FOURTHOUGHT Q1 ECONOMIC REVIEW:

PERSEVERANCE - LESSONS FROM HURRICANE IAN

FourThought
PRIVATE WEALTH

PERSEVERANCE

LESSONS FROM HURRICANE IAN

by Scott Pinkerton and Jake MacFarlane

Our headquarters is in Venice Florida. In late August we were hit by Hurricane Ian.
Prior to Ian, Venice never suffered serious hurricane damage. Why? I have heard just about every crazy hurricane theory/reason; from offshore Indian burial grounds to weird pre-historic undersea archaeological structures that supposedly protect Venice (and provide the supply of Sharks Teeth).

We humans are pattern seeking, storytelling machines. We are quick to draw conclusions and see patterns in randomness. People errantly drew conclusions from previous hurricane experiences that led to tragic consequences.

For example, in 2017 with Hurricane Irma, we evacuated my mom from her assisted living facility, drove to the only spot in Florida not in the cone, Jacksonville, to ride out the storm. Guess, where the storm hit? Jacksonville. What conclusion would one draw from such an experience? Don't evacuate.

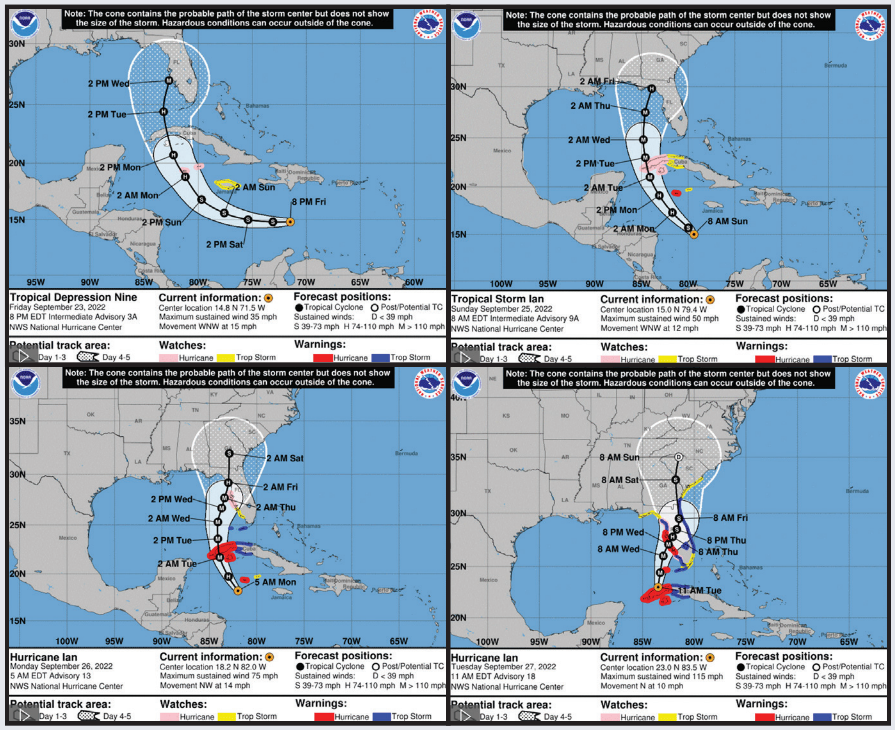
It is healthy and natural to let our past experiences influence our decision making. But, when developing a plan for your personal safety or for your investments it is critical to turn off the emotional part of our brains and fire up the slowing thinking, analytical parts. Our emotional brains overweight recent experiences (recency bias) and sees patterns in randomness.

Our belief is that the current economic and geopolitical storm is fundamentally different from the last three economic recessions. We believe this slow down marks a change in the way the world's economies and our investment's function and inner-relate. The main point of this paper is to highlight some of these changes and the "street signs" to watch, to help us adapt as the facts change.

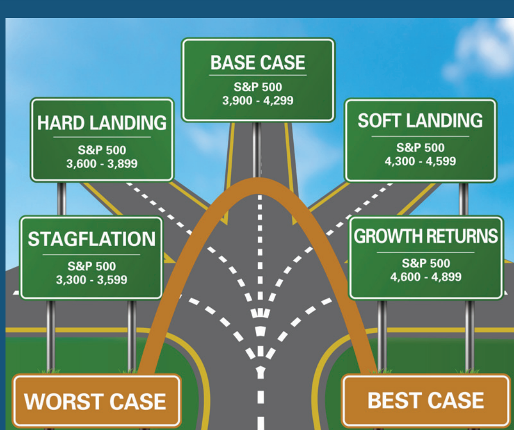
For additional graphs and more in-depth discussion, please watch our Economic Webinar: https://attendee.gotowebinar.com/recording/8547096947902278231

REMINDER:

What are street signs and how do we use them?



FourThought investment principal #1. We are not Gods. Therefore, we cannot predict the future. Note how the path of Ian changed in a week; likewise, this economy will change directions as well. The process of predicting holds the door and lets many investing bias' in. Once you predict you will find yourself subjected to confirmation bias, over confidence bias, recency bias and many others. A better process is to forecast, based on your best thinking and change as the facts reveal themselves. It is like we are on a massive road trip, and we don't know the destination. But we diligently watch for street signs to give us clues and steer accordingly.



WATCH THE STREET SIGNS AND ADJUST YOUR ASSET ALLOCATION AS ROAD CONDITIONS CHANGE.

POLITICAL DYSFUNCTION
INFLATION
YIELD SPREADS
EARNINGS
WORKFORCE PARTICIPATION
US CHINA TENSIONS
UKRAINE

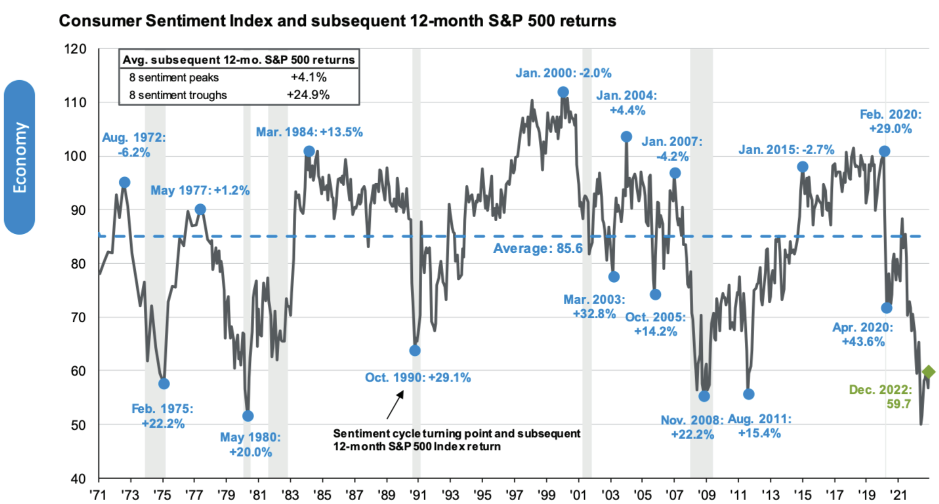
Thinking Like a Reptile

Consumer sentiment hit a 40 year low late last year. Americans are more pessimistic about the economy than in the middle of the Global Financial Crisis (when many global banks went bankrupt) and during Covid, when the world economy shut down and we didn't yet have a vaccine. This seems strange in a country with virtually no unemployment, low levels of personal debt and near record high consumer balance sheets.

Why is that and what does it mean?

The answer is not empirical but rather sociological. In our opinion it is a soup of ingredients including the psychological impact of covid, divisive politics, the influence of social media, and other factors that is making things spicy. The bottom line for us is to recognize that these influences impact the investors both professionals and individuals.

We know that we have two broad ways of thinking: an emotional "reptilian" way, and a slow thinking analytical way. We are seeing an increase in volatility as investors let their emotions get the best of them and make huge investment bets and changes. There will be frustration as the economy fails to rebound as quickly as it has in previous recessions because this time its different.



Source: FactSet, Standard & Poor's, University of Michigan, J.P. Morgan Asset Management.
Peak is defined as the highest index value before a series of lower lows, while a trough is defined as the lowest index value before a series of higher highs. Subsequent 12-month S&P 500 returns are price returns only, which excludes dividends. Past performance is not a reliable indicator of current and future results.
Guide to the Markets – U.S. Data are as of December 31, 2022.

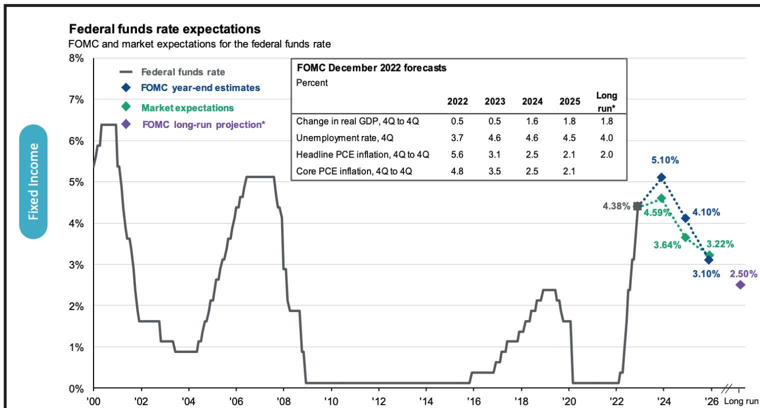
ACTIONABLE ITEMS:

We look for many to "throw the baby out with the bathwater" and discard great technology and innovation companies because all the pundits agree that growth stocks are out of favor. We expect volatility which will provide opportunities for portfolio repositioning.

Fed to the Rescue? Not this time

We have lived through a bunch of hurricanes and a bunch of economic storms. What did the 2001-02 tech bubble/911,the 2007 & 8 global financial crisis and the COVID recessions have in common? The Federal Reserve came to the rescue by lowering interest rates, quantitative easing and massively stimulating the economy.

These were all shocks to our world; consumer demand and money supply dried up. The result were relatively quick rebounds in asset prices and fairly short recessions (although they were deep). This is not going to happen this time. In fact, in many ways, the Federal Reserve is the villain of this weakness not the hero. The problem we have is too much money chasing too few goods. We need to increase supply. This is going to take longer to accomplish, and the world's central banks don't have all the tools to do it. We will also need immigration reform (labor supply), fiscal restraint (stop digging the stimulative hole), and incentives for businesses and people to invest in production. Many of these are happening but it will take a while.



FOMC December 2022 forecasts
Percent

	2022	2023	2024	2025	Long run*
Change in real GDP, 4Q to 4Q	0.5	0.5	1.6	1.8	1.8
Unemployment rate, 4Q	3.7	4.6	4.6	4.5	4.0
Headline PCE inflation, 4Q to 4Q	5.6	3.1	2.5	2.1	2.0
Core PCE inflation, 4Q to 4Q	4.8	3.5	2.5	2.1	

Source: Bloomberg, FactSet, Federal Reserve, J.P. Morgan Asset Management.
Market expectations are based off of the respective Federal Funds Futures contracts for December expiry. *Long-run projections are the rates of growth, unemployment and inflation to which a policymaker expects the economy to converge over the next five to six years in absence of further shocks and under appropriate monetary policy. Forecasts are not a reliable indicator of future performance. Forecasts, projections and other forward-looking statements are based upon current beliefs and expectations. They are for illustrative purposes only and serve as an indication of what may occur. Given the inherent uncertainties and risks associated with forecasts, projections or other forward-looking statements, actual events, results or performance may differ materially from those reflected or contemplated.
Guide to the Markets – U.S. Data are as of December 31, 2022.

ACTIONABLE ITEMS:

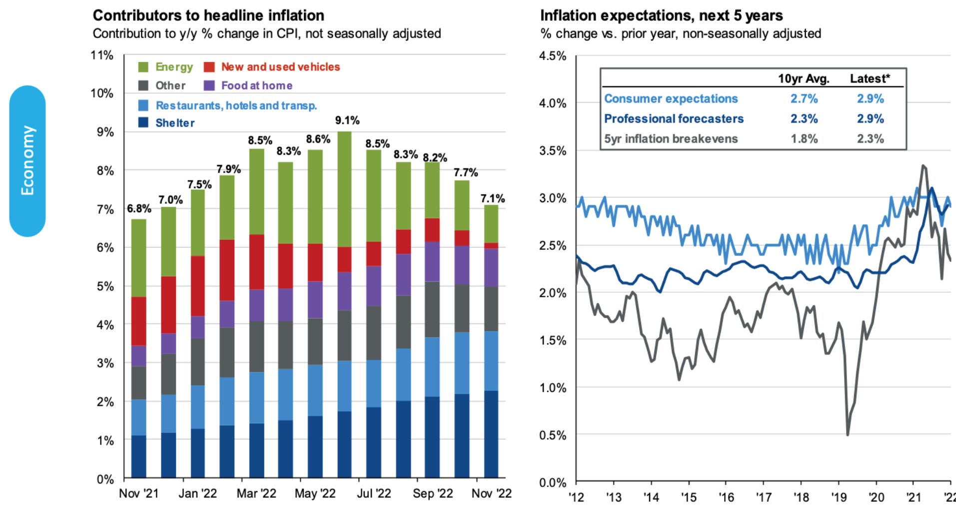
Investors need to lower their return expectations, invest for current income and preserve.

Inflation Drivers: Has inflation peaked?

Many of the items that spiked in the fall are returning to normal as the supply chain bottlenecks have been fixed. Did anyone really think that a car would go up in value after you drove it off the lot? However, housing costs and labor costs are actually rising. We fear that we may have to live with an elevated rate of inflation for the next 3-5 years.

ACTIONABLE ITEMS:

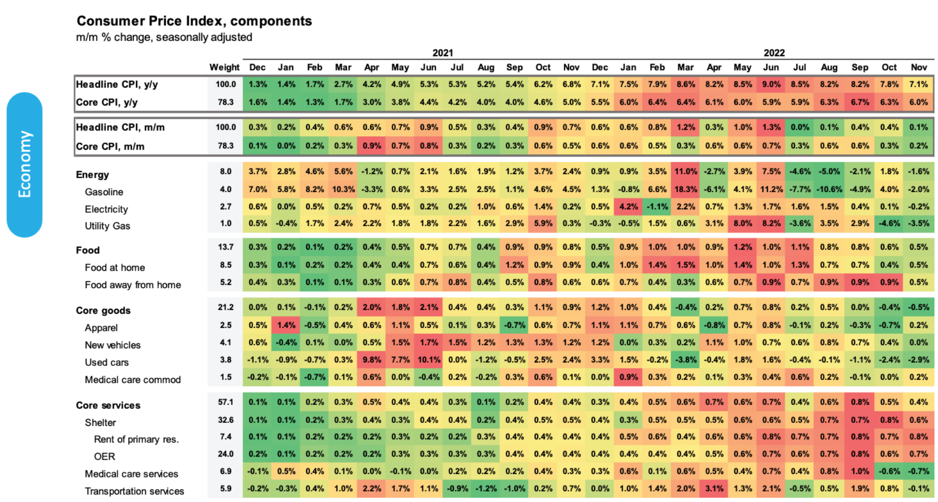
Focus on companies and investments that have pricing power (if Microsoft bumps their annual cost, you will pay it) and have a history of income that grows faster than inflation. For example, apartment REITs that have been marked down but have guaranteed rent escalations in their leases.



Source: Bureau of Labor Statistics, FactSet, Federal Reserve Bank of Philadelphia, University of Michigan, J.P. Morgan Asset Management. Contributions mirror the BLS methodology on Table 7 of the CPI report. Values may not sum to headline CPI figures due to rounding and underlying calculations. "Shelter" includes owner's equivalent rent and rent of primary residence. "Other" primarily reflects household furnishings, apparel, education and communication services, medical care services and other personal services. *Reflects the latest daily 5yr/5yr breakevens, preliminary or final Consumer Sentiment survey, and the quarterly Survey of Professional Forecasters interpolated to a monthly series. The Survey of Professional Forecasters reflects the median estimate by professional forecasters of average CPI inflation over the next 5 years. The series has been adjusted by J.P. Morgan Asset Management to exclude realized inflation readings within the forecast window.
Guide to the Markets – U.S. Data are as of December 31, 2022.

Inflation Heat-map

In this exhibit green is good-low inflation; red is bad - high inflation. Note how green the far right is becoming. Inflation is mitigating. Also note the red area, housing. With mortgage rates increasing and the cost of construction and land still high, we don't have a flood of new supply. However, things might be better than they look. The main component of housing costs is OER or Owners' Equivalent Rent. This statistic attempts to measure what a homeowner would have to pay to rent the house that they lived in. It is reporting big, but somewhat phony, price increases. Energy, labor and housing costs are going to take time to bring down.



Consumer Price Index, components
m/m % change, seasonally adjusted

	Weight	Dec	Jan (2021)	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
Headline CPI, y/y	100.0	1.3%	1.4%	1.7%	2.7%	4.2%	4.9%	5.3%	5.3%	5.2%	5.4%	6.2%	6.8%	7.1%
Core CPI, y/y	78.3	1.6%	1.4%	1.3%	1.7%	3.0%	3.8%	4.4%	4.2%	4.0%	4.0%	4.6%	5.0%	5.5%
Headline CPI, m/m	100.0	0.3%	0.2%	0.4%	0.6%	0.6%	0.7%	0.9%	0.5%	0.3%	0.4%	0.9%	0.7%	0.6%
Core CPI, m/m	78.3	0.1%	0.0%	0.2%	0.3%	0.9%	0.7%	0.8%	0.3%	0.2%	0.3%	0.6%	0.5%	0.6%
Energy	8.0	3.7%	2.8%	4.6%	5.6%	-1.2%	0.7%	2.1%	1.6%	1.9%	1.2%	3.7%	2.4%	0.9%
Gasoline	4.0	7.0%	5.8%	8.2%	10.3%	-3.3%	0.6%	3.3%	2.5%	2.5%	1.1%	4.6%	4.5%	1.3%
Electricity	2.7	0.6%	0.0%	0.5%	0.2%	0.7%	0.5%	0.2%	0.2%	1.0%	0.6%	1.4%	0.2%	0.5%
Utility Gas	1.0	0.5%	-0.4%	1.7%	2.4%	2.2%	1.8%	1.8%	2.2%	1.6%	2.9%	5.9%	0.3%	-0.3%
Food	13.7	0.3%	0.2%	0.1%	0.2%	0.4%	0.5%	0.7%	0.7%	0.4%	0.9%	0.9%	0.8%	0.5%
Food at home	8.5	0.3%	0.1%	0.2%	0.2%	0.4%	0.4%	0.7%	0.6%	0.4%	1.2%	0.9%	0.9%	0.4%
Food away from home	5.2	0.4%	0.3%	0.1%	0.1%	0.3%	0.6%	0.7%	0.8%	0.4%	0.5%	0.8%	0.6%	0.6%
Core goods	21.2	0.0%	0.1%	-0.1%	0.2%	2.0%	1.8%	2.1%	0.4%	0.4%	0.3%	1.1%	0.9%	1.2%
Apparel	2.5	0.5%	1.4%	-0.5%	0.4%	0.6%	1.1%	0.5%	0.1%	0.3%	-0.7%	0.6%	0.7%	1.1%
New vehicles	4.1	0.6%	-0.4%	0.1%	0.0%	0.5%	1.5%	1.7%	1.5%	1.2%	1.3%	1.3%	1.2%	1.2%
Used cars	3.8	-1.1%	-0.9%	-0.7%	0.3%	9.8%	7.7%	10.1%	0.0%	-1.2%	-0.5%	2.5%	2.4%	3.3%
Medical care commod	1.5	-0.2%	-0.1%	-0.7%	0.1%	0.6%	0.0%	-0.4%	0.2%	-0.2%	0.3%	0.6%	0.1%	0.0%
Core services	57.1	0.1%	0.1%	0.2%	0.3%	0.5%	0.4%	0.4%	0.3%	0.1%	0.2%	0.4%	0.4%	0.3%
Shelter	32.6	0.1%	0.1%	0.2%	0.3%	0.4%	0.3%	0.4%	0.4%	0.2%	0.4%	0.5%	0.5%	0.4%
Rent of primary res.	7.4	0.1%	0.1%	0.2%	0.2%	0.2%	0.3%	0.2%	0.2%	0.3%	0.4%	0.4%	0.4%	0.4%
OER	24.0	0.2%	0.1%	0.2%	0.2%	0.2%	0.3%	0.3%	0.3%	0.3%	0.4%	0.4%	0.4%	0.4%
Medical care services	6.9	-0.1%	0.5%	0.4%	0.1%	0.0%	-0.1%	0.0%	0.2%	0.2%	0.2%	0.4%	0.3%	0.3%
Transportation services	5.9	-0.2%	-0.3%	0.4%	1.0%	2.2%	1.7%	1.1%	-0.9%	-1.2%	-1.0%	0.2%	0.7%	0.0%

	Jan (2022)	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov
Headline CPI, y/y	7.5%	7.9%	8.6%	8.2%	8.5%	9.0%	8.5%	8.2%	8.2%	7.8%	7.1%
Core CPI, y/y	6.0%	6.4%	6.4%	6.1%	6.0%	5.9%	5.9%	6.3%	6.7%	6.3%	6.0%
Headline CPI, m/m	0.6%	0.8%	1.2%	0.3%	1.0%	1.3%	0.0%	0.1%	0.4%	0.4%	0.1%
Core CPI, m/m	0.6%	0.5%	0.3%	0.6%	0.6%	0.7%	0.3%	0.6%	0.6%	0.3%	0.2%
Energy	0.9%	3.5%	11.0%	-2.7%	3.9%	7.5%	-4.6%	-5.0%	-2.1%	1.8%	-1.6%
Gasoline	-0.8%	6.6%	18.3%	-6.1%	4.1%	11.2%	-7.7%	-10.6%	-4.9%	4.0%	-2.0%
Electricity	4.2%	-1.1%	2.2%	0.7%	1.3%	1.7%	1.6%	1.5%	0.4%	0.1%	-0.2%
Utility Gas	-0.5%	1.5%	0.6%	3.1%	8.0%	8.2%	-3.6%	3.5%	2.9%	-4.6%	-3.5%
Food	0.9%	1.0%	1.0%	0.9%	1.2%	1.0%	1.1%	0.8%	0.8%	0.6%	0.5%
Food at home	1.0%	1.4%	1.5%	1.0%	1.4%	1.0%	1.3%	0.7%	0.7%	0.4%	0.5%
Food away from home	0.7%	0.4%	0.3%	0.6%	0.7%	0.9%	0.7%	0.9%	0.9%	0.9%	0.5%
Core goods	1.0%	0.4%	-0.4%	0.2%	0.7%	0.8%	0.2%	0.5%	0.0%	-0.4%	-0.5%
Apparel	1.1%	0.7%	0.6%	-0.8%	0.7%	0.8%	-0.1%	0.2%	-0.3%	-0.7%	0.2%
New vehicles	0.0%	0.3%	0.2%	1.1%	1.0%	0.7%	0.6%	0.8%	0.7%	0.4%	0.0%
Used cars	1.5%	-0.2%	-3.8%	-0.4%	1.8%	1.6%	-0.4%	-0.1%	-1.1%	-2.4%	-2.9%
Medical care commod	0.9%	0.3%	0.2%	0.1%	0.3%	0.4%	0.6%	0.2%	-0.1%	0.0%	0.2%
Core services	0.4%	0.5%	0.6%	0.7%	0.6%	0.7%	0.4%	0.6%	0.8%	0.5%	0.4%
Shelter	0.3%	0.5%	0.5%	0.5%	0.6%	0.6%	0.5%	0.7%	0.7%	0.8%	0.6%
Rent of primary res.	0.5%	0.6%	0.4%	0.6%	0.6%	0.8%	0.7%	0.7%	0.8%	0.7%	0.8%
OER	0.4%	0.4%	0.4%	0.5%	0.6%	0.7%	0.6%	0.7%	0.8%	0.6%	0.7%
Medical care services	0.6%	0.1%	0.6%	0.5%	0.4%	0.7%	0.4%	0.8%	1.0%	-0.6%	-0.7%
Transportation services	1.0%	1.4%	2.0%	3.1%	1.3%	2.1%	-0.5%	0.5%	1.9%	0.8%	-0.1%

Source: BLS, FactSet, J.P. Morgan Asset Management. Heatmap shading is relative to the two-year period shown. Component weights may not add to 100. OER refers to owner's equivalent rent.
Guide to the Markets – U.S. Data are as of December 31, 2022.

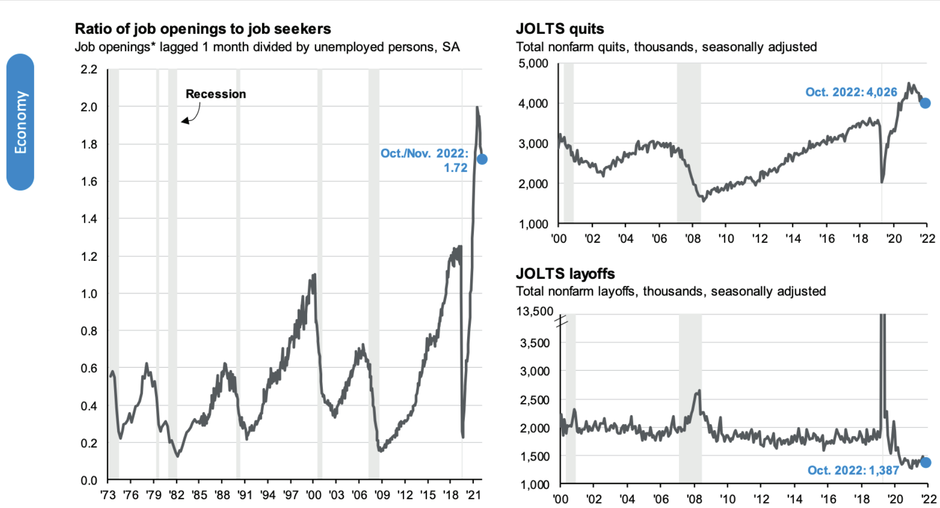
ACTIONABLE ITEMS:

Inflation has probably peaked and soon the Fed will stop raising rates. Now is a great time to fill up those bond ladders.

Labor Demand: Double-edged Sword

Low unemployment is good right? Well, for people who are retired, your self-interest might be to have “more slack” (isn’t that a nice way to say people lose their jobs) in the labor market because rising wages are a big component of inflation.

On the other hand, it is hard to imagine a deep recession when everyone who wants to work is working. This may be impossible to fix. The youngest baby boomers (the largest generation in history) just turned 60. They are exiting the workforce at a great rate than people entering the workforce. We may see a higher, persistent long term inflation rate. The era of 0% interest rates is over.



Source: U.S. Department of Labor, J.P. Morgan Asset Management. *JOLTS job openings from February 1974 to November 2000 are J.P. Morgan Asset Management estimates.
Guide to the Markets – U.S. Data are as of December 31, 2022.

ACTIONABLE ITEMS:

Watch for potential positive surprises including immigration reform, productivity enhancements and workforce participation. These could signal positive surprises.

SURVIVING THE STORM

55+ YEAR OLD’S

- Prepare for the flood.
- The goose that lays the golden eggs.
- Don’t go outside during the storm.

YOUNG PEOPLE:

- Keep buying.

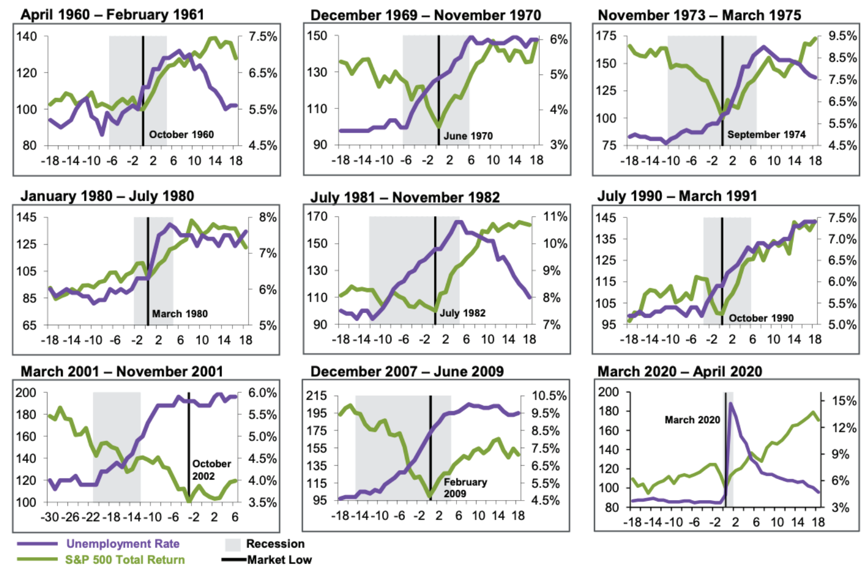
THRIVING:

- Bonds are attractive
- Multi Family Real Estate demand is robust
- Quality is not at a premium.

Recessions and the Stock Market

When the average investor hears that many are predicting a recession, the reptile part of their brain kicks in and they want to flee. The problem is that inflation indicators are backward looking and are used to confirm that our economy has contracted for two simultaneous quarters. See the problem? We don't know we are in a recession until we have been in a recession for six months. Often, we are out of the recession before we know we are in it. More relevant for investors, eight of the last nine recessions the market bottomed before the economy did. This means that the market bottoms while the economic news worsens. Don't try to time the market – you will get burned.

Equities



Source: BLS, Ibbotson, J.P. Morgan Asset Management. Time zero represents the numeric low of the S&P 500 Total Return Index associated with the recessionary period defined by the shaded grey area; data shown in months. S&P 500 Index is rebased to 100 at time zero.
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ACTIONABLE ITEMS:

Don't pay too much attention to the labels of when we are in or out of a recession. The economy will slow down; long-term solid companies will survive and thrive. Use weakness to add to positions.

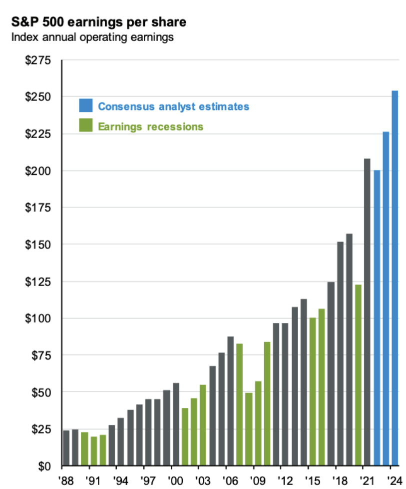
Earnings: Our Primary Concern

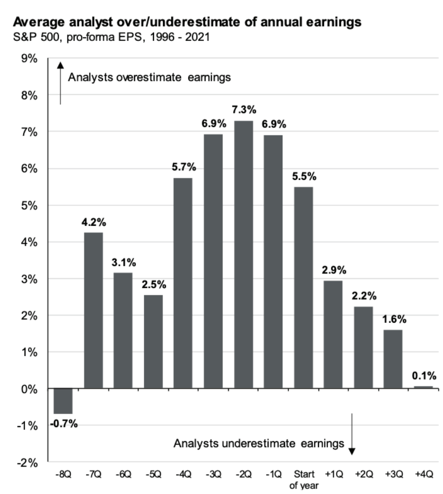
On the right is the NFIB small business survey. Small businesses expect to do three things next year: raise prices, raise employee compensation and experience lower sales. Will the projected price increases offset higher compensation and lower sales? We doubt it. We think corporate margins will be squeezed and earnings will not meet analyst expectations. This makes many stocks falsely appear to be cheap.

ACTIONABLE ITEMS:

Security selection is key.
Analyst need to dig deeper than historic PE ratios.

Equities





Source: Compustat, FactSet, Standard & Poor's, J.P. Morgan Asset Management.
Historical EPS levels are based on annual operating earnings per share. Earnings estimates are based on estimates from Standard & Poor's and FactSet Market Aggregates. *Earnings and multiple growth are both year-to-date percent changes of next 12-month estimates. Past performance is not indicative of future returns.
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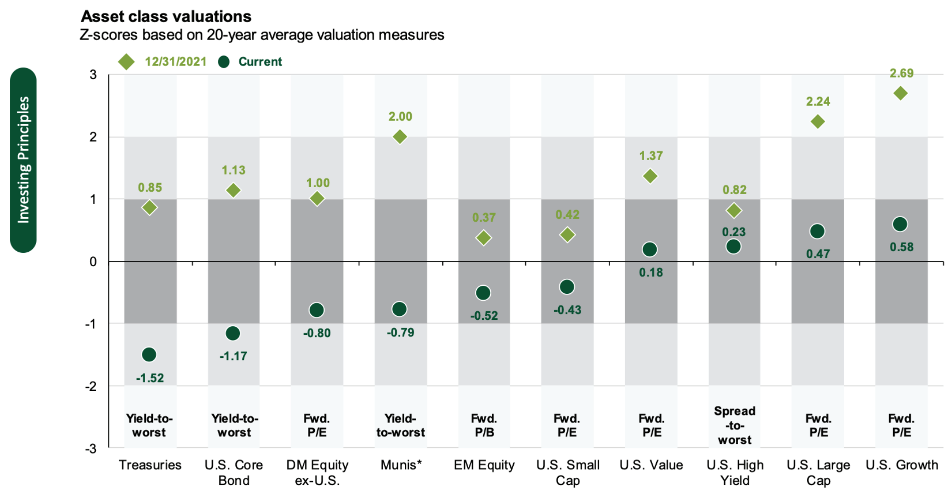
Valuations Matter

This graph shows the current valuation of various markets compared to last year. Things are much more attractive this year than last. Not surprising after the negative returns in 2022. Quality bonds, international and small cap stocks are all attractive based on historical valuations.

ACTIONABLE ITEMS:

Don't forget to diversify. Certain asset classes have performed so poorly, for so long, the investing risk/reward analysis is compelling.



Source: Bloomberg, BLS, CME, FactSet, MSCI, Russell, Standard & Poor's, J.P. Morgan Asset Management.
U.S. Large Cap: S&P 500, U.S. Small Cap: Russell 2000, U.S. Mid Cap: Russell Midcap; EM Equity: MSCI EME, DM Equity: MSCI EAFE, U.S. Value: Russell 1000 Value, U.S. Growth: Russell 1000 Growth, U.S. High Yield: J.P. Morgan Domestic High Yield Index, U.S. Core Bond: Bloomberg US Aggregate, Treasuries: Bloomberg U.S. Aggregate Government – Treasury, Munis: Bloomberg Municipal Bond. *Munis yield-to-worst is based on the tax-equivalent yield-to-worst assuming a top-income tax bracket rare of 37% plus a Medicare tax rate of 3.8%.
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CONCLUSION

I went down into my safe room when Ian hit. It was around 2 pm. I came up around 4 pm thinking that it must have passed but she was still blowing hard. I repeated this drill hourly. It wasn't until about 2 am that it finally passed. When will this economic storm pass. No one knows. Let me repeat, no one knows. The most dangerous thing to do in the middle of the storm is to try to put up shutters. In my 35 years of investment management experience, I have noticed a single, omnipresent paradox: when everyone is convinced that the worst is yet to come and that things will go lower, people feel comfortable getting out. When everyone gets out, there is no one left to sell. If there is no one selling the markets can't go down. In short, when everyone is pessimistic markets rally. Don't worry about what will happen in 2023. 2023 will be very much like 2008, the recovery begins, market bottoms and the opportunity to buy world class companies presents a once in a decade opportunity. The question is which companies will emerge as dominating forces for the next decade?

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