10 PREDICTIONS FOR 2023

Theme: The Fed Calls the Shots

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2022 Review – THEME: Tug of War Between Earnings Tailwinds and Valuation Headwinds

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.

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.

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.

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1. The U.S experiences a shallow recession as real GDP is in bottom ten of last 50 years.
2. Inflation falls substantially, but remains above Fed's target.
3. Fed funds reaches 5% and remains there for the balance of the year.
4. Earnings fall short of expectations in 2023 due to cost pressures and revenue shortfalls.
5. No major asset class is up or down by a double-digit percentage for only the fourth time this century.
6. Energy, Consumer Staples, and Financials outperform Utilities, Technology, and Communication Services as Value beats Growth.
7. The average active equity manager beats the index in 2023.
8. International stocks outperform the U.S. for the second year in a row (first time since 2006-2007).
9. India surpasses China as the world's largest population and is the fastest growing large economy.
10. A double-digit number of candidates announce for President.

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Conclusion

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.

In either scenario, analysts' estimates for earnings are still too high and will need to be reduced. The consensus forecast for 2022 earnings is $231 for the S&P 500 and $254 for 2023. Our estimates are $200 and $230. Profit margins are off their peak, but remain elevated by historical standards. As revenue growth slows, negative operating leverage should place further downward pressure on profit margins, creating negative earnings revisions.

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.

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.