

November 22, 2022

A New Bull Market or a Bear Market Trap? – Alex Petrovic, CFP®

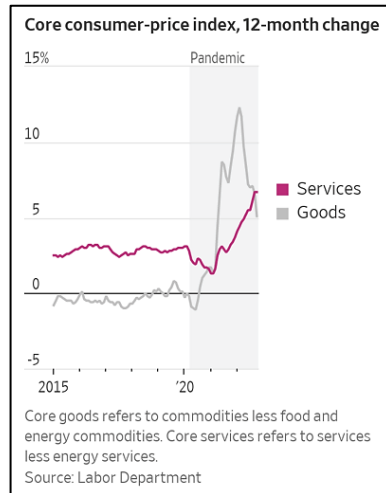
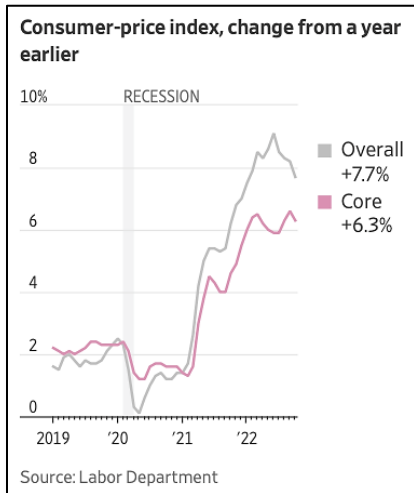


You may have noticed that my title of this quarter’s newsletter article is the same as last quarter’s title. The stock market, as measured by the S&P 500 Index made its first bottom in mid-June; it was down 22% YTD. The markets rallied strong in July and August (when I wrote the last newsletter), and the S&P 500 Index was only down 11% YTD.

Then September hit. Historically, September (not October as some think) is the worst month for the U.S. stock market, and oh boy it delivered. The S&P 500 Index made a new low, down 25% YTD. Then in October and so far in November, the stock market has made another substantial rally. As of mid-November, the S&P 500 Index is down about 17% YTD.

So... I repeat the same paragraph I wrote in August, and I still feel the same way.

While this (the stock market rally) is welcome, it begs the question... is the worst over in the stock and bond markets? Or is this a bear market trap that sucks investors into thinking we are now in a new bull market? I am not yet ready to say the ‘coast is clear’, and I still believe caution and patience is warranted.

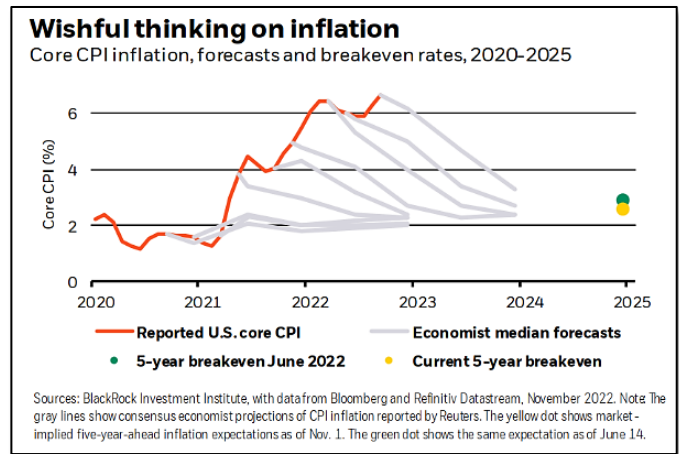


While the markets have cheered the lower-than-expected inflation report for October that was released on November 10, inflation is still nowhere close to the U.S. Federal Reserve’s stated inflation target of 2%.

Plus, as you can see in the second chart, while goods inflation has peaked and has come down substantially, the very tight labor market has caused higher inflation in the services sector of our economy.

So, what are the two biggest issues causing me, and many other investment professionals, to doubt the worst is behind us?

First, no one knows how long it will take for inflation to come down. The next chart shows how hard it has been to predict inflation. Economists' forecasts (in gray) have consistently predicted inflation moderating, yet inflation kept getting stronger. This is fundamental reason why many investment professionals, including me and the U.S. Federal Reserve, have been wrongfooted the past 12 months because most people assumed inflation would moderate and by extension the Fed wouldn't have to raise interest rates high and fast, which is what has happened.



The next point is really just an extension of the difficulty of predicting inflation... no one knows how high interest rates must go, and for how long, to bring inflation down to 2%. Now, there have been some encouraging signs domestic inflation is coming down: 1) goods inflation (e.g. used cars, lumber, industrial metals, etc.) has decelerated considerably and 2) the threat of a U.S. recession as caused many companies to reconsider hiring since a slowdown seems very possible, and this potentially eases rising labor costs.

Right now, the markets are predicting the Federal Reserve to increase interest rates to a high of 4.25% - 5.25%. However, if inflation proves to be more resilient, then the Fed may have increase rates well above 5%. This would most likely increase the risk of a recession and its severity.

The second main reason I believe we have not seen the bottom in stock prices is that there is still a decent chance of a recession in 2023. If so, this would most likely hurt corporate profits and stock prices.

The U.S. is forecast to enter a recession in the coming 12 months as the Federal Reserve battles to bring down persistently high inflation, the economy contracts and employers cut jobs in response, according to The Wall Street Journal's latest survey of economists. On average, economists put the probability of a recession in the next 12 months at 63%, up from 49% in July's survey. Economists' average forecasts suggest that they expect a recession to be relatively short-lived. Of the economists who see a greater than 50% chance of a recession in the next year, their average expectation for the length of a recession was eight months. The average postwar recession lasted 10.2 months.

Source: https://www.wsj.com/articles/economists-now-expect-a-recession-job-losses-by-next-year-11665859869?mod=hp_major_pos2#cxrecs_s

Some economists maintain that a "soft landing," whereby inflation subsides without a significant economic downturn, is possible, as the U.S. could navigate a "narrow path" to avoid a recession next year, Goldman Sachs analysts led by chief economist Jan Hatzius wrote in a note to clients on Monday.

Hatzius put the chances of a recession next year at only 35%, as opposed to 70% of economists and nearly 100% of company CEOs. In the note, Hatzius wrote that a "very plausible non recessionary" way forward for the economy could still play out, citing "durable" economic growth and a stabilizing job market.

Source: <https://fortune.com/2022/11/08/fed-unnecessarily-pushing-economy-into-recession-2023-ipmorgan/?showAdminBar=true>

Now, there is a chance we could dodge a recession, but given the strength of the labor market and how higher wages may be propelling inflation, this very well could mean the only way inflation comes down to 2% is because of a Federal Reserve induced recession that ultimately hits the labor market.

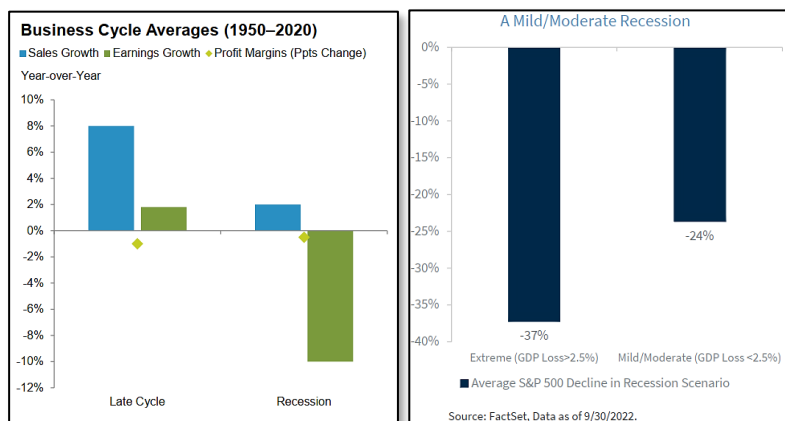
Stocks surged last week after the October core Consumer Price Index rose less than expected, stoking market hopes a Federal Reserve pause on rate hikes is nearer. That's optimistic, we (Blackrock Investments) think. Goods inflation is easing as it needed to, but the labor constraints driving wage

growth and core inflation persist. So the Fed is still on a path to create a recession via policy overtightening. Source: Blackrock Weekly Commentary 11/7/2022.

So, corporate profits are one of the most important drivers of the stock market, and what normally happens to corporate profits in a recession? They go down. See the left chart's green bars.

So, the multi-trillion-dollar question for the stock market is, how much bad news is already priced into stocks?

As you can see from the chart on the right, since 1945 the S&P 500 Index has fallen on average 24% during mild/moderate recessions. We were down 25% back in September. Some professionals argue that most of the bad news is already priced into U.S. stocks, and that if a recession occurs and corporate profits fall, the market probably won't go much lower. If inflation starts to come down quickly, we dodge a recession and corporate profits don't take a hit, then I agree. However, I am not ready to say "the coast is clear" regarding sticky inflation, a recession and a drop in profits.



So, I admit I am not very optimistic in the near-term. My best guess is that we will see a bottom in the stock market sometime in 2023. As was mentioned in my last newsletter... "Earlier this year, Goldman Sachs Group Inc. research found the stock market had fallen at least 15% on 17 occasions going back to 1950. In 11 of those instances, the market only hit its trough around the time the Fed started easing monetary policy (AKA interest rates started to go down)."

So far, we don't see any major cracks in the global financial system that would cause the economy and/or markets to suffer a severe setback. At this time, we are expecting a potential recession to be fairly 'vanilla' and mild to moderate.

In conclusion, near-term we still believe caution and patience is warranted. Longer-term we are optimistic about the U.S. economy, corporate America, and the stock market. There are many U.S. and global challenges, but the U.S. and corporate America is in a strong position, and we advise clients to continue to 'hold on tight' as we ride the stock market roller coaster together. The stock market has paid off over the long-term, and we believe this will be the case in the future.

Let's do the numbers – Jim Stoutenborough, CFP®

- October provided some positive returns, and in some cases very positive returns for the stock funds but stocks are still down for the year. Even with large company stocks popping 8.1% in October, the S&P 500 is down (-17.7%) for the year. The Russell 2000 Index (small U.S. companies) had the highest gains in October up 11% the last 31 days ending Halloween, but the index was still in the negative for the year at (-19.1%). The international index showed some life up 5.5% for the month but, the MSCI World ex US, ended up down (-22.2%) with two months to go in the year.



- Our bond funds were either trading water or down slightly in October. The U.S. Aggregate Bond Index (quality U.S. corporate and gov't bonds – these are bonds that are all rated investment grade which means there is very little chance that the bond holder will not get his money back) down (-1.3%) for October and coming in at (-15.7%) for the year. Much of this explained by the continued rise in interest rates that started with the 10-year treasury at 1.53% on New Year's and ending on Halloween at 4.08%.

Asset Class	Index/Category	Thru 10/31	2021	2020
Cash and cash alternatives	Average 1-yr CD Rate	1.10%**	0.14%**	0.21%**
U.S. Bonds	Barclays US Aggregate Bond Index	-16%	-1.5%	8%
U.S. Large Companies	S&P 500 Index	-18%	29%	18%
U.S Small Companies	Russell 2000 Index	-19%	15%	20%
International Stock Market	MSCI World ex US NR USD	-22%	13%	8%

Numbers come from Morningstar, Raymond James and **Bankrate.com

2023 IRS Increases – Bryson Slater, CFP®



Inflation is not the only thing on the rise! Many of the thresholds and limits governed by the tax code are also tied to inflation. This is designed to prevent inflation from causing an increase in taxes. The higher the reported inflation, the higher the tax code adjustments.

Effective for the 2023 tax year (taxes filed in early 2024), we will see a significant bump in many of these figures. Income tax brackets will be increased by 7% across the board. The income at which people are phased out of making IRA contributions has also increased. Social Security benefits will receive an 8.7% boost. See the chart below for some of the other adjustments.

There are a few items that will not be adjusted upwards to account for the inflation. For instance, the Child Tax Credit (\$2,000), Deduction for Capital Losses (\$3,000), and the State and Local Itemized Tax Deductions (\$10,000) are among the tax code figures that remain unchanged.

	2022	2023
Retirement Plan Contributions		
401(k), 403(b), 457, TSPs	\$20,500	\$22,500
Catchup Contribution	\$6,500	\$7,500
IRA and Roth IRA	\$6,000	\$6,500
SEP IRA	\$61,000	\$66,000
SIMPLE IRA	\$14,000	\$15,500
Standard Deduction		
Married	\$12,950	\$27,700
Single	\$25,900	\$13,850
Miscellaneous		
HSA - Individual	\$3,650	\$3,850
HSA - Family	\$7,300	\$7,750
Healthcare FSA	\$2,850	\$3,050
Annual Gift Tax Exclusion	\$16,000	\$17,000
Social Security Payroll Tax	\$147,000	\$160,200

Spend Your FSA - Bryson Slater, CFP®

Many clients utilize a tax-advantaged Flexible Spending Account (FSA). You can have a few different types of FSAs: a Health Care FSA, a Limited Expense Healthcare FSA, and a Dependent Care FSA. Each variation of the account can allow you to pay for unique expenses for you, your spouse, or your dependents. Unlike a Health Savings Account (HSA), the balance in an FSA must be liquidated each year. Congress waived this requirement in 2020 and 2021 due to many people delaying healthcare and/or not needing dependent care during the pandemic. Participants were able to carry over the balance from 2020 into 2021 and again into 2022. However, that carryover allowance is no longer in place. FSA balances must be disbursed according to the standard rules going forward.

Many Health Care FSAs and Dependent Care FSAs allow a 2.5 month grace period to spend down the prior year's balance. This effectively extends the spending deadline to March 15th. However, we recommend you confirm your plan's grace period with your provider if you intend on carrying a balance into the 2023 calendar year.

Health Care FSAs are a useful tool that allows individuals to pay for out-of-pocket medical expenses, including everything from copays and doctor's appointment deductibles to Tylenol and Advil. The IRS determines which expenses can be reimbursed by an FSA. For a comprehensive list of Health Care and Dependent care FSAs, please visit <https://www.fsafeds.com/support/eligibleexpenses>.

Inside & Outside of PFS

Alex Petrovic - Winter has arrived in Kansas City, but what a wonderful autumn it was! I still can't believe 2022 is almost over! Time flies! Thankfully, the KC Chiefs are in a good position so far this year, minus the recent injuries. Fingers crossed as the Chiefs enter the final stage of the season. Plus, it's World Cup soccer time! Go USA!

Our family has had a nice fall. Both, Dasha and I, have been very busy at work, but we have been good about not trying to do too much most evenings and weekends. Though Dasha and I look forward to having more time to hang out with friends and take adventures, we cherish this time with the boys.

Ben has had a good start to 1st grade, and it's hard to believe it's almost halfway done! He is reading and writing ahead of schedule, along with his math skills. Ben recently took up indoor rock climbing. He embraced it right away and is enjoying the challenge. Normally, Ben is cautious by nature, so Dasha and I were happy with how he embraced climbing, and more importantly, wasn't as concerned about making mistakes or failing. Ben reminds me of myself at his age. Lastly, Ben has been a very good big brother. Though not perfect of course, we are quite pleased how well the kids get along... so far. 😊 The jammies in this picture are from the 1993 movie *The Nightmare Before Christmas*, one of Ben's favorite Christmas movies. Though it's a little scary at times, it's a cute holiday movie.



Little Alex is a cute, cheeky little sponge. He said his first sentence this month, and he loves to read with all of us, including Ben. He got his first haircut, and now looks more like a little boy. He still has his soft blond hair though, which I love. One of my favorite things is a sweet little Alex sitting on my lap, while I kiss his soft head. On the flip side, his toddler stubbornness and tantrums (expected of course) are occasionally epic. This is for sure payback for me being an occasionally difficult child. 😊

Our family trip this fall was back in early October when we went to the San Diego area (more specifically, Encinitas, a bit north of San Diego) for a week to see some long-time friends and hang out and relax with the kids. Ben and I visited back in May, but in the summer, we decided a trip to SoCal in early fall was a good idea for all of us.

Our friends George and Leslie were extremely hospitable to all of us. We added four more to their normal household of five! Unfortunately, we were a little late for warm ocean water. However, the weather overall was nice, and we visited La Jolla, the San Diego Zoo (the picture to the right) and the Birch Aquarium at Scripps Institution of Oceanography. Ben got to enjoy Legoland with Dasha this time around. I took Ben back in May, and he REALLY (of course) wanted to go again. I am happy Dasha and Ben had a great time together, a fun mother-son day!



We hope all of you enjoy the upcoming holidays! We remember those we have lost, and we cherish our family, friends and faiths! It's a time for remembrance, celebration, and hopefully some relaxation too.

Bryson Slater - These past few weeks have been extra busy as I have encountered a couple of different life events! For the first time in my life, I moved to a new state... Kansas. Previously, a lifelong Missouri resident and graduate of Mizzou, I didn't think I'd ever see the day. After 10 post-college years of jumping from Westport, to mid-town, to the Plaza, and finally to West Plaza, I am still getting acclimated to the lack of drifters and debris in the streets on this side of the state line. However, I think I'll survive!

I moved in with my girlfriend, Maggie, and her vicious guard dog, Burt. Burt is a masculine 10lb Shih Poo. To add fuel to the fire, we also had the bright idea of adopting an additional furry 4-legged friend. Enter Bruce! Bruce is a hefty 19lb Shih Apso. The four of us are nestled in Fairway, Kansas, and I couldn't be happier!

Marsy Gordon – The last few months have included some amazingly beautiful fall weather, and I hope you have been able to enjoy it. As of this writing, it looks like winter is on its way. It has been a busy time at the office, and at home. Now I am looking forward to spending some quality time during the Thanksgiving season with my family. All of my kids and their families will be at our house for Thanksgiving dinner, and we have planned time to get together with extended family as well. I send my best wishes that you have wonderful experiences for all the upcoming holidays.

Dana Dell – Hello everyone! Can you believe 2022 is almost over? This year flew by. I guess what they say is true...time flies when you're having fun! It has almost been a year for me here at Petrovic Financial. I am so happy I have gotten the pleasure to speak with almost everyone.

In my opinion Fall is the most beautiful time of year. I love the beautiful colors and the cooler, sweater weather. And knowing Christmas is around the corner makes me so happy.

My family will be starting the holiday season in Baldwin City. This year I'm taking my whole family on the Snow Globe Express. I'm sure it will be even more fun than when I took just the kids on the Polar Express a few years ago. I love trains and Santa Clause! It's a magical time of year!!!

Hope everyone finds something fun to do for the holidays. Keep your family close and make sure you tell them you love them every chance you get.

I hope everyone has a very Merry Christmas and a Happy New Year!!! 2023!!!

Jim Stoutenborough – Not much has been going on so I will give you a Milken update. It's hard to believe it's been almost 3½ years since we brought him home from Wayside Waifs. He is a typical cat going through periods of affection and aloofness. He prefers having someone in the apartment with him even though that doesn't mean he wants to hang with me. But when he sees me leaving for work and knowing he'll be alone for awhile he'll run between me and the door and demand some attention before I leave. It's the same routine in reverse when I come home immediately demanding love, food and play in that order.

He has also decided that the footstool in the living room is his and will from time to time defend it with extreme prejudice. He enjoys looking out the screened patio door or window screen at the occasional bird or squirrel making this growling cackle noise. This along with the athleticism he displays during playtime reminds me that he shares a lot of DNA with his larger relatives in the wild.

He has his meal routine of breakfast, lunch, dinner, and night-time snack. I do breakfast and dinner and my daughter handles lunch and the night-time snack. One night my daughter was on vacation with her mom and I forgot to give him his night-time snack – only to be reminded at 1:30 in the morning waking up to a meowing Milken staring directly at me an inch from my face demanding food.

It's official though that he does like my daughter better than me. I am okay with that. They did have a bit of a rocky start with him chewing through a cord on one of her electrical devices in the first week and her getting used to the cat attitude after having only dogs all her life. They have developed a kind of unique bond, with him sleeping outside her door most nights waiting for her to get up. Sometimes when I come home on those rare days when she isn't with me, he'll look past me as I'm coming in looking for her.

All in all, the last 3½ years with my “furry bro” have been great and enjoyable with Milken's unique personality and those times when he is not on his best behavior is more than compensated for those times when he is “purr-fect”.

Jeannine Shaffer - Evidently, some people thought I was no longer working since I did not have a note in the last quarterly newsletter. As they say, all work and no play make Jack a dull boy. Actually, coming to work every day is what keeps me sane. I took a day off last week and didn't know what to do. Also, my husband works from home, so if I was there, he would be asking me to help him.

There is always some home improvement project we are working on. The family room project is finally done, so we will hopefully begin replacing a bathroom floor next. Several years ago, I thought putting a pebble floor in the bathroom would be like a foot massage. It is not!

Marilyn Brohm – I've had a tough fall in more ways than one. I was taking my big poodle, Brownie, to a new dog park and wasn't paying attention when he jumped at another dog and flipped me. I landed squarely on my left hip. After a stay in the hospital, I've been working from home. I'm getting better each day and can walk around the house without aid, but still use a cane when I go out. I felt pretty sorry for myself for a while, but realize, it could have been much worse and I'm thankful for my great friends and family!