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Economic & Market Update

2022 REVIEW | JANUARY 2023 OUTLOOK

Persistent inflation, carried over from 2021 and exacerbated by the Russian invasion of Ukraine and the imposition of harsh sanctions on Russia by the Western allies, was the primary driver of the global economy and markets in 2022. Further, higher interest rates resulted in one of the worst years ever for the bond market and were the biggest drivers of the equity bear market that developed during the year. Though the U.S. consumer remains strong, oil prices, China's "zero-Covid" policy, and USD strength are worth watching as the Fed monitors inflation and attempts to engineer an economic soft landing. Should earnings stay strong, and the Fed succeed, rates may no longer be an impediment to equity valuations in 2023.

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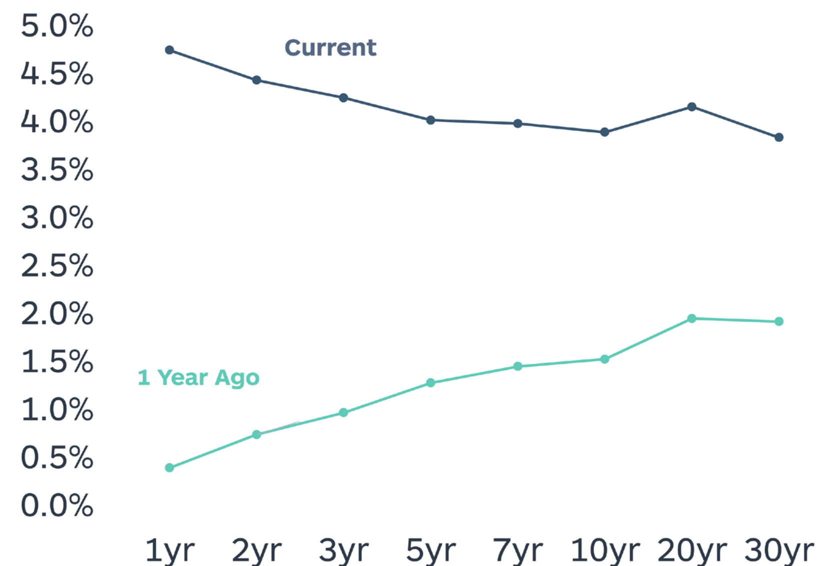
REVIEW OF 2022

- Persistent inflation, carried over from 2021 and exacerbated by the Russian invasion of Ukraine and the imposition of harsh sanctions on Russia by the Western allies, was the primary driver of the global economy and markets in 2022. Supply chain disruptions caused by the war interrupted the expected progress on inflation as food and energy prices rose sharply in the first half of the year. Inflation ultimately peaked in June (hitting a 40-year high) and began to dissipate in the second half of the year, but not fast enough as shelter and a few other services sectors proved sticky in their ability to maintain price increases. This forced the Federal Reserve (Fed) and eventually other central banks to become much more aggressive in their tightening policies. The federal funds rate rose throughout the year from effectively zero in January to roughly 4.50% by the end of the year, as the Fed was forced to implement four 75-basis-point rate increases during the year.
- Interest rates across the Treasury yield curve also increased sharply as the 10-year U.S. Treasury Note rose from 1.50% at the beginning of the year to nearly 4.25% by October [Exhibit 1]. The unprecedented increase in policy rates from extremely low levels heightened fears the Fed was tightening into an already slowing economy. This concern was best reflected in the eventual inversion in the yield curve as the spread between the 2- and 10-year U.S. Treasurys turned negative in July. While there were extenuating circumstances around trade and inventories, gross domestic product (GDP) in the United States contracted in the first half of the year, which further added to the belief the economy was already in recession.
- Higher interest rates resulted in one of the worst years ever for the bond market and were the biggest drivers of the equity bear market that developed during the year. The bond market, as measured by the Bloomberg U.S. Aggregate Bond Index, had its worst year since the index's inception in 1977. Major equity indices posted their worst returns since 2008 during the peak of the Great Recession. Despite the negative first and second quarter GDP prints, corporate earnings likely grew around 6.0% for all of 2022 as the U.S. economy resumed

Exhibit 1: Treasury Yield Curve

As of 12/31/22

Source: FactSet



its GDP growth in the second half of the year. However, without the energy sector, earnings would have fallen by 1.5%. Valuations on this earnings growth declined rapidly as cash and fixed-income securities were finally able to compete effectively after years of extremely low yields. Particularly hard-hit were the more speculative and growth-oriented stocks whose valuations benefited greatly from near-zero interest rates in 2020 and 2021. This allowed the value style of equity management to significantly outperform growth stocks throughout the year. The energy sector was a key contributor to this outperformance [Exhibit 2].

- Despite higher interest rates and higher prices, U.S. consumers remained resilient, fueled by continued job and wage growth and the ability to tap into the accumulated savings from pandemic-driven fiscal relief packages delivered in 2020 and 2021. Businesses grew more cautious in their spending as the year progressed, but

they still committed to capital projects that would satisfy consumer demand. There were some indications of excessive spending on inventory accumulation in certain goods sectors, which should help alleviate inflationary concerns in 2023. Notable in the business spending statistics was the healthy commitment to technology and intellectual property, which should enhance workforce productivity as manufacturers secure their supply chains by shifting more production back to the United States.

» Oil prices, which spiked higher early in the year due to feared supply disruptions from sanctions placed on Russia, reached a peak in mid-year and then began to trend down as Russian oil was still able to find its way into markets and production began to increase in non-OPEC nations [Exhibit 3]. The resulting decline in gasoline and other energy prices in the United States helped reduce inflation at the end of the year. However, the Russian reaction to sanctions and price caps was to slow and sometimes stop the flow of natural gas to Europe, putting severe pressure on the European economies at the same time the European Central Bank and Bank of England are aggressively tightening monetary policies.

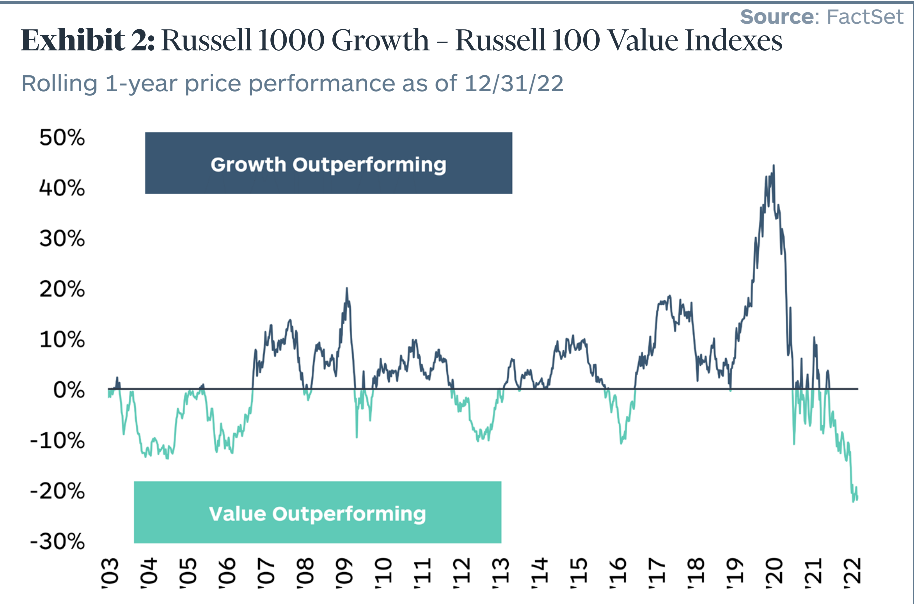
» In China, the maintenance of "zero-COVID" policies and the imposition of harsh lockdowns in cities that experienced only a few cases hampered production in various regions throughout the year. President Xi Jinping effectively consolidated his authority at the Communist Party Congress and began to overtly favor state-owned enterprises over the entrepreneurially based industry champions in the technology and communication services sectors. With the property sector struggling with high debts and the effects of overbuilding and the pressure on exports from continued trade battles with the United States, the Chinese economy slowed more than expected in 2022.

» The U.S. dollar rose significantly against most currencies due to its safe-haven status and early, aggressive Fed rate increases. This sharp rise offset virtually all the outperformance seen in various foreign equity markets compared to those in the United States. U.S. dollar appreciation is also expected to exert pressure on the earnings of U.S. multinational companies when fourth quarter earnings are reported early in the new year.

Source: FactSet

Exhibit 2: Russell 1000 Growth – Russell 100 Value Indexes

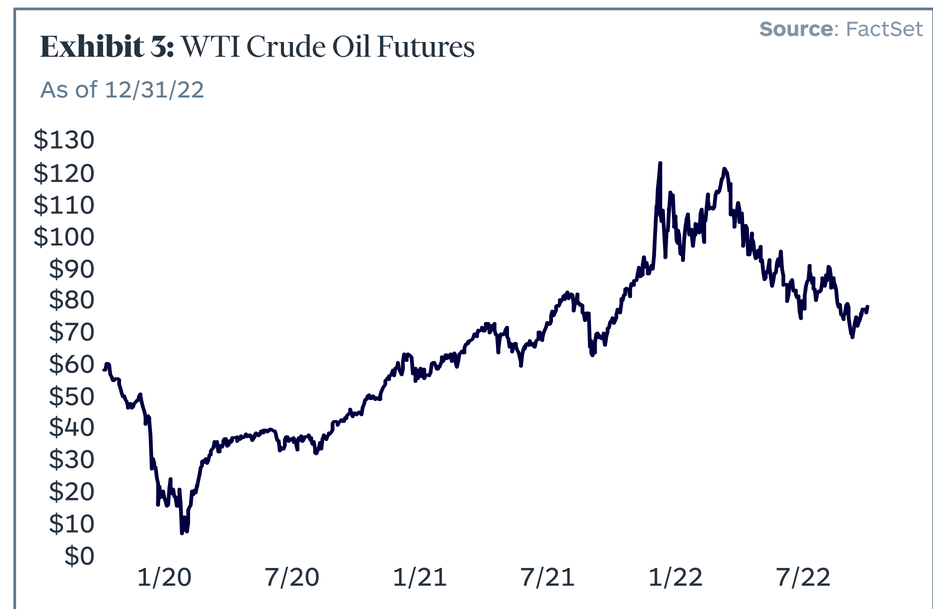
Rolling 1-year price performance as of 12/31/22



Source: FactSet

Exhibit 3: WTI Crude Oil Futures

As of 12/31/22



January 2023 Outlook

2023: THE PATH FOR INFLATION

» The mid-year 2022 peak in the inflation rate and subsequent steady improvement should continue into 2023 as supply chains have largely unclogged and inventories have been effectively replenished, if not somewhat overbuilt. Demand has remained rather strong but should decline somewhat because of aggressive monetary tightening by most central banks around the world. Shelter inflation has been the stickiest in resisting declines seen in many other sectors, but the U.S. housing sector is already in recession and prices are beginning to decline in many regions. This will inevitably lead to a slowdown in overall shelter inflation in the coming months [Exhibit 4].

» The component of inflation that most concerns the markets and the monetary policymakers going into 2023 is wages. The labor market remains tight as employers are reluctant to lay off workers in some services sectors and labor force participation has struggled in returning to pre-pandemic levels. In a service-oriented economy, wages are the largest input cost in many industries and any entrenched supply-demand imbalance can have a longer-term effect on the overall inflation rate. While politically distasteful, the Fed would like to see the labor markets loosen a bit. Ideally, this would occur from greater labor force supply, but it could also be driven by lower labor demand in a slow growth, potentially recessionary economy [Exhibit 5, 6].

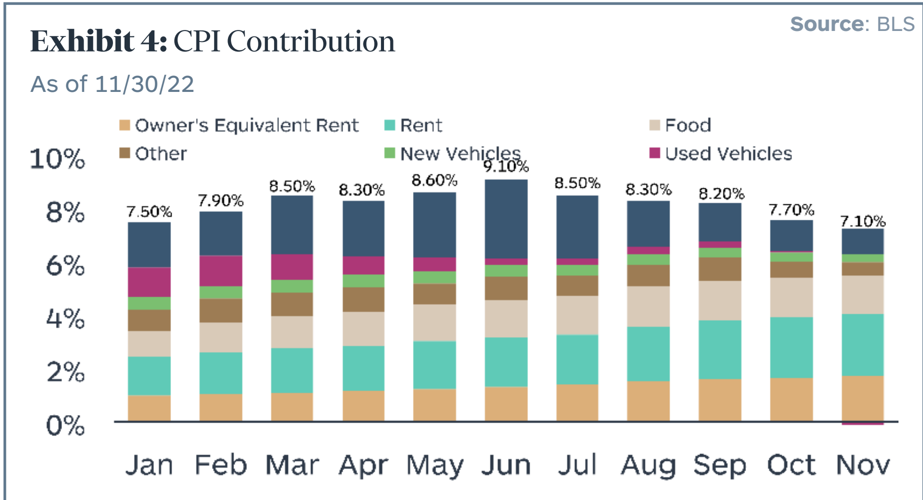


Exhibit 4: CPI Contribution
As of 11/30/22
Source: BLS

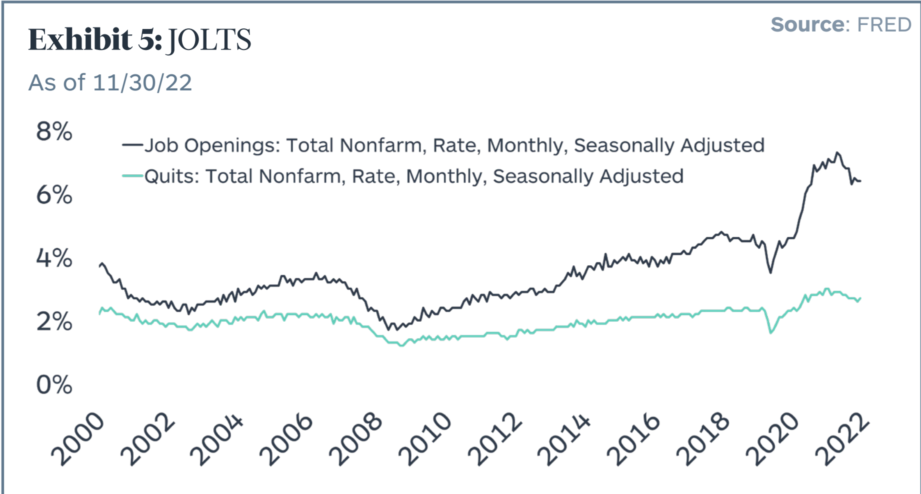


Exhibit 5: JOLTS
As of 11/30/22
Source: FRED

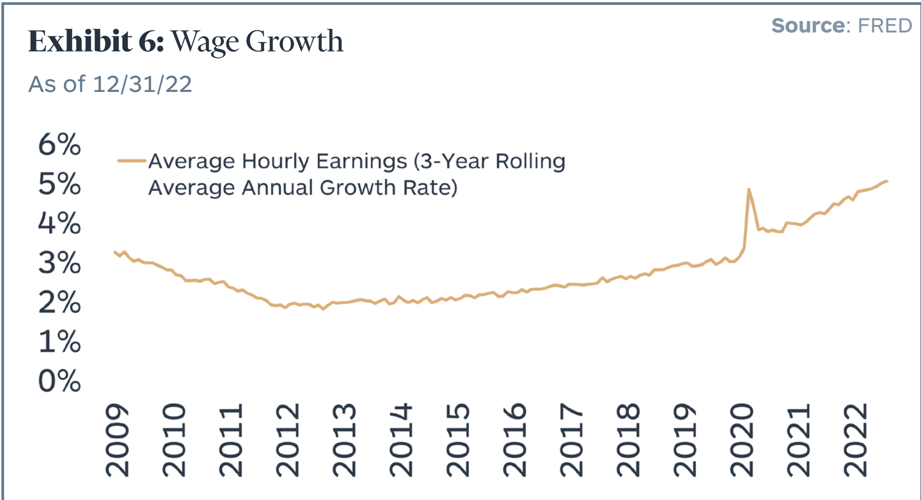


Exhibit 6: Wage Growth
As of 12/31/22
Source: FRED

THE FED'S NEXT MOVES

- Given the improving inflationary indicators, there was broad market disappointment that the Fed refrained from sending a stronger signal after the December Federal Open Market Committee meeting that it was close to the end of the tightening cycle. Hopes for a strong year-end equity market rally were dashed when the Fed and Chair Jerome Powell maintained that inflation remains too high and the labor market too tight, with policy needing to remain restrictive until inflation is vanquished. The forecasts of the various Fed governors were for the federal funds rate to continue rising above 5.0% in 2023, although there is some dissonance with market expectations that the terminal federal funds rate will stay below 5%, which would entail only 50 basis points more of tightening before they stop [Exhibit 7].
- Having increased rates and reduced its balance sheet so aggressively in 2022, the Fed may very well be entering the jawboning phase of its tightening strategy by continuing to stress remaining vigilant about fighting inflation while awaiting further confirmation that the combination of greater supply and reduced demand will bring inflation much closer to its 2% target. In the absence of recession, core inflation should end 2023 at around 3.0%. Of course, continued tightening into an already slowing economy heightens the risk of a policy error and a stronger economic contraction, which would bring the inflation rate down to the Fed target much faster. Markets are looking for clearer signs the Fed is near finished with rate increases. Hopes for a "pivot" whereby the Fed begins to decrease rates would probably only occur in a recessionary environment.

SOFT VS. HARD LANDINGS

- Should the U.S. economy indeed fall into recession in 2023, it would be the most anticipated recession over the last 60 years, as nearly 50% of economists surveyed believe the economy will contract over the next year. Certain key economic indicators such as the monthly ISM manufacturing survey are beginning to signal recession. However, the ISM services survey remains comfortably in expansion as consumers were generally sated in their goods demand over the past few years and notably shifted their spending patterns toward services and experiences such as travel, events and dining out after having been largely denied these spending opportunities due to the pandemic [Exhibit 8]. The strong labor market with ample wage growth is another factor pushing back on the belief that a recession is inevitable. Perhaps these are both lagging indicators that are destined to begin declining due to higher interest rates. Nevertheless, this inherent strength in certain sectors of the economy could allow

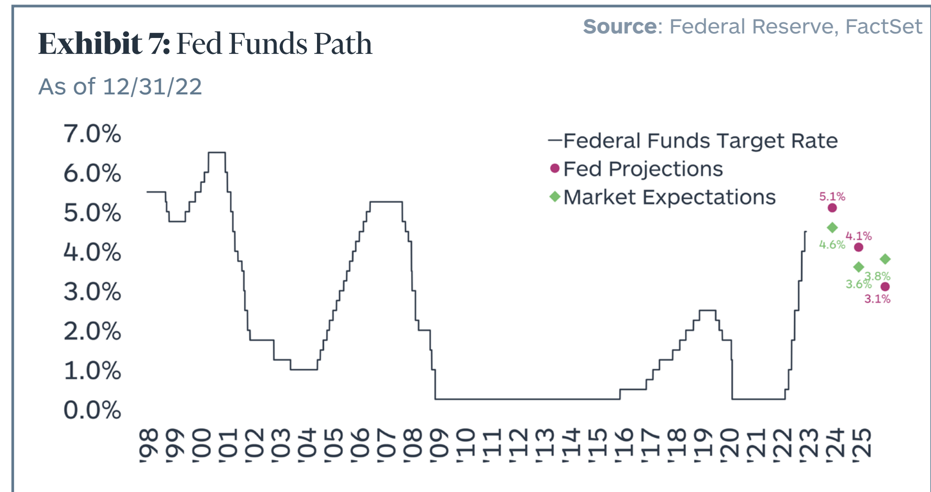


Exhibit 7: Fed Funds Path

As of 12/31/22

Source: Federal Reserve, FactSet

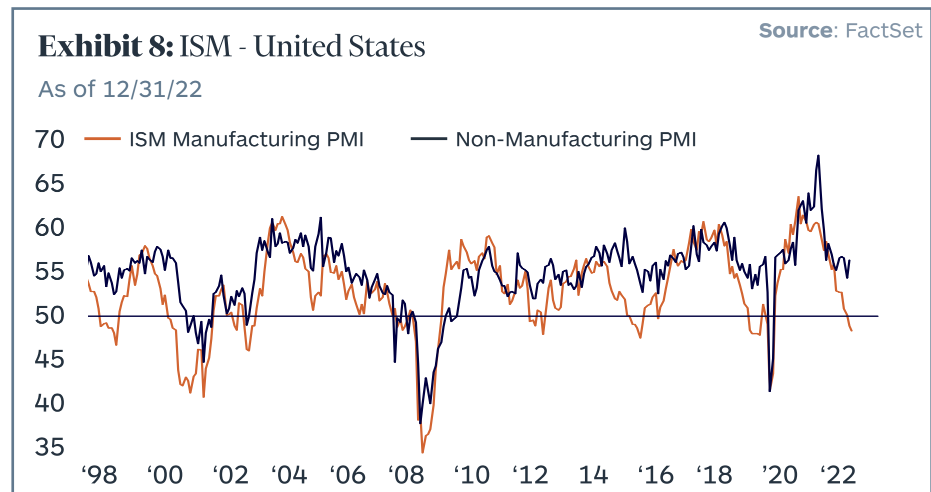


Exhibit 8: ISM - United States

As of 12/31/22

Source: FactSet

for any recession to be short and shallow and may be already fully priced in by markets. The lack of any notable inventory excesses and greater energy independence should greatly mitigate the deeper economic contractions experienced in the late 1970s and early 1980s or the more recent financial crisis recession of 2008. Unemployment rates will have to increase to loosen the tight labor markets, but only to roughly 4.5% in a slow growth/mild recessionary environment.

» Looking at market indicators of the state of the economy and possibility of recession, the sharply inverted yield curve stands out as a sign the Fed may be tightening too aggressively, as longer duration bond buyers remain willing to accept yields below 4% going into the new year in anticipation of near-term Fed ease due to an oncoming recession. A market indicator that rather strongly counters the notion that the United States is on the precipice of recession is the interest rate spread between high-yield debt and that of same maturity Treasurys. Historically, this spread widens to roughly 1,000 basis points as fears increase of rising defaults on below-investment-grade debt in an oncoming or existing recession. The spread is currently below the long-term average of 500 basis points, which means so-called "junk bond" buyers remain relaxed around future defaults.

PEAK GLOBALIZATION HAS PASSED

» Growing trade frictions with China and even some disputes with our close European allies at the end of the last decade introduced the concept of deglobalization as free trade with other countries did not necessarily equate to fair trade. The pandemic and the resulting stress on supply chains revealed the weakness in the "just in time" inventory management philosophy espoused through most of the century. As businesses began to understand that having key components of their products sourced thousands of miles away by people with different beliefs and ideologies might not be such a good idea, the thought of returning production back to domestic shores grew in popularity in recent years. While still somewhat anecdotal, there have been highly publicized announcements of U.S. and foreign businesses building factories in the United States to make products that were previously manufactured overseas.

» The implications of this reshoring movement should be positive for the U.S. economy with some analysts calling it a "manufacturing renaissance." The potential downside inherent in bringing manufacturing back to the United States is the high labor costs, which could result in more entrenched inflation and/or lower profit margins for the manufacturers. We believe that a necessary accompaniment to this reshoring trend will be a requisite increase in corporate spending on productivity-enhancing technology equipment and software. Higher productivity would warrant higher wages while keeping unit labor costs under control. Achievement of this goal could result in a boost to real GDP growth without provoking higher inflation. As of now, this productivity story is aspirational, but the strong corporate spend over the last few years on technology appears to confirm that American businesses understand both the problem and the opportunity. European businesses are seeing similar reshoring trends with an additional catalyst being the need to invest more in energy production to lessen their dependence on Russian energy imports.

GOOD NEWS IN THE LABOR MARKET MAY BE BAD NEWS FOR FINANCIAL MARKETS

» Normally, a strong labor market would be welcomed by economists and financial markets participants as a sign of an inherently strong economy. Unfortunately, due to the worst inflationary environment experienced in two generations, consistent employment growth and low unemployment rates are exposing a historic mismatch between the demand for and supply of labor. The number of job openings in the U.S. economy is roughly 70% higher than the number of unemployed persons. Wages are rising at a rate deemed to be too fast by markets. Going into 2023, both the Fed and the markets are in the uncomfortable position of looking for some slack to develop through job declines and a higher unemployment rate, which should take pressure off wages [Exhibit 9].

COMMODITIES: FROM HEADWIND TO TAILWIND

» Acute shortages of key commodities due initially to the pandemic and then the effects of the Russian invasion of Ukraine were the catalysts for the worst inflation environment seen in the developed economies

since the early 1980s. As COVID-19 lockdowns generally ended, commodity producers reacted to the higher prices by meaningfully accelerating their production. Demand for commodities has also slowed somewhat due to the combination of high prices and tighter monetary policies. Prices are now back down closer to pre-pandemic levels for most commodities in the energy, industrial and agricultural spaces, which has helped greatly in allowing overall inflation to peak and then improve toward the end of 2022 [Exhibit 10].

» Oil prices followed a similar pattern to most other commodities in peaking around mid-year and then declining in the second half. However, oil and natural gas continue to be subject to artificial supply restrictions imposed by the OPEC cartel as well as Russia's apparent willingness to weaponize its vast energy supply in what has evolved into a proxy war not just with Ukraine, but with the Western European allies who had become dependent on Russian energy supplies. Any unforeseen supply constraint could revive inflationary concerns and serve as a tax on global economic growth.

U.S. DOLLAR STRENGTH AND ITS IMPACT ON INTERNATIONAL EQUITIES

» The excessive U.S. dollar strength experienced in 2022 was due to the combination of growing geopolitical risks and a Fed that was much more aggressive than other global central banks in raising rates to fight incipient inflation. Now that inflation is beginning to dissipate and the Fed is closer to the end of its tightening than other central banks, the U.S. dollar began to stabilize in the fall and has entered a distinct downtrend moving into 2023. The stronger U.S. dollar was a definite headwind to the earnings of U.S. multinational companies so that effect should lessen in 2023. It is difficult to make an aggressive call for continued U.S. dollar weakness, but currency is expected to be more neutral for U.S. equities in 2023 as neither revenues nor earnings should be greatly impacted by currency translation.

» The sharp appreciation of the U.S. dollar also masked the rather strong outperformance in 2022 of many international equity markets in their local currencies compared to the United States. Notably lower valuation levels in many of these markets provided somewhat of a cushion in a year of broad price declines. The recent stabilization and depreciation of the U.S. dollar may help these international markets to show additional outperformance against the United States in both local currency and U.S. dollar terms. Surprisingly aggressive domestic protests in China appear to have convinced the government to alter their "zero-COVID" policies, which may help stabilize and ultimately boost Chinese economic and earnings growth. Looser mobility policies will also help already thawing global supply chains.

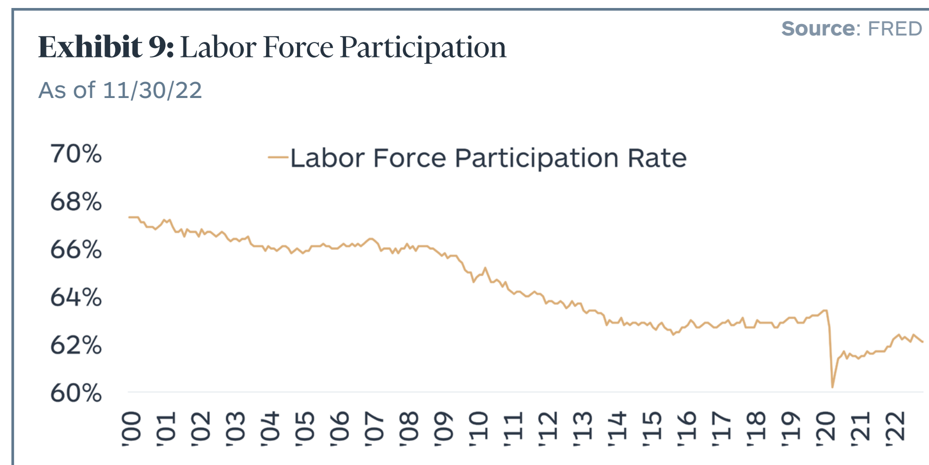


Exhibit 9: Labor Force Participation
As of 11/30/22

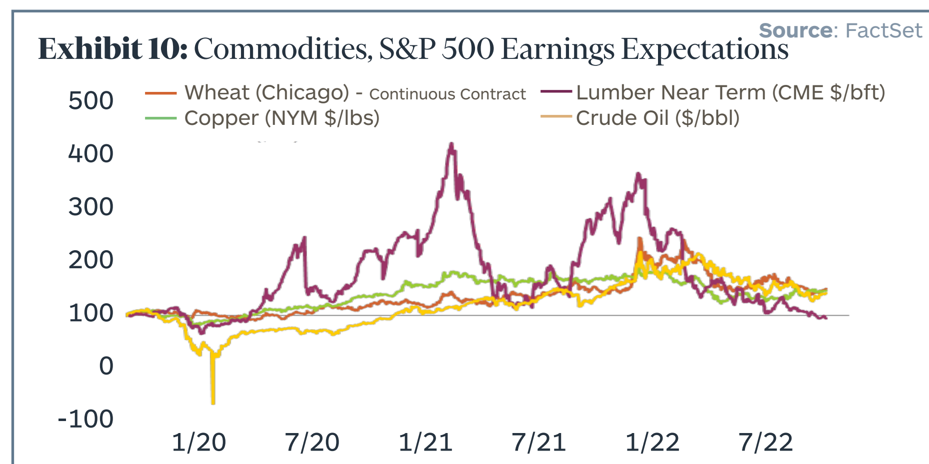


Exhibit 10: Commodities, S&P 500 Earnings Expectations

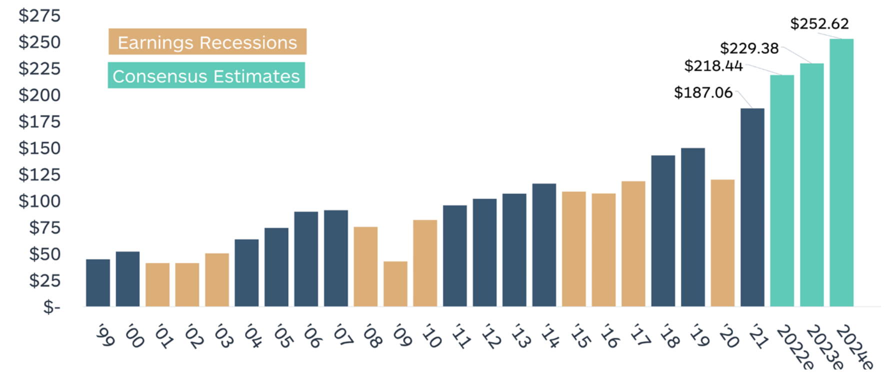
U.S. EQUITIES: ALL EYES ON EARNINGS

- With the Fed near the end of its tightening cycle and the economy expected to slow in 2023, interest rates will no longer be the impediment to equity valuations they were last year. The focus will now shift to the effect the aggressive monetary tightening of 2022 will have on the economy and corporate earnings. With a healthy consumer and a still strong labor market, a recession in 2023 is not inevitable. Revenues should still be able to grow in both real and nominal terms as inflation dissipates throughout the year, although additional Fed tightening much beyond the 5% level would prove challenging. Profit margins have moved back down closer to the average seen in the 2010s, but lower input inflation and higher employee productivity should prevent any collapse in margins.
- As the era of financial repression characterized by virtually free money is apparently over, companies with weak management and business models will be more exposed and should slowly disappear from the landscape. This could lead to a greater premium being placed on strong management teams that can quickly and effectively rightsize their cost structure in reaction to slower demand and higher input prices, particularly wages. The ability to easily pass on cost increases to the ultimate consumer was likely a temporary phenomenon now that overall inflation has begun to decline.
- Slow, but generally positive economic growth should lead to positive revenue growth for U.S. corporations in 2023. The general maintenance of the current level of profit margins should lead to earnings growth in the mid-single-digit range. As the market progresses through 2023, the outlook for 2024 profits will begin to have a greater influence on equity prices. With the Fed expected to be finished tightening by the end of the first quarter, a volatile first half of the year should give way to a strong second half led by hopes for an economic recovery and stable rates that should allow some multiple expansion to supplement the positive earnings growth [Exhibit 11].

Source: FactSet

Exhibit 11: Earnings Expectations

As of 12/31/22



What This Means for Investors

- 2022 was an unusual year in markets with both equites and bonds suffering sharp declines as investors were reminded how inflation can ravage financial asset portfolios. While monetary policymakers were caught somewhat off guard by the persistency and severity of the first true inflationary cycle in 40 years, rate increases implemented during the year and the natural reaction of supply to higher prices should prevent any recent inflation from becoming entrenched.
- Normalization of interest rates has increased the attractiveness of fixed-income securities in investment portfolios and has likely corrected many of the valuation excesses that grew in the equity markets. Investors should again begin to see the benefits of broad diversification within the liquid asset classes that are now positioned to provide fair returns. The illiquid asset classes in private equity, private debt and real estate may see some delayed marks to lower market values, but opportunities abound for recently raised funds to invest in assets at much cheaper valuation levels.

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