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"From Inflation to Recession?"

Dear Clients and Friends: January 17, 2023

We bet investors are quite glad to see 2022 coming to an end. For three years now, we have faced a number of unusual circumstances. We've moved from pandemic shutdowns and bear markets in 2020 to all time equity market highs in 2021. This culminated in 2022 with a slowing global economy, rising inflation, a determined Federal Reserve, continued supply chain disruptions, and the first war in Europe in 75 years. It's no surprise that volatility was the norm and ever present.

While investors had plenty to fret over throughout the year, it seemed pessimism hit its apex in October. This set up a surprisingly positive ending to a very tumultuous year. U.S. stocks, both large and small cap indices, returned about +7% for the quarter, but still down -18% to -20% for the year. International stock indices surged, thanks partially to a falling U.S. dollar, returning +15% during the quarter but still down -16% for the year. Fixed income markets also participated, turning in a +1.5% quarter, but down -13% on the year. To be sure, it was still a disappointing and challenging year.

The digestion of the varying economic challenges seemed to manifest itself in a tug-of-war between the Federal Reserve and financial markets. The centerpiece has been the Fed's fight against inflation. As they raised interest rates in an effort to cool inflation by slowing the economy, financial markets swooned with fears of recession. Anticipating an eventual Fed pivot, intermittent rallies in equities and bonds soon followed. These rallies resulted in loosening financial conditions, thwarting the Fed's efforts. In response, the Fed ratcheted up rates and rhetoric again. New market swoons ensued. This was the dance in 2022. Three separate bounces of 10% or more played with the psyches of professional and amateur investors alike.

The volatility and worrisome headlines have led to conversations with many clients who have presented smart observations and asked good questions. Their main questions and concerns tended to be: Are we heading into a recession and how will it affect the stock market?

The current setup is that an amalgamation of global events, in response to the COVID pandemic, has yielded the highest inflation in decades. Because ongoing, long-term, elevated inflation causes a loss of purchasing power and diminishes standards of living, the Fed has fought back by aggressively raising interest rates. Higher interest rates increase consumer and corporate borrowing costs, causing reduced demand and slower economic growth. The Fed believes the subdued demand will bring prices down, leading to lower inflation. However, throughout history, these efforts have often resulted in "policy errors" with the Fed going too far and inducing a more severe economic downturn than planned. Recessions are characterized by rising unemployment and lower wages for workers. Corporations experience declining earnings, bankruptcies, and defaults. These effects compound the slower growth,

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hurt corporate prospects and generally result in poor stock market performance. Thus, even though generally part of the business cycle, avoiding recession is the preferred route.

Inflation

So, the root of the current problem is inflation. Are we making progress? We believe that through a combination of the Fed's work, supply chains clearing up, manufacturing coming back online, and COVID restrictions being rolled back, progress is being made. December's Consumer Price Index (CPI) eased for the sixth straight month. While still up 6.5% year-over-year, this is well below the peak of 9.1% in June.

Inflation, in the beginning of the pandemic, was predicted to be "transitory" or brief. A more nuanced interpretation was that many prices were rising because of idiosyncratic supply-demand imbalances that would wash away as the economy normalized. People's behaviors in what they bought and did changed rapidly, throwing off the delicate balance. As our behaviors slowly returned to normal, prices have followed. That normalization has just taken far longer than anyone expected but is clearly under way. We do not expect all prices to go back to where they were, but we do expect them to level off.

GDP Growth and Jobs

Two characteristics of a recession are contracting economic growth and job losses. Economies, both here and abroad, have shown slower growth but continue to make progress. The U.S. witnessed a slight contraction in the first half of the year following the torrid growth of 2021. However, activity picked back up in the third quarter as GDP growth registered 3.2%. For the fourth quarter, the Atlanta Fed's GDPNow estimates growth should be in the 4% range. This is solid growth and far from recessionary.

Still, much like inflation, growth has come to different parts of the economy in waves. As the world started to reopen last year, manufacturing went into overdrive playing catch up to pent-up demand and depleted inventories. At the same time, consumers were still limited in their "outside" activities causing the services side to be very weak. Today, the opposite is true. Manufacturing, having caught up with demand, is slowing. Consumers' attention has now shifted from buying things to doing things. The service economy, including entertainment, health care, restaurant, and travel industries, is booming. Growth may be uneven, but progress is being made. Over time, normalization should occur here as well.

The labor market continues to show strength too. December's report showed another 223,000 jobs were added for the month, bringing the total to 4.5 million for the year. The unemployment rate ticked down to 3.5%, matching a 53-year low, with the labor participation rate continuing to rise. At the same time, we saw wage increases continue to slow. Headlines of layoffs have started to emerge but have been heavily concentrated in the tech sector where over-hiring occurred based on pandemic behaviors and trends. We think nearly every business owner will tell you that the real problem is a shortage of quality employment candidates, not too many. Deep, painful recessions are generally not associated with such a strong labor market.

Earnings

The different stages of the pandemic have produced waves of strengths and weaknesses in earnings similar to those seen with inflation and growth. Largely though, earnings have been resilient. Consolidated earnings for companies included in the S&P 500 are expected to be flat to down about -3% for 2022 compared to 2021. The stock market, however, is

more concerned with the future than the past. Current expectations for 2023 still call for growth of about 10%. This level is likely too high and will need to come down. The volatility and stock price declines observed over the last year were markets adjusting valuations in consideration of lower expectations. A great deal of investors' concerns has already been incorporated into current stock prices.

On the positive side, corporate profit margins remain very strong. A tremendous amount of debt refinancing was completed over the last five years rendering the recent rise in interest rates to be less immediately concerning for most companies. They also see same benefits from receding inflation and easing supply chains as consumers. Their costs of inputs are stabilizing while wage pressures are starting to moderate. As volumes remain robust, these reduced cost pressures should make their way to the bottom line, keeping earnings stable.

Outlook

So, are we heading into a recession and what's going to happen to the stock market? We must first acknowledge that making precise predictions about the short-term future is a hazardous endeavor. Dr. David Kelly, Chief Global Strategist at JP Morgan, sums up our views, "We don't see the economy falling off a cliff, if anything, it will be like stepping into a swamp." The overall economy seems strong enough and does not possess the excesses to produce a painful recession. If we do enter a recession, it will also be the most anticipated recession of all time and will likely be mild and localized to certain sectors and regions of the economy. Not everyone will get wet.

Nevertheless, a host of challenges remains in front of us. Most importantly, the Fed is not done yet. Although inflation data is moving in the right direction, the Fed is adamant that it is not taking any chances. They will keep rates "higher for longer" keeping pressure on the economy and raising risks of a policy error. While suddenly higher mortgage rates have cooled an overheated housing market, the cooling could be too much. There are also longer-term structural issues in the labor market where quality and numbers are a real problem. Lastly, geopolitics of the Russia/Ukraine war, ongoing trade conflicts with China, lingering COVID issues, and America's own political concerns will weigh on the outlook.

Regarding potential returns for investment portfolios, we are again cautiously optimistic. The poor results of the recent past have increased expectations for the future. Bonds are now priced to deliver yields not seen since the Financial Crisis and equities across the globe have been rerated to more compelling valuations. Also, much of the meme stock, cryptocurrency, and highly valued growth company speculation has been removed from the market. Calmer waters should lie ahead for investors. Inflation is falling, the Fed is nearing an end off its tightening cycle, and much of the expected weakness in economic growth is already reflected in market valuations.

Thank you again for your continued confidence and trust as we work through these extraordinary times. We welcome your comments, questions, and referrals. Please don't hesitate to contact us. Stay safe and well.

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