FOURTHOUGHT Q2 ECONOMIC REVIEW Perseverance II – Who Are You Going To Believe?

White Paper
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FourThought
PRIVATE WEALTH

FROM THE DESK OF:
Scott Pinkerton
Senior Planner

Jake MacFarlane
Research Analyst

The current momentum in the stock market juxtaposed against tightening economic conditions reminds us of a great Chico Marx quote: “Are you going to believe me or your own eyes?”. There are things happening before our very eyes that everyone seems to not believe. In this note, we will share what we see and what we think it means for the economy and short-term investing.

It’s important to remember we take a big dose of humility medicine when making economic forecasts. We are constantly watching the economic street signs that reveal themselves regularly and adjusting our forecast. Therefore, our outlook doesn’t result in bold policy changes within our portfolios but rather informs our thinking from an individual asset allocation perspective and **gives us a sense of what should be emphasized and avoided.**

Over the last year, we have seen a tug-of-war between bulls and bears as the S&P500 has traded in a band of +/- 10% around the $4,000 level. This lack of direction is a side effect of very aggressive monetary and fiscal policies enacted during the Covid crisis mixed with evolving geopolitical risks. In other words, our economy was in a car accident when Covid hit, we injected morphine to treat the wounds (via fiscal stimulus and quantitative easing), and now we need to take additional medicine to eradicate inflation.

Q1 Returns – Surprise, Surprise

Headlines were:

- Inflation remains sticky above 5%
- Banking crisis
- China escalation
- Russia-Ukraine worsening
- Interest rates continue to climb to 5%

Yet, the market return was positive as the S&P500 advanced 7.5%, led by growth stocks as the best-performing sectors in the S&P were Technology, Communications, and Consumer Discretionary. We are left now with the market trading above an 18x P/E ratio, which is remarkably expensive when inflation is considered at 5%.

310 West Venice Avenue | Suite 201 | Venice, Florida 34285
Phone: 941-408-8557 | Toll-free: 866-209-8557 | Fax: 941-408-0785 | fourthought.com

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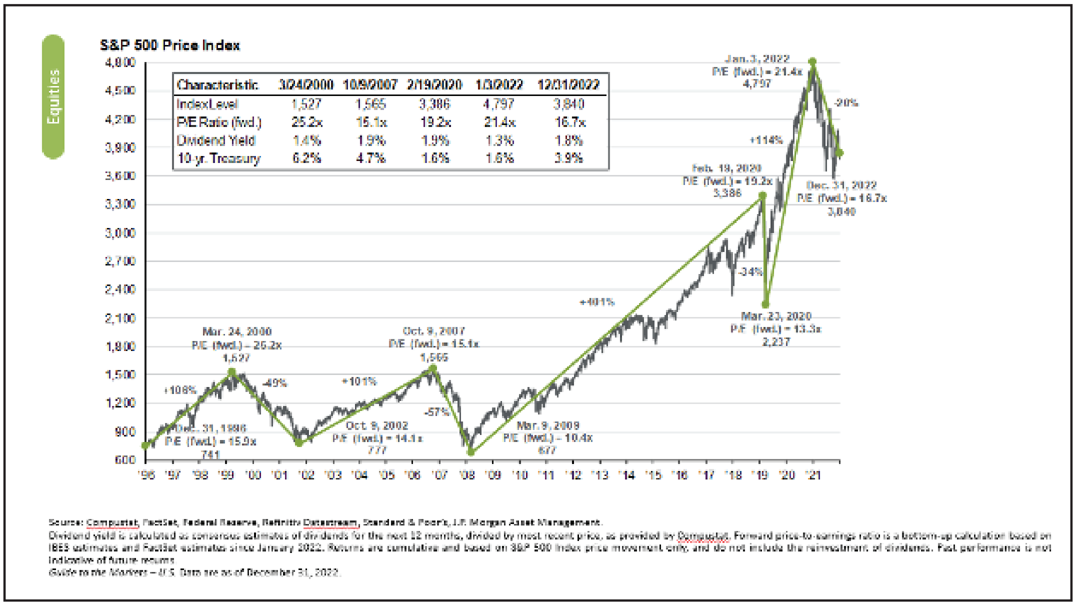
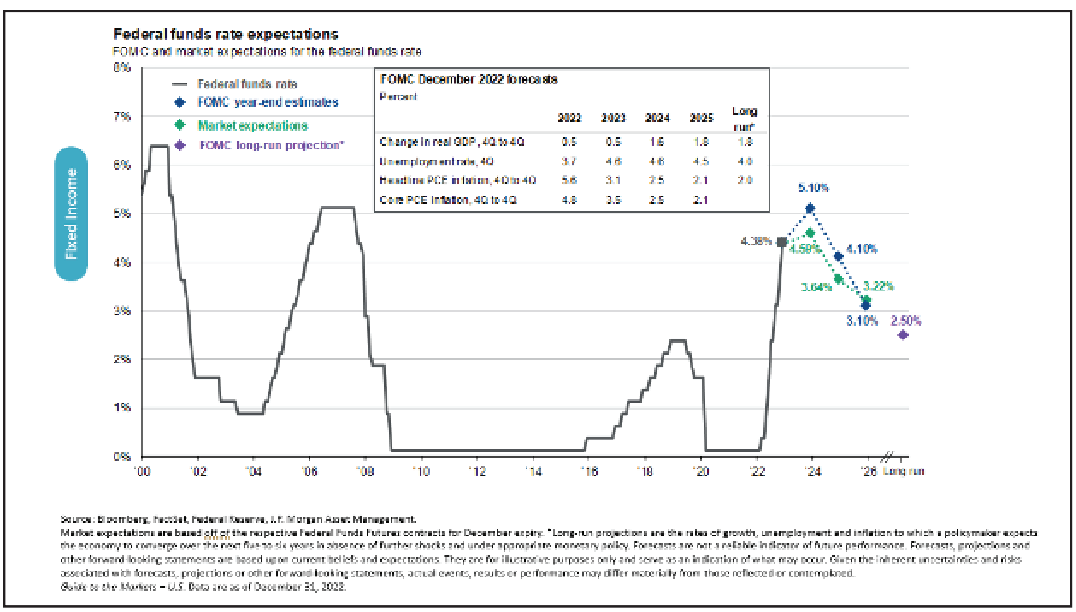


Market Reaction

We can see from equity returns over the quarter that risk appetite is returning for market participants. With the market trading at a premium valuation, it suggests that the market is expecting the Fed to lower rates at the end of the year – we see confirmation of this in the chart below.



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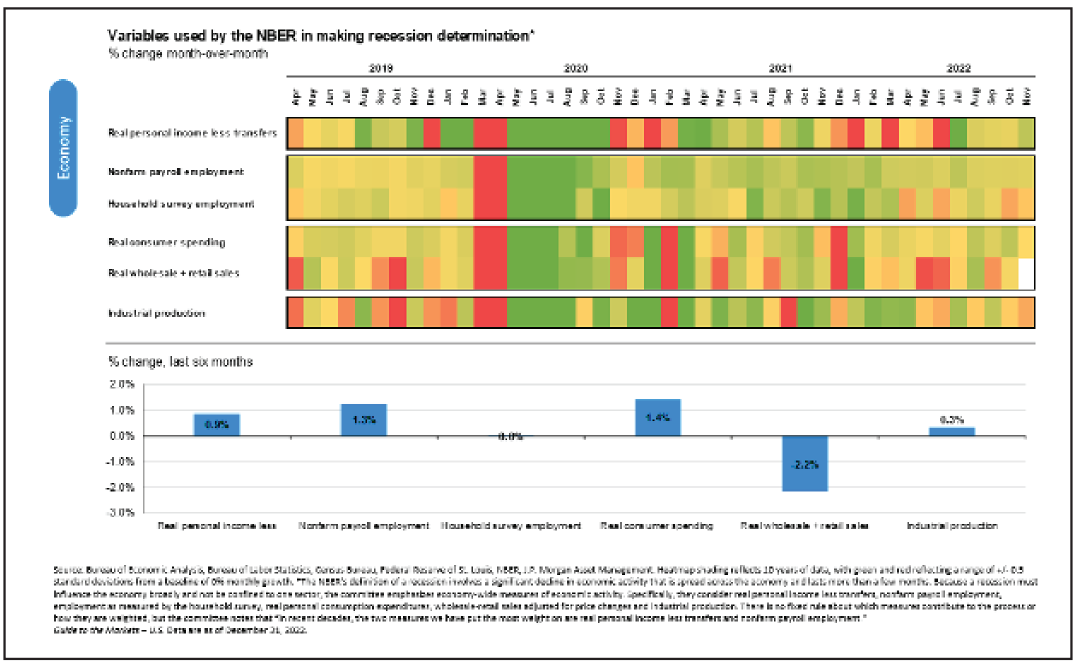
The green dot is market expectations for rates whereas the blue dot is the Fed's rate expectation. The first dot to the right shows year-end rate expectations – where the market is expecting lower rates than we currently have, and the Fed is expecting rates to be higher. Who will be right?

Economic Data

The Fed has a dual mandate – to ensure full employment and stable prices (tame inflation). For the last year or so, we have seen far too high inflation whereas other economic data points to strong employment and a healthy consumer. So, the Fed was given free rein to enact tighter monetary policy and raise interest rates very aggressively, which to much surprise, hasn't impacted the economy as much as some expected.



Recession determinates used by the National Bureau of Economic Research show that for the most part, the economy continues to be in good shape. This has allowed the Fed to enact aggressive policies to fight inflation. We believe we are near the top of the rate hiking cycle, but we do not expect rates to fall in 2023 until the market does. However, the strength of the economy points to a higher probability of avoiding a recession even in the face of high inflation and restrictive monetary policy.

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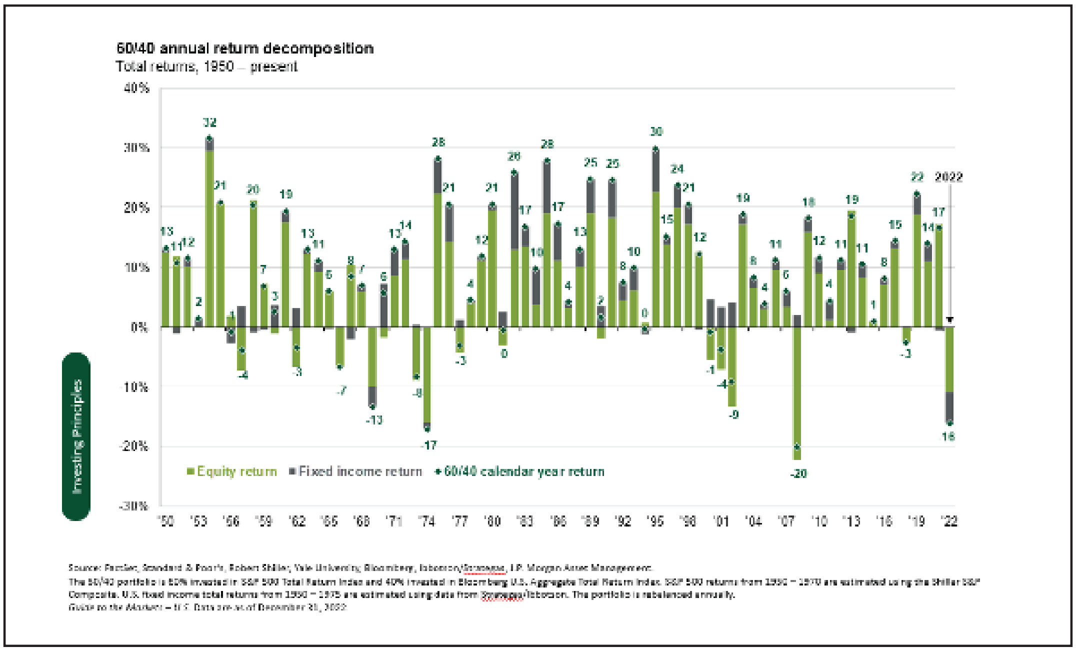

Exuberant Market Vs Pessimistic Consumer

Consumers are ridiculously pessimistic. Consumer sentiment measures are worse now than at any time since 1970. As the chart suggests, investing in the dips in consumer sentiment rating has historically led to strong results over the next 12 months.

Did we bottom in October of 2022 or will sentiment drag again? Strong equity returns to begin the year would point to potentially having already bottomed out. However, weaker-than-expected earnings results and tightening credit conditions could lead to more dips in the future.

One issue on the horizon comes in the form of consumer savings and borrowing. Personal savings rate is well below the average level over the last 60 years as consumers on average are still spending. As a result, we also see consumer credit outstanding rise in nominal terms and as a percentage of disposable income. At some point, consumers will tighten their spending which would have a real impact on businesses and the overall economy.

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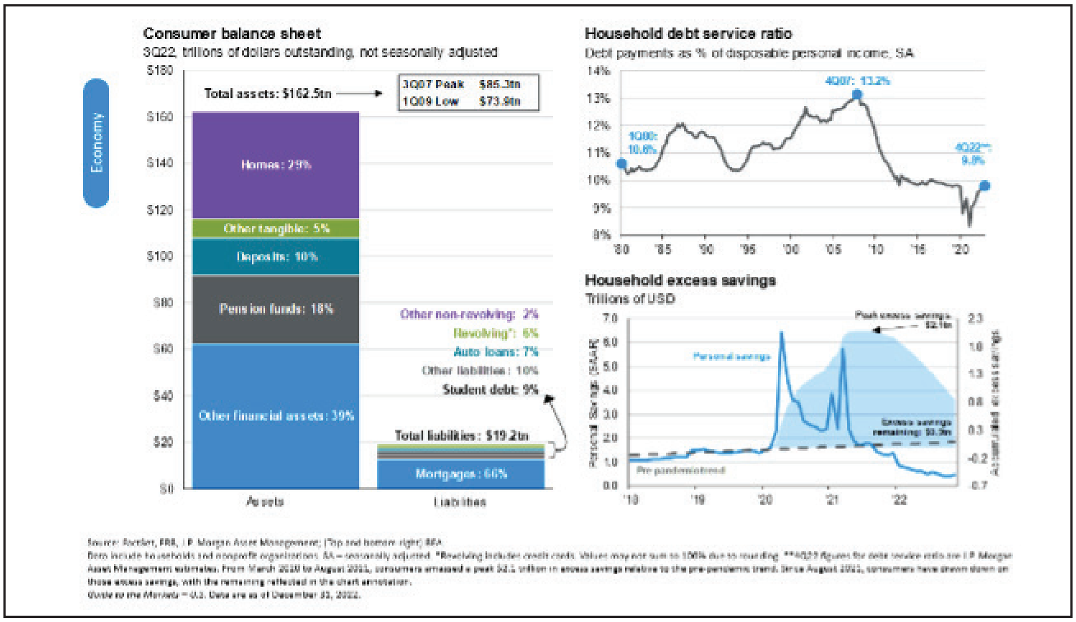
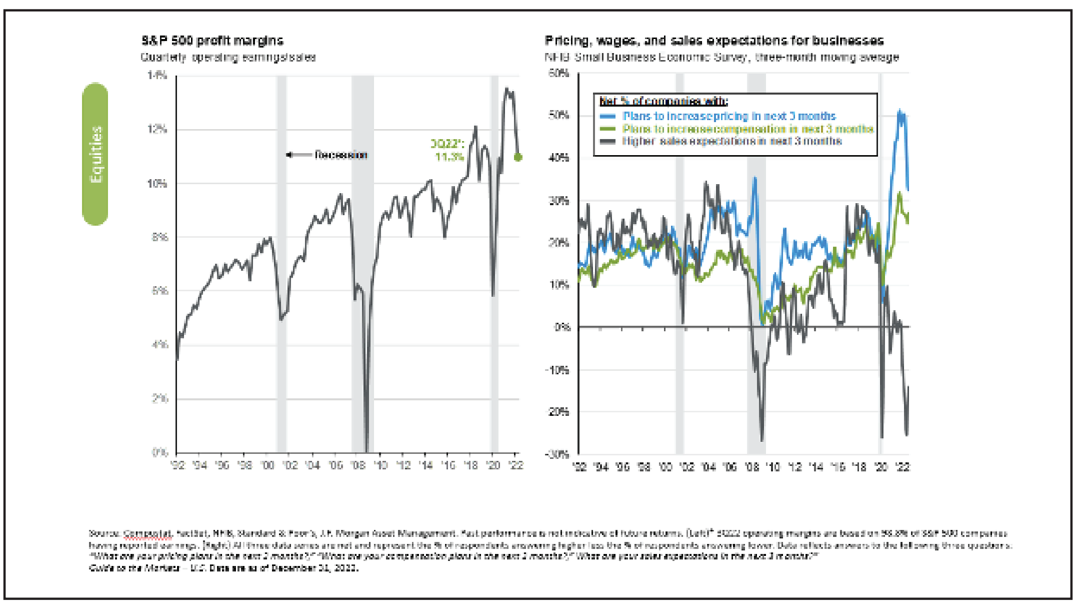


Corporate Earnings

We believe corporate earnings could be in trouble as businesses tend to pull back in capital expenditures (Capex) after earnings fall and weakness in the general consumer. Also, with the increased level of interest rates, companies could be compelled to reduce Capex purely due to an increase in the average cost of debt financing.



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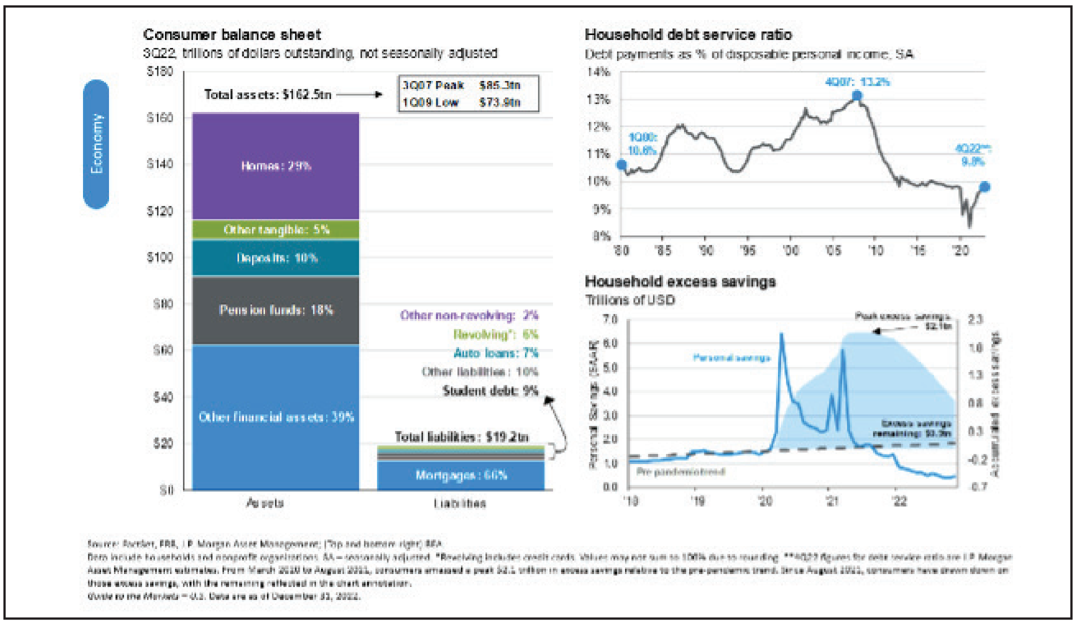
A reduction in business spending could lead to weaker-than-expected earnings results, whereby analysts are still expecting about 10% earnings growth in 2023. However, this effect could be further compounded by a reduction in consumer spending tendencies. As a result, we are narrowing our scope to high-quality companies that operate in mission-critical industries that are less sensitive to cyclical pressures in the economy. Companies with durable competitive advantages and immense pricing power will have an easier job protecting their earnings in our opinion.



Outlook

Remember, we don't know what we think we know, and we don't control what we think we can control. This is exemplified by the actions of our Federal Reserve. Mohamed El Arian recently shared this analogy about the Fed that is helpful: imagine the Fed is driving a car on a foggy highway.

First, they said that the inflation in the system was transitory and kept up the economic speed by keeping rates low. But when inflation was more persistent, they were late to acknowledge it, and once acknowledged they continued to keep the pedal to the metal. Then they slammed on the breaks by raising rates 8 times. Finally, their banking supervision allowed issues like Silicon Bank to fester. This kind of driving leads to accidents.

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What is an investor to do? First, slow down. Now is not the time to ramp up risk. Stay with quality. We do believe that rates will come down so investors should use this opportunity to lock in their bond ladders. However, it is likely that rates will go up a bit before they come down but don't wait. Lock in bonds incrementally.

Stay with quality companies with wide economic moats (inherent business advantages) that have pricing power. Prepare for more persistent inflation. Consider investments that have historically surfed the wave of inflation (like energy pipelines and storage). Buy quality assets when they dip - for example, publicly traded REITS trading at deep discounts to NAV, quality health care companies, and cell towers.

Finally, everyone should take a chill pill. We have virtually no unemployment, and we have significant technological advancements. So, although rates are higher, they won't be for long. The seeds of recovery are planted and are being fertilized.