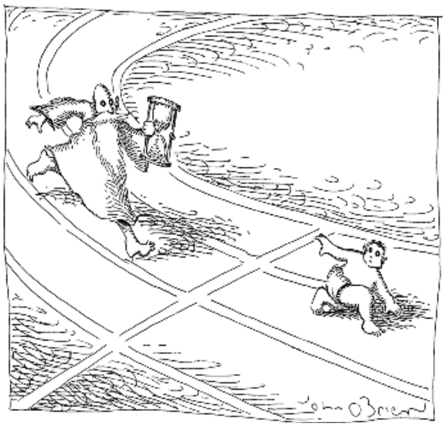
MONTAG

CELEBRATING 40 YEARS 1982-2022

Viewpoints

FOURTH QUARTER 2022



John O'Brien/CartoonStock—Used by permission

WELCOME

Another New Year has begun, closing the chapter that was 2022 — the year that marked the 40th anniversary of our founding — in the history books. Like the three quarters that preceded it, 2022's 4th quarter was anything but dull. At MONTAG, new quarters bring about many closing and reporting activities. Calendars fill with client meetings and visits. Year-end reporting takes on special importance too, as tax season looms. Suffice it to say things are pretty busy around here.

Speaking of "around here" and "new quarters", MONTAG has relocated its office! December saw us packing up the office formerly located at the Georgia-Pacific Center downtown and our subsequent relocation to new offices at the Galleria Center, northwest of town. Our first official day in the new office was Tuesday, January 3rd.

Please note our new address, and we look forward to your next visit when you can see our new home first-hand. Meanwhile, we hope you enjoy our latest edition of *Viewpoints*. M

Inside This Issue

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Visit us at montagwealth.com

200 Galleria Parkway
Suite 1450
Atlanta, GA 30339

404.522.5774

January 9, 2023

MARKET OBSERVATIONS — *Chris Guinther, Senior Investment Strategist*

Let's begin by noting the 2022 fourth quarter's market numbers, and those for the year in full, as of December 31:

	Q4 2022	2022
S&P 500	7.6%	– 18.1%
DJIA	16.0%	– 6.9%
NASDAQ	– 0.8%	– 32.5%

As these numbers make plain, 2022 saw poor performance in most sectors with the exception of energy and some industries within the materials sector. The good news is the 2022 bear market in both fixed income (bonds down 13%) and equities (S&P 500 down 18%) has meaningfully improved return expectations going forward. We still see a variety of challenges ahead for 2023, including rising interest rates, high inflation, falling earnings expectations and a generally struggling global economy.

The FED and Economic Growth

Economic growth continues to slow and a recession is still likely. A year ago, the FED influenced recovery following the pandemic-induced recession, pushed the economy into a position of excess demand and generally made for a good economy. But now the backdrop is changing as headwinds have intensified as a result of tighter monetary policy with higher interest rates to battle inflation and reduced fiscal stimulus by the government. We continue to look for more deceleration in economic growth in 2023, with all developed economies likely slipping into recession around the world. Our forecast anticipates that global GDP will expand by around 2% in 2023, which is less than a third of 2021's GDP growth rate, and about half of the 2022 rate. That said, a few economic indicators have shown more resilience in the past few months, suggesting that the probability and expected depth of a recession might be lower than we initially feared. Should a recession materialize, we expect it to be of just middling depth at this time, as we don't see the significant bubbles which proceeded other major economic peaks like in 2000 and 2008. A moderate recovery could take hold toward the end of 2023 if inventory levels continue to improve, supply chains normalize, labor costs cool and inflation stabilizes or even falls.

Continued on page 2

MARKET OBSERVATIONS *continued from page 1*

Inflation—Inflation continues to fall from extremely high levels in August, which will likely cap interest rates. The four main drivers that pushed inflation to multi-decade highs are all reversing course. Supply-chain problems have faded, commodity prices have declined, monetary stimulus has turned to tightening and fiscal stimulus has been reduced. For these reasons, we expect inflation to continue to drift down from the August high of 9.1%. We recognize, however, that other factors may slow its descent. Labor markets remain especially tight, the breadth of the inflation shock may make high prices stickier, and the shelter component of CPI only changes/improves slowly. It could take even longer for inflation in the Eurozone and U.K. to come down given the region's unique challenges, mainly weaker currencies, and energy shortages.

Central Banks — Central banks are approaching the tightening/raising finish line which will cap interest rates. The quantity of monetary tightening delivered to tame extremely high inflation has been massive across the world. U.S. policy rates are already around 4 percentage points higher after less than a year of increases. But the rate-hiking cycle is starting to slow outside North America and Europe as inflation begins to ease. Some emerging-market countries have ended their rate hikes and the pace of tightening is mostly decelerating elsewhere. The U.S. fed funds rate is expected to peak near 5%, compared with a starting point of about 0% at the start of this year. This is double the "neutral policy rate" – that which neither stimulates nor restricts growth. But most of the hard work has been done and there is a possibility that policy rates in developed markets start to decline over the second half of 2023 if inflation cooperates and growth slows.

Stock Valuation — Exceedingly high asset and stock valuation risks are diminished but earnings remain vulnerable to falling. Equity markets stabilized in the past quarter but, even with the recent bounce, still finished the year with significant losses. The good news for investors is that stocks are now much more reasonably priced than they were at the start of 2022. The recent bear market pulled most equity market valuations back towards long term average price/earnings ratio for the first time since March 2020 and could temper some of the downside risk. Should we enter a recession, and have earnings decline, stock prices could also resume their decline. Many analysts have already begun downgrading their profit forecasts for S&P 500 Index companies ahead of a potential recession, but the downward revisions have been small so far. We think these estimates are vulnerable to further downside given that earnings are still above their long-term trend and companies are facing headwinds from rising costs and slowing demand. In this environment, stock gains could be limited in the near term absent evidence that the economy is headed for a soft landing.

Conclusion — We continue to position relatively conservatively for a wide range of possible outcomes. Given the unprecedented inflation and withdrawal of stimulus, we recognize that uncertainty is elevated and that there is a wide range of potential outcomes for the economy and financial markets. That said, we note that bonds, at today's higher yields, offer more ballast in a balanced portfolio should the economy enter a downturn. We believe a cautious approach to risk taking remains appropriate in this environment. We know there is a lot of uncertainty in the world and in the markets, but your team at MONTAG will continue to monitor the ever-changing dynamics and actively adjust client portfolios to reflect the market conditions relative to each client's investment objectives.

Chris Guinther is Senior Investment Strategist & Portfolio Manager

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LET'S GET <u>REAL</u> *– Ned Montag, CEO*

The year 2022 was extremely difficult for investors, and all the major stock and bond market averages posted double digit price declines. In the case of stocks, almost all the name-brand averages were down about 20%. This wipe-out occurred as the Fed battled inflation with an unprecedented series of large interest rate hikes. The last time we saw a sustained period of stress on both stock and bond prices from persistent inflation was the 1970s, and that decade was characterized by positive returns only from interest and dividends, with price declines in bonds and topsy turvy swings in stocks.

As is evident, the prediction business is hazardous and very prone to error, particularly for periods as short as a year. So, as usual, we will avoid predicting stock and bond market behavior in 2023. However, there is an economic ratio that has signaled either opportunity or danger over the past 100 years, with nearly infallible reliability. That ratio is the relationship of interest rates to inflation, termed the "real rate of

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DID YOU KNOW?

In 2023, Chinese New Year will fall on **Sunday, January 22nd, 2023**. As a public holiday, Chinese citizens are given 7 days off from work from January 21st to January 27th in 2023.

Each New Year is associated with one of the 12 animals of the Chinese Zodiac. What animal sign will be associated with Chinese New Year 2023?

A. Dragon
B. Rabbit
C. Snake
D. Horse

(Answer on Page 4)

"The point is that we look towards 2023 with a different perspective than 2022."

DIVIDENDS, STOCK RETURNS, and INFLATION — *John Montag, CIO*

When I joined the firm back in 1995, cash provided a 5% yield. Think about that for one moment: if you did nothing except let cash sit in your portfolio, you satisfied the typical spending policy for an endowment, 5%.

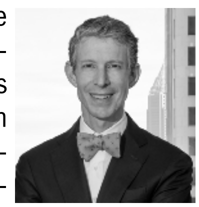
Concurrently, many clients looked towards their bond income ("interest") as the primary source for spending. Stock income ("dividends") was an additional benefit and the growth in stocks ("price appreciation") that much more cushion. At the time Dad often showed a chart to clients similar to the one below. It shows that dividends were a significant percentage of the stock market growth from the 1920s through the 1990s.

The left side of this chart shows a dark blue line, meaning a large part of stock returns came from dividends. During the past two decades, however, this changed and the dark blue portion became that much smaller. For thought since 2013 interest rates fell below 4% and the stock market appreciated considerably, meaning the dividend yield declined as well. In other words, the aforementioned 5% ("just by doing nothing") went closer to 1-2% depending upon the portfolio. Investors who make regular withdrawals from their portfolios needed to think differently.

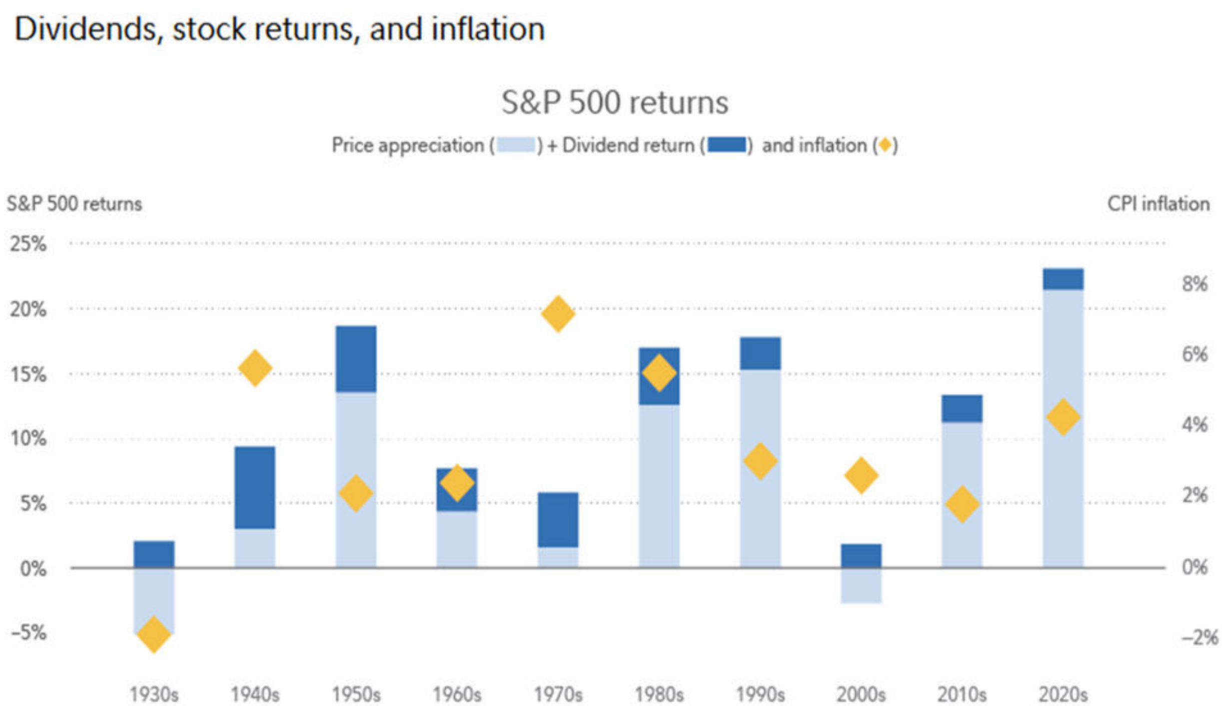
Fast forward to 2022, a year in which it has been a mess across all returns. ("mess" being a technical term here...) Currency and commodity investors have benefited, but everyone else has suffered. Concurrently interest rates have risen back to above 4%, a seismic shift.

Where does this leave investors with respect to opportunity? Oddly, that rise means that cash is finally doing something again. Remarkably, when we review portfolios now- as compared to the past decade – it appears that doing nothing once again could generate income, while sidestepping market volatility and a potential long-term recovery.

The point here is that we look towards 2023 with a different perspective than 2022. With that in mind I encourage you to contact your portfolio manager to discuss whether the information above should be incorporated into your conversation. M



John Montag is President & Chief Investment Officer



Source: Bloomberg Financial L.P., Morningstar, and Fidelity Investments, as of 7/31/22.

LET'S GET REAL *continued from page 2*

interest" or "real yield." If interest rates exceed the rate of inflation, the "real yield" is positive, and positive real yields have signaled better times ahead with remarkable accuracy. If inflation exceeds interest rates, the real yield is negative and a sign of likely future stress in the economy and the markets. Currently, Ned Davis Research calculates the real rate on 10-year Treasury bonds at negative 3%, signaling that investors should remain cautious. However, negative 3% is a big improvement over the negative 6% real yield at the start of 2022, and the trends in rates (upward) and inflation (down) suggest that real yields could be positive before the end of 2023, which would be a very hopeful sign.

Probably a big reason that real yield readings are a good clue to stock market direction is that positive real yields tend to develop in times of economic stress, when inflation and the economy are contracting. By such time, the stock market has usually bottomed out. Conversely, when inflation is in a strong uptrend, so too are business earnings, and stock prices may have risen too far on an unrealistic belief that good times will last indefinitely, even as the Federal Reserve prepares to slow the economy.

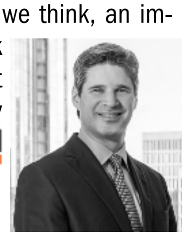
Remarkably, every major bull market in stocks over the past 100 years either initiated or was propelled in its early stages by notably high levels of real rates. Every single time. The nearly 500% advance from 1920 until the fall of 1929 started with real rates at positive 7.6%. The long bull market stretching from 1949 until 1965 started with a real rate at positive 3%, and the return on stocks over this long period was 700%. The 17-year bull market that kicked off in 1982 began with a massively high real rate of positive 12%, as Fed Chairman Paul Volcker hiked short-term rates into the mid-teens to crush a runaway inflation. During the next 17 years, the Dow Jones Industrials rose from 800 to 11,000.

In contrast, negative real yields were already in place during the sharp bear markets of 1973-74, 1978-1981 and just prior to the financial system crack-up in 2008. The stock and bond markets are influenced by many factors, but the level of real yields at any moment can be a good signal of risk or opportunity.

The onset of the COVID pandemic has prompted a structural shrinkage in the labor forces of the major Western economies, including the U.S. This development caught the Federal Reserve flatfooted. The same occurred with our European and Japanese counterparts. (Like we said, the prediction business is tough.) As a result, the U.S. Fed, the Bank of England, the European Central Bank and the Bank of Japan are all raising rates rapidly in an effort to weaken consumer demand and bring demand and supply back into balance. Whether curtailing excess spending is going to solve the structural shortage of workers in the Western world is, at best, debatable. And the investment world watches monthly labor statistics closely.

If the labor movement, after spending four decades in retreat, regains its bargaining power with employers, the Fed may have to remain in a rate hiking mode longer than some investors anticipate. And getting rates high enough to influence the cost of labor, as well as the cost of goods and services, may take time. The stock and bond markets may remain on the defensive in the meantime.

As stated, we are not in the prediction business, but we are in the analysis business. Tracking when rates become high enough to begin taming inflation will be, we think, an important clue to when the stock and bond markets will be set up for new bull markets. Stay tuned and welcome to 2023!



Ned Montag is CEO

DID YOU KNOW? *(from page 3)*

ANSWER: "B: Rabbit"

Answers Dragon, Snake, and Horse are the animals for Chinese New Years in 2024, 2025, and 2026, respectively.

The specific date is decided by the Chinese Lunar Calendar, which is based on the cycles of the moon and sun and is generally 21–51 days behind the Gregorian (internationally-used) calendar. While the date of Chinese New Year changes every year, it always falls between January 21st and February 20th. The day of Chinese New Year is a new moon day, usually the second after the winter solstice.

Offices, banks, factories, shops, and most non-essential services in China will close doors for a week's holiday. Hotels and large retail outlets stay open and may even be busier than usual! School holidays are four weeks long and migrant workers abandon their factory and construction jobs for weeks to return home.

Source: Chinahighlights.com

A PARTING THOUGHT

"Every new beginning comes from some other beginning's end."

Seneca (65AD)

"Closing Time", Semisonic (1998)

MONTAG

200 Galleria Parkway
Suite 1450
Atlanta, Georgia 30339
404.522.5774
montagwealth.com
inquiry@montagwealth.com

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