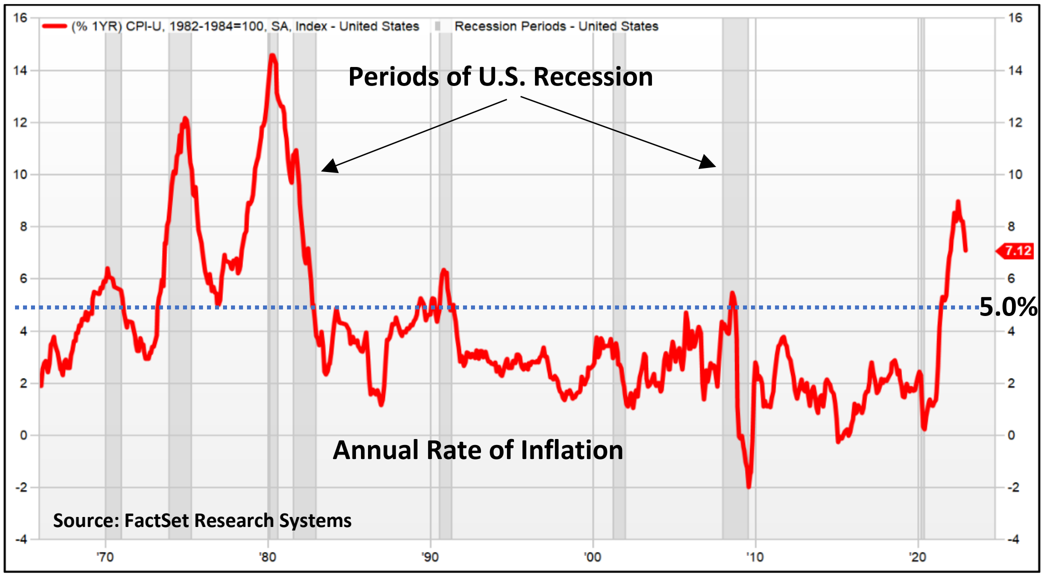
2023 may not be the most positive year for global economic growth, but it may be a much better one for financial markets as investors anticipate the changing landscape of loosening labor markets, reduced wage pressures and slowing inflation.

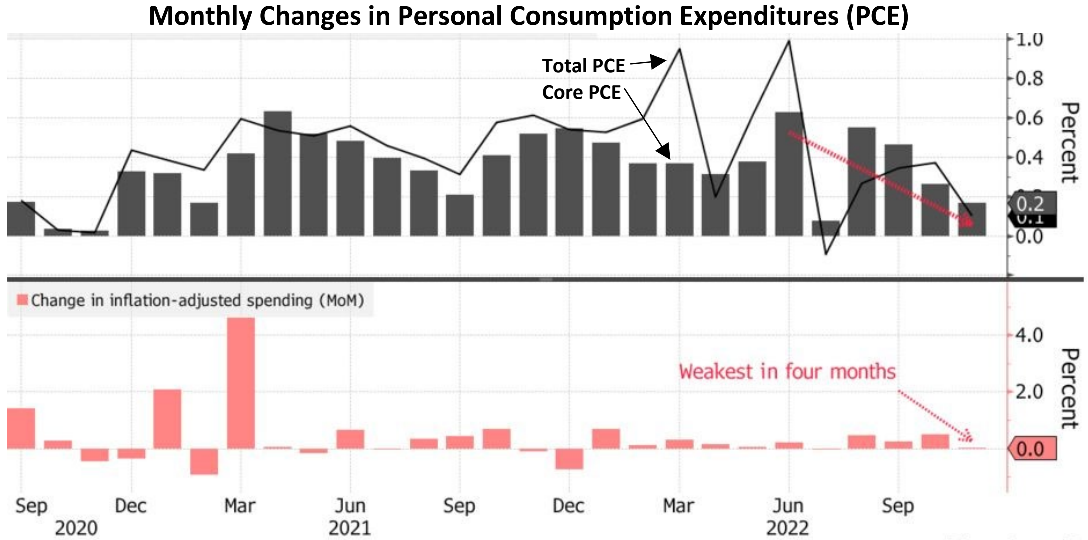
Recession



During the past 50 years, when inflation has risen above 5% on an annual basis, a recession has followed, and this economic cycle is not likely to be different. Why? The Fed has been tightening aggressively and will continue to raise rates to slow demand. As demand "cools" so will price increases and inflation. As the two charts below show, the Fed is achieving its objective.

The PCE or Personal Consumption Expenditure Index, the Fed's preferred measure of inflation, has declined during the last several months from an *annual* rate of +7.2%[iii] in June to an *annual* rate of +5.5%[iv] in November (the chart shows monthly rates). The lower chart shows that inflation adjusted Personal Spending (demand) is at its lowest level in four months. Declining prices and slowing demand should take the pressure off the Fed and slow rate hikes.

Monthly Changes in Personal Consumption Expenditures (PCE)



Monthly Changes in Personal Spending

Source: Bureau of Economic Analysis

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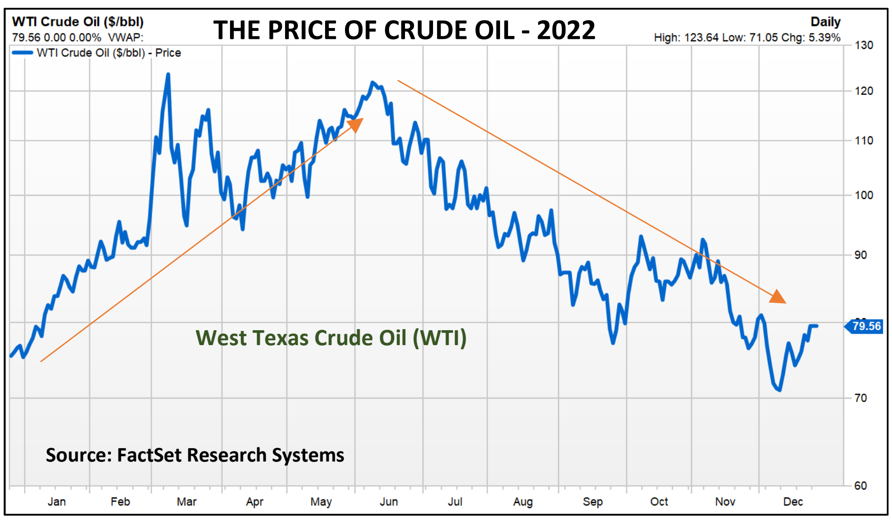
Mild Recession

No one wants to experience a recession. However, recessions occur regularly and are consistent with economic cyclicality. While each recession, and expansion are unique, the good news is that economic expansions last more than three times as long as recessions e.g., 47 months vs. 14 months.[v]

There are several economic cross currents right now, but the likelihood of a U.S. recession is increasing. As we consider the possibility of a U.S. recession, if one occurs, we expect it to be mild. The rationale for that conclusion incorporates several factors: First, the number of job openings far out number available workers. As a result, if layoffs continue to be announced, and hiring deferred, the unemployment rate should increase only modestly. Secondly, the amount of capital that remains unspent by individuals and state governments should serve as an economic buffer to be spent as economic activity wanes. State governments and individuals are estimated to have $250 billion and $1.5 trillion[vi] of unspent capital, respectively. Businesses too have higher than normal levels of spendable cash and recent federal legislation passed to help rebuild U.S. infrastructure is an additional positive.

The factors above plus the likelihood that declining price and demand trends continue should reduce inflation to more "acceptable" (not the Fed's target of +2.0%[vii]) levels by mid-2023 and bring an end to rate hikes. The Fed will not likely be in a hurry to reduce rates, but declining prices and a recession may push them to do so by year end.

All of the above lead to our conclusion of a mild recession. An important caveat to that conclusion though is what happens to the price of crude oil in 2023.



One may recall that crude oil prices increased from $79.00/bbl at the beginning of 2022 to $120/bbl by early June. As a result, gasoline prices spiked from $3.13/gal to $5.00/gal[viii] or an increase of almost 60%. Price increases of that magnitude, for a non-substitutable purchase, have a significant negative impact on consumer spending. Like a tax, higher energy prices take money out of consumers' pockets and the visibility of the trend (gas stations on every corner) becomes a psychological negative.

Since June, crude and gasoline prices have declined, but the price remains volatile and easily impacted by economic trends, geopolitical events or even the whim of a small group e.g., OPEC+.

Various Scenarios

The most positive scenario for the financial markets currently is for a pickup in disinflation trends (declining used car prices, rents, gasoline, housing), a pause by the Fed in its rate raising agenda, a weaker U.S. dollar, fewer corporate earnings cuts because of rapid cost cutting, moderate spending by consumers, and a disciplined recovery in the Chinese economy, the world's second largest.

The less positive financial market scenario is the Fed remains quite hawkish and interest rates remain higher for a longer period, that a recession in Europe is more severe than anticipated, that 2023/2024 corporate earnings estimates are too optimistic, and that the Fed makes a policy mistake by being too restrictive for too long.

Our expectation is (no surprise) in the trail that runs partially though the above expectations. We agree that the likelihood of a recession has grown, but that it will be mild if it occurs. The structure of the U.S. economy today is much different than a decade or more ago, and far less dependent on highly cyclical heavy manufacturing and labor, thus reinvigorating a stalled economy is easier. The current labor market is tight and expected to remain that way so wages and spending should continue to grow. Corporate and individual balance sheets are in satisfactory shape; inflation will decline but persist at a level modestly above the Fed's 2.0% target, the Fed will not make a major policy mistake, and will end their rate raising strategy before mid-year. If we are near correct, both bonds and stocks should rally from current levels and provide positive returns in 2023 and 2024. The unknown? Energy prices.

Final Thoughts

2022 has been a most challenging year and 2023 has the chance to be another one. We know that making short-term prognostications is fraught with "danger" and a great deal of uncertainty. That's why we focus on "the longer term." We take strategic actions when financial markets are at extremes, we stress diversification, we invest only in companies with strong financial/business fundamentals, and we strive to know you and your objectives well.

We believe that the key to investment success is staying disciplined and avoiding trading in and out of the market. It may be difficult to embrace now, but the current uncertainties may provide opportunities, the issues of high inflation and interest rates will be remedied and those with patience and discipline can be rewarded as markets rebound from current depressed levels.

We highly value our relationship and friendship with you, and we thank you for your confidence particularly during this volatile and challenging period. We look forward to any questions, comments and/or critique that you may have and most importantly, we look forward to visiting with you soon.

[ii] Federal Reserve Bank of St. Louis, 11/15/1994
[ii] Bankrate, 12/27/2022
[iii] Bureau of Economic Analysis, 12/23/2022
[iv] Bureau of Economic Analysis, 12/23/2022
[v] Bespoke Investment Group, 12/23/2022
[vi] Barron's Magazine, 11/14/2022
[vii] Federal Reserve Bank of San Francisco, 1/10/2022
[viii] FactSet Research Systems, 12/26/2022