"Planning Vs. Predicting"

Market Commentary – December 2022

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The second estimate of Gross Domestic Product (GDP) shows that the output of goods and services produced by labor and property located in the U.S. grew at an annual rate of 2.9% in the third quarter of 2022. This is higher than the advance estimate of 2.6% and much higher than the 2022 Q2 decrease of -0.6%. Inflation seems to be cooling, although it remains high. The Consumer Price Index (CPI), a measure of inflation on consumers, jumped 7.7% year-over-year in October. While the Bureau of Labor Statistics touts this is the smallest 12-month increase since the period ending January 2022 (CPI peaked at 9.0% in June 2022), it remains very high (from 2012-2020, CPI ranged from -0.2% to 2.9%). The Producer Price Index (PPI), a measure of inflation on domestic "producers" of goods and services, rose 8.0% year-over-year in October after peaking at 11.7% in March 2022. The Federal Reserve wants to see inflation around 2%. Unemployment remains low at 3.7% in October, although that is higher than 3.5% in September. Some economists believe unemployment needs to rise (i.e., workers need to be laid off) before we see inflation truly calm down. Employers competing for scarce labor by raising wages has contributed to overall price increases in goods and services.

On November 2, the Federal Open Market Committee (FOMC) announced a fourth consecutive 0.75% increase in the benchmark federal funds rate to a target range of 3.75% to 4.0%. The next FOMC announcement on monetary policy is scheduled for December 14. Earlier today in a speech televised on financial media, Fed Chair Jerome Powell signaled a possible slowdown in the pace of tightening (less than 0.75%). Fed funds futures still forecast a peak rate at 4.75% to 5.0% by May 2023. The Fed's balance sheet continues to shrink, with the pace finally accelerating to the Fed's target. The Fed had initially promised reductions of $47.5 billion per month starting June 1 and $95 billion per month starting September 1. With assets at $8.914 trillion on May 25, they should be $427.5 billion lower by now. As of November 23, assets were $8.621 trillion, down only $293 billion. We note, however, that assets are down $102 billion since October 26, slightly faster than the $95 billion/month target pace. Fed balance sheet reductions are creating headwinds for the stock market, especially growth stocks.

Technical factors of the market are bullish (more demand than supply), while fundamentals are fairly priced – therefore, we are mildly bullish on the market. The Standard & Poor's forecast for S&P 500 operating earnings per share (EPS) over the next 12 months is $228.61, which implies a price-to-earnings (P/E) ratio of 17.8 with the S&P 500 at 4,080. The earnings yield (E/P) of 5.60% represents fair value relative to the 10-year U.S. Treasury note yield of 3.68%. There are even more attractive opportunities in mid cap and small cap stocks. Using 2022 earnings, S&P reported on November 22 that the P/E of the S&P 400 Mid Cap index was 14.7 (6.81% E/P) and the S&P 600 Small Cap index was 15.1 (6.62% E/P). These numbers would likely be even more favorable with 2023 estimates (which were not provided by S&P).

The S&P 500 closed slightly above its 200-day moving average (4,050), which is a test for the bulls. Momentum buying could push the prices higher to the next major level of resistance at the August 2022 high (around 4,300). Support should be felt near the 50-day moving average (3,800). December may see some tax loss selling in beaten down stocks (plenty of those in 2022). We also have favorable seasonal factors to look forward to, including the Santa Claus rally and start of a new year (fresh money buying).

Successful investing is more about planning for the future than predicting it. When investors try to *predict* the future, they can easily become paralyzed by trying to time the exact high or low. A better approach is to *plan* for market gyrations with a balance of stocks and cash. If stocks rise in price, investors can enjoy the profits (capital gains and dividends). However, if stocks fall in price, cash can be used to incrementally buy more stocks at lower prices. (The corollary is to incrementally sell stocks into strength – covered calls can help on this front.) By buying and selling incrementally, investors free themselves of the paralysis that plagues so many as they are too concerned about "being right".