Investment Management of Virginia

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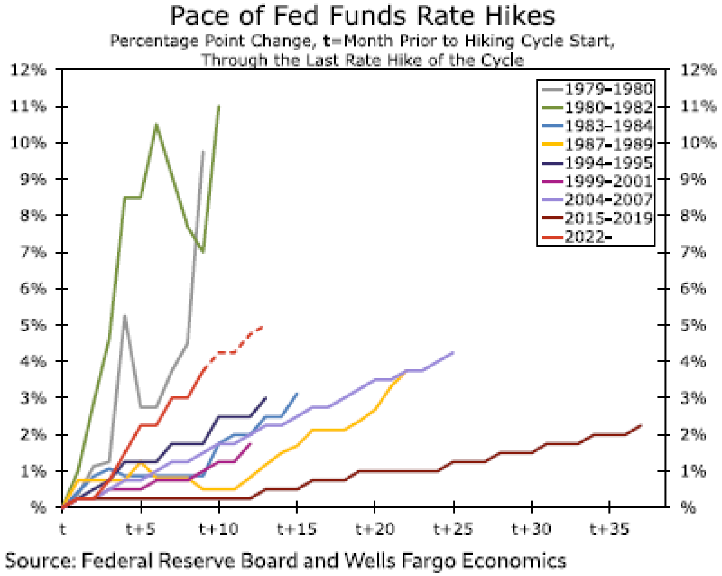
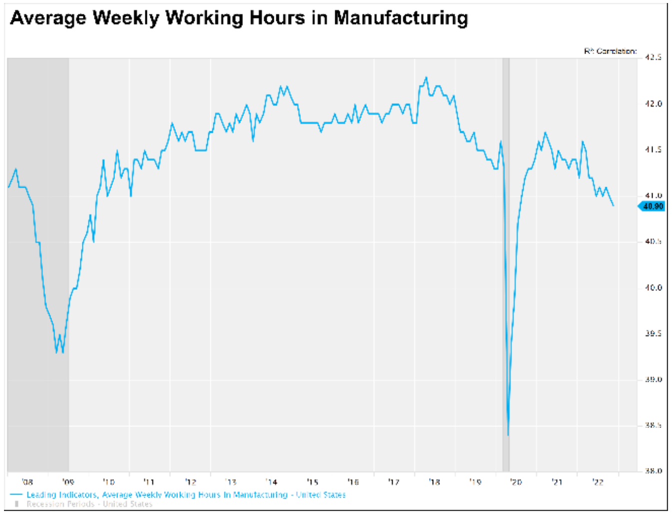
Interesting Charts and Commentary

A Long Normalization Process

The most aggressive Fed-tightening cycle since 1982 is having varying effects on the economy, with measures such as residential construction and home-selling activity responding quite negatively, even as other key metrics such as consumer spending and hiring activity remain remarkably resilient. However, the labor market is now showing signs of cooling (finally).



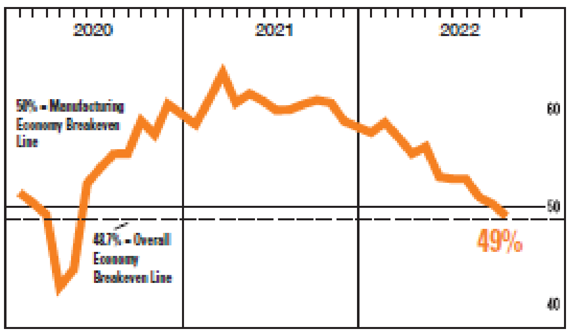
Average Weekly Hours



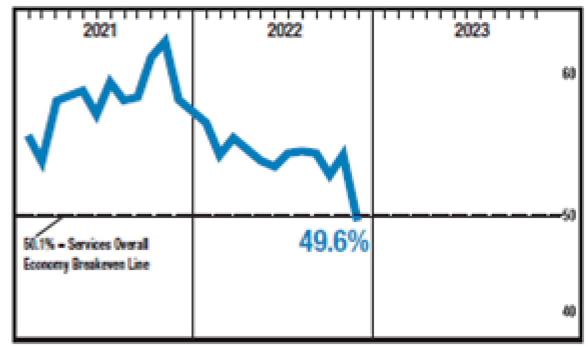
Stuck in The Middle with You

Clowns to the left of us, jokers to the right, and here we are stuck in the middle. Lagging indicators are holding up well while leading indicators are showing signs of weakness. The consensus expectation is for a recession in 2023, but the current data suggests the U.S. economy is still growing. However, Manufacturing PMI, Services PMI, and Architectural Billings have all dipped into contraction territory.

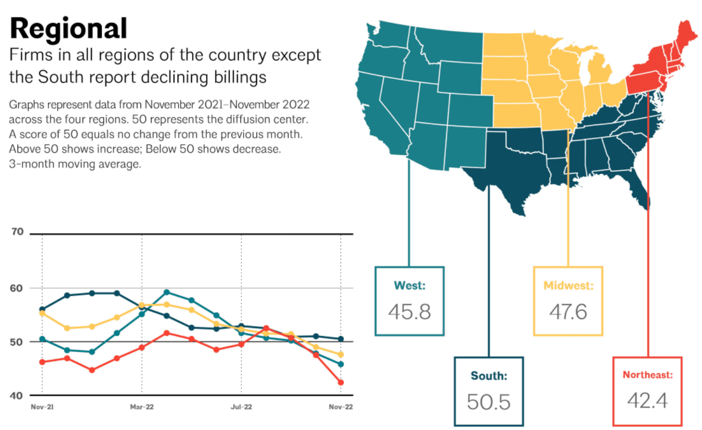
U.S. Manufacturing PMI



U.S. Services PMI



U.S. Architecture Billings Index

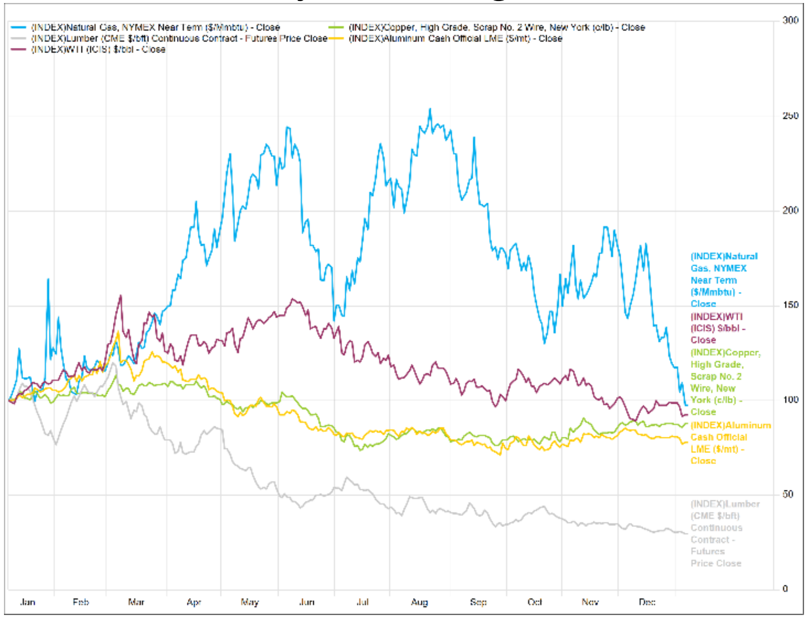


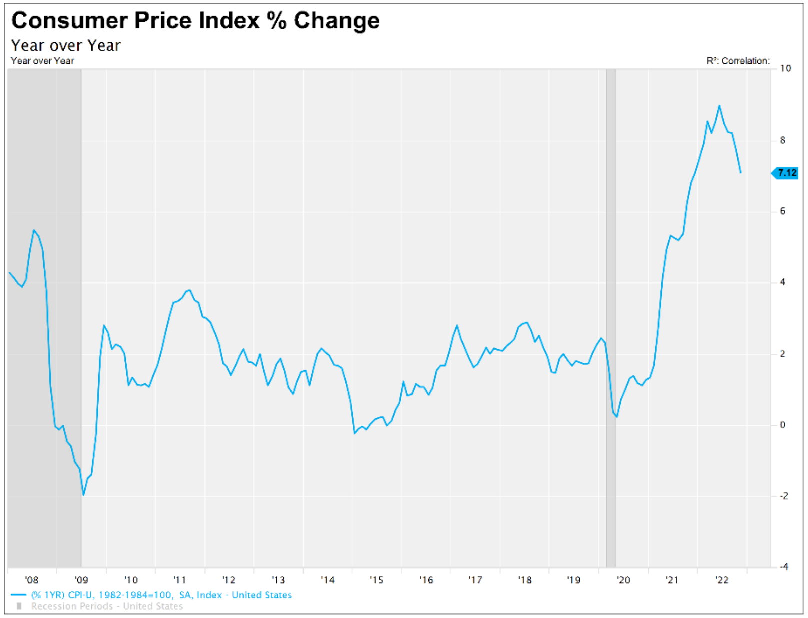
Source: Architecture Billings Index, November 2022, ISM "Report on Business" November 2022

Inflation Probably Has Peaked…

Europe has not experienced a winter energy crisis (yet), and declining energy prices have brought down inflation expectations. Consumer Prices and Producer Prices have all begun to show month-over-month declines.

Commodity Price Change YoY



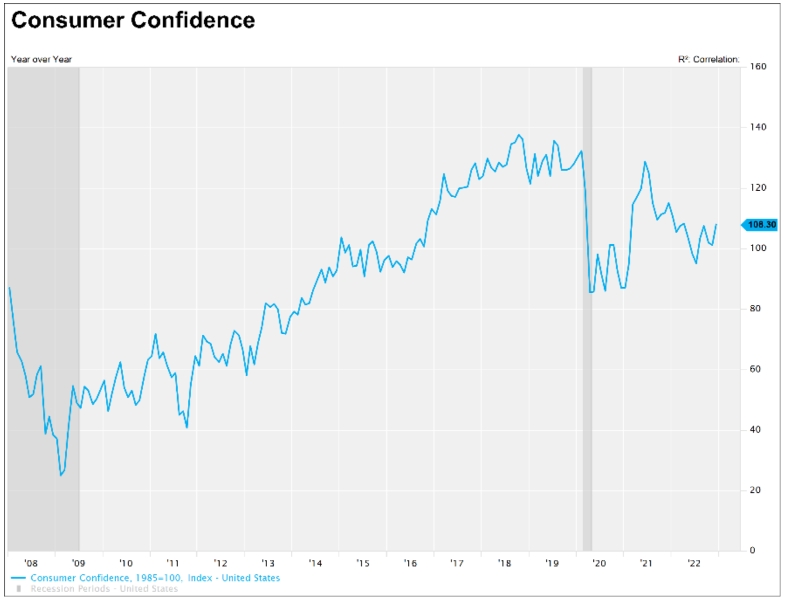


Source: Factset

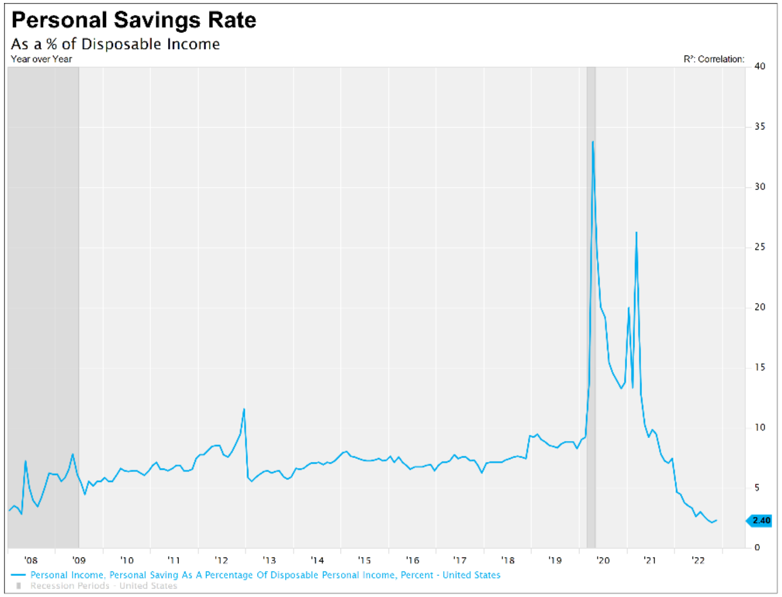
…But the Damage to The Consumer Has Already Been Done

The U.S. Consumer basically has used up the excess savings built up over the last several years. The personal savings rate is now back to the lowest levels since 2005.

Consumer Confidence



Personal Savings Rate

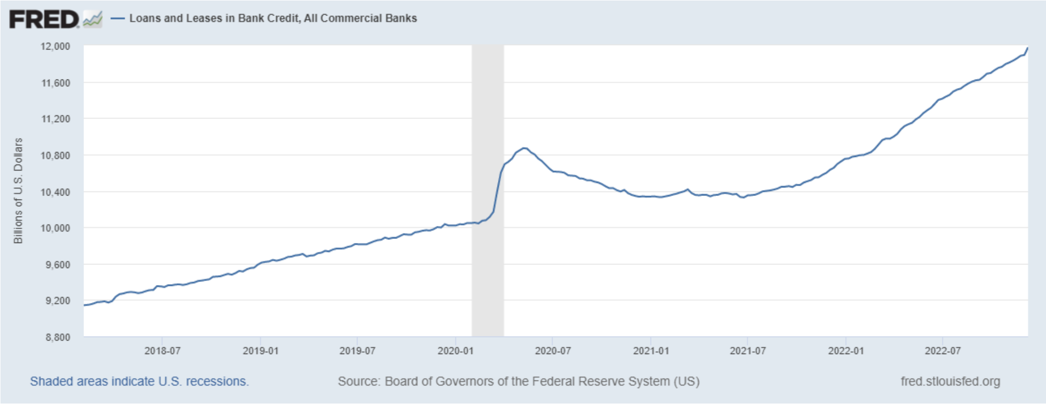


Source: Factset

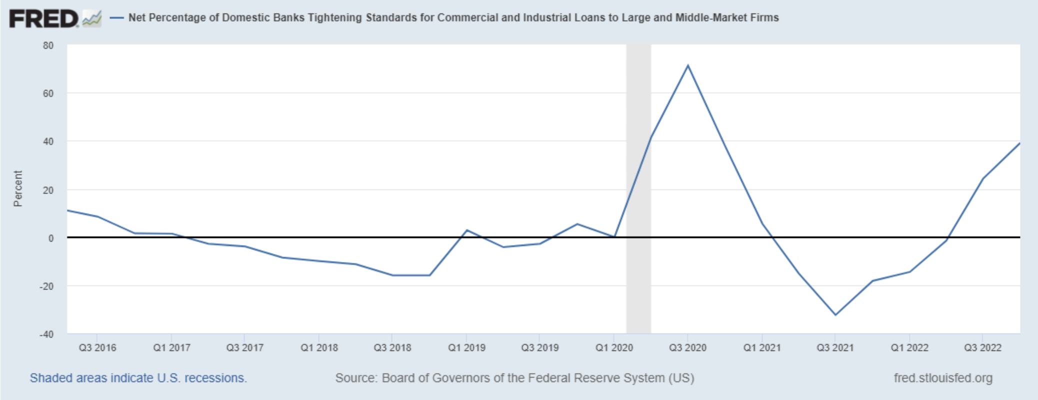
Despite Tightening Financial Conditions, Banks Remain in Good Shape

The Fed typically raises rates until something in the financial system breaks. However, banks remain well-capitalized and are continuing to make loans. Banks are tightening credit standards which will slow economic growth.

Bank Loans & Credit Growth



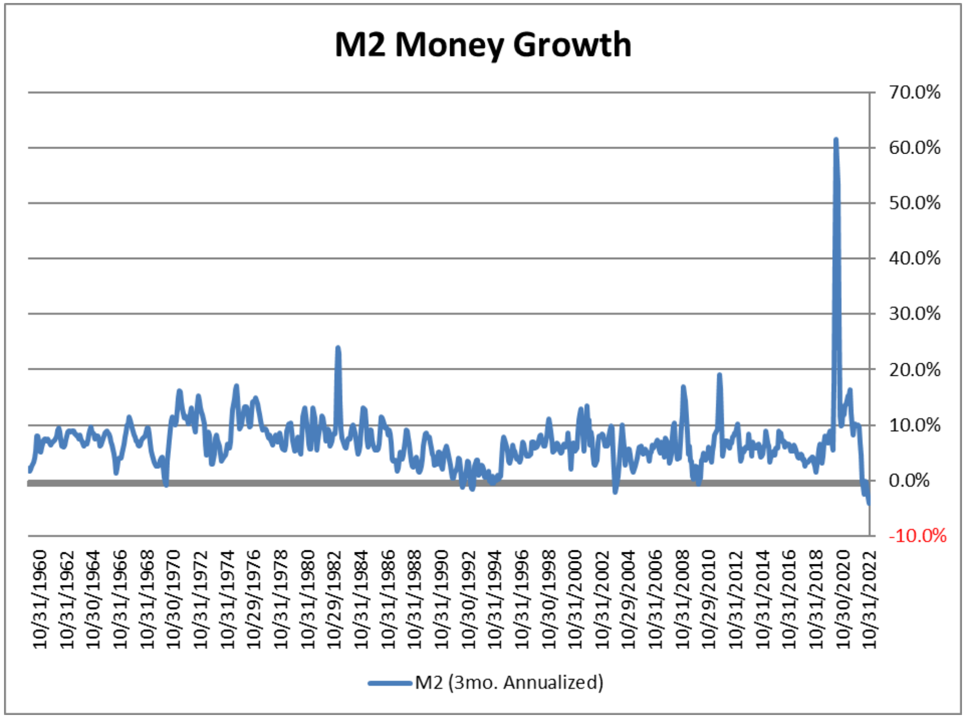
Banks tightening standards



Source: St. Louis Federal Reserve

Fiscal Conditions Remain Tight

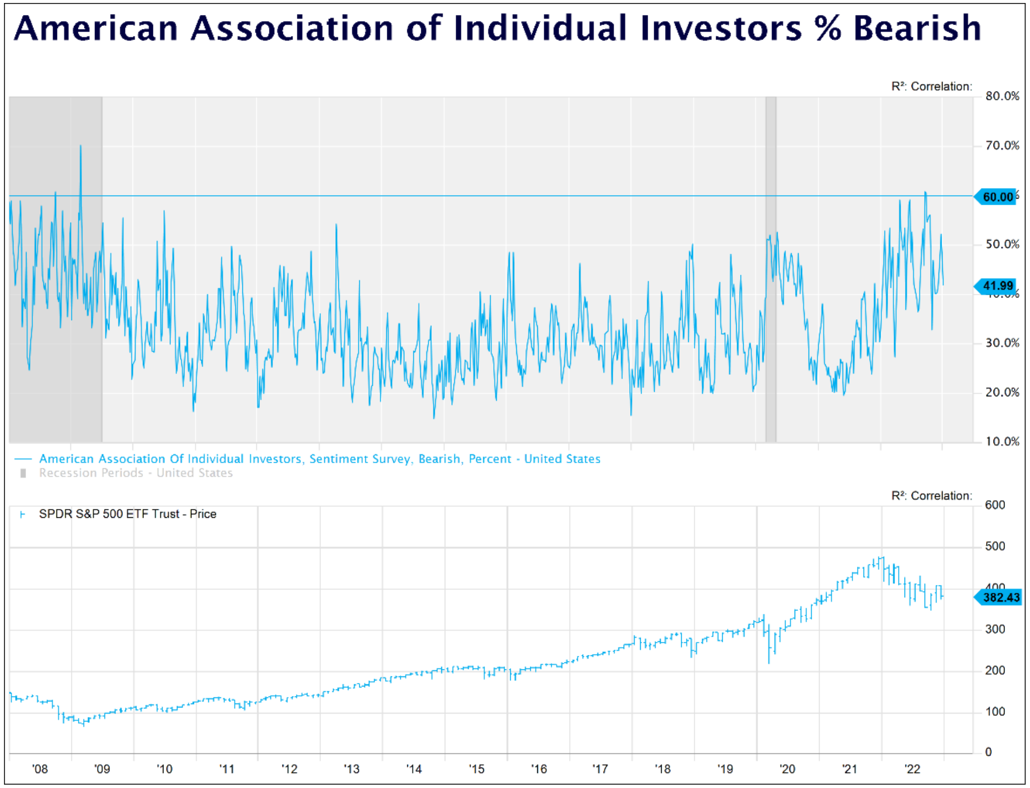
The Federal Reserve is now at risk of tightening too much and causing a recession. M2 Money growth has seen the largest seven-month decline since World War II. According to Professor Jeremy Seigel, "This is too much. The Fed cannot continue that decline. It will cause a recession. Normally a 5% increase in the money supply achieves 2% inflation. But money growth was way too rapid from March 2020 to 2022 and now is way too slow.”



Sources: FactSet, “The Excessive Bearishness is Great for Equity Investors”, Transcription of an interview with Jeremy Seigel at the Investment Insights Summit with Robert Huebscher, Dec. 13, 2022.

Sentiment Remains Negative

Sentiment remains negative, which can be bullish from a contrarian perspective. While the fourth quarter rally in the indexes helped sentiment bounce slightly, it still remains at levels normally seen at major market lows.

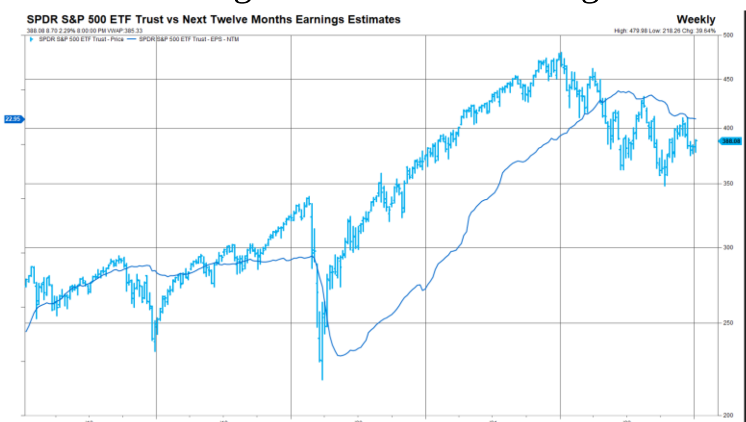


Source: FactSet data

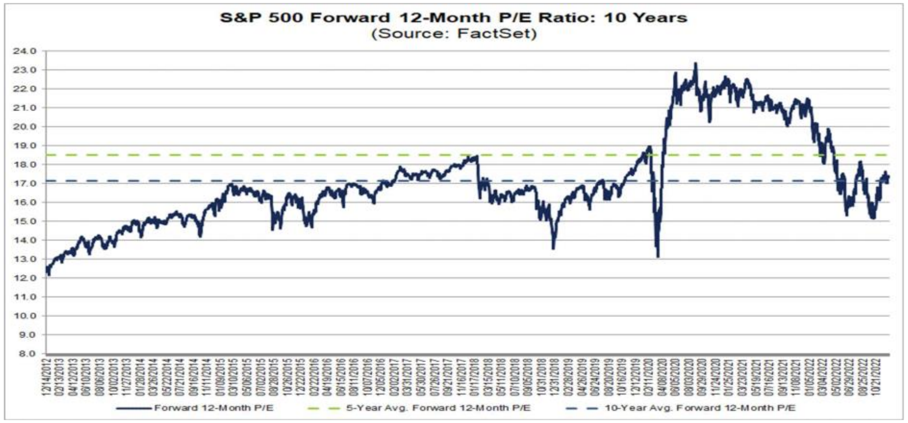
Equity Valuations Appear Reasonable But Earnings Estimates Continue to Decline

Stocks generally do not rise unless earnings estimates are also increasing. Analysts have already cut 2022 estimates, but based on recent comments from companies such as Apple and Tesla, it looks like earnings estimates could have another leg down. Until there is more clarity on the direction of earnings revisions, expect choppy market dynamics.

Earnings Estimates Are Falling



Valuations Are Back To Average



Source: FactSet

Conclusion

- The most aggressive Fed-tightening cycle since 1982 is having varying effects on the economy, with measures such as residential construction and home-selling activity responding quite negatively, even as other key metrics such as consumer spending and hiring activity remain remarkably resilient. However, the strong labor market is now showing signs of cooling (finally).

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- The U.S. Consumer basically has used up the excess savings built up over the last several years. The personal savings rate is now back to the lowest levels since 2005.

- The Fed typically raises rates until something in the financial system breaks. However, banks remain well-capitalized and are continuing to make loans. Banks are tightening credit standards which will slow economic growth. However, the Federal Reserve is now at risk of tightening too much and causing a recession. M2 Money growth has seen the largest seven-month decline since World War II. According to Professor Jeremy Seigel, "This is too much. The Fed cannot continue that decline. It will cause a recession. Normally a 5% increase in the money supply achieves 2% inflation. But money growth was way too rapid from March 2020 to 2022 and now is way too slow."

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Disclosure:

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