Capital Ideas

01/06/2023

Capital Ideas Advisors
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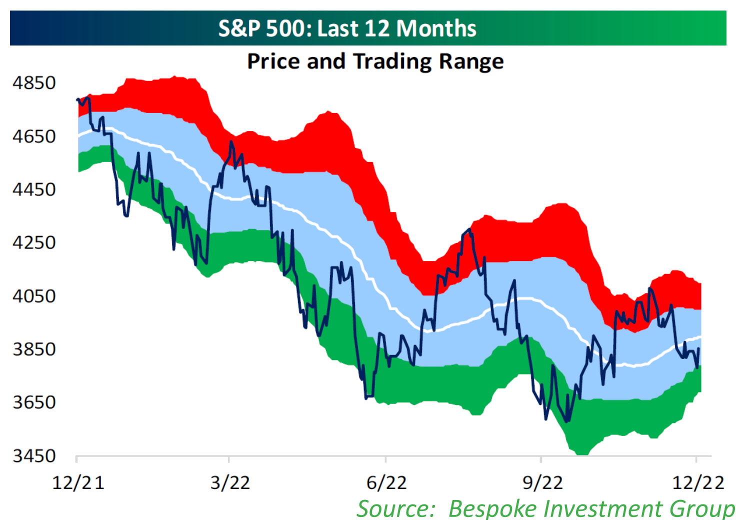
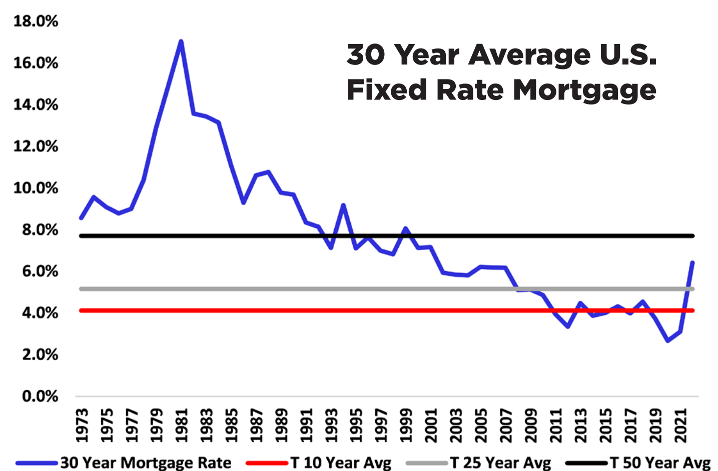
Dear Reader,

We hope you and your families had a great holiday season and a Happy New Year! 2022 was a challenging year for markets – stocks suffered their fourth worst yearly decline since World War II. And bonds generated significant losses as well when the Bloomberg U.S. Aggregate Bond Index posted its largest full-year decline since inception in 1976.



Source: Bespoke Investment Group



Entering the new year, many of the issues that plagued us in 2022 remain, concerns regarding elevated inflation and interest rate policy, a potential economic slowdown or recession, and increased geopolitical risk. Assets repriced significantly in 2022. The yield on the 10-year U.S. Treasury note rose to 3.88% from 1.51% and the S&P 500 declined approximately 20% as earnings multiples contracted due to those higher rates. In 2023 interest rates will continue to have ripple effects throughout the broader economy. Due to higher mortgage rates causing substantially higher monthly payments housing prices may continue to weaken. Currently the average 30-year mortgage rate is 6.4% compared to 3.1% at the end of 2021 and an average rate of 4.1% over the past decade. To put that in perspective, the monthly payment for a new

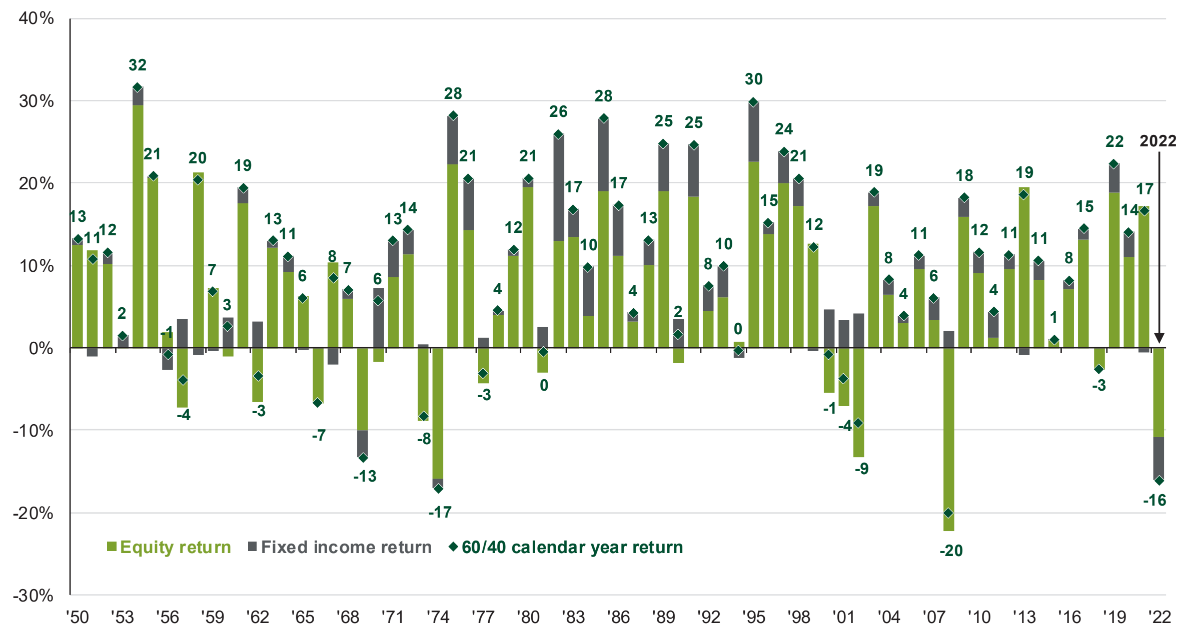
$500,000 mortgage increased to roughly $2,500 from $1,700 in less than twelve months. So rising interest rates alone reduced pre-tax income for this American household $800 per month. Nationally this significant reduction in disposable income substantially reduces overall consumption, the linchpin of American economic growth.

Businesses will also be forced to grapple with higher borrowing costs to finance growth which, all other things being equal, reduces profits. This implies companies may have a higher return threshold to justify new capital investments. This will put downward pressure on prices these businesses are willing to pay for labor, raw materials or equipment. For example, assume a manufacturer intends to finance a $1 million equipment purchase with a bank loan. That equipment is expected to generate a gross 20% annual return, or $200,000 before taxes and debt service. For a conventional 5% 10-year commercial loan debt service payments would be $127k per year yielding a $73k net profit. Given the Fed's aggressive short term rate hikes, that same bank loan would likely now price at a rate of around 9%, increasing annual debt payments and reducing the company's expected profit to just $48k.

The above example which illustrates the higher costs now facing corporate investment decisions. Due to higher interest costs alone manufacturers will be less willing or able to buy equipment necessary for expansion. Only if the manufacturer is able to reduce the equipment's purchase price could net profit margins be maintained. The lower price results in a lower loan amount which would offset the higher interest cost for the equipment. This is exactly what the Federal Reserve is trying to achieve. By raising borrowing costs the Fed hopes to reduce

60/40 annual return decomposition

Total returns, 1950 – present



Source: FactSet, Standard & Poor's, Robert Shiller, Yale University, Bloomberg, Ibbotson/Strategas, J.P. Morgan Asset Management.
The 60/40 portfolio is 60% invested in S&P 500 Total Return Index and 40% invested in Bloomberg U.S. Aggregate Total Return Index. S&P 500 returns from 1950 – 1970 are estimated using the Shiller S&P Composite. U.S. fixed income total returns from 1950 – 1975 are estimated using data from Strategas/Ibbotson. The portfolio is rebalanced annually.
Guide to the Markets – U.S. Data are as of December 31, 2022.

J.P.Morgan
ASSET MANAGEMENT

demand for the goods and services Americans are willing to buy and by lowering the price they are willing to pay. To the extent that the Fed is successful, this will almost certainly reduce inflationary pressures as demand is negatively impacted. The only question that remains is how aggressive our central bank will be going forward and how costly that will be in terms of economic growth.

Looking forward, we believe markets will ultimately react to the underlying data regarding both inflation and economic growth. There remains a great deal of uncertainty across markets and the broader economic backdrop, but we offer some predictions for the new year:

> **Investors will increasingly focus on economic growth compared to the trajectory of interest rates.** This will be a product of both inflation data trending lower and late-stage consumer and business spending behavior.
> This suggests that contrary to the current situation, as the year progresses positive economic data such as strong GDP growth will be increasingly viewed as positive for stocks.
> This change of attitude contrasts with last year when positive economic data was often met with a negative market reaction because investors were predominately concerned with implications for interest rate policy.
> **The Fed will raise rates by a quarter of a percentage point at both its February and March meetings then pause.** This will bring the Fed Funds target rate to a peak of 4.75-5.00%.

Corporate earnings will show positive nominal growth in 2023.
We believe earnings will be a positive surprise in 2023. The median consensus estimate for S&P 500 earnings for 2022 is $200.19. Fourth quarter 2022 numbers will be released early this year. While the outlook for corporate earnings is murky, we should have more clarity in the coming weeks, and believe the index should generate more than $50 of earnings per quarter in 2023.

Stocks may post above-average returns in 2023.
Driven by higher-than-expected corporate earnings and sentiment potentially improving, we believe stocks will generate an above-average year of performance in 2023 following a historically bad year which substantially lowered expectations.

As always, we thank you for your patronage and encourage you to call us with any questions or concerns.

Wishing everyone a healthy, happy, and prosperous 2023!

Sincerely,

CJ Brott

Karen Burns

Andrew Kerai