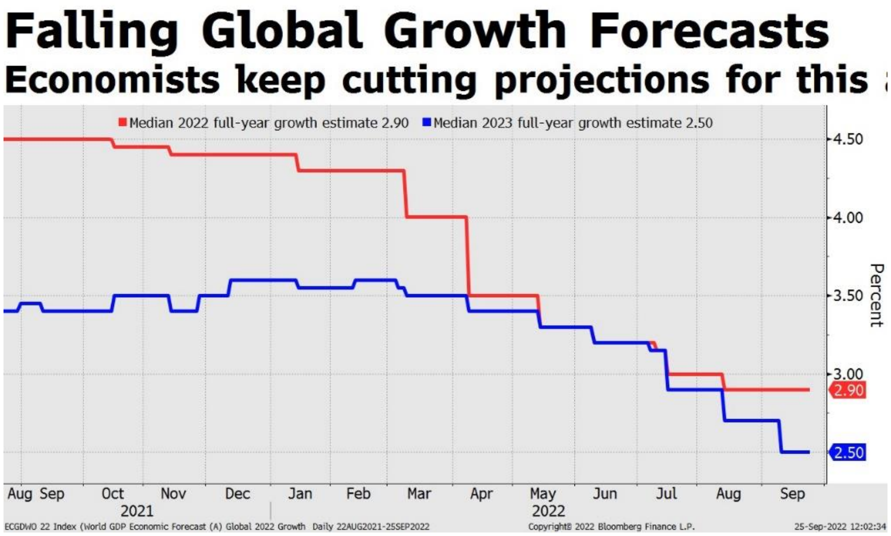
Courier Capital, LLC
Registered Investment Adviser
An affiliate of Five Star Bank

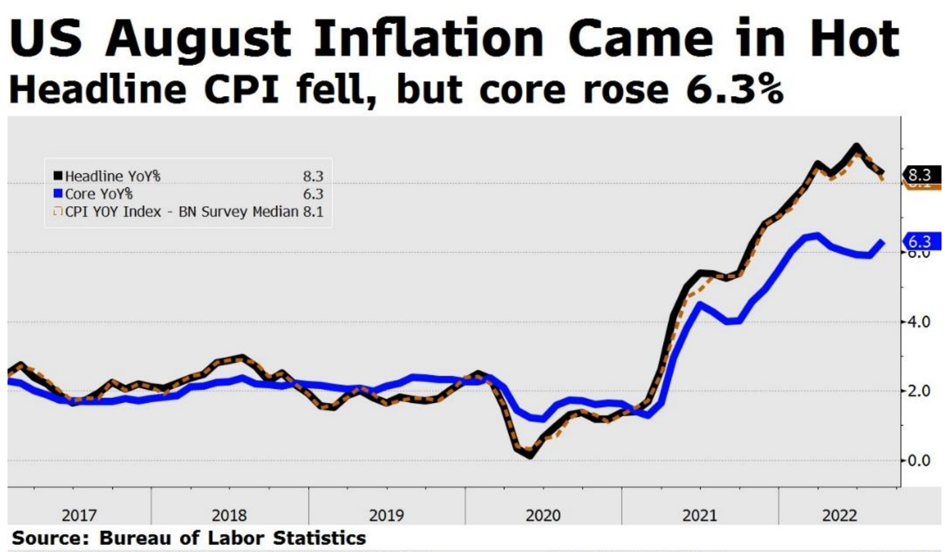
Economic and Market Update – COOLING DOWN (09/30/2022)

Latest Developments and Economics

There is abundant evidence that the U.S. and global economies are cooling rapidly. After two negative quarters of GDP growth in the U.S. for 2022 the Federal Reserve Bank of Atlanta is forecasting a flat GDP reading for the third quarter. If so it would be the first non-negative quarter this year. If they are correct the chances of positive U.S. GDP growth in 2022 are very slim. The fourth quarter would need to make up for negative cumulative growth during the prior three. This extends to next year also as economists continue to drop global growth forecasts. They have fallen from about 4.50% for 2022 at the beginning of this year to the current 2.90%. The initial forecast of 3.50% for 2023 now stands at about 2.50%. Of course, the fact that inflation data seems to not be cooling down as quickly as expected is part of the problem challenging global growth. This is coupled with geopolitical issues and remaining effects of COVID.

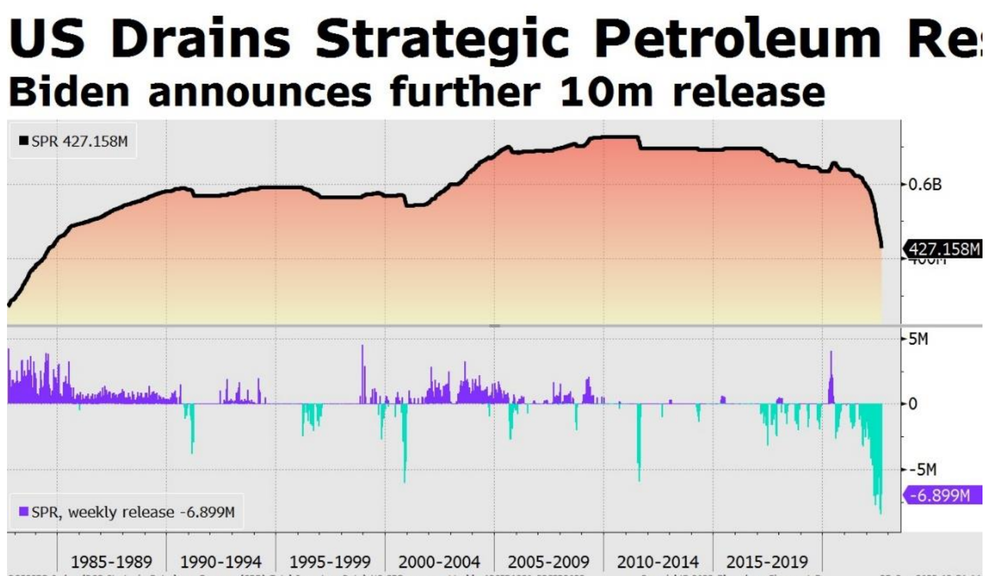


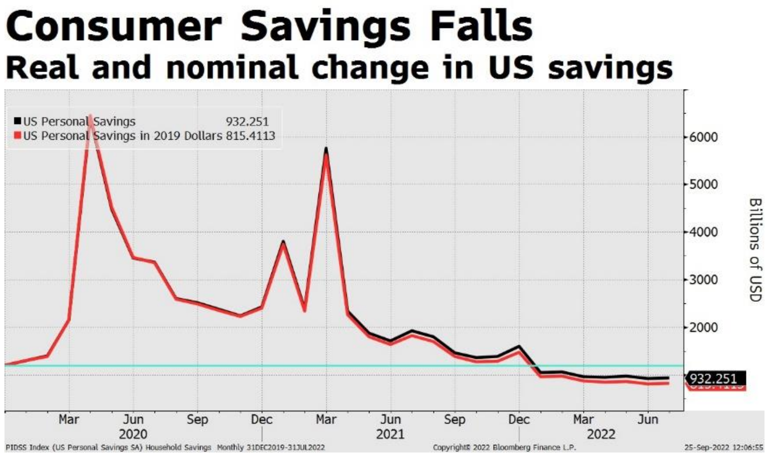
The August headline inflation reading of 8.3% year-over-year was the lowest since February. That news was eclipsed by the fact that the core inflation (headline less food and energy) rose again and stands at 6.3%. The decline in gasoline prices was a major contributor to the lower headline inflation but other items are not falling quickly. Food increased the headline number (offsetting much of the energy) but the core inflation data reflected continuing increases in the calculated cost of shelter and medical services. According to former Treasury Secretary Larry Summers inflation still needs to take a turn. He notes that “core inflation is higher this month than last month, higher this quarter than last quarter, higher this half of the year than the previous one, and higher this year than the previous one”. The Fed’s preferred inflation indicator, PCE, also increased 7.3% - higher than the expected 7.1%. One good note is that the producer price index (PPI) came in as expected and did not increase. The fact that producers are not seeing higher prices may be the start of the change.

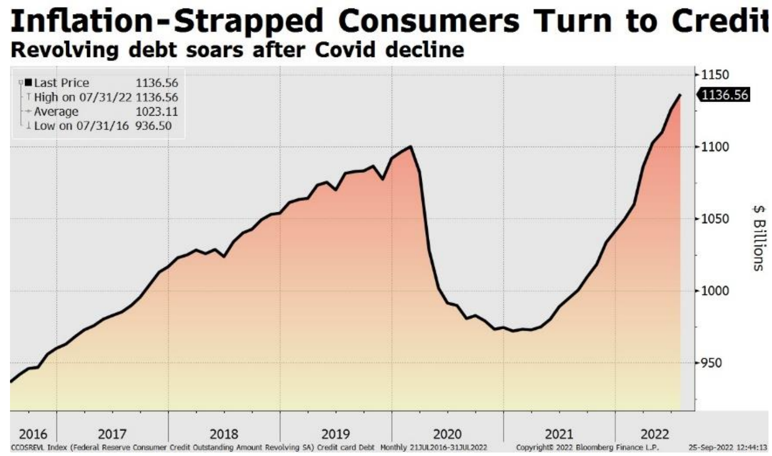


The labor market continues to be described as "tight" by the Federal Reserve. This is a reflection of a record 11 million jobs that continue to be open with only about 6 million people looking for jobs. The addition of 315,000 jobs in August was higher than the expected 293,000 but less than the 3-month average of 402,000/month. The gains were broad based across the economy. Wages also moderated and, although still high at about 6.0%, remain well below inflation. The job gains were reduced by a cumulative 107,000 for the prior two months. Also, initial jobless claims came in at a 5-month low of 193,000 when 215,000 was expected. This data confirms that the labor market is not slowing down. The unemployment rate rose to 3.7% as more people entered the work force. The question about why there are 5 million less workers than jobs is still an issue and the cause of worker shortages as well as a source of inflation. Many believe that the worker shortages are primarily due to people unwilling to work but data reveals that the problem may also be demographic in nature. Recent data shows that there were just under 64 million people enrolled in Medicaid before the pandemic in Febraury 2020 and that number rose to just under 82 million in May 2022 – an increase of 18 million people. In addition, more labor data shows that the participation rate of 18-64 year olds in the work force is pretty much back to prepandemic levels. It is the 65+ age group who are participating less than prior years. The acceleration of retirements and more people of retirement age may also be a significant contributor to worker availability.

Commodity prices have also retreated lately from multi-year highs. The fear of recession and slower global growth has impacted metals, energy and even some agricultural products. The significant retreat in gasoline can be attributed to a couple of factors. First would be the anticipation of global demand due to the slowdown in economic activity and the release of oil from the Strategic Petroleum Reserve (SPR). The reserve balance now stands at 427 million barrels – down from over 620 million barrels one year ago. The reserve balance has not been below 450 million barrels since 1984. These two factors have played a part in OPEC reversing its announced production increase last month. Further on energy, Russia's Gazprom has shut off natural gas supplies to Europe until further notice and now there is suspicious damage inflicted on the pipeline. While Europe has been able to store natural gas to get through the winter, a colder than normal season could deplete the supply faster than expected and would impact price.

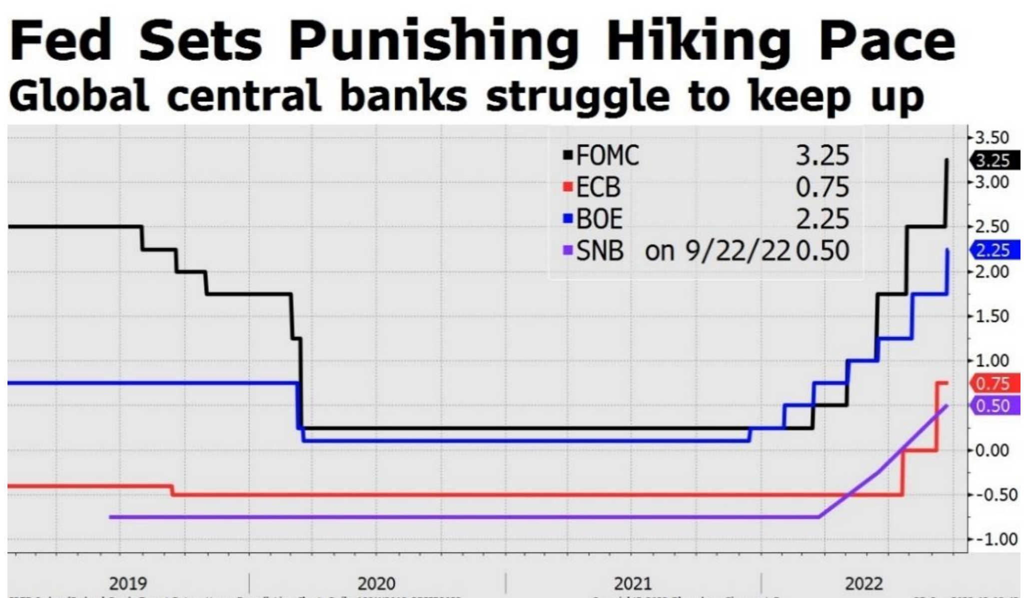




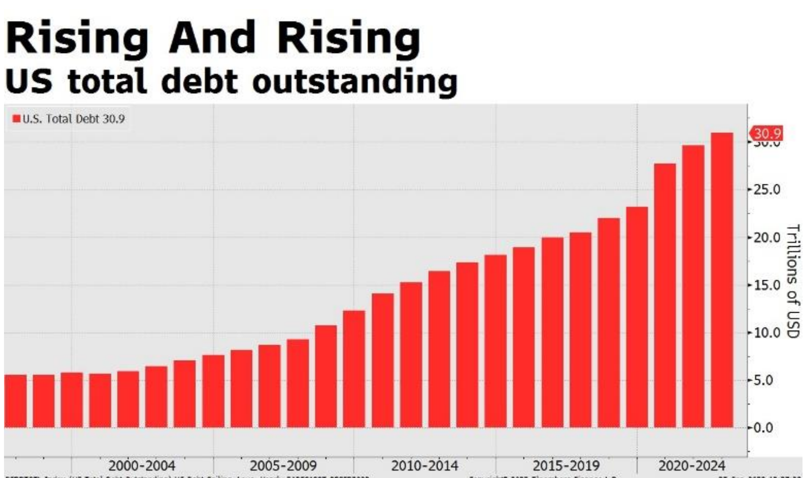


The rise in prices has impacted consumers pocketbooks even though they continue to spend. They have depleted their savings and have increased their use of credit to support their current spending levels. After reaching a high of over $6 trillion during the pandemic savings have fallen below $1 trillion today. In addition, total revolving debt now surpasses prepandemic levels.

Almost 80% of developed economy central banks are raising interest rates to combat inflation but none as quickly as the U.S. The Federal Reserve executed their third consecutive rate increase of 0.75% as expected but were decidedly forceful in their position that rate increase will continue until they see firm evidence of inflation's retreat towards the 2% target. The Fed indicated that they plan to continue rate increases until a target interest rate of about 4.60% within the next 12 months from about 3.25% today. Europe and U.K. are also raising and even the Swiss Central Bank raised rates to finally get above zero.

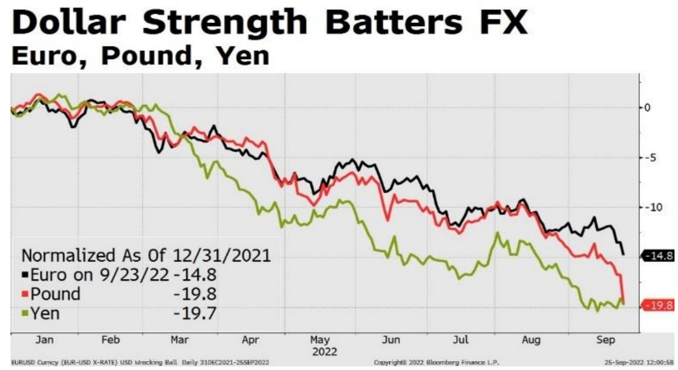


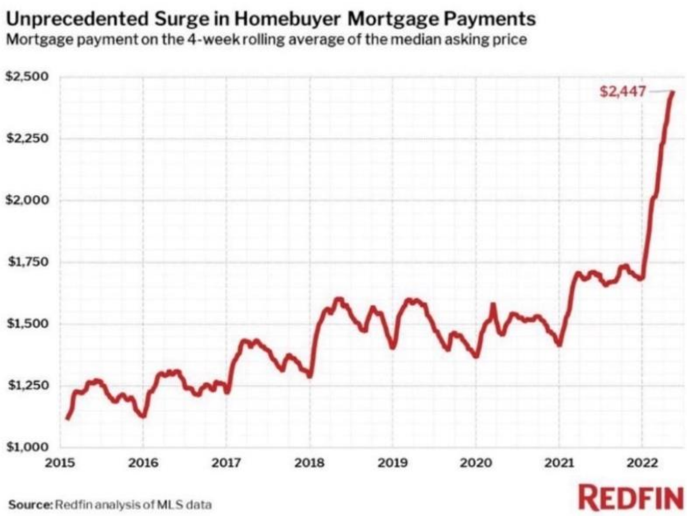
The fast pace of rate increases is having far reaching impact on government, business, and consumers.



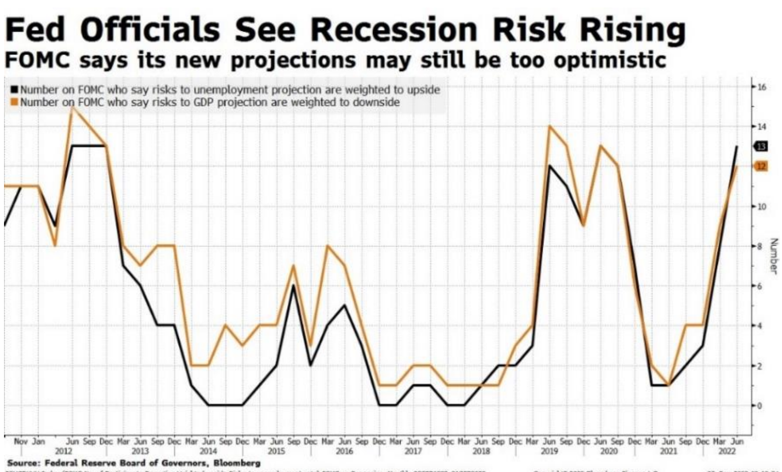
The pandemic fiscal stimulus programs increased what was already significant annual deficits. These additions to national debt have caused total debt to reach $31 trillion. Each 1% increase in interest rates results in about $300 billion in interest costs annually to service that debt.

The dollar continues to gain strength as well against all major currencies. The Euro, Yen and Pound are all down 15-20% versus the dollar this year. This is bad for U.S. corporations as it makes U.S. goods more expensive internationally. In addition, any revenues earned by U.S. corporations overseas are worth less as they are converted back to U.S. dollars.



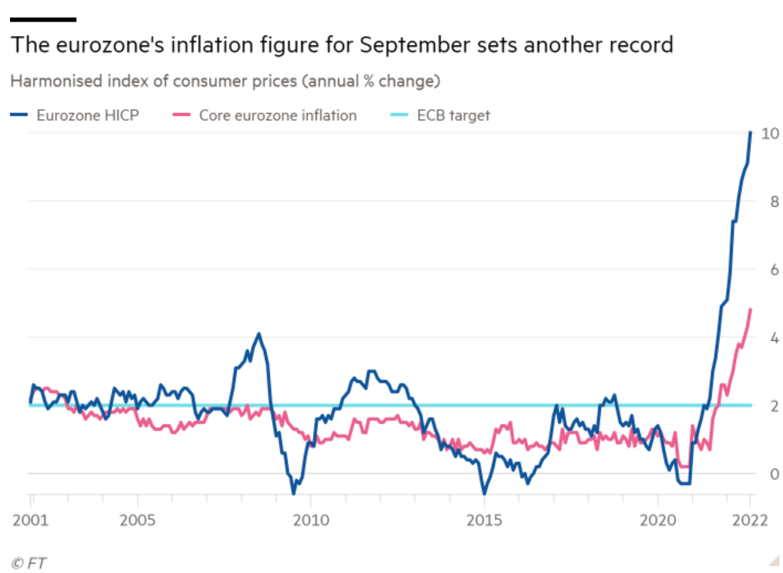


The rising interest rates means that consumers are finding it much more expensive to finance and purchase. Housing has been on the forefront lately as mortgage rates have risen dramatically since the beginning of the year. In January 30-year mortgages were somewhere between 3.25-3.50%. The last week of September saw that same mortgage rise to about 6.50-6.75%. The mortgage payment difference on a median-priced house is illustrated in the chart to the left. This has caused a severe decline in housing activity.



This has caused a significant increase in the chances of recession in the near term. JP Morgan has estimated the chance of recession at 92%. Officials at the Federal Reserve have also increased their estimate of recession (left). Chairman Powell himself in his recent press conference indicated that "The chances of a soft landing are likely to diminish". That is Fed speak for a recession may be looming.

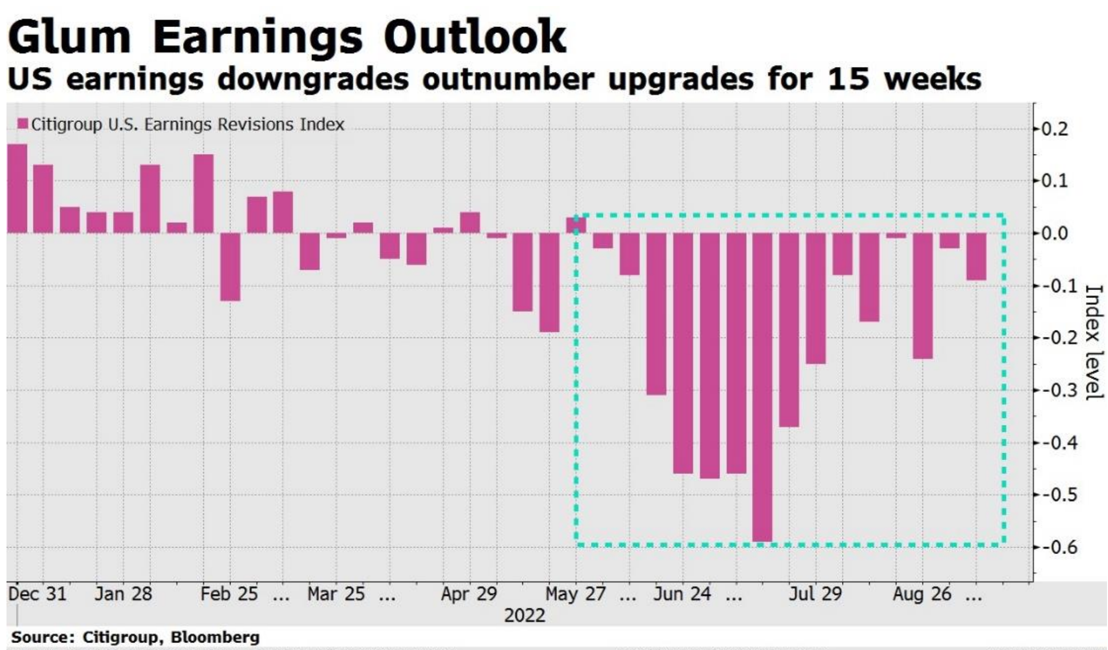
Internationally all eyes are on the Eurozone and the U.K. in particular. Eurozone inflation is rising quickly and reached 10% while core inflation is about 5% versus a 2% target. This is driven by the cost of energy caused by the Russian actions and Europe's prior dependence on Russian oil and gas. This was exacerbated by the potentially intentional and unprecedented damage to the Nord Stream pipeline bringing Russian gas to Europe. In the U.K. the Bank of England continues to raise rates to combat inflation while PM Liz Truss is going the opposite direction by announcing a massive tax cut on top of the energy subsidies to consumers. The central bank also had to step in to support the Gilt and lower bond rates as yields rose dramatically after the announcement. The International Monetary Fund and others look to have convinced Truss to reevaluate the policy as it could fuel inflation even further.



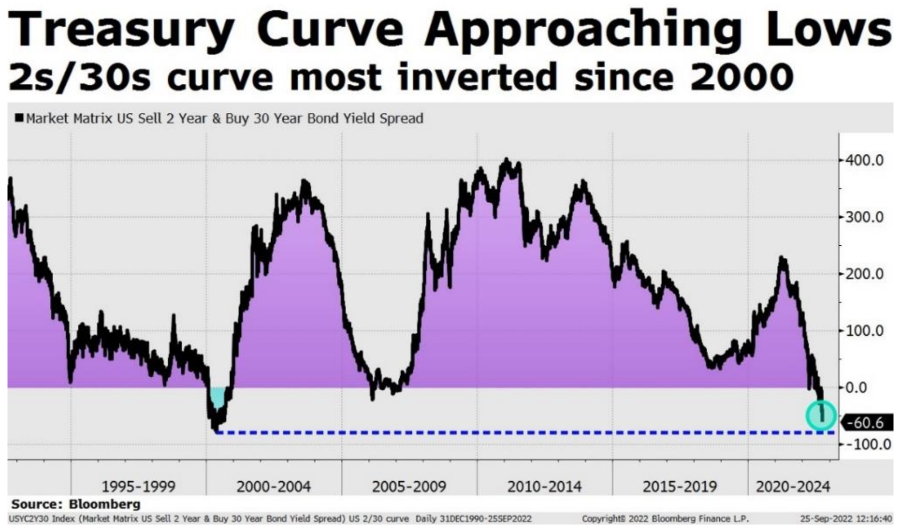
Financial Markets

The last day of the month saw further declines in risk assets which brought to a close a terrible week within a terrible month of a terrible quarter. The inflation data that came in worse than expected solidifies the markets expectation that the Fed may have to be as aggressive as they have advertised to bring inflation down. The uncertainty is exactly how far might be by next year. The quickly rising rates have affected both equities and fixed income. The S&P 500 was down 9.2% in September which brings 2022 total return to -23.9%. Growth stocks are now down over 30%. Most U.S. equity indices are down about the same 20%. Developed international equities are worse, down about 27% for the year. Fixed income has provided relatively little cover as the U.S. Agg is down about 14% in 2022 due to the quickly rising rates. The graph above is a visual representation of part of the "pain" that Powell said we would endure. The markets look a little more like a meltdown than a cool down.

The combination of a slowing economy, reluctant consumer and strong dollar are quickly causing revisions in company earnings estimates as well. In October we will get a better picture of how U.S. companies are navigating through these conditions. Earnings growth in Q3 are at estimated at 2.9%. Current estimates of 2023 earnings are $235. If the current lower multiple of 15.5 is applied that would suggest an index level of 3,640 – about 55 points (1.5%) higher than September month end. The key will be that company earnings do not cool down any further.



As mentioned earlier holding long-dated fixed income has been rather painful this year given the rare speed at which interest rates have gone up this year. The U.S. Agg return of -14% pales in comparison to long-dated U.S. Treasuries which are down over 30% in 2022. The recent Fed activity has caused yields on short-dated bonds to increase significantly. The 2-year U.S. Treasury bond started the year yielding 0.78% and now yields 4.22%! The longer-dated maturities have not moved as much. This has caused the most significant yield curve inversion since 2000 as the 30-year Treasury only yields 3.79% (from 2.01%). While not every yield curve inversion has led to a recession, every recession has been preceded by a yield curve inversion. Given the situation the time may be approaching to slightly increase duration in fixed income portion of portfolios.



When the S&P 500 is Down 25% or Worse Since 1950

Peak	Trough	% Decline	+1 Year	+3 Years	+5 Years	+10 Years
12/12/1961	6/26/1962	-28.0%	31.2%	69.2%	94.8%	171.1%
11/29/1968	5/26/1970	-36.1%	32.2%	44.3%	27.9%	97.5%
1/11/1973	10/3/1974	-48.2%	1.4%	23.8%	42.0%	188.4%
11/28/1980	8/12/1982	-27.1%	43.9%	81.2%	238.6%	403.9%
8/25/1987	12/4/1987	-33.5%	14.7%	34.1%	96.8%	387.1%
3/24/2000	10/9/2002	-49.1%	0.2%	1.9%	21.5%	38.3%
10/9/2007	3/9/2009	-56.8%	-6.9%	3.7%	61.2%	209.6%
2/19/2020	3/23/2020	-33.9%	56.4%	???	???	???
1/3/2022	9/30/2022	-25.2%	???	???	???	???
Averages		**-37.6%**	**21.6%**	**36.9%**	**83.3%**	**213.7%**

Data: Ycharts

Finally, while the short-term volatility is unsettling, time in the market is a friend. The chart to the left shows that of the nine times since 1950 that the S&P 500 was down over 25%, the following three, five and ten-year periods have been positive and most of the time the 12 months following was also positive.

Should you have any questions please contact us.

Image sources: Bloomberg and CNBC unless otherwise noted

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