The Longo Group

Source: Bloomberg 12/2022

Week of **January 9, 2023**

With Employment Strong, Fed is Set on "Higher for Longer"

Markets continue to struggle as employment data remains strong – a tenacious trend that gives the Fed agita.

When the FOMC minutes were released last week, we learned that all the governors remain staunch on their view that rates will not be cut in 2023 – and nearly all of them (17 out of 19) are forecasting the terminal rate above 5%. Ten of the Fed officials are forecasting 5.13%, five are at 5.40% and two say 5.63%. The minutes restate the Fed's concern about easing too soon and having inflation reaccelerate.

Data does show that inflation is peaking – which is good – but it's the labor market that needs to cool down in order for the Fed to get more comfortable about inflation's future. We believe that inflation expectations are anchored and that the market is expecting the Fed to be successful in its fight against inflation as 5-year breakeven yield has fallen sharply from 3.76% in April 2022 to 2.21% today.

A New Year's Data Gift

There were two bright spots in the data releases last week. First was last Friday's payroll report, revealing that wages came in better than expected, showing a year-over-year decline from 4.8% to 4.6%. But the report also indicated that the unemployment rate fell from 3.6% to 3.5%. We believe the Fed wants this number to go up and is targeting 5.0%. The second piece of good news came from the ISM Services Index, which fell below 50 into contraction territory at 49.6. So ISM Services now matches ISM Manufacturing which has a reading (48.4) consistent with recession readings below 50. ISM Services also had prices paid falling – which is a good sign that inflation is coming down. So data for both ISM goods and services is signaling an economic slowdown along with a possible peak in pricing.

We believe the S&P 500 is in the process of testing the October lows near 3500. An oversold rally to 4000 may occur in the near-term. The 2- and 10-year Treasuries could test their recent highs of 4.79% and 4.33%, respectively, but they may be in the process of trying to peak. The risk to both markets is that the Fed is calling for higher rates for longer than the market is pricing in. Current thinking in the market has pushed expectations for rate cuts to July; we don't believe the Fed is on the same page.

As we have been saying, as long as the Fed is raising interest rates, stocks and bonds will remain volatile.

We continue to expect that in 2023 we'll see an important bottom in the equity market and a peak for interest rates. This supports a 60/40 asset allocation model again. The risk to our call is higher rates for longer.

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Week of **January 9, 2023**

Dogs of the Dow Should be a 2023 Winner

The Dogs of the Dow is an annual strategy of buying equally the 10 highest yielding stocks in the Dow Jones Industrial Average (DJIA). In periods of market declines and volatility, this strategy has done well. Last year, the Dogs of the Dow was up 1.5% on a total return basis and on an absolute basis was down only 1.0%, clearly beating all the market averages in 2022. Since 2000, the Dogs of the Dow has outperformed the DJIA. The list of stocks this year are all high-quality companies with an average yield of 4.5%. The basket is not biased toward Growth but towards Value – which aligns with our thesis that Value will lead the next Bull. We believe this basket of stocks should again beat the market on a total return basis in 2023.

Dogs of the Dow	Ticker	Dividend Yield 12-30-22
Verizon Communications	VZ	6.62%
Dow	DOW	5.56%
Intel	INTC	5.52%
Walgreens Boots Alliance	WBA	5.14%
3M	MMM	4.97%
International Business Machines	IBM	4.68%
Amgen	AMGN	3.24%
Cisco Systems	CSCO	3.19%
Chevron	CVX	3.16%
JP Morgan Chase	JPM	2.98%
Average Yield		**4.5%**

Source: Dogsofthedow.com, 01/06/23

Inflation vs. Price-Earnings Multiples

Fundamentals drive stock prices, but inflation influences the price-earnings multiple that investors will put on the equity market. The chart below examines the S&P 500 price-earnings multiples versus ranges of inflation. The lower inflation the higher P/E; conversely, higher inflation leads to lower earnings multiples. We believe the market is likely to trade to a 16.5x-15x multiple (against an inflation range of 4%-6%). Using $213 for consensus earnings points to a range for the S&P 500 of 3500-3200, which also aligns with the important technical levels for the market.

Week Ahead

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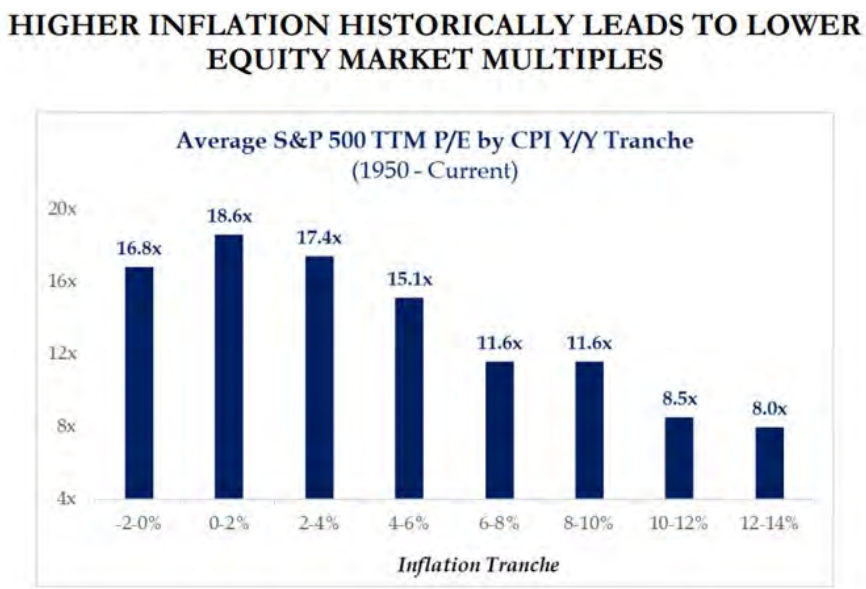

Source: Strategas, 01/2023

It's Earnings Season Again

This week officially starts earnings season, with all eyes on the bank stocks leading the charge. According to FactSet: "Despite concerns about a possible recession this year, analysts still expect the S&P 500 to report single-digit earnings growth in CY 2023. The estimated (year-over-year) earnings growth rate for CY 2023 is 5.5%, which is below the trailing 10-year average (annual) earnings growth rate of 8.5% (2012 – 2021)."

Reporting companies' comments and full-year outlooks will be crucial to how Wall Street analysts treat their earnings numbers for 2023. Many in the industry believe analysts have been too optimistic with their estimates and that they need to lower their earnings numbers. Should this occur, this would be another reason for stocks to remain under pressure in the near term.

Positioning

We will continue to beat the drum for Quality as long as the Fed is raising interest rates. As noted above, this is the time to shift to areas in Value while reducing exposure to Growth. Like the Dogs of the Dow strategy, there's going to be increased demand in Dividends as well as short-term U.S. Treasuries and, yes, cash. Continue to diversify into bonds staying in the 3–5-year range but prepare for longer duration assets once the Fed gets closer its peak terminal rate near 5%.

This Week

This is the week earnings season kicks off and sets the tone for 2023 earnings expectations.

Aside from earnings, the market (and the Fed) will be paying attention to the release of CPI data and, of course, jobless claims. One eye on the day's data, one eye on the future. Always. This is how we keep the ship steady as we move through troubled waters. Patiently.

Calendar

Mon.

11:00 a.m. NY Fed 1 & 5 year expectations
12:30 p.m. Atlanta Fed President speaks
3:00 p.m. Consumer credit
Earnings: Acuity Brands, AZZ, Commercial Metals, PriceSmart, Tilray, WD-40

Tue.

6:00 a.m. NFIB sma;;-business index
10:00 a.m. Wholesales inventories
Earnings: Albertsons, Bed Bath & Beyond

Wed.

None scheduled
Earnings: KB Home, Shaw Communications

Thu.

8:30 a.m. CPI, Initial & Continuing jobless claims
2:00 p.m. Federal budget
Earnings: Taiwan Semiconductor Manufacturing

Fri.

8:30 a.m. Import price index
10:00 a.m. UMich consumer sentiment index, 1 & 5 year consumer inflation expectations
Earnings: Delta Air Lines, JPMorgan Chase, UnitedHealth Group, Greenbrier, Bank of America, BlackRock, BNY Mellon, Citigroup, First Republic Bank, Wells Fargo

Source: MarketWatch/Kiplinger's