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WEEKLY ECONOMIC UPDATE JAN. 23, 2023

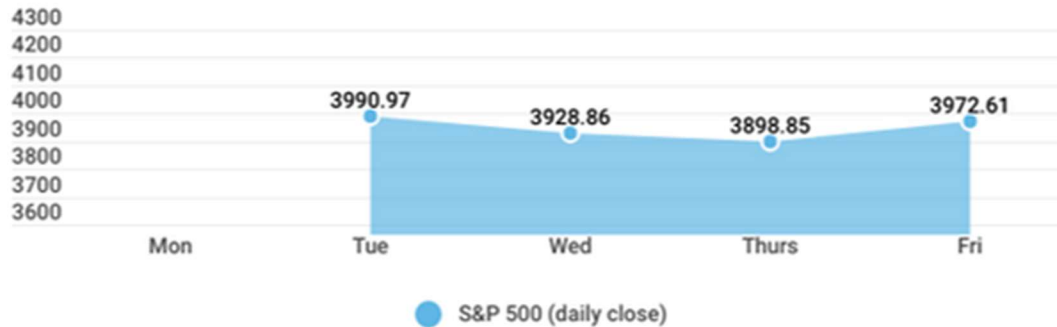
Stocks showed mixed results last week as recession fears resurfaced in response to weak economic data and a tepid start to a new corporate earnings season.

The Dow Jones Industrial Average skidded 2.70%, while the Standard & Poor's 500 declined 0.66%. But the Nasdaq Composite index gained 0.55% for the week. The MSCI EAFE index, which tracks developed overseas stock markets, lost 0.50%.^{1,2,3}

MARKET INSIGHTS



Market Index	Close	Week	Y-T-D
DJIA	33,375.49	-2.70%	+0.69%
NASDAQ	11,140.43	+0.55%	+6.44%
MSCI-EAFE	2,070.00	-0.50%	+6.49%
S&P 500	3,972.61	-0.66%	+3.47%



	Treasury	Close	Week	Y-T-D
	10-Year Note	3.48%	-0.02%	-0.40%

Sources: The Wall Street Journal, January 20, 2023; Treasury.gov, January 20, 2023

Weekly performance for the Dow Jones Industrial Average, Standard & Poor's 500 Index, and NASDAQ

Composite Index is measured from the close of trading on Friday, January 13, to Friday, January 20, close.

Weekly performance for the MSCI-EAFE is measured from Friday, January 13, open to Thursday, January 19, close. Weekly and year-to-date 10-year Treasury note yield are expressed in basis points.

Mixed Economic Data

Stocks weakened to start the week amid discouraging corporate earnings and troubling economic data. Disappointing retail sales and manufacturing reports sparked concerns that the Fed may have gone too far in hiking rates, while a drop in initial jobless claims diminished chances of a near-term pause in rate hikes. Welcome news from two big technology names on Friday powered a strong rally that mixed significant indices.

The start of the earnings season was a drag on investor sentiment. While 69% of the S&P 500 constituent companies that reported earnings by Thursday (48 companies) exceeded expectations, the percentage of "beats" is below the three-year average. More concerning, however, was that average earnings declined by more than 2%.⁴

Consumers Retrench

Retail sales fell 1.1% in December, capping an overall weak holiday shopping season. November retail sales were revised downward to -1.0%, from the earlier estimate of -0.6%. Compared to November-December 2021, sales increased by 5.3%, below the 6 to 8% increase expected by The National Retail Federation.^{5,6}

Many economists viewed these lackluster numbers as evidence of a weakening consumer. A more cautious consumer raises more concerns about a recession at some point this year since the primary driver of U.S. economic growth is consumer spending.

This Week: Key Economic Data

Tuesday: Purchasing Managers' Index Composite.

Thursday: Gross Domestic Product (GDP). Durable Goods Orders. New Home Sales. Jobless Claims.

Friday: Consumer Sentiment.



"Courage is the first virtue because it makes all other virtues possible"

– Aristotle



One of our favorite Wall Street sayings is that "trends continue until they change." In 2022, two long-term trends changed. Inflation, which had consistently drifted lower over the past 40 years, suddenly rose – partially for structural reasons and partially for temporary ones. Ditto for interest rates. The yield on the 10-year Treasury peaked at about 16% in 1981 and then fell over the next four decades to below 1% in 2021. The positive implications of this multi-decade trend for risk assets are difficult to overstate. In 2022, this trend dramatically changed, as rates shot up to roughly 4% and could go higher as the Fed continues its efforts to contain inflation by raising the cost of borrowing.

The upshot of these sea-changes in inflation and interest rates in 2022 was a bear market across pretty much every asset class from bonds to stocks to real estate. The stock market (as measured by the S&P 500) fell by roughly 25% peak to trough during the year but has partially recovered recently. As of 12/31, it was down over 18%. The tech-heavy Nasdaq was hit much harder, down 33% in 2022. Treasuries, widely described as “risk-free” because of the assurance of repayment by the federal government, had an historically bad year, with investors in 10-year Treasuries seeing a loss of nearly 17% in 2022. Higher mortgage rates have pummeled house prices. Most other forms of real estate also came under pressure. With asset prices broadly down, the good news is that expected future returns are higher. Asset prices could, of course, go lower before entering a new secular bull market, but it appears that we are now in a bottoming process that will ultimately allow asset prices to rise again. How soon, from what level, and how fast they recover is a matter of debate. The answers depend on the interplay between secular and cyclical forces and the Fed’s determination to squeeze inflation back down to around 2% from its current level of over 7%.

To understand how inflation has made such a dramatic and unwelcome turnaround in such a short period of time, it is helpful to review a bit of economic history. For the past several decades, inflation has been held in check by the twin forces of technology and globalization. Technology enabled businesses to become much more efficient and gave consumers and businesses unprecedented price discovery powers. Globalization opened vast quantities of cheap foreign labor, which enabled businesses to relocate manufacturing operations to countries offering less expensive workers. This kept the lid on U.S. domestic wages. As inflation subsided, profits rose, interest rates trended lower, and asset values expanded.

While technology is still a deflationary force, globalization is not. In fact, we have swung from a period of labor surplus to labor shortage as China’s labor force is now aging. In addition, the persistent supply chain shocks of the past two years have highlighted the risks of being overly reliant on foreign operations. And escalating political tensions between the U.S. and China have raised the specter of future disruptions. This constellation of factors is inducing U.S. manufacturers to bring operations back home — leading to a trend of re-shoring and near-shoring. These shifts in the labor market supply demand balance portend higher trend-line inflation than the sub-two percent inflation we experienced for a couple of decades.

Adding to inflationary pressure are two cyclical or temporary pressures. The first is Covid, which led to the aforementioned supply chain issues, creating both shortages and price increases. The second is the war in Ukraine, which has led to disruptions in commodities like oil and grains, leading to higher prices for both. The combination of all these factors pushed headline inflation from under 2% to over 9%. While inflation has peaked, and is heading lower, it is still well above the Fed’s target.

Since the Fed is determined to push inflation back near 2%, it will likely continue monetary tightening and keep interest rates elevated through much of 2023. This may cause a recession, which could pummel corporate profits, which in many cases are already suffering from inflationary cost pressures. All

this adds risk to the stock market, but it may also set up the market for a strong rally once the Fed takes its foot off the brakes.

For investors, the key is to position portfolios to withstand the near-term risks stemming from possible recession and inflationary cost pressures on the one hand, and on the other, to benefit from the eventual economic upturn that will inevitably follow any slowdown.⁷

Footnotes and Sources

1. The Wall Street Journal, January 20, 2023
2. The Wall Street Journal, January 20, 2023
3. The Wall Street Journal, January 20, 2023
4. The Earnings Scout, January 19, 2023
5. Census.gov, January 18, 2023
6. The Wall Street Journal, January 18, 2023
7. advisorperspectives.com/commentaries/2023/01/13/equity-outlook-the-times-they-are-a-changin?topic=alternative-investments

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The Dow Jones Industrial Average is an unmanaged index that is generally considered representative of large-capitalization companies on the U.S. stock market. Nasdaq Composite is an index of the common stocks and similar securities listed on the NASDAQ stock market and is considered a broad indicator of the performance of technology and growth companies. The MSCI EAFE Index was created by Morgan Stanley Capital International (MSCI) and serves as a benchmark of the performance of major international equity markets, as represented by 21 major MSCI indexes from Europe, Australia, and Southeast Asia. The S&P 500 Composite Index is an unmanaged group of securities that are considered to be representative of the stock market in general.

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