Lane Asset Management

Stock Market in Focus

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Paraphrasing Warren Buffett and his paraphrasing Benjamin Graham (considered a founder of stock analysis and value investing), the stock market is at once both a voting machine and a weighing machine. Not everyone votes the same way but the majority of votes define the current direction of the market. From one period to the next, voters (investors) change their mind (votes) based on change in conviction – either they hop on board the consensus and the current trend continues or the consensus changes its mind based on new and surprising information and the trend slows down or reverses.

As a weighing machine, investors are looking for a certain return on their investment and take a position based on their expectation of future returns expressed in present value terms. The weighing machine takes on a longer-term view. That's why an expectation of rising interest rates in the future result in declining stock and bond values as future earnings have a lower present value, all other things being equal. On the other hand, an expectation of falling inflation can give rise to the point of view that the Fed will be easing and the future interest rates will be lower and this can lead to an improving market, all other things being equal.

The fundamental factors affecting markets in 2022 and so far in 2023 are an unprecedented number and combination of headwinds. They include the wide-ranging effects of COVID, restrictive monetary policy to combat inflation, the invasion of Ukraine by Russia, climate change, potential recession, Washington politics and a potential federal debt default (albeit, likely short-lived if it happens at all), increasing U.S. dollar strength (harmful to exports and to emerging economies with U.S. dollar debt), a "fiscal cliff" (a reduction in federal spending relative to prior periods) and geopolitical tension with China and in the Middle East, to name some of the more familiar factors.

As a result of these factors and the frequently changing opinions (votes) of investors, markets have experienced one of the most volatile periods in recent times. The chart on page 4 vividly illustrates this volatility.

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Technical analysis, the study of stock price behavior, provides a means of forecasting short- and long-term price movement. While past performance is no guarantee of future results, technicians like myself use various technical indicators to assess the market and position investment portfolios. Additional information on technical analysis is provided in the appendix to this report.

The chart on the next page shows daily price movement for the last 4 years for the S&P 500 (using the ETF “SPY” as a proxy) along with 50-, 100-, and 200-day moving averages. January was a strong month for the S&P with the price of SPY moving above these critical moving averages and the faster moving averages moving over the slower ones from below was another positive sign.

The chart also shows lines of support and resistance. These are price points that have a history of being turning points in price movement. At this writing, $410 is acting as a point of resistance with the price of SPY having trouble getting past it. The downward sloping dotted red arrow also illustrates a line of resistance. This was broken to the upside in late January, a hopeful sign at the time, but there’s now reason to suspect the line of resistance may hold.

The MACD indicator at the bottom of the page provides an indication of current price momentum. MACD appears to be peaking at this time at a level consistent with prior reversals in price trend, not a hopeful sign.

Finally, while the roughly 25% price drop in the S&P during 2022 wasn’t the worst drop in the last 20 years (the Covid collapse in 2020 and the financial crisis in 2008-9 were worse), the period since January 2020 was decidedly the worst in terms of market volatility. As indicated on the prior page, given the number of challenging headwinds, this vividly demonstrates how investor opinions have been buffeted by new information. The way I see it, investors would very much like to see through the market headwinds to an end of the downturn just as they have seen prior market selloffs eventually recover. This has been referred to as FOMO, the fear of missing out. However, new information upset consensus optimism on multiple occasions making the market one of the most difficult to maneuver in recent memory.

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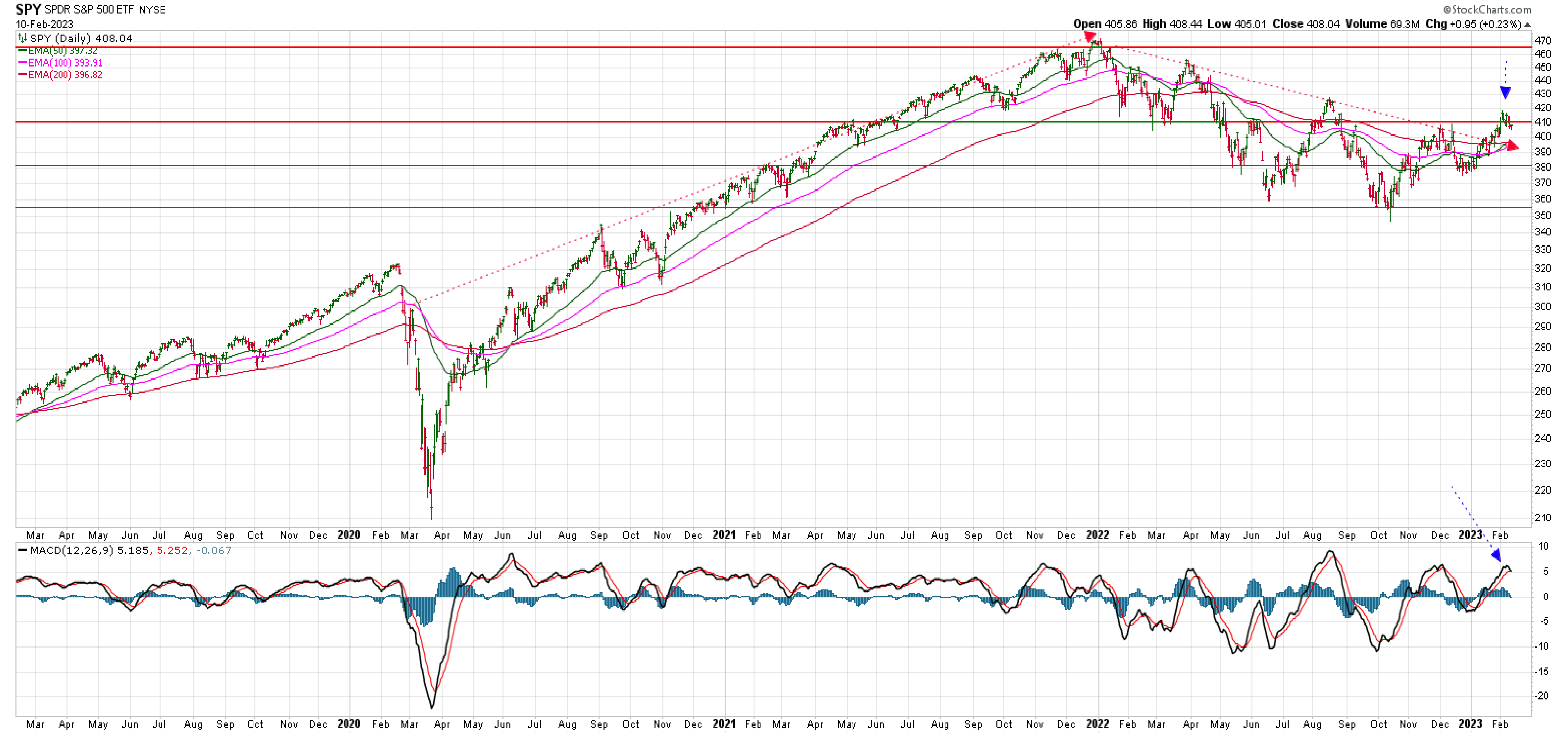

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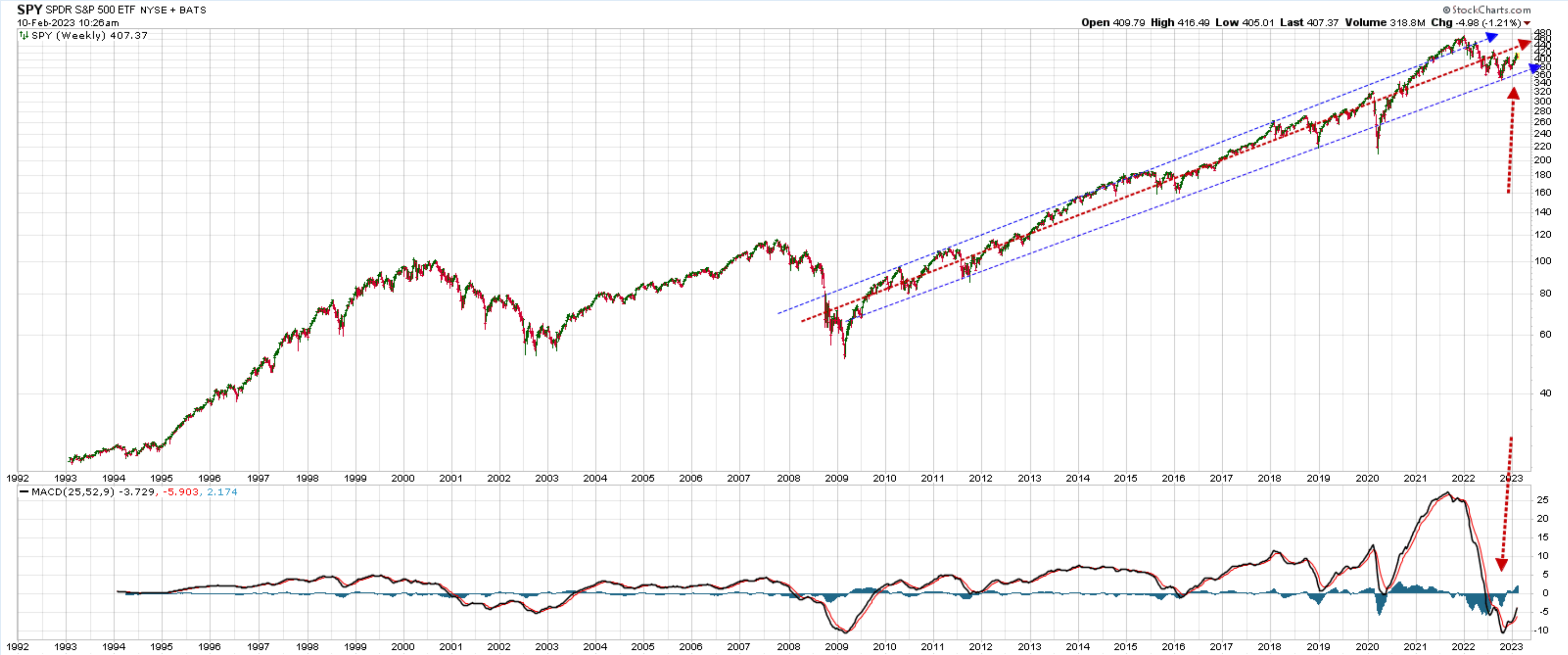
This is a chart of weekly price movement of SPY. Several points are worth noting:

- Since 2009, the S&P has remained in an upward-trending channel with reversion to the mean (the red dotted line)
- The channel provides a useful indication of the potential swings in the S&P: about +/- 30% top to bottom; SPY is currently about 15% off the bottom of the channel and moving up, a hopeful sign
- The MACD momentum indicator has reversed to a greater degree than prior corrections during 2022, also a hopeful sign



The chart on the next page shows the "VIX" indicator compared to movement in the S&P 500 (using SPY). Using the new artificial intelligence-based ChatGPT to describe the VIX (also known as the "fear gauge":

"The VIX, also known as the CBOE Volatility Index, is a financial benchmark used to measure the market's expectation of volatility over the next 30-day period. It is often referred to as the "fear index" because it reflects market participants' expectations of near-term volatility in the S&P 500 Index options prices. The VIX is calculated by the Chicago Board Options Exchange (CBOE) and is widely used as a barometer of investor sentiment and market volatility."

Observing the chart on the next page, I note the following:

- The VIX rarely goes below 15, recently hovering between 18-20
- When the VIX bottoms in the 18-20 range and then reverses upward, a corresponding reversal (downturn) occurs in the S&P (SPY) as shown at the arrows (when fear goes up, stock prices retreat).
- Based on this pattern, the short-term outlook for the S&P is negative

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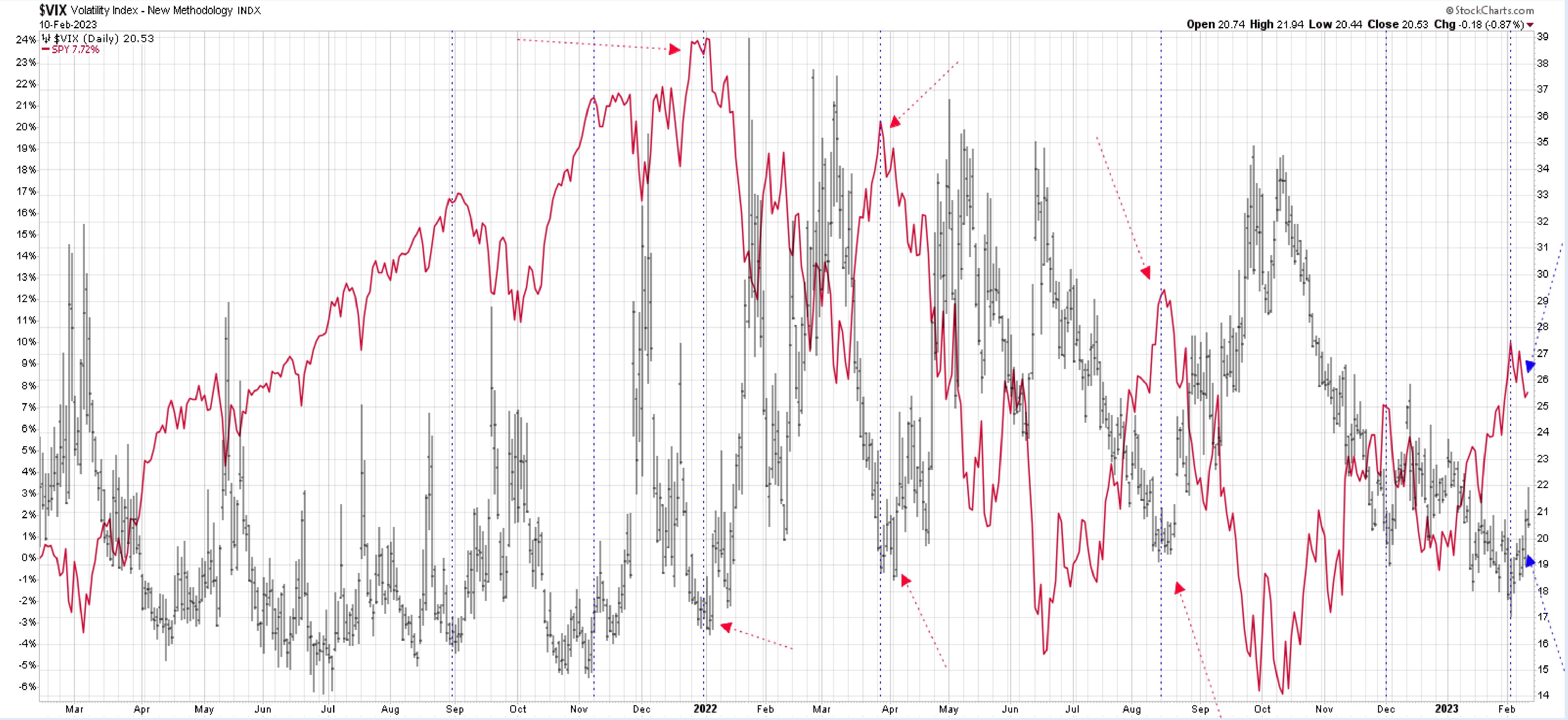

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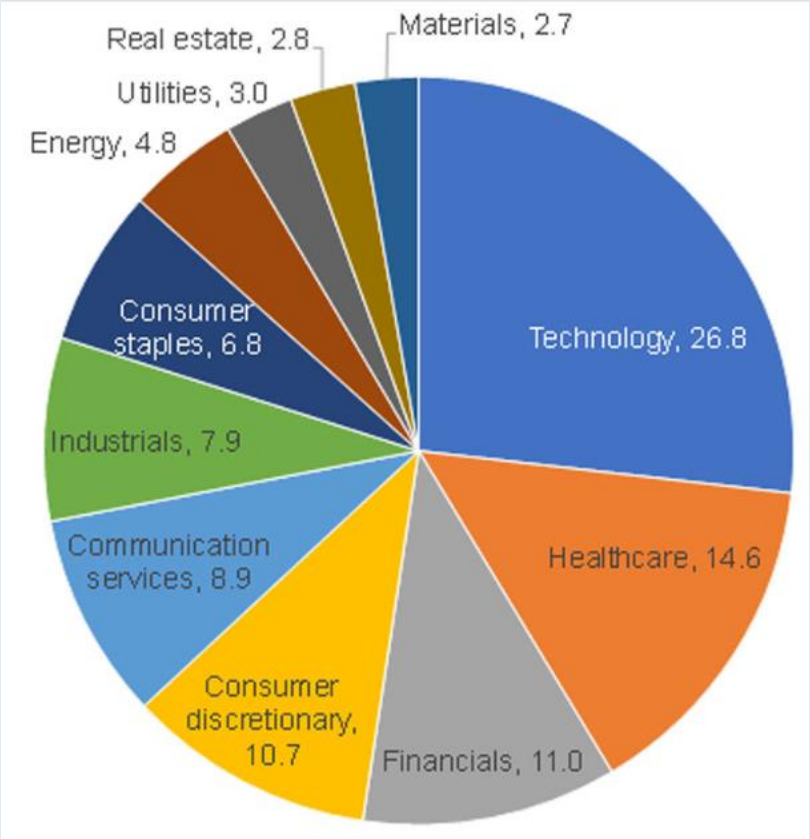
The charts below show the 11 sectors and their weightings that make up the S&P 500. Note that only energy had a positive return for all the periods shown. Within the S&P 500, 10 companies, mostly technology, make up about a quarter of the entire index. Several of the sectors are even more heavily impacted by very few stocks. For example, 3 companies account for about half of the technology ETF (XLK), the technology sector, 4 companies account for about half of consumer discretionary ETF (XLY), and 7 companies account for about half of the popular NASDAQ 100 ETF (QQQ).

These weightings highlight the importance of having a broadly diversified portfolio to minimize volatility and improve risk-adjusted returns. This also illustrates why benchmarks based on sectors can lead to distorted results.



NAME	1D PERF	5D PERF	1M PERF	3M PERF	6M PERF	YTD PERF	1Y PERF
XLY - Consumer Discretionary Select Sector SPDR Fund	-01.49%	-02.42%	+09.77%	+04.51%	-11.14%	+14.34%	-19.83%
XLV - Health Care Select Sector SPDR Fund	+00.71%	-00.38%	-01.74%	-01.53%	+00.35%	-02.70%	+01.63%
XLU - Utilities Select Sector SPDR Fund	+01.64%	-00.63%	-05.62%	-01.19%	-09.28%	-04.28%	+03.75%
XLRE - Real Estate Select Sector SPDR Fund	-00.47%	-02.71%	+04.95%	+03.98%	-09.60%	+07.91%	-10.46%
XLP - Consumer Staples Select Sector SPDR Fund	+00.41%	-01.09%	-03.12%	-00.65%	-01.92%	-02.62%	-01.37%
XLK - Technology Select Sector SPDR Fund	-01.18%	-01.69%	+09.77%	+06.78%	-05.49%	+12.00%	-11.91%
XLI - Industrial Select Sector SPDR Fund	+00.38%	-01.01%	+00.79%	+02.72%	+05.05%	+03.67%	+02.66%
XLF - Financial Select Sector SPDR Fund	-00.14%	-00.74%	+02.45%	+02.72%	+06.18%	+06.20%	-08.85%
XLE - Energy Select Sector SPDR Fund	+03.21%	+04.23%	+01.97%	+00.02%	+21.54%	+02.44%	+36.54%
XLC - Communication Services Select Sector SPDR Fund	-00.94%	-05.55%	+07.28%	+13.06%	-05.54%	+14.54%	-21.66%
XLB - Materials Select Sector SPDR Fund	-00.22%	-02.23%	-00.17%	+02.24%	+04.02%	+04.98%	-02.22%

The Economy

I'm asked where the economy is going and how that will affect investments. While no one can answer that with high confidence, all data that I follow point to a slowing economy:

- For about 300 of the S&P 500 reporting so far, Q4/2022 earnings are down -6.7% according to Zacks Research. (That said, 71% beat expectations and that probably helped account for the strong market performance in January.)
- Earnings estimates for Q1/2023 are expected to be down -7.5%, a worsening percentage decline over the last two months. Q2/2023 estimates have actually improved in recent weeks, primarily on account of the energy sector.
- The Treasury yield curve is at its most extreme inversion level since 1981. Inversions have always been followed by recessions within 6-12 months.
- Purchasing managers' indexes (PMIs) are in contraction territory as is the small business optimism index.
- The Fed, despite having eased from 50bp increases in the policy rate to 25bp last month, does not yet show any sign of backing off its expected goal (called the terminal rate). The next FOMC meeting is on March 22nd. There are two inflation reporting dates before then: February 14th and March 14th.
- While new home sales improved slightly from a relative low, building permits and existing home sales are all in sharp decline.
- Retail sales are falling on a month-to-month and year-over-year basis.

Despite this gloomy outlook, January's market performance was quite good suggesting investors have absorbed the bad news and are anticipating a better future on the strength of recent positive news on inflation. This brings to mind the "voting machine" aspect of the market referred at the beginning of this report. How the market proceeds from here will depend on how investor expectations for the economy are realized or dashed in coming weeks and months.

My outlook for the market is guardedly optimistic SO LONG AS there are no negative surprises from the many areas of potential headwinds. This could turn out to be a tall order.

Appendix

Stock Market in Focus (SMiF) presents my view of equity market conditions and factors that I believe may indicate direction in coming weeks and months. For the most part, these factors are based on what's called "technical analysis," or TA. Other factors, collectively referred to as "fundamental analysis," or FA, include various economic, financial, demographic, political and geopolitical conditions that impact investment markets. Those factors also inform my view of market direction but trading decisions are based entirely on technical analysis.

Technical analysis is the study of different indicators of price movement and trading volume of stocks, funds or indexes that can be suggestive of future price direction. The more these indicators agree with one another, the more reliable the trend interpretation, though there is no guarantee of outcome. Another way to look at TA is that it is essentially an analysis of investor behavior seen through market action which is presumed to indicate, if past is prologue, the direction investors believe a given investment is headed. However, past performance is no guarantee of future results. The next page provides a brief description of the technical factors I use in this report.

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Appendix

There are hundreds of technical analysis indicators and an almost unlimited number of parameters used in them. My analysis focuses on three of them: moving averages, momentum (using the "MACD"), and support/resistance channels, and trading volume. These four are briefly described below.

The daily and weekly price charts show price movement for the indicated exchange-traded funds (ETFs) in the charts used in this presentation. Moving averages indicate price trend with steeper moving averages indicating stronger trend. Various moving averages of different lengths are also shown. As faster moving averages cross over slower ones from above, the market is viewed as weakening and consideration should be given to reducing position exposure; when faster moving averages cross over slower ones from below, the market is viewed as improving and consideration should be given to increasing exposure.

The MACD indicator at the bottom of some charts is another indicator of price momentum. MACD is used to indicate the momentum of price trend and can also be used to indicate a reversal in trend. If different signals are given by the moving averages and the MACD, caution is advised as a reversal in trend may be coming.

Charts also show levels of support and resistance, some of which are horizontal lines and some of which upward or downward sloping. The longer price remains within a channel, the more reliable the channel is for forecasting. When price moves definitively outside of a channel, further movement in the direction of the trend may be expected. When price returns to the channel and then resumes its departure, additional weight can be given to price direction.

Volume indicates the number of shares traded during a period. Increasing volume may indicate conviction of traders. Very high volume, especially within a downtrend in prices, can indicate a reversal.

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Investing involves risk including loss of principal. Investing in international and emerging markets may entail additional risks such as currency fluctuation and political instability. Investing in small-cap stocks includes specific risks such as greater volatility and potentially less liquidity. Small-cap stocks may be subject to higher degree of risk than more established companies' securities. The illiquidity of the small-cap market may adversely affect the value of these investments.

Investors should consider the investment objectives, risks, and charges and expenses of mutual funds and exchange-traded funds carefully for a full background on the possibility that a more suitable securities transaction may exist. A prospectus for all funds is available from Lane Asset Management or your financial advisor and should be read carefully before investing.

Note that indexes cannot be invested in directly and their performance may or may not correspond to securities intended to represent these sectors.

Investors should carefully review their financial situation, making sure their cash flow needs for the next 3-5 years are secure with a margin for error. Beyond that, the degree of risk taken in a portfolio should be commensurate with one's overall risk tolerance and financial objectives.

The charts and comments are only the author's view of market activity and aren't recommendations to buy or sell any security. Market sectors and related exchanged-traded and closed-end funds are selected based on his opinion as to their usefulness in providing the viewer a comprehensive summary of market conditions for the featured period.

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