COLORADO
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Economic & Market Review

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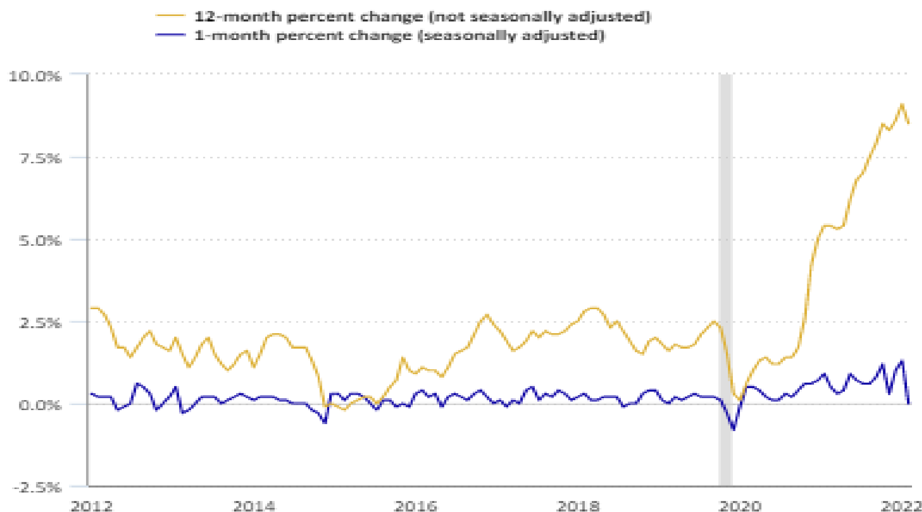
Dear Clients and Friends,

After a respite from late June into early August, the stock and bond markets rolled over in the last few weeks. Many of our clients are worried and wondering what the rest of the year is likely to bring. While short term prognosticating is not our forte, we can at least put things in context for you before the Labor Day weekend.

The stock market is being driven by the bond market, the bond market is driven by the Fed, and Fed is being driven by inflation data.



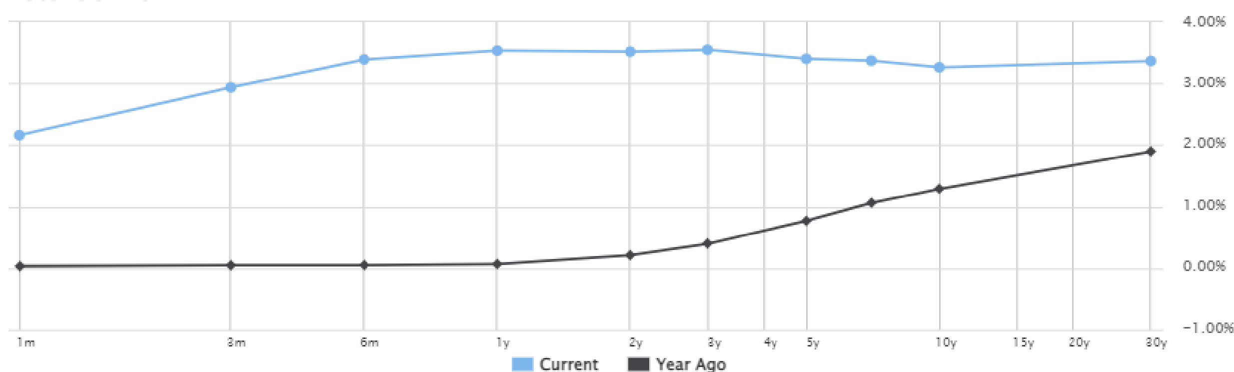
The latest CPI report was in July, and the 8.5% year-on-year increase was down from 9.1% for the 12 months ending in June. You can see the tiny hook in the chart above showing the decline.

Energy prices rose 33% and gas prices were up 44% versus a year ago. As most people know, gas prices declined some in August. As mentioned in a previous letter, gasoline has an outsized importance in people's thinking about inflation. It represents only 5% of the CPI but is something people see every day. Shown below is a table showing the make-up of CPI and inflation through last July.

Expenditure category	Relative importance	% Change Jul. 2021-2022
All items	100.0	8.5
Food	13.4	10.9
Food at home	8.3	13.1
Food away from home(1)	5.1	7.6
Energy	9.2	32.9
Gasoline (all types)	5.2	44
Electricity	2.6	15.2
All items less food and energy	77.4	5.9
Commodities less food and energy commodities	21.1	7
Apparel	2.4	5.1
New vehicles	4.0	10.4
Used cars and trucks	4.0	6.6
Shelter	32.1	5.7
Medical care services	6.8	5.1
Transportation services	5.9	9.2

Once again, I would highlight the 32% weight of shelter in the index. While home prices are still up over the last year, they have begun to cool. The Case-Shiller Home Price Index rose 18% in the year ending June, down from 19.9% the month before. The Case-Shiller index reports on a two-month delay, and reflects a three-month average; so, it will be slow to reflect current conditions. Existing home sales have fallen for six straight months through July. The average rate on 30-year fixed rate mortgage is about 5.5%, up from 2.9% a year earlier. So, we should begin to see some relief in the shelter inflation data over the next few months.

As I said above, stocks are following bonds, bonds are following the Fed, and the Fed is following inflation. Short-term bond yields have risen from 0% a year ago to 2.25% today. The 1 – 3-year



yields have risen to 3.5%, and 5 years and further are at about 3.2%. The implication of the yield curve is that the Fed will raise rates to about 3.5% and hold them there for up to 3 years. Inflation will gradually decline, which is why longer-term yields are lower.

There is a lot of volatility in the markets because there is uncertainty in how this will play out. As discussed above, it appears that inflation peaked in July, so bond yields stopped rising in June and declined from 3.5% to 2.5% as shown. This led to the stock market rally in June and July.

One of the tools the Fed uses is called forward guidance. Another word for it is jawboning. The Fed was not happy with the market anticipating lower rates and began jawboning in August, with the culmination being Chairman Powell's speech last week from Jackson Hole, Wyoming. The Chairman made it clear the Fed was going to continue raising rates (and keep them there) until they see clear evidence that inflation is coming down. The market got the message and the yield on the 2-year bond duly ran up from 3.4% to 3.55%.

Today, as I write this, we had an unemployment report that was about as goldilocks as the Fed could hope for. The U.S. added 315,000 new jobs, which is neither too hot nor too cold. In addition, more people came into the work force, so the unemployment rate rose to 3.7% from 3.5%. At this point, bad news is good news because it means the Fed may not need to be as aggressive in tightening as the market fears. That is why the 2-year yield fell back to 3.45%.

We are going to continue seeing this tug-of-war for a while longer as the data comes in, so strap your seatbelts on for a few more months.

How about stocks?

Stocks followed bonds lower from January through June, then higher from June into August, and then lower the last two weeks. Today, it is the same pattern with yields lower and stocks higher.

This pattern is likely hold but get weaker over the next few months. As shown above, 10-year yields have been hovering around 3% since late April. If rates stay near this level, the stock market will begin worrying more about earnings than rates. Earnings estimates have fallen in recent weeks. 2022

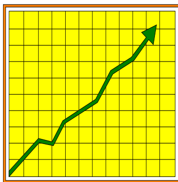
estimates were $225 for the S&P 500 and are now about $210. Here is a simplified matrix to help you think about valuation. I would argue the market normally trades between 16x and 20x earnings, with a midpoint of 18x. That has been the history for the last 35 years or more. It will trade at the higher end when the economy is good and interest rates are low, and at the lower end during periods of uncertainty and higher interest rates. Today the market is at ~ 4000, so it is assuming about $220 of forward earnings and putting a 'normal' P/E ratio of 18 on that number. As we look into 2023 the question will be whether those earnings will grow as estimated, or be higher or lower. If the economy slows more than anticipated, or interest rates rise more, then we could retest the lows we saw in June (and possibly go lower). If the economy can slow enough to cool inflation and earnings can keep growing, then we'll start moving back to the old highs of 4600 or higher.

	Earnings		
P/E	**210**	**220**	**230**
16	3360	3520	3680
18	3780	3960	4140
20	4200	4400	4600

The reason you can have confidence that the market will recover is simply that earnings will recover. They always have. Even if there is a recession, earnings will come back and grow again and be higher than they were before. Sometimes there is a pause in the economy, or even a recession, then there is a recovery and another period of growth.

We are not panicked. We rebalance portfolios during good times and bad. We stick with our plan and continuously look to make portfolios better. Seasonally, this has historically been a period of volatility so stay prepared but remain calm and enjoy the autumn.

Happy returns,



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And Your Entire Colorado Financial Mgmt. Team

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For further information, please visit:

CPI information: U.S. Bureau of Labor Statistics

Fed Yield curves: U.S. Department of the Treasurey