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Economic Indicators | February 2023 | By Kim W. Suchy

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Optimism has been on the rise on Wall Street as investors continue to see the green shoots of a soft landing in the economy. However, long before anyone declares victory over a possible recession, let's look at what factors are giving rise to optimism and whether they are bound to gain traction or fade away.

First, the global markets have taken a big turn for the better as the doom and gloom scenario painted for Europe has managed to reverse as the brutally cold winter coupled with surging gas heating costs never transpired. Rather, a mild winter coupled with sources of natural gas that did not involve Russia as a supply source gave Europe a huge economic boost, enhancing margins for those energy intensive companies. In addition, China has announced that it is abandoning its "zero Covid" policy and is now opening back up to the world. This will facilitate the reduction of some supply chain disruptions that have not already been fulfilled by other countries. The fact that India and a host of Southeast Asian countries initiated efforts to establish production capabilities to satisfy a broad range of supply chains has enhanced the global economy. Diversifying away from single source suppliers provides favorable economics.

Thus, from a global perspective, inflationary pressures stemming from supply chain issues has calmed down. Assuming free trade can rekindle itself, this could conceivably turn deflationary. Supply growth combined with falling prices has attracted ample investment capital to Europe and now China. These markets carried cheaper valuations than the U.S. IBES reports that as of 1/19, the forward P/Es of the major MSCI stock indexes were: US (17.6), Japan (12.2), Emerging Markets (12.1), and the UK (10.5). No wonder they have outperformed the U.S. year to date.

Here in the U.S., we are beginning to see signs of recovery. Real GDP, our economic growth with the effects of inflation stripped out, came in higher than expected, growing at an annualized rate of 2.9% in the Q4. For the year, real GDP was up roughly 1%, making it the weakest year since 2009, other than 2020's pandemic year. Remember, last year real GDP started out with two negative reports in Q1 and Q2 but finished strong in the second half.

While this looks good on the surface, we remain cautious as the consumer represents nearly 2/3 of GDP. With reports that retail sales, housing, and consumer confidence all waning, future quarters may not hold onto recent gains. The two saving graces right now are falling inflation (CPI and PPI) and that the labor market remains very strong - so the possibility of consumer credit degradation remains muted. We are certainly treading a fine line here as the Fed needs to be extremely careful of the lagged impact of unprecedented hikes and the magnitude of future hikes; too much hurts the labor market, too little may not mitigate inflation.

So, like a good Economist, I *assume* the Fed has got this right by raising rates and monitoring the impact accordingly. What I cannot assume is that Congress will get the spending problem under control. Hopefully, spending and the debt ceiling issues can get resolved without too much carnage. In previous debt ceiling periods, short-term T bills and stocks declined as the battle unfolded, then rebounded once an agreement was reached. With the House holding a very slim majority, expect a war.

The markets seem to be telling us that investors are optimistic about the markets. Economic fundamentals, while facing some headwinds, are looking better. The Fed is closer to the end of hikes than the beginning and Congress will painfully agree to a new debt ceiling but watching the battle would likely be banned from Netflix. Certainly, we are off to a great start in 2023 but remember, there was considerable tax loss harvesting in late 2022, particularly in the tech sector, and it left valuations dirt cheap. Investors jumped on these attractive valuations which is why we have seen such an extraordinary gain in the major indexes thus far. We certainly don't expect these returns to extrapolate themselves but do believe the markets identifying segments that have respectable longer-term potential.

Here is your look at developments in the global marketplace.

POSITIVE DEVELOPMENTS

- The Bureau of Labor Statistics reports that the overall inflation rate (CPI's yoy % change) moved down in December for the 6th consecutive month. At 6.5%, this is the lowest inflation rate since October 2021. Core inflation (which excludes food/energy) also moved down to 5.7%, its lowest level since December 2021.

- Producer prices in December fell 0.5%, the most for any single-month since April 2020. Falling costs for food and energy more than offset rising prices across most other categories. This gave a boost to the equity markets as it gave ample fodder for the Fed to contemplate a halt to rate increases down the road.

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    - Note, some of the root causes leading to inflation, namely supply chain disruptions, soaring commodity prices, and elevated shipping costs, have all eased materially from a year ago.

- If history is a valid guide, 2023 may be an up year for the S&P 500. Standard and Poor's data shows that since 1942, during each of the 3-mo., 6-mo., and 12-mo. periods following each of the 20 mid-term elections, the S&P 500 was up on average by 7.6%, 14.1%, and 14.9% respectively.

- European equity markets are moving higher primarily due to the region avoiding the predicted bitter winter conditions and skirting high heating and power bills and the inflation impact that results. While still high, inflation across Europe dropped for the 2nd consecutive month in December, according to Eurostat, the European statistics agency. Eurozone annual inflation was down to 9.2% yoy last month from 10.1% in November.

NEUTRAL DEVELOPMENTS

- The Commerce Department reported that housing starts in December fell 1.4% and have declined 21.8% yoy. However, single family home starts rose 11.3% in December to an annual pace of 909K while multi-family home starts declined 18.9% to an annual pace of 463K. Single family home starts posted their highest level since August suggesting that lower mortgage rates may be facilitating life in the housing market.

- To date, the 425 bps increase in the federal funds rate represents a 17x increase over where the rate stood at the start of 2022 (25 bps). We have never seen the federal funds target rate rise so quickly. As I have stated before, there is a lag, how long we do not know, between action and impact. So, this explains the outpouring of "let's wait and see sentiment". The Fed will likely wait and assess the lagging effects of their tightening moves so far on inflation and the economy. Remember, inflation is not the only mandate, they must also assess the impact on the job market; they don't want to spark too much unemployment. So, pausing, or discussions thereof, will likely be in the cards soon.
    - *Note, the unemployment Rate moved down to 3.5% in December, near pre-pandemic levels and tied for the lowest rate since 1969. Wage pressures mount at these levels.*

- Durable goods orders climbed 5.6% in December (+6.1% including revisions to prior months), easily beating the consensus expected +2.5% and are up 11.9 yoy, while orders excluding transportation are up 2.1%. A word of caution here is that the surge in new orders was due to the volatile commercial aircraft category, which after plummeting 30.7% in November, rebounded 115% in December.

- Real GDP rose at a 2.9% a/r in Q4, which is, at face value, good news. However, about half of the increase in real GDP was due to a surge in inventories, which isn't sustainable and is almost certain to slow at some point. Meanwhile, net exports (oil and oil byproducts) added 0.6 percentage points to the real GDP growth rate in Q4.

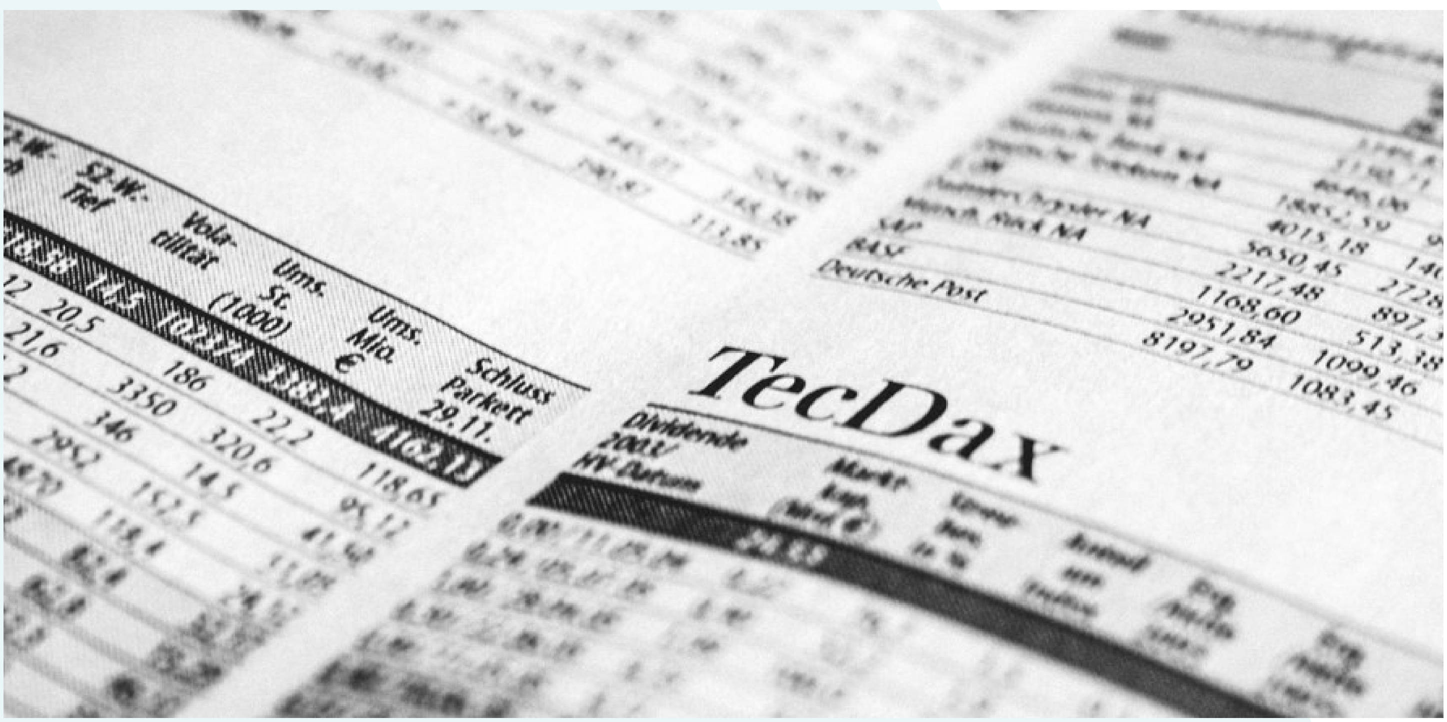
NEGATIVE DEVELOPMENTS

- *Existing* home sales closed 2022 by falling for the 11th month in a row and is now at the lowest level in over 10 years. Declining affordability is the driver as the surge in mortgage rates, with interest rates on 30-yr fixed rate mortgage in the mid-6% range. Sales may remain relatively low as many homeowners are sitting on attractive mortgages at extremely low interest rates, which would make them reluctant to take on higher monthly payments with a new mortgage rate.

- Industrial production fell 0.7% in December. This, coupled with a weak capacity utilization print, rattled the markets in mid-January as hints of recession were brewing. Capacity utilization declined to 78.8% in December from 79.4% in November.

- Retail sales tanked in December, falling by 1.1%, on the heels of a downwardly revised 1.0% decline in November. The weakness in retail was quite broad as 10 of 13 retail categories declined in December, led by gas stations, autos and non-store retailers (internet and mail-order), dropping 4.6%, 1.2%, and 1.1% respectively for the month according to First Trust Economics. The saving grace may be that retailers discounted merchandise quite heavily in December so as to not carry holiday left-over inventory.

- Factset reports that Q4 earnings season for the SP500 continues to be subpar. As of 1/30/23, 29% of the companies in the SP500 have reported actual results for Q4 2022 to date. Of these companies, 69% have reported actual EPS above estimates, which is well below the 5yr.average of 77% and below the 10yr. average of 73%.



THE MARKETS

The market rally in January has been both robust and broad. When investors think the world is ending, they sell small companies and buy big ones; especially those with nice dividends. Conversely, when extensive optimism prevails, investors buy all capitalizations; especially smaller cap stocks. In January, small caps surged as buyers gobbled up the cheapest segment of the market. They also latched on to many of the larger cap tech stocks as tax loss harvesting left these shares relatively cheap.

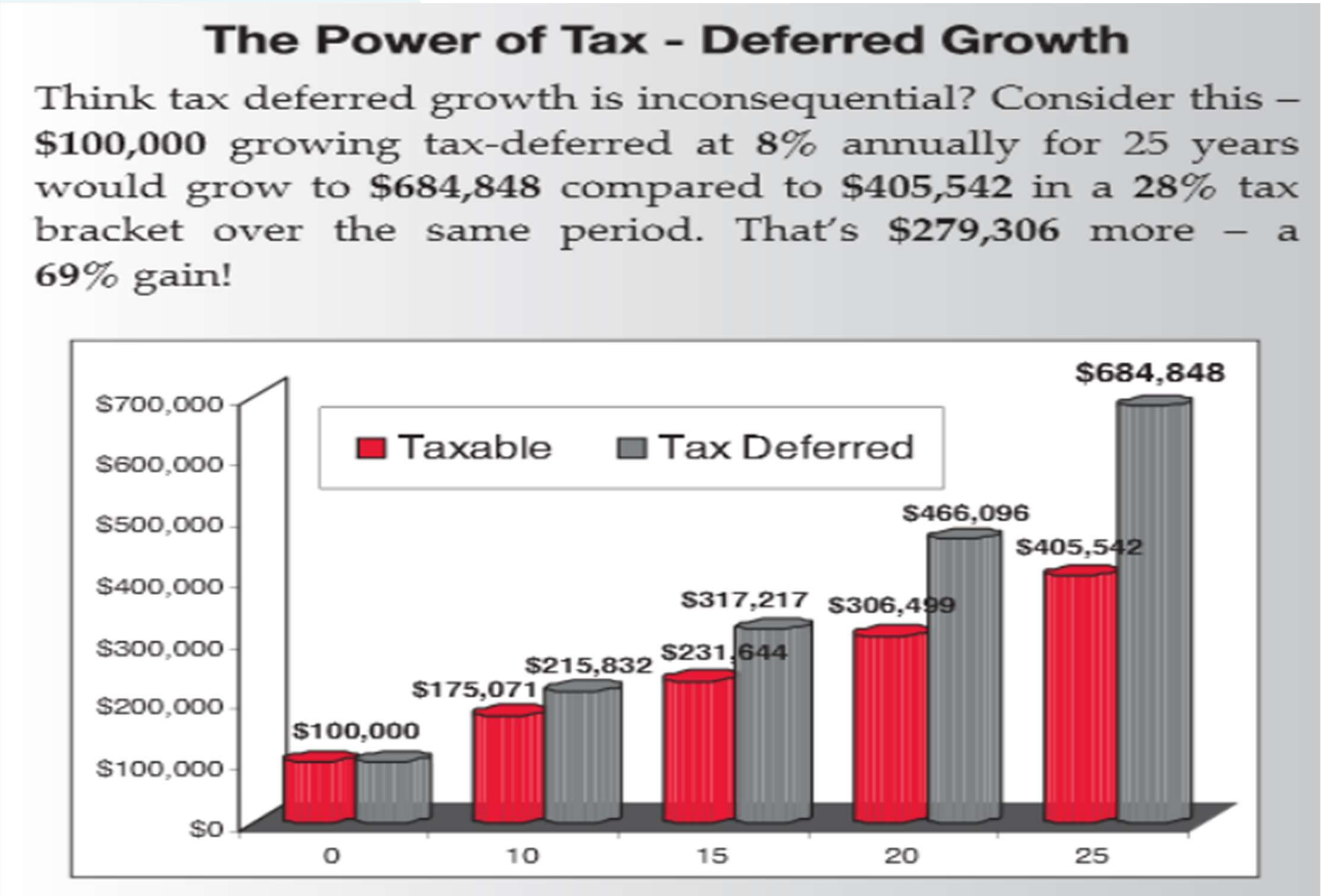
Communications, consumer durables and technology were the strongest performing sectors while utilities, health care and consumer staples were laggards.

In the international arena, the Asian markets Hong Kong, Shanghai and Japan posted 10.4%, 6.2% and 4.7% returns respectively. In Europe, Germany, France and U.K. logged 8.7%, 9.4% and 4.3% returns respectively.

The yield on the US 10 yr. Treasury closed the month yielding 3.52% while the 2 yr. closed at 4.2%. The inversion is currently 68 bps suggesting that the Treasury market believes a recession is in the cards. The US GDP expanded by 2.9% in the last quarter of 2022, beating market expectations of a 2.6% advance, underscoring the economy's resilience. Still, a Commerce Dept. report revealed that core PCE price inflation fell to a 14-mo. low of 4.4% in December, giving rise to the belief that inflation is beginning to fall.

U.S Index	Last Month (% return)	1-YR (%)
S&P 500	6.4	-10.5
Dow Jones	2.8	-3.8
NASDAQ Comp	11.0	-19.7
Russell 2000	9.7	-5.8

Source: https://tradingeconomics.com/stocks



Source: https://wallstreetinvesting.blogspot.com/2016/08/taxable-and-tax-deferred-investment.html

GRAPH OF THE MONTH – TAX DEFERRED GROWTH VS TAXABLE GROWTH

The graph of the month highlights the power of tax-deferral over time versus having that money in a taxable account. As you can see, assuming an 8% annual return and a 28% tax bracket, a tax deferred account would grow nearly 70% more than the taxable account over 25 years.

In taxable accounts, investors must pay taxes on capital gains and/or income in the year it is realized or received. Over time, the tax savings one would save in a tax-sheltered account compounds year after year, which explains the increasing magnitude of growth the further the time horizon.

As you prepare for 2022 taxes and the year ahead, it is essential to assess your allocations in and between taxable and tax-deferred assets. Given this example, it could be very beneficial to contribute or max out contributions to the tax-deferred resources available to you, such as 401K, 403b, and 457 employer-sponsored plans, IRA's, and life insurance. It is important to note that the 2022 IRA contribution deadline is April 15, 2023, so you aren't late to make your 2022 IRA contributions.

Please let us know if we can help guide you through your tax deferred options, investment allocations, and your retirement goals.

NEWS YOU CAN USE

January 2023 will end up being the fifth warmest January on record, which data goes back to 1872. Given the exceptionally warm weather, natural gas prices fell by 40% this month. However, the outlook for early February brings chills. A pool of Artic air is forecasted to rush south this weekend, of which this type of chill is only experienced every 10 years. Chicago temperatures are supposed to reach near 0-degree Fahrenheit Thursday and Friday with 15 mph winds. Hunker down Northerners!

https://www.msn.com/en-us/weather/other/below-zero-temperatures-expected-later-this-week-after-fifth-warmest-january-on-record/ar-AA16U9Jn

Novak Djokovic snagged his 10th Australian Open career title by sweeping Stefanos Tsitsipas in the men's single final on January 29th. Djokovic, 35, has now won 22 Grand Slam singles titles, tying him with Rafael Nadal for the men's record. Djokovic was unable to compete in last year's Australian Open because he was not vaccinated for COVID-19, which was a widely publicized narrative.

https://www.cbssports.com/tennis/news/australian-open-2023-novak-djokovic-tops-stefanos-tsitsipas-for-22nd-grand-slam-title-tying-nadals-record/

On January 31st, the White House entered into a partnership with India with the intent of competing with Chinese military equipment, semiconductors and Artificial Intelligence. The U.S. aims to build out more mobile phone networks in India to compete with China's Huawei Technologies. The US also intends to welcome more computer chip specialists from India to encourage collaboration on military equipment and advanced technologies.

https://www.reuters.com/technology/us-india-partnership-targets-arms-ai-compete-with-china-2023-01-31/

As always, if I can be of additional guidance, please feel free to call me at 312.485.6847.

Best regards,

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