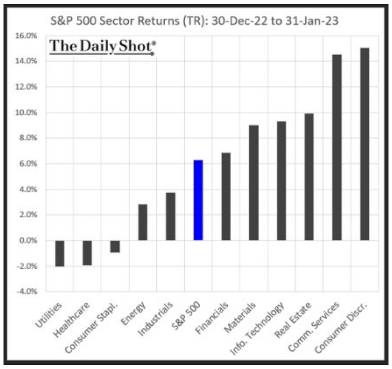
EQUITY MARKET UPDATE

As of 01/31/23 | Volume 12, Issue 1 | FFTAM.com

Stocks rallied sharply to start the new year. Investors were encouraged by the economic reopening in China, better than expected data from Europe, and speculation that the Federal Reserve is nearing the end of their rate hiking campaign. Last year's biggest losers were the leaders in January due to short covering, retail investors bottom fishing, and a decline in long-term interest rates on decelerating inflation data. Earnings season has begun, and results are weak. Tepid profit forecasts, along with the recent rally, have stocks trading at elevated valuations. The bulls are justifying this with hopes of a soft economic landing (a Goldilocks scenario); however, we believe this will be a factor that contributes to above average volatility as we move through the year.

US Stocks Jump on Investor Optimism

The S&P 500 gained 6.28% in January. Growth was in vogue as the 10-year US Treasury yield fell 0.37%. Consumer discretionary (+15.02%), communications (+14.50%), real estate (+9.90%), and technology (+9.32%) were the best performers. Returns were also heavily influenced by the big tech companies—Apple, Amazon, Tesla, NVIDIA, Meta Platforms, Alphabet, and Microsoft—which accounted for 45% of the month's gains.



The Dow Jones Industrial Average increased 2.93% for the month. A higher allocation to value sectors like staples, healthcare, and energy hurt results versus the S&P 500. The Dow also has a lower allocation to the technology and consumer discretionary sectors that were the best performers for the month.

The NASDAQ led the pack by jumping 10.73% in January. This was a sharp reversal for the index after spending all of 2022 in last place among major indexes. The decline in long-term interest rates was likely the contributing factor, along with retail investors loading up on FANG stocks and Tesla. Valuation in tech remains steep relative to other parts of the market, so we are cautious because investors have shrugged off most of the earnings shortfalls that have been reported thus far.

Middle-to-small-sized companies were also strong performers in January with the S&P 400 Mid Cap Index gaining 9.22%, while the S&P 600 Small Cap Index increased 9.49%.

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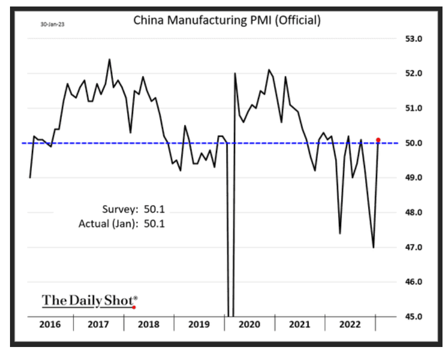
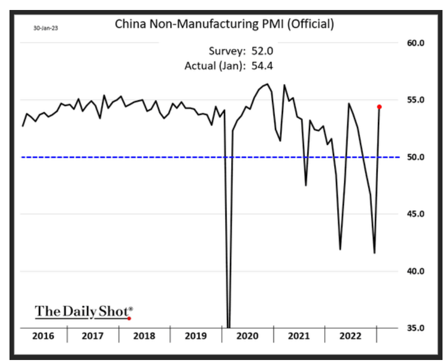
International Stocks Increase on China Reopening and Lower European Inflation

Eurozone inflation fell to an eight-month low of 8.5%. This was well below the forecast estimate of 8.9%. Lower energy prices were the primary reason for the decline as winter continues to be much milder than normal throughout Europe. This was welcomed news, but the report showed signs that inflation is becoming more entrenched throughout the economy as core inflation (which strips out food and energy) was unchanged once again at 5.2%. Eurozone Manufacturing PMI was 48.8, the seventh straight month of contraction, although an improvement from the previous month. Services PMI improved once again to 50.7, its first expansionary reading since July. GDP also eked out a 0.1% gain last quarter. The data remains lackluster, but it is much better than forecasted. Signs point to Europe possibly evading a recession as we enter 2023.

Persistently high inflation pressured the ECB to raise interest rates once again by 0.50%. Despite the weak economic data, they have signaled further rate hikes are needed. ECB President Christine Lagarde highlighted that "wage growth over the next several quarters is expected to be very strong compared to historical patterns."



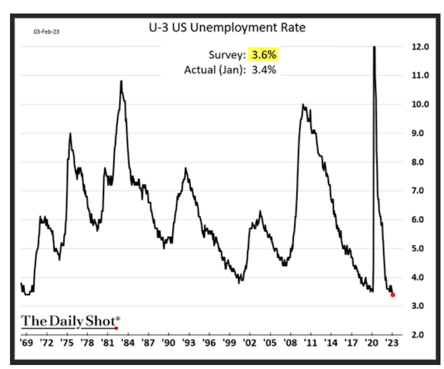
The Chinese economy is showing signs of acceleration after reopening. China's Manufacturing PMI rose to 50.1. Service activity skyrocketed to 54.4 from last month's depressed reading of 41.6. This was the first time since August that both indicators were in expansionary territory. Job growth and mobility indicators also improved as consumers craved social outings after three years of constant lockdowns to prevent the spread of COVID-19. Home sales fell for a 19th consecutive month, but the pace of decline moderated. The encouraging early data has some within the government speculating that President Xi will announce a GDP growth target of 5%-5.5% for 2023, well ahead of the weak 3% growth seen last year. The positive news was moderated by a report that China's population declined last year for the first time since 1961. This is a long-term problem for the economy since China is already experiencing a shrinking workforce due to an aging population.



With current economic data coming in better than feared, along with a decline in the value of US dollar, investors have been increasing their international exposure. There is also a steep difference in valuation between international stocks and the S&P 500. Europe and emerging markets trade at a 40% PE discount to the S&P 500, near historical highs. This helped international stocks in January with the MSCI EAFE Index gaining 8.12%, while the MSCI Emerging Markets Index increased 7.90%.

US Economic Momentum Slips, Services Reaccelerate, and Fed Hikes Again

The labor market remains strong. Last month, the economy added 517,000 jobs. The unemployment rate fell to 3.4%, the lowest level since 1969, even as labor force participation improved. Average hourly wages were up 4.4% from one year ago, an amount that far exceeds both Fed expectations and the pay raises seen pre-COVID. The



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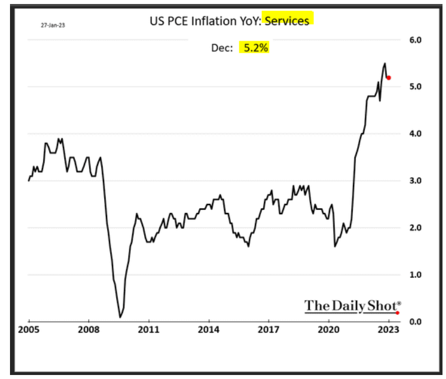
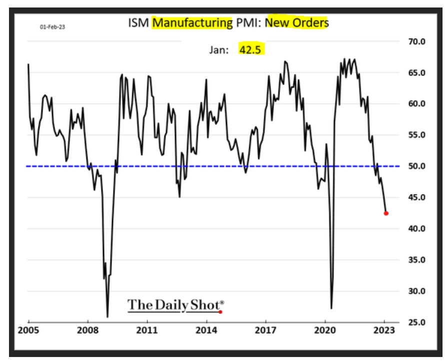
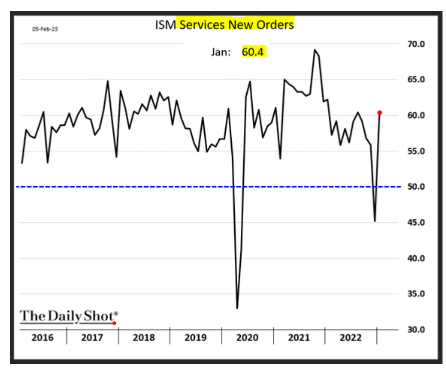
JOLTS report showed there are 11.01 million jobs available but unfilled. That equates to 1.9 job openings for every unemployed person—near the all-time high. The demand for labor continues to far outstrip supply in most industries which signals tightness in the labor force and intense competition to recruit and retain employees. This is something the Fed is paying very close attention to because wage inflation is the most durable and hardest to defeat type of inflation.







Consumer inflation eased as prices jumped 6.5% from one year ago. That was the softest reading of the year. Core inflation that removes food and energy prices rose by 5.7%. PCE data, the Fed's preferred measure of inflation, also cooled with total prices climbing 5.0%, while prices ex-food and energy increased 4.4%. The data presents a major challenge for the Fed. For the past four months, inflation has slowed significantly from the previous high-water marks; however, it remains stubbornly high compared to the Fed's 2% target, especially when you look at inflation in rents and services. With high levels of inflation still existent in many parts of the economy, the Fed must take a harsher stance on interest rates to defeat it. We are seeing further evidence that widespread inflation is a strain for consumers despite the strong labor market and higher wages. The savings rate has plunged to 3.4%, near the all-time low. Credit card balances have surpassed pre-COVID levels and growing briskly. With more of their paychecks going towards everyday essentials (food, shelter, and energy), consumers are running out of discretionary income. Consumer spending fell 0.2% last month. Expenditures on services remain strong, but retail sales fell 1.1%--the largest decline of the year—as shoppers pulled back sharply on holiday-related purchases, electronics, home improvement, and autos.

Business investment data is slowing as household demand for goods weakens. The ISM Manufacturing PMI was in contractionary territory for a third straight month with a reading of 47.4. New orders (42.5) contracted for the seventh time in eight months, while prices paid increased to 44.5. This signals that inventories are plentiful and supply chain conditions have healed for most goods. Meanwhile, the ISM Service PMI (55.2) spiked back into expansionary territory. Prices paid (67.8) and new orders (60.4) for services remain very strong. Finally, home sales fell for the tenth straight month as 30-year mortgage rates remain elevated.

The Fed responded to the data by raising interest rates another 0.25%. During the press conference, Chairman Jerome Powell stated that "ongoing increases in rates" would be appropriate. He mentioned the Fed was now more focused on the extent of future rate hikes rather than the pace which suggests the central bank will move in traditional 0.25% increments. He reiterated once again the Fed is purposefully moving interest rates into restrictive territory and will leave them there for considerable time to ensure inflation is defeated. Mr. Powell believes the Fed has significantly addressed the inflationary environment, but it remains "premature" to declare victory given the tight labor market and above average level of service inflation. He also acknowledged this strategy will weigh on economic growth. The Fed maintained its 2023 GDP growth forecast of 0.5%. The market is currently pricing-in a terminal interest rate near 5%. The Fed is currently at 4.75%. It is important to remember that further interest rate increases are coming on top of the Fed's quantitative tightening program that involves shrinking the balance sheet by $95 billion each month.

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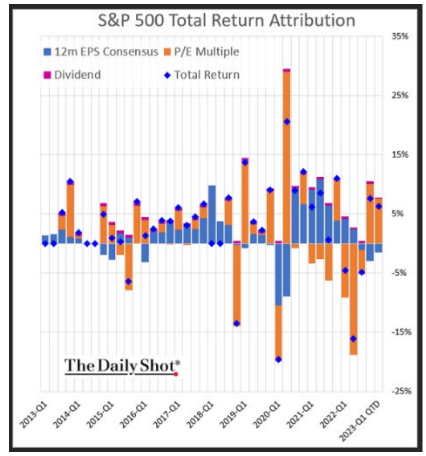

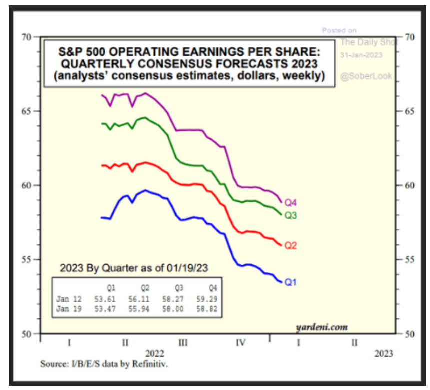

Market Rally Increases Valuation, While Earnings are Weakening

The market rally in January increased the forward PE ratio on the S&P 500 to 17.84x 12-month estimated earnings. This is in-line with the 5-year and 10-year average multiples of 18.54x and 17.23x, respectively. It is also less than the pre-COVID PE ratio of 19.40x. This is fair, in my opinion, since interest rates are at their highest levels in 15 years.

We are in the thick of earnings season, and results have been subpar. With 50% of the S&P 500 having already reported, earnings are down 3.52% from one year ago. If this trend continues, it will be the first time the index has shown year-over-year profit declines since the third quarter of 2020. As we have previously discussed, earnings have been struggling for nearly six months. In the last two earnings seasons, the entire profit growth was attributable to energy. If you backed out the energy sector, earnings growth was already negative for the remainder of the economy.

Looking forward to 2023, company forecasts have been weak as CEOs are cautious given the inflation and macroeconomic headwinds. Analysts were forced to chop their full year earnings forecasts once again. They now see 2023 profit growth of 3.4%, and they have downgraded their growth expectations for every quarter. Even though analysts have tampered down their expectations for future profit growth, we believe investors need to beware of companies that cannot clear the lowered hurdle, especially among names that carry high valuations and little-to-no dividend yield.

Our Outlook & Strategy

The biggest challenge for stocks in 2023 still involves central banks navigating how to remove emergency stimulus policies needed during the depths of the pandemic without tipping the global economy into recession. A watchful eye also needs to be kept on China as they try to reopen their economy after a long bout of "Zero Covid" policy. Higher interest rates increase the attractiveness of bonds, which reduces the PE multiples investors are willing to assign to stocks. This places outsized stress on stocks trading at lofty valuations, especially those that cannot clear the earnings growth hurdles analysts have forecasted.

A major disconnect continues to exist in the markets where investors are increasingly betting the Fed will cut interest rates in the second half of the year while the Fed has remained firm on interest rates being kept at high levels all year long, even in the face of a weakening economy, to avoid the mistake of the 1970s when the Fed cut rates to stimulate the economy after the 1973-1974 recession only to see inflation reappear with a vengeance. This disparity aided growth stocks tremendously in January, and we believe it will serve as a catalyst for overall market volatility as we move through 2023.

Finally, the equity risk premium that compensates stock investors for the excess risks taken compared to bonds remains thin versus historical standards. We used the rally in January to trim some of our tech and industrial holdings that have rallied significantly from the October lows. With the proceeds, we boosted select positions in real estate, healthcare, utilities, and communications. Their lower valuations and defensive business models should lead to relative outperformance in a volatile market environment facing numerous macro challenges.