MARKET COMMENTARY

WHAT WILL DRIVE RETURN?

Earnings drive stock prices over time. This simple truth is evident in the past century's market performance. Over the past 100 years, both the S&P Composite index and S&P Composite index earnings gained about 6-7% per year. The profits, along with the market's appraisal of the value of those earnings, rose and fell year-to-year. Sometimes, those swings in earnings and valuations were large, creating excitement and anxiety.

What drove the earnings growth? Fortunately, we see an excellent and rational cause for the growth in earnings. As the chart below shows, we can trace growth in stock prices to economic growth (Chart A on page 3). And economic growth is rooted in "real" phenomena like gains in productivity and workforce. We also see that earnings are partly driven by inflation. This last part helps explain why, over time, stocks provide some inflation protection.

THE INFLATION ERA

In the two years after the start of the pandemic, the U.S. economy went from bust to boom. After losing 20 million jobs in early 2020, the government undertook policies to inject 40% more money into the economy by the following year (Chart B on page 3). Notice that the increase in money supply is more significant than we saw during the 1970s by a wide margin. However, the surge in money was not matched by a similar rise in the supply of goods and services.

We know this because the economy's total value is now larger than some estimate the economy should be able to produce. Today, the economy is estimated to be about $25.7 trillion, much larger than the Congressional Budget Office's (CBO) $25.3 estimate of potential output. This means that the economy, operating about $400 billion above potential, is overheating.

Compounding the issue is recent data on productivity. The Bureau of Labor Statistics productivity estimate shows significant weakness. This data shows productivity (output per hour) declining at a -2.4% rate, the most significant contraction since the 1970s. Another source, the Federal Reserve's (Fed) staff, recently cited lower productivity as the main reason for reducing their estimate of the economy's potential output. This cut to the estimate suggests that the Fed needs to tighten more than they did before the adjustment.

A rapid expansion of money against a backdrop of weakening productivity set the stage for inflation. The roots of the inflation problem we are now experiencing are not new. We have seen this movie before.

WHAT'S HAPPENING NOW

Since last spring, we are no longer seeing outsized additions to the money stock. Money supply growth has flattened out recently, and some parts of the supply chain are returning. Imports from China, for example, are up about 16% over a year ago. There is some reason, therefore, to expect the inflation curve to start to bend down.

To bring down the growth in the inflation rate, the Fed has been aggressively raising interest rates. When they meet this week, they are widely expected to increase rates by a further 0.75%. We now see the central bank as exercising a "restrictive" monetary policy. As policy tightens, the odds of an outright recession grow.

A favorite early indicator of recession is the "yield curve." A favorite measure of the changing yield curve is seen below (Chart C on page 3). The graph shows the difference between the 3-month U.S. Treasury bill and the 10-year U.S. Treasury bond. Typically, longer-term rates are higher than shorter-term rates as investors demand greater compensation for taking on the risk of a longer-term investment. Investors would accept lower rates for the greater risk of owning longer-term bonds because they expect the economy to falter. In most cases the bond market made this bet in recent years, recession followed.

WHAT'S NEXT?

We cannot know for sure what comes next. The cycle is evolving rapidly from a focus on inflation and an overheating economy to a concern about weakness. S&P 500 earnings forecasts are up about 7% from a year ago, but that growth is falling fast. For several months, the growth rate has been declining by about 1-2% per month. If the economic outlook continues to darken, earnings growth continues to slip, and interest rates continue to press higher, the bullish case for stocks will be tougher to make.

Chart A

LONG VIEW: STOCK MARKET & ECONOMY

Source: Bloomberg

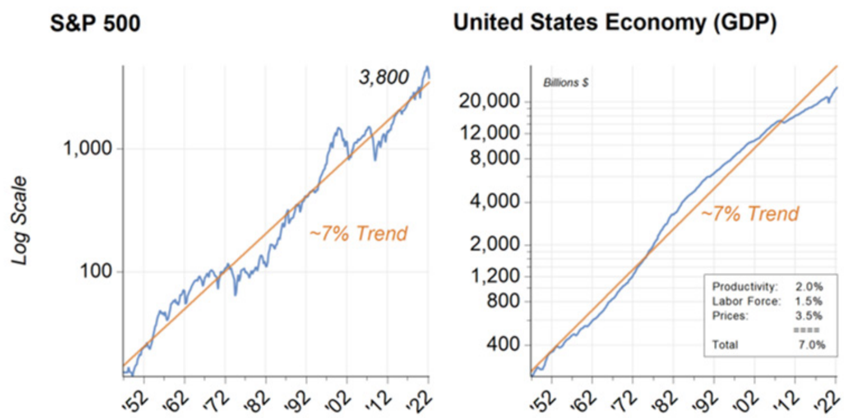


Chart B

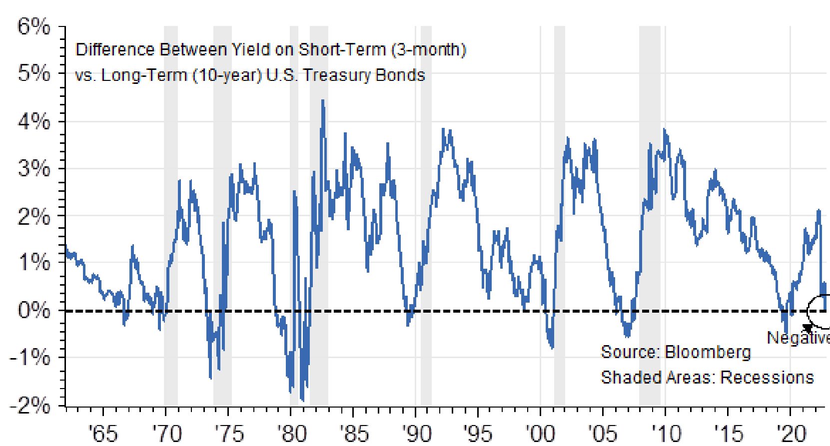
MONEY SUPPLY GROWTH (2-YEAR CHANGE IN M2)

Source: Bloomberg

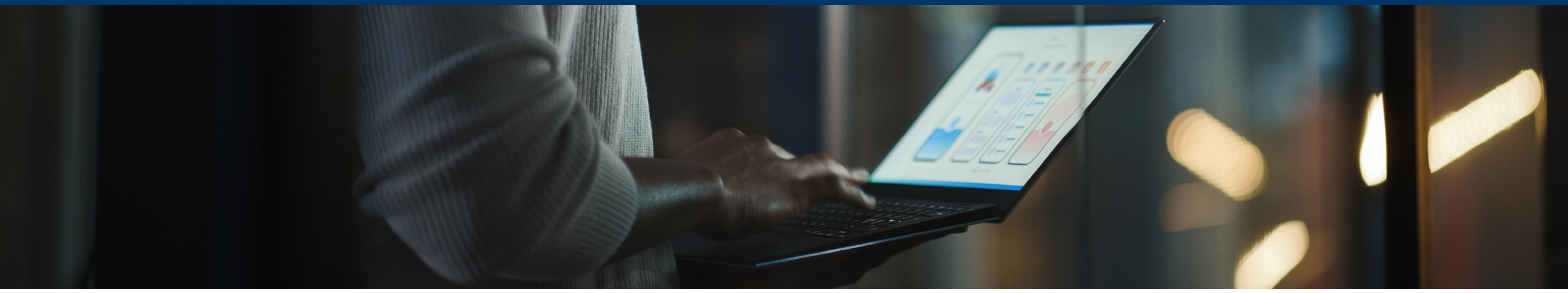
Chart C

YIELD CURVE TURNS NEGATIVE

Source: Bloomberg



CONCLUSION



Ultimately, we expect the current problems to resolve and give way to growth and positive returns, as we have seen in the past. Whether that turning point arrives soon or further off, we continue to recommend a focus on high-quality companies. If it turns out that inflation fades, the recession is avoided, and markets rally, we see no reason why higher-quality companies would not participate in a rally. On the other hand, if troubles continue or deepen from here, the market is likely to look for durable, flexible, and predictable companies.

WCA Fundamental Conditions Barometer Description: We regularly assess changes in fundamental conditions to help guide near-term asset allocation decisions. The analysis incorporates approximately 30 forward-looking indicators in categories ranging from Credit and Capital Markets to U.S. Economic Conditions and Foreign Conditions. From each category of data, we create three diffusion-style sub-indices that measure the trends in the underlying data. Sustained improvement that is spread across a wide variety of observations will produce index readings above 50 (potentially favoring stocks), while readings below 50 would indicate potential deterioration (potentially favoring bonds). The WCA Fundamental Conditions Index combines the three underlying categories into a single summary measure. This measure can be thought of as a "barometer" for changes in fundamental conditions.

WCA Quality Indices are based on Washington Crossing Advisors' quantitative analysis of firms along three dimensions: asset profitability, consistency, and leverage. Higher quality companies are defined as those which fall in the top quintile of largest-cap U.S. companies and tend to have higher average profitability, greater than normal consistency, and low leverage. Lower quality companies are defined as those which fall in the lowest quintile based on the same criteria. Indices are reconstituted annually, continuously rebalanced, and presented on a total return basis, as calculated by Bloomberg. Indices are unmanaged and do not represent performance of any actual portfolio or portfolio strategy offered by Washington Crossing Advisors, LLC.

Standard & Poor's 500 Index (S&P 500) is a capitalization-weighted index that is generally considered representative of the U.S. large capitalization market. S&P 500 Growth Index and S&P 500 Value Indices are designed to provide a comprehensive measure of global equity growth and value performance.
S&P High Beta Total Return Index is designed to measure the performance of the constituents of the S&P 500 that are most sensitive to changes in market returns.
S&P Low Beta Total Return Index is designed to measure the performance of the constituents of the S&P 500 that are least sensitive to changes in market returns.

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