Fourth Quarter 2022
American Portfolios Quarterly Market Commentary
by Chief Investment Officer Clifford T. Walsh, CFA®

THE FOURTH QUARTER of 2022 failed to produce the Santa Claus rally we all had hoped for, but still, the quarter was solid and welcome after experiencing the dreadful returns in both equities and fixed income throughout the first nine months of the year. All of the major U.S. equity indices were positive, but there was a wide dichotomy between value and growth in the quarter, with growth lagging significantly despite underperforming for most of the year and interest rates rallying somewhat. As far as sectors are concerned, Industrials (19.2%), Materials (15%) and Energy (22.8%) led the way, while Consumer Discretionary trailed (-9.1%) and Communication Services were the next worst performer (0.4%). Not surprisingly, high yield bonds outperformed in the risk-on environment (4.2%) with the corporate sector outperforming U.S. Treasuries[i].

ECONOMIC ACTIVITY, THE FED AND INFLATION

The Economy

Let's get the bad news out of the way. A recession is happening in 2023 and, with a bottoms-up consensus earnings expectation for the S&P 500 still showing 8% growth for the year[ii] and a 17-times earnings multiple, it looks hardly factored into the equity markets. With downward revision to historical economic data, it's actually quite possible the recession started in the fourth quarter of 2022.

There are three reasons we forecast a recession. First, the Fed has never tightened financial conditions so quickly (because they were so late to the game). An economy fueled by debt simply can't maintain its growth rate when the benchmark interest rate rises from 0.125% to 4.375% in nine months[iii]. Not to mention, inflation is eating away at the consumer's purchasing power and will continue to do so in the short term. Second, the Conference Board's leading economic indicator index has fallen each month for the past nine (interesting correlation to the aforementioned rate hikes?). All nine times (dating back to 1959) the economy has experienced similar weakness, it has ended in recession. Finally, the U.S. consumer is on shaky ground while the so-called strength in employment is, unfortunately, just a façade when digging a bit into the numbers.

The Fed and the Inverted Yield Curve

As of this writing, the 10- and 2- Year U.S. Treasury spread inversion is greater than 70 bps (hovering just above December's low of 84 bps, the lowest since September 1981)[iv]. This spread has never inverted without a recession following, dating back to 1976—a period in which we've experienced six recessions. So, it is a question of when, not if. When looking at the 10-Year Treasury compared to the 3-Month Bill, the inversion is roughly 125 bps[v]. What's more, when this inversion has occurred in the past for more than 20 days, a recession has followed in eight out of eight occurrences, dating back to 1969. Right now, we're at about 10 weeks of inversion, so well past the historical trigger point. Based on history, this would suggest a recession is seven to eight months away at the longest … if we're not already in one.

Whether or not the Fed raises rates much more from here doesn't really matter to us that much, and we think the financial market impact will be muted. We believe inflation has peaked and the yield curve will not react to near-term Fed hikes except at the very short end. We ultimately expect the Fed to pause the rate hike cycle in the first half of the year and perhaps pivot to rate cuts in the second half.

Before one jumps into equities, he or she must know three things. Despite tactical trading opportunities, neither of these occurrences have proven to be the bottom in equity prices throughout history. Furthermore, the S&P 500 has never bottomed before the recession has even started. And finally, equities do not bottom while the yield curve remains inverted, meaning the Fed must be well along on its rate-cutting journey before it makes sense to take on buy-and-hold risk.

Leading Economic Indicators are Slipping…

The Conference Board's index of leading economic indicators dropped 1.0% in November, double the consensus expected decline. This was coupled with a downward revision for October (to -0.9% from -0.8%). This is the ninth consecutive decline (now running at a -6.5% annual rate). Each time this has occurred in the past, a recession was on the horizon or the economy was already in the midst of one. Meanwhile, the coincident indicators appear to be flattening out, showing only 0.1% growth in November while the lagging indicators showed 0.2% growth. The trend is growing clear. Economic activity is slowing and possibly quite rapidly.[vi]

The Housing Market, Credit and the U.S. Consumer

After dropping 12% in the final week of last year, mortgage applications dropped another 0.5% in the first week of 2023—the fourth week in a row of contractions. Despite a pullback in mortgage rates (relatively speaking) and the recent decline in home prices (broadly speaking—not necessarily in all local markets), homebuying applications are down 44% from one year ago, sitting at the lowest level in eight years. The MBA mortgage loan application index, which incorporates both new purchases and refinancing, is also down more than 40%, sitting at more than a 20-year low. November also saw the 10th consecutive decline in resale activity, continuing the housing market's current record streak, which previously stood at eight months (2007[vii]).

Every region posted significant declines in sales activity last month. Additionally, median prices declined 2% sequentially in November—the fifth consecutive monthly decline, which is something not experienced in more than seven years. What many don't realize is that the housing market has a greater wealth effect on households than the stock market. The top 10% of U.S. households own roughly 90% of equities, while the bottom 90% of U.S. households own more than 55% of real estate in the U.S. What's more, only 50% of U.S. households own equities at all, while 65% of U.S. households own a house[viii]. The downdraft in this market will have a significant impact on consumer spending, both from a psychological standpoint and a physical one (cash-out refinances.)

Given the combination of housing market woes, high rates of inflation and rapidly-expanding credit card balances (revolving credit surged 16.9% YOY in November)[ix], it appears as if the U.S. consumer is borrowing heavily to keep up, not with the Joneses, but with the prices of everyday goods and services. We expect this rate of change to slow as inflation eases, but still expect high levels of outstanding credit to remain, placing a ceiling on consumer spending.

But What About Employment? It's Not as Good as it Looks…

It is true that, even with some discrepancies that will be discussed below, the U.S. unemployment rate is extremely low; if stable, this is good for consumer spending. But as with many things related to the financial markets, the importance is not necessarily where things are, but changes on the margin. And changes are happening in the employment market … and none of them are good. With earnings expectations likely to decline, as discussed below, and profit margins likely to contract, we think the labor market will shrink in the coming quarters, providing yet another economic headwind.

We've discussed the huge difference between non-farm payrolls and the household survey in the past, and its only widened since then. This discrepancy indicates that many workers have gotten second jobs to keep up with inflation. The Establishment survey attempts to forecast all jobs currently occupied, whereas the Household survey looks solely at employed individuals—meaning the former double counts for individuals with two jobs (or potentially more). Employers are offering part-time work instead of full-time work and individuals are looking to add to base earnings to keep up with gangbuster rent and consumer prices.

If the labor market was as tight as the headlines and mainstream media report, wage growth would not be decelerating. What's more, when we strip out seasonality and jobs added via the births/deaths of businesses forecast model, there is a reversal of more than a million jobs in just the past three months. Are we really to believe that new businesses are being formed at such a clip in the midst of all the aforementioned headwinds while the largest companies across the country are cutting headcount by the thousands and tens of thousands? It doesn't make sense. Not to mention, the workweek is also shrinking, meaning less pay for hourly workers. Hours get cut first, then jobs, so this is just the start.

Even the Fed is predicting more than a 1% increase in the unemployment rate due to its own rate-hiking actions. This suggests roughly 2 million jobs will be cut when all is said and done. Certainly, we've had solid economic times with 4.5% unemployment, but it is not the level of the unemployment rate, but the changes on the margin, that drive recessions. We've never not seen a recession when unemployment has risen by this much.

Inflation

There is no doubt to us 2023 will bring a substantial decline in inflation. In many cases—particularly discretionary consumer goods—we may even see double-digit deflation, based on inventory levels. The supply shocks from COVID, Russia's invasion of Ukraine, and China's seeming merry-go-round of openings and closings, can't seemingly get worse. And the U.S. consumer is apparently strapped and not likely to rebound any time soon. Not to mention, commodity prices—particularly oil, which impacts nearly every business—is down roughly 30% since last summer's peak[x], sure to cycle through goods and services pricing in the coming months. As crazy as it may sound, excess capacity will likely be the story for 2023 rather than ongoing price inflation, although some areas may stay stubbornly high due to other factors (i.e., eggs-bird flu, natural gas-war overseas.)

What is not being talked about is the huge role rent is playing in inflation; it's one of the few variables that has not pulled back. Rent and owners' equivalent of rent make up 40% of core CPI[xi]. It is a slow-moving indicator, given the annual lease signing process, but it is on the decline. What's more, multi-family apartment and condo construction starts are at a 40-year high[xii]. New supply coming online in 2023 will be significantly deflationary to the rental market and the broader inflationary picture, given its significant impact on CPI.

THE IMPACT ON EARNINGS

One of the major issues we've cited as reason for avoiding market risk over the past few quarters has been earnings expectations that were simply too high, not reflecting the negative impact of a Fed hellbent on squashing inflation with higher interest rates. The good news is we continue to see progress here. The fourth quarter witnessed the biggest cuts to quarterly earnings forecasts since the second quarter of 2020[xiii].

The bad news is there are still significant cuts likely to be made and, depending on how much the economy contracts in the coming quarters, analysts may continue to have to play catch-up. As of this publishing, earnings are expected to grow significantly—bottoms-up forecasts call for 8%, while top-down forecasts estimate 5%—in 2023, despite all of the aforementioned economic headwinds. We are watching this closely. But it appears more likely that earnings contract by a double-digit rate rather than grow 5%-8% this year.

DESPITE MIDTERMS OVER AND DONE, GEOPOLITICAL CONCERNS REMAIN

The Debt Ceiling

Yes. It's back. The U.S. is at the debt ceiling. We're not really sure what the purpose of the debt ceiling is since it's doubled in the past decade, but we do know that it means politicizing and deal making will take place in an effort to raise the debt ceiling, so Congress can keep borrowing from the future to pay for the present. It will be interesting to see how it all plays out. Will hardcore Republicans hold their ground? The fiscal conservatives want spending cuts while Democrats want tax increases. Looking at history, previous debt ceiling debacles were bullish for Treasuries and gold, while bearish for stocks and the U.S. dollar. This is in line with our existing views at the present time.

PUTTING IT ALL TOGETHER…

So, what does a recession mean for the financial markets at this point? It means that the bear market is not over and that the low is not in for broad equity prices. Remember, last year was about the Fed's froth and the impact of higher interest rates on the market multiple, not a recession or earnings contraction. The equity markets have never bottomed while the Fed was still in a tightening cycle.

The good news is now, finally, there is an alternative. You may remember an asset class called bonds. With the massive rate hikes already stifling inflation through economic demand destruction, long-duration bonds should rally (it's already begun), helping to ease the downdraft in equities due to relative valuation support. Albeit, it will not stop the downdraft, not with the likelihood of an earnings contraction coming and multiples at 17-times, but it will soften the blow. If you're not willing to take the duration risk, you can get a risk-free rate of 4.5-4.75% at the front end of the yield curve. We recommend balance throughout the curve, and overweight in total for fixed income over equities.

It is simply too early to go overweight equities while the yield curve is still massively inverted, or inverted at all. That being said, there's a light at the end of the tunnel. We expect the Fed to pause in the middle of the year and perhaps begin to cut rates as soon as the third quarter. The equity markets will surely rally on the pause and the pivot. However, historically these turning points in Fed policy have not signaled the end to bear markets and these opportunities tend to be more tactical than buy and hold. The equity markets typically make their bear market bottoms in the last third of the recession and closer to the last rate cut, not the first.

Once we see more reasonable earnings expectations and equity prices, we will look to take on more risk. We continue to believe that 2023 will be much more about trading tactical runs in the equity market than about buy and hold. That might be a late 2023 or even early 2024 story.

The alternative asset class should offer some interesting opportunities, as well. With declining interest rates likely on the horizon, U.S. dollar strength should fade, perhaps providing renewed interest in gold and related equities—and perhaps emerging market stocks, too, although not alternatives. Hedged or long/short equity strategies can also benefit from a downdraft in equities, or at least soften the blow.

As much as everyone hopes for a better 2023, last year was only part one. The pain of part two has yet to come. Patience, discipline and an understanding of history are required. With that, we will get through 2023, perhaps bruised, but not down for the count. And then we will likely be positioned for a multi-year equity bull run.

QUESTIONS AND COMMENTS

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Sources

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