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ICON Insights

Market Commentary - December 2022

By Craig Callahan, DBA | ICON Founder & President **Published 12'2'2022**

Equities

If you follow financial news, you have probably noticed some themes, patterns, and reversals of opinions. Most of the speculation is focused on the Federal Reserve (Fed) and how high it will need to take the rate on Federal Funds and how long it will keep it at that level. On November 30, 2022, data was released that showed inflation at a level less than expected. The S&P 1500 gained over 3% that day on very heavy trading volume. The speculative reasoning behind the advance was that the Fed would not have to take the Federal Funds rate as high, or keep it there as long as previously anticipated, perhaps avoiding a recession. Two days later a jobs report showed hiring and a strong labor market, so the speculators did a 180-degree reversal. The S&P 1500 opened down over 1% as investors reasoned the Fed policy might have to go tighter and longer than was hoped after the inflation data was released two days earlier.

The S&P 1500 Index gained 5.58% in November of this year, extending its advance off the short-term low of October 12 to 14.37% through November 30. We believe the driving force behind this advance is the speculation that the Fed will not need to take the Federal Funds rate as high, or keep it there as long, as feared over the summer and early fall. There is additional supportive conjecture that the Fed might "pivot," as it has been labeled, and even reduce its Federal Funds target rate (ease) in 2023.

We have not joined in on this game of "Fed guessing." We focus on value and look for behaviors and conditions that usually occur at market bottoms and the beginning of new bull markets. As for value, the ICON market Value/Price (V/P) ratio entered December 2022, at 1.05 – meaning stock prices, on average, are slightly below our estimate of fair value. We therefore do not see the need for stock prices to plunge, but major market bottoms usually have stocks priced at a deeper discount to fair value. It wouldn't take much to get to those deeper discount levels; a continued drop in the yield on the ten-year Treasury combined with a modest sell off in stocks could do it. In such a setting, we would expect other supportive conditions to fall in place. As we are not there yet, we continue to be comfortable holding much higher than normal levels of cash.

Bonds

We have been writing about the potential for short-term and long-term interest rates to become decoupled. In other words when the Fed begins tightening, short- and long-term rates move higher in tandem. There becomes a point, however, when investors expect that the tightening will slow the economy and reduce inflation. Then, while the Fed may continue to raise short term interest rates, longer term rates drop. Since the peak in the 10-year Treasury on October 24, its yield has dropped from 4.24% to under 3.60% while the yield on the 13-week Treasury Bill has increased from 4.03% to 4.43%. It is too early to tell if this trend will continue, but in the short run, at least, it seems to signal that investors expect a significant reduction in inflation over the next year or two.

Summary

It would be very unusual for the stock market to find a bottom and begin a new bull market before the Fed is even done raising the Federal Funds rate. It seems risky to bet on the "pivot" scenario while the Fed is still raising raising the Federal Funds rate. We remain content holding more cash than normal while we wait for better values and more of the conditions and behaviors that usually accompany outstanding buying opportunities.

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ICON's value-based investing model is an analytical, quantitative approach to investing that employs various factors, including projected earnings growth estimates and bond yields, in an effort to determine whether securities are over- or underpriced relative to ICON's estimates of their intrinsic value. ICON's value approach involves forward-looking statements and assumptions based on judgments and projections that are neither predictive nor guarantees of future results. Value readings are contingent on several variables including, without limitation, earnings, growth estimates, interest rates and overall market conditions. Although valuation readings serve as guidelines for our investment decisions, we retain the discretion to buy and sell securities that fall beyond these guidelines as needed. Value investing involves risks and uncertainties and does not guarantee better performance or lower costs than other investment methodologies.

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The unmanaged Standard & Poor's Composite 1500 (S&P 1500) Index is a broad-based capitalization-weighted index comprising 1,500 stocks of Large-cap, Mid-cap, and Small-cap U.S. companies.

Federal Funds: In the United States, the federal funds rate is the interest rate at which private depository institutions (mostly banks) lend (federal funds) at the Federal Reserve to other depository institutions, usually overnight. Changing the target rate is one form of open market operations that the Chairman of the Federal Reserve uses to regulate the supply of money in the U.S. economy.

The 10-year yield is the benchmark 10-year yield to maturity reflected by the current issue 10 year U.S. Treasury note. A 13-Week Treasury bill (T-Bill) is a short-term debt obligation backed by the Treasury Dept. of the U.S. government with a maturity of less than one year.

Sources: Bloomberg

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8480 E Orchard Road, Suite 1200
Greenwood Village, CO 80111
1-800-828-4881 • ICONAdvisers.com