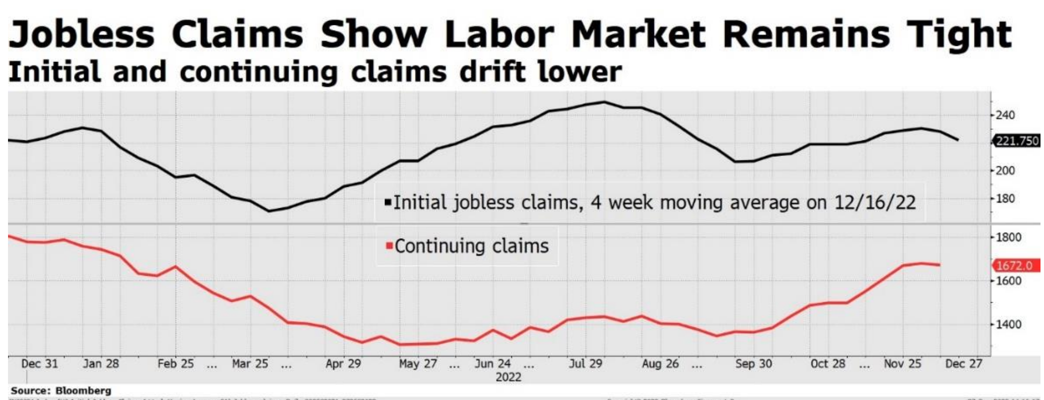
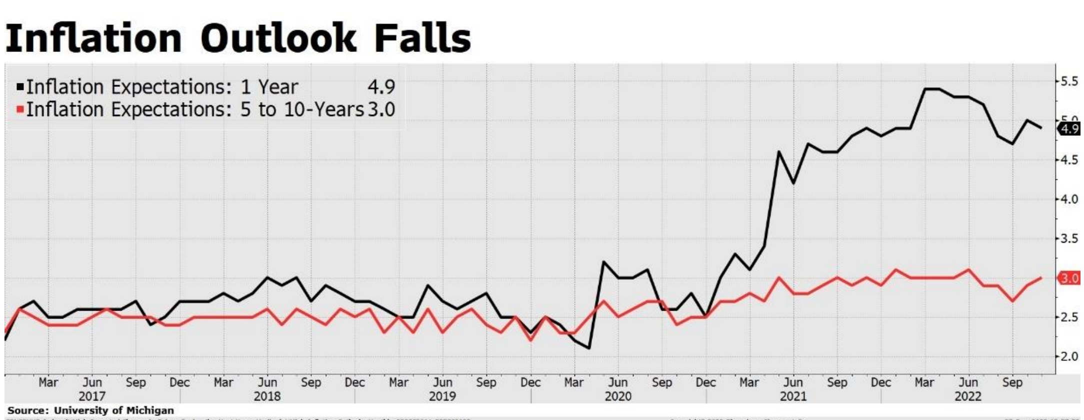
Courier Capital, LLC
Registered Investment Adviser
An affiliate of Five Star Bank

Economic and Market Update – HEADING IN THE RIGHT DIRECTION (12/31/2022)

Latest Developments and Economics

The economy added 263,000 jobs in November and the unemployment rate stayed at 3.7% - signs of growth and a fairly resilient economy. The tightness in the labor market was also responsible for continued growth in wages – about 5.1% increase year-over-year. This was not the direction that the Federal Reserve was hoping for in trying to put the brakes on the economy. Other than labor and employment though, most data show a slowing U.S. and global economy. All measures of inflation continued their slowing (though still high). The Consumer Price Index (CPI) came in at 7.1% year-over-year with energy and used cars leading the way down and most other categories slowing their increases. Of course, the Federal Reserve is looking for this to continue in the direction towards their 2.0% average target. The employment and wage situation may make it difficult to get close to that target soon. This may start to change as there have been some high-profile job reductions announced (tech and financial services especially) and previously announced workforce reductions are starting to show in the data. Initial jobless claims are rising slowly, and continuing claims are mounting.

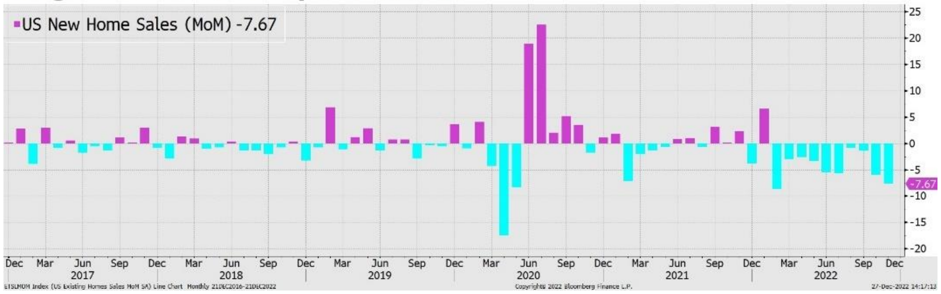




All this data is having an impact on future perceptions of inflation – which are coming down. Inflation expectations for the next 12 months stand at 4.9% (from 7.1% today) and the longer-term expectations are in the more historically normal range of 3.0%

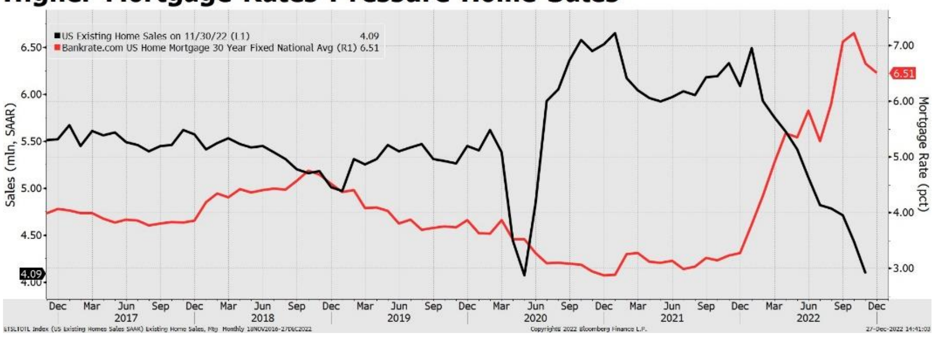
Signs of a slowing economy are coming from many corners of the economy.

New Home Sales Drop
Longest streak of drops on record



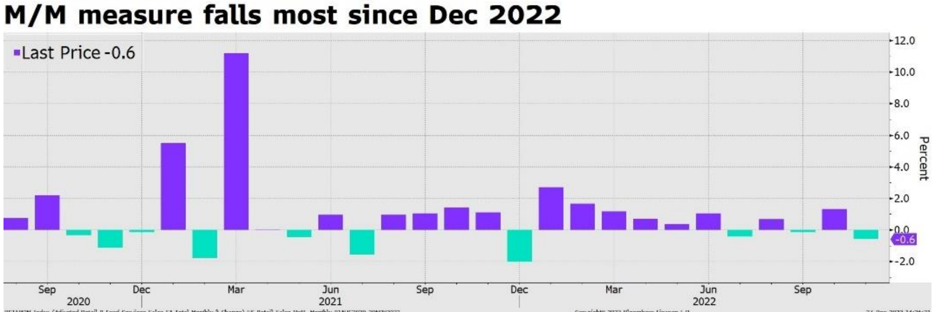
New home sales have fallen for the last 10 months and only January was the only month in 2022 with an increase. The median price of a new construction home is $471,200 due to inflation in building materials – 9.5% higher than last year.

Higher Mortgage Rates Pressure Home Sales



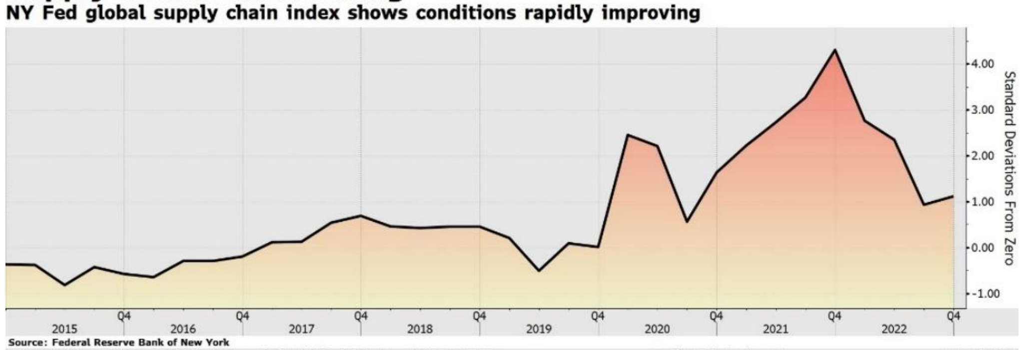
Existing home sales have fallen off a cliff as mortgage rates have increased significantly. The rates have settled down a bit with an average 30-year mortgage of 6.51%. The result is sales of just over 4 million units – down 1.50 million from the beginning of the year.

US Retail Sales Drop
M/M measure falls most since Dec 2022

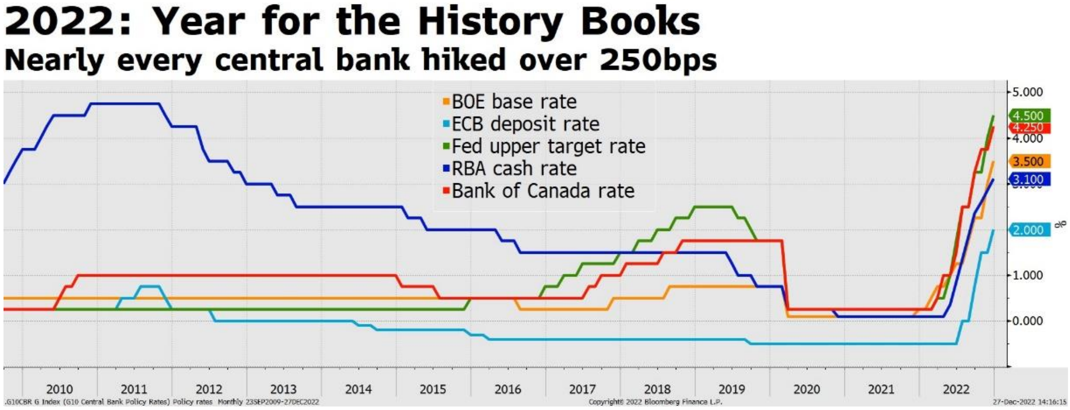


The consumer is weakening also. Retail sales had been robust but have weakened to a -0.6% in the last reading. Autos and building materials led the decline which was broad. This was despite higher real income due to increased salaries and falling gasoline prices. It seems that low saving rates and higher borrowing costs are having an effect.

Supply Chains Are Healing
NY Fed global supply chain index shows conditions rapidly improving

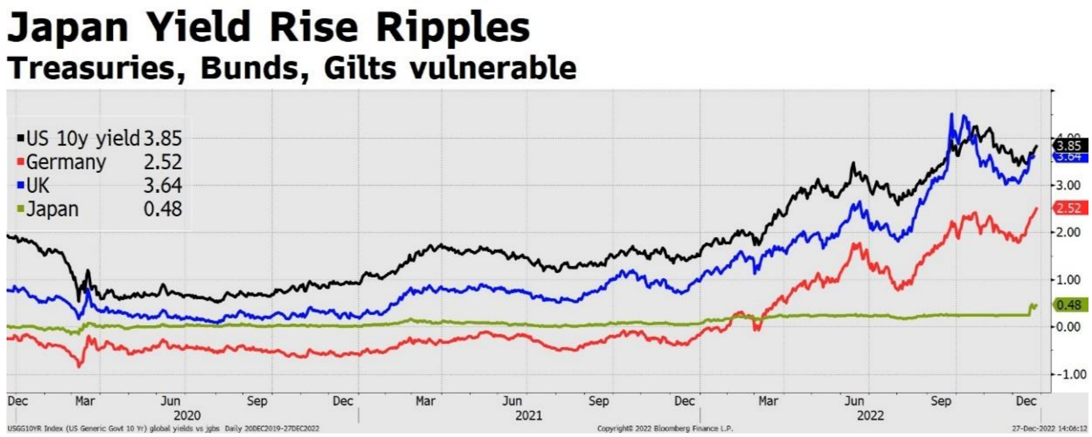


The slowing economy coupled with supply chains that are beginning to recover have combined to let the Federal Reserve slow the pace of interest rate increases. After 4 consecutive 0.75% rate increases the Federal Reserve raised by 0.50% in December. Chairman Powell was very quick to state that this does not mark a turning point in the Fed's positioning just a slowing pace. Chair Powell also said that the Fed will cut rates only when confident that inflation is moving down in a sustained manner further indicating such cuts could occur in 2024 but not next year. They also increased their 'target' endpoint in rates, which is higher than previously articulated. They now see 5.00-5.25% as the current terminal rate but this is a moving target and, if inflation does not settle it could go a bit higher. If this is the case, then they would have another 0.75% to go to reach their stated target from the current 4.50% level. This is expected to come in the first half of 2023, but the exact path is not certain (it could be 0.25% for the next three meetings or another 0.50% first followed by another 0.25%).

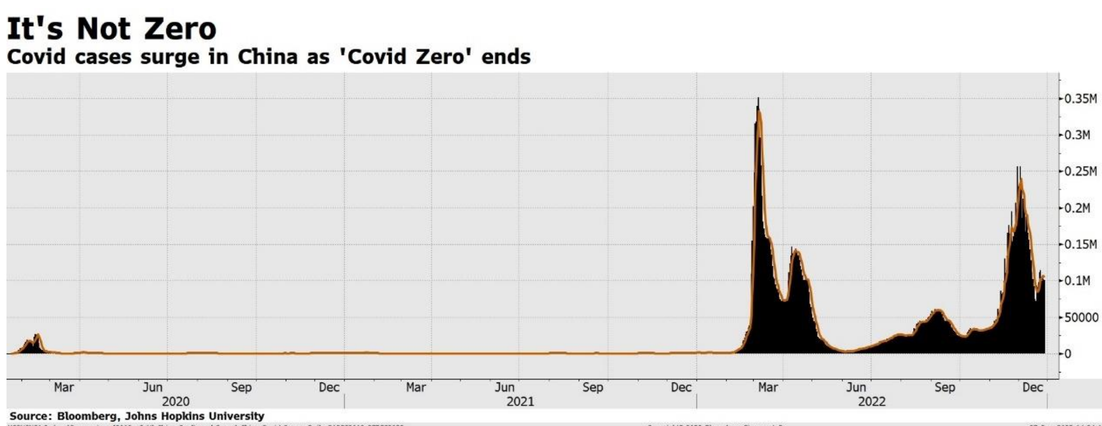


The U.S. Central Bank isn't the only one raising rates globally. Most developed market central banks also raised interest rates (by a similar 0.50%) in December. In fact, developed market interest rates have risen by 2.50% during 2022 from the very low base before the year started.

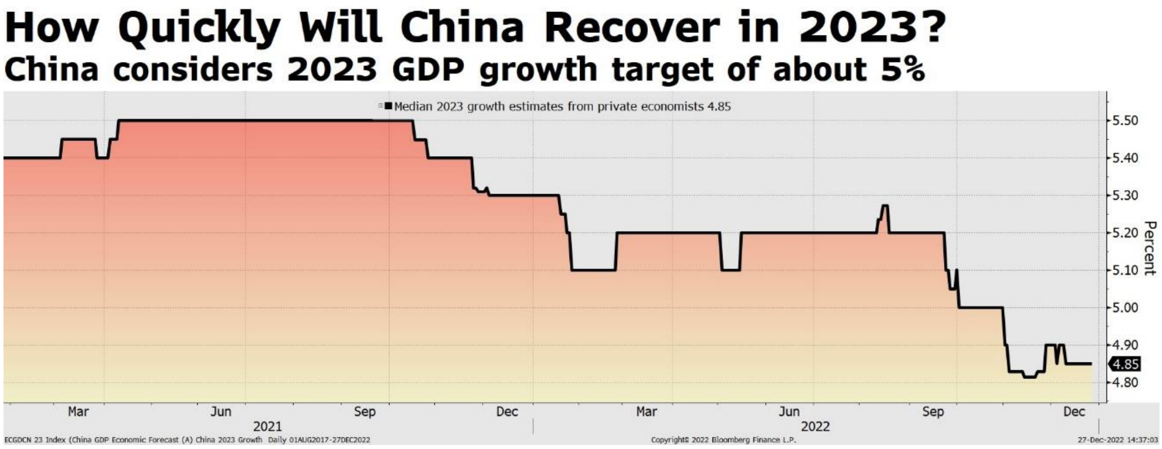
In a surprise move, and a significant change in interest rate policy, even Japan made a change that allows rates to rise. Japan practices yield curve control – essentially controlling each interest rate and maturity. The central bankers did not change their target rate of roughly 0% for the 10-year government bond but, they did allow the range around that target to vary 0.50% versus the previous 0.25%. In sum, they are allowing rates to float up more – the same direction as most other developed central banks. This had the effect of tanking Japanese stocks and the value of bonds as yields rose quickly to the 0.48% (chart above). It also had an impact on the Japanese Yen as it rose against most currencies including the U.S. dollar. In fact, the dollar has been heading down against major currencies – a better direction from a U.S. corporate profit and inflation perspective.



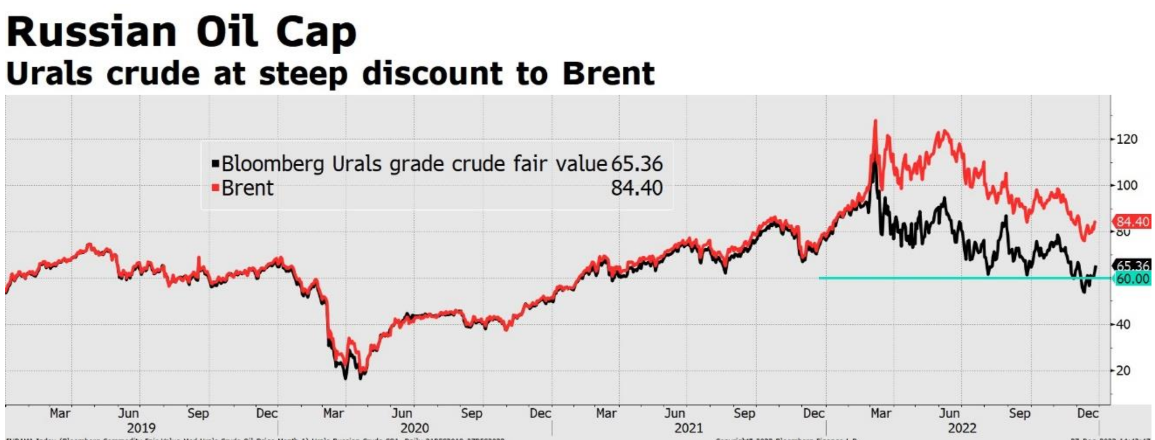
Staying on the topic of international news, China also provided a huge surprise in December by basically abandoning their Zero-COVID policy that was in place for three years. This policy required significant mass testing and the immediate strict shutdown and quarantine of whole cities once COVID was detected. The reversal is surprising given that the policy was endorsed by President Xi Jinping himself.



The country, which is basically unvaccinated, is seeing a significant rise in COVID cases. The official Chinese story on the policy change is that the virus is now much more mild and it is an appropriate time to move to a new phase. Other influences might have been the recent mass protests against the policy, the impact on the Chinese economy of rolling shutdowns and the ineffectiveness in halting the spread of the virus. This change in policy has both positive and negative consequences. On the negative side this means increasing cases of COVID among the unvaccinated Chinese people – for how long we do not know. This also could mean a renewed spread of the virus globally as Chinese citizens travel again and incoming visitors to the country will not be tested. In response, many developed nations (the United States included) will begin to require negative COVID tests from people arriving from China starting January 5. On the positive side this change may allow the Chinese economy to begin to recover and aid the global economy in avoiding a significant recession. China is far off its official growth target of around 5.5% and is currently under 5.0%. The recovery to a 5.0% growth rate in 2023 will depend not only on the path of the virus in China but also the reaction of people who have been conditioned to avoid the virus for the past three years to resume 'normal life' regardless of official policy.

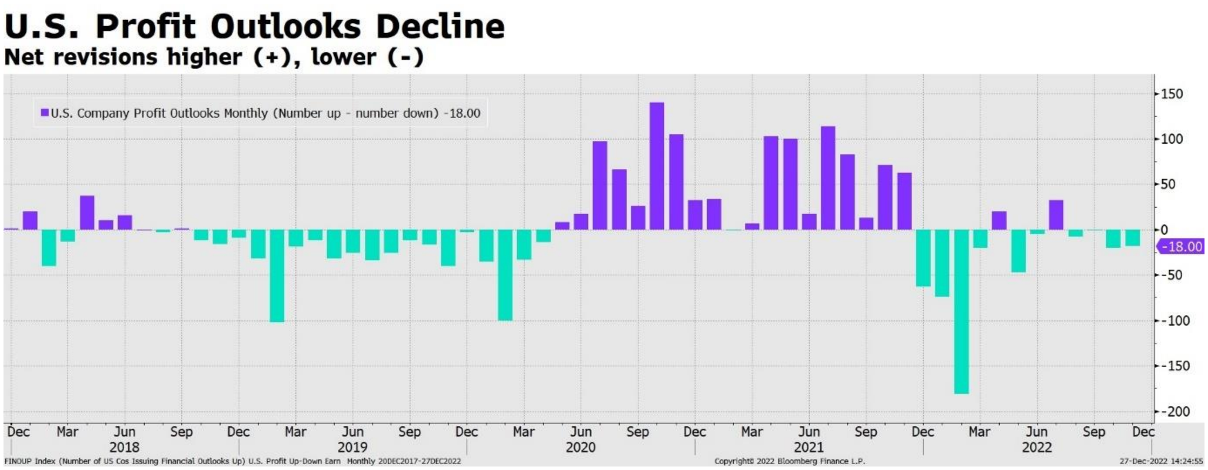


The final international topic is the price cap paid for Russian oil. The G7 countries, the European Union and Australia have agreed to a price cap of $60/barrel in an attempt to stop Russia from benefitting from the increase in oil prices that it created by invading Ukraine. This is close to the price Russian oil has been selling for currently and a significant discount to Brent crude oil for the rest of the world. This will be implemented using shipping insurance as a tool to ensure the price paid is $60 or less. Russia, the second largest oil producer behind Saudi Arabia, will still have plenty of outlets for its oil but price is expected to stay near the cap. Russia, in retaliation, has responded with a ban on the sale of oil to any nation agreeing to the cap for five months starting in February 2023.



Turning our attention forward into a new year here are some of the key topics (that we know about) which we will be keeping our eye on as we begin 2023:

1) **Interest Rates** – Interest rates in the U.S. and the developed world are still on an upward path but the question now isn't as much the pace but the final endpoint (i.e.: terminal rate).
2) **Inflation** – The interest rate question will depend on the inflation path. If inflation does start to subside quickly in 2023 then the Federal Reserve could justify a lower terminal rate. If inflation continues unabated or, does not slow fast the Federal Reserve may continue to hike.
3) **Employment and Wage Growth** – If companies continue to struggle to find qualified workers and wage pressure continues as a result the consequence could be a significant source of continued inflation in 2023. Should the current economic conditions drive more people back into the workforce this may generate some slack in a tight labor market and alleviate one source of inflation.
4) **Corporate Earnings and Guidance** – The results of 2022 Q4 and corporate guidance for 2023 will be crucial to equity market valuation. There has been a significant downgrade in expected GDP in 2023 (recession or no recession) and earnings estimates have come down with them. In addition, Zombie companies may come under more stress as they need to refinance their large debt in the face of rising rates. Zombie companies are firms that are unviable without aid or a large amount of leverage. The Federal Reserve estimates that about 9% of listed public companies in the U.S. could be zombies.



5) **The Russia-Ukraine War** – When the invasion began in February 2022 it was not expected to last long. We are now approaching one year with no resolution in sight. A resolution could certainly relieve stress on the energy and food prices.
6) **China Reopening** – With the change in COVID policy discussed above, the path of reopening is rather cloudy. China and Russia are just two potential sources of geopolitical events that we know of now. Others could be lurking such as a return of terrorist activity or developments with Iran or North Korea.
7) **Consumer and Spending** – The consumer has already slowed, and they are taking on more debt to finance their living standards. The longer this goes on the more the consumer is stretched. If they continue to slow spending it will drive down the path of U.S. economic growth.

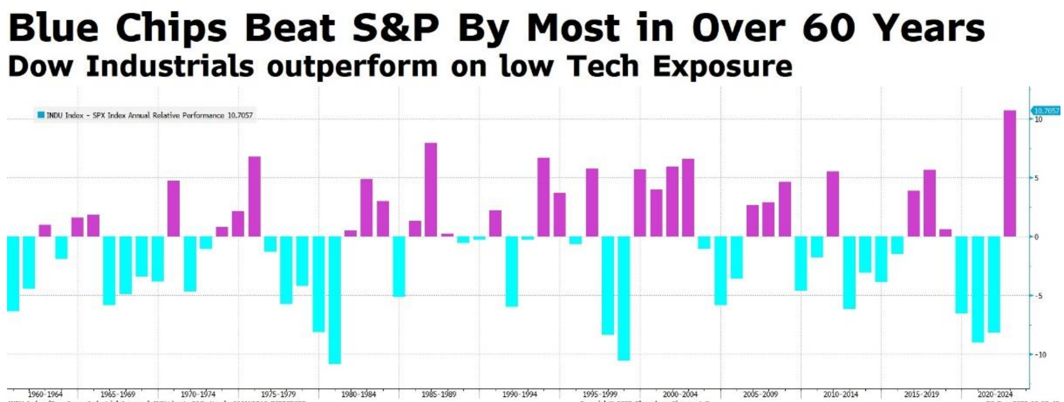
Financial Markets

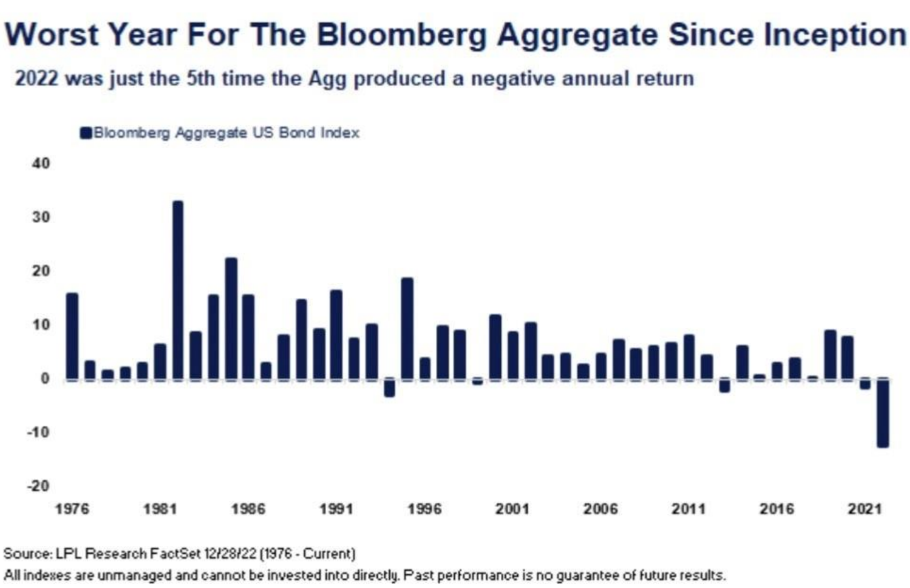
Inflation, rapidly rising interest rates, Russia Ukraine war, China COVID and fears of a recession in the U.S. combined to make 2022 the worst year in financial markets since 2008 (though fourth quarter was positive). The same is true of global financial markets as well. In addition, this was a rare year in the fact that both equities AND fixed income were both down significantly in the same year. Starting with U.S. equities the S&P 500 was down 19.4%, the NASDAQ 33.1% and the Dow Jones industrial Average only 8.8% (all excluding dividends).

Unusual that there is such a divergence in the performance of the three main equity indices and rare that the Dow Jones results were so much better. The explanation has its roots in the stocks that make up each index (as well as how they are calculated). Technology stocks were among the worst performing stocks of the year with some of the major names suffering significant losses as they are most impacted by rising interest rates. An example of some of the names and their 2022 performance are:

Apple (-27%); Amazon (-50%); Alphabet/Google (-39%); Microsoft (-29%); Meta/Facebook (-64%) and Tesla (-65%).

The NASDAQ 100 is mainly considered a technology-related index because these stocks make up a significant portion of the index (almost 50%). The Information Technology sector also makes up a significant weight of the S&P 500. At the beginning of 2022 the six stocks above comprised about 25% of the entire S&P 500. Because of the decline, the whole information technology sector is now just over 25% of the S&P 500 and these six stocks now represent less than 19% of the index. The decline of this sector was responsible for over 8.2% of the 19.4% overall decline (and the other 10 sectors accounted for the remaining 11%). The Dow Jones Industrial Average, in addition to being calculated differently, has only 30 stocks in the average. Of those stocks information technology only makes up about 18% of the total (and Apple and Microsoft are the only two out of the six above in the average). The Dow Jones Industrial Average is also balanced off by a heavy weighting in health care and energy stocks which didn't perform nearly as poorly as technology. Actually, energy and utilities were the only positive sectors for the year.

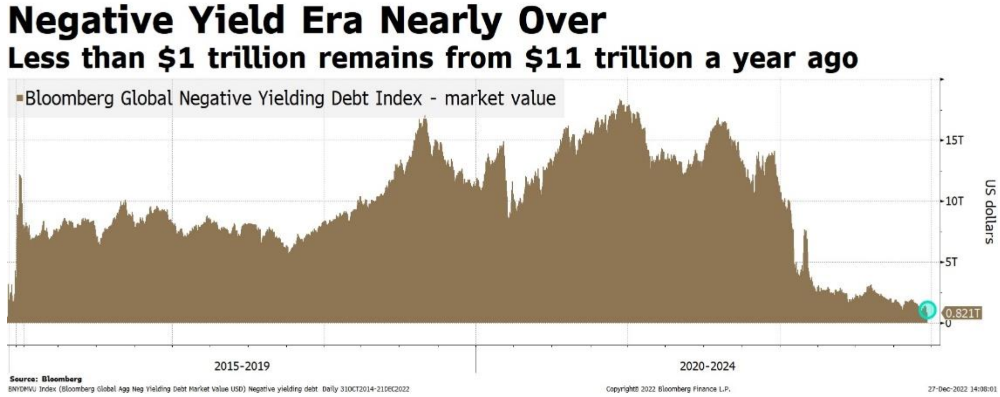


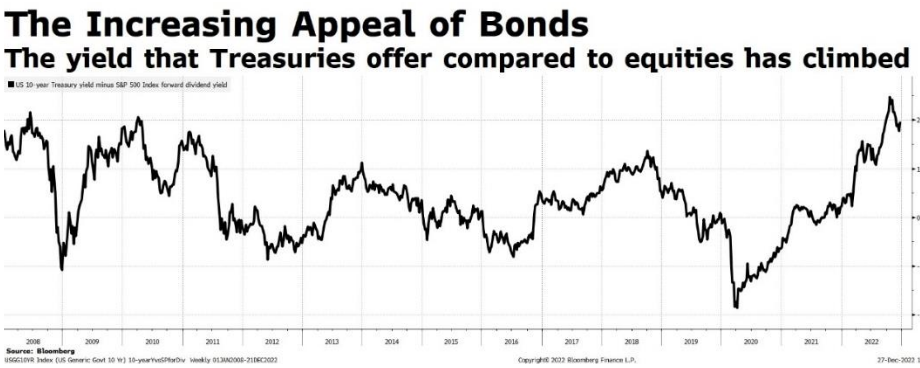


Bonds did not fare much better this year. Investment grade bonds, represented by the U.S. Bloomberg Aggregate, were down almost 12% for the year – the worst performance since the index was created and only the 5th time that the return was below zero.

However, not all news surrounding fixed income in 2022 was bad.

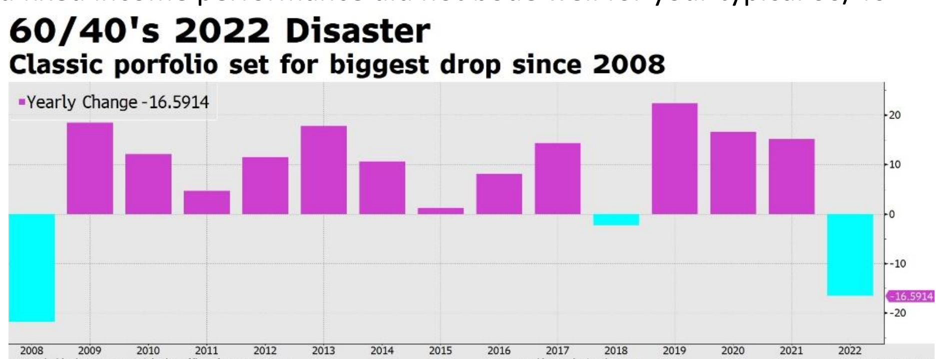
First, the increasing interest rates by central banks means that nearly all the negative-yielding bonds have been eliminated. Out of nearly $11 TRILLION in negative yielding bonds globally less than $1 trillion remains. Between maturities and continued increases in interest rates by central banks that will most likely be eliminated soon as well.





Another positive development from the rise in rates is that bonds are attractive as an investment once again. The increase in rates means that there is a positive yield coming from bonds. Typical government or corporate investment grade bonds have yields that are above 4.0% - even for short maturity notes. This is finally above the dividend yield on dividend-paying equities. So, there is finally an alternative to equities for investor savings.

Taken together the combination of equity and fixed income performance did not bode well for your typical 60/40 portfolio in 2022 since the total return was about -16.6%. On the positive side it is rare for the S&P 500 to have two negative years in a row and, if inflation starts to decline in a meaningful way, the path back to positive returns could be close at hand.



Should you have any questions please contact us.

Image sources: Bloomberg and CNBC unless otherwise noted

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