U.S. MARKET REPORT

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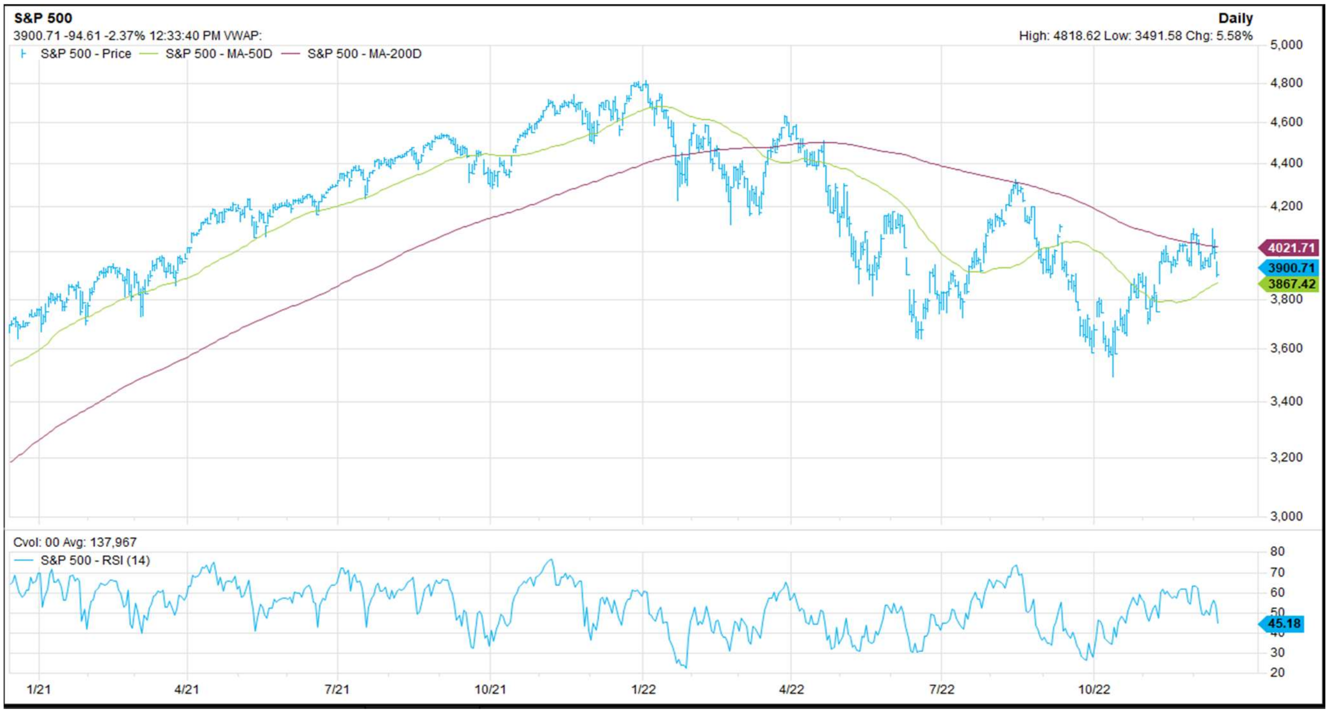
S&P 500



Source: Factset

Main Points

- Recent data is confirming what the stock market has been telling us since the beginning of 2022: The economy is either in a recession or nearing a recession.
- The recent inflation figures have much improved and the outlook for stock returns for 2023 is becoming more positive.
- Despite the good inflation figures and the negative outlook for growth, the Fed has indicated its intention to continue to raise interest rates to ensure that inflation is vanquished.
- Stock returns in the near-term may remain under pressure due to the Fed's current interest rate policy. However, as more data accumulates that inflation is indeed declining, stock prices are likely to rally in expectation that the Fed will have to change policy and a new growth cycle will emerge.
- We are unconvinced that the recent Euro strength can continue.
- Bond yields may have peaked and a gradual extension of portfolio duration is reasonable.

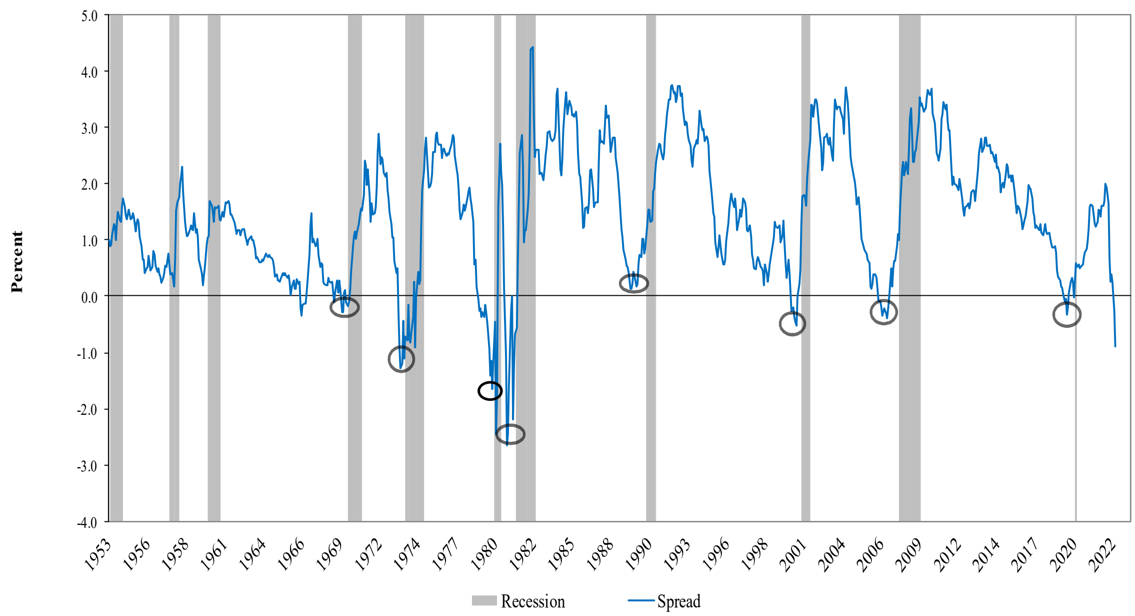
Recession Risk High: Stock Prices Have Been Warning for Months

Indications that the economy is in or nearing a recession are growing louder. Retail sales for November declined a surprising 0.6%, while Industrial Production decreased 0.2%. These figures were further confirmed by the ISM Manufacturing Purchasing Manager's Index, which fell to 49.0 in November.

Figures below 50 indicate that the manufacturing sector is contracting. Another important indicator for the business cycle is the 3-month – 10-year U.S. treasury yield curve. As of this writing, the 10-year U.S. treasury bond is yielding 3.445%, while the 3-month U.S. treasury bill is yielding 4.333%. As seen in Chart 1 below, recessions typically follow an inversion of the yield curve (an inversion is when short-term yields are higher than long-term yields). These leading indicators--the yield curve, the Manufacturing PMI and the stock market--are suggesting that a recession is already underway or will be shortly.

The Federal Reserve has long kept its focus on the labor market in making policy decisions, and less so on the leading indicators discussed above. Fed models have relied on a theory known as the Phillips curve, which shows an inverse relationship between unemployment and inflation. The number of jobs increased a surprisingly strong 263,000 in November and the unemployment rate stayed at a low 3.7%. So, despite the indications of slower inflation, and the leading indicators of recession, the Fed seems determined to stay focused on the continued strength in the labor markets. We would point out that this focus on labor appears to be politically determined. Every first-year economics student is taught that unemployment is a lagging indicator. Furthermore, there is no objective data that substantiates the Phillips curve.

Chart 1 **Treasury Yield Spread (10 Year minus 3 Month Yield)**



Source: Federal Reserve, FVCM

The inflation data has gotten surprisingly better in recent months, but the Federal Reserve is expressing determination to continue to raise interest rates. U.S. consumer prices rose a mere 0.1% in November (a 1.2% annualized rate), reflecting price declines in some manufactured goods, rents and energy. Over the past 5 months, prices have risen at 2.5% annualized rate, while the year-over-year rate remains an unacceptably high 7.1%. Clearly the Fed's aggressively tight monetary policy is having the desired effect of putting downward pressure on prices. Furthermore, as previously discussed, leading indicators are already flashing warning signs of recession, which would cause further downward pressure on the price level.

"The worst pain would come from a failure to raise rates high enough and allowing inflation to become entrenched."
Federal Reserve Chairman Jerome Powell, December 14, 2022

The Fed said that it required more economic data to change its view of the current state of inflation. As expected, the Fed raised short term interest rates 0.5% to a range of 4.25% to 4.50% following the meeting that ended Wednesday (December 14th). But the Fed now sees rates rising to about the 5.1% level before it considers pausing the hikes. This new 5.1% level was higher than the forecast of 4.6% the central bank said in September. The stock market has since declined following this negative surprise. The Fed appears focused on the fact that prices for services continue to rise at a fast pace and the continued strength in employment growth. The drop in stock prices indicates that the market is concerned about the Fed focusing too much on a lagging indicator like employment, and that the effect on the real economy may end up being more severe than necessary, or at least previously anticipated. Nevertheless, Powell and the Fed are determined to establish credibility as inflation fighters, which is a good thing. It is better to be more aggressive now and successfully tame inflation than do too little and let the battle drag onward.

The most recent data from S&P Global indicates that earnings for the S&P 500 peaked in the first quarter of 2022 and have since been declining. The decline in earnings has occurred despite strong sales growth of about 13%. Part of the estimated 6% decline in 2022 operating earnings was due to an "unrealized investment loss" by Berkshire Hathaway that S&P estimated to have reduced earnings for the index by some 4.74, or about 2.4%. The rest of the earnings decline was due largely to narrower profit margins as wholesale costs for businesses rose very sharply. As indicated in the table below, we expect pressure to remain on profit margins in 2023 and earnings are expected to increase only about 2% to 200.37, despite a 6% estimated increase in sales.

S&P 500

	Revenue	Operating Earnings	Special Items	GAAP Earnings	Oper Margin	Net Margin
2010	962.71	83.77	6.42	77.35	8.7%	8.0%
2011	1,052.83	96.44	9.49	86.95	9.2%	8.3%
2012	1,092.37	96.82	10.31	86.51	8.9%	7.9%
2013	1,116.81	107.30	7.10	100.20	9.6%	9.0%
2014	1,163.32	113.01	10.70	102.31	9.7%	8.8%
2015	1,127.13	100.45	13.92	86.53	8.9%	7.7%
2016	1,150.68	106.26	11.71	94.55	9.2%	8.2%
2017	1,231.57	124.51	14.63	109.88	10.1%	8.9%
2018	1,343.01	151.60	19.21	132.39	11.3%	9.9%
2019	1,415.01	157.12	17.65	139.47	11.1%	9.9%
2020	1,362.39	122.37	28.24	94.13	9.0%	6.9%
2021	1,566.80	208.21	10.34	197.87	13.3%	12.6%
2022(e)	1,732.85	195.67	10.85	179.29	11.3%	10.3%
2023(e)	1,831.00	200.37	10.89	189.48	10.9%	10.3%

Stock prices may fall in the weeks ahead, but investors should consider price declines as a buying opportunity. During the two months from mid-October through mid-December, the S&P 500 had a nice upward run of 14%. The Fed's announcement on December 14th that it intends to keep raising interest rates until they're above the 5% level seems to have put a solid end to that rally. Markets never go in any direction without reversals, and we think this reversal is only temporary. The primary fundamental factor that will determine market returns in the year ahead will be inflation. If the data continues to move in the direction we've seen over the past five months, the Fed will likely pause monetary tightening sometime in the first half of 2023 as we start to see weakness in the labor market. It is quite likely that once investors realize that the Fed can take its boot off the necks of businesses and consumers, the markets will rally in anticipation of the inevitable reacceleration of growth. Hence, we are optimistic for 2023 as a whole despite expected volatility in the near-term.

Recession versus S&P 500 (SPX) Peaks, Troughs, and Recovery Times

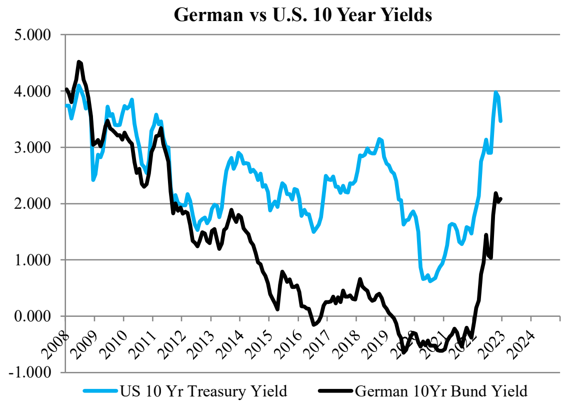
Recession Start	Recession Fnish	Months of Recession	SPX Peak Month	SPX Value	# Mos SPX Peak before Recession	SPX Low Month	SPX Value	Months of Decline	Percent Decline	SPX Recovery Month	SPX Value	Months until Recovery	Years until Recovery
1973.12	1975.04	16	1972.12	118.05	12	1973.09	63.54	9	-46%	1980.07	121.67	91	7.6
1980.02	1980.08	6	No Related Peak										
1981.08	1982.12	16	1981.03	136.00	5	1982.07	107.90	16	-21%	1982.11	138.53	20	1.7
	No Recession		1987.08	329.80		1987.11	230.30	3	-30%	1989.07	346.08	23	1.9
1990.08	1991.04	8	1990.05	361.23	3	1990.10	304.00	5	-16%	1991.02	367.07	9	0.8
2001.04	2001.12	8	2000.08	1517.68	8	2002.09	815.28	25	-46%	2007.09	1526.75	85	7.1
2008.01	2009.07	18	2007.10	1549.38	3	2009.02	735.09	16	-53%	2013.03	1569.19	65	5.4
2020.03	2020.05	2	2019.12	3230.78	3	2020.03	2584.59	3	-20%	2020.07	3271.12	7	0.6
	Unknown		2021.12	4766.18		2022.09	3585.62	9	-25%				
Averages		11			6			10	-30%			38	3.2

Source: Federal Reserve, Factset, S&P Global, FVCM Month end SPX values used in all calculations.

The table above highlights the relationship between the S&P 500 (SPX) and recession. Since the 1970s, the SPX started to decline an average of six months before each recession, with the exception of short recession of 1980. We are now in the 12th month since the SPX peaked, which would match the previous longest period, which was before the 1973 recession. This data supports the supposition that we are now in a recession, or very close to one. It's also worth noting that the 25% decline in the SPX between December 2021 and September 2022, is close to the 30% average decline over all the periods. We can't promise that the SPX low hit in September 2022 will be the final low for this Bear market, but if the inflation data continues to moderate, we think that the chances are pretty good. Also note that the average time for the SPX to recover to previous highs is 38 months. This data varies greatly but suggests that it could take up to another two years before we get back to the old high of 4766 for the SPX. If that were the case, the SPX would return about 12% per year over the next two years.

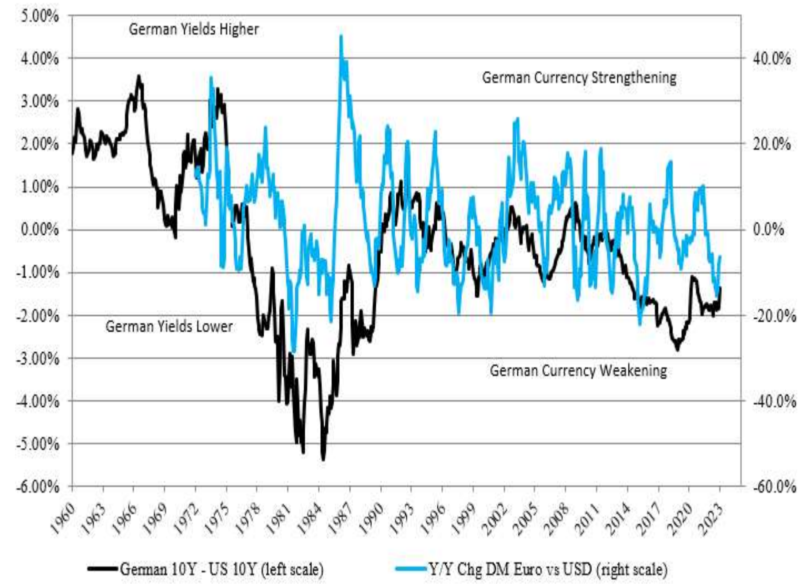
German bund yields have recently risen faster than U.S. yields and the Euro has strengthened. We are unconvinced that the Euro rebound can continue. The spread between the 10-year German bund and the 10-year U.S. Treasury bond was its widest at 2.0% in April 2022. Since that time, yields of both have risen but the yields on the bunds have come up the most. The spread is now 1.38% (Chart 2). As seen in Chart 3 below, when German yields are rising relative to U.S. yields, the German currency tends to strengthen. When German yields fall relative to U.S. yields, the German currency tends to weaken. Looking ahead, we're not optimistic that yields in Europe can continue to rise in a relative fashion. High debt levels in certain regions of the Eurozone may limit the ECB's ability to tighten monetary policy as much as desired without triggering a negative financial event of some type. We also note that the Euro has been in a downward trend since 2008 (Chart 4). From a technical perspective, the Euro is now hitting resistance in the 1.05/1.06 area. While we are not bullish on the Euro, it should be noted that currency exchange rates are infamously difficult to model and the best forecast is often the naïve forecast. Hence, we recommend investors approach f/x rates with the expectation that little will change in the months ahead.

Chart 2



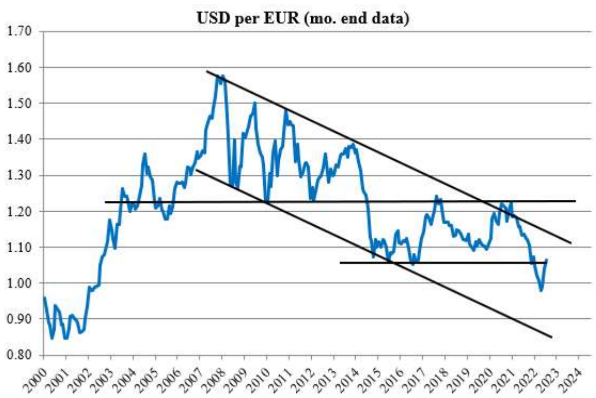
Source: Federal Reserve, FVCM

Chart 3



Source: Federal Reserve, FVCM

Chart 4



Source: Federal Reserve, Wall Street Journal, FVCM

Bonds have done well over the past several weeks as yields on the 10-year U.S. treasury bond has fallen from a high of 4.3% in late October to 3.5% now. The decline in long yields reflects the market concerns about a slowing economy and recession. The overall trend in long-term interest rates is likely to be downward in the months to come as new economic data confirms a slowdown. A gradual accumulation of longer dated bonds would seem reasonable at this stage of the business cycle.
