Retirement Income Solutions

Helping to grow and preserve your wealth

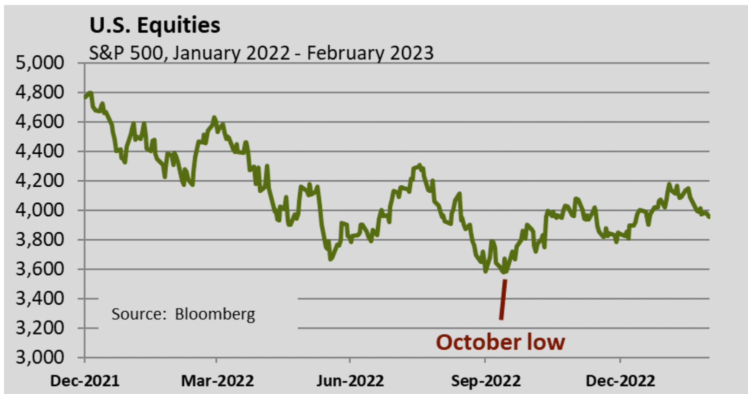
CELEBRATING 30 Years

Trending in the Right Direction

March 2023

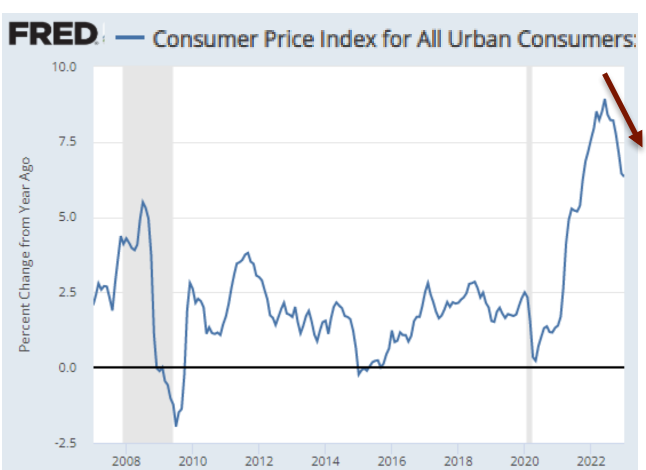
Summary

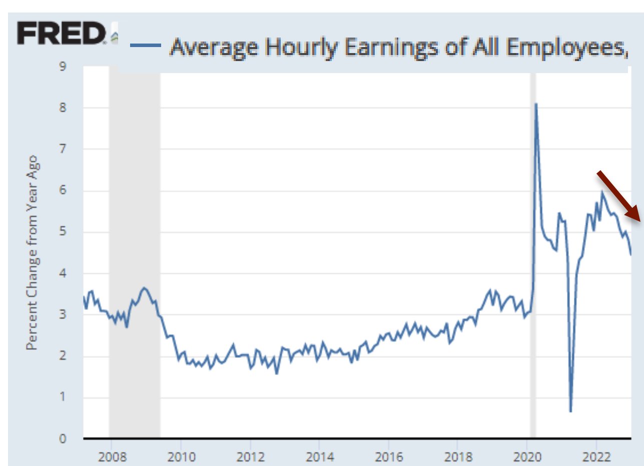
The U.S. stock market saw a bear market in 2022, falling 25% before bottoming in October. Fears of a recession weighed on markets as the impacts of inflation and higher interest rates were unclear. While the economy is likely to slow this year, it has been quite resilient in the face of rapid monetary tightening.



The Fed has raised rates dramatically. Just over a year ago, the Fed had short-term rates pegged at a very low level (0.0% to 0.25%). After eight hikes, the Fed Funds Rate sits at 4.5% to 4.75%, and it is expected to reach at least 5.5% later this year.

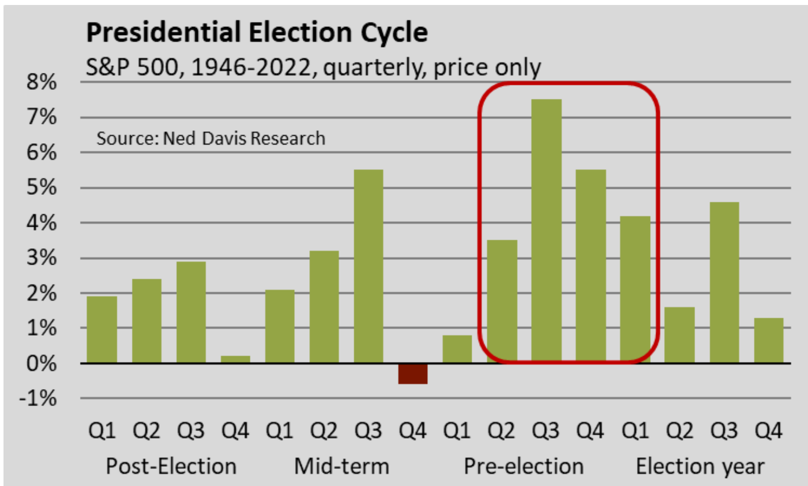
Higher interest rates will begin to slow the economy and employment as it becomes more expensive to borrow money to start a new venture, expand a business, or buy property. However, many aspects of the economy have been resilient given the pace of interest rate increases over the past year. For example, employment continues to be very strong. While unemployment is a lagging indicator, the January reading was 3.4%, the lowest since the 1960s. Wage gains (see chart, below) were elevated but are trending back to historical norms. Inflation (see chart, below) is finally responding to the higher rate environment and seems to be moderating.





Presidential Election Cycle

The presidential election and seasonality are notable cycles for financial markets. The low for 2022 occurred in October, which is the most common month for market reversals. The subsequent rally gained 14% through January, before dropping 3% in February. A lackluster February does not diminish the favorable trend from the presidential election cycle. In fact, fourth quarter strength is often followed by a pause in February, which is the second weakest month of the year, seeing an average decline of 0.1% since 1900. The presidential election cycle is entering the strongest period of the four-year cycle. After the mid-term lows, the stock market typically exhibits strength as optimism builds for the upcoming election (see chart, below).



Summary of Current Positioning

While expectations for a bumpy year continue, there is room for optimism in both stock and bond markets. It is still unclear how difficult the transition will be back to the desired level of inflation of roughly 2.0% to 2.5%, but the risk of a painful recession in 2023 has lessened. Markets are hyper-sensitive to short term data, and volatility is likely to stay high until inflation is more clearly back on track.

After falling 25% last year, much of the slowing economy is already baked into current stock prices. If the well-anticipated recession is relatively mild, then the lows from October 2022 may be the low point for this cycle. The S&P 500 is still 20% below its prior high, providing plenty of upside opportunity ahead. The outside shock of the pandemic disrupted cyclical tendencies, but both seasonality and the presidential election cycle patterns have re-emerged over the last year. The next 4-6 months have historically been quite favorable when viewed through a cyclical lens.

Bond returns in 2022 were by far the worst on record. However, the environment is significantly more positive looking forward. For example, the 10-year Treasury bond is now yielding roughly 4.0%, compared to less than 1.5% just 18 months ago. Not only is the yield higher, but the risk of losing principal has diminished. Bond prices suffer when rates go up because the older rates offered are no longer competitive (they are less desirable, so the price of older bonds falls). Rates could continue to go up if inflation remains stubbornly high, but the risk of loss is significantly lower than just 12-18 months ago.

Consumer sentiment is typically a contra indicator. When expectations are very low, it is easier to exceed them, and vice versa. Current expectations are very low, as inflation has consumers more worried about the future than any point since the European Debt Crisis in 2012. Accordingly, client portfolios are modestly overweight equities but remain under their maximum equity allocation target.

If you have questions on the investment environment or your portfolio, please call us at 734-769-7727. To find an electronic copy of this document and other recent commentaries, please visit our website at www.risadvisory.com.

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