

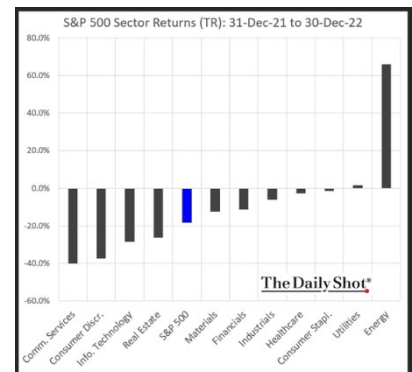
# EQUITY MARKET UPDATE

As of 12/31/22 | Volume 11, Issue 12 | FFTAM.com

Stocks ended the year on a sour note. Investors sold equities as economic data slowed around the world. This further ignited concerns of a recession in 2023. Inflation cooled, but it remains stubbornly high, especially in labor and services. The Federal Reserve raised interest rates again and reiterated its vow to keep rates at elevated levels throughout 2023. Stocks finished the year with their worst results since 2008. As we enter the new year, the answers to three questions are likely to dictate market performance in 2023. First, how much higher will central banks raise interest rates? Second, will they stick to their plan of keeping rates high in the face of a weakening economy? Finally, how will China’s economy perform as COVID-19 restrictions are lifted?

## US Stocks Drop on Weaker Economic Data

The S&P 500 fell 5.77% in December as a series of datapoints indicated economic momentum is slipping. Losses were widespread as every sector experienced negative returns. Consumer discretionary (-11.26%), technology (-8.37%), and communications (-7.84%) saw the worst results as investors once again bailed on stocks with higher valuations, thin dividend yields, and weakening growth prospects. Four stocks—Tesla, Apple, Alphabet, and Amazon—accounted for 50% of the month’s decline. The S&P 500 finished the year with a loss of 18.13%. Only two sectors—energy (+65.43%) and utilities (+1.56%)—were positive in 2022. Technology (-28.19%), consumer discretionary (-37.03%), and communications (-39.89%) were the clear laggards.



The Dow Jones Industrial Average slipped 4.09% for the month. A higher allocation to staples, healthcare, and energy aided results versus the S&P 500. The Dow also has a lower allocation to the technology and consumer discretionary sectors which struggled all year. The Dow was the best performer among major indexes in 2022 with a decline of 6.86%.

The NASDAQ dropped another 8.66% in December. The index continues to struggle as investors remain cautious about unprofitable and poorly capitalized companies. The index fell every month in 2022 except for March, July, October, and November—all of which saw increased hopes the Fed would slow or stop their rate hiking campaign. The NASDAQ was the worst performing major index in 2022 with a decline of 32.51%. The index was disproportionately hurt by nine stocks—Tesla, Amazon, Alphabet, Meta Platforms, NVIDIA, PayPal, Netflix, Salesforce, and Disney—that all carried high valuations, zero

# EQUITY MARKET UPDATE

As of 12/31/22 | Volume 11, Issue 12 | FFTAM.com

dividend yield, and experienced disappointing earnings growth. These companies accounted for almost 60% of the index's decline in 2022.

Middle-to-small-sized companies performed in-line with their large cap peers in December with the S&P 400 Mid Cap Index falling 5.54%, while the S&P 600 Small Cap Index declined 6.72%. In 2022, this area beat its large cap brethren with the S&P 400 Mid Cap Index dropping 13.10%, while the S&P 600 Small Cap Index was down 16.15%.

## International Stocks Outperform US on Lower USD and China Reopening

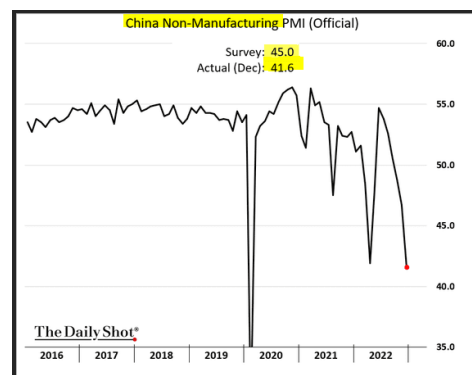
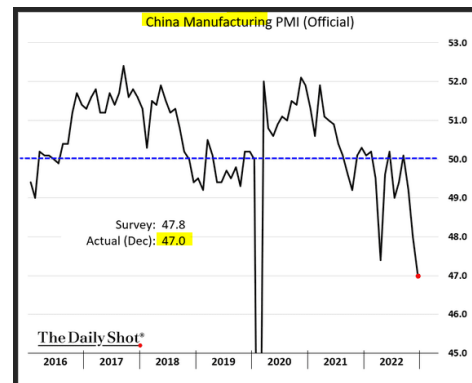
Eurozone inflation was unchanged at 10% last month. This was slightly less than forecasted as energy prices fell month-over-month on warmer than expected weather. This was welcomed news, but the report showed signs that inflation is becoming more entrenched throughout the economy as core inflation (which strips out food and energy) was also unchanged at 5%. We finally saw a crack in producer prices which fell -2.9% for the month, which was much worse than expected. Year-over-year, PPI is still up 30.8%. Logically, businesses in Europe cannot pass along the full extent of inflation, so profits are being squeezed. Eurozone Manufacturing PMI was 47.8, the sixth straight month of contraction. Services PMI improved for the first time in seven months to 49.8. All signs point to Europe teetering on the brink of recession as we enter 2023.

Persistently high inflation pressured the ECB to raise interest rates once again by 0.50%. Despite the weak economic data, they have signaled further rate hikes are needed. ECB President Christine Lagarde announced during her press conference that the central bank is also planning to shrink its balance sheet.

The ECB was not alone in raising rates. In a surprise move, the Bank of Japan announced they are willing to allow their 10-year government bond to float plus or minus 0.50% from 0%. Japan was the lone major central bank that had not acted on interest rates to curb inflation.

The Chinese economy continues to struggle from the effects of extreme drought, constant lockdowns to combat the spread of COVID-19, and a depreciating property market. As the month ended, China was reporting daily records for COVID-19 infections. Economic results are feeble. China's Manufacturing PMI ticked down to 47, while data showed further shrinkage in new orders with a reading of 43.9. Service activity slipped for a third month with a contractionary reading of 41.6. Job growth remains a challenge with youth unemployment of 18.4%. That is very concerning considering China's shrinking workforce due to an aging population, and it highlights the severity that COVID lockdowns are having on both the economy and society. Home sales fell for an 18<sup>th</sup> consecutive month.

With the economy stumbling, officials in China took dramatic steps on COVID-19 restrictions. First, the National Health Commission lowered the quarantine period for people infected with COVID-19 to five days. They also introduced a new measure that allows a COVID positive person to quarantine at home rather than at a centralized facility. President Xi also lifted the restrictions for inbound travelers. This resulted in a travel booking boom as many Chinese citizens looked to take an international vacation



### ABILENE

400 Pine Street  
Suite 300  
Abilene, TX 79601  
325-627-7100

### BEAUMONT

3515 Dowlen Road  
Beaumont, TX 77706  
409-600-6460

### BRYAN/COLLEGE STATION

1716 Briarcrest Dr  
Suite 400  
Bryan, TX 77802  
979-260-2134



### ODESSA

3555 Billy Hext Rd  
Odessa, TX 79765  
432-367-8912

### SAN ANGELO

222 S. Koenigheim St San  
Angelo, TX 76903 325-  
659-5987

### SAN ANTONIO

9601 McAllister Fwy  
Suite 1204  
San Antonio, TX 78216  
210-864-4774

### FORT WORTH

1000 Forest Park Blvd  
Suite 200  
Fort Worth, TX 76110  
682-703-6404

### HOUSTON

24080 Hwy 59 N  
Kingwood, TX 77339  
281-318-4625

Not FDIC Insured | May Lose Value | No Bank Guarantee

### STEPHENVILLE

2201 W. South Loop  
Stephenville, TX 76401  
254-918-6262

### SWEETWATER

201 Elm Street  
Sweetwater, TX 79556  
325-235-6644

# EQUITY MARKET UPDATE

As of 12/31/22 | Volume 11, Issue 12 | FFTAM.com

for the first time in three years. However, as the year ended, many countries, including the United States, began requiring a negative COVID test for incoming travelers from China. Italian officials reported that nearly 50% of incoming travelers on flights from China are COVID positive. This indicates a bumpy road for China’s reopening, but as we witnessed in the US and Europe, herd immunity can be gained within six to twelve months.

With many challenges facing international markets, investors are proceeding with caution. However, hope that inflation has peaked caused the US dollar to fall for a second straight month. This helped international stocks with the MSCI EAFE Index gaining 0.11%, while the MSCI Emerging Markets Index fell 1.51%. Year-to-date, the two indexes are down 13.92% and 19.94%, respectively.

## US Economic Momentum Slips, Fed Slows Pace of Future Rate Hikes

The labor market remains strong. Last month, the economy added 223,000 jobs. The unemployment rate fell to 3.5% even as labor force participation improved. Average hourly wages were up 4.6% from one year ago, an amount that far exceeds both Fed expectations and the pay raises seen pre-COVID. The JOLTS report showed there are 10.46 million jobs available but unfilled. That is a decline from the summer highs, but it still equates to 1.7 job openings for every unemployed person—near the all-time high. The demand for labor continues to far outstrip supply in most industries which signals tightness in the labor force and intense competition to recruit and retain employees. This is something the Fed is paying very close attention to because wage inflation is the most durable and hardest to defeat type of inflation.



Consumer inflation eased as prices jumped 7.1% from one year ago. That was the softest reading of the year. Core inflation that removes food and energy prices rose by 6%. PCE data, the Fed’s preferred measure of inflation, also cooled with total prices climbing 5.5%, while prices ex-food and energy increased 4.7%. The data presents a major challenge for the Fed. For the past three months, inflation has slowed significantly from the previous high-water marks; however, it remains stubbornly high compared to the Fed’s 2% target. High levels of inflation have also spread to almost all parts of the economy meaning the Fed must take a harsher stance on interest rates to defeat it. With inflation more fully embedded in the overall economy, consumers are struggling to keep pace despite the strong labor market and higher wages. The savings rate has plunged to 2.4%, near the all-time low. Credit card balances have surpassed pre-COVID levels and growing briskly. With more of their paychecks going towards everyday essentials (food, shelter, and energy), consumers are running out of discretionary income. Consumer spending rose 0.1% last month. Expenditures on services remain strong, but retail sales fell 0.6%--the largest decline of the year—as shoppers pulled back sharply on holiday-related purchases, electronics, home improvement, and autos.



Business investment data is slowing as household demand for goods weakens. The ISM Manufacturing PMI was in contractionary territory for a second straight month with a reading of 48.4. New orders (45.2) contracted for the sixth time in seven months, while prices paid plunged to 39.4, its weakest reading since April 2020. This means inventories are plentiful and supply chain conditions have healed for

### ABILENE

400 Pine Street  
Suite 300  
Abilene, TX 79601  
325-627-7100

### BEAUMONT

3515 Dowlen Road  
Beaumont, TX 77706  
409-600-6460

### BRYAN/COLLEGE STATION

1716 Briarcrest Dr  
Suite 400  
Bryan, TX 77802  
979-260-2134



### ODESSA

3555 Billy Hext Rd  
Odessa, TX 79765  
432-367-8912

### SAN ANGELO

222 S. Koenigheim St San  
Angelo, TX 76903 325-  
659-5987

### SAN ANTONIO

9601 McAllister Fwy  
Suite 1204  
San Antonio, TX 78216  
210-864-4774

### FORT WORTH

1000 Forest Park Blvd  
Suite 200  
Fort Worth, TX 76110  
682-703-6404

### HOUSTON

24080 Hwy 59 N  
Kingwood, TX 77339  
281-318-4625

Not FDIC Insured | May Lose Value | No Bank Guarantee

### STEPHENVILLE

2201 W. South Loop  
Stephenville, TX 76401  
254-918-6262

### SWEETWATER

201 Elm Street  
Sweetwater, TX 79556  
325-235-6644

# EQUITY MARKET UPDATE

As of 12/31/22 | Volume 11, Issue 12 | FFTAM.com

most goods. The ISM Service PMI (49.6) nosedived into contractionary territory for the first time since May 2020. Finally, housing starts and mortgage applications are weak as 30-year mortgage rates remain elevated.

The Fed responded to the data by raising interest rates another 0.50%. During the press conference, Chairman Jerome Powell stated the Fed has “some ways to go” in raising interest rates. He said they are purposefully moving interest rates into restrictive territory and will leave them there for considerable time to ensure inflation is defeated. He reiterated that “pain” would likely be felt by households and businesses, and it was “very premature” to expect the Fed to pause further rate hikes. He said the Fed would not waver until unemployment rose, wage inflation reverted, and housing corrected. Mr. Powell believes the Fed has significantly addressed the inflationary environment; therefore, they are entering a new phase in which rate hikes will be smaller in size. He also acknowledged this strategy will weigh on economic growth. The Fed lowered its 2023 GDP growth forecast to 0.5% from 1.2%. The market is currently pricing-in a terminal interest rate of 5%. The Fed is currently at 4.5%. It is important to remember that further interest rate increases are coming on top of the Fed’s quantitative tightening program that involves shrinking the balance sheet by \$95 billion each month.

## Market Slump Lowers Valuation, While Earnings are Weakening

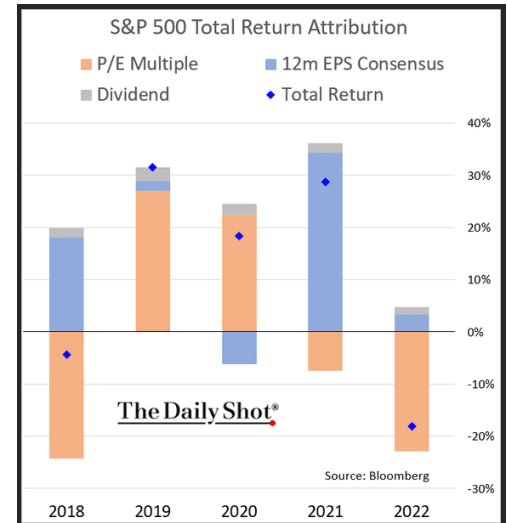
The market decline in December lowered the forward PE ratio on the S&P 500 to 16.52x 12-month estimated earnings. This is below both the 5-year and 10-year average multiples of 18.51x and 17.14x, respectively. It is also less than the pre-COVID PE ratio of 19.40x. In 2022, the PE multiple on the S&P 500 shrank by its largest amount since 2018. This is fair, in my opinion, since interest rates are at their highest levels in 15 years, and an argument can be made that stocks still have not fully discounted the competition being offered by bonds. For example, according to Merrill Lynch, only 16% of the stocks in the index carry a dividend yield greater than the 10-year US Treasury, the lowest level in 11 years.

We are once again on the brink of a new earnings season. Analysts are expecting fourth quarter earnings to fall 2.8% from the previous year. If that comes to fruition, it would mark the first time profits have declined on a year-over-year basis since the third quarter of 2020. As we have previously discussed, earnings have been struggling for nearly six months. In the last two earnings seasons, the entire profit growth was attributable to energy. If you backed out the energy sector, earnings growth was already negative for the remainder of the economy.

Looking forward to 2023, analysts are forecasting profit growth of 5.3%; however, it is important to understand how they come up with that view. The consensus calls for anemic growth of 1.5% and 0.8% for the first two quarters of 2023, followed by double digit earnings growth in the back half of the year. Even though analysts have tampered down their expectations for future profit growth, we believe investors need to beware of companies that cannot clear the lowered hurdle, especially among names that carry high valuations and little-to-no dividend yield.

## Our Outlook & Strategy

The biggest challenge for stocks in 2023 still involves central banks navigating how to remove emergency stimulus policies needed during the depths of the pandemic without tipping the global economy into recession. A watchful eye also needs to be



### ABILENE

400 Pine Street  
Suite 300  
Abilene, TX 79601  
325-627-7100

### BEAUMONT

3515 Dowlen Road  
Beaumont, TX 77706  
409-600-6460

### BRYAN/COLLEGE STATION

1716 Briarcrest Dr  
Suite 400  
Bryan, TX 77802  
979-260-2134



### ODESSA

3555 Billy Hext Rd  
Odessa, TX 79765  
432-367-8912

### SAN ANGELO

222 S. Koenigheim St San  
Angelo, TX 76903 325-  
659-5987

### SAN ANTONIO

9601 McAllister Fwy  
Suite 1204  
San Antonio, TX 78216  
210-864-4774

### FORT WORTH

1000 Forest Park Blvd  
Suite 200  
Fort Worth, TX 76110  
682-703-6404

### HOUSTON

24080 Hwy 59 N  
Kingwood, TX 77339  
281-318-4625

Not FDIC Insured | May Lose Value | No Bank Guarantee

### STEPHENVILLE

2201 W. South Loop  
Stephenville, TX 76401  
254-918-6262

### SWEETWATER

201 Elm Street  
Sweetwater, TX 79556  
325-235-6644



# EQUITY MARKET UPDATE

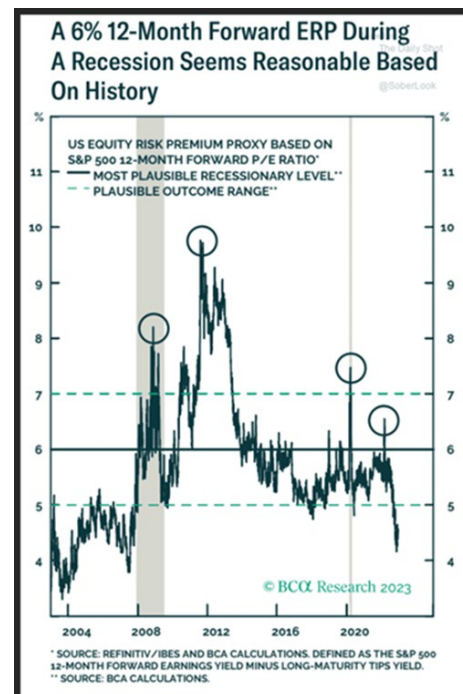
As of 12/31/22 | Volume 11, Issue 12 | FFTAM.com

kept on China as they try to reopen their economy after a long bout of “Zero Covid” policy. Higher interest rates increase the attractiveness of bonds, which reduces the PE multiples investors are willing to assign to stocks. This places outsized stress on stocks trading at lofty valuations, especially those that cannot clear the earnings growth hurdles analysts have forecasted.

We believe 2022 was a year in which both stocks and bonds had to adjust to the higher interest rate environment caused by inflation, while 2023 will be a year in which the market has to adjust to low levels of economic growth. We believe investors are still too optimistic about credit and the profit erosion caused by a weakening economy. For example, Fed Fund futures are pricing-in interest rate cuts in the back half of the year, while the Fed has remained firm on interest rates being kept at high levels all year long even in the face of a weakening economy to avoid the mistake of the 1970s when the Fed cut rates to

stimulate the economy after the 1973-1974 recession only to see inflation reappear with a vengeance. This disconnect will be challenged as we move through 2023, and it will likely spark bouts of elevated volatility.

We enter the new year with a cautionary tone. Even though 2022 was a down year, a strong argument can be made that several excesses remain in the market. PE ratios have fallen, but they remain elevated compared to previous periods of high interest rates. If a recession should occur, analysts have likely not cut earnings estimates enough. Also, the equity risk premium that compensates stock investors for the excess risks taken compared to bonds remains thin compared to historical standards. All these factors remind me of the challenges the market had to face in the 2000-2002 and 2008-2009 timeframes. The difference this time is the Fed will likely be reluctant to stimulate the economy if the recession is mild to prevent reigniting inflation. This gives the market negative skew compared to analyst expectations; therefore, we have been realigning our allocations. We recently trimmed our exposure to financials and industrials while boosting select positions in real estate, healthcare, and utilities that should relatively outperform the market during a sell-off caused by a deteriorating economy. These areas should also do well in an environment of steady-to-slightly declining interest rates as the Fed nears the end of their rate hiking cycle.



## ABILENE

400 Pine Street  
Suite 300  
Abilene, TX 79601  
325-627-7100

## BEAUMONT

3515 Dowlen Road  
Beaumont, TX 77706  
409-600-6460

## BRYAN/COLLEGE STATION

1716 Briarcrest Dr  
Suite 400  
Bryan, TX 77802  
979-260-2134



## ODESSA

3555 Billy Hext Rd  
Odessa, TX 79765  
432-367-8912

## SAN ANGELO

222 S. Koenigheim St San  
Angelo, TX 76903 325-  
659-5987

## SAN ANTONIO

9601 McAllister Fwy  
Suite 1204  
San Antonio, TX 78216  
210-864-4774

## FORT WORTH

1000 Forest Park Blvd  
Suite 200  
Fort Worth, TX 76110  
682-703-6404

## HOUSTON

24080 Hwy 59 N  
Kingwood, TX 77339  
281-318-4625

Not FDIC Insured | May Lose Value | No Bank Guarantee

## STEPHENVILLE

2201 W. South Loop  
Stephenville, TX 76401  
254-918-6262

## SWEETWATER

201 Elm Street  
Sweetwater, TX 79556  
325-235-6644