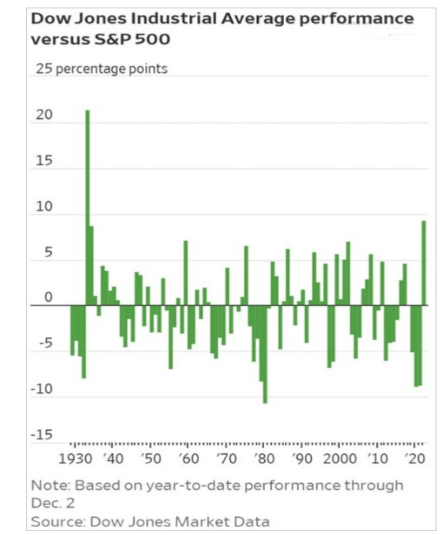
EQUITY MARKET UPDATE

As of 11/30/22 | Volume 11, Issue 11 | FFTAM.com

Stocks rallied in November on expectations the Fed will begin reducing the pace of future interest rate hikes. Inflation data was less than expected, and year-over-year comparisons are becoming more difficult for upward inflation surprises. Economic data shows the US economy remains on firm footing although momentum is slipping in some areas. The situation is much different overseas. Europe is slowing significantly, and China continues to combat the spread of COVID-19. The combination of high prices from recent inflation mixed with high interest rates from central banks worldwide have investors worried about a possible recession in 2023.

US Stocks Pop on Speculation of Slower Fed Rate Hikes

The S&P 500 increased 5.59% in November on renewed hopes the Fed will begin raising interest rates at a slower pace. Gains were widespread as every sector experienced positive returns. Materials (+11.76%), industrials (+7.85%), and financials (+7.04%) saw the best results as investors increased the odds of a possible soft landing for the economy in 2023. In the last two months, the S&P 500 has gained 14.14%. This has cut year-to-date losses in half with the S&P 500 down 13.12%. Energy (+70.17%), staples (+2.26%), and utilities (+2.10%) are the only positive sectors in 2022.



The Dow Jones Industrial Average jumped 6.04% for the month. A higher allocation to financials and industrials aided results versus the S&P 500. The Dow also has a lower allocation to the technology and consumer discretionary sectors which have struggled this year. Year-to-date, the Dow is down 2.89%.

The NASDAQ gained 4.37% in November. The index continues to struggle despite the recent rally as investors remain cautious about unprofitable and poorly capitalized companies. The index has fallen every month so far 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. Year-to-date, the NASDAQ is the worst performing major index with a decline of 26.12% as investors shy away from high valuation companies as interest rates rise. The index has also been hurt by disappointing earnings announcements from Meta Platforms, Netflix, PayPal, Alphabet, Amazon, and NVIDIA. The recent sell-off in Tesla have also weighed on results.

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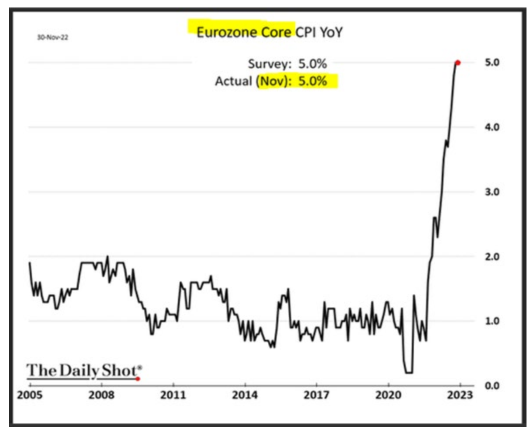
Middle-to-small-sized companies continue to do well with the S&P 400 Mid Cap Index improving 5.95% last month, while the S&P 600 Small Cap Index gained 4.00%. So far in 2022, this area has beaten its large cap peers with the S&P 400 Mid Cap Index dropping 8.00%, while the S&P 600 Small Cap Index is down 10.11%.

International Stocks Surge on Lower USD and Slower Inflation

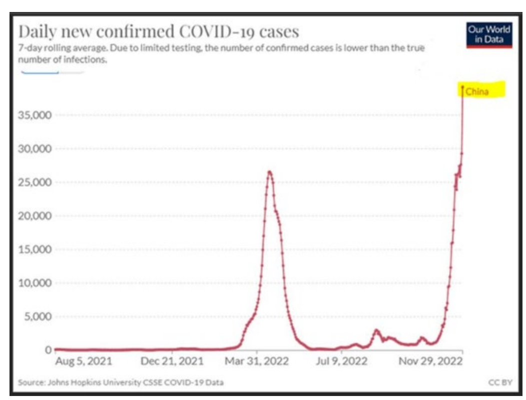
The Eurozone finally got a small reprieve on inflation as CPI "cooled" to 10%. This was less than forecasted, and it marked the first time in 16 months that year-over-year inflation slowed from the previous reading. This was welcomed news, but the report showed signs that inflation is becoming more entrenched throughout the economy as core inflation (which strips out food and energy) increased further to 5%. We finally saw a crack in producer prices as Germany reported a monthly drop in prices primarily due to lower energy costs. However, businesses in Europe have been unable to pass along the full extent of inflation, so profits are being squeezed. Eurozone Manufacturing PMI was 47.1, the fifth straight month of contraction. Services PMI decelerated for a seventh month to 48.5. Despite the weak data, the Eurozone reported third quarter GDP growth of 0.2%. That was in-line with expectations, and many believe the current quarter is likely to show a decline in economic activity.

As I have discussed in the past, the European Union has many challenging years ahead. They got 35% of their total energy needs from Russia prior to the Ukraine invasion. The region has scrambled to find new sources, but none of the solutions provide an immediate fix.



To protect citizens and small businesses from skyrocketing energy prices, both the UK and the European Union announced plans to cap energy prices. However, British Prime Minister Rishi Sunak unveiled his economic plan that calls for increased taxes and a shorter duration of consumer protection against high prices as the UK tries to repair its finances after the former Prime Minister Liz Truss unleashed a market fallout from her proposal to cut taxes in hopes of stimulating business activity.

Persistently high inflation and a sinking euro pressured the ECB to raise interest rates once again by 0.75%. Despite the weak economic data, they have signaled further rate hikes are needed. They are proceeding much slower than the Fed because the ECB faces the unique challenge of rate hikes disproportionately hurting highly indebted countries in Southern Europe.



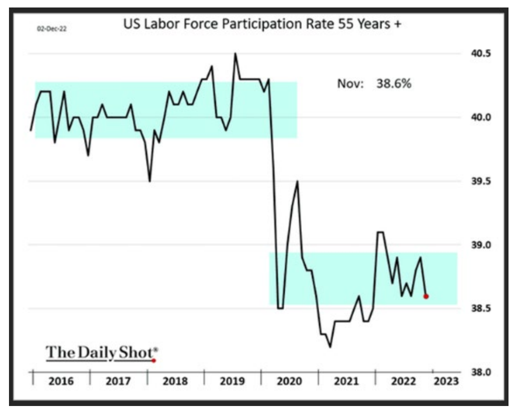
The Chinese economy continues to struggle from the effects of extreme drought, constant lockdowns to combat the spread of COVID-19, and a depreciating property market. As the month ended, China was reporting daily records for COVID-19 infections. To contain the situation, almost 60% of the country's GDP was under

COVID related restrictions. This resulted in citizen protests across the country. Economic results are feeble. China's Manufacturing PMI ticked down to 48, while data showed further shrinkage in new orders with a reading of 46.4. Service activity slipped for a second month with a contractionary reading of 46.7. 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 a 17th consecutive month. With the economy stumbling, officials cut the bank reserve requirement by 0.25%. This should free-up around 500 billion yuan ($70 billion US dollars) for additional lending. President Xi also unveiled a 20-point plan to soften COVID controls for international travelers to China. The government finds itself in a difficult position with COVID infections increasing, while vaccination rates remain low by global standards. The inability to fully reopen is straining economic activity. Businesses around the world are suffering from additional supply chain disruptions, and foreign investors continue to withdraw capital from China.

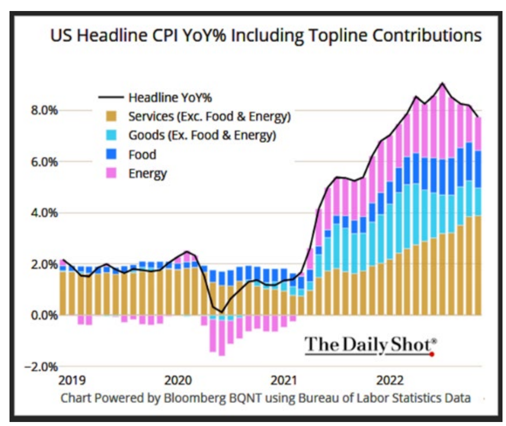
With many challenges facing international markets, investors are proceeding with caution. However, hope that the Fed is nearing the end of their rate hiking campaign caused the US dollar to fall by 5% last month. This helped the MSCI EAFE Index surge by 11.09%, while the MSCI Emerging Markets Index jumped 14.64%. Year-to-date, the two indexes are down 16.78% and 21.08%, respectively.

US Economic Momentum Slips, Fed Signals Slower Future Rate Hikes

The labor market remains strong. Last month, the economy added 263,000 jobs. The unemployment rate held steady at 3.7% as labor force participation declined slightly. Average hourly wages surged 5.1% from one year ago, an amount that far exceeded expectations and the pay raises seen pre-COVID. The JOLTS report showed there are 10.33 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 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 7.7% from one year ago. That was the softest reading since January. Rising prices for homes and rent worsened. Core inflation that removes food and energy prices rose by 6.3%. PCE data, the Fed's preferred measure of inflation, showed similar results with total prices climbing 6%, while prices ex-food and energy increased 5%. The data presents a major challenge for the Fed. It shows that despite the strong labor market and higher wages, consumers are struggling to keep pace. The savings rate has plunged to 2.3%, the second lowest reading in history! 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, however, remains resilient rising 0.8% last month. Expenditures on services are very strong, and retail sales jumped 1.3% as consumers spent more on cars, furniture, restaurant meals, and gifts for the upcoming holiday season.



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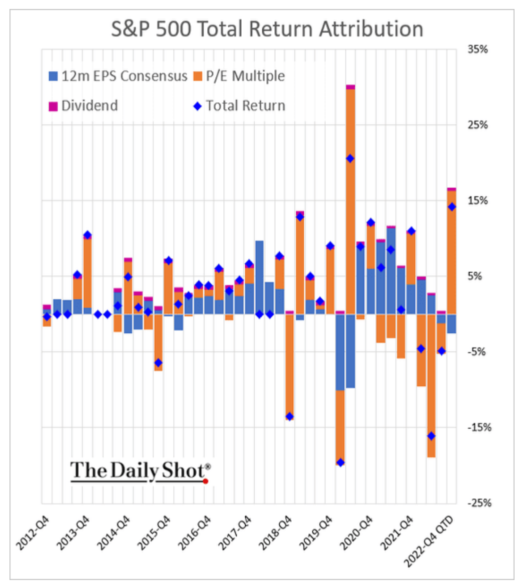
Business investment data is mixed. The ISM Manufacturing PMI fell into contractionary territory with a reading of 49.0. New orders (47.2) contracted for the fifth time in six months. Prices paid remained high with the producer price index (PPI) jumping 8% on a 12-month basis, although it has been trending down for four straight months. Inventories are improving and healthy signaling supply chain conditions have healed for most goods. The ISM Service PMI (56.5) was a stronger than its manufacturing cousin. Finally, housing starts and mortgage applications are weak as 30-year mortgage rates remain elevated.

The Fed responded to the hot employment and inflation data by raising interest rates by another 0.75%. During the press conference, Chairman Jerome Powell stated the Fed is 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. However, Mr. Powell gave investors a glimpse into future thinking. He said the Fed believes they have significantly addressed the inflationary environment; therefore, they are prepared to enter a new phase in which rate hikes will be smaller in size. The market is currently pricing-in a terminal interest rate of 5%. The Fed is currently at 4%. 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.

<u>Market Rally Increases Valuation, While Earnings are Weakening</u>

The recent rally has the S&P 500 trading at 17.35x 12-month estimated earnings. This is below the 5-year average multiple of 18.56x, and it is slightly above the 10-year average multiple of 17.12x. It is also less than the pre-COVID PE ratio of 19.40x. This is fair, in my opinion, since interest rates are much higher today than the previously stated periods, and an argument can be made that stocks have not discounted enough the competition being offered by bonds.



Earnings season just concluded and results were lackluster. Year-over-year earnings growth was 2.5%, the worst showing since the third quarter of 2020. If you exclude the energy sector, earnings declined 5%. This was the second straight quarter of annual profit declines when backing out the results from energy companies. Earnings are being negatively impacted by the poor showing in communications. The sector reported year-over-year profit erosion of 23%, far worse than the analyst estimate of a 13.2% decline. Major misses from Meta Platforms and Alphabet account for the bulk of the shortfall.

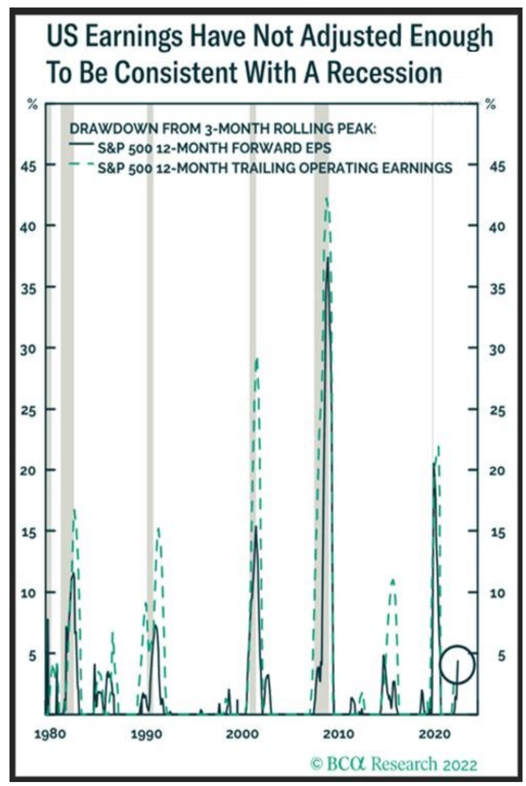
Earnings season was so bad that analysts finally appear willing to cut future profit forecasts. This had been a source of contention as economists argued for months the economy was showing signs of heading towards recession, while company specific analysts forecasted continued prosperity. Currently, analysts are projecting an earnings decline of 2.4% for the fourth quarter, followed by anemic growth of 1.5% and 0.8% for the first two quarters of 2023. This is a major downward revision from previous forecasts. Analysts are still adamant that growth will reaccelerate in the second half of 2023.

These data points tell me three things. First, the rally in stocks the past two months have made valuations appear unattractive compared to the weak earnings forecasts and the appealing bond yields currently in the marketplace; therefore, further downward price volatility is to be expected. Second, with analysts bringing down their expectations for future profit growth,

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. Finally, the lowered earnings expectations from analysts signal they expect a soft landing for the economy in 2023 or a mild recession. If they are right, there is no need for interest rates to return to 0% given the structural shortages in food, housing, energy, and labor that are powering inflation. This last point is important to keep in mind since it means we will not see PE ratios for the overall market expand back to the 20s like the past few years; therefore, most of the future total return for stocks will come from earnings growth and dividends paid.

Our Outlook & Strategy

The biggest challenge for stocks is central banks navigating how to remove emergency stimulus policies needed during the depths of the pandemic without tipping the global economy into recession. Russia's invasion of Ukraine, global drought, and China's continuing battle with COVID-19 complicate matters by pushing inflation higher. 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 both stocks and bonds have fully accounted for the higher interest rate environment caused by inflation. However, as we enter 2023, we believe both are still too optimistic about credit and profit erosion caused by a weakening economy. For example, junk bonds have vastly outperformed investment grade corporates in fixed income this year. I also previously mentioned that analysts are slashing their future earnings expectations, yet they still forecast 2023 earnings growth of 36% in consumer discretionary names! That seems highly unlikely given the Fed's comments on keeping interest rates at elevated levels for an extended period and the increased odds of a recession. Therefore, if analysts need to ratchet down their earnings forecasts further, the sectors seeing the sharpest downward revisions are ripe for further losses, especially in the names that have above average valuations and no dividend yield.

We believe the rally of the past two months in the face of economic challenges presents an opportunity to pivot portfolios once again. Cyclical stocks that do well in the early innings of an economic recovery have rallied tremendously off the summer lows. Much of this had to do with technical indicators signaling a short-term buying opportunity and investor hope that the Fed would usher in a soft landing for the economy. At current levels, many of these companies deserve a haircut. We have 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.