SlateStone WEALTH

Balancing Your Life Goals with Financial Results

# Investment Review & Outlook

January 2023

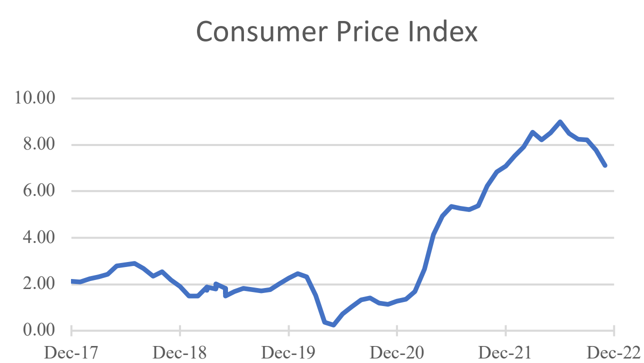
## Review

Both share prices and bonds rallied in the fourth quarter, but not by enough to overcome a dismal year. A meaningful growth slowdown is underway in the US and Europe. The abandonment of China's "Covid Zero" policies will add to the short-term disruption. 2022 was characterized by geopolitical tensions, rate hikes, and inflation concerns across regions, with significant losses across asset classes.

| Real GDP | | | | | | |
|---|---|---|---|---|---|---|
| | FY 2022 | FY 2023 | 3Q:22 | 4Q:22 | 1Q:23 | 2Q:23 |
| United States | 2.1 | 1.3 | 3.2 | 2.5 | 1.0 | 0.8 |
| Canada | 3.6 | 1.0 | 2.9 | 1.0 | 0.3 | 0.3 |
| Japan | 1.2 | 1.6 | -0.8 | 3.5 | 2.0 | 1.2 |
| China | 2.6 | 4.4 | 9.0 | -1.1 | 2.0 | 10.4 |
| Euro Area | 3.4 | 0.6 | 1.3 | -0.5 | -0.5 | 1.5 |
| United Kingdom | 4.1 | -0.3 | -1.2 | 0.0 | -0.5 | -0.5 |

Source: JP Morgan, Global Data Watch, Jan 6, 2023

We expect the Federal Reserve to continue to push over-night interest rates higher over the coming months. We believe a 0.25% increase is likely in both February and March bringing the terminal rate to 5%.




Source: Bloomberg, Nov 30, 2022

There is a significant lag between monetary policy change and effect. The Fed is likely to pause and reassess its restrictive policy by the end of the first quarter. Some improvement in the inflation rate is already apparent, but we are a long way from the Fed's 2% goal. At this point, there is no sign of a Fed pivot away from its' tightening stance.

## Global Markets

Energy was the only sector with positive results in 2022. In the fourth quarter energy led the way, followed by the industrial sector. The weakest sectors in the fourth quarter were consumer discretionary (automobiles) followed by communication services.

Short-term Treasury interest rates have continued to move higher, particularly on the shorter side of the yield curve. We intend to extend maturities.

The US Dollar peaked against a basket of 10 major currencies on Sep 27 and has moved lower since then. That is bad news on the inflation front, but a positive for the upcoming earnings season.

**Equity Market Performance**
**To 31-Dec-2022, in US Dollars**

| | 4th Quarter 2022 | 12 Months 12/31/2022 |
|---|---|---|
| MSCI World Index | 9.8% | -18.1% |
| | | |
| EMU | 22.8% | -17.9% |
| France | 22.2% | -13.3% |
| Germany | 24.6% | -22.3% |
| Switzerland | 10.4% | -18.3% |
| United Kingdom | 17.0% | -4.8% |
| Japan | 13.2% | -16.7% |
| Australia | 15.7% | -5.3% |
| EAFE | 17.3% | -14.5% |
| USA | 7.0% | -19.9% |
| Emerging Markets | 9.7% | -20.1% |

Source: Morgan Stanley Capital International,
Total return, dividends less withholding tax reinvested



Data sources: Standardandpoors.com, Bloomberg, MSCI.com *Continued on page 2*

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# Outlook

We do not know if the US economy will slip into recession in 2023. It does seem highly likely that the US economy will experience slower growth and more modest inflation over the next few years. Europe is probably already in recession, while China experiences a bumpy shift away from "Covid zero" policies.


Source: Bloomberg, Dec 30, 2022

As the US economy begins to slow, five-year forward inflation expectations have already drifted down close to the Fed's long-term goal. The challenge for the Fed is more related to wages than prices. By some measures, the US is facing the tightest labor market in decades. Wage growth is beginning to roll over. Headline generating layoffs have been concentrated in technology and home building, but outside of those sectors layoffs are at the lowest level in 20 years according to Challenger data.

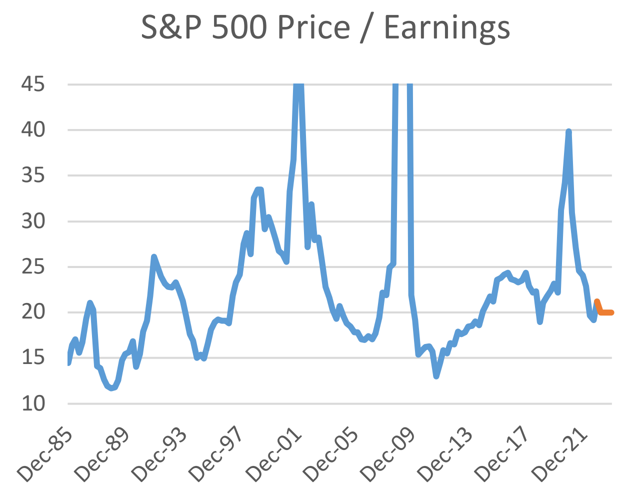
Once earnings for the fourth quarter of 2022 are reported, we expect the full year-over-year earnings to have declined by about 9%. Assuming we do not fall into recession in 2023, we could look for a 12% gain in S&P 500 earnings this year.

| **Standard & Poor's 500** | | | | |
|---|---|---|---|---|
| | Annual Earnings | %Change Y-o-Y | Price/ Earnings | Year-end Price |
| Dec-13 | 100.20 | 15.8% | 18.5 | 1848.36 |
| Dec-14 | 102.31 | 2.1% | 20.1 | 2058.90 |
| Dec-15 | 86.53 | -15.4% | 23.6 | 2043.94 |
| Dec-16 | 94.55 | 9.3% | 23.7 | 2238.83 |
| Dec-17 | 109.88 | 16.2% | 24.3 | 2673.61 |
| Dec-18 | 132.39 | 20.5% | 18.9 | 2506.85 |
| Dec-19 | 139.47 | 5.3% | 23.2 | 3230.78 |
| Dec-20 | 94.13 | -32.5% | 39.9 | 3756.07 |
| Dec-21 | 197.87 | 110.2% | 24.1 | 4766.18 |
| Dec-22e | 180.95 | -8.6% | 21.2 | 3839.50 |
| Dec-23e | 203.97 | 12.7% | 20.0 | 4080 |

Source: Standardandpoors.com Dec 30, 2022, Slatestone Wealth

In Europe consumer spending is being crowded out as energy costs replace other forms of consumer spending. While European governments attempt to shield consumers from high energy bills there is a negative impact on employment, housing, and production. Core inflation in Europe is still running at 5%, forcing the European Central Bank to tighten into economic weakness.

Interest rates moved up substantially in 2022 and that is likely to continue with 0.25% bumps in February and March 2023. The immediate impact of rising interest rates can be seen in the falling Price / Earnings ratio for the S&P 500. Since both interest rates and the market P/E are mechanisms that discount future cash flows, they are loosely correlated. Our best guess is that a market P/E in the range of 20X earnings can be sustained over the visible horizon.




Source: Standardandpoors.com Dec 30, 2022, Slatestone Wealth

If we do move into recession sometime in 2023, the risks from an over leveraged banking sector look much better than in 2008. US bank Tier 1 capital ratios are substantially higher than in 2008, plus a lot of risky lending has migrated from banks to capital markets and private credit lenders. US bank wholesale funding is now 7.5% of bank liabilities down from 17.5% in 2000 and loan-to-deposit ratios fell from 1.00% in 2008 to 0.65%, the most liquid banks have been since the 1970's.

On the fixed-income side, our conservative approach to bond investments in the context of credit quality remains in place. The short end of the yield curve has moved up over the course of recent months. As short-term Treasuries move up above 4.5%, we will extend our average maturity by reducing our exposure to cash equivalents. That assumes the 5-year average inflation rate tops out near the current estimate of 2.5%.

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