ECONOMIC UPDATE DECEMBER 2022

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Stocks continued their ascent in November although at a slower pace than in October. Large cap stocks in the S&P 500 index gained 5.6% for the month bringing their year-to-date loss to -13.1%. Small cap stocks in the Russell 2000 were up 2.3% leaving them with a year-to-date loss of -14.9%. International stocks rebounded strongly; stocks in the MSCI EAFE index were up 11.3% and emerging market stocks were up 14.8%. Their year-to-date returns are just below US markets at -14.5% and -19.0% respectively. Long-term yields came down in October resulting in a 3.7% monthly gain for the Barclays US Aggregate Bond Index; it's year-to-date return is still negative at -12.6%.

Third quarter GDP growth was revised higher to 2.9%. The major factor supporting the economy right now is very low unemployment. However, the effects of rising interest rates will likely be felt in the economy next year and many analysts expect a recession by the end of 2023. The recession may be shallow and hopefully if it curtails demand, we'll see supply chain shortages get resolved and inflation reduced.

Inflation continues to be a major factor affecting returns. Although inflation has probably peaked, it will take time to see significant improvement. Parts of the inflation equation are proving to be sticky. Wages and housing are two examples where inflation is likely to persist. When inflation is high, GDP growth, Price/Earnings ratios and stock returns have been historically lower than when inflation is low.

The decline in stock prices so far has been from price/earnings ratio compression rather than because earnings have fallen. Earnings have held up so far. If we do have a recession and earnings are negatively impacted either from falling demand or higher labor and input costs, we could see the market revisit recent lows. If earnings are not impacted because companies were able to pass through their higher input costs, then inflation will still be a problem and further tightening could ensue.

The Fed's primary tool for combatting inflation is raising interest rates. The Fed has acted very aggressively this year, hoping to get inflation under control. The year began with the Fed Funds rate at 0%-0.25%. It is now 3.75% to 4.0%. Recent comments by Fed Chairman Powel suggested that the rate of increase could slow. Strategas Research projects the Fed Funds Rate may peak at 5%-5.25%. Although that would mean short-term rates will climb, long term rates may not rise as much. Already, the 10-year Treasury has backed off its recent high of 4.2% and was at 3.7% at the end of November. The yield curve is inverted as the 10-year Treasury yield is below shorter-term Treasury yields. As such, the bond market seems to be confirming that it also expects a recession.

The stock rally over the past two months was encouraging and could continue through the end of the year. However, more volatility is likely in the new year as many of the analysts we follow have 2023 year-end S&P 500 targets near or below current levels. We continue to encourage investors not to try and time the market by trading in and out. The stock market typically anticipates and moves based on what is coming in the economy. This means that the economy can still feel bad but the market could start to move higher. Instead, we advocate for investing according to risk tolerance. Although bond returns were terrible this year, yields are not expected to have the same sharp increase in 2023, so bonds are likely to provide more protection in the next year. If you have questions about how your account is being managed, please contact your advisor.

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