

Winter 2023 Edition

By: Henry Pizzutello, Chief Investment Officer

PREDICTIONS AND THEMES FOR 2023

The start of a new year is always known for predictions. That being said, we do not believe in “predicting.” Instead, we think correctly identifying major market themes helps the investment process of forecasting the direction of the markets, and more importantly, the risks that may undermine such “predictions”. If we focus on the risk side of the equation, we believe it is fair to say that a recession in 2023, should it occur, would be one of the most widely anticipated economic events in history. What markets are doing now is pricing in the “obvious recession.” Going into 2023, this has been one of the few times that experts across the board have agreed that we are going into recession

From a trading perspective, contrarian instincts lead us to look at what happens if a recession does not happen, but the inverted yield curve, declining Leading Economic Indicators, and a still above-market multiple (even after last year’s decline), all suggest that there is a better than even money chance of a contraction in the year ahead. Paradoxically, this is construed as a positive, as consensus opinion tends to be reflected in market prices — in other words, if everyone already expects things to be bad, the prices already reflect that sentiment. As we saw a number of times last year, surprises are not met well by Mr. Market.

With that being said, these are some themes that we think will have influence on the direction of markets in 2023.

LOWER INFLATION MAY NOT EQUATE TO LOWER RATES

The mitigation of inflation should not be much of a surprise. What may be a surprise to markets is that lower inflation may not lead to materially lower interest rates. With the year-over-year increase in the CPI falling from 9.1% in June to 7.1% today, the data is supporting the fact that inflation has likely peaked. However, there are a number of factors that make it unlikely that we will reach the Fed’s stated target of 2–2.5% inflation. Domestically, we still have a tight labor market, and there is still global disruption in the energy supply until the Russia Ukraine conflict is resolved, to highlight the two most obvious factors. We think it is more likely that inflation will moderate to 4% range by the end of the year. That will take some pressure off yields, both in the U.S. and globally, but a good portion of that has already been discounted by the market.

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Financial markets are living in a central bank world. Since November 2021, when the Fed started a bearish narrative, the global bond and equity markets have been under pressure. We are seeing a “return to normalcy” and the transition from Qualitative Easing (QE) to Qualitative Tightening (QT) will not just end suddenly, even with the much anticipated and hoped for “Fed pivot”. The bill from the excessive fiscal spending and interest rate suppression over the past decade is finally coming due. The U.K Gilt crisis in late September and Japan’s recent decision to abandon yield curve control are watershed events for global debt markets, and a sign of things to come.

CHINA REOPENS

China’s approach to COVID has been very similar to its policy stance on economic growth. The country maintains that the internal fiscal policy and government can control and spur growth, regardless of outside global and economic pressure or interference. Similarly, it has adopted that stance regarding COVID – essentially stating that the “no tolerance” policy that has been adopted is the only way to control the pandemic. We have seen that this policy has been largely ineffective in controlling the virus, and has had significant negative effect on economic growth, both in China and on the rest of the world. To the extent that China realizes that this policy is untenable in the long run, it seems reasonable to assume that once that process is over, China will revert to the historical playbook and go for growth. This is likely to have a significant positive impact on the global economy, especially in emerging markets and commodities, but may also make the inflation issue more complicated.

EARNINGS GROWTH MAY NOT BE REWARDED

There has been enough evidence to see that market expectations for the higher inflation and interest rates has already been discounted. However, even though there is widespread consensus that we will enter a recession during the next 12-18 months, as discussed above, it does not seem that prices are reflecting this “certainty”. From a market multiple perspective, we are still in the upper range of normal historical values. Multiples tend to compress during periods of higher inflation, but the current market valuations seem to already have baked in expectations of lower rates and higher growth. Should either of those not go according to plan, it will be reflected in a lower multiple of earnings. On the flip side, we have some history to suggest that markets are poised for a recovery from last year. Since 1940, there has not been a pre-Presidential election year that has been negative. While not being slaves to cause and effect, there is some logical basis for this. Politicians, being the self-serving animals that they are, tend to look out for themselves and focus on re-election chances in the year preceding. Economic policies that sway voters tend to be reinforced, and it is likely to be the case this year as well. However, given the disproportionate effect that central banks and interest rates have had on market valuations, the consequences of being wrong on those assumptions is far higher than in previous years.

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LIGHTNING ROUND QUESTIONS

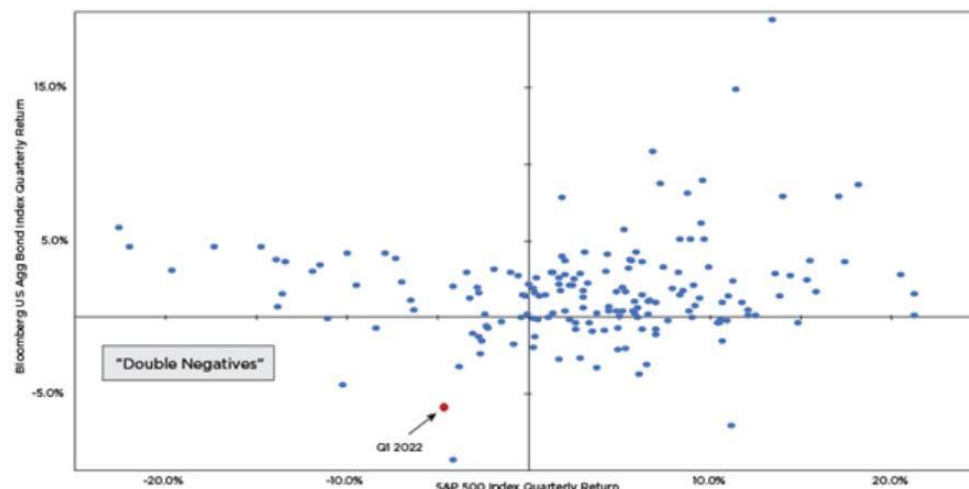
What are your expectations for the Fed in terms of rate hikes?

The December meeting showed the first signs of the “Fed pivot”. The next FOMC meeting is on Feb. 1, when we would anticipate a 50-basis-point hike. Past that, the level of increase will be data driven. Even a 25 basis point hike in March would bring the target rate to 4.75%. The current 10 year Treasury is now at 3.55% and the 2 year is at 4.25%. If yields stay the same, that would invert the curve substantially and we would see significant pressure to stop, and to ultimately ease rates to avoid a recession. For comparison, the last time yields were this inverted was during the early 1980’s, as we were coming out of the worst interest rates environment in our history. That process took 5 years to run its course, as opposed to about 16 months today.

What do you see in store for equities in 2023?

The broad consensus is that a recession is coming. The standard view now is that the fundamentals are deteriorating and that companies are not going to be able to maintain earnings. The housing market bubble is popping and the consumer is slowly running out of cash – all of this while the Fed is in tightening mode. Those are all conditions that are really happening, and put together they clearly spell a recessionary environment. However, that does not necessarily mean equities are going to move lower. Because we are broadly in agreement that these factors will create a recession, it tells me that a lot of bad news is priced in already. More often than not, these negative sentiment conditions present good buying opportunities. Even with all of the above, the markets seem to have priced in the appropriate amount of risk. However, if interest rates do not move significantly lower as inflation cools, it will spell trouble for equities, as that scenario is not priced in.

As seen in the graph below, 2022 was an outlier in terms of relative performance for both equities and fixed income. While under more normal circumstances, fixed income acts as a “brake” for negative equity returns, last year fixed income performance added gasoline to the fire. As we discussed earlier, the last time that the U.S. was in an inflationary period like today was in the late 1970’s and it took 5 years for the process to fully be resolved – as opposed to the significantly shorter time span of today. Hence, the outlier in 2022.



Source for chart data: FactSet Research Services, Nationwide 940 Competitive Intelligence Team

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Do you see as opportunities in fixed income in 2023?

Fixed income is finally being priced attractively, which is a departure from the trends of the past 5 years. Yields are now reflecting the risks that have always been there but were suppressed by the ZIRP (zero interest rate policy) mandates of the past. From a risk-reward perspective, bank loans, structured notes and asset backed notes are especially attractive, as well as high-yield assets.

With the protection you have with rates being much higher, I think the relative value to equities is compelling. Bonds had the worst year on record in 2022 with equity-like volatility (and negative returns). Expectations have now been reset and fixed-income should have a positive year in 2023.

Cryptocurrency? Will it survive?

Unfortunately for a lot of digital asset investors, the best thing that could have happened for the long-term has cost them mightily in the short term. The recent troubles with FTX, Binance, Gemini and other platforms in the digital universe have now brought to light what has been the Achilles heel of the asset class – the lack of effective regulatory oversight. This process will take a bit more time to weed out, but the major beneficiaries will be the largest, most stable assets – specifically Bitcoin and Ethereum. The parallels to the dotcom crash in the early 2000 are telling. Investors really couldn't tell the difference between Pets.com and Amazon when things started to unravel, and companies either went bankrupt or went down 90% (as did Amazon). At the end of the day, the companies that had a reason to exist and prosper in a different environment did just that, and the companies that were riding the wave of momentum were left by the wayside.



Regulatory oversight will help to move that process along, and there will be no opposition from any of the remaining players, as the credibility arguments that they can police themselves has been shot. Large losses in speculative schemes are always reason for regulators and governments to pay attention.