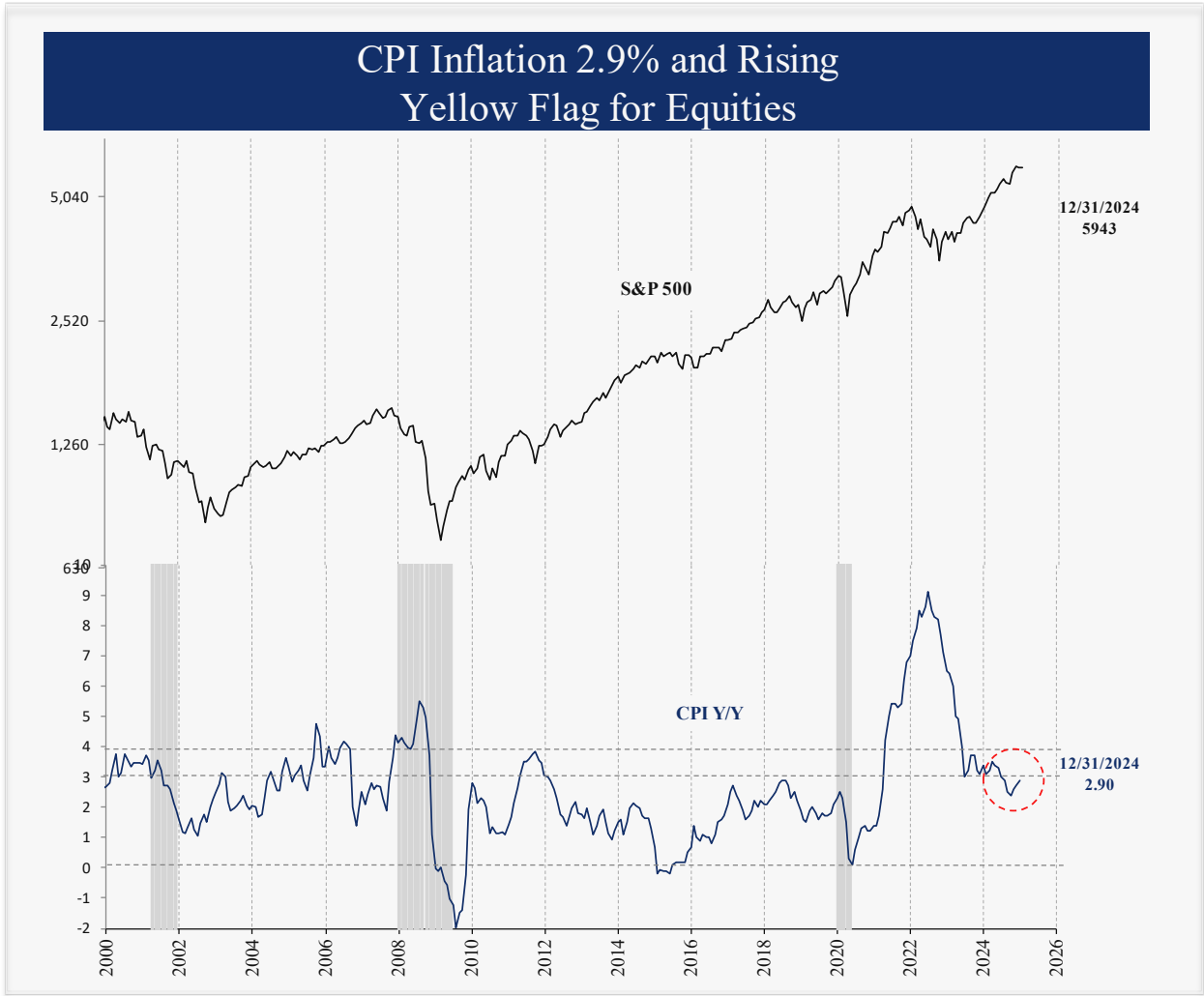


Investing Environment Review and Outlook – Volume 89

Last month we discussed the higher equity volatility ahead, weakness in Q1 of the presidential cycle, and equity investor positioning. This month we discuss the inflation trend change and high equity valuations.

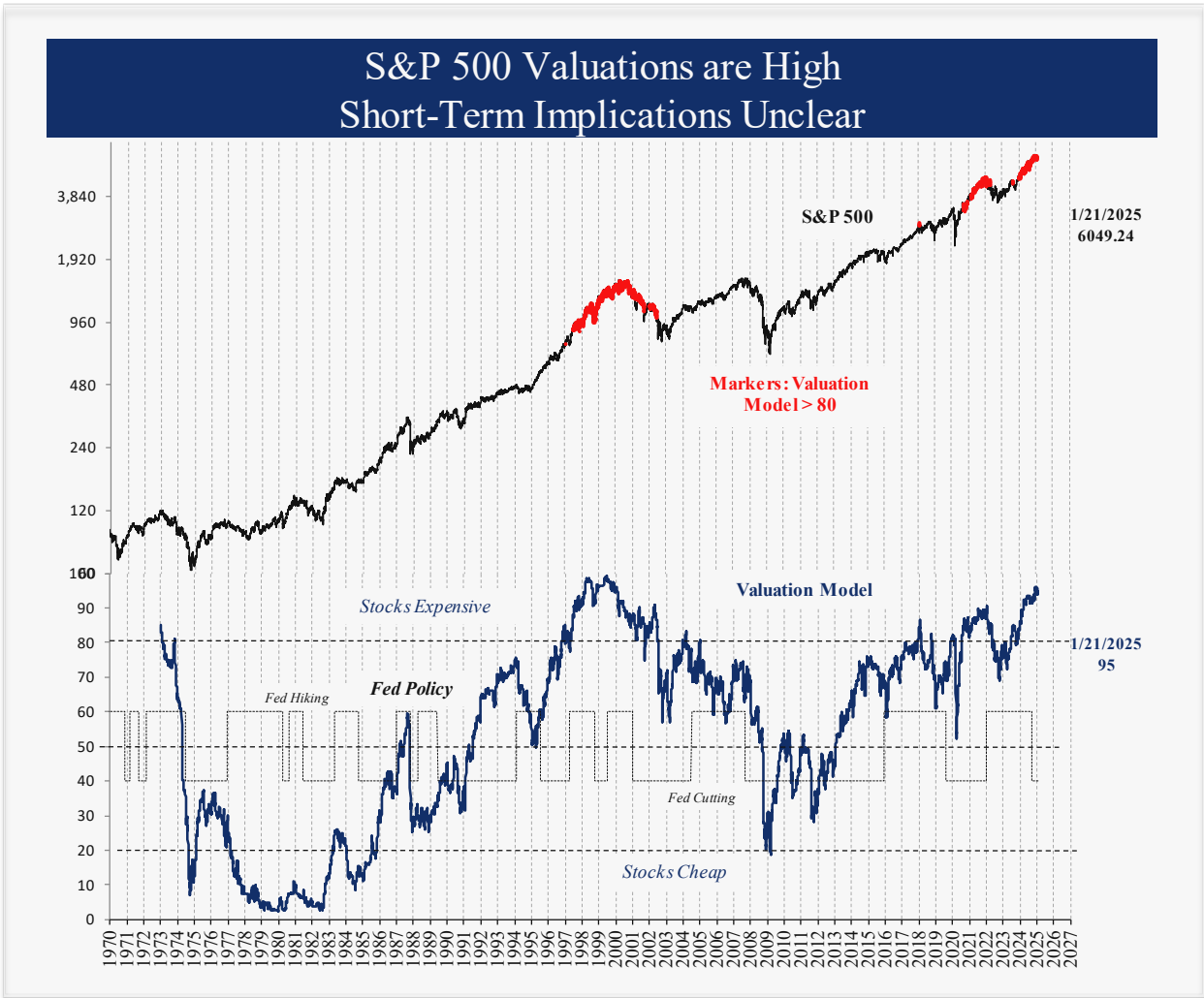
CPI Inflation Trend Change: Yellow Flag for Equities

CPI headline inflation for December was reported at 2.9% Y/Y, up from the recent low of 2.4% in September. The trend change is significant for equity returns historically. Since 1950, the S&P 500 returned 16.1% when CPI Y/Y was falling vs. just 4.8% when rising. Consider that the S&P 500 is up 55% since the last CPI trend change to the downside in October 2022, after inflation peaked at 9.1% in June of that year. The S&P 500 expected return is better at 8.6% when inflation is rising AND below 4% as it is today, but the fact remains that rising inflation today is an offset to the consensus-expected outperformance of equities. After two years of 20% + returns, the rear-view mirror bias is widespread.

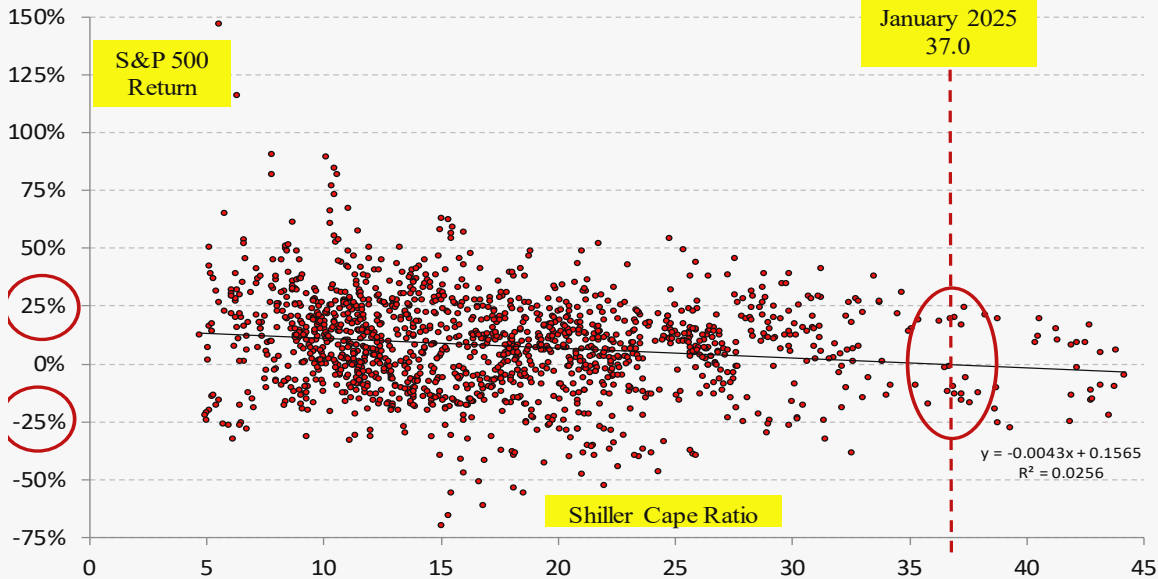


U.S. Equity Valuations are High: Short-Term Implications Unclear

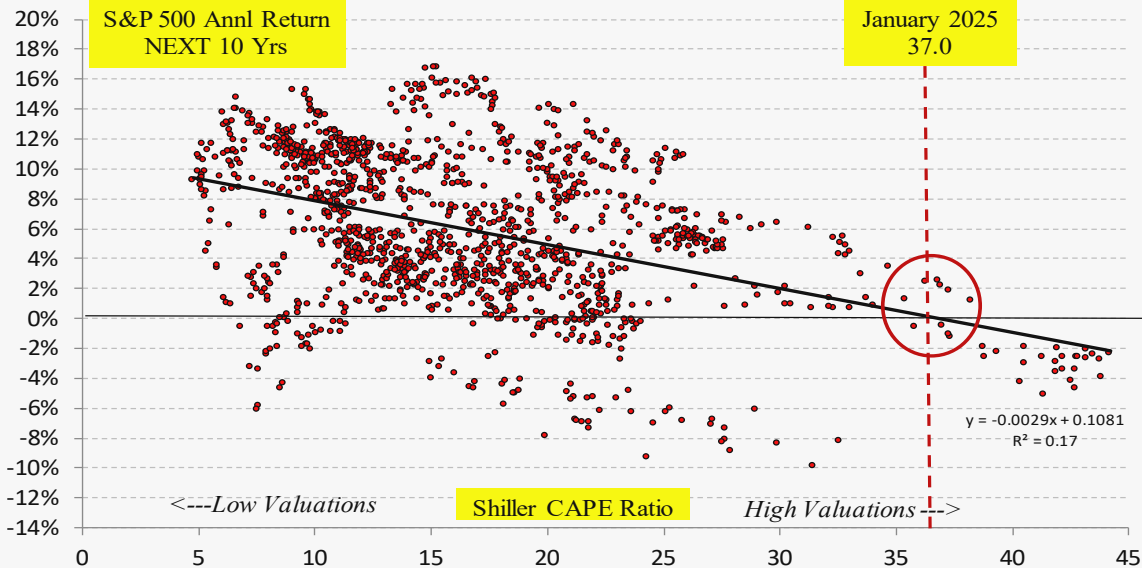
U.S. equity valuations are high by almost any measure. For instance, Shiller’s CAPE ratio (cyclically adjusted price earnings ratio) for U.S. equities, at 37.0, is in the 98th percentile of readings since the series started in 1871. Similarly, our valuation model reached 95.0, the highest since the year 2000. In this model we adjust each industry group for its norm, so historical comparisons are valid. Historical tests show that high valuations are predictive for lower returns 10 years, out but in the short term are inconclusive. For instance, in prior cases the Shiller CAPE ratio was this high, returns one year out ranged from -25% to +25%. 10 years out is a different story. Annualized returns after valuations this high ranged from -5% to +2% at best.



Valuation NOT Significant 1 Year Out
Prior Cases Cape 37 S&P 500 +/- 25%



High Valuations Followed by Low Returns 10 Years Out
Prior Cases CAPE at 37 S&P Returned -2 to +3%



We continue to monitor economic and market conditions and analyze their impact on asset classes. Thank you for your support and please contact us with any questions.



Michael Schaus
Director of Market Research