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YEAR-END WRAP-UP

The Federal Reserve has been playing catch up for the past nine months in its fight to tame inflation, tightening credit conditions aggressively since March. It has increased its reference rate from 0% to a range of 4.25% to 4.50% currently, the fastest pace since the 1980s, and it is widely expected to continue its tightening, albeit less aggressively, into 2023. The peak rate is forecast to be just above 5%. Borrowing costs are now back to their 2007 highs. The Fed is also aggressively shrinking its balance sheet through quantitative tightening (QT), while M2 money supply growth has plunged to a 1% annual rate this year, down sharply from the 24% rate in 2021 and well below the 6% rate we normally expect. Until recently, there were scant signs beyond the housing sector of the economic weakness the Fed had hoped to induce. Consumers, flush with cash, continued to spend and business outlays remained firm as companies struggled through COVID-induced supply chain issues to meet customer demand.

Recently, we have seen signs that economic momentum is slowing. Manufacturing activity, as reflected in *Industrial Production* data, which had been looking surprisingly strong in recent months, declined 0.6% last month. Overall manufacturing *capacity utilization* declined to 79.7% in November from 79.9% in October. November was also a weak month for *retail sales*, with the headline measure falling 0.6%. Earlier consumer resilience, fueled by a high savings rate as consumers ate into the excess savings amassed during the pandemic, and growing borrowing, has given way to more cautious spending, particularly for goods. While a variety of recent inputs, including the upward creep in recurring applications for US unemployment benefits, show the *labor market* losing some momentum, overall, the employment measures we follow point to further near-term strength and tightness. How long the labor market can continue to outperform other aspects of the economy, an important question, remains to be seen. We believe continued Fed tightening will result in clearer labor market softness as we enter 2023; further evidence the labor market is cooling should provide the FOMC with the confidence it needs to eventually end the current tightening cycle.

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Forward-looking, high-frequency economic indicators for November were mixed, showing the divergence in the US economy between goods and services.

> The *ISM Manufacturing* index dipped last month with only six of eighteen industries reporting growth. The index declined to 49.0 in November signaling contraction for the first time since the pandemic shutdowns. Respondent comments were mainly focused on concerns about the pace of future activity with some customers pulling back on new orders due to worries about an economic slowdown. What was most notable was the absence of comments related to the supply-chain issues that have plagued the manufacturing sector over the past few years. New orders, not surprisingly, fell into contraction territory as consumers have been shifting their purchasing from goods toward services which had been scarce during the pandemic.
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> The *ISM Non-Manufacturing* index increased to 56.5 in November, well above 50, signaling expansion ahead. Thirteen of the eighteen industries surveyed reported growth. The business activity index jumped to 64.7 from 56.5. New orders were strong. Clearly, businesses and consumers are continuing to shift resources away from goods to the still-reopening services sector. Recall that pre-pandemic, services accounted for roughly 69% of consumer spending. That number fell to 65% during the depths of the pandemic as consumers stayed home. As of the third quarter, consumer spending rose to 66%. We expect to see further growth in the services sector, which accounts for over 80% of GDP, as consumption continues to shift back to the pre-pandemic status quo.
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> Our firm's proprietary Economic Model, designed to signal a change in the direction of the economy six to nine months in advance of an inflection point, broke trend months ago pointing to a possible recession next year. The Leading Economic Indicators (LEI) are also pointing to a slowdown.

THE FED

As the economy shows signs of slowing and headline inflation numbers recede from their mid-year peaks, some economists and Fed officials have called for an end to Fed tightening soon. Earlier this month the Fed moderated its expected rate increase to 50 basis points, a rate lower than the four previous 75 basis point hikes. Others worry inflation will not ease enough next year to satisfy Fed policy makers, a scenario that would call for raising rates higher or holding them at a higher level for longer, boosting the chances of a sharp downturn in the economy. That leaves a divided Fed with two difficult questions: how high to raise rates from current levels and how long to hold them at that level to bring inflation down toward its 2% target. Fed Chairman Powell has reiterated his concerns about the risks of not doing enough to curb inflation, acknowledging the Fed is also trying to strike a balance that avoids unnecessary economic pain. The divide falls into two camps: the *doves*, who argue high inflation reflects unexpected disruptions such as the pandemic, Russia's invasion of Ukraine and

China’s zero COVID tolerance policy, believe inflation is likely to steadily decline and want to minimize potential job losses. *Hawks* also see inflation slowing but to levels between 3% and 4% if hiring does not slow significantly. They worry that without a weaker labor market, price pressures will remain unacceptably high as employees win bigger wage increases that keep paychecks and prices rising in lockstep, precipitating a dreaded wage-price spiral. The *hawks* worry the Fed will start cutting rates too soon once the unemployment rate rises, risking a repeat of its disastrous stop-and-go tightening of the 1970s. Recall inflation did not come down until the 1980s, when then-Fed Chairman Volker raised rates sharply. Unemployment rose to 10.8% in 1982, its highest level at the time since the Great Depression.

Whether the *doves* or the *hawks* prevail remains an open question. How the Fed reacts to the economic data it will parse in its deliberations over the next few months will determine whether it is able to engineer a hoped for “soft landing,” skirting a recession. Given the Feds’ uneven record, a mild recession next year appears to be in the cards.

INVESTMENT OUTLOOK

Very slow growth in inflation-adjusted profits, higher interest rates and recession fears have combined to push stock valuations sharply lower in 2022 following several years of near 15% annual return. This year, S&P 500 equities have declined almost 20%, NASDAQ shares are nearly 33% lower, and hundreds of highly speculative, small cap tech shares, darlings of the 2021 speculative bubble, have fallen as much as 75% from their October 2021 highs. SPACS, so-called *meme* stocks, and crypto currencies have crashed. In short, the speculative excesses of the last bull run are being wrung out, a necessary cleansing process. Equities are expected to remain volatile; there is likely some additional pain in store for stock investors over then near term. How much weakness will occur remains to be seen. Using a 10-year US Treasury yield of 3.6% (near today’s close) to discount future profits suggests the S&P 500 index is fairly valued at about 3,700. The S&P 500 closed yesterday at 3,821. At a 10-year Treasury yield of 4%, fair value would fall to 3,350. Fair value for the S&P 500 would also be about 3,350 if the 10-year Treasury yield remains at 3.6% and corporate profits decline 10%, which is what we would expect to occur in a mild recession. So, fundamentally there is room for the stock market indices to fall further over the near term as investor sentiment around recession concerns ebbs and flows, prior to an eventual turnaround. Market technicians point to support for the market around the 3,200 level on the S&P 500. Obviously, if the Fed is able to engineer a soft landing, stocks should rally substantially, recouping in short order much of the ground lost this year.

We believe we are rapidly approaching a peak in the Fed credit tightening cycle, potentially reducing pressures on equity valuations, and setting the stage for the next sustained advance which we expect to be prolonged and strong, and for which we are well-prepared. Equity portfolios under our supervision are broadly diversified between *growth* and *value* investments, tilted toward *value* which has outperformed *growth* by about 24 percentage points this year following substantial out-performance by *growth* in the prior 5 years. *But for the time being, the economy and stock markets need to pay the price for the massive artificial monetary and fiscal stimulus of 2020-2021. Most of that bill came due this year and the balance will be paid early in 2023.*

As Fed tightening and expectations for rising inflation mounted, bond investors were also badly bruised through much of the year. The aggregate fixed income indices suffered double digit declines. In our view, the rise in interest rates has made bonds investable once again. We have, therefore, modestly extended durations in clients' laddered bond portfolios using the proceeds of maturing issues yielding less than 1% to add selectively to corporate obligations yielding close to 5% which come due in about two years.

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Happy Holidays to all!!

We wish you, our valued clients and friends, good health, happiness and success in the New Year.

MBF

Indexes are unmanaged, do not include fees or expenses and are not available for direct investment. Definitions: Personal Consumption Expenditures Index (PCE): A measure of the prices that people living in the United States, or those buying on their behalf, pay for goods and services. The PCE price index is known for capturing inflation (or deflation) across a wide range of consumer expenses and reflecting changes in consumer behavior. Conference Board's Confidence Index: The Consumer Confidence Survey® reflects prevailing business conditions and likely developments for the months ahead. ISM Manufacturing Index: The ISM manufacturing index or purchasing managers' index is considered a key indicator of the state of the U.S. economy. It indicates the level of demand for products by measuring the amount of ordering activity at the nation's factories. ISM Non-Manufacturing Index: The Institute of Supply Management (ISM) Non-Manufacturing Index is an economic index based on surveys of more than 400 non-manufacturing (or services) firms' purchasing and supply executives. S&P500 Index: The S&P 500 Index, or Standard & Poor's 500 Index, is a market-capitalization-weighted index of 500 leading publicly traded companies in the U.S. S&P500 Growth Index: The S&P 500 Growth Index is a stock index administered by Standard & Poor's-Dow Jones Indices. As its name suggests, the purpose of the index is to serve as a proxy for growth companies included in the S&P 500. S&P500 Value Index: The S&P 500 Pure Value Index refers to a score-weighted index developed by Standard and Poor's (S&P). The index uses what it calls a "style-attractiveness-weighting scheme" and only consists of stocks within the S&P 500 Index that exhibit strong value characteristics.