# Fourth Quarter 2022 – Investment Commentary

WEST SHORE BANK

After their transitory inflation theory fizzled in late 2021, the Federal Reserve (Fed) abruptly reversed course and in 2022 embarked on their most aggressive monetary policy in decades. As inflation and Fed rate increases pushed higher most of last year, pressure on stock and bond markets intensified. While there were short-lived pockets of strength in the markets, the Fed's reiterated (and often questioned) commitment to lower demand, soften the labor market, and curtail inflation proved to be too much to overcome as markets finished last year sharply lower.

**Table 1 - Stock Index Total Returns as of December 30, 2022**

| Equity | 1-Month | 3-Month | YTD | 1-Year | 3-Year | 5-Year | 10-Year |
|---|---|---|---|---|---|---|---|
| Dow Jones Industrial | -4.09 | 16.01 | -6.86 | -6.86 | 7.32 | 8.38 | 12.30 |
| S&P 400 | -5.54 | 10.78 | -13.06 | -13.06 | 7.23 | 6.71 | 10.78 |
| MSCI Developed | 0.08 | 17.34 | -14.45 | -14.45 | 0.87 | 1.54 | 4.67 |
| S&P 500 | -5.76 | 7.56 | -18.11 | -18.11 | 7.66 | 9.42 | 12.56 |
| MSCI Emerging | -1.41 | 9.70 | -20.09 | -20.09 | -2.69 | -1.40 | 1.44 |
| Russell 2000 | -6.49 | 6.23 | -20.44 | -20.44 | 3.10 | 4.13 | 9.01 |
| NASDAQ | -8.67 | -0.79 | -32.54 | -32.54 | 6.10 | 9.67 | 14.43 |

These short-term bear-market stock rallies were driven by a better-than-expected monthly inflation number or on the premise the Fed was close to pivoting away from sustained rate increases. Each time though, the Fed quashed pivot hopes by reiterating their commitment to quelling inflation even at the expense of an economic recession as failing to do so would bring greater economic harm as was the case in the 1970's.

This past quarter is a good example as markets rallied in October and November on improving inflation numbers and the belief that the Fed would acquiesce to investor sentiment and affirm a pivot in monetary policy at the December FOMC meeting. Instead, Fed Chair Jerome Powell echoed their duty to price stability and actually raised their 2023 projections for the short-term target rate and inflation. These projections and comments sank markets in December. Similar to the debate on whether inflation was indeed transitory or sustained, there is now a growing disconnect between the Fed and market on whether its effort to corral inflation is approaching a policy misstep.

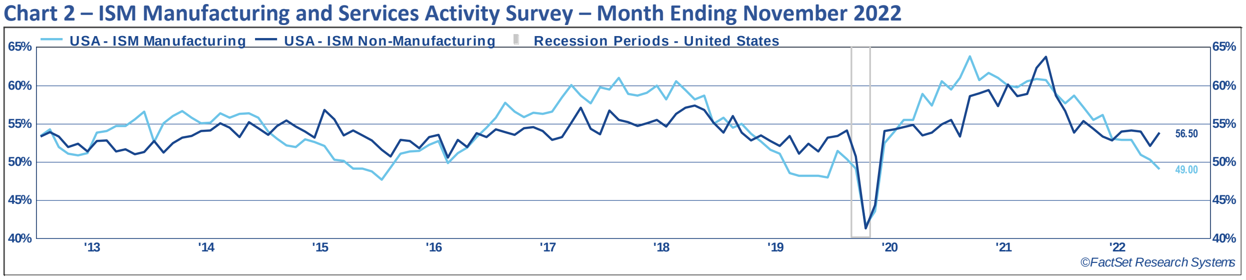
Those in the Fed camp contend that risks to inflation are to the upside as the labor market remains strong, COVID-related supply and demand imbalances persist, and the war in Ukraine has and will continue to put pressure on food and energy costs. Those in the policy misstep camp contend the Fed has not allowed enough lag time for the rate hikes to take effect on the economy and inflation, and that there are historically reliable market measures pointing to a pending recession. As I always like to say, "let's go to the tape" and review economic trends and market indicators.

**Chart 1 – U.S. Existing Home Sales – Month Ending November 2022**

The first industry affected by the rate increases was the housing market, which has weakened considerably as mortgage rates have doubled and housing sales have plummeted. Through November 2022, existing home sales have declined 10 consecutive months and are down -35.4% from the same period one-year ago as shown in Chart 1. Moreover, home builder sentiment has tanked to 10-year lows and annual home price increases are rapidly decelerating yet still up y/y. Home prices are not expected to get hammered as inventories remain historically low and spec building has been muted since the Great Recession.

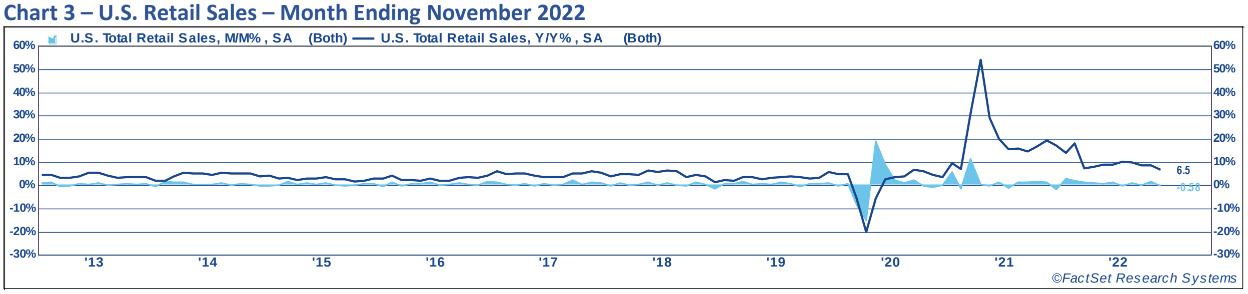
Manufacturing has seen a gradual decline in business activity, falling into contractionary territory in November. According to the ISM Manufacturing Survey, November activity fell to a level of 49.0% breaking a string of 29 straight expansionary readings. Readings above 50% are considered expansionary and readings below 50% contractionary. Indeed, there was broad-based weakness of components in the survey showing acceleration in contractionary readings including new orders, backlogs, employment, deliveries, inventories, exports, imports, and prices. Survey respondents cited softening demand, generally higher economic uncertainty, a more cautious outlook, improving but persistent supply chain issues, and apparently peaking inflation.

**Chart 2 – ISM Manufacturing and Services Activity Survey – Month Ending November 2022**




Unlike the manufacturing survey, business service activity has been much more resilient, expanding for 30 consecutive months with November coming in at 56.5%. Most components of the service survey are growing albeit at slower rates, including new orders, employment, prices, backlogs, and imports. Survey respondents cited pre-pandemic volumes, solid new orders, sustained cost pressures, persistent supply chain shortages, and shortage of available workers. The end of the pandemic saw economic demand shifting from goods to services, and services related demand and inflation are a primary focus of the Fed.

**Chart 3 – U.S. Retail Sales – Month Ending November 2022**



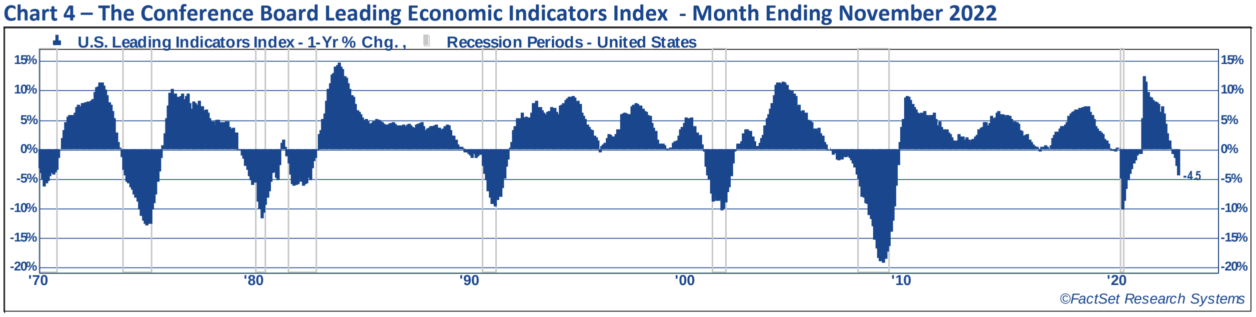

When most COVID restrictions were lifted in early 2021, the one area that saw tremendous growth was retail sales. Historically, annual retail sales growth is around 4%-5% but from March 2021 to February 2022 monthly y/y growth ranged from +17.7% to +53.7%. For the remainder of 2022, monthly retail sales growth trended lower with November coming in at +6.5% compared to the same period one year ago (y/y). Monthly retail readings remain choppy but, despite high inflation, the U.S. consumer remains resilient. Economists and analysts surmise that generous fiscal pandemic stimulus policies drove strong 2021 growth while a tight labor market along with continued albeit lessened fiscal stimulus is buoying consumers.

One area the Fed is keenly focused on is the labor market, stating it wants to see meaningful signs of softening within the labor market before taking its foot off the rate hike pedal. COVID structurally altered the labor market with some six million workers dropping out of the labor force. Because of the structural change, this is an area we predicated rate hikes were going to take longer to affect, and this has been the case. The labor market continues to be tight with roughly two jobs for every unemployed person. Labor market stats remain strong as there are still roughly 10.3 million job openings available, weekly initial jobless claims have not budged and remain persistently low, monthly job gains have averaged 272,000 over the last three months, and average hourly wage gains remain elevated at +5.0% annually.

The Fed also wants to see economic weakness expand into other areas of the economy hoping that it will lessen overall demand. There are signs below-trend growth is already taking hold as 2023 GDP and corporate earnings estimates are moving lower. There are also signs of a pending recession as two historically reliable measures are predicting. The first being an inverted yield curve and the second being the Conference Board's Leading Economic Indicators Index (LEI).

The treasury yield curve, which historically has been a reliable harbinger of pending economic activity, has been inverted for quite some time. An inverted yield curve is when short-term rates (2yr bond) are higher than longer-term rates (10yr bond) and this is important as an inverted yield curve has preceded the last eight recessions. Additionally, last quarter the spread between the 2yr bond and 10yr bond reached -82 basis points or -0.82%, its highest inversion level since April 1980.

**Chart 4 – The Conference Board Leading Economic Indicators Index - Month Ending November 2022**




Similar to an inverted yield curve, the LEI has also been a consistent predictor of recessions. The LEI is a gauge of 10 indicators designed to show whether the economy is improving or deteriorating and presently it is indicating that a recession is likely as the LEI has fallen for nine straight months. November's LEI reading was -1.0% and showed broad-based weakness as 9 of the 10 component indicators declined. Since 1970, weakness in the LEI has preceded every U.S economic recession.

So "the tape" clearly illustrates the economy is slowing with ongoing strength in the labor market, solid business service activity, and abating resilience in the U.S. consumer. It also shows traditionally dependable indicators signaling that the probability of a recession in 2023 is high. Due to the Fed and high inflation, interest rates shot up sharply throughout most of last year ushering in one of the worst bond markets in history. The question now is whether the Fed is in on the verge of a policy misstep. Have they already raised rates high enough to bring inflation under control? The bond market believes this is the case.

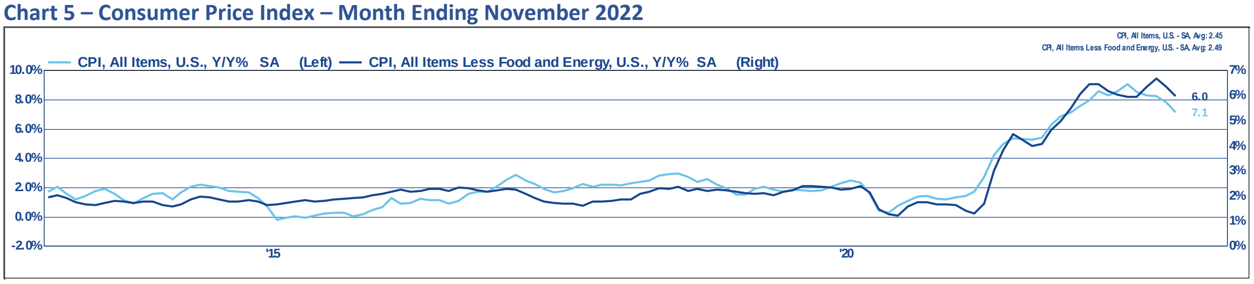
**Table 2 – Fixed Income Index Total Returns as of December 30, 2022**

| Fixed Income | 1-Month | 3-Month | YTD | 1-Year | 3-Year | 5-Year | 10-Year |
|---|---|---|---|---|---|---|---|
| Bloomberg Inter Gov't/Credit | -0.18 | 1.54 | -8.23 | -8.23 | -1.26 | 0.73 | 1.12 |
| Bloomberg Municipal | 0.29 | 4.10 | -8.53 | -8.53 | -0.77 | 1.25 | 2.13 |
| Barclays Michigan Muni | 0.21 | 3.65 | -8.97 | -8.97 | -0.78 | 1.39 | 2.33 |
| Bloomberg High Yield | -0.62 | 4.17 | -11.19 | -11.19 | 0.05 | 2.31 | 4.03 |
| Bloomberg Aggregate | -0.45 | 1.87 | -13.01 | -13.01 | -2.71 | 0.02 | 1.06 |

As aforementioned, in December the Fed raised their 2023 target rate projection from 4.6% to 5.1% with the likelihood of a policy pivot to lowering rates not happening until 2024. The CME Group's FedWatch Tool paints a differing viewpoint with an increasing chance of a rate cut beginning as early as September 2023. We are in the camp of a Fed policy misstep.

Inflation accelerated higher for much of 2022 but decelerated towards the end of the year as did economic activity. The Fed shifted their short-term rate transparency stance from giving near-term guidance to being data dependent.  Economic data and market measures are plainly showing a slowing economy and an approaching recession. The Fed should allow some lag time for the rate hikes to take affect before pursuing additional rate hikes.

**Chart 5 – Consumer Price Index – Month Ending November 2022**




Presently, our strategy remains being neutral on stocks as valuations remain below historical averages, especially in the small-cap and mid-cap spaces. We expect stock markets to remain volatile in the first half of 2023 and then rally on a Fed pivot in the second half of 2023. On the bond front, we continue to favor a shorter overall duration but have moved back to neutral on sector exposure. We expect the yield curve to flatten over the course of the year and eventually move towards an upward sloping curve indicative of economic expansion and an improving inflation rate.  The main risks to the economy and markets are sustained high inflation and increased geopolitical risks.

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Sources:  FactSet, The Federal Reserve, U.S. Department of Labor, National Association of Realtors, U.S. Census Bureau, ISM, National Association of Home Builders, The Conference Board, & CME Group