the serious investor
WINTER 2023

THE SERIOUS INVESTOR: WINTER 2023

Welcome to the winter edition of LVW's *The Serious Investor*.

Investors' focus shifted during the fourth quarter as inflation eased and they began anticipating the end of the Fed rate hike cycle. The 12-month change in the Consumer Price Index fell from 8.2% in September to 6.5% in December, down considerably from its peak of 9.1% in June.[1] Crude oil prices fell by roughly one-third from their June peak[2], contributing to the decline in the inflation rate. Consumer sentiment rose sharply in January 2023[3] to its highest reading since last April, supported by $1.4 trillion of pandemic savings, strong household balance sheets and a collapse in 12-month inflation expectations to 5%.[4]

We believe the market's assessment of the data may be a bit optimistic, and the Federal Reserve may need to raise rates more and keep them high for longer than the market is currently factoring in.

The Federal Reserve continued to raise its target short-term interest rate, which ended December at 4.5%. The Fed's tightening slowed the economy, with many leading economic indicators falling into recessionary territory. The labor market remained strong. The unemployment rate was 3.6% in November and employers added 770,000 jobs in the fourth quarter - a decline from the more than 1.1 million added from July through September[5], but still consistent with an expanding economy. The U.S. dollar weakened against most currencies.

In all, these conditions created a risk-on environment in the fourth quarter. The S&P 500 Index gained 7.1%, international developed stocks gained 16.2% and emerging market stocks advanced 9.7%. Bond returns were essentially flat, despite experiencing significant volatility within the quarter. Despite a strong fourth quarter, stocks posted their seventh-worst year on record, while bonds had their worst year.[6] As a result, 2022 was among the most difficult years on record for a 60/40 investor, and the worst since 1937.[7]

The consensus view is for a recession in 2023. Many companies also expect a recession, as indicated by the ISM purchasing manager and services indexes, which recently fell into contractionary territory. That said, corporate and consumer balance sheets are generally in good shape.

Our investment discipline considers markets through the lenses of valuation, growth and liquidity. Our analysis leads us to the following conclusions as of early January:

Valuation: U.S. stocks are priced for a soft landing, while non-U.S. stocks are less expensive
Stocks got cheaper in 2022. Corporate earnings continued to grow, and the S&P 500 declined 18.1%, leaving the benchmark's price-to-earnings ratio at 19x as of the end of the year, right at its 10-year average. U.S. stocks are priced as if the Fed will navigate a soft landing, while non-U.S. stocks continue to trade at lower valuations relative to their long-term averages. Rising interest rates have normalized pricing in most areas of the fixed income markets. For example, the Bloomberg U.S. Aggregate Bond Index trades at an average price of 89 with a yield-to-worst approaching 5%.

Growth: Earnings and revenue growth softens

Corporate revenues and profits continued to grow in the fourth quarter, but at significantly slower rates than in the prior quarter. Earnings estimates for 2023 are flat to slightly down compared to 2022, meaning estimates don't reflect the strong consensus for a U.S. recession this year. Corporate profit margins peaked last year and have been contracting, pinched by increasing wage and inputs costs.[8]

Liquidity: Tightening introduces risk

Dollar liquidity is tight, as measured by M2 (money supply). M2 peaked in March 2021 and has been declining since, and now has gone negative for the first time since 2015.[9] This is the danger zone where financial or economic accidents historically have tended to occur. At the same time, the Fed continues to trim its balance sheet, selling approximately $90 billion in bonds each month and extracting that liquidity from the market. The full effects of the Fed tightening likely have yet to be digested by the economic system and financial markets. This pillar is the one that presents the highest potential for systemic risk.

Entering 2023, we continue to position portfolios cautiously, emphasizing opportunities that we believe have a strong margin of safety, and seeking to limit exposures where growth is slowing and valuations remain elevated.

Sources:
[1] Bureau of Labor Statistics
[2] The Wall Street Journal
[3] University of Michigan Surveys of Consumers
[4] Federal Reserve Bank of New York
[5] Bureau of Labor Statistics
[6] Bloomberg
[7] Ritholtz.com
[8] Bloomberg
[9] BCA Research

LVW ADVISORS

