

WEB ADDRESS

www.chjwealthmanagement.com

PHONE

(281) 298-2700
(877) 824-4299

MAILING ADDRESS

10200 Grogan's Mill Road, Suite 340
The Woodlands, TX 77380

January 2023

1st QUARTER OUTLOOK

The Great Reset

2022 was the year of the Great Reset in the financial markets. In an historic fashion, with a mandate to crush inflation, the Federal Reserve raised interest rates throughout the year bringing the Fed Funds rate from near zero to over 4% by year end. The size and pace of the rate increases stunned market participants, many of whom doubted the Fed's resolve. The result was a bear market in stocks and the worst year for bonds in decades.

There is an old adage on Wall Street that goes "don't fight the Fed". From 2009 until the end of 2021 the Fed had been consistently accommodating with regards to monetary policy. Interest rates stayed low for more than a decade with just minor blips along the way. Don't fight the Fed means that when the Fed is accommodating you simply stay long stocks. From 2009 up until 2021 the bears continuously fought the Fed and paid the price as stocks continued higher throughout the decade. Now, I am not referring to traders who daily move in and out of the market. Indeed, good traders have no religion.

There is an old adage on Wall Street that goes "don't fight the Fed"

But for investors, "don't fight the Fed" is a pretty good religion to latch onto. Indeed, despite all the troubles and disasters that arose over the last decade, the Fed remained mostly accommodating and stocks mostly moved higher.

As 2021 was winding down, the Fed made it clear that the inflation that they hoped was "transitory" after the pandemic, was actually a huge problem that had to be dealt with. Supply chains were still jammed, and demand was robust coming out of the lockdowns of the previous year. The Fed cannot affect supply, so they turned their attention to destroying demand. How does the Fed destroy demand? The Fed destroys demand by raising interest rates and making easy money less available in the financial system (Quantitative Tightening). So, in late November of 2021, the Fed Chairman made it very clear that the Fed was going to embark on tightening monetary policy going forward. The markets flinched, but in general took an "I'll believe it when I see it" attitude. Many of the higher flying, no earnings, growth stocks that emerged during the pandemic had already begun to collapse by the end of 2021, but the S&P 500 actually hit an all-time high on January 3rd, 2022.

The Fed was signaling that they were going to raise interest rates in 2022, but the markets still were skeptical. Who could blame them, the Fed had remained accommodative even though most believed

that the need to do so had passed long ago. Don't fight the Fed works both ways and just as the bears were defiant for the previous dozen years the bulls appeared defiant in early 2022. But as the markets became convinced that the Fed was serious about fighting inflation that old Wall Street adage came true once again. Stocks tumbled throughout the year in 2022. Yes, there were relief rallies along the way, but in the end the bulls found out that it is just as painful to fight the Fed when monetary policy becomes restrictive.

Given the complete change of direction from the Federal Reserve, a reset in valuing assets was expected and indeed underway. Some stocks that appeared attractive in a zero-interest rate environment didn't look so good once money became scarcer. The Nasdaq which houses many of the growth names that flourished the year or two before dropped more the 30%. The market averages moved into bear market territory throughout the year and except for a couple of sectors, namely energy and health care, it was a very difficult year for stocks.

"Given the complete change of direction from the Federal Reserve, a reset in valuing assets was expected"

As mentioned, bonds had one of their worst years ever. As interest rates rise, bond prices fall and in 2022 many investors saw their bond portfolios tumble in value as much as 15% or even more. Most investors have never seen the value of things like bond mutual funds fall in value like they did in 2022. Indeed, bonds had basically been in a bull market for the last 40 years. The path from high double digit interest rates in the early 1980's to zero percent by 2021 meant that with a few exceptions along the way, bond prices were always moving higher (remember as rates fall prices rise and vice versa).

So, 2022 saw a Great Reset in both stock and bond prices. Interest rates had never been moved that far that quickly and investors got caught in the tsunami.

Waiting For Godot (Recession)

With the Fed determined to slow demand by raising interest rates, market participants have become more and more convinced that what the Fed will do is actually push the U. S. economy into a recession. We did have 2 negative quarters of GDP in the first half of the year, but that is not the "official" definition of a recession. The National Bureau of Economic Research evidently is the authority on recessions and their definition is "a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real GDP, real income, employment, industrial production and wholesale retail sales." All right then. What I do know is that it is really hard to have a recession when everyone who wants a job has one. The unemployment rate is 3.5% and there's about two job openings for every job seeker at the moment.

But the narrative for most of 2022 was all about the upcoming recession that will start sometime soon, or maybe later, but surely sometime in 2023, or maybe not. Investors have been waiting for the corporate earnings declines that would accompany this coming recession and the bears insist that stock prices are not accurately reflecting the decrease in earning that will soon be upon us. As a matter of fact, we start an earnings season next week that is predicted to be very gloomy, and what could be the first of several ahead of us. So, the bears insist that the lows that we saw in the market averages last summer will not be the bottom of this cycle, that another leg down in this bear

market will occur when the markets finally realize and acknowledge that a recession is upon us, and earnings estimates are too high and must be adjusted downward.

If the bears are right, we probably have more wood to chop in this bear market and the first couple of quarters of 2023 are likely going to be similar to 2022.

But what if the recession that we have been waiting for does not materialize, or at least is much more benign than what is being predicted? The odds of avoiding recession are rather low according to pundits. But how are institutional investors positioned this time? If they are convinced that recession is a given, are they positioned as such in their portfolios? That seems to be the big question at the moment. Not whether we get a recession or not, but instead how are investors positioned as we watch the play unfold. If investors are cavalierly bullishly positioned and a real deep earnings recession occurs, then it would likely be the case that new lows in stocks are in our future. But if investors are more cautiously positioned and a deep recession occurs or better yet does not occur, then it is likely that we have seen the lows in this bear market and we are back to simply dealing with how much longer it will last. As we entered 2023, sentiment was extremely bearish. That could be taken as a good sign for the bulls but again, are investors positioned as bearishly as they seem to be. We will only find out the answer as things unfold over the coming months.

"Not whether we get a recession or not, but instead how are investors positioned as we watch the play unfold."

I always talk about the same concept as we enter each earnings season. Share price reactions after corporate earnings releases are often more about how investors were

positioned before the release and what the expectations were. For instance, if the shares of company A move higher the weeks before the earnings release in anticipation of good news, then even good news itself may not move the shares higher after the release. Indeed, the shares sometimes actually go down on the good news. It's called buy the rumor, sell the news. The reverse can also hold true. Shares of company B go down for weeks before the earnings release. The news is bad, but the shares have been selling off for weeks and often you see a stock move higher even on what one might have thought was bad news.

So, as we move into the first quarter of 2023 what might be more important than how bad a recession we will have (or don't have), is how investors are positioned going in. Sentiment readings might be the one thing that the bulls could build a case around. Stay tuned.

Inflation

Watch this week's inflation numbers and inflation numbers in the coming months. If inflation continues to moderate, then the Fed might begin to back off their hawkish stance. The quicker the Fed is able to back away from this rate hike cycle the better chance we either avoid a recession or a least moderate one. If inflation remains stubborn and the Fed does, indeed, have to stay higher for longer, the odds of a recession, severe or not, grows. Make no mistake, the markets have underestimated the Fed's resolve to tame inflation. The Fed has to continue to talk tough even when the markets believe and the data shows that inflation is moderating. The markets didn't think the Fed would raise rates as much as they did in 2022.

The moral of the story is simply watch what the Fed does (not what they predict as Fed officials' predictions of the future are no better than anyone else's) and then don't fight them.

Summary

For this quarter's summary I'd like to go back to last quarter and reiterate the following:

"The bottom will develop over time, and most won't have any idea how it happened. It just does. The Fed still has work to do, and the economy still has adjustments to make. As we have phrased it all year, 'there is still a lot of wood to chop.'" If you are a young investor with decades before retirement, this market environment is a gift.

Enjoy it and keep buying at lower prices. Years from now you will be delighted that you did. For investors in the distribution phase of your investment life, we build portfolios to provide the current income necessary to maintain a quality retirement, while a market disturbance like this one plays itself out.

So, though it is not easy, the best thing for an investor to do while in a lengthy bear market is to show patience and act with reason and not emotion. This bear market will end at some point, but as we have seen over and over again it still will take some time before we set sail on the seas of the next bull market that will take stocks to new all-time highs and reward those who were able to stand the turbulence."

As always, we appreciate that you entrust us to manage your money and guide you on your road to financial success. We strive to keep you informed and to provide you with the best service in the industry. These are difficult and confusing times, but hopefully our daily updates are helpful and provide you some comfort.

Do not hesitate to contact us with any thoughts or questions. If you feel that we can help someone you know and love, and help guide them through these times, please let us know.