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# John’s Market Outlook – December 12, 2022

Since my last Market Outlook on September 12, the S&P 500 fell 13%, then rose 11%, ending up a little lower than where it started. Fixed income (bond) prices have done a similar round trip.

<u>The Federal Reserve raised the Fed Funds rate</u> by another 150 bp to 3.75-4.00%. The Fed will continue raising until it thinks rates are high enough to force inflation down to 2%/yr. During 2023, the Fed Funds rate is likely to reach or exceed 5.0%.

<u>Leading economic indicators continued declining.</u> Falling LEIs preview more slowing in the US economy. Housing has already weakened substantially. The job market and wage growth remain strong, but pockets of weakness are emerging - layoffs in technology and housing, less demand for temporary help.

<u>S&P 500 earnings are deteriorating.</u> Forecasts were rising until mid-year, and then started falling. 3Q’s earnings for the S&P 500 were weaker than 2Q’s. 4Q22 and 2023 forecasts fell again.

<u>Inflation passed its peak but remains very high</u>. Inflation in goods has decelerated while rising wages continues to drive very high inflation in services. Shelter (housing) inflation is still high but should slow mid next year due to housing market weakness.

<u>Yield curves are inverted, which has nearly always predicted a recession</u>. I continue to believe the recession will be mild to moderate.

I try to keep these notes short, so for charts with more detail, please see the **Appendix**.

<u>We are *starting* to see some of the things on my September 12 list</u> of “what to expect in coming months”. That list was: inflation trends lower, employment weakens, housing market slumps, a recession emerges, S&P 500 margins revert to pre-pandemic levels and 2023 earnings forecasts fall.

<u>The S&P 500 fell to about 3,600 in October. Was that “the bottom”? I think not,</u> for two main reasons.

<u>First, we are still waiting for the conditions to create a bottom</u>. My list is only *starting* to get checked off. Inflation has only just started easing, jobs are stubbornly strong, the Fed is not ending its rate increases, S&P 500 profit margins are far above normal, and forecasted S&P 500 EPS looks too high.

Second, S&P 500 price level did not go low enough. Here is a "back-of-envelope" estimate: in my view, 2023 S&P 500 EPS is likely to be about $195-210. A price-earnings (PE) ratio range of 16-17X implies a S&P 500 price range of about *$3,100-3,400*. A more detailed analysis using margins and cash flows suggests S&P 500 fair value range of about *$3,200-3,500*. Pre-pandemic, before the flood of liquidity unleashed in 2020/21 and now being withdrawn, the S&P 500 reached about $3,350.

In short, I think the S&P 500 – and, by extension, most equity indices – is likely to turn down in coming months. Between now and mid 2023, I think the S&P 500 is likely to reach new price lows in the $3,100-3,500 range. Then we will, in my opinion, be at or near the *durable bottom* for equities.

No-one has a crystal ball and these are unusual times. We *may not fully check off every item* on my list. If the expected recession is *particularly mild* or just a mid-cycle downturn, the S&P 500 *could* bottom in the upper part of the ranges discussed. With the economy slowing, earnings forecasts falling, and rates rising, I would rather be patient than get pulled in for the last market downturn.

In the past two months, most portfolios were moved *slightly* more aggressive. Going into year-end, I plan to move them more conservative. I will also be realizing losses to reduce capital gains taxes.

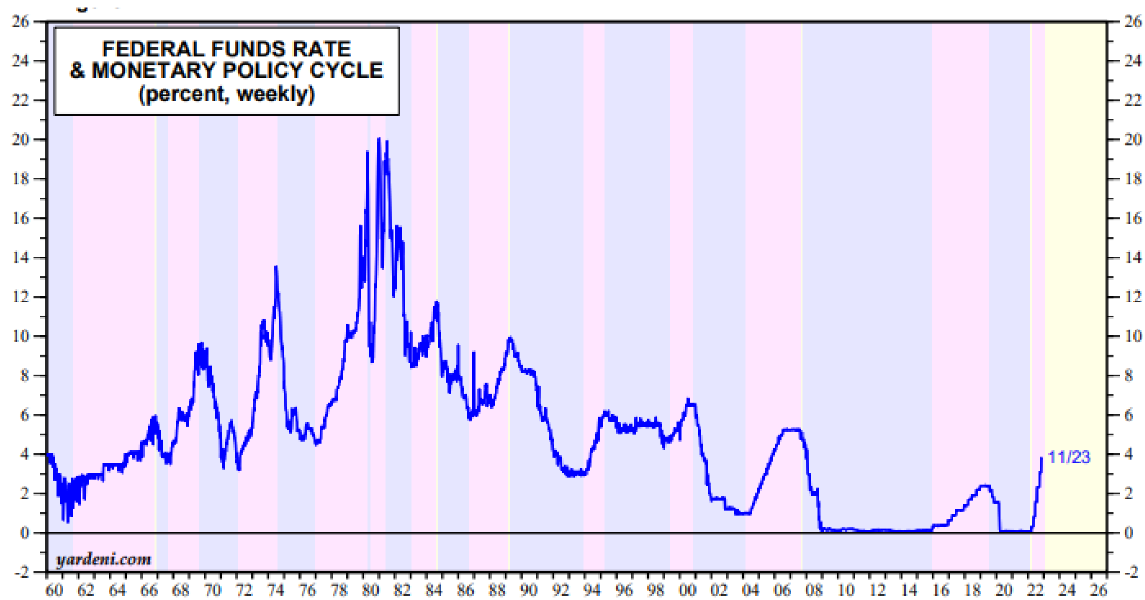
As for sectors and asset classes:
- I still favor US markets. UK/Europe have yet to face the brunt of winter energy demands. The war in Ukraine will drag into 2023 with no clear end in sight. China is trying to end its "zero-Covid" lockdown, but its economy has deep challenges, the economic benefits of "reopening" may be delayed by the pent-up Covid wave, and US-listed Chinese stocks may yet be delisted.
- Metals and other commodities provide exposure to a China re-opening. Longer-term, copper is vital to renewable energy and is likely to be in tight supply.
- Expensive US oil names are being replaced in the portfolios by natural gas and LNG names, and European majors diversified in oil, gas, and renewables. Energy also provides exposure to China.
- Many consumer and real estate names are attractive here, *if* the recession is mild. Larger healthcare names have become more expensive, but many smaller ones remain buyable.
- I am adding, selectively, to technology names that have dropped to reasonable valuations. Defense names have been trimmed on valuation.
- In financials, I continue to favor insurers over banks.
- High-quality bonds are getting more attractive but in the short term, prices look somewhat high.
- In general, smaller and mid-sized companies are more attractively valued than the large-cap companies that are household names.

I would be happy to go deeper into this outlook and other investment topics than was possible in this brief summary. Please email johnliu@laurelhurstasset.com or call 510 847 0070.

Thank you!

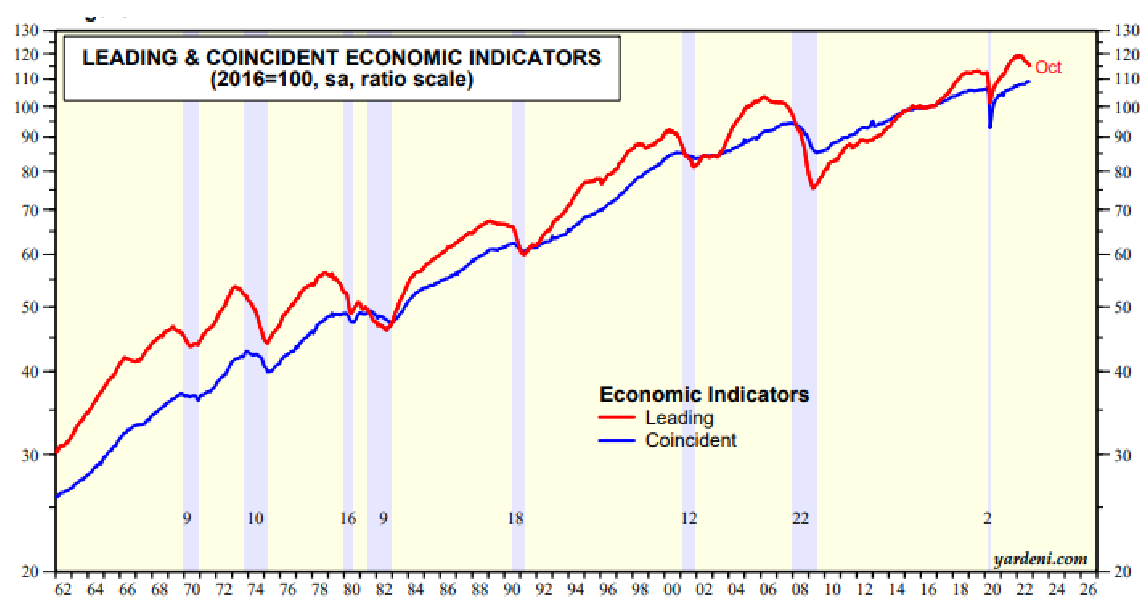
## APPENDIX TO DECEMBER 2022 OUTLOOK – SELECTED CHARTS AND TABLES

**The Fed funds rate is likely going to 5-6%.**




Note: Blue shaded areas are periods of monetary easing between cyclical peaks and troughs in the federal funds rate. Red shaded areas are monetary tightening periods.
Source: Federal Reserve Board.

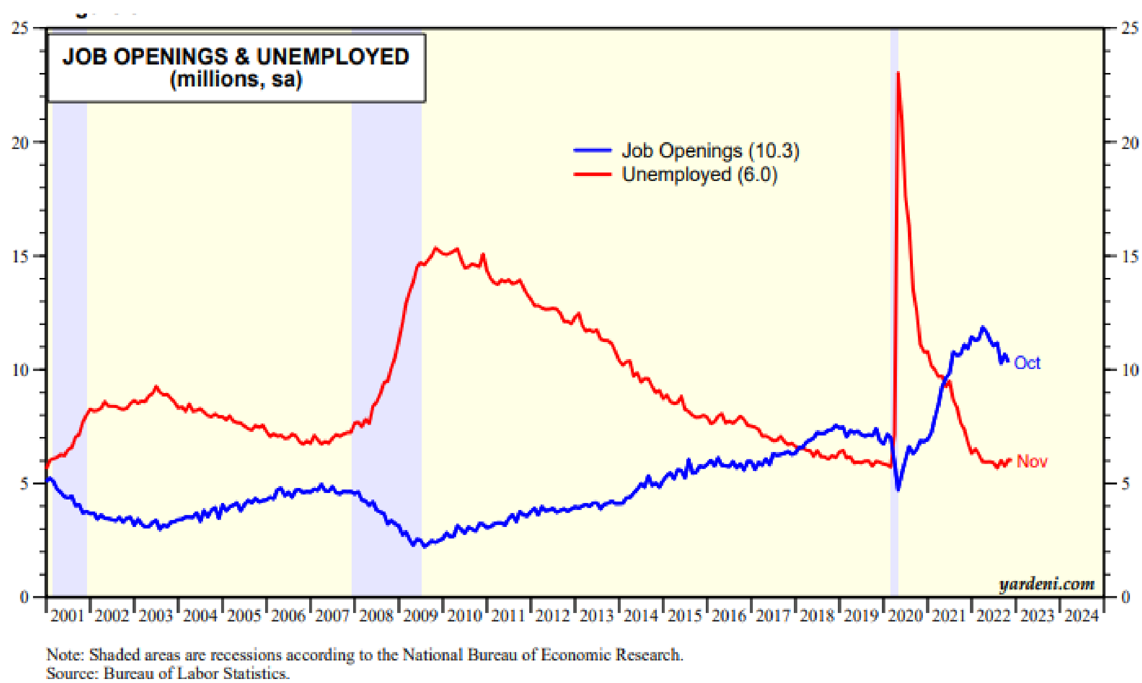
**Leading economic indicators (red) are falling, similar to before prior recessions (shaded).**



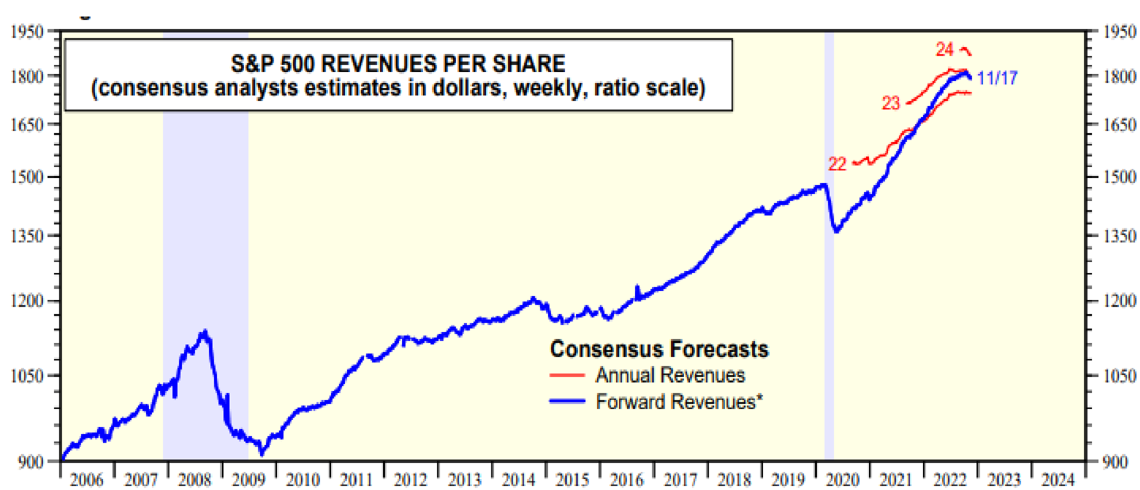

Note: Shaded areas are recessions according to the National Bureau of Economic Research. Numbers above time line reflect number of months from peak of leading indicators to peak of business cycle.
Source: The Conference Board.

Coincident indicators represent the economy as it is now. Leading indicators represent the economy as it is likely to be in the future. The shaded periods are recessions.

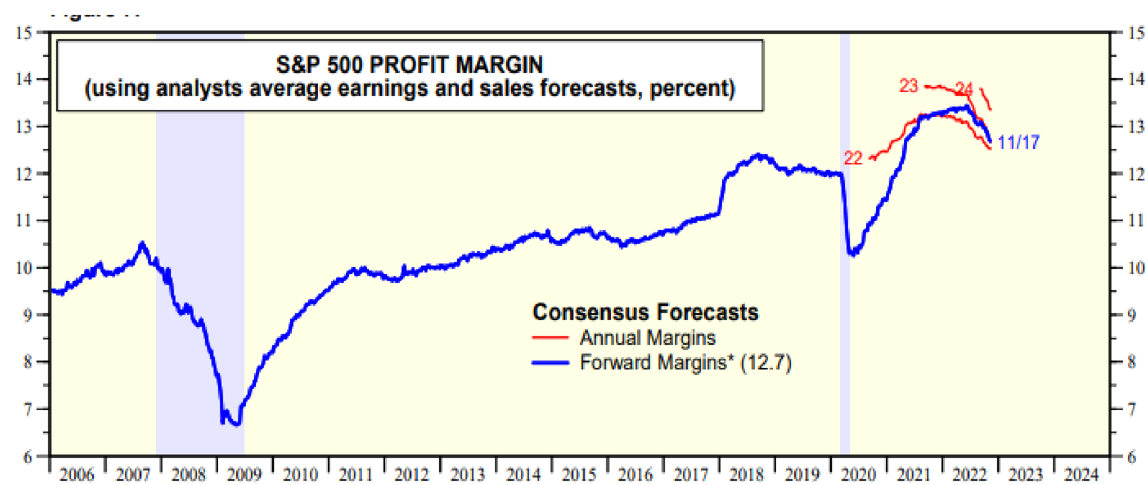
**The job market is starting to soften, but is still very strong with more open jobs (blue) than persons seeking work (red).**



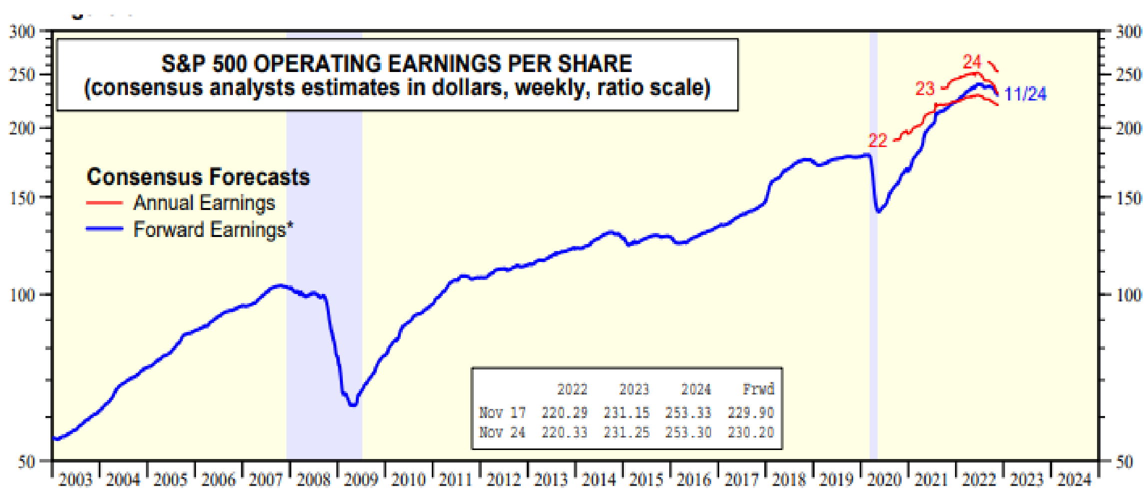

**S&P 500 consensus forecasts started declining in mid-2022.**




The chart above shows forecast revenue. Red lines show progression of forecasts for calendar years 2022, 2023, and 2024. The blue line shows the "next 12 months" forecast. Inflation is driving revenue growth. The next two charts show forecast margin and earnings.



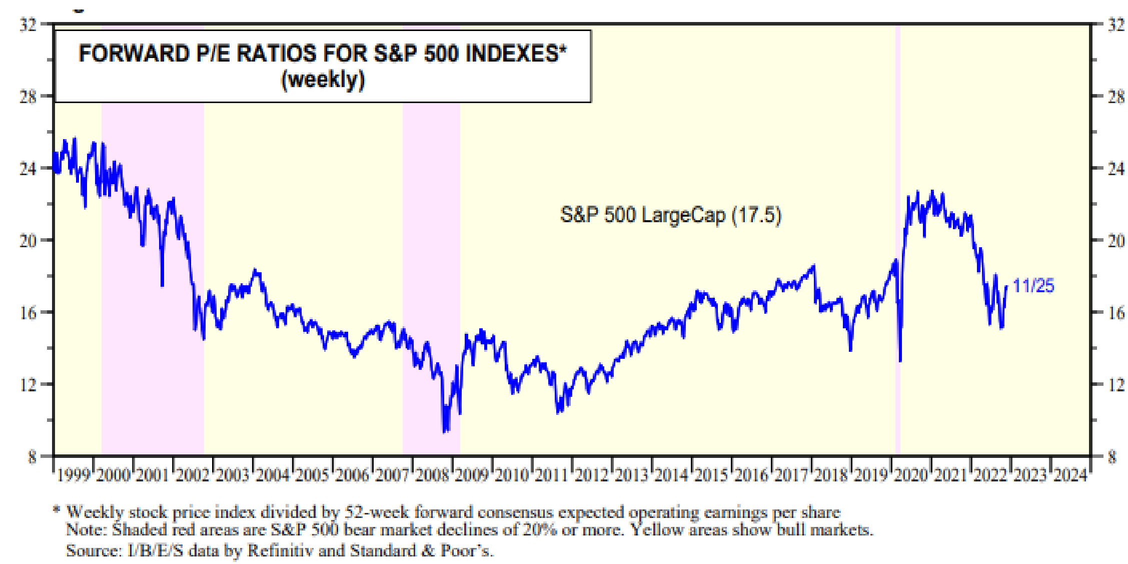

S&P 500 profit margin rose to record highs during the pandemic. Much of that gain is temporary.



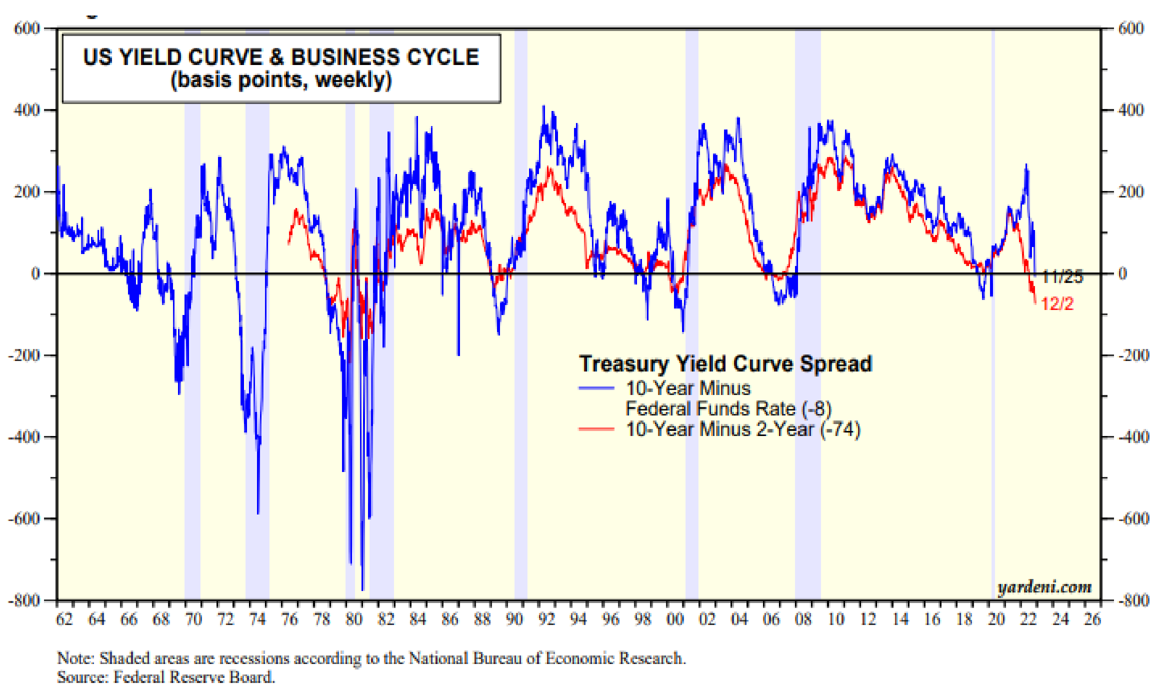

* Time-weighted average of the consensus estimates for current and next year.
Note: Shaded areas are recessions according to the National Bureau of Economic Research.
Source: I/B/E/S data by Refinitiv and Standard & Poor's.

Forecast S&P 500 EPS for 2023 has declined to $231, but that still implies +5% growth over forecast 2022's $220. In recession years, EPS typically declines -10% or more. A *very* mild recession or mid-cycle correction may see EPS flattish.

**The S&P 500 price/earnings ratio has declined back to the pre-pandemic range (15-17X).**

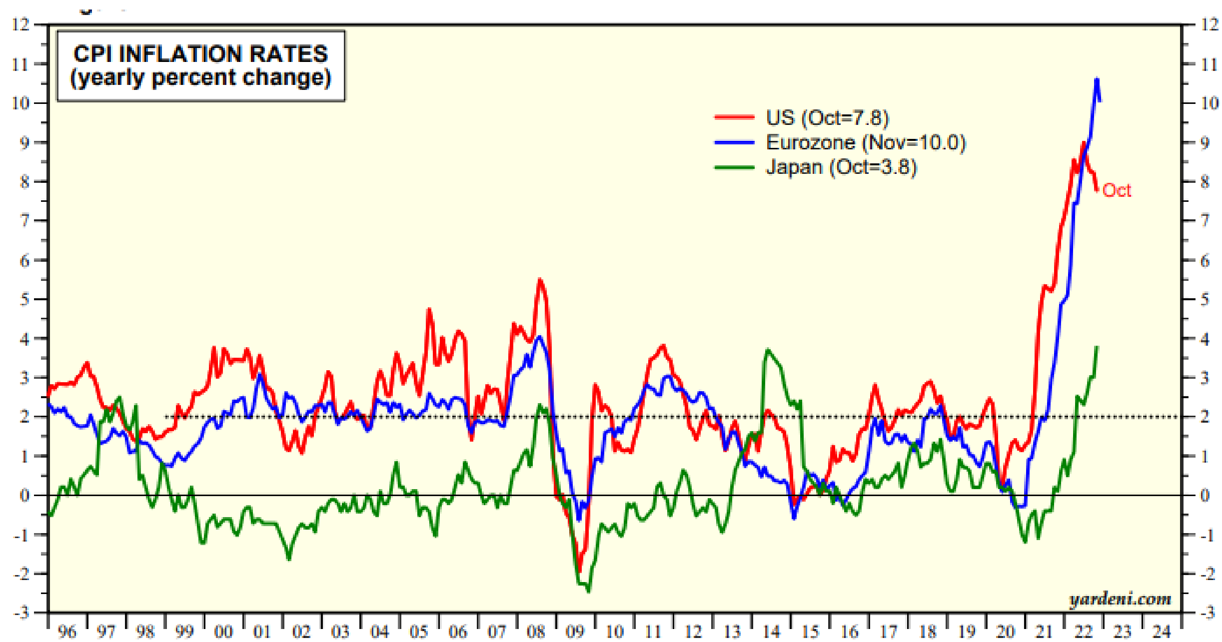



**Yield curve inversion is historically a reliable recession indicator.**



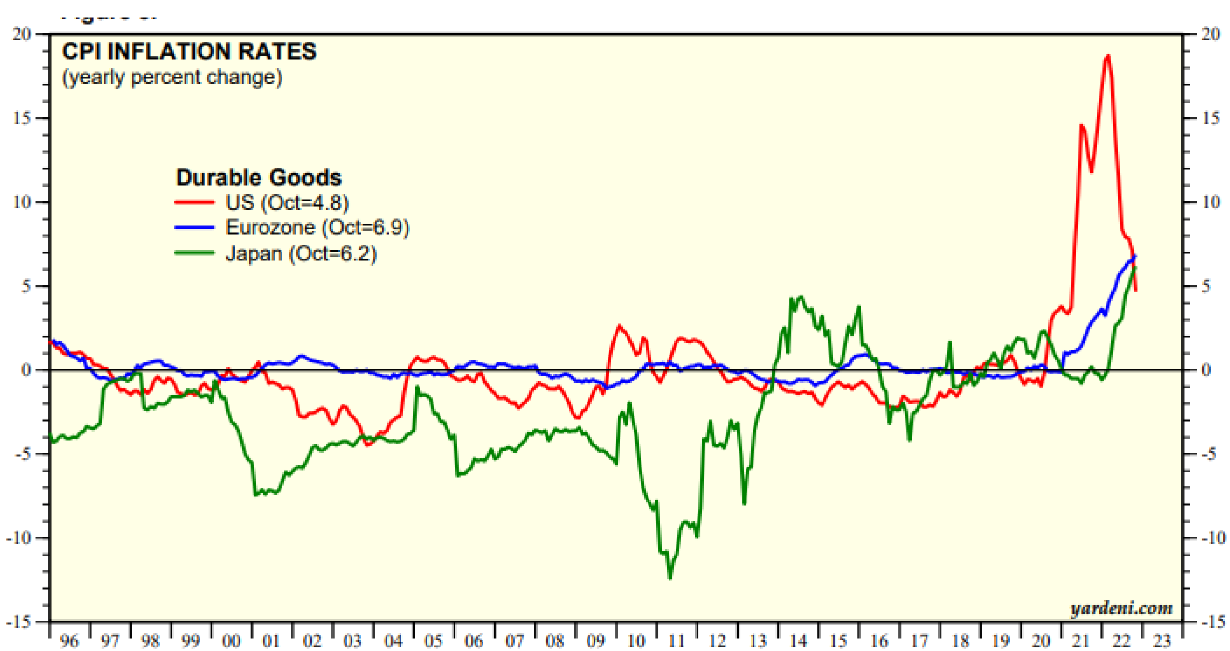

"Inversion" means that long rates are lower than short rates, e.g. as of December 6 the 10 year US Treasury yield of 3.563% is lower than the 2 year US Treasury yield 4.391%.

**US inflation has peaked but has only just started to decline.**




Note: Dotted line is the 2.0% inflation target of the Fed, ECB, and BOJ.
Source: Haver Analytics.

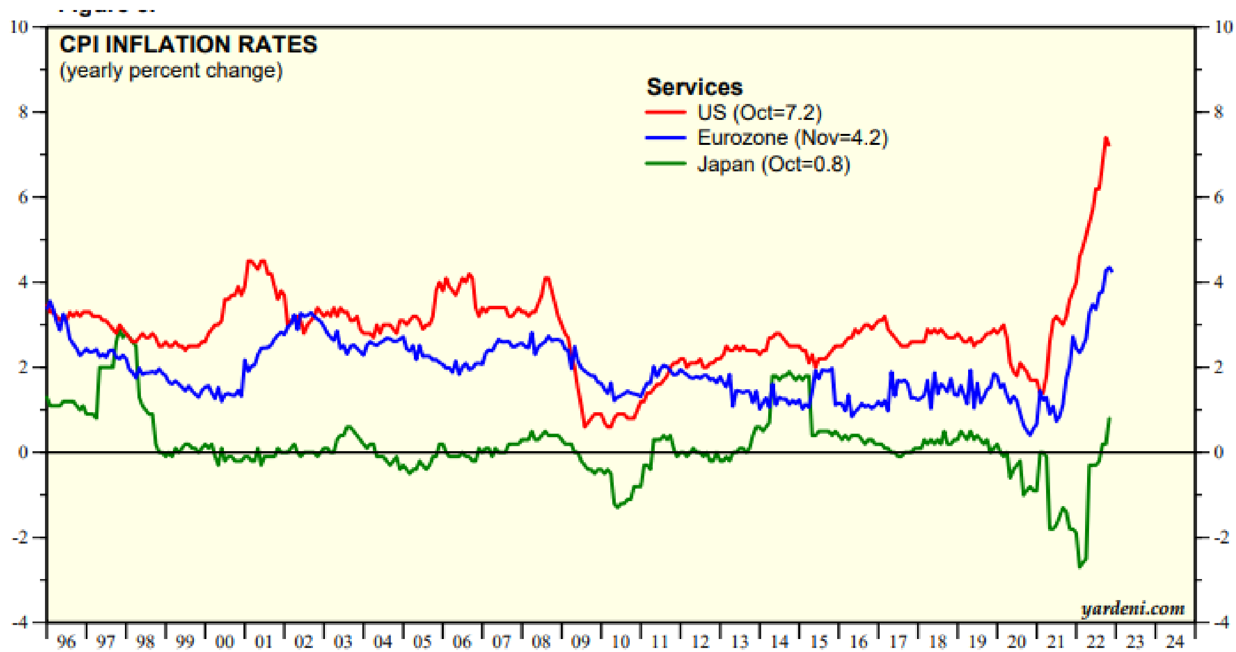
To halt rate hikes, the Federal Reserve needs to see inflation clearly heading down to 2%/yr.




Source: Bureau of Labor Statistics.

"Goods" inflation is slowing rapidly. Global supply chains are de-bottlenecking.

*My opinions and best judgment as of the date written, not investment recommendations or guarantees. For clients of Laurelhurst Asset Management, 1001 SE Water Ave Ste 217 Portland OR 97214.*




Source: Haver Analytics.

"Services" inflation still rising. These prices are driven by wages, which are still rising. Services including housing are the large majority of the inflation index.