LaFleur & Godfrey
PRIVATE WEALTH MANAGEMENT

Fall 2022 Commentary

Dan Van Timmeren   John Koczara
Chris Walker   Todd Fridline   Aaron Ritsema

Everyone Take a Deep Breath!

Economic Perspective: We believe the current economic environment is far too pessimistic than many in the media suggest. The jobs market remains on moderating, but solid, footing with unemployment at 3.5% near all-time lows. While nonfarm payrolls (+263,000 jobs) in September experienced the lowest monthly gain since April 2021, the report was still strong nonetheless. Importantly, wage gains only rose 5% year-over-year – slightly below forecast. As you may recall, the Federal Reserve has been concerned about wage inflation so a moderation in average hourly earnings is viewed positively. In addition, the recent JOLTs (Job Openings and Labor Turnover Survey) report showed a decline in available jobs to 10 million (from 11.2 million). The decrease of available jobs (supply), combined with moderating job gains (demand), will help bring the jobs market into better balance – another positive for economic bulls and stock market participants. These data points give us increased confidence that wage inflation will decrease over time & that our soft landing economic forecast is still on the table.

The strong service sector (the vast majority of the U.S. economy) has held in there well. The ISM Non-Manufacturing PMI Index ended the quarter with a reading of 56.7 – well in economic expansion territory (above 50). Business activity (59.1) and new orders (60.6) also confirmed continued economic growth. Importantly, pricing pressures eased (68.7) and supplier deliveries grew (53.9). Regarding global supply chains, ISM Chair Anthony Nieves said "Based on comments from Business Survey Committee respondents, there have been improvements regarding supply chain efficiency, operating capacity and materials availability…". Our investment team cannot overstate the importance of global supply chains opening up. This will help ease the burden of the Fed trying to bring down inflation which should result in a decrease in the frequency & magnitude of restrictive rate hikes.

With mortgage rates more than double (approaching 7%!) from just over one year ago, we are starting to see cracks in the housing market. National prices seem to have peaked but certain regions have seen double digit declines. Refinancings are way down due to higher rates which could eventually impact the consumer. Banks may need to increase reserves but remain very well capitalized and we believe are in no way at risk of material mortgage losses. We continue to monitor this closely.

Net-net, it looks like the U.S. economy will exit the first half 2022 'technical' recession with a decent bounce during the second half of the year. Our closely watched (real time) Atlanta Fed GDP Now indicator has third quarter economic growth at 2.9%. If that holds true, the pervasive economic pessimism should dissipate and we could enter a 'not too hot, not too cold' period for our economy.

Market Perspective:

There is nothing good to say about the stock market this year. The bear market declines have ranged from 20% - 35%. Sector leadership from former darlings Technology, Healthcare and Consumer Discretionary have given way to Energy, Utilities and Consumer Staples. This transition from Growth to Value is commonplace during stock market 'risk-off' periods. The key question is: how durable and long-lasting will the new change in leadership continue? We believe our economic forecast shared on the previous page reveals the answer. If the economy is soon to exit a two (quarter)-and-out recession, high-quality growth names are attractive and should be bought or added to on weakness. A not too hot, not too cold economy in 2023 should benefit both Growth & Value names coming out of the recession.

We have mentioned before in previous commentaries that corporate earnings estimates need to reset lower for the market to go higher. The typical earnings decline during a recession is almost 30%. We are currently at 25% (ex-Energy). This suggests we are in the 7th or 8th inning of the market discounting mechanism.

On the bright side, we have begun to see corporate share buyback activity increase. Several companies, including Johnson & Johnson, Comcast & Hologic, have increased share buybacks to support their discounted share prices. Because the Inflation Reduction Act will impose a 1% tax on these buybacks beginning 2023, we expect more companies to frontload purchases through the end of the year which leads us to believe that the worst of the stock market declines may be behind us.

In addition, we have two more things going for us: favorable seasonality and the midterm elections. Historically, stock returns are strongest from October to April during the calendar year for a variety of reasons (year-end bonuses, tax refunds, etc.). As you know, the midterms in November will likely result in a divided government in some form. The market tends to outperform given this outcome. Looking back in time, the average midterm year decline is 19% (which we have well exceeded). However, we have looked at data going back to the 1930's and what we see is the market has shown gains of over 30% from the mid-term election lows one year later.

Looking Ahead:

Bear markets are incredibly painful but, believe it or not, are necessary to reset long-term investor expectations & remove excess speculation in the markets. The end result is a fortification of the market's foundation which sets the stage for the next bull market. Unfortunately, we have experienced three of these significant market declines in the last 5 years. Historically, they happen only once every 5-7 years! Yes, geopolitical risks (Russia / Ukraine, China / Taiwan, etc.) are on the rise. In our opinion, those will never go away. What has gone away is ZIRP – the Fed's zero interest rate policy. The normalization of interest rates to higher levels is healthy for our economy in the long run but unfortunately has resulted in a 'rip the Band-Aid off' tightening policy from our Federal Reserve which is very painful in the short run. This has resulted in well above average volatility for investors. This should dampen over time as inflation comes down in the coming months / quarters & interest rates go from parabolic to range bound.

We leave you with a quote regarding fear from famed investor Warren Buffett in 2016: "During such scary periods, you should never forget two things: First, widespread fear is your friend as an investor, because it serves up bargain purchases. Second, personal fear is your enemy. It will always be unwarranted. Investors who…simply sit for an extended period with a collection of large, conservatively financed American businesses will almost certainly do well." We wholeheartedly agree! It is why we position our clients' equity portfolios with all-weather, sleep-at-night companies. Brighter days are ahead. Thank you for your continued confidence.