10 Predictions for 2023

The Fed Calls The Shots

What's Inside

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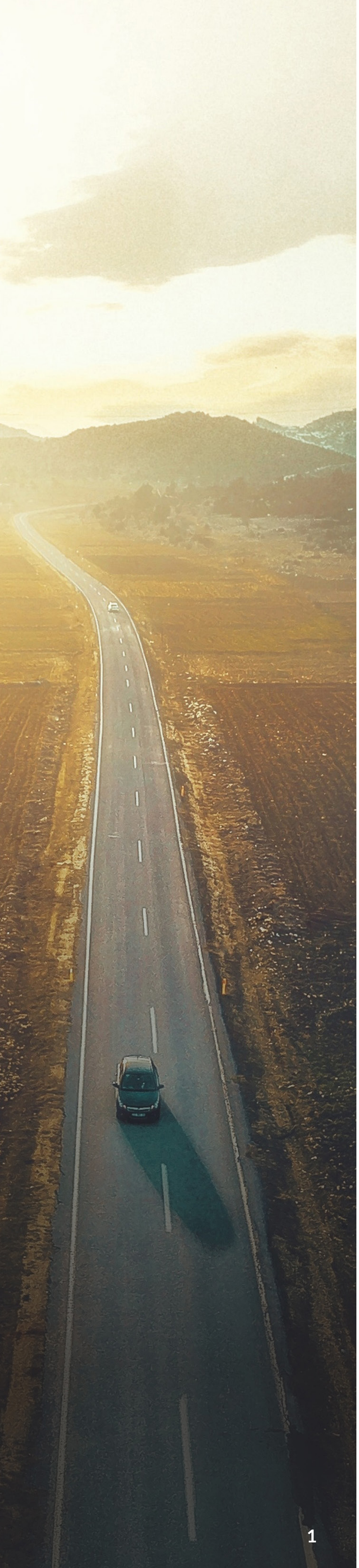

2022 Review

Near record volatility for 2022

Global financial assets experienced near record volatility in a generally hostile environment for investors given that the Fed and other central banks left themselves exposed to a rise in inflation as we cautioned in our year ahead outlook for 2022.

2022 was the first year in nearly fifty that stocks and bonds both had negative returns for the first three quarters. At the beginning of the year, we expected a down year, but not a 25+% bear market. Equity market performance was mostly driven by valuation compression as bond yields adjusted sharply higher in response to elevated inflation and monetary policy normalization by the Fed and other central banks. The P/E ratio of the stock market peaked at 22x at the January 3 high and fell to a low of 15x at the October 12 low. The Bull/Bear Ratio (BBR) fell to a bear market low of 0.57 in mid-October. Historically, BBR readings of 1.00 or less have offered great opportunities for long-term investors. Sentiment continued to lean risk-off on hawkish takeaways from central bank speeches and increasing growth fears. The path of least resistance was lower for most of 2022 with bounces repeatedly reversed by Fed pushback against occasional easing of financial conditions and expectations (or hopes) of a Fed pivot.

Multiple factors drove the market

Other major observations from 2022 include the massive outperformance of value over growth, and defensive over cyclical stocks. Energy stocks behaved as if there was no bear market at all. International stocks eked out outperformance over the U.S. despite China's zero-Covid policy and the ugly Russia-Ukraine war. The strong showing of Democrats in the midterm elections surprised most pundits.

Inflation is key

The key economic question for 2023 is whether central banks will be able to bring down inflation to acceptable levels without a recession. Beyond the inflation dynamic, we remain concerned about potential political and economic shocks that could impact the U.S. and global economy via higher uncertainty and/or tighter financial conditions. It is with this backdrop that we proceed as usual with fear and trepidation (and hopefully some good educated guesses) to unveil our prognostications for 2023 in the form of the Ten Predictions.

10 Predictions for 2022: Scorecard

As things currently stand, we will achieve 7.5 correct predictions for 2022, consistent with our long-term average of 7.0-7.5. Here is a brief rundown for the 2022 predictions.

Prediction / Score		Explanation
1 1/2 correct	**U.S. real growth and inflation remain above-trend but decline from 2021 levels.**	Real GDP did decline from 2021 levels but was not above trend; conversely, inflation was above trend, but did not decline. Needless to say, nominal growth was significantly above trend and above 2021 levels, but the mix (too little real growth, too much inflation) was problematic.
2 1/2 correct	**Inflation falls, but core inflation remains stuck at around 3%**	The notion that core inflation has risen and is stuck is an accurate reflection of the changed environment in the U.S. economy. And, of course, inflation has been falling over the last several months, but has not fallen below year-end 2021 levels.
3 ✓ correct	**For the first time since 1958/1959, 10-year Treasuries provide a second year of negative returns.**	The rise in Treasury yields (and the fall in bond prices) during 2022 has been breathtaking. On top of last year's fall, the two-year decline in the price of a ten-year Treasury has eclipsed all modern records. Thankfully, bonds have never had three years in a row of negative total return.
4 ✓ correct	**Stocks experience their first 10% correction since the pandemic and fail to make the gains widely expected.**	We were in a small minority at the beginning of the year arguing for a down equity year. Of course, we didn't expect the carnage to be as severe as it was. And the first half of the year was the first in history to be down more than 20% while earnings expectations moved higher.
5 1/2 correct	**Cyclical, value, and small stocks outperform defensive, growth, and large stocks.**	Cyclicals got clobbered by defensives, value trounced growth and small vs. big remains close. Economic weakness and recession concerns caused defensives to beat cyclicals. Rising interest rates, among other things, allowed value to beat growth. Small stocks remain cheap versus big ones.

10 Predictions for 2022: Scorecard (Continued)

Prediction / Score		Explanation
6 ✓ correct	**Financials and energy outperform utilities and communication services.**	Thanks to the energy sector's massive outperformance (best sector in 2022) and communication services underperformance (worst sector in 2022), this prediction is solidly in the money. Financials and utilities both outperformed but have made little difference to the overall results of this prediction.
7 ✓ correct	**International stocks outperform the U.S. for only the second year in the last decade.**	International stocks beat U.S. stocks by nearly 2% in 2022. This is amazing given the strength of the dollar and the myriad of problems overseas.
8 ✓ correct	**Values-based investing continues to gain share.**	While information is more anecdotal than ideal to evaluate this prediction, it is clear that the dialogue, education and adoption of values-based investment management is on the upswing. We are witnessing more and more individuals and institutions desiring to line up their portfolios with their values (despite all the ESG "noise").
9 ✓ correct	**After a 60+ year low in 2021, federal interest expense as a percentage of revenue begins a long-term move higher.**	With interest rates rising as fast as they have in 2022, this prediction has looked as easy as "shooting fish in a barrel". And with debt rising rapidly and interest rates unlikely to fall much, if at all, onerous consequences are likely to be seen as this trend continues.
10 × incorrect	**Republicans gain at least 20-25 House seats and barely win the Senate.**	Well, this one, according to the polls, looked solid going into election day. Needless to say, we missed the mark on this prediction. The usual mid-term election results of the incumbent party losing ground, especially with disapproval rates so high, did not materialize.

2023 Outlook

Waiting on the effects of the Fed

The most significant reason for economic growth to weaken is that the full effects of the substantial monetary tightening over the past ten months have yet to be felt. The main focal points for 2023 will be the Fed (and the recession question) and corporate earnings. We expect the Fed to raise rates to 5% or more and keep the rate at 5% or above for the balance of the year as inflation falls but to still unacceptable levels. We acknowledge the Fed could blink and acquiesce to a 3-4% inflation rate "for the time being" in which a soft landing might be possible. But if the Fed insists on their 2% target, a recession is almost inevitable. In the meantime, what the Fed has already done (raising rates from zero to 4 ¼% in a short period of time) will have a delayed impact on the economy, to be felt in 2023. We expect a mild recession in the U.S. in 2023 – mild due to the cash on corporate balance sheets, a reasonably healthy corporate sector, and a relatively strong banking system.

Expect negative revisions to earnings

As predicted, inflation peaked in mid-2022, after rising very fast and proving not to be "transitory." Falling inflation is occurring owing to the Fed's raising of rates to slow growth, a significant slowing in money growth (a hangover from the substantial excess of money growth post the pandemic), dollar strength, lower commodity prices, and some let up in supply chain disruptions. However, wage rates, service prices, and rent inflation are likely to stay stubborn and prevent inflation from getting anywhere close to the Fed's 2% target. It is the Fed's reaction to, yes lower, but persistent inflation that is the key investment question for 2023. See lower left slide.

Working through recession fears

For equities, we expect the lows of last October to be re-tested as growth fears/recession talk increases/earnings estimates are reduced. Bonds should rally during this period. Eventually, the focus will turn towards better economic prospects for 2024. When that occurs, bonds should falter and equities can rally.

Fed calling the shots in 2023

In conclusion, 2023 is shaping up to be another challenging year for investors. While "the Fed will call the shots," the shots they call will have a profound impact on earnings generation and the right multiple to put on those earnings. Like 2022, we expect 2023 to show plenty of volatility (in both directions) to keep things interesting. We wish our clients, our prospects, and our readers a happy, healthy and profitable 2023.

Key Questions

1. Have central banks already overtightened?
2. Will we have a recession?
3. What are trough earnings?
4. What is core inflation rate?
5. Can bond yields fall further?
6. How will QT complicate things?
7. Will there be breakage (liquidity/credit)?
8. How long will the dollar stay strong?
9. What happens to the war and oil prices?
10. Will China rebound and prevent a global recession?

10 Predictions for 2023

Theme: The Fed Calls the Shots

	Prediction	Explanation
1	**The U.S experiences a shallow recession as real GDP is in bottom ten of last 50 years.**	The most obvious reason to expect economic weakness in 2023 is that the full effects of the quickest and largest monetary tightening in 40 years have yet to be felt. Monetary policy impacts our economy with long and unpredictable lags. Along with the inverted yield curve, substantial negative money growth, and high inventory levels, this slowdown will likely result in a mild recession. However, there are factors that cause us to think that a recession is likely to be mild, including still high cash balances for consumers, strong corporate balance sheets, and a reasonably healthy banking system. A not to be dismissed risk is that most central bank tightenings end with a financial accident involving a credit or liquidity issue.
2	**Inflation falls substantially, but remains above Fed's target.**	As predicted, inflation peaked in mid-2022, after rising very fast and proving not to be "transitory." Falling inflation is occurring owing to the Fed's raising of rates to slow growth, a significant slowing in money growth (a hangover from the substantial excess of money growth post the pandemic), dollar strength, lower commodity prices, and some let up in supply chain disruptions. However, wage rates, service prices, and rent inflation are likely to stay stubborn and prevent inflation from getting anywhere close to the Fed's 2% target. It is the Fed's reaction to, yes lower, but persistent inflation that is the key investment question for 2023. See lower left slide.
3	**Fed funds reaches 5% and remains there for the balance of the year.**	Having been so slow to respond, the Fed has ratcheted up interest rates (starting in March) at the fastest pace sine the 1980's. In recent months, each inflation report (whether good or bad vs. expectations) has caused the Fed to revise up its estimate of the terminal Fed funds rate. We believe that rate is at least 5%, and that level will be retained for the balance of the year due to inflation not coming down as far as the Fed ideally wants. That would be a negative surprise to current consensus expectations, which sees rates falling by year-end. The gap between Fed funds and the current inflation rate is still pretty wide historically.
4	**Earnings fall short of expectations in 2023 due to cost pressures and revenue shortfalls.**	Next to the Fed and recession probabilities, earnings will be the major focus of investors in 2023. We believe consensus expectations are too high and will fade over the next six months or more. This is connected to our recession forecast which acknowledges the long and unpredictable lags between monetary tightening and economic impacts. Earnings typically fall around 15% during recessions. So far, the biggest downward revisions have occurred in communication services, consumer discretionary, materials, and technology. The smallest negative revisions have occurred in utilities, financials, consumer staples and healthcare, with energy revisions substantially positive. Our initial guess for 2024 earnings is a sharp rebound but only to levels forecasted by the consensus currently for this year.
5	**No major asset class is up or down by a double-digit percentage for only the fourth time this century.**	Many will argue that this is a prediction with not much conviction. We start by observing that single-digit positive or negative returns for cash, bonds, and stocks have occurred only a little more than 10% of the time this century and about 20% of the time over the last 100 years. So, it is not a prediction that has a high probability of occurring. We do expect bonds will be in a trading range whereby the 10-year U.S. Treasury meanders with a 3-handle yield. While stocks may fall early in the year if our recession and earnings concerns materialize, visibility into 2024 recovery should enable some recovery. What we do know is that stocks have never found a bear market low until a recession has started (if there is a recession). In our view, stocks and bonds are no longer very expensive, but are not necessarily cheap either.

10 Predictions for 2023 (Continued)

	Prediction	Explanation
6	**Energy, Consumer Staples, and Financials outperform Utilities, Technology, and Communication Services as Value beats Growth.**	We are repeating from 2022 our favored sectors to be energy and financials (as well as adding consumer staples) and our non-favored sectors to be utilities and communication services (and adding technology). Is it possible that energy and technology are slowly reversing weights to some degree? It is possible that the average stock outperforms mega-cap stocks again in 2023? The energy stocks are still small in capitalization relative to the sector's earnings weight (technology is just the opposite). Consumer staples are typically late cycle outperformers. Financials are both cheap and of higher quality than in the last several cycles. Utilities are expensive vs. both stocks and bonds and communication services continue to experience poor fundamentals and lots of competitive pressures.
7	**The average active equity manager beats the index in 2023.**	The active vs. passive debate rages on. (We think it's not either/or but both/and. The question is which way to lean in a given period.) Active managers have experienced huge headwinds in the last decade due to artificially low interest rates, strong equity returns, and low correlations. Many of these conditions have reversed/are reversing. Active managers historically have done better when the average stock beats the index, when fundamentals matter, and when interest rates are flat to up. That said, selection of strong performing active managers is as difficult as outperforming as an active manager!
8	**International stocks outperform the U.S. for the second year in a row (first time since 2006-2007).**	Given all the headwinds (especially the strong dollar), it is hard to believe that international stocks outperformed U.S. stocks in 2022 for only the second year in the last decade. We expect that to be repeated in 2023, making it the first two years in a row run in 15 years. For some time, U.S. stocks have been more expensive than international stocks (partly justified due to higher growth sector weights in the U.S.) If we get some dollar weakness and value outperforms growth again (as we expect), international stocks should outperform.
9	**India surpasses China as the world's largest population and is the fastest growing large economy.**	Needless to say, significant attention has been given to China, the largest country in the world from a population standpoint, and the second largest economy in the world. Much less attention has been given to India, which will overtake China in population in 2023 and is the fastest growing large economy in the world. China is still a "force to be reckoned with," but is suffering from economic strains due to the Covid lockdowns, over-leveraged real estate construction, a declining population emanating from the one-birth policy that lasted until recently, and an increasingly totalitarian government. India, by contrast, is a country of great promise, capitalistic tendencies, and a more open government. Challenges remaining, but India is replacing China in many ways as the country with the most hope and promise.
10	**A double-digit number of candidates announce for President.**	With the ink hardly dry on the 2022 midterm elections, Washington D.C. has already pivoted to focus on 2024, a presidential election year. Interestingly, replacement of the party in power has happened in eight of the last nine elections, the most volatile period in nearly 150 years. We expect a double-digit number of candidates to run for president. This will be an easy prediction to get right if President Biden decides not to seek re-election. We will continue to witness the aftermath of the peak in globalization. In addition, we are on the brink of a significant increase in interest expense on the national debt. Importantly, the third year in the presidential cycle historically enjoys the best stock market performance of the four. In fact, since 1950, the U.S. stock market has never declined in the twelve months following the midterm election.

Focus Five: 2023 Factors

Factor	Main Points	Portfolio Response
1 Economy/Earnings	• Fed path critical • Inflation falls, but still too high • Expect mild recession • Earnings estimates too high • Watch money growth	• Be flexible • Focus on high earnings predictability • Likely tough year to make money (but easier than 2022) • Consider alternative investments
2 Fixed Income	• Yield curve to stay inverted • Fed balance sheet unwind massive • Inflation path critical	• Move duration to neutral (own more bonds!) • Selective in spread products • Muni's attractive, if tax appropriate
3 Equities	• Recession question looms • Earnings focus huge • Multiples not egregious • Likely retest of lows	• Focus on earnings • Buy dips/trim rallies • Expect modest returns
4 Sectors	• Cyclical earnings cuts likely • Energy cash flow enormous • Financials cheap and higher quality	• Overweight energy, consumer staples, and financials • Underweight utilities, technology, communication services • Own value vs. growth
5 International	• Central banks behind U.S. • Markets significantly cheaper • Dollar weakness finally?	• Slowly increase international weighting

What to do?

1. Expect choppy markets (buy dips/trim rallies)
2. Focus on earnings growth (not P/E expansion) and free cash flow
3. Own some bonds (unlike advice a year ago)
4. Diversify across asset classes and geographies (more non-U.S.)
5. Own high-quality value and less expensive growth
6. Consider an absolute return strategy to complement market exposures
7. Don't fight the Fed; don't fight the tape

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