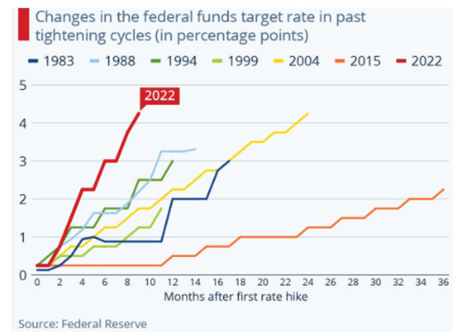
# *The* Advisor

A quarterly publication from Ables, Iannone, Moore & Associates, Inc.

## *Market Update - First Quarter, 2023*

**THE S&P 500** closed out 2022 down nearly 20%, its worst performance since 2008. If the year felt like a gut punch it's because it was. For historical comparison, over the last 95 years going back to 1928, there have only been six other times the market closed out a year lower on a percentage basis. For inquiring minds, three of those six times were 2008, 2002 and 1974. The other three were in the 1930's.




How did bonds fare? Not good. In fact, by several measures it was the worst year on record. The Nasdaq was down more than 34%. Was there any good news, you might ask? Sure, relatively speaking, the Dow Jones Industrial Average outshined its peers, only dropping near 10%.

Ok, 2022 was one for the ages and we could spill gallons of ink breaking it all down but instead we'll summarize it as a market (stocks and bonds) trying to price the implications of the Fed tightening and ratcheting down on financial conditions at a historic pace. How hawkish, exactly, was the Fed last year? The target rate went from 0% in March to 4.25% in December. We can turn to a chart from Statista to illustrate what this looks like compared to previous Fed tightening cycles.

If last year was a market trying to adjust to the Fed's hawkish policy then 2023 will be a market trying to adjust to the impact of that policy on the real economy. Here are the drivers that we believe will have the most impact on the upcoming year.

**Inflation and by extension that means the Fed** – We have to start here because inflation is the entire basis for the Fed's actions. The two mandates for the Fed are price stability (control inflation) and maximum employment. Notice the dual mandate says nothing about real money in the economy or money supply. Spoiler alert, that is because the Fed doesn't control the money supply; instead, they are left to target an interest rate environment that can only influence the demand side of the equation. When the consumer price index (CPI) is high, as it is now, the Fed moves towards a restrictive policy in hopes that the outcome will be prices fall.

The trade off for these policy tools is employment. The concept is rooted in what is called the Phillips curve which you may have heard Jerome Powell reference and it states that inflation and unemployment have an inverse relationship. Said another way, when inflation is high unemployment is low and therefore the economy can absorb tighter financial conditions that will bleed through the system setting off a chain reaction of lower demand, revenue, profits and finally culminate in job loss which will invariably bring prices (inflation) down.

The Fed is loyal to the Phillips curve and that is why you hear so much discussion around the unemployment rate and job openings. The Fed believes we are coming off a red-hot economy post-Covid with an extraordinarily tight labor market that presents ample room to continue tightening. We're much more skeptical of the Phillips curve, the jobs opening data and even the establishment survey of the non-farm payroll report. We see cracks and discrepancies in the data and believe not all price increases are created equal meaning there is a supply side to the equation the Fed cannot fix. But, when the only tool you have is a hammer, everything is treated like a nail. The Fed will keep hammering away at the consumer price index (CPI) dismissing any data aberrations or root causes so let's get an update on where inflation stands.

The December CPI report from the Labor Department showed inflation at 6.5% year over year (current prices compared to 12 months ago). Core inflation, which takes out food and energy, was at 5.7%. Are there signs that inflation is cooling off? Yes, for example, if we look at inflation levels over the last six months and extend that over the course of a year (annualizing the rate) inflation would be 1.9%. The Producer Price Index (PPI), a measure of inflation for producers, dropped 0.5% month-over-month in December which was the largest monthly decline since April 2020. Annualizing the last six months also shows this index is in contraction.

The above is worth repeating, both CPI and PPI have fallen below the Fed's 2% target range when using the last six months annualized. Starting in July, month-over-month measures fell hard. Keep in mind, the Fed didn't even start its tightening campaign until the middle of March last year. It's hard to believe a rate move from 0% in March to 1.25% in June is the main reason inflation fell in the back half of the year. But if it was, then why the plans for 5.00% plus in 2023? Actually, the better question is, what if it wasn't entirely the Fed rate hikes? Just something to think about. Bottom line, it is possible inflation rears its head again but if the last six months are any indication of the future then a new inflationary regime change isn't the problem – deflation is.

**Fundamentals** – Ultimately, we're talking about revenue, margins, cash flow and earnings. Intuitively, it's easy to see how company fundamentals are impacted by business conditions which are impacted by inflation and the Fed's monetary policy. With that, we present a current state of conditions for a few key data points:

**In contraction**

- ISM Manufacturing
- ISM Non-Manufacturing (Services)
- New Orders
- Industrial Production
- Manufacturing Production
- Retail Sales
- Consumer Price Index (CPI)
- Producer Price Index (PPI)

**Holding up or showing signs of strength**

- Low Unemployment Rate
- Job Openings (demand for labor)
- Housing
- GDP

What you can't see for the contraction section, without data in a chart, is a similar trend we discussed above about inflation. Something happened in June/July of last year and accelerated in November/December. The counterbalance has been the labor market and the consumer. So where does that leave things for 2023?

**The Outlook – Pocket Twos** – In the card game Texas Hold'em when you are dealt a pair of twos it's called pocket twos. Traditionally, it's a hand you wouldn't fold but you also wouldn't place a big bet prior to the flop (for the non-poker player the flop is when the dealer reveals three community cards for the table). The market coming out of 2022 and into 2023 has dealt pocket twos, in our opinion. Inflation is cooling off and despite the Fed's commitment to higher rates in 2023 there is little debate we are closer to the end of their tightening cycle than the beginning. Which means if the labor market, the consumer and fundamentals prove resilient then markets could begin pricing recovery sooner than the consensus forecast. The bear side says there are cautionary signals coming from real-time and forward-looking data which suggests the economy is already in contraction.

We're sitting on pocket twos. Folding isn't the play; however, indications are far from "all-clear". Our plan of action is continuing to think in risk-adjusted terms, position portfolios with an eye towards preservation, capitalize on the yield environment and maintain prudent equity exposure. It is our belief 2023 will prove to be a year of reckoning between markets and the economy which will open the door of opportunity for investors.

To our clients, thank you for the opportunity to serve your investment needs. To our other readers, if you would like a complimentary review of your investment accounts, please do not hesitate to contact us. As fiduciaries, we will happily provide you with an opinion based on your specific situation.