January House View

Weekender

January 6, 2023

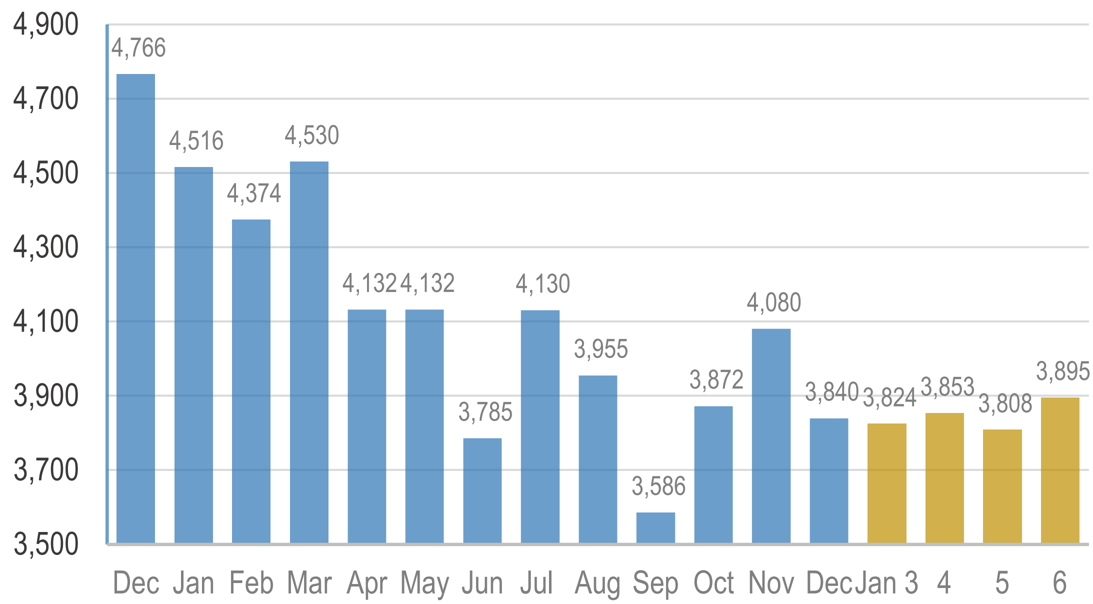
Good morning and welcome to the *Weekender* for Saturday, January 6, 2023. US equity returns for 2022, as measured by the S&P 500, were lower by -19.4%. The much narrower thirty-member Dow Jones Industrial Index fell by only -8.8%, while the tech-heavy Nasdaq lost almost one-third of its value, down by -33.1%. For the first trading week of 2023, US equity markets, again using the S&P 500 as proxy, were higher by 1.4% after a strong rally on Friday, which came on the back of strong labor data giving markets hope that a soft economic landing is possible.

The Dow does not outperform the tech-heavy Nasdaq very often. Over the past fifty years, from 1972 to 2022, the Dow only outperformed the Nasdaq by more than 20 percentage points once, in 2000, when the internet bubble burst. Share prices of high-flying internet stocks, many of which were concept companies with no revenues or profits, some with no business plan other than the moniker dot com in their name, came crushing back to earth when the bubble popped. In 2000, the Nasdaq fell by -39.3%, while the Dow fell by -6.2%. The Dow also outperformed the Nasdaq in 2001, although by less than twenty percent.

When technology shares underperform by such a large margin, compared to the Dow, it is a sign that the market is rerating shares by pushing valuations back down toward historical averages. We believe the re-rating process is mostly complete, in general. We expect equity moves from here to be governed by fundamental adjustments in operating environments that impact a company's earnings and free cash flow per share.

Standard and Poor's 500 Index

Monthly and DailyLevels



This *Weekender* is a summary of our January House View which lays out, mostly in narrative form, our forward view of the US and global economy and related financial markets. Our typical *Weekenders* will return in video and print format on Saturday, January 14, 2023.

Please be sure to consult a qualified financial advisor prior to making any financial decisions.

House View Summary

Since the beginning of the pandemic, in January 2020, global economies have experienced unprecedented increases in money supply, government spending, and erosion of consumer discipline. Combined with a schizophrenic closing and opening of economies in response to health concerns, these factors drove prices of everything to unreasonable and unsustainable levels. An everything bubble was inflated. Financial and product markets suffered the typical symptoms of inebriation. Loss of balance, rational grounding, and self-control. Financial markets spent most of 2022 in a well-deserved hangover waiting for the world to turn upside up again.

Alcohol increases the production of stomach acid which causes abdominal pain, nausea, and vomiting. It also causes blood sugar to fall prompting shakiness and mood disturbances in addition to a number of other effects like headaches, sleepiness, and a generalized inflammatory response. But hangovers are not permanent and tend to fade away as alcohol is metabolized, mostly by the liver.

I have only had alcohol once in my life. It was on an overnight flight from São Paulo to New York. After boarding, a flight attendant offered me a flute of champagne or orange juice. I chose what looked like orange juice from the tray, tipped my head back and finished it off in one gulp. It wasn't orange juice but mimosa, a combination of champagne and orange juice. I don't remember much else about the trip home after I snuggled into my business class seat. I am a relatively nervous flyer and don't sleep well on planes, preferring to meet my impending doom in full awareness. Not this time. I woke up as the wheels touched down at JFK. Best sleep of my life. At least until my Propofol-induced colonoscopy twenty years later.

The point. Over the past year, financial markets have been trying to metabolize the overdose of monetary and fiscal stimulus provided to cushion the economy and consumers from an expected worst-case scenario of the pandemic. But the worst-case scenario never materialized, leaving vast amounts of excess liquidity sloshing around in global economies and financial markets. How this excess is mopped up will determine the direction of markets over the next few years.

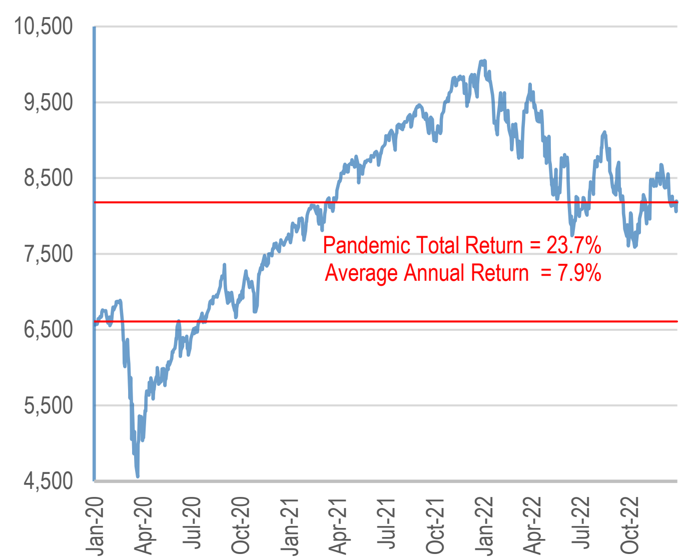
Perspective

Perhaps the most important and hardest thing to do at the beginning of a new year is to put the previous year into proper perspective. During the pandemic years (2020-21), government-sponsored policies and programs injected trillions of dollars of liquidity into financial and product markets around the world. Inflation across almost every category of product and service resulted. However, last year, broad inflationary pressures began to abate. Financial inflation, as manifest in excess valuations of stocks, bonds, and other financial assets, fell the fastest, in part, because of the availability and liquidity of markets for financial assets where buyers and sellers can trade in milliseconds. Product price pressures have been coming back in line gradually over the past six months as global supply chains mend and pent-up pandemic demand is satisfied and inventories topped off with precautionary surpluses. Real asset (property) prices and wages remain upward sticky because markets for real assets are illiquid and non-homogenous and the labor markets remain tight.

Despite last year's remarkable declines, US equity markets, as measured by the S&P 500, closed 2022 23.7% higher than their pandemic-eve level on December 31, 2019. In the three-years since the pandemic began, the S&P 500's simple average annual return was 7.9%. Placed in perspective, this is a reasonable, albeit not stellar, performance.

Pandemic Era Returns

January 2, 2020 - December 30, 2022



We believe the US economy, corporate earnings, and financial markets are in the process of sounding out a new post-pandemic normal. If history is a guide, markets are likely to overshoot on the downside before lifting back to a more sustainable level. This creates remarkable entry opportunities and the chance to "buy right," a condition critical to maximizing investor returns.

We believe stocks of companies that possess pricing power, a strong balance sheet, consistent unit sales growth and unflinching willingness to repurchase their shares, are worth buying today and holding for the long-term. During market declines, like the one experienced last year, investors often sell what they can (liquid shares) instead of what they should (overvalued shares), creating incredible buying opportunities in names that have been beaten down below their margin of safety. While some attractive isolated equity opportunities exist, we do not believe it is time to buy equities broadly. Instead, corporate bonds with the highest investment grade rating should be used as a short-term proxy for equity exposure until equity valuation signals confirm it is time to wade back into equity markets more broadly. Valuations of broad equity market indices have only come down to where they were before the pandemic. We expect earnings estimates for 2023 to fall considerably by the end of the second quarter of 2023. Earnings downgrades are likely to continue to put downward pressure on stocks, in general.

Recession, Stagflation, or Slow Growth

One of three economic scenarios are likely to prevail in the months ahead—recession, stagflation, and growth.

Recession. If economic recession advances from likelihood to certainty, labor markets will come apart, spending will decrease, earnings will fall, and stock prices will follow. High quality bonds, both government and corporate, are particularly attractive in this environment. They have fixed coupon payments that are attractive, while equities struggle in a tough economic environment. In addition, as the Federal Reserve lowers rates in an attempt to guide the economy from recession to expansion, bond prices will rise. As interest rates fall, stocks look attractive again.

Stagflation. A scenario of slow growth, no recession, and persistent inflation is called stagflation. Key to this scenario is maintaining a tight labor market. Historically, recessions are accompanied by deteriorating labor conditions. Data released this week show a tight labor market. Job openings rose more than expected, initial jobless claims did not show any deterioration, the unemployment rate remains close to all-time lows, and the US economy continues to add laborers to the workforce. Without a significant deterioration in the labor market, inflation is unlikely to meet the Fed's 2% target. But external pressures on the consumer are still likely to constrain spending enough to slow economic growth to a crawl. If a stagflationary environment prevails in the United States, the return maximizing strategy is the same as that mentioned under recession with one difference. The best time for taking on broad equity exposure will be delayed.

Slow Growth. Slow growth and a return to Goldilocks, where everything is just right, is our most unlikely scenario. Its probability is based upon the idea that most of the inflationary forces currently prevailing in the economy are transitory and will return to their pre-pandemic levels. With inflation in hand, the Fed will feel at ease lowering interest rates earlier than expected, increasing the odds of a soft landing. Economic growth will be slow but corporate earnings will recover faster, in this scenario, as cost pressures moderate and the consumer continues to spend. As an investment strategy, initiating a position in bonds remains the best starting point. Building positions in equity is more urgent than the previous two scenarios.

Economic outcomes rarely come in the neatly wrapped packages described above. However, they are helpful to understand the range of options available. Regardless of economic scenario, we believe it is prudent to initiate positions in government and investment grade corporate fixed income presently. The timing of when to increase equity exposure is determined by which economic scenario prevails. However, it's not whether equities should be included, but when they should be included. Consequently, being wrong on a particular economic scenario may result in being a little early or a little slow, a difference that doesn't matter in the long-term.

Our View

We expect economic growth from the fourth quarter of 2022 to come in stronger than most expect. However, we also expect growth to stall out in the first and second quarters of 2023. Not as a result of employment dislocation, but because of modest declines in consumption as consumers are increasingly overextended. Product and service inflation is already falling and by mid-2023 will be negative, accentuated by easier comparisons. This will give the Fed some breathing room. While they may not decrease rates, we expect them to hold off raising them. By mid-2023 equity markets will be discounting an environment with lower rates, lower inflation, and softer growth. These positives will be juxtaposed with the realities that earnings will still be soft.

Anemic economic growth that comes in below the rate of inflation, but not an outright economic contraction, is a very real possibility. A tight labor market may be the lifeline the US economy needs to evade full-blown economic recession. However, a toxic combination of higher inflation constraining purchasing power, higher interest rates making capital purchases increasingly difficult, an overindebted consumer that will need to begin deleveraging soon, spent personal savings, and dried up fiscal stimulus and payment moratoria ensure the economy will not be able to operate at its full capacity.

Whether an economic recession materializes or not, financial markets will shortly continue to discount an earnings recession. Lower corporate earnings will be driven by softer consumer demand from a tighter consumer and compressed margins from price discounts and rising cost pressures.

Our tactical asset allocation with a projected annual return of 8% includes: Twenty-five percent alpha equity; ten percent equity income; ten percent government bonds; twenty-five percent corporate fixed income; and 30% core equity. By mid-2023, we anticipate trimming the corporate fixed income positions in exchange for larger core equity allocations. However, this timing may change depending upon which economic scenario materializes.

Market Narrative

The S&P 500 closed out 2022 at 3,839.50, lower by -19.4% from where it started the year. Seven important divinations are critical to help understand what transpired in markets over the course of the pandemic and where the best opportunity set exists for 2023.

First, the powerful equity market gains in 2021 of 26.9% for the S&P 500 were unwarranted and unearned. Meaning, they were unjustified by sustainable growth in corporate earnings. In 2022, financial markets took back 2021's unearned gains.

Second, when looking over the whole pandemic period from January 1, 2020 to the end of 2022, the S&P 500 Total Return Index, which reinvests dividends, rose by 24.8%. The average annual total return over the three pandemic years comes out to 7.9% which is about half the average annual return of the S&P 500 Total Return Index from the end of the credit crisis (January 1, 2010) to the beginning of the pandemic (January 1, 2020) of 13.3%.

Third, equity valuations using the common price-to-earnings ratio, averaged 16.1. Going into the pandemic the PE ratio for the S&P 500 was 19.8, expensive compared to historical averages. As stock prices rose during the pandemic, valuations reached 27.1 times forward earnings. After a year of price declines, the forward PE ratio for the S&P 500 ended the year at 15.5, relatively close to the pre-pandemic average, but still not low enough to be considered cheap. In the face of coming economic softness or recession, it's very likely earnings will be falling, driving up the PE ratio from its current levels. The graph below shows the S&P 500, the blue line, and consensus earnings estimates for the S&P 500, the gold line. Future earnings estimates are falling. We expect estimates to continue to decline as first and second quarter 2023 results are reported.

Fourth, equity markets spent the first two years of the pandemic (2020 – 2021) exercising their animal spirits. In the graph below, the blue line shows the cumulative gain in member companies that do not generate profits while the gold line tracks the cumulative return of the S&P 500. Simple observation shows the buildup of the pandemic bubble in unprofitable concept stocks followed by pricking of the bubble and dramatic declines over the past two years. Inflation, higher interest rates, and disappearing stimulus payments pushed concept shares lower. With the market's animal spirits all but exhausted, fundamentals will trump unicorn fairytales for the foreseeable future.

Fifth, ever since the credit crisis, the US Federal Reserve has actively pursued policies that kept interest rates artificially low, keeping bond yields low in tandem, which made bonds unattractive and stocks the only portfolio investment worth holding. The Fed's attempts to bring inflation to heel by raising interest rates are breathing life into the fixed income market for the first time in more than a decade. We believe inflation and interest rates will stay well above the Fed's target rate of 2.0% for the foreseeable future making fixed income, once again, an essential and useful staple of all portfolios.

Sixth, all financial market bubbles are a function of excess liquidity which eventually needs to be mopped up. Inflation began building in early 2021 making interest rate increases essential and urgent. But the Fed delayed their response insisting that inflation was only transitory and would correct itself. It didn't. By the time the Fed changed its view on inflation, it had become entrenched requiring the most aggressive interest rate response in post-World War II economic history.

Throughout 2022, equity markets softened reflecting reduced valuation premia created by excess liquidity from fiscal and monetary pandemic-related stimulus. By mid-summer 2022, equity valuations had returned to their pre-pandemic trend of 17.6x historical earnings. The US economy is now weakening going into 2023 which will result in downward earnings revisions and continued softness in equity prices. While we do not pretend to be market timers, buying right is a key discipline required to exploit what the markets offer any investor. We do not believe a bias for being fully invested necessitates taking an equity beating when returns can be harvested in other instruments.

Seventh, after the pandemic dust settles, a lasting lesson will highlight a "tyranny of experts" that continues to foment instability in almost every aspect of modern life. As a response to pandemic uncertainties, politicians and bureaucrats surrounded themselves with a quorum of credentialed experts who would loudly declare the righteousness of each chosen remedy while ignoring their costs. This is not a blindsided swipe at Dr. Fauci, or any expert, in particular. It is a general assessment of our move, as a society, toward the perceived value of celebrity at the expense of empirically proven principles.

The economic cleanup costs of the pandemic have yet to be felt. But some of them include rising healthcare costs, lower long-term productivity, education deficits, increased poverty and crime, a decline in global free trade in exchange for a return to bilateral arrangements, and labor market dislocation. These are all structural changes that may take a generation to find a new trend. There are also many areas where the pandemic has facilitated a weakening in the social fabric and contract that has formed the foundation for democratic and capitalist societies for over a hundred years. A trendy move toward soft-quitting, continuing to live with parents well past the point of adulthood, men withdrawing themselves from the labor force and higher education cohort, and a heightened sense of comfort with social isolation.

We believe financial markets are embarking on a shift as fixed income instruments become as essential a component of diversified portfolios as they were a generation ago. Bonds have not been useful yield instruments since before the Credit Crisis. Yields, in general have been declining since the early 1980s. Higher inflation and the actions of the Federal Reserve to fight it are waking up fixed income instrument around the world.

With these seven perspectives in hand, we believe investor returns can be maximized by taking advantage of a resurgent bond market driven by high interest rates which are likely to remain persistent over the next 9-12 months. Being overweight fixed income while the Federal Reserve tightens into peak-rates will provide exceptional current yield, while rates continue to rise, and capital appreciation, as they fall, following the Federal Reserve into a more accommodative monetary stance, which we believe will happen in late 2023 to early 2024. Over the next 6-9 months we expect equity prices to continue to fall as earnings estimates moderate going into economic softness and recession.

To be clear, we expect equities to remain in a bearish tonal environment until there is a turnaround in global growth, or at least a hint of one, an improvement in investor sentiment, and a return to a normal degree of market liquidity. Each of these conditions are likely to begin to present themselves as the Federal Reserve begins to lean away from contraction and into accommodation.

In the year ahead, we believe markets will move in step with four fundamental forces: 1. Interest rates; 2. Consumer strength; 3. Earnings, and 4. Economic growth.

Interest Rates

The Federal Reserve continues to stress that interest rates will remain higher for longer, a tone that is critical to force markets to begin discounting positive real interest rates. In other words, an end of free money. It's fair to say that financial markets do not believe the Fed's rhetoric. On four separate occasions, financial markets have jumped the gun to get ahead of what they believed was a pivot by the Fed, just around the corner.

We believe interest rate risks are roughly symmetrical. Inflation is coming down from peak levels fairly quickly. If it continues to decline at the current cadence, the Fed will have a lot less pressure on them by Summer. On the other hand, wage pressures remain strong, driven in large part to a labor market that refuses to yield to the Fed's dramatic actions.

Despite asymmetric risk, we expect the Federal Reserve to continue raising rates in smaller and smaller degrees until the beginning of Spring at which time they will probably sit tight and assess for the rest of the year. In this environment the real estate market will continue to get pounded into submission. It is likely that the Fed will stop raising rates once their target rate gets close to 5.25-5.5%, up from 4.5% today.

Consumer Strength

From an economic perspective, the consumer is getting stretched. Their incomes are still not keeping up with inflation, delinquencies on consumer, credit card, autos, and mortgages are beginning to rise, savings levels as a percent of disposable income are at all-time lows, consumer deposits are falling. Spending over the Christmas season was much weaker than forecast portending a really rough year ahead. How rough will depend on the labor market. At present, unemployment remains close to record low levels. If the labor market remains tight, any economic slowdown is likely to be short and shallow.

In addition, intermediate inventories of unfinished goods require employees to complete the products and prepare them for the retail channel. This combined with the fact that many "would be" workers, who were active in the labor market before the pandemic, have elected to withdraw from the work force leaving a labor shortage as manifest by there being more job openings outstanding than there are unemployed persons to fill them. We believe the labor market will soften after the holiday season. However, the demographically induced structural labor market comeuppance of a smaller working cohort due to low birth rate has burst upon the economy in a dramatic fashion, brought forward a bit by the pandemic. Long-term labor surplus is likely a thing of the past.

Earnings

Earnings declines are not priced into the market which could send equity values lower by 12.5% from current levels. This move is being driven by a combination of a 6.0% drop in earnings and a 6.5% drop in valuation multiples from 18.6 x today to its average pre-pandemic multiple of 17.6 x earnings. For the fourth quarter of 2022, we expect earnings to show modest declines with positive pricing power and continued margin erosion. However, by the end of the second quarter of 2023, we believe corporate profits will shrink by 6.0% driven by deep discounting required to clear bloated inventories, a softening consumer, and margin compression from higher costs.

For the third quarter of 2022, sales grew by 11.5%, driven by pricing power among consumer discretionary sectors and higher year-over-year commodity prices propping up margins for materials, industrials, and energy sectors. Earnings only grew by 4.7%, showing considerable margin compression.

We believe fourth-quarter earnings are likely to come in relatively strong given reported strength in consumer spending, incomes, and labor markets. However, we expect earnings for the first and second quarters to show significant signs of decay.

Economic Growth

Manufacturing and services in the United States are in contraction. Leading economic indicators have fallen in ten of the last 11 months. The economy falls into recession every time this happens. Wholesale and retail inventories continue to rise requiring copious discounting to heave it out of the supply chain which will weigh on profit margins for at least the rest of 2023. New orders that typically follow the holiday selling season will be pushed back.

The US economy is contracting and will continue to do so into the first half of 2023 creating a foundation for the early stages of an economic recession. With economic growth slowing and inflation remaining persistent, albeit at much lower levels, we believe the US economy is entering the first stagflationary period in a generation.

The Institute of Supply Management and Standard and Poor's each publish their own purchasing manager's indices (PMIs) for both manufacturing and services as well as producing a composite reading that weights them together. On Friday, the S&P release confirmed the general trend exhibited in the ISM data from a week ago. The US manufacturing reading was 46.2, lower than expected, signifying US manufacturing is clearly in contraction. The services reading was even worse at 44.4 while the composite was 44.6. All readings were lower than analysts had been expecting and they all suggest that the US economy is in contraction.

Over the past month a bevy of economic data has been released showing concerted deterioration in the US economic landscape. The Empire Manufacturing Survey was a disaster. The Philadelphia Fed Business outlook survey was much more negative than expected. Retail sales, on a month-over-month basis was negative, although year-over-year data came in relatively strong. Industrial production numbers came in showing a decline on a month-over-month basis. The point: the recent trend, tracking from mid-October to present, suggests contraction. But it's a contraction that has yet to tip over the labor market.

Conclusion

That's it for this *Weekender* and our January 2023 *House View*. Have a wonderful week.