YANKE FINANCIAL

5540 Centerview Dr, Ste 200 | Raleigh, NC 27606
919-306-5811 | Toll-Free: 800-513-2812 | Fax: 919-375-2303
patrick.yanke@yankefinancial.com
www.yankefinancial.com

YANKE FINANCIAL, LLC NEWSLETTER WINTER 2023

Into the Unknown

Great Diversity of Opinion

Patrick H. Yanke, CFP®
Branch Manager

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As I sit down to write this newsletter, I feel the need to point very specifically to the date. As rapidly as things are changing in this environment, much of what I say here could already be old news by the time this is published. Quite honestly, that's one thing plaguing the markets… a rapidly changing environment. Markets tend to like certainty over uncertainty. There isn't much certainty to be found these days. Those with a doom-and-gloom outlook can find economist predictions to meet their outlook… and so can the Pollyannas. We're only going to know for sure in hindsight.

Market Perspective

Volatility was a defining feature of the markets in 2022, as higher interest rates and inflation, the war in Ukraine, and recession fears sent markets tumbling. There were significant losses in both global stocks and bonds and only commodities posted significant gains. However, calmer waters may lie ahead for investors. Inflation may be easing, the Fed may be near the end of its tightening cycle, and much of the expected weakness in economic growth is already reflected in market valuations.

As investors consider last year's performance, it's important to take a longer-term view. In particular, it's worth noting that a broadly diversified portfolio could have risen by more than 30% between the end of 2018 and the end of 2022. Even after losses last year, many investors are well ahead in their long-term plans and, after last year's reset in valuations, they are being offered a much broader menu of investment opportunities and higher potential returns than existed a year ago.

Economy on the Edge of Recession

There is a looming danger that the U.S. economy could slip into recession in the near future. While U.S. consumers have been largely resilient so far, higher interest rates are weighing on home-building, trade and business investment. In particular, higher inflation is squeezing consumer wallets, cutting the personal saving rate to 2.3% and boosting credit card balances. While excess savings from the pandemic supported spending in 2022, balances are now drying up and it is unlikely consumers will see further aid from the federal government.

Mortgage rates have more than doubled since the start of last year, contributing to continued declines in home building, home sales and consumer spending associated with setting up new households. In addition, the dollar rose by roughly 9% in 2022—even after a late-year sell-off. This high exchange rate, combined with weakness overseas, will likely boost imports and curtail exports thus dragging on overall economic growth. As the economy confronts these challenges, it is likely to see very weak real GDP growth with a greater than 50% chance of tipping into a recession by the end of 2023. For investors, this possibility may already be baked into valuations.

Labor Markets

The labor market continues to be a bright spot in an otherwise gloomy environment, with the official unemployment rate at 3.5% in December—at its 50-year low. However, the economy appears to be losing momentum, even in the labor market. Job openings have come down and will likely fall further, as businesses reel back hiring efforts in the face of slower demand and higher costs. Initial and continuing jobless claims have also begun to trend higher, although they still sit below historical averages.

However, there is also a limit to how much weakness we may see in employment going forward, as U.S. businesses still face a structurally smaller labor force than prior decades. Diminished legal immigration, particularly over the course of the pandemic, and baby-boomers reaching retirement age have left the economy short of workers. This will somewhat resolve itself as higher wages and a higher cost-of-living lure some workers back into the labor market, allowing the economy to see additional months of solid job growth and low unemployment. As such, the unemployment rate may only nudge slightly higher in the year ahead. Wage growth has also moderated and will likely slow further, providing some relief to businesses and inflation.

Earnings Growth Slowing

Following a strong 2021 in which S&P 500 operating earnings per share (EPS) rose by 70%, profits came under pressure amidst higher costs and receding demand in 2022. This lead operating EPS to decline by an estimated 4% over the year. Looking forward, consensus expectations for a double-digit gain in earnings in 2023 look too optimistic, and earnings are expected to be flat-to-down relative to 2022.

Rising costs, rather than deteriorating sales, have caused weakness in earnings and pricing power should continue to differentiate winners and losers in 2023. Energy companies will continue to benefit from high margins, while businesses that provide essential goods and services should be supported. Elsewhere, rising labor costs, higher interest rates and slowing nominal sales growth should bite into profits. In addition, a higher dollar poses a headwind for companies with overseas sales and recession concerns could cause management teams to further reel in spending and investment.

A recession would lead to a further decline in profits and lower inflation tends to coincide with lower corporate profit growth, posing an additional headwind in the year ahead. However, if a recession that eventually leads to less wage pressure and easier monetary policy materializes, it could set up a better long-term environment going forward.

Inflation

2022 was a year of high and rising inflation with headline CPI inflation peaking at a 9.1% y/y gain in June. The good news is that there are signs that a sustained inflation downtrend is underway. Most recently, consumer prices fell 0.1% m/m in December. A modest pace of monthly inflation easing has been mostly sustained over the last five months. I don't see deflation on the horizon, though, so high prices are likely here to stay.

MY BUSINESS PHILOSOPHY

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Moreover, when looking at the components of inflation, the major hotspots of inflation from earlier this year have simmered down a bit. After Russia's invasion of Ukraine sent global commodity prices soaring early in 2022, energy prices declined in the second half of the year. Easing supply constraints, combined with lower consumer demand, have allowed inflation to simmer across core goods categories. While shelter inflation remains elevated, it is expected to soon peak and decline to reflect cooling rental markets. The remaining problem for inflation is services prices outside of shelter, which are highly correlated with labor market dynamics. With the end of support from the Strategic Petroleum Reserve, expect energy prices to rise—potentially confusing the softening view of inflation.

The Fed

2022 was also a year of aggressive monetary tightening, with the Fed hiking rates by a cumulative 4.25% throughout the year. Despite signs that the labor market and inflation are easing, the Fed has maintained its hawkish stance on monetary policy. At its December meeting, the Fed increased the federal funds rate by a reduced pace of 0.50%—following a series of 0.75% hikes—and remained firm on its higher-for-longer messaging.

The Summary of Economic Projections signals further rate hikes from the Fed ahead. The median expectation among FOMC members indicates that rates will rise to a range of 5.00% to 5.25% by the end of 2023. Meanwhile, the Fed will continue quantitative tightening, reducing their massive bond holdings at a maximum pace of $95 billion per month.

The Fed's updated economic projections showed a perplexing picture of higher inflation, slower growth and higher unemployment compared to previous projections. The current median FOMC expectation for the annual core PCE inflation rate is now higher for 2022, 2023 and 2024 versus its September projections, despite recent evidence that inflation is easing. Other revisions suggest the Fed believes below-trend growth and an increase in unemployment will be necessary to combat inflation, but that a soft landing is still possible.

Interestingly, futures markets disagree with the Fed's forecast for the federal funds rate for 2023. Despite Powell opposing the idea of rate cuts, futures markets have priced in rate cuts for the second half of 2023, reflecting the concern that overly aggressive Fed action could tip the economy into recession.

Global Economy

High inflation and tighter financial conditions have become a worldwide phenomenon with weakness broad-based in the global economy. Economic momentum declined in the second half of 2022.

In particular, the Eurozone economies and the UK have been hindered by higher energy prices and energy shortages due to the Ukraine war, resulting in slumps in consumer confidence and spending. In addition, inflation has risen sharply across Europe and caused central banks to adopt more hawkish policy positions. Key policy rates of the ECB and the Bank of England began the year at -0.50% and +0.25% respectively. Today, they have risen to 2.00% and 3.50% respectively and are both set to move higher in the months ahead even amidst recession risks.

While growth was particularly weak in China in 2022, it should improve in the coming years. Actions taken by policymakers, such as the easing of zero-Covid policies, liquidity injections for the real estate sector and efforts to ease geopolitical tensions should act as economic tailwinds. Given this, Chinese growth is expected to accelerate in 2023 and normalize back to trend in 2024.

The dollar is now trading near a 20-year high in nominal terms. In real terms, once inflation is considered, the dollar is close to its highest level since 1985. The dollar's strength has been a function of weak overseas growth, geopolitical and macroeconomic uncertainty, and the Fed's aggressive tightening cycle compared to other central banks. The high dollar has contributed to a worsening current account deficit, now amounting to roughly 4% of GDP. Due to lagged effects, this is likely to widen further over the next year, undermining the competitiveness of U.S. manufacturing and diverting U.S. demand towards overseas producers. The rising dollar has also undermined returns on international equities. Over the long run, economic forces may gradually drive the dollar down.

Fixed-Income Markets

I have warned for years about the risks in fixed-income securities at historically-low interest rates. Rising rates would see the loss of significant value. That was realized last year as 10-Year Treasuries lost over 16% and 30-Year Treasuries were down over 33%! Debts markets are generally not as volatile as equity markets… until both are down together as they were last year. Going forward, there may be better value in fixed-income than there has been for decades. The greatest damage to valuations may be behind us and there are finally decent yields to provide income—at least at the short end of the yield curve.

It's Not About How You Feel

For many Americans, 2022 was a very disappointing year with sharply rising inflation and interest rates, falling stock prices and the shock of Russia's invasion of Ukraine. These factors drove consumer sentiment down to its lowest level on record in June and has only staged a modest rebound since then.

When investors feel gloomy and worried about the outlook, their natural tendency is to sell risk assets. However, history suggests that trying to time markets in this way is a mistake. On average, buying at a confidence peak returned 4.1% while buying at a confidence trough returned almost 25%.

This doesn't suggest U.S. stocks will return anything like 25% in the year ahead as many other factors will determine that outcome. However, it does suggest that when planning for 2023 and beyond, investors should focus on fundamentals and valuations rather than how they feel about the world.

Summary

My long-term outlook favors equities over bonds—just don't expect higher than average gains this year. This is an environment for strong investment managers and careful stock selection. Overseas holdings may benefit long-term investors with greater growth potential. Income-oriented investments may struggle in a rising interest rate environment. Equities are my recommendation for a 10-year outlook. Balance is in favor.

Take the long view with your investment assets and dust off financial plans. When was the last time you reviewed your plans? Your estate plan should be reviewed at least bi-annually and updated with every change of life. Most importantly, make sure you have carefully delegated who will execute your documents for you. To review existing documents, develop new plans, or do end-of-year planning, talk to an advisor soon.

Source: General economic statistics are from JP Morgan "Guide to the Markets" 1Q2023.

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