GCM Quarterly Report

New look, same great taste!

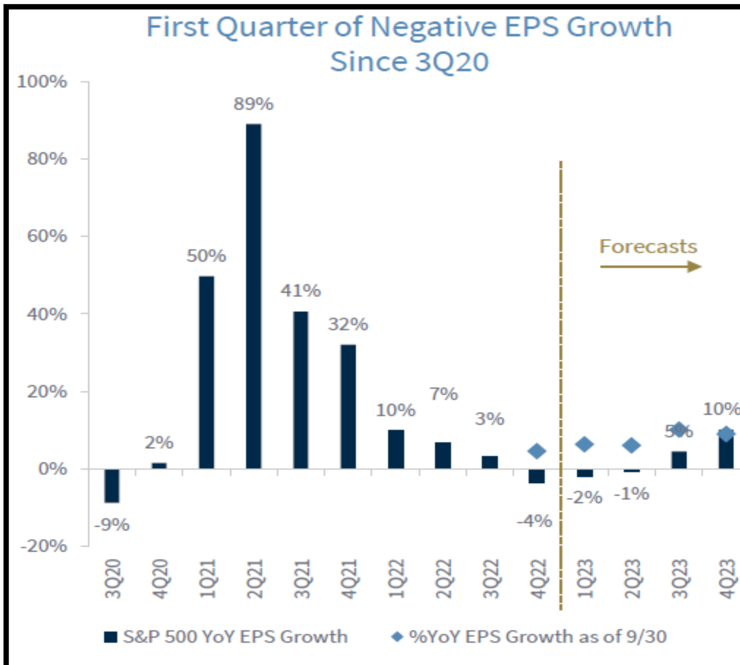
Winter 2023

The state of corporate America

Corporate earnings season is underway, with just under 3/4ths of S&P 500 constituents reporting 4th quarter 2022 results as of this writing. As expected, the results have been weak, with an average earnings decline of about 5% compared to the 4th quarter of 2021. Considering 2021 was, by nearly all accounts, an excellent year for the markets and consumers alike, it comes as no surprise that this year's holiday results didn't quite measure up. That being said, earnings for the full calendar year of 2022 are expected to break records, with average earnings per share (EPS) of the S&P 500 estimated at $219.51 (compared with $208.49 for 2021 and $163.13 for 2019). Looking forward to the rest of 2023, analyst forecasts are currently expecting slight declines in earnings through the first half of the year followed by a recovery in the second half, yielding low single digit earnings growth for the full year. No doubt estimates will be adjusted as the year progresses, but these expectations are not inconsistent with larger-scale economic forecasts for a mild recession this year.

At the sector level, Energy reported year-over-year earnings growth of 57.7% and the best profit margins of the S&P 500's 11 sectors. Airlines also did well, reporting earnings growth of 36.8% for the quarter as air travel has boomed back. Communication Services (looking at you, Alphabet and Meta) reported the worst quarterly earnings decline at nearly 25%. Looking to 2023, analysts expect the Consumer Discretionary and Financial sectors to report the strongest results, probably due to high prices for goods (Consumer stocks) and high interest rates (Financial stocks). All earnings data in the last two paragraphs was taken from [Factset.](Factset)

Last year's combination of strong earnings and a lousy market environment have helped bring down valuations considerably, with the S&P 500 now trading very close to its 5-year average valuation and just slightly above its 10-year average valuation. As we've discussed in previous newsletters, valuation on its own is not a sufficient data point to determine the market's trajectory, but historically the market tends to trade better when valuations are more reasonable. We'll return to markets at the conclusion of our newsletter.



Source: FactSet, Data as of 2/2/2023.

Illustration above from Raymond James February webinar

Market Statistics	Jan '23	YTD	2022	3-Year Annl.	5-Year Annl.
S&P 500	6.28%	6.28%	-18.11%	9.88%	9.54%
Dow Jones Ind. Avg.	5.27%	5.27%	-14.04%	8.26%	7.05%
Russell 2000 (Small Cap)	9.73%	9.73%	-20.76%	7.12%	5.14%
MSCI EAFE (Foreign)	8.10%	8.10%	-14.45%	4.25%	2.13%
MSCI ACWI (Global)	7.17%	7.17%	-18.36%	6.83%	5.53%
MSCI Emerging Mkts.	7.90%	7.90%	-20.09%	1.40%	-1.48%
Barclay's Aggregate Bond	3.08%	3.08%	-13.01%	-2.35%	0.86%
iShares Gold ETF (GLD)	5.76%	5.76%	-0.77%	6.31%	7.04%

Source: Morningstar, as of 2/14/2023

Economic growth was positive for 2022, but inflation remains a concern

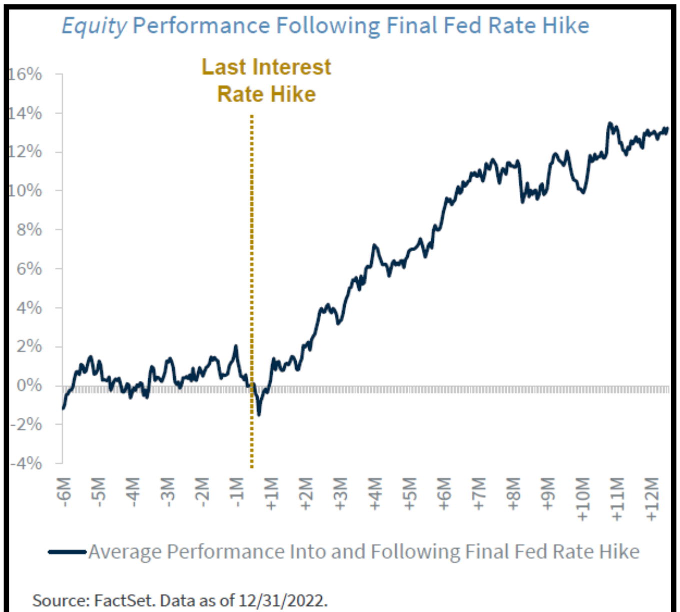


Illustration above from [Raymond James February webinar]

Economic growth reported a positive surprise for the fourth quarter, with US GDP increasing by 2.9%. For the full year, US GDP grew by just over 2%, in-line with long-term expected averages, despite a weak January-June (data from BEA). The most recent jobs report indicated the unemployment rate stands at 3.4% with nonfarm payrolls rising by more than half a million. All of these figures point to the US economy on solid footing (data from BLS).

After several months of reprieve, inflation has yet again surprised to the upside. CPI for January rose 0.5% for the month, annualized at 6.4%. This is not only higher than expected, but higher than the previous couple of months as well; both November and December experienced monthly increases of just 0.1%. It's important to note that one data point on inflation does not make a trend, and CPI is only one of several measurements the Fed considers when determining the path of inflation. A cooler report for February would help make the case that inflation is indeed easing and January was an anomaly. This one will have to fall in the "wait and see" category for now.

Inflation coupled with strong labor data puts the Federal Reserve in an awkward position. Forecasts coming into 2023 indicated the Fed was likely to raise rates a handful of times – possibly 2 or 3 increases of 0.25% each – with the expectation that inflationary pressure was going to finally subside and we'd start to see signs of a cooling economy, indicating their efforts to apply the brakes to a potentially overheating marketplace were working. However, given the data we've received recently, the Fed may decide further rate increases are necessary. If there is one thing the market does not want more than anything else this year, it's more rate increases.

Where do we go from here?

After last year's frustrating rollercoaster ride, January's strong rebound offered a welcome reminder that markets don't just go down all the time. There's an old expression on Wall Street: as goes January, so goes the year. Historically, the stock market has been positive about 70-75% of the time, so any hackneyed prediction that the market will finish the year higher, regardless of why, has a fair chance of being right. Beyond that though, strong January returns have portended stronger-than-average calendar year returns for the market. Going back to the 1930s, years in which the market's January return was positive have historically seen an average full-year return of about 8%. Years in which January's return was negative have historically seen an average full-year return of about 2%. Notably, it has also been rare to experience two consecutive negative years. Since the 1940s, back-to-back annual market declines have only occurred three times: during WW2, during the oil crisis of the 1970s, and during the tech bubble in the early 2000s. Does this mean the remainder of 2023 will build on January's strength? It's too soon to tell, and there are still many unknowns with the potential to influence the outcome (the debt ceiling, inflation/interest rates, and economic activity being three significant ones). We remain, as ever, cautiously optimistic.

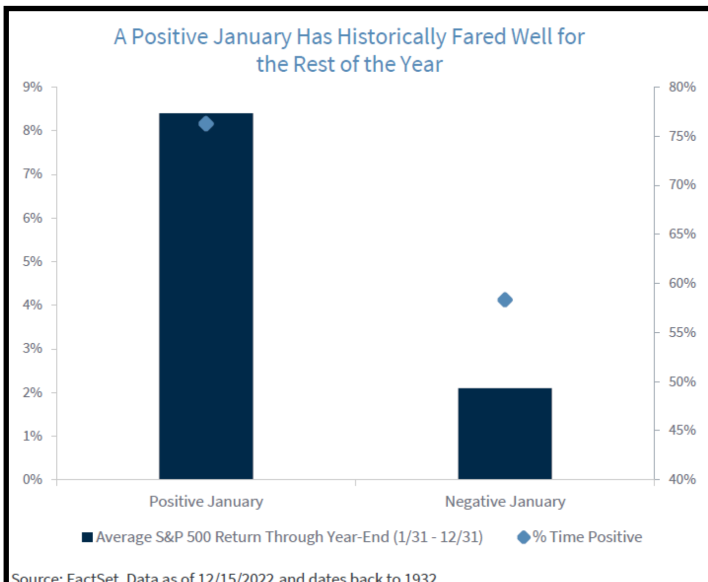


Illustration above from [Raymond James February webinar]

Ben's Corner

It's no secret that I don't harbor warm and fuzzy feelings for politicians. Some of my prior editorials have expressed a … level of frustration … with the "do as I say, not as I do" attitude that is routinely expressed around Washington. Worse, ad hominem rhetoric usually supersedes data, leaving the public to choose sides in a tribal war rather than forming policy positions based on fact. The debate over the debt ceiling, this minute's hot-button issue, is being handled in largely the same irresponsible way. I'm going to focus this editorial on two questions: first, what is the origin of the debt limit and how does it work, and second, does it serve a useful purpose? As a point of clarification, I use the terms "debt limit" and "debt ceiling" interchangeably.

The debt limit originated with the Second Liberty Bond Act of 1917. Prior to this law, and per the Constitution, Congress authorized debt as it was incurred. During World War I, Congress wanted the government to have some flexibility to borrow money without asking for approval in order to fund the ongoing war effort. Thus was born the idea of a maximum limit on the amount of debt the United States could create; Congress says the government can borrow $X and as long as the total amount of outstanding debt remains under $X, all is well. In 1917, the ceiling was about $15 billion. Today, it's just under $32 trillion (that's a thousand billion), most of which has been added in the last 60 years. In fact, since 1966, the debt limit has been raised at least once under every single presidential administration. Republican leadership has added just over $16 trillion to the limit, while Democratic leadership has added just over $14 trillion.

Importantly, the debt ceiling does not limit the amount of spending Congress can authorize. Instead, it limits the Treasury's ability to pay for spending which has already been authorized during past legislative sessions. The consequence of this – what we're experiencing now – is that the current Congress rarely wants to take responsibility for bills that were approved by their predecessors. I am not blaming Democrats or Republicans for this; as I mentioned above, the debt ceiling has been raised under both parties as a result of laws that were enacted by both parties. This is a Congressional accountability issue, not a party issue.

The way the United States has chosen to limit debt – by instituting a maximum dollar amount – is very unusual. Only the US and Denmark follow such a practice, and Denmark's debt limit is so high by design that it is unlikely to ever be reached. More commonly, countries implement limits as a percentage of their GDP. Germany and other nations of the EU follow this practice. This allows the amount of debt a country can issue to theoretically rise with the growth of their economy. Alternatively, some countries like Australia have no debt limit at all.

Now, to the question of whether the debt limit serves a useful purpose. I'm taking the "no" side. First of all, the mere existence of a debt ceiling does not, on its own, enhance a country's creditworthiness. Standard & Poor's rates Australia and Germany as AAA credits while the United States carries a rating of AA+. Quite simply, some other countries are better at managing their finances than we are despite having more flexible methods for issuing debt. Second, the debt ceiling does not limit Congressional spending in practice. Louise Sheiner, a Senior Fellow at Brookings, cites the rise in US debt from 70% of GDP in 2011 to 79% of GDP in 2019 (despite several debt ceiling crises during that time) as recent evidence of this. Today, it's about 120% of GDP (Source: St. Louis Fed).

Ultimately, debt is nothing more than trust. It's trust that the person you lend money to will pay you back according to the terms of your agreement. Unlike a person, a sovereign state has the ability to print an unlimited amount of their currency. When lending to a sovereign state, you're trusting that the country will not print mountains of currency to pay back your debt, making the currency itself (and the money paid back to you) worthless. A statutory limit on how much a nation can borrow serves no purpose in enhancing this trust. In fact, the risk that the United States may not be able to pay prior debts it has incurred if the ceiling is not raised deteriorates this trust. Either Congress should be required to authorize new debt when they pass a law (which comes with its own set of challenges), we should adopt a GDP-based limit, or we should abolish the limit entirely. The status quo is unproductive and harmful to the legislative process, and Congress doesn't need any help doing their job poorly.

Interesting fact of the quarter

Our interesting fact of the quarter concerns animals, crows to be specific. Crows are not only among the smartest birds on the planet, they are among the smartest animals on the planet. They remember faces, use tools, understand analogies and relationships, and solve problems. In fact, this study published in PLOS One, compares crows' reasoning skills to that of a seven-year-old human child. Maybe we should let them serve in Congress too (the birds, not the kids).

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