The Quarterly Perspective

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ABOUT

Harman Wealth Management

At Harman Wealth Management, we provide private, advanced, independent planning and investment management to individuals, families, and institutional clients.

We value in-depth economic research, evidence-based investment methods, and rigorous risk management. We are committed to insightful, objective solutions, and always working solely for the best interest of our clients.

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Looking into 2023 and Surveying Silver Linings

After a rough 2022, progress on inflation, interest rates offer hope for 2023

First things first, 2022 was a stinker for markets – both stocks and bonds. By September, nearly all major U.S. stock indices suffered through some degree of a bear market. Many continue to wobble. Likewise, with interest rates rising at a pace not seen in 40 years, major bond categories offered little portfolio assistance as they, too, saw the steepest pullback in years.

With sentiment battered and bruised, it is perhaps timely to remind investors that storms (even in markets) do eventually pass.

Looking back, 2022 will likely be characterized as a year of painful transition. It will mark the end of suppressed, ultra-low interest rates and a return to the old normal in interest rates. Instead of raising rates over an orderly, multi-year process, high inflation forced the Fed's hand and necessitated the fastest pace of rate hikes seen in forty years. Combined, stubborn inflation and rapidly rising interest rates were difficult for investors to digest.

Clearly, bad years are never easy to go through, but in light of it all, silver linings are starting to emerge. Consider the following:

Inflation Growth has Peaked.

The most common metric for gauging inflation, the Consumer Price Index (CPI), measures the annual pace of change. In June, CPI peaked at an annual change of 9.1% and has progressively declined since.[1] Over the last five months, underlying data has provided reason for optimism that the declines will persist well into 2023.

Interest Rate Increases are Nearly Over.

The grave uncertainty clouding 2022 about how far the Fed would increase interest rates is nearing an end. Declining inflation will likely lead the Fed to deliver its final interest rate hike sometime in early 2023. Already, the Fed says they are targeting 5.25%, a spot they can easily arrive at by March.[2] If this materializes, then the Fed is nearly 90% of the way through its rate-hiking cycle.

Bonds are Poised for Better Forward Returns.

Rapid moves in interest rates led bond funds to suffer through one of their worst single years in memory. The silver lining, though, is this was likely a one-off event related to the Fed's hasty maneuvering. With inflation trending down and the Fed's soon-to-be pause on interest rates, many bond categories appear oversold. Furthermore, the single biggest factor for future returns, the starting yields, are at the highest levels since 2009.[3]

The Economy has been Extraordinarily Resilient.

With 40-year highs in inflation and a forceful pivot in monetary policy, few would have predicted the economy would still be standing as resilient as it has. Yet, here we are. After stumbling in the first two quarters of 2022, real GDP is on pace to grow at an annualized 3.4% in the back half of 2022.[4] Supporting that growth is a labor market which continues to add jobs at a remarkable pace. Even with the economy slowing down, 2022 is expected to record the second-highest year of job growth in U.S. history.[5]

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What Does it Mean for Investors?

Years such as 2022 remind investors that long-term investing success is never simple and rarely easy. Since 1957, for any given ten-year period in U.S. large-cap stocks (through the S&P 500 index), an investor would experience two negative years out of ten on average.[3] Additionally, even in positive growth years, markets can be prone to sizeable pullbacks. Nonetheless, U.S. markets have consistently recovered.

Looking ahead, so much of what aggravated markets in 2022 will be ending in 2023. While the economy is expected to see further slowing and volatility may not be over, encouraging news may be around the corner.

If current trends hold, models show meaningful drops in the inflation rate occurring in March and again in May of the coming year. Should the economy continue to soften, then inflation is likely to fall at an even faster rate. While the threat of economic contraction still lingers, the Fed is much better prepared to support the economy when the time is right. Because they have raised interest rates, they have also restored their primary tool for countering economic slowdowns.

Sources:
1 Bureau of Labor Statistics
2 U.S. Federal Open Market Committee
3 Ice Data Indices, LLC
4 Federal Reserve Bank of Atlanta, GDPNow
5 Bureau of Labor Statistics

"...on many fronts, the housing backdrop is vastly different than 2008, and a rebound could be sooner than many think."

About That Housing Slowdown... Think Correction, Not Crisis

Markets are adjusting to higher rates, but a recovery may be sooner than many believe.

One of the amazing stories of 2020 and 2021 was housing. In the context of record low mortgage rates and historic undersupply of available homes, housing prices shot up like a rocket, up 23% across the country in 2021 alone.[1]

Last year ushered in a new story, though. With unrelenting inflation and a runaway housing market, the Fed's attempt to reign it in led to the steepest level of rate increases since 1981. In response, affordability plunged as mortgage rates climbed. The slowdown hit hard. Housing starts dropped to 2016 levels while homebuilder sentiment dipped to 2011 levels. Compared to the sky-high numbers in 2021, home sales were down a whopping -28% in October.[2]

Crossing into 2023, the pessimism in housing has some fearful of another 2008 housing collapse. However, on many fronts, the housing backdrop is vastly different than 2008, and a rebound could be sooner than many think. Consider the following:

1. **Homeowner Equity:** Of all the mortgages across the U.S., only 2.2% have negative equity, or are valued as less than the mortgage principal. In comparison, homes with negative equity reached nearly 25% in 2009.[3]

2. **Locked-In Low Mortgage Rates:** In 2020 and 2021, mortgage rates recorded the lowest two calendar years in rates since the 1950s. What resulted was the largest refinance boom in modern housing history. As of August, 95% of all mortgages carry a rate of 5% or lower.[4] So, while the homebuyers of the last 6 months have been negatively impacted, it is hardly representative of what the vast majority of American homeowners are experiencing.

3. **Housing Demand Is Demographic:** Combine an undersupplied housing market with the largest generation (the Millennials) moving through their family formation years, and what do you get? More home demand. It translates to an ample supply of first-time homebuyers as well as a substantial number of "move-up" purchasers as families get bigger.

4. **Mortgage Rates Could Very Likely Come Down.** Wait a second, the Fed plans on holding rates higher for a while, but mortgage rates could come down? That's right. There is usually a gap between the 30-year mortgage rate and commonly watched U.S. treasury rates. This year that gap widened to historically wide levels. If the gap just goes back to "normal," it means mortgage rates could easily fall 1% to 1.5%. From today's levels, it means the housing market could easily see mortgage rates back in the low 5% range next year.

Fast Facts: Housing

63%
Of all homes are mortgaged

95%
Of all U.S. mortgages have rates at 5% or lower

Only **2.2%**
of mortgages have negative equity

Sources:
1 Census Bureau
2 National Association of Realtors
3 CoreLogic. Home Equity Insights, Q3, 2022.
4 CoreLogic, Higher Mortgage Rates Lead to Strong Lock-In Effect, November 9, 2022.

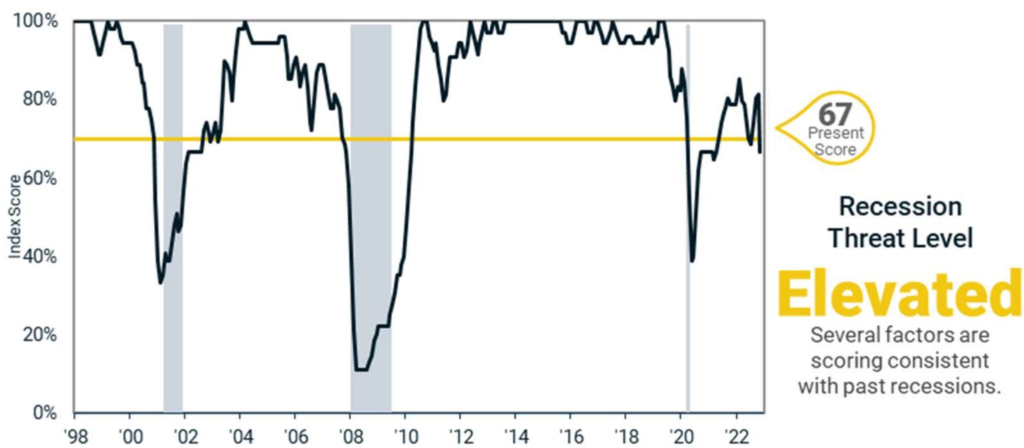
"The index score is teetering at the threshold line for conditions consistent with an economic recession."

Business Cycle Risk Profile

- At its current level, the index value reflects an elevated risk of a recession.
- The index score is teetering at the threshold line for conditions consistent with an economic recession.
- Underlying factors are sending mixed messages. Inflation metrics, which were problematic for much of the last 18 months, are showing improvement. Employment has continued increasing at a remarkable pace.
- Industrial production, so hampered by supply chain hiccups, now shows potential to increase in 2023.
- Because of the still high year-over-year inflation numbers, the Fed will maintain interest rate policy in the restrictive range for the first part of 2023. Should inflation decline below 4%, the Fed will likely look to start decreasing soon after.
- The economy has demonstrated resilience in several areas, including manufacturing, consumer demand for services, and employment growth.

Alphalytics Research Economic Systemic Risk Index

Three Month Average, Weighted Diffusion Index



Shaded areas represent U.S. recessions.
Signal line represents historical mark where economic factors signaled imminent risk of recession.
Source: NBER, Federal Reserve Bank of St. Louis.

Interpreting the Index Score:

- The index score measures nine economic factors that have demonstrated co-movement with the deteriorating conditions of the past seven recessions dating back to 1970.
- When the index score is at 100, it means all nine of the factors are measuring at levels consistent with past economic expansion.
- When the index score is below 100, it means that one or more of the weighted factors has moved to a level consistent with past economic contractions.
- In aggregate a score of 70 or higher is interpreted as a composite profile consistent with past economic expansion. A score lower than 70 is interpreted as a composite profile consistent with past economic contraction.
- Markets can, and sometimes do, demonstrate volatility even though the economic factors are measuring consistent with expansion.

Interested in Adaptive Business Cycle Investing?

Today's markets, economies, and policies are more complex than ever, challenging investors on what to watch and when to take action.

At Harman Wealth Management, we understand sound investments are uniquely supported by the conditions that favor them. And, when conditions change, so do the investments that benefit.

That's why we conduct rigorous and disciplined tracking of the U.S. business cycle. We also track the cyclical factors that shape our investing environment, like currencies, commodities, and rates. We embrace a world where investing dynamics are constantly evolving and believe it's imperative to have an investment strategy that adapts with it.

With Adaptive Business Cycle Investing we invest consistent with business cycle forces, aligning investments with the conditions driving returns in the present, rather than chasing what worked in the past.

About Harman Wealth Management

At Harman Wealth Management, we provide private, advanced, independent planning and investment management to individuals, families, and institutional clients.

We value in-depth economic research, evidence-based investment methods, and rigorous risk management. We are committed to integrative advanced planning by aligning investment objectives with business cycle opportunities and risks.

At Harman Wealth Management, our aim is to help clients realize their goals within a disciplined, insightful, and rewarding relationship.

For more information about Harman Wealth Management or investing with the business cycle, contact us at 281-719-8601.

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It is our goal to help investors by identifying changing market conditions. However, investors should be aware that no financial advisor can accurately predict all of the changes that may occur in the market. Information is based on sources believed to be reliable; however, their accuracy or completeness cannot be guaranteed.

Investing involves risk including the potential loss of principal. No investment strategy can guarantee a profit or protect against loss in periods of declining values. Past performance is no guarantee of future results. There is no guarantee that a diversified portfolio will outperform a non-diversified portfolio in any given market environment.

Please note that individual situations can vary. Therefore, the information presented here should only be relied upon when coordinated with individual professional advice.

The Standard and Poor's 500 is an unmanaged index generally representative of the U.S. stock market and cannot be invested in directly.

In general, the bond market is volatile as prices rise when interest rates fall and vice versa. This effect is usually pronounced for longer-term securities. Any fixed income security sold or redeemed prior to maturity may be subject to a substantial gain or loss. Bonds are also subject to other types of risks such as call, credit, liquidity, interest rate, and general market risks.

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