Pinnacle Capital Management, LLC

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Recession Fears and Opportunity

Happy New Year! 2022, the year the world was supposed to return to normal is finally over. Covid related disruptions that caused temporary inflation were going to disappear, while the year was going to bring us growth, prosperity, low interest rates and positive market returns. As they say, "a funny thing happened on the way to the forum!" So let's review the year just past and see what's likely in store for 2023.

Let's start with market returns. The S&P 500 returned -18.13% in 2022. While stocks were broadly down, it was the big tech / growth stocks that had the worst year. This can be illustrated by comparing returns of the less tech heavy Dow Jones Industrial Average and the tech-oriented Nasdaq Composite. They returned -6.86% and -32.51%, respectively, last year. These returns were driven by a slowing economy and fears of a significant recession caused by rising interest rates. Speaking of rising interest rates, bond prices tend to fall when interest rates rise. As a result, the Bloomberg US Aggregate Bond Index returned -13.01% in 2022. Clearly, there was no place to hide last year – that is, except in commodities. A broad-based commodity index, the S&P GSCI Index, returned +8.71% in 2022, though even that index had negative returns from mid-year on.

The inflation we saw last year, and the Federal Reserve's (Fed's) moves to attempt to quash that inflation, were largely the product of 1) economic strains caused by and revealed by Covid-19, 2) disruptions due to the war in Ukraine, and 3) economic consequences as a result of some of our responses to those strains. Simplistically, we've discovered that our economy had become highly dependent on a low-cost, efficient production system that left little room for disruption. This was combined with an emerging labor shortage. Meanwhile, years of faith in a high tech and a green future resulted in sustained under investment in basic industry, infrastructure, and natural resources. Covid-19 wasn't the straw that broke the camel's back – it was the 10-ton boulder.

Our responses only exacerbated the issues. While demand briefly fell, the problems caused and revealed by Covid-19 were largely related to our inability to obtain adequate supply and a fundamental shortage of labor. The government's response had been largely to stimulate demand, which overwhelmed a weakened supply situation. At the same time it proceeded with regulatory changes which discouraged expansion of supply, especially in the areas of natural resources. The Fed Reserve (Fed) first missed the signs that this new inflation was anything more than a temporary problem. Then it decided to control inflation by tamping down demand. It's tool for driving down demand was to drive interest rates up.

The Fed, by driving up interest rates, has had an impact on demand, especially in the housing

markets. Rising mortgage rates drove out both speculators and fundamental buyers. But beyond housing, and perhaps the automobile market, interest rates have the biggest impact on businesses. As a result of both the Fed's words and actions, businesses have become cautious with respect to investments and inventory. Supply has been reduced – or at least not expanded sufficiently - which largely offset much of demand weakness that might have softened prices. Perhaps a strong positive of this is that the need to reinvest in basic capacity, inventory, and distribution will become a tailwind for economic growth for several years once the interest rate raising cycle has peaked.

Meanwhile, government overspending and disincentives to invest in basic resources have resulted in supply shortages. Notwithstanding recent declines in gasoline prices, we believe commodity prices will likely rise for the next several years. The problems have been exacerbated by commodity supply shortages resulting from the war in Ukraine. On the other hand, China is beginning to relax its policy of Covid related shutdowns. This should both spur global economic demand and, unfortunately, add new upward pressures on commodity prices.

In the U.S., consumers generally have healthy finances while the job market remains strong. There have been widespread announcements of job cuts, especially among large tech companies. But demand from smaller companies is taking up much of the slack. Though overall demand for workers isn't at the peak level we've recently seen, it is still well elevated by historic standards. Therefore, we believe those forecasting imminent recession may be wrong. Growth should remain tepid, though positive, while the Fed keeps interest rates up. Final demand should remain healthy, and inflation should remain elevated, though not at the highest levels we saw last year.

Despite the wishes of the markets, economic growth in 2023 will likely result in further interest rate increases. The primary risk is that the Fed may overplay its hand, going to extremes. Meanwhile, excessive government debt for all the spending "emergencies" must be serviced. Federal interest payments are ballooning. A risk is that large tax increases become a necessity in politicians' minds.

Market returns should be better in 2023, at least for stocks. The first few months of the year should show some mild inflation readings, which might encourage the bond markets. Lower rates, at least in the short-run, might result in expanding market multiples. Initially, large cap growth stocks that performed so poorly in 2022, might show a strong rebound. However, our expectation is that inflation will prove to be stubbornly high. The Fed in turn is likely to keep raising interest rates. In this environment, we think basic industry, consumer, and commodity sectors are likely to perform best. The hurt in the bond markets shouldn't be as bad as in 2022, but positive fixed-income returns will still be tough to come by. At least initially, we prefer keeping maturities short, though this is not as easy a call as in 2022. We also recognize that most fixed-income investors are not looking for total return. Instead they are often looking for consistent income. Locking in at least some of the higher rates might be prudent. Please consult your financial advisors.

To sum matters up, we expect positive economic growth in 2023, inflation to remain stubbornly above where the Fed would like, and for interest rates to continue to creep upward. Positive results in the equity markets are likely, but many risks abound. While the economy will likely defy negative expectations in 2023, positive investment results won't be easy to come by. But they are certainly possible. Best success and health to all our readers in the new year!

5845 Widewaters Parkway
East Syracuse, NY 13057
(315) 234-9716

244 North Main Street
Mansfield, MA 02048
(774) 719-2759

www.pcm-advisors.com

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