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# Economic & Market Summary
# January 2023

In 2022, inflation rose to the highest level the US has seen in decades. A number of factors contributed including supply chain disruptions, a rebound in service sector spending, pandemic fiscal stimulus, and a shrunken labor force. The war in Ukraine compounded the problem by disrupting energy and commodity markets. In our view, the Federal Reserve was clearly caught off guard and waited far too long before taking action. When it became evident high inflation was not “transitory” as policy makers believed, Fed officials quickly began retracting monetary stimulus. The Fed started shrinking its balance sheet and raised its main policy interest rate from about 0% to over 4%. With inflation still running at 5-7% compared to the Fed’s target of averaging 2%, more tightening is forthcoming. The Fed has signaled rate increases will continue until inflation clearly trends downward and the labor market softens. Fed Chair Jerome Powell has underscored the Fed’s commitment to cooling inflation and has openly acknowledged that some economic pain may be necessary.

So far, the economy has tolerated high inflation and the Fed’s rate increases. Real consumer spending, which accounts for about two thirds of the economy, grew 1.9% on average over the last three quarters. Unemployment has also remained very low with job openings still out-numbering job seekers. However, it typically takes six months or more for Fed policy changes to impact the economy, so we’ve yet to feel the full effects of the large rate increases from the second half of 2022.

Many market forecasters believe the economy will soon enter a recession which suggests the Fed will fail to cool inflation without economic disruption. Indeed, after being so wrong on inflation it’s easy to see why many doubt the Fed’s credibility. Near-term economic conditions will likely be challenging with an uneven impact across companies and industries. Businesses that benefited from the pandemic and over-invested to meet a temporary surge in demand will probably see greater pressure. However, the economy has two things going for it that should provide some cushion to tighter monetary policy and high inflation. First, excess savings are still very high relative to pre-pandemic levels, giving consumers a buffer against rising prices and interest rates. Second, because businesses have struggled to fill job vacancies, we think many firms will be reluctant to cut staff significantly even if demand slows.

Stocks had a difficult year with the S&P 500 and NASDAQ 100 down 19% and 33% respectively. Many speculative assets, such as cryptocurrency and SPACs, collapsed in 2022 as the Fed withdrew stimulus and made the environment for ultra-risky investments unfavorable. Consensus estimates for 2023 S&P 500 earnings have come down over the last six months but still show year-over-year growth of 5% on revenue growth of 3%. This implies profit margin expansion which seems somewhat aspirational especially if demand slows and firms hold on to workers. Aggregate stock valuations also don’t seem unusually pessimistic at 16.5x forward estimates. If the economy does contract and earnings fall further, additional short-term market weakness is likely. Bonds had their worst year in decades and reflect a more pessimistic economic outlook. Three month US government bonds yield more than ten year bonds and credit spreads have widened which are classic recession indicators. Our view is that stock prices will not sustain an upward trend until it’s clear inflation is retreating and the Fed can pause or even reverse restrictive monetary policy. Encouragingly, inflation has showed tentative signs of decelerating over the last few months. We close with a reminder that successful long-term investing requires committed ownership of high-quality businesses through periods of short-term disruptions. Nobody knows when markets will finally bottom, but they will bottom eventually and a new bull market will begin.

Mark J. Sprtel, CFA

*If you’re a current client and your financial situation has materially changed or you would like to discuss your accounts in detail, please contact your investment manager. To request our SEC Form ADV Part II, please contact Mark J. Sprtel, Chief Compliance Officer, at the address above.*