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Weekly Commentary

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Macro View

By Hubert Marleau

Probable Economic Outcomes for Next Year

Submitted December 31, 2022

Trying to guess what lies ahead is hazardous because historical data on which forecasters rely are all over the place. Moreover, there are many big unknowns and many vexing queries, which can overlap with geopolitical concerns. In recent years, a noticeable shift in the investment landscape has occurred from globalization to deglobalization; plentiful energy to scarce; Washington consensus to conflict among great powers: codependency to isolation; population growth to ageing; fiscal responsibility to largesse; free capitalism to state capitalism; free markets to regulations; disinflation to inflation; and from a loose monetary regime to a conventional one.

Because I only have limited knowledge on how, what and when these broad forces will actually affect the investment terrain strategically over the short term, I prefer to watch the path of the money supply, follow growth data, and monitor inflation numbers. I think I can do this with reasonable discipline. Moreover, I know that the aforementioned structural forces will slowly but surely get reflected in the monetary and economic variables that I regularly and diligently follow.

The performance of the stock market in 2023 will be determined by the pace of inflation, the path of growth, and how the Fed will respond to these two forces. One thing that I do know is that the course of the money supply will have a determining effect on the course of N-GDP. However, I'm not sure whether the monetary aggregates will slowly or quickly affect inflation more than growth, or growth more than inflation. Consequently, we don't know what will be the reaction of the Fed because it is data dependent. It's a guessing game.

In the past 12 months, the U.S. money supply has hardly grown - only 0.01% - and is down at an annual rate of 5.2% over the past 3 months. which is definitely enough to sustain the current 7% pace of the economy. According to the Atlanta Fed's NowCasting Model, the R-GDP was running at an annual rate of 3.7% in the

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December quarter and according to the BLS, the PCE deflator was rising at an annual rate of 3.25% during the last 3 months. Although the money supply has risen some since Thanksgiving, reflecting the surge in retail sales, its decline is expected to resume as the enthusiasm of the holiday season wanes. Put simply, it is safe to assume that the money supply will continue to be impacted by the Fed's persisting effort to shrink its balance sheet and by the private banks' new policy to tighten their lending standards. In this connection, either slower growth or lower inflation or both will happen in 2023.

First, there is the Fed's official line: that of a soft landing, meaning narrowly avoiding a contraction, while reducing inflation, forecasting a 0.5% growth and a 3.5% inflation rate. Job openings and excess savings are two factors which could basically prevent the economy from falling too far while inflation abates. I give this scenario a 40 % chance.

Second, I think that there is a 35% chance for an "immaculate disinflation", where inflation comes down quickly without help from a recession, namely 1.5% growth and 2.5% inflation by the fourth quarter of 2023. Put simply, the fall in the money supply might only affect inflation. There is a funding stream for industrial infrastructure, energy and semiconductor manufacturing going on, which could have strong multiplier effects on the real economy and, in turn, blunt any downturn.

Third, there is a lower chance - I say 25% - but nevertheless a somewhat considerable one - that a stagflation scenario could materialize, where the level of economic activity falls 1.5% and inflation stubbornly stays around 5.5%. A minority of market strategists is fearful that the Fed would pursue an even tighter monetary policy than now, should inflation become as entrenched as it was 40 years ago.

Interestingly, Goldman Sachs (GS), an investment bank not to be trifled with, is betting against the crowd. So are Morgan Stanley and Credit Suisse. In a note to their clients, GS wrote: "Our most out-of-consensus forecast for 2023 is our call that the US will avoid a recession and instead continue progressing toward a soft landing. Part of our disagreement with consensus arises from our more optimistic view on whether a recession is necessary to tame inflation."

At this time, based on where 5-year Treasuries are trading, the Fed's current policy rate (4.33%) is about 33 bps higher than the neutral one (4.00%), a level that is consistent with stable economic conditions. Viewed in another way, the real Fed funds rate, the so-called r-star, is already at 2.00% (policy rate [4.33%] less 5-year inflation expectation [2.36%]. Bill Gross, the former bond king at Pimco, in an article in the FT, wrote: "Apart from this period, historical statistics over the last several decades would show that an r-star in the US of 2% would be enough to flatten growth and raise unemployment. And an r-star of 0 or less would be enough

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to accelerate inflation above central bank targets. It's the 2% that forecasters seem to pass over in their analysis. I would argue that with the Fed's inflation target of 2% and with the targeted current Fed funds rate at 4.25% to 4.50% and going higher in February, we are already at the optimum r-star and will probably stay there for some time if inflation appears to be approaching acceptable levels, even above 2%."

Three Economic Scenarios, Three Stock Market Outcomes:

Under the Fed's soft landing scenario, the S&P 500 would be choppy, but ended up higher, about 10%, by year-end than where it closed on December 31, 2022. That would be 4200.

Under "immaculate disinflation," the S&P 500 would rise, perhaps by as much as 25% and possibly reach 5000.

Under the stagflation scenario, the S&P 500 would fall precipitously by as much as 15% to 3200.

Nothing is ever 100% certain when it comes to the stock market. This is why waiting for something to happen is the hardest part. The dopamine hit in our brains triggers more anticipation than the event itself. That is why the market behaviour is impacted by whether we think a threat is near or far away.

I know that I will get it wrong when it comes to predicting where the S&P 500 will be in 12 months from now. Forecasting is far from a perfect science, but a necessary one, which is why I forecast often.

2022 was a terrible year for investors. Looking back, the S&P 500 was down 19.4%. It was the worst year for the stock market since 2008 mainly because the darlings of the pandemic were hammered. However, the bear market of 2022 may have bottomed last October when evidence was mounting that inflation had peaked and its rate had started to fall.

Presently, based on the weighted probability of the three likely scenarios, my forecast, for the record, is that the S&P 500 will be at 4200 by year-end. Should the P/E multiple stick around 16.0 times, investors would then have to forecast by year-end an EPS of $262.5 for 2024. That is not an unreasonable assumption because Big Tech, Industrials, and Energy could carry the day. These sectors are cheap, historically and relatively, given their respective growth prospects for earnings, the reshoring of the supply chain and the modernization of the power grid, making it critically important to stay invested.

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A recent survey of top Wall Street forecasters by MarketWatch put the average at 4031, ranging from 3400 to 5000. At this point, the “immaculate disinflation” is ahead of the other two scenarios by a nose. Incidentally, instances where U.S. stocks fall for 2 years in a row are rare. On the contrary, going back to 1946, the S&P 500 has advanced 13.5%, on average, in years following a double-digit pullback, according to Tom Lee, head of research at Fundstrat Global Advisors. Viewed in another way, losses followed by losses happened only 3 times or 3.5% of the time.

Hey, the Epiphany is coming up! Perhaps the celebration will give the market some positive surprises.

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