Bitterroot
CAPITAL ADVISORS

Memorandum

Date: December 5, 2022

To: BCA Clients and Friends

From: Sid Nadkarni, BCA CIO

Subject: Q4 Rally in Equity Markets and Our Thoughts Looking Forward

Global equity markets have rallied sharply thus far in Q4 with the MSCI ACWI Index up 14.5%, the S&P 500 up 13.8%, the MSCI EAFE Index up 19.7% in USD, and the MSCI Emerging Markets Index up 11.5% (each from 10/1/22-12/2/22). Several key factors have driven this rally, including:

- Positive inflation reports – lower than expected US inflation across various reports including Consumer Price Index (CPI), Producer Price Index (PPI), and the Fed's preferred gauge, Personal Consumption Expenditures (PCE). Inflation was lower than anticipated both on a year-over-year and month-over-month basis. Importantly, several leading inflation indicators are showing signs of rapid slowing including sequential housing price declines, plateauing rents, and declines in prices for many goods including used cars. Inflation moderated in Europe as well. Supply chains are normalizing at a faster pace, which is also reducing some previous inflationary pressures.
- Central banks moderating pace of rate hikes – several central banks have indicated plans to slow the pace of interest rate hikes, most notably the US Fed. While the Fed has cautioned that peak terminal interest rates may be higher than previously predicted, the slowing pace of increases followed by a potential pause has emboldened investors that a soft landing may be feasible.
- China reopening sentiment – Throughout 2022, China has maintained its strict Zero-Covid policy. However, sluggish below-target 2022 growth coupled with increasing social pressure may lead to a reversal or loosening of this policy which would drive pent-up demand in China (with positive knock-on effects for global growth).
- Better European economic data and mild winter thus far – Investors have been worried that Europe is most exposed to a recession given its energy crisis. Thus far however, Q2 ,and Q3 GDP data have been better than feared; consumer spending remains resilient, and Europe has so far experienced a very mild start to winter leading to ample gas storage (gas shortages were perceived as a significant risk a few months ago).

118 EAST MAIN STREET, BOZEMAN, MT 59715 USA +1.406.556.8200 BITTERROOTCAPITAL.COM

- Strong consumer health – In the US and most Western nations, consumer spending remains robust, driven by the utilization of still-high excess pandemic savings coupled with solid labor markets.
- Seasonality – Generally speaking, equity returns in Q4 have historically surpassed returns in other quarters ("the Santa Claus rally"). With a lack of earnings catalysts until late January / early February, investors have focused on positive inflation-related macroeconomic data (relative to expectations).

Some investors are betting the above factors will lead to a sustained resumption of a bull market in equities next year, surpassing the 2021 highs. While recent data has undoubtedly been incrementally positive and may indicate a better chance of achieving the goldilocks scenario (slowing inflation coupled with a modest recession / corporate earnings declines), *we caution that many uncertainties and risk factors remain*. These include:

- Manufacturing data and PMI surveys indicate a widespread slowing of industrial activity. The US Manufacturing Purchasing Managers Index (PMI) recently retreated into contractionary territory with a sharp drop in new orders. Eurozone PMI surveys have remained in negative territory for the past four months. Historically, slowdowns in manufacturing PMI surveys have presaged future earnings declines. Additionally, economic effects from interest rate hikes tend to lag by six to twelve months. As such, global economies will likely increasingly feel the adverse effects of 2022 monetary tightening in 2023. Interest rate curves are now sharply inverted in the US, with 10-year bonds yielding 80bps less than 2-year bonds (the largest such gap since the early 1980s). Globally, interest rate curves are generally inverted and forecasting upcoming recessions.
- Inflated corporate earnings expectations – Wall Street analysts forecast S&P 500 2023 earnings growth of $235 vs. $220 in 2022, or 6.8% growth. This forecast appears optimistic as corporate spending seems to be declining. It is unclear whether consumer spending will remain as resilient in 2023 once pent-up pandemic demand normalizes or should job losses accelerate. In previous recessions, corporate earnings declined by 10% to 30%. During previous downturns, market lows were not reached until S&P earnings began to decline.
- Valuations are not cheap – The S&P is presently trading at 17.7x forward earnings (vs. a historical average of 16x). If one haircuts current earnings forecasts to flat growth in 2023, the S&P is trading at 18.5x, and if one assumes a 5% YOY earnings decline, the S&P's valuation increases to 19.4x.
- Labor market strength may lead to higher-than-expected interest rates – While some measures of inflation have peaked and are slowing, labor markets worldwide continue to experience tightness. In the US, job growth continues to surpass expectations and there are still 1.6 jobs available per unemployed person. Annual US wage growth remained above 5% year-over-year and accelerated to 0.6% month-over-month in November. The Fed will be hard-pressed to pause rate hikes with wage growth well above desired levels.

- Increasing risks of stagflation or overtightening by central banks – the labor dynamics mentioned above may lead to a period of stagflation. Inflation may moderate but then plateau and remain well higher than target. Concurrently, economic growth may slow meaningfully and fail to revive. If inflation plateaus, the central banks may overtighten and cause deep recessions.

To summarize, there is definite cause for optimism based on inflation and other data over the past two months. However, myriad risks remain. Uncertainty about the ultimate trajectory of declining inflation and the magnitude of corporate earnings declines remains high. We expect equity markets will remain highly volatile in 2023 as investors digest the path of rate hikes and their ultimate terminal rate, the prospects for recession, and the likely decline in corporate earnings. Our base case is for equity markets to remain relatively flat (+/- 5% over the next 12 months). However, the market could easily retest the June and October 2022 lows during the first half of 2023. *As such, we recommend that investors continue to maintain dry powder to deploy during market corrections*. In the meantime, short-term Treasury bills and notes yield 4.3% to 4.7% in the US and 4.0% to 4.3% in Canada and serve as an attractive place to park cash.

As always, we welcome the opportunity to speak further, so please do let us know if there are any topics you wish to discuss. If we don't talk before then, have a happy holiday season, and we look forward to connecting with you in the New Year.

THE BCA TEAM