Bell Institutional

January 2023

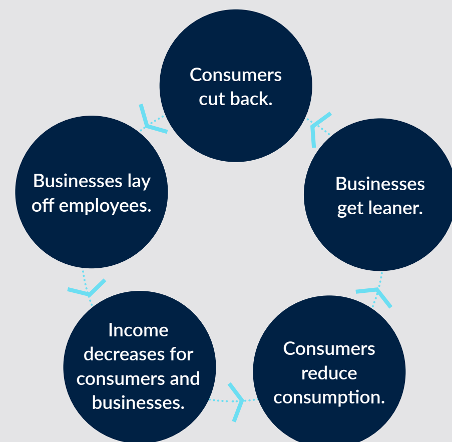
Is Economic Stage Being Set for Decline?

According to the current economic narrative, consumers and the economy are in good shape. Perhaps that's because consumers are generally reluctant to change their spending habits in response to what might turn out to be a temporary condition. After all, inflation was supposed to be transitory.

AS A RESULT OF INFLATION:

The problem is there is only so much savings depletion and credit stress this pattern can endure before reaching a breaking point. After that, a self-reinforcing cycle moves the economy in the opposite direction.

AFTER BREAKING POINT:



THE RESULT? Economic growth subsides or declines ... gradually and then suddenly.

Employment, personal income, personal spending and corporate earnings held up well in 2022 – likely due to the unprecedented buildup of $4 trillion in consumer savings during the pandemic. That money helped households withstand the shock of rising inflation and higher borrowing costs.

With the economy's core characteristics doing fine, why did the stock, bond and real estate markets decline throughout the year? Perhaps markets were responding to the surge in rising interest rates and what that portends for the future.

What Could the Future Hold?

Everyone wants to know the answer to this question, so I am happy to oblige and share my opinion. Let me remind you at the start of this forecast that this exercise has two potential outcomes … lucky or wrong.

My best guess? In 2023, the economy looks like it is about to experience the effects of that self-reinforcing cycle shifting in the opposite direction – gradually at first and then suddenly, suggesting more challenges may be ahead.

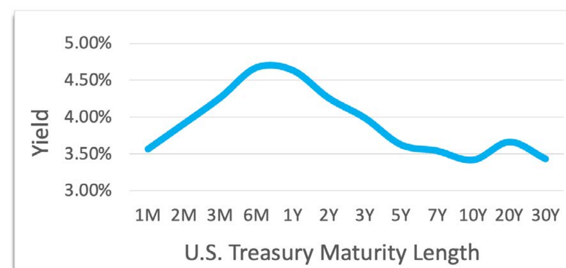
It feels like the Federal Reserve's interest rate hikes may have gone too far and too fast, which leads me to believe the next phase will be the Fed leaves interest rates too high for too long.

Four Signs the Economy May Be Heading Toward Decline

1. The economic response to changes in Fed interest rates operates with a delay of around nine months, known as "uncertain lags." This means the most recent four 75-basis-point Fed rate increases have not worked their way into the economy. Once these and future hikes work their way in, the stage likely will be set for economic decline. Whether it will be labeled a recession is yet to be seen, considering there has been a reluctance to declare the first two quarters of declining gross domestic product (GDP) in 2022 a recession, even though declining GDP has been the primary determinant in the past.

2. The lag in economic impact also holds true for fiscal policy – like the stimulus checks and enhanced unemployment programs enacted by Congress in the wake of the pandemic. Pre-pandemic, personal savings were collectively around $1.5 trillion. By about mid-2020, that level rose to over $6 trillion. Those savings have since been spent, and collective savings today hover around a half-trillion dollars, according to the Bureau of Economic Analysis. Consumers no longer have the support of elevated savings to maintain consumption patterns.

3. The U.S. Treasury yield curve is inverted, meaning longer-term interest rates are lower than short-term interest rates. When investors are willing to accept lower interest on longer maturity bonds, they are placing more value on the investment's safety than on the interest level. In other words, the yield curve suggests a slowing economy could be looming.



4. We see inflation moderating and continuing to trend downward, settling in around 3% rather than the Fed's desired 2%. The quest for the 2% inflation target is what we see as the catalyst to push the economy into a mild recession as the Fed holds interest rates at elevated levels while inflation remains above its desired target.

What about the stock market?

Stocks had a great run since the end of the financial crisis in 2009, supported by near zero fed funds rates and Fed quantitative easing programs that drove short- and long-term interest rates lower. This pushed returns and valuations higher than they had been for quite some time. The low-rate environment lasted so long

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that corporations completely rearranged their capital structure to favor debt over equity when it came to financing expansion plans. Some companies even issued low-cost debt for the primary purpose of simply repurchasing their own company stock. In cases like this, a company that had little or no sales or profit growth could report increased earnings per share simply because they had fewer shares of stock outstanding.

The stock market loved it, but, for every action there is an equal and opposite reaction. The elixir of easy money and stimulus-fueled consumer demand took its toll. Inflation made its presence known after a long hiatus, and the availability of low interest rates disappeared. As of early December, the S&P was down -15.6% YTD in 2022.

The consensus forecast for S&P 500 earnings in 2023 is about $230. At a price to earnings (P/E) ratio of 17, this suggests the market is fairly priced. We lean toward expecting earnings pressure in 2023, which probably coincides with elevated investor fear. It would not come as a surprise if 2023 earnings were $210 or $220, and P/E ratios were 15 or 16. The following chart shows the range of potential outcomes for different earnings and P/E considerations:

Equity Review

Where does the market go from here?

S&P 500 Potential Next Twelve Months (NTM) Earnings Per Share

	200	210	220	230 ★	240
19x	3,800 -6.9%	3,990 -2.2%	4,180 2.4%	4,370 7.1%	4,560 11.8%
★ 18x	3,600 -11.8%	3,780 -7.4%	3,960 -2.9%	4,140 1.5%	4,320 5.9%
17x	3,400 -16.7%	3,570 -12.5%	3,740 -8.3%	3,910 -4.2%	4,080 0.0%
16x	3,200 -21.6%	3,360 -17.6%	3,520 -13.7%	3,680 -9.8%	3,840 -5.9%
15x	3,000 -26.5%	3,150 -22.8%	3,300 -19.1%	3,450 -15.4%	3,600 -11.8%
14x	2,800 -31.4%	2,940 -27.9%	3,080 -24.5%	3,220 -21.1%	3,360 -17.6%
13x	2,600 -36.3%	2,730 -33.1%	2,860 -29.9%	2,990 -26.7%	3,120 -23.5%

- Current NTM earnings estimates for the S&P 500 are $229.79
- Current NTM earnings per share multiple is 17.8x
- As financial conditions continue to tighten, it is possible that actual earnings come in below estimates
- Month-end price of the S&P 500 Index was $4,080

As of November 30, 2022

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Looking at the markets, the prospect – and potential severity – of a recession in 2023 is not clear. If weaker growth reigns, declining earnings drag the stock market lower before declining interest rates help it stabilize. It would not surprise us if the S&P 500 retests its lows or even drops below the 3,500 level seen in October 2022. We expect firms with solid financial statements and balance sheets to be the winners if the economy slows.

Stocks are a function of investor confidence, cash going into the market and corporate earnings. We expect corporate earnings to come under some pressure, while higher yields on bonds provide a reasonable alternative to invest some cash that would have been directed toward stocks in the past. This results in another year of uncertainty for stocks, which we expect to see in the form of volatility.

What about bonds?

This is the first time in about 15 years that bonds are paying a reasonable interest rate. Bond returns look bad this year because rising interest rates erode the value of bonds. There are several articles floating around that suggest the popular 60% stock, 40% bond portfolio allocation is dead. We disagree. Sure, it struggled in 2022, but from where things are today, it still looks compelling.

Our bond market strategy targets high-quality investment grade bonds with maturities of 10 years or less. This is not a market to make allocations to below investment grade securities, even though their elevated yields are a strong incentive attracting investors. The prospect of a slowing economy will result in increased default possibilities for this portion of the credit market.

We expect 2023 will be a better year for bonds, as yields are currently much higher than they were last year at this time. As a reminder, rising yields hurt returns for existing bond holders. With higher interest rates in place today, there won't be as much room for rising rates to have the same impact on bond portfolios as they did in 2022.

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What does this mean for your portfolio?

Most investors look long-term when making portfolio allocations, so it is important to look beyond next year. We maintain a capital market outlook that examines many different sources of input to generate a 5- to 10-year forecast for returns. As it currently stands, after processing our collection of data, the 5- to 10-year outlook for stock returns is about 8%. Many investors think of the S&P 500's 16% return from the beginning of 2009 through the end of 2021 as a normal stock market return. Unfortunately, that run in the stock market is about 6% higher than its long-term average of 9.5%.

Should you use the prospect of a recession and falling market next year as an opportunity to time the market with your investment portfolio? No – circumstances could all turn out different than outlined. This is just a bump in the road along the path of achieving long-term investment success. Would you get a new car just because you hit a bump in the road? Probably not. There is no need to get a new portfolio either.

Our strategy is to capture incremental income and let it accrue to the benefit of the portfolios. To that end, we favor domestic allocations to high-quality assets, with elevated dividend and income producing qualities that have incrementally better yields, to help offset price volatility while looking to deliver on long-term portfolio goals.

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Greg Sweeney, CFA®
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Tenure: 09/1992
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