First Quarter 2023 — Economic and Capital Markets Commentary

Return to Trend?

"The whole reason that our capitalist system works the way it does is because there are cycles, and the cycles self-correct."

– Seth Klarman, Baupost Group

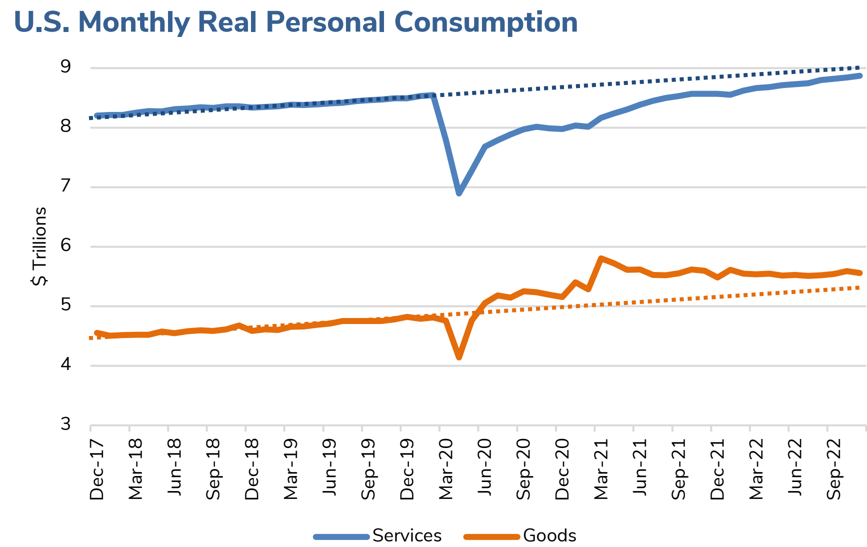
In 2022, inflation was higher than at any time in the past 40 years, a major power started a war in Europe for the first time in nearly 80 years, and U.S. consumers and businesses grappled with an extraordinary degree of uncertainty. Broad stock indexes declined throughout the year, while bond prices had their worst annual performance in decades.

Based on the information above, an investor could assume the U.S. economy was in a veritable tailspin and unemployment was significant. Surprisingly, this was far from the truth. GDP growth is expected to be weak but at least slightly positive for the year just ended, while unemployment has remained near the low end of its historic range.

Stock market declines had more to do with investors' appetite for risk. Stockholders reevaluated their willingness to assign high valuations to many companies in the face of economic and corporate earnings growth that was declining to more normalized levels from the excesses of 2021. Simultaneously, bond price declines were caused primarily by the Federal Reserve's aggressive interest rate hikes to combat the excessive inflationary environment the world found itself in.

Many economists and market prognosticators have taken the expected slowdown in economic growth as a clear sign that a recession is looming at some point in 2023. While we would absolutely agree that a recession is possible **every** year, we would note that a return closer to trend line growth and normalized unemployment in 2023 does not necessarily imply a deep recession or that any recession is imminent. However, it is clear that as long as the Federal Reserve continues with its hawkish monetary policies, a return to the high growth rates and high stock valuations of 2021 seems unrealistic in the near term.

As 2022 progressed, the extreme high and low economic data points from the prior two years began to revert to their more normalized long-term trendlines. With COVID no longer restricting consumer choices, spending on goods tapered off while spending on services, such as travel, increased, as the graph of Real Personal Consumption shows. As a result, albeit in fits and starts depending on the industry, the growth rates of many businesses returned to trend as well.



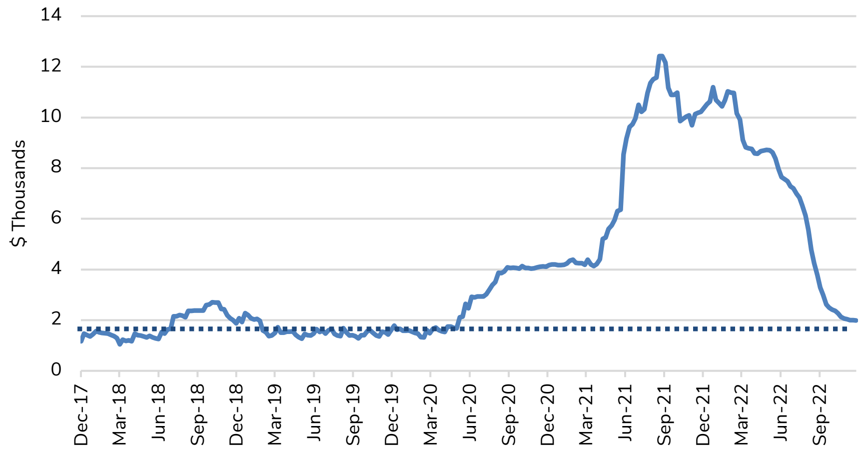
Many early pandemic winners saw growth slow while the fortunes of other companies hit hard by the pandemic disruption picked up.

Compressed Cycle

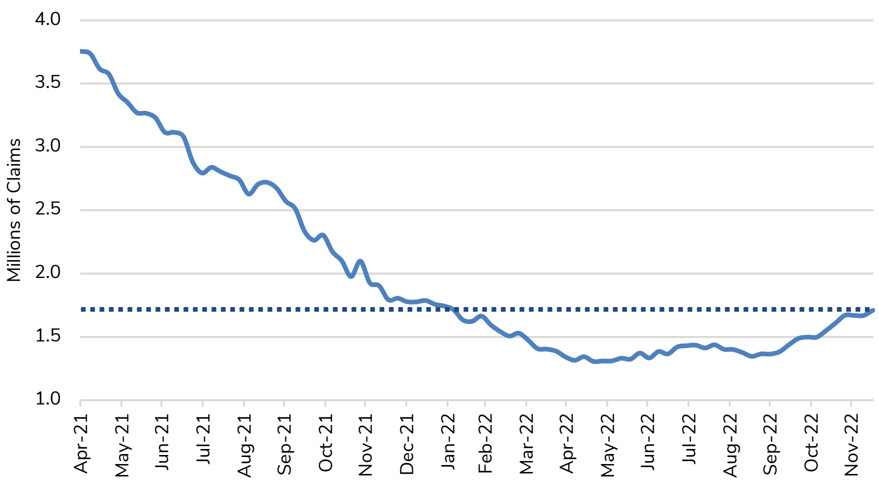
What the U.S. economy experienced from 2020-2022 could best be described as a compressed economic cycle. At the beginning of this period, the economy went into an immediate and sharp COVID-induced recession, followed by a massive expansion fueled by government transfer payments (with the attendant high commodity prices that are typical of rapid expansions). As 2022 brought the end to this compressed bust/boom cycle, many economic metrics moved back toward where they were before 2020.

On the positive side, supply chains mostly corrected themselves from the debacle they endured in 2021. Many supply costs in the transport area normalized (as shown in the graph of Shipping Container Rates), while inventories increased, and U.S. companies found it easier to obtain raw materials from domestic and foreign sources than they had in 2021.

Composite 40' Shipping Container Rate, East-West Trade Route



U.S. Continuing Jobless Claims



On the negative side, while not significantly higher, continuing jobless claim data began to return to its pre-covid levels (1.6-1.7 million) in 2022 as companies, particularly in the technology sector, announced layoffs after over-hiring during the pandemic.

A Market Repricing

The year 2022 could be considered a repricing of the market. Earnings for companies in the S&P 500 Index over the past 12 months were roughly in line with the prior 12-month period. However, stock performance was broadly lower, as investors were unwilling to pay as high a price for corporate earnings as they were in 2021.

As a result, heading into 2023, the U.S. stock market could be considered more fairly valued based on individual company earnings than it has been in some time. Those earnings will no doubt be heavily affected by inflation, the Federal Reserve's response to inflation, consumer spending, and the fear of recession throughout the coming year.

At Mitchell Sinkler & Starr, we will follow these factors and their impacts closely and continue to seek to take advantage of areas of the market where long-term growth is appropriately priced for our clients, subject to their investing goals and objectives.

- Mitchell Sinkler & Starr's Portfolio Managers

Data Sources: U.S. Federal Reserve, Bloomberg Finance L.P.

Economic and Capital Markets Data

	Dec 31, 2022	(One Year) Dec 31, 2021	(Three Years; Pre-COVID) Dec 31, 2019	(Five Years) Dec 31, 2017
S&P 500 Index	3840	4766	3231	2674
Price / Earnings Ratio	18.5	26.2	21.6	22.5
Dividend Yield	1.87%	1.38%	1.82%	1.89%
Federal Funds Rate	4.50%	0.25%	1.75%	1.50%
10-Year U.S. Treasury Yield	3.88%	1.51%	1.92%	2.41%
Gold ($ per oz)	1,823	1,829	1,517	1,303
Oil (Brent, $ per barrel)	86	78	75	67
Bitcoin ($)	16,530	46,333	7,158	14,043
GDP (Annualized)*	2.6%	6.9%	2.1%	3.2%
Unemployment**	3.7%	3.9%	3.5%	4.1%
Inflation (Annualized)	6.5%	7.0%	2.3%	2.2%

While stocks and bonds both declined dramatically last year, potential future returns now look more favorable. With U.S. stocks trading at a price-to-earnings multiple of 18.5 and Treasury yields above 3.5%, return expectations for diversified portfolios appear more balanced.

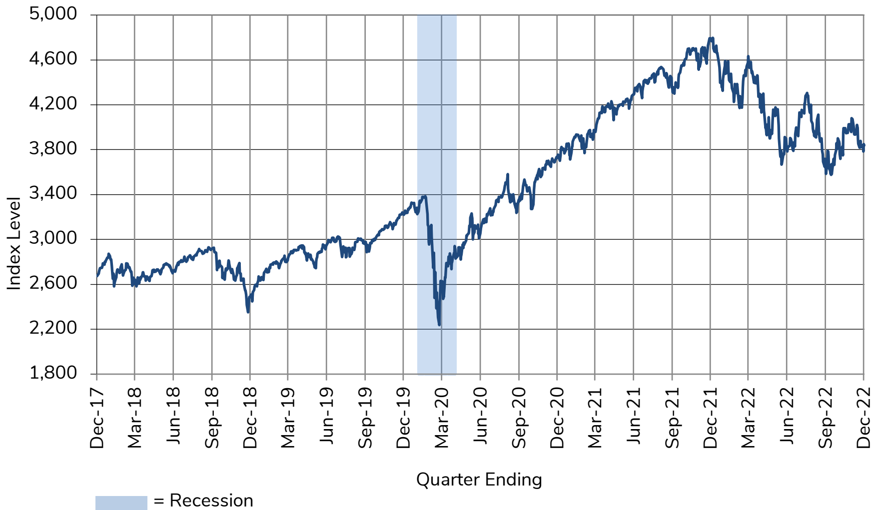
*GDP Data as of September 30, 2022

**Unemployment Data as of November 30, 2022

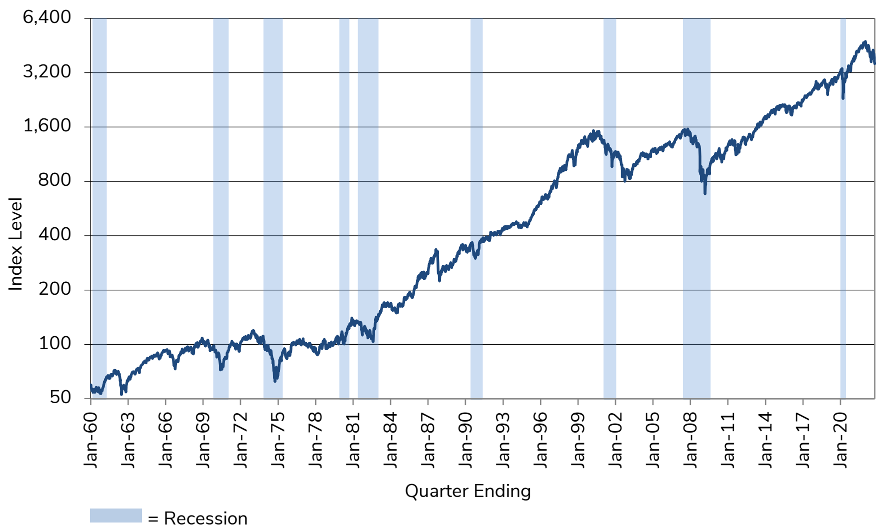
Quarterly Charts

The S&P 500 endured its worst year since 2008. While never pleasant, this is part of all market cycles. After the first two years of the 2020s produced such above-average returns, a more normalized environment for equity investors should have been expected at some point this decade.

S&P 500 Index - 5 Years



S&P 500 Index — Since 1960



As inflation cools, the Federal Reserve is expected to stop raising interest rates in 2023. The impact of their unprecedented increases last year has yet to be fully felt across the broader economy, however, creating uncertainty as to when more normal economic growth resumes. And while not a precondition, in general, economic growth tends to drive earnings growth.

Decade-by-Decade Market Returns

S&P 500 Index	1960s	1970s	1980s	1990s	2000s	2010s	*2020s*
Opening Level	60	92	108	353	1469	1115	*3231*
Closing Level	92	108	353	1469	1115	3231	*3840*
Beginning Price / Earnings Ratio	17.6	15.1	7.4	14.7	29.3	19.4	*21.2*
Ending Price / Earnings Ratio	15.1	7.4	14.7	29.3	19.4	21.2	*18.5*
Earnings Growth	6.0%	9.1%	5.1%	7.6%	1.4%	10.2%	*10.2%*
Total Return	7.8%	5.9%	17.5%	18.2%	-0.9%	13.6%	*7.6%*
Price Appreciation	4.4%	1.6%	12.6%	15.3%	-2.7%	11.2%	*5.9%*
Dividend Return	3.4%	4.3%	5.0%	2.9%	1.8%	2.3%	*1.7%*
Avg 10-Year U.S. Treasury Yield	4.8%	7.4%	10.4%	6.5%	4.3%	2.5%	1.8%

Returns for each decade are annualized.

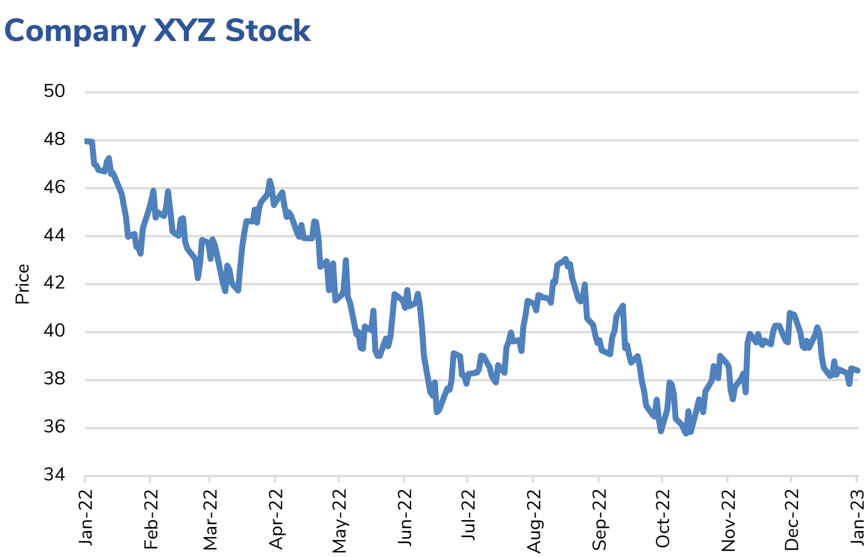
Source for table & chart data: U.S. Federal Reserve, Bloomberg Finance L.P.

Investment Insights — Anchors Aweigh!

December 2022

How Anchoring Bias Can Sink Your Investment Strategy

The ups and downs of the stock market can take a toll on even the most seasoned investor. Add in the influence of cognitive or behavioral biases, and it's no wonder we sometimes make less-than-optimal investment decisions. One of the most common biases investors must contend with is anchoring. This refers to the tendency to attach undue importance to initial data points when making decisions and to make insufficient adjustments based on new information.



Investors often encounter this bias when contemplating stock prices. For example, an investor viewing the 2022 chart of Company XYZ shown here may conclude the stock is undervalued based on its starting point and refuse to sell until the price recovers. New information, such as a recent decline in the company's earnings, should alter the investor's analysis, but anchoring bias may lead the investor to dismiss that information and fixate only on the stock's beginning value.

Anchoring bias can also influence the analysis of a company's results. If company A has grown earnings 20% on average over the last few years, anchoring bias may lead an investor to believe this pace of growth is likely to continue, despite new evidence to the contrary. On the other hand, if company B has historically struggled to grow but reports changes to operations that could drive future earnings growth, this same investor may dismiss the new announcement. In both cases, if the investor remains anchored at their initial growth rate assumptions and fails to incorporate the new information, their estimates for forward earnings—and ultimately the company's prospects as an investment—will be biased.

To counteract anchoring, investors should always ask themselves whether initial data points are having an undue influence on their decisions and should strive to treat all information objectively. That's certainly easier said than done, but well worth the effort.

Phillip D. Beckner, CFA, CAIA