LaFleur & Godfrey
PRIVATE WEALTH MANAGEMENT

Winter 2023 Commentary

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Could An Economic Slowdown Be Good News For Stocks?

Economic Perspective:

The economic landscape has market participants confused. On one hand, we could say that the consumer is alive and well - buoyed by the strong labor market and wage gains. On the other hand, we could argue that a recently weak retail sales figure suggests the opposite. As usual, the devil is in the details.

Consumer confidence usually lives and dies with the labor market. Based on the most recent payroll data reported, there is good reason for optimism. ADP payrolls gained 235,000 last month – well above the 153,000 estimate. In addition, nonfarm payrolls in December advanced 223,000 – beating the 200,000 estimate. As a result, the Atlanta Fed GDPnow estimate for fourth quarter economic growth recently rose to +4.1% up from the previous 3.8% estimate. On top of these strong labor reports, the recent JOLTs report stated there are currently 10.45 million job openings! No wonder why the Fed anticipates keeping interest rates 'higher for longer'.

As strong as the above data seem on the surface, we have seen a change in trend of the underlying economic data that raise several yellow flags. First, regarding the above-mentioned payroll data, wage gains were lower than expected. Typically, a rolling over of wage gains precedes labor market moderation and softness. This is necessary to cool down the economy and inflation with it. We have already seen considerable employment weakness in the manufacturing and technology sectors in recent months. It may only be a matter of time until we see more of a broadening out into other sectors. Because retail sales have softened recently (last report showed a 0.6% monthly decline – its largest drop of 2022), it is likely that the retail sector may be next. The more the gap between available jobs & job seekers declines, the more likely the Fed is to pause its restrictive monetary policy. We will continue to monitor the employment numbers closely.

Our domestic economy's engine is powered primarily by service-related industries. It is why our investment committee closely monitors the ISM Services Index monthly reports. As a reminder, any data point above 50 signals economic expansion whereas a below 50 number signals contraction. Last month's ISM Services Index came in at 49.6, joining the ISM Manufacturing Index below 50, which foreshadows economic weakness as we enter 2023. As a result, the Fed has lowered its 2023 economic forecast to +0.5% growth. We believe it is possible that one of the four quarters in 2023 could come in negative but, for the most part, any economic decline will be short-lived and not sustained. It is more likely we achieve a soft landing with 1-2% economic growth in 2023 than a sustained decline & hard landing scenario playing out.

Market Perspective:

The stock market is still very much Fed dependent – but increasingly less so versus a year ago. While we believe they were late to the party tightening monetary policy (raising rates), they most certainly took away the punch bowl in 2022 by raising interest rates to 4.25 – 4.50% in a single year! We are cognizant that the Fed's 'ripping off the Band-Aid' to normalize interest rates was painful. However, it was very much necessary as Fed influence on the markets had gotten out-of-hand. The stock market's reaction with declines of almost 20% on the S&P 500 Index and 33% on the Nasdaq have left many investors dazed and risk averse as we enter a new year. Rightfully so given the bifurcated economic data of late! However, our investment committee believes there is considerable reason for equity optimism in the upcoming year.

Disinflation (a decline in the rate of price increases) is upon us. PCE headline inflation ended the year with an increase of 5.5%. This is down from a peak of 7% reached in June 2022. Core PCE inflation, which strips out food & energy costs, ended the year with a 4.7% increase. We believe this trend will continue and that we could end the year around 3% inflation – still off the Fed's preferred inflation target of 2%. As a result, rates will remain higher for longer – especially if Fed Chair Jerome Powell can engineer a soft economic landing. Inflation 'relief' will help corporate profit margins which should help offset lower revenues from slower economic growth and strong U.S. dollar headwinds. Net-net, this will be a positive for equities, alleviating pressure from Jay Powell and the Fed.

Our investment committee has often preached that company fundamentals (not the Fed) need to once again become the long-term drivers of stock prices. It is why we closely watch the change in earnings estimates for both the stock market & the individual stocks we own. Earnings estimates, at <u>negative</u> 2.2% for the current quarter, are likely to be down during the first half of 2023. The market has already priced this in. As we approach the halfway point of the year, we expect stabilization and potential earnings 'beats' thereafter. This is likely to 'backweight' and move the strongest returns of the year to the second half.

Looking Ahead:

Last year culminated with the worst stock & bond market <u>aggregate</u> returns since 1931 and 1969! It is very uncommon to experience such negative returns together as the asset classes are typically negatively correlated. However, keep in mind that it is not often that ZIRP (zero interest rate policy) is removed & runaway inflation happen in the same year either! As a result, the global stock market's synchronized decline resulted in a global P/E (price/earnings) valuation multiple contraction from a high near 22x to 15.5x today – a 30% decline! In our opinion, the risk-reward ratio has significantly flipped in the favor of long-term investors. No longer are stocks overbought – we believe they now trade at attractive levels with a much-improved margin of safety. The Father of Value Investing, Benjamin Graham (Author of <u>The Intelligent Investor</u>), would certainly agree! If our investment committee is correct that an economic slowdown, not deep recession, is upon us, we are confident that our clients are well-positioned for a turnaround in investor sentiment for the upcoming year and beyond.

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