PMI
INSIGHTS

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THE PATH AHEAD.

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One of the main highlights for the equity markets as we came into 2022, was the Federal Reserve's (the Fed) acknowledgement that inflation may not be as "transitory" as previously thought. This change in narrative set the stage for returns in "risk assets" for what has proven to be a most challenging year for investors. A look back at the performance of the stock market can be aptly surmised by just one word **volatility**. The biggest out-performer (as of date of writing) was Energy up 53%, followed by Consumer Staples up 1.9% and Utilities up 1.9% as investors sought to de-risk their portfolios by rotating into more defensive areas of the market **(See Figure 1)**. Unfortunately, the crystal ball for 2023 presents for an equally difficult period ahead with no clear path in sight as investors grapple with the possibility of a "recession".

Figure 1

Name	YTD Total Return (%)
SPX Index	-13.1
Energy	53
Consumer Staples	1.9
Utilities	1.9
Health Care	-8.3
Industrials	-10.7
Financials	-14.1
Materials	-14.8
Consumer Discretionary	-21.2
Information Technology	-26
Real Estate	-27.9
Communication Services	-34

**Returns as at 12/22/22*
Source: Bloomberg

Mixed Picture

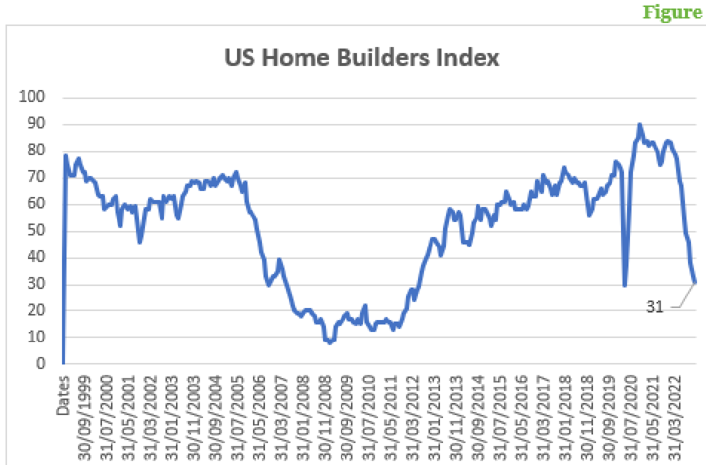
Market pundits are wondering relative to the Fed "what will they do next?". However, a more prudent question with inflation being a lagging indicator would be, "what are the impacts of what they have already done?". With the Fed having undertaken one of the most aggressive tightening cycles in decades, the extent to which it will ultimately have an effect on slowing the economy is a topic of debate. On the positive side, corporate earnings have held up reasonably well, wage growth is still the strongest in over 20 years and unemployment at 3.7% is the lowest it's been in over 40 years. Despite such glimmers of hope, cracks are starting to appear, and the outlook for 2023 is uncertain with recession odds increasing.

Some of the contributing economic factors are:

1) Housing Market

A look at the US Homebuilders Index (USHBMIDX) shows a rapidly decreasing level of confidence. This is nearly in line with what was experienced during the Covid-19 meltdown as the effects of higher home mortgages and prices are being felt (**See Figure 2**).

Figure 2



Source: Bloomberg/ PMI

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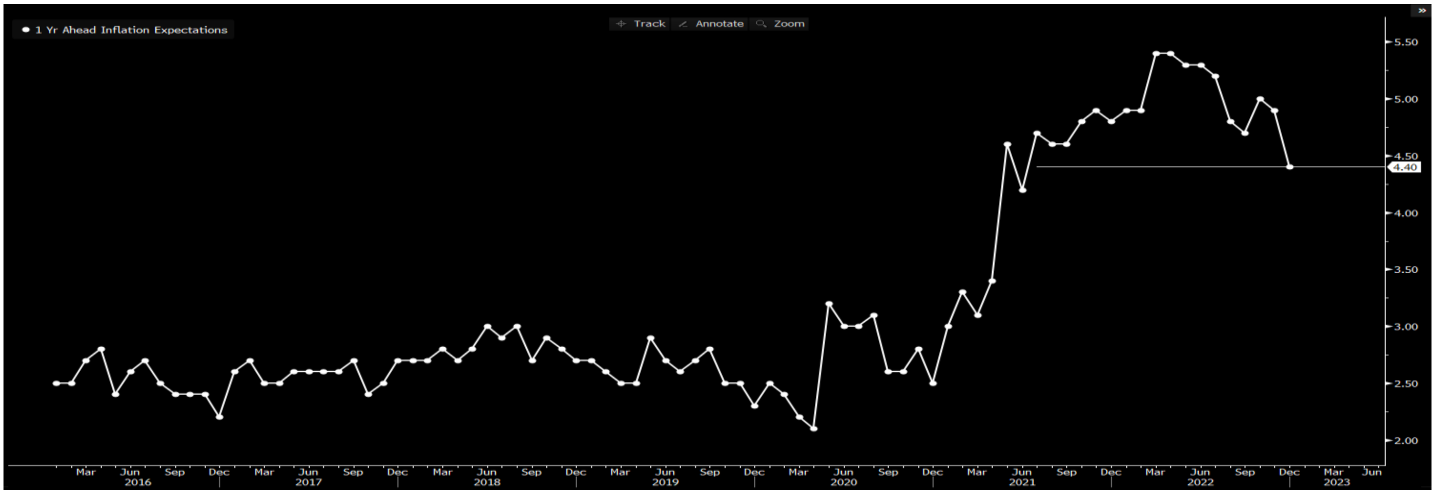
2) Inflation Expectations continuing to ease

The Index of Consumer Expectations focuses on three areas: How consumers view prospects of their own financial situation, how they view prospects for the general economy over the near term and how they view prospects for the economy over the long term. The latest reading at 4.40 is the lowest reading in 18 months (**See Figure 3**).

Figure 3

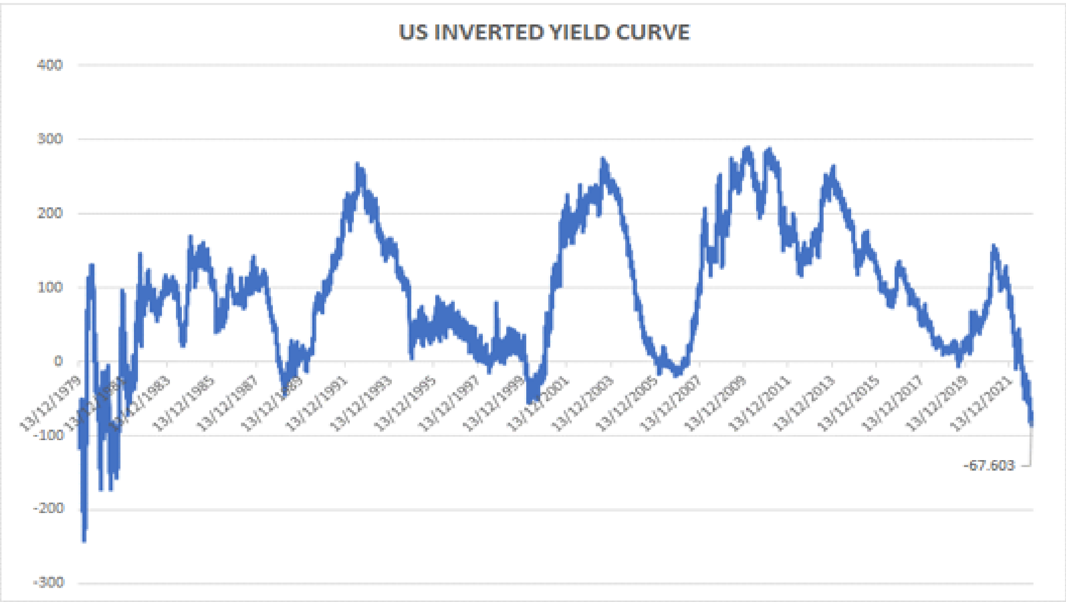


Source: Bloomberg

3) Inverted Yield Curve

Figure 4

The US yield curve is at its most inverted since the early 1980's (**See Figure 4**). A persistent inverted yield curve normally is a red flag that the bond market is discounting a slow-down in economic activity and normally can be used as a reliable predictor of an upcoming recession. For clarity, while an inverted yield curve in of itself may not lead to an upcoming recession, every recession that has occurred followed an inverted yield curve.

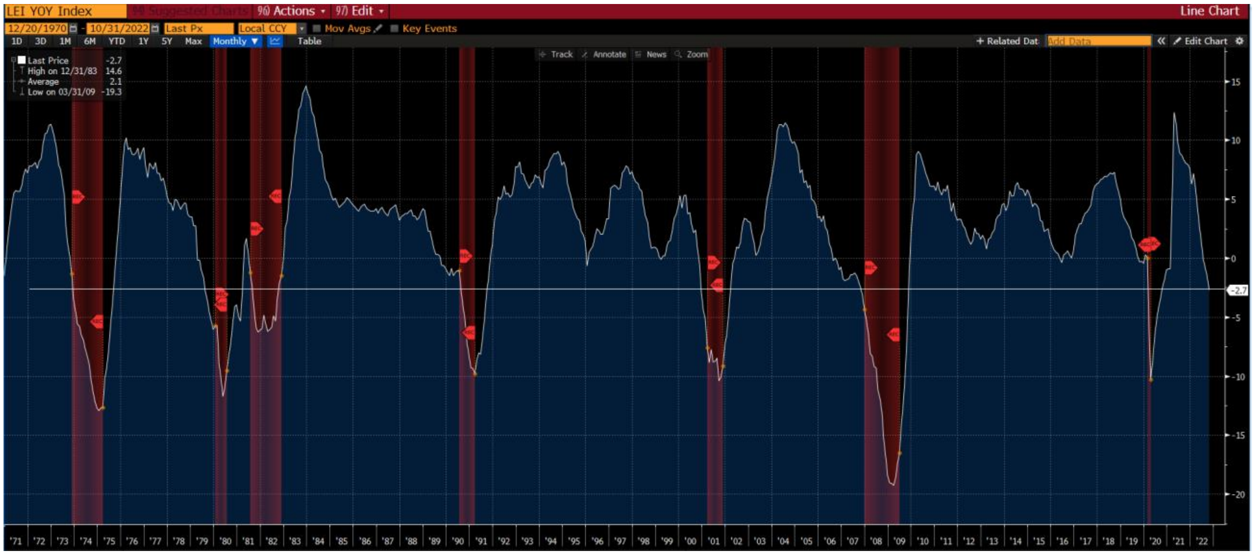


**Data as at 12/19/22*
Source: Bloomberg/ PMI

4) Leading Economic Indicators in the red.

The Conference Board Leading Economic Index which serves as a predictor or anticipator of turning points in the business cycle has been down for eight months in a row. In addition, on a historical basis (going back to the 1970's) each time it has been this negative, the economy was already in a recession or just a few months away from a recession (**See Figure 5**).

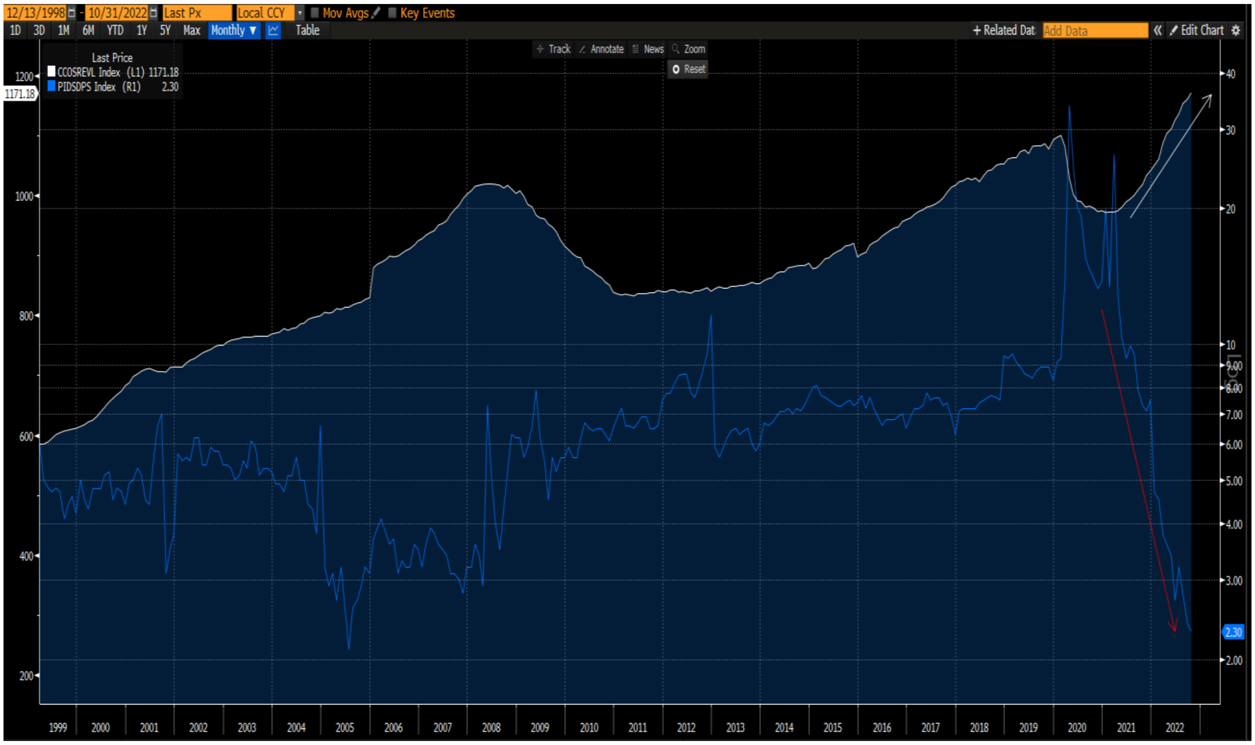
Figure 5



Data as at 10/31/2022
Source: Bloomberg/ PMI

5) US Consumer Debt at record highs while Savings at lowest since 2005

Figure 6



Data as at 10/31/2022
Source: Bloomberg/ PMI

The US consumer is tapped out. Consumer debt has not slowed down and is at all-time highs, while Personal savings continue to head lower and currently is at its lowest levels since 2005 (**See Figure 6**).

6) Bearish Market Technicals

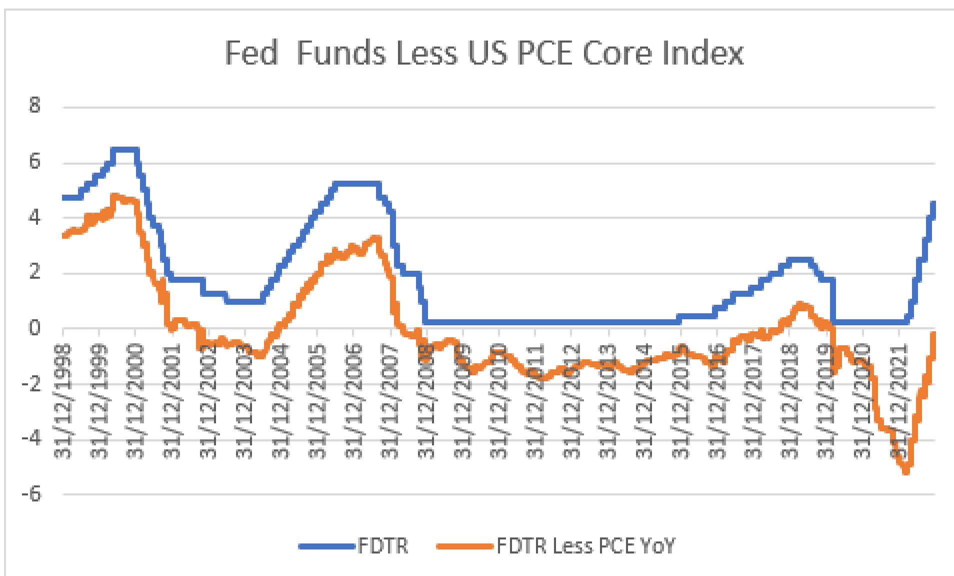
The market as represented by the S&P 500 Index price action continues to be "Bearish". The index failed to break through its major trendline resistance (**See Figure 7**) on the past 3 separate occasions (including the most recent rally from the bottom in October) which is indicative of a "rolling bear" market. The index also continues to trade below its 200-day moving average having failed to stay above it on its most recent rally.

Figure 7

Source: Bloomberg/ PMI

Stock Market Implications (Are we close to a bottom?)

Figure 8

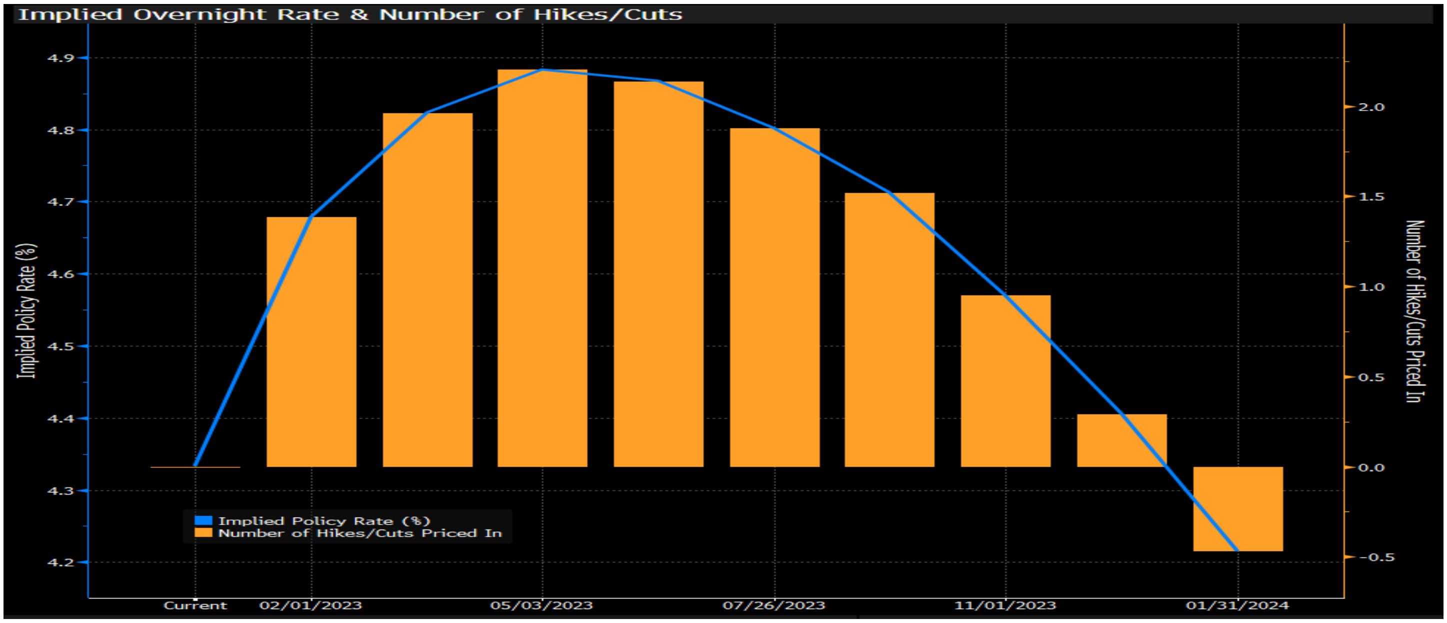


Source: Bloomberg/ PMI

The Fed is still a long way off from getting inflation down from its current level of 7.1% to its target of 2%. Calls for a Fed pivot in light of the previously mentioned deteriorating economic outlook may still be premature. Historically, using the Fed's preferred measure of inflation the PCE Deflator, the peak Fed funds rate does not occur until the Fed funds rate less the PCE deflator is positive (**See Figure 8**). Even with the recent 50 bps hike bringing the Fed rate to 4.50%, with the deflator at 4.7%, this would mean there are further hikes to go. This will further negatively affect stock valuations and inevitably corporate earnings (especially if rates are higher for longer) which thus far have been resilient. This will be challenging for stocks with a higher probability hard landing scenario as the Fed tightens into an already fragile economy.

Peak Fed Fund Rate

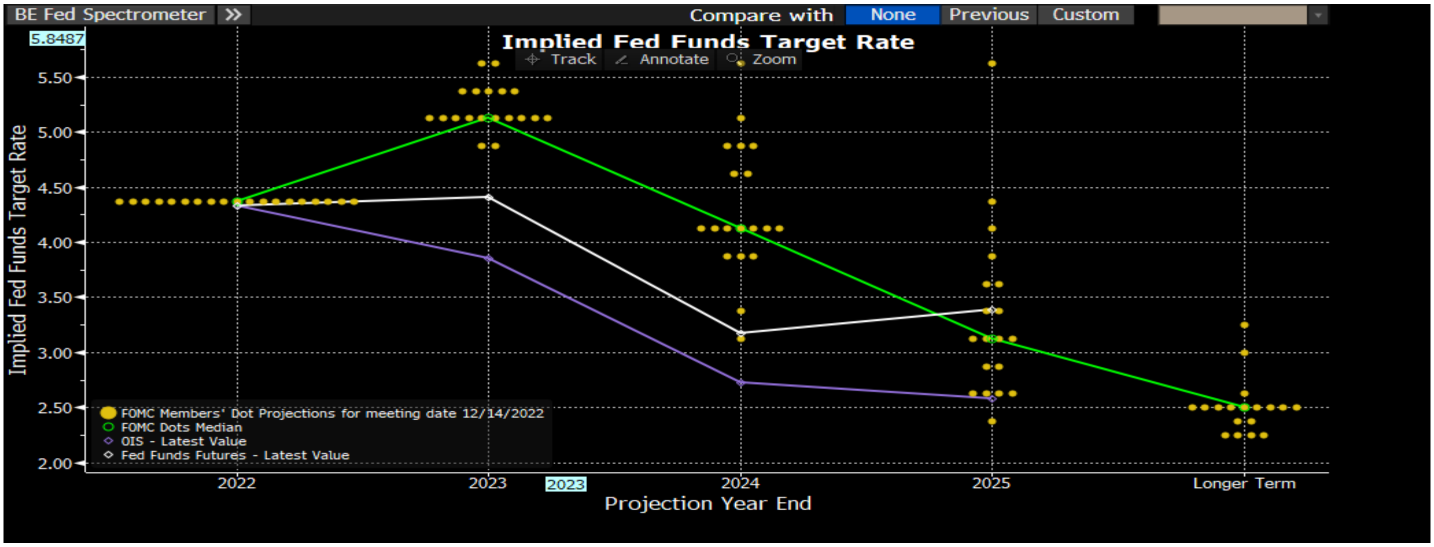
Figure 9



*Data as at 12/19/22
Source: Bloomberg

With the latest inflation number coming in below market estimates 7.1% versus 7.3% YoY, market expectations via Fed futures have now revised the terminal rate expectations to 4.8% within the first half of 2023. Many market participants expect the Fed will now only hike 25 bps at its next meeting and that it may be its last hike (**See Figure 9**). This remains in contrast to the Fed's guidance (**See Fed Dot Plot projections, Figure 10**) which median resides at 5.12% for 2023 (i.e., higher). This disconnect between the market and Fed will be concerning if the Fed stays its course.

Figure 10



Source: Bloomberg

Past cycles and Bear Market Bottoms

Figure 11

Source: Bloomberg/ PMI

Looking at past cycles, the bottom of the bear market did not occur until the Fed was in the latter stages of its quantitative easing (QE) (within the recession) and rates close to or at the bottom of the easing cycle (**See Figure 11**).

Portfolio Positioning

What does this all mean for the investor? The Fed still has a ways to go in its pursuit of restoring its inflation target. With cracks starting to show in the underlying economy, the lagging effects of further tightening of financial conditions is expected to provide headwinds for stocks as investors debate the odds of a "soft" versus "hard-landing" within the economy. The historical playbook suggests this bear market has further to run. The market trading at a forward P/E multiple of 17.33x is not ideal from a valuation perspective. Although valuations have come down, earnings have proven to be somewhat resilient and are expected to come under further pressure as corporate profitability becomes challenged in the ensuing economic decline.

As this part of the market cycle plays out, investors are reminded of the following:

1) Equities as an asset class has been one of the best return generators for wealth creation over the longer-term. **Figure 12**, below shows the total returns and annualized (CAGR) returns for the S&P 500 over various time periods.

Figure 12

S&P 500 Index Returns over varying time periods		
Time Period	Total Return	CAGR
12/29/72 to 12/21/22	13584.25%	10.34%
12/21/12 to 12/21/22	228.57%	12.62%
12/21/17 to 12/21/22	57.73%	9.54%

Source: Bloomberg/ PMI

2) While not readily apparent, trying to fish for a market bottom is ill advised. For market timing can be difficult and when the inevitable recovery ensues it will offer some of the market's best returns and missing out on these days can have a detrimental effect on your portfolio's longer-term performance (***as highlighted in PMI Insights, July 1, 2022 "Staying the Course!"***).

PMI continues to navigate these challenging times on behalf of its clients by focusing on core wealth preservation strategies, with tactical overlays that identify shorter-term trading opportunities with attractive risk/return tradeoffs.

Opportunity will reside through an active stock picking approach with a focus on defensive sectors. Some examples include consumer staples, healthcare, and utilities like what we have seen for 2022 with a shift to position into early-stage cyclicals as we near a bottom with a recovery in sight.

Fixed Income as an asset class has once again become attractive especially within the short end of the curve. Investors are now able to lock in "equity like" returns over the next year (4.62% yield on 1 yr treasury at time of writing). This will act as a "buffer" for investor portfolios.

Long dated bonds are also attractive as long-term rates and are expected to come down in response to a weakening economy. PMI