Hudson Advisor Services, Inc

# OUR VIEW OF THE MARKET

By William N. Hudson, Jr., David D. Burrows, William Hudson III, Evan Coppola, & Jeremy Hudson

Volume 93 January 2023

We liked a financial column we saw which talked about the large number of "known unknowns" facing the economy and financial markets in 2023. Most important, no one really knows how hard it will be to reduce inflation or whether the U.S. economy will experience recession.

Given the uncertainties, Wall Street forecasters are all over the place for 2023. The average forecast expects the S&P 500 to end 2023 at 4,009 – up slightly from 3,839 at year-end 2022. But the predictions range from a low of 3,400 to as high as 4,500 – the widest discrepancy since 2009. Much of the diversion relates to differing viewpoints of what the Federal Reserve will do in 2023. We see this debate daily on CNBC. At Hudson Advisors, we believe in the old wisdom: "Don't fight the Fed." To us, the Fed has been quite firm and consistent in its intention to stamp out high inflation and get back to its target range of 2%. That intention was reflected in the minutes of the most recent Fed meeting which suggested that Wall Street should not underestimate the anti-inflation policy. We think the Fed would like the so-called 'soft landing." But it will tolerate a modest recession if necessary. We are waiting for the "unknowns" to be more known. Our view is on the plus side of neutral with regards to the market outlook. It will take until mid-year for the inflation/recession dynamic to be clearer. The stock market will be unsettled for the first half of the year. It may start to recover in the second half if the economic news is good. In this environment, as always, we seek to protect client money and look for future opportunities,

## MARKET TRENDS

The accompanying chart summarizes stock and bond market trends in the fourth quarter and full year of 2022. Both markets took a strong hit from all the negative economic news and from the onset of much higher interest rates.

**Equity Market:** Investors started 2022 with the hope that inflation would be short-lived. That hope was dashed as inflation reached levels not seen in 40 years. The Federal Reserve moved to reverse its modern policy of low interest rates. They moved with four successive rate increases of 75 basis points to bring short-term rates to 4%. The stock market reacted badly to this policy change. It went into a year-long slump despite occasional attempts to rally – especially in the fourth quarter. It ended with the worst year since 2008.

The S&P 500 concluded the fourth quarter ahead 7.56%, but with a decline of 18.11% for the year. The Dow Jones Composite Average was ahead 13.26% for the quarter, but down 8.79% for the full year. The Russell 2000 was ahead 6.23 % for the quarter and still down 20.44% for the year. The worst performer was the Nasdaq Composite which was down 0.79% for the quarter and 32.54% for the year. The market was slightly positive but fluctuating in early 2023.

**Fixed Income Market:** The monetary tightening by the Fed has sent bond yields surging, hurting bond prices, and eliminating the hedge that bonds often offer against stocks. Some analysts observed that it has been 50 years since stock and bond prices fell this much in unison. The yield on the benchmark 10-year U.S. Treasury Note (which moves inversely to prices) ended on December 30 at 3.873% up from 1.496% at the end of December. The Bloomberg U.S. Aggregate Bond Index was down more than 18%, its worst year since 1976.

### MAJOR MARKET INDEXES

| | 2023 Return |
|---|---|
| **Dow Jones Composite Average TR** | -8.79 |
| **S&P 500 Index TR** | -18.11 |
| **Russell 2000 Index TR** | -20.44 |
| **NASDAQ Composite TR** | -32.54 |
| **EAFE Index NR** | -14.45 |
| **Bloomberg Aggregate Bond Treasury TR** | -12.46 |

*Source: Morningstar® as of December 31, 2022*

## THE OUTLOOK

**The Economy**: The pandemic recovery has created some quirky economic reporting. The U.S. GDP was technically negative in the first two quarters of 2022 – but was not labeled a recession. The economy is expected to have about 2% growth for the full year when the final numbers are tabulated. One clear trend has been a robust labor market with over 4 million jobs created in 2022. While recent months show some cooling, the unemployment rate remains an historically low 3.7%. Consumer spending has also been strong. spurred in part by pandemic household savings.

Economists are quite divided in their outlook for 2023. One camp sees a shallow but brief recession that would come in the second half of the year as result of the Fed's monetary tightening. A second camp sees a more complicated "swamp recession" which may take a year or two for recovery. A third camp supports the soft-landing idea in which the economy slows but avoids recession. We obviously will be watching the economic tea leaves each month to see which scenario unfolds.

**The Market:** Corporate earnings will be key to stock market performance. The forecast at the outset of 2022 was for about 10% growth for the year. But earnings have turned negative in recent months – the result of increased interest rates –and the full-year forecast for 2022 is now about 6%. Not surprising, the prognosis for 2023 is uncertain. Some forecasters see earnings several points positive, others see a basic flat trend, and others see a decline of perhaps 10% if a recession is deeper and prolonged.

We always look carefully at Price/Earnings ratio. The forward 12-month P/E ratio is now 16.1. – as compared to over 20 in the past two years. So stocks are now more reasonably priced but still higher than the 100 year average of 15. The effect of lower corporate earnings on this ratio going forward remains to be seen.

In addition, at Hudson Advisors, we have some concern for the political situation in Washington. Failure to manage the debt limit would sow chaos in financial markets. It is an unpredictable situation that overrides the other forecasting. On balance, as stated, we are on the plus side of neutral in our expectations for the market. One ray of hope is that the U.S stock market will be more attractive than most international markets. Our best guess is for the market to struggle in the first half of the year, but then gain positive traction if we avoid serious recession.

## OUR STRATEGIES

As**set Allocation:** Most clients should stick to portfolio strategies previously identified. We advise against an increased allocation to equities at this time. For some clients, we may recommend taking some money off the table right now. For new clients, we will recommend a 60% allocation to equities to be phased in over a 12- to -18-month period. The other 40% of assets will be short to intermediate term bonds, cash, and alternative investments.

**Preferred Equities**: As always, despite market conditions, we look for long-term equity opportunities. Our focus is on companies that can weather both the short-term period and flourish in a longer time frame. We want fundamentally sound companies with reasonable valuations and that pay dividends. In that context, we are looking at these sectors which are similar to last quarter.

HEALTH CARE: This sector has proven to be economically resilient and has provided good returns historically.

UTILITIES: Companies in this sector have provided consistent earnings and good dividends.

TECHNOLOGY: We are interested in selective technology companies with emphasis on innovation, especially those helping to build out 5G infrastructure.

CONSUMER STAPLES: Some of these companies can actually do well in an inflationary environment where consumers stick to basics like food and household items.

FINANCIALS: Higher interest rates can improve banking net interest income and we are interested in regional banks.

**Other Assets**: Our aversion to long-term bonds remains and is reinforced by the inflationary outlook. We like bond maturities under two years which now have higher rate returns than previous years. We like laddered investments with a mix of U.S. Government, municipal, and high-quality corporate bonds. We also like the new better-paying opportunities in money market funds.

.

**Dow Jones U.S. Sectors Total Return**
**(Percent Change for YTD, Ending December 31, 2022)**
***Source: Morningstar®***

| | | | |
|---|---|---|---|
| **Oil & Gas** | **62.25** | **Consumer Services** | **-30.27** |
| **Basic Materials** | **-7.57** | **Telecommunications** | **-5.75** |
| **Industrials** | **-14.04** | **Utilities** | **1.52** |
| **Consumer Goods** | **-23.42** | **Financials** | **-13.66** |
| **Health Care** | **-4.49** | **Technology** | **-34.53** |

**William Hudson, Jr., William Hudson, III CFP ®, Jeremy Hudson, & Evan Coppola**
4445 North Hwy A-1-A, Suite 233 • Vero Beach, Florida 32963 • (772) 231-8101
237 Main Street, Suite 600 • Buffalo, New York 14203 • (716) 803-6587
**David Burrows**
29 Hillside Drive • Greenwich, CT 06830 • (203) 302-3530
**www.hudsonadvisors.com • (877) 504-1964**