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WHAT'S NOT TO LOVE?

Well, maybe a punk stock market like last year accompanied by inflation at a forty year high, or possibly the persistently sour political environment that seems intent on leaning left.

Politics, other than the swing mentioned above, were pretty much up to many of the same old games, including blaming everyone but one's self for all that's going the wrong way. The same old games, but they're not up to the intent, in some respects, of the founding fathers who gathered those many years ago in the "City of Brotherly Love" to help build a nation. William Penn, who preached the importance of religious tolerance, might be somewhat displeased these days. It's likely that those folks never intended for those founding principles to be simply a marketing concept.

But take heart, there are some signs of creativity afoot. This is particularly true in one recent example where our previous leader may have been attempting to improve on the concept of presidential libraries. In essence, for the convenience of the citizenry, the plan suggests decentralization. Our previous leader hoped to provide a convenient location in Florida where historical documents might be viewed. Hey, isn't everyone moving to Florida?

But our current leadership has gone not one, but four times better. In fact, his decentralization plan would create four new locations for his presidential library, where guests can visit without having to travel to a large, crowded city. How convenient and thoughtful. While there will be four locations, it is believed, unfortunately, that there will be no lending capabilities offered. Those who may be coming to visit from halfway around the world should take this into consideration before booking flights. It should also be noted that there will not be any multilingual translators available.

It has been suggested that all of these concepts, or proposals, shouldn't surprise anyone as they've been generated in Washington. Senator John Kennedy (R) of Louisiana recently stated in referring to the denizens of Foggy Bottom, that they're "not like most other teenagers, they're all over forty!"

Meanwhile, back on Wall Street, the markets proved disappointing last year. A good deal of the credit for that goes to the Fed who, on St. Patrick's Day, began an aggressive monetary tightening program. As a result, interest rates (i.e., fed funds) have moved from essentially 0% to 4.25-4.50% following the 50 basis point increase voted December 14th. They are expected to add another .25% at their next meeting (Jan. 31/Feb. 1) bringing the range to 4.5% to 4.75%. Some forecast that rates could approach 5% by year-end '23. That depends on the unemployment rate, the level of inflation, and the condition of the economy. Most of our business clients see inflation as having largely peaked and note that a lot of previously unavailable supplies seem to have begun flowing again.

Now that the world, including the US, are planning to build more chip manufacturing plants, what do you think could happen to those prices in several years? Would it surprise to see a glut?

Turning to the chart below, it was certainly a challenging year for all asset classes. Most equity indexes were off double digits. Growth got crushed. Value lost ground but hung in there on a relative basis. And, the historic areas of safety generally didn't provide their normal cover this downturn. Fixed income was marked down across the board as rates increased at a record pace throughout the year.

We find it interesting to view 2022's performance through an additional lens. If we organize performance data by "when things actually happened," a more hopeful view looking into 2023 emerges.

	4Q 2022(%)	9 MTH 2022(%)	YTD 2022(%)
Dow Jones Industrials Average	16.0	-19.7	-6.9
Standard & Poor's 500	7.6	-23.9	-18.1
Standard & Poor's Equally Weighted	11.6	-20.7	-11.5
NASDAQ Composite	-0.8	-32.0	-32.5
Russell 2000	6.2	-24.6	-20.4
Russell 1000 Growth	2.2	-30.7	-29.1
Russell 1000 Value	12.4	-17.8	-7.5
MSCI World	9.9	-26.2	-17.7
Euro STOXX 50	24.8	-31.9	-15.1
EAFE	17.4	-26.8	-14.0
MSCI Emerging Mkts	9.7	-26.9	-19.7
BBG Aggregate	1.9	-14.6	-13.0
BBG Muni	4.1	-12.1	-8.5
BBG 5 Yr Muni	3.1	-8.1	-5.3

Morningstar

The final quarter of 2022 was the only quarter of the year with positive returns, and those positive returns were pretty much across the board. Not all sectors participated equally. Value outperformed growth by a wide margin. Large caps outperformed small caps. The less tech in your small cap index, the better the return for the quarter. Industrials bounced significantly along with Europe. Emerging markets almost generated double digit returns. And municipal bonds outperformed their taxable brethren. Not a bad finish to an extremely challenging year.

HARD LANDING NOW IN THE CARDS...CHINA WILL REOPEN… DEBT CEILING CIRCUS, AGAIN

The global economic environment continues to present challenges for investors, consumers, and business leaders alike. Following unexpectedly high 6.5% and 3.2% real growth in 2021 and 2022, the UBS global economics team led by Arend Kapteyn expects sub 3% real GDP growth throughout the world in both 2023 and 2024. Those expectations are pretty much unchanged since we last wrote.

Our US economics team led by Johnathan Pringle is even more cautious. On an annual basis, the team's US growth expectations are at stall speed, 0.4% in 2023 and 0.3% for 2024. In addition, they now expect a "hard landing" resulting in a shallow recession starting in the second quarter of 2023 and lasting through year end. They don't see positive quarterly US GDP growth returning until early 2024.

Those expectations make sense to us understanding that historically, monetary policy has a 9–12 month lag before fully showing up in economic activity. The Fed started slamming on the brakes with sizeable and steady interest rate increases late in the first quarter of 2022 and kept them on throughout the summer and fall in an unprecedented fashion.

Positive US GDP growth is expected to return during the second quarter of 2024. That recovery is expected to reestablish quarterly US GDP growth in the 2.5% range, typical of the "pre-pandemic" economic environment. That would be welcome to consumers, business leaders and investors.

The Fed is balancing the need to break inflation (by reducing demand through higher interest rates) against their full employment mandate (avoiding excessive layoffs as demand slows). This is a tough balancing act. Our current expectation is the Fed will be successful in their inflation fight thereby allowing their policy rate to fall from its current (near 5%) level to just over 1% by year end 2024. We see less success on employment, short term. Unemployment currently stands at a mid 3% level. Our team thinks it is headed towards 5% by year end 2024.

That combination of rates and employment should create a less volatile economy with some slack in the labor force, a welcome change from the current situation.

China is the other potentially big economic story of 2023. After more than a decade of powerful growth, China's economy grew only 3% in 2022. Their highly restrictive "Zero Covid" policy was the main reason.

We are unsure whether it was growing protests in many of China's most important regions or pre-established government policy whose time had come, but the government decided to loosen Covid restrictions materially after we entered 2023.

Unleashing the pent-up demand and productive power of the Chinese economy will be an important story to follow in 2023. It will definitely be positive for global growth. However, if the reopening of the US economy serves as an example, it will also be volatile. Our China economic team led by Tao Wang is looking for real GDP growth to accelerate and stay in the 5% range in 2023 and 2024. They had a great call early last year believing there was no way China could grow at their projected 5.5% rate. Should the team be right again this year, that will be reassuring news for many other economic regions.

The US debt ceiling and the economic situation in Europe also deserve some mention.

As Treasury Secretary Yellen said in early January, we are quickly approaching the country’s debt limit, and something needs to be done. There are all sorts of levers to pull, but Congress needs to raise the debt ceiling from its current $31 trillion level by mid-summer 2023 (probably July but maybe August) at the latest. Given the divide in Congress, you can expect an emotional and public debate as both political parties use the situation to try and differentiate themselves from each other, probably thinking more about the upcoming 2024 Presidential election rather than their day job which includes making sure we can pay our bills when they are due (ugh)!

Regardless of the media angst that will be created as we move from spring to summer, expect resolution before any material problems are created. The Congress has raised the debt limit 80 times since the 1960’s. We expect #81 will happen by late summer 2023.

The situation in Europe is better news. Unfortunately, the Ukrainian war has no end in sight. However, through a combination of powerful fiscal support, warmer weather, gas inventories hovering around 85% of total storage capacity well into the winter season, the shuttering of production facilities that were large, inefficient users of fuel, and general conservation at the individual level, Europe has weathered the winter of 2022-2023 in much better fashion than many expected only months ago.

There remains very little visibility into the future, and winter will come again next year, but give the Europeans credit because it looks like they may avoid what was once thought to be a definite recession in 2023.

STRATEGISTS MAINTAIN CAUTIOUS VIEW

Given the expected backdrop of slower growth ahead, S&P 500 earnings are seen about 4% lower than 2022 for this year (report “Stall Speed” 1/12/23). That would translate to $215 versus $225 last year. At current market levels that shows the S&P is selling at 18.6x earnings. The range, we should note, has been between approximately 16-22x earnings over the past 6-8 years. The longer-term average for S&P multiples has centered around 15x. The point is that at current levels the S&P is trading at roughly the average P/E of recent years!

In conversation this past week with David Lefkowitz, UBS’s CIO, Head of US Equities, consensus S&P earnings forecasts for 2023 are between $200 and $225 for several large investment firms (including Morgan Stanley, Credit Suisse, Citicorp, and Goldman Sachs) that suggests the mean would approximate $215. The expected range for the S&P this year is

between 3700 and 4400 based on multiple conversations with strategists and portfolio managers. Most of us will recall that the S&P traded just under 3600 both in September and October of last year. So, no surprise if the S&P were to spike down to the mid/high 3000's at some point this year.

We have pointed out frequently in past years that forecast valuation levels are simply a statistical exercise to provide a relative sense of possible outcomes. No one should expect markets to perform that precisely, these levels are to provide a picture of where the S&P could trade around given certain assumptions about economic growth, earnings power, inflation and the cost of capital.

Keith Parker, Chief Strategist for the UBS Investment Bank, believes that slower growth this year may lower margins and corporate earnings. He forecasts a 2.7% year over year decline in 4Q 2022 earnings which follows "7 quarters of robust growth." He sees a small "beat" in reported earnings somewhat offset by estimate downgrades of 2-3%, "but likely not as bad as feared."

It's interesting that so far in 2023 the S&P is about 4% higher on the year, a surprise indeed to the bearish forecasters that have been looking for a recession as far back as we can remember. Of course, under the old "stopped clock" maxim, they'll be right at some point. We do believe that we've been in a recession (perhaps a "rolling recession") for some time. Many of our clients and friends have had challenging issues to contend with; supply problems being a key issue and then finding and keeping good employees. Several of our friends who own restaurants and hotels speak of spotty trends that prove hard to predict. This post-COVID effect is still a factor for many businesses. For some, the cost of fuel is a factor.

The Fed is expected to raise rates in February, perhaps 25 basis points, and then stay on hold for a while to determine if inflation levels are becoming more benign. Unemployment of 4.5% may be tolerated by the Fed (it's currently 3.5%). Layoffs have already been seen and may continue but not seen as becoming significantly worse. Recent layoffs are possibly to deal with over-hiring during COVID.

There are lots of distractions for investors to deal with. But one should remember that valuation levels have already come down a fair distance from 22x earnings to around 18x earnings. Corporate and consumer balance sheets are in good shape. Savings levels still provide decent liquidity to the potential economy. We have yet to see what "pro-growth" initiatives may come out of the more conservative leadership in the House.

We see inflation peaking and economic growth re-establishing a modest upward track (low single digits) in '24 and '25. Nothing to write home about but positive, nevertheless. One needs also to remember that S&P is not GDP (US). World growth, particularly with China, is expected to improve and will be part of a global recovery catalyst. S&P earnings are not just derived from the US. Even with more "onshoring" envisioned, the globally generated earnings are about 40% of the total. Also remember the disconnect that can exist between reported earnings and cash flows. The earnings can be a porridge of non-cash items.

Long-term investors, which most of you are, should be looking for opportunities that present themselves in a mild recession.

A friend the other day said "so, earnings are going to be negative this year?" We found that an interesting, if strange, question. Earnings are likely to be down, not negative, from last years' higher number but decidedly positive.

As most all of you know, we always look out years not weeks. We are interested in secular trends, not what the next couple of months looks like.

There will always be bumps along the way which is why we always advocate keeping some liquidity around for near-term needs. It's important to maintain diversification in portfolios, which as most all of our clients have seen, helps protect capital.

We should mention that fixed income yields are back to attractive levels and can provide cash flow alternatives for portfolios. In addition, we continue to employ alternative investments which promise no to low correlation to equity markets.

It may be bumpy this year, but according to Bloomberg/UBS historical data in the two and three years following a decline like 2022 (-18-20%), the S&P 500 averaged 22.8% and 26.5% returns. This information appears on page 35 of the January 2023, US Equity Market Outlook David Lefkowitz, CFA, CIO, Head of US Equities. Should you like to see the data, please let us know.

So, expect some swings, up and down, in a year like this, but don't lose sight of the longer-term objective. Lastly, one of the more interesting things to keep in mind is that the bulk of S&P 500 returns earned each year historically were achieved in only 6-8 trading days of the year. While that's true, no one has a crystal ball which points out in advance when those days will occur.

So, hang in there this year and don't annualize the 4% earned thus far in 2023.

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