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Zevin Asset Management

INVESTMENT UPDATE

The Storm before the Calm?

PHILIP HERGEL, SENIOR QUANTITATIVE ANALYST

We don't think we are alone in saying that we will be happy to have 2022 in the rear-view mirror. This was a year filled with pervasive and relentless unrest, conflict, and sorrow. In 2022, Orwellian propaganda, doublespeak, and outright disinformation policies continued to spread around the globe. When the Merriam-Webster dictionary selects "gaslighting" as the word of the year – you know it was an unpleasant year. Some examples of extreme global unrest this year include:

- We witnessed Putin's unprovoked and barbaric invasion of peaceful Ukraine. The Ukrainians have responded with heroic resistance, but nonetheless there have been hundreds of thousands of senseless deaths and the fighting continues.
- We experienced intensifying political polarization between the left and the right here in the U.S., but this trend also spread to other countries.
- Brazen racism and homophobia seemed to intensify along with accompanying hate speech on social media and other fringe platforms.
- According to the Gun Violence Archive, there have been 41,103 gun-violence deaths in America so far this year – that's more than double the capacity of Boston's TD Garden. We also learned that firearms became the leading cause of death for children in the U.S. – a disgusting and avoidable statistic. Meanwhile, and as a result, the debate over gun laws and 2nd Amendment rights has intensified in America.
- Monkeypox reemerged around the world and COVID-19 deaths continued to climb. Conflicting views on how to deal with viruses in general continued around the world as we approach the three-year anniversary of the first COVID-19 death.
- Geopolitical tensions increased between China and most of the rest of the world. Also, North Korea missile testing continued, with missiles coming so close to South Korean territory that air-raid sirens were triggered in November.

And we haven't even mentioned economies or markets yet! In 2022 inflation remained stubbornly high, robbing households of spending power and forcing global central banks to aggressively tighten monetary policy. As a result of the pending interest rate hikes, the benchmark global equity index peaked on the very first trading day of 2022, spent most of the year trending lower, and is set to end the calendar year in negative territory for the first time since 2018 and only the fifth time in the last 20 years. Likewise, fixed-income assets retreated along with gold, real estate, and cryptocurrencies. Just about the only asset class which fared well was commodities, which soared in the first half of the year on worries of shortages owing to Russia's invasion of Ukraine.

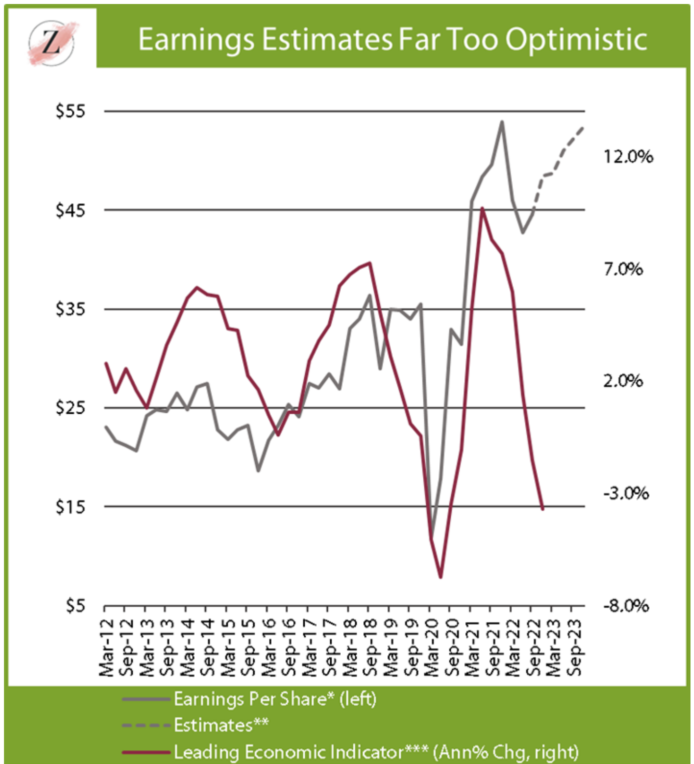
Chart 1

*Source: Citigroup Inc. Measures the number of inflation series globally which were stronger vs. weaker than expected.

OUT WITH THE OLD, IN WITH THE NEW!

As we look ahead to 2023, we are hopeful that things can surely improve on many of these fronts. Regarding financial markets, there are growing signs that inflation is peaking, which should lead to more accommodative monetary policy. **Chart 1** shows a measure of global inflation (OECD consumer prices in gray line) along with an indicator of global inflation trends (maroon line). This latter measure is clearly in decline, indicating global inflation should be slowing shortly. The key takeaway from such a trend reversal is that with falling inflation, central banks do not need to hike policy rates so aggressively which would positively impact corporate earnings and equity markets. In fact, chatter has increased in recent weeks on the timing of central banks' "pivot" from tightening to easing, indicating central banks' acknowledgment of the current economic slowdown.

Chart 2



*As reported. **Source: S&P Global Inc. ***Source: The Conference Board.

So, inflation now seems to be peaking and interest rates are rising more slowly with a reversal possibly on the horizon. Good news, right? Not so fast – there's a fly in the ointment. Analysts tend to be too optimistic on corporate earnings and this cycle is no different. However, the likelihood of downward revisions to earnings estimates is especially large this cycle given the massive amount of global tightening we've experienced in 2022. In fact, economic data releases have already started coming out soft, but this reality is not yet reflected in earnings estimates. **Chart 2** shows a standard measure of earnings per share for the S&P 500 along with earnings estimates out to the end of 2023 (gray dotted line). Quite clearly, earnings are forecasted to continue to climb higher. The leading economic index shown in **Chart 2** has a consistent correlation with earnings and it is in dramatic decline, suggesting earnings estimates will likely be adjusted lower in coming months and/or quarters. This could be the catalyst for some short-term stock market weakness. Also, while global equity markets are indeed less expensive, they are far from cheap and remain vulnerable to lower earnings forecasts. In the near-term, as economies weaken in response to past monetary tightening, fixed-income securities should continue their current trend of relative strength while equities could face volatile conditions. Beyond the near term, once monetary policy is less restrictive, the outlook for global equities will be more positive.

A major economic risk in 2023 is the likelihood of a global recession. However, given monetary authorities' repeated comments on letting the data dictate their policy and on timing their pivot, a recession might well be shallow or even avoided. Also, it's worth noting that although there have been 15 recessions in the U.S. since 1929, the S&P 500 fell in only six of these periods. Historically, markets have tended to weaken during the tightening cycle (as we're experiencing currently) but during a recession when central banks are becoming more accommodative (as should be the case in 2023) equity markets tend to rally more often than not.

BOTTOM LINE

2022 was an unpleasant year of unrest and we are glad to see it go. For 2023 we're thinking about the "storm before the calm," the possibility of continued equity market volatility in the first half followed by a more positive equity outlook in the second half of the year as central banks turn less restrictive.

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2 Oliver Street, Suite 806, Boston, MA 02109 • www.zevin.com • invest@zevin.com • 617.742.6666