INCISIVE INVESTOR

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WEEK IN REVIEW

STOCKS FALL ON LAST TRADING DAY OF 2022

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U.S. stocks were paring losses heading toward the closing bell on Friday but were still on track for their worst annual losses since 2008, as tax-loss harvesting along with anxieties about the outlook for corporate profits and the U.S. consumer took their toll.

The Dow Jones Industrial Average DJIA fell about 182 points, or 0.6%, to 33,039. The S&P 500 SPX dropped nearly 26 points, or 0.7%, to around 3,824. The Nasdaq Composite retreated 72 points, or 0.7%, to about 10,406.

Stocks logged their biggest gains of the month on Thursday, with the Dow gaining 345 points, or 1.05%, to 33,221 as the main equity indexes rebounded following losses earlier in the week that had sent the Nasdaq Composite to a fresh closing low for the year. The S&P 500 was on track Friday to cap off its fourth straight down week, its longest streak of weekly losses since May, according to FactSet data.

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LOOKING AHEAD TO 2023

Will inflation peak?

In recent weeks, risk assets rallied after data suggested an inflation peak was imminent, led by long-duration stocks and bonds. In 2023, inflationary pressures will likely decelerate as base effects, the historic pace of tightening financial conditions, and rising recession odds combine. Bonds may benefit from falling inflation, but profits and stock prices may still suffer.

Increasing costs, fading wealth effect

During 2021, economic growth and corporate revenues soared due to government transfer payments and consumers' spending power.

A company's revenue can be broken down into units and prices. Revenue is generated by the number of units sold and the price at which they are sold. It was not only unit growth that was strong, but also prices paid, as demonstrated by four-decade high inflation. Corporate input costs rose, but higher prices of goods and services sold offset (or exceeded) them, preserving profit margins.

Companies generally raise prices during inflation booms due to a positive wealth effect. During this episode, rising values for financial assets, used cars, homes, etc., combined with very high savings and rising wages generate significant pricing power. Cycles like this are common during periods of high inflation. When inflation recedes, however, what happens is also typical.

A boom in inflationary prices, like the one we just experienced, tends to be ephemeral. For pricing power to be sustained, value-add must accompany it. Over the past year, that hasn't happened.

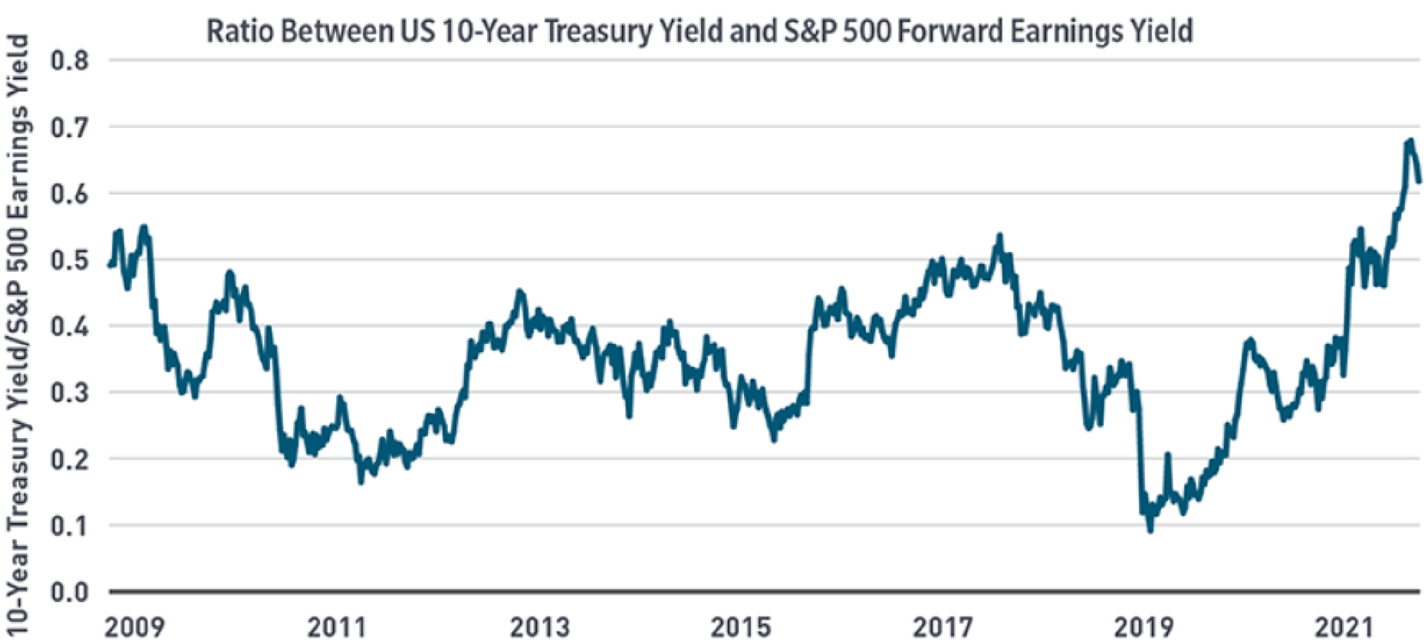
Consumer behavior changes as the wealth effect fade due to falling financial asset prices and increasing investor anxiety. It has already begun to manifest. According to operating results from some retailers this earnings season, consumers have begun prioritizing necessities, such as food, over non-essentials. When consumers' capacity to spend cannot meet the price at the checkout counter, inflation usually peaks.

Although falling inflation may result in higher equity multiples because long-term interest rates may have peaked (which is good for long-duration bonds), investors may be underestimating the drag on profits resulting from falling prices.

Outlook for 2023

Despite the deceleration of inflation, the slowdown should prove a tailwind for select bonds, particularly high-quality sovereigns, municipalities, and investment-grade issues. Compared to equities, bonds haven't been this cheap in over a decade. Below is a chart comparing the yield offered by the US 10-year Treasury to the S&P 500's 12-month forward earnings yield.

BONDS LOOK CHEAP IN COMPARISON TO STOCKS



Source: FactSet. Weekly data from 4 December 2009 to 2 December 2022. S&P 500 Forward Earnings Yield is calculated as 1 divided by next-twelve-months price to earnings ratio.

A decline in inflation is good for fixed income, but it will likely halt this earnings cycle and result in a long overdue profit margin reset, but not for all.

High capital costs and mandatory capital investments will most affect companies with uncompetitive products or services. Financial bailouts and a return to unnaturally low-interest rates will likely be precluded by softened inflation, but still relatively higher in the post-GFC period. As a result, these assets will become stranded.

Even well-run companies may experience some, albeit small, margin resets. However, the opportunity to gain market share and a greater share of profit pools leads to even better operating performance over the long term. There will likely be a new and positive earnings cycle for enterprises with a demonstrable value proposition and the ability to exceed their natural cost of capital as inflation slows and margins contract.

Tesla Inc. TSLA shares were down 0.4% after their worst run of losses in more than four years.

Southwest Airlines LUV shares were trading about flat even as the company said it expected its holiday travel fiasco to impact fourth-quarter profits.

Las Vegas Sands Corp. LVS was among the best performers in the S&P 500 index on Friday, with its shares up 1.2%, as it confirmed renewed gaming concessions in Macau.

AN ARM AND A LEG

A visit to the hospital can be painful, for both your body and your wallet. Don't let it be more painful than it has to be. [Click to learn more].

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Park 10 Financial has the knowledge and expertise to answer all of your concerns.

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