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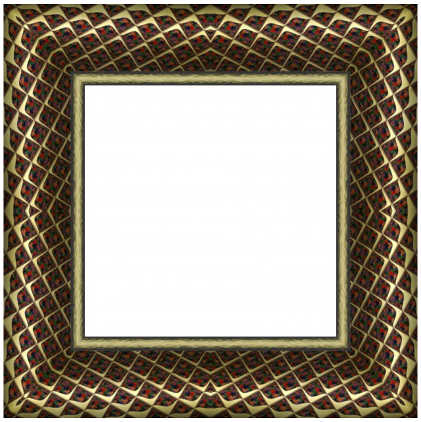
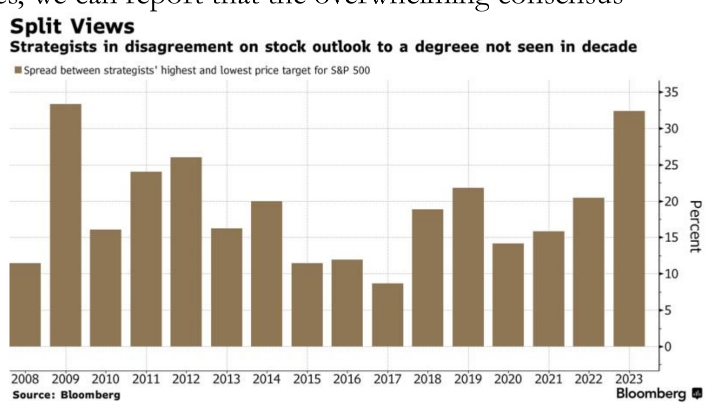
We are approaching the end of yet another year, which is traditionally the time when most Americans commit to losing weight or getting more sleep, and most investment firms and their strategists offer their prognostications about the year to come. While the success rate for each of these endeavors is disappointingly low, history suggests that the third objective is probably the most challenging. After all, as was reportedly noted by Yogi Berra, "It's tough to make predictions, especially about the future."

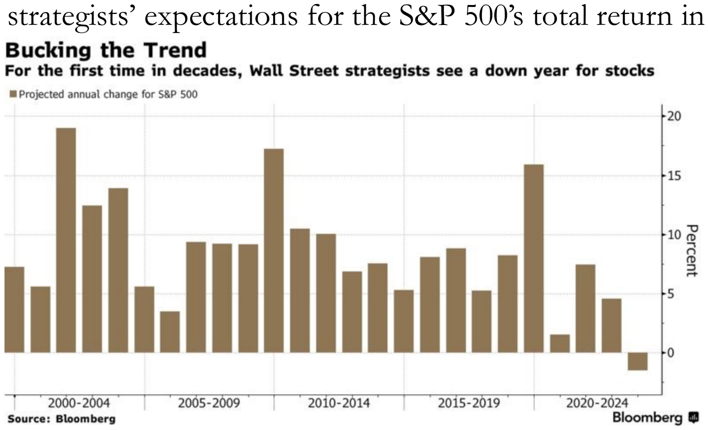


With that truism in mind, let us start this commentary with a look at what the collective wisdom of Wall Street, and the seeming consensus of investors, portfolio managers, economists, and strategists around the world suggests that the picture is likely to look like in 2023 and beyond.

After considering a wide array of sources, we can report that the overwhelming consensus opinion seems to be that there is no overwhelming consensus opinion. Further, this distinct lack of consensus seems to be common to almost everything, ranging from projections about inflation and the outlook for monetary policy to expectations for stock market returns.

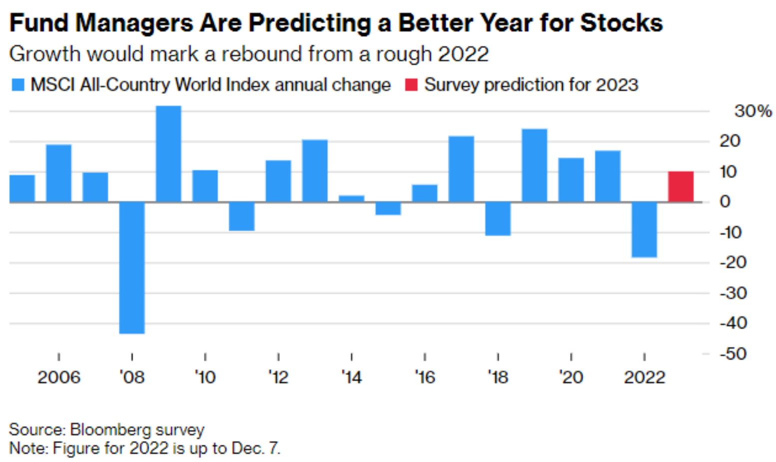


Indeed, a just released Bloomberg survey of Wall Street strategists revealed a massive spread of over 30% between the most bearish and most bullish strategists' expectations for the S&P 500's total return in 2023. That is the biggest divergence in more than a decade.



While this survey revealed remarkably divergent expectations, the weight of opinion was decidedly negative. As evidence, this marked the first time in decades that this survey of strategists has predicted negative equity returns for the year to come. Of course, given the contrarian nature of markets, this may be quite bullish, in that it may suggest that much of the negative news is already known and understood by investors, and thus already largely reflected in equity prices.

In sharp contrast to these macro-oriented strategists, portfolio managers, who concentrate more on individual securities than on broad markets, appear to be relatively bullish. As evidence, of the 134 fund managers just polled by Bloomberg News, 71% expect the domestic stock market to go higher in 2023, with an average gain for the year of 10%.



Only 19% of these fund managers (from major firms like Blackrock and Goldman Sachs) expect the equity markets to decline in 2023.[1]

Of note, this expectation for a 10% gain is actually fairly modest based upon historic precedent as, since 1960, the average one-year-forward return for the S&P 500 once it loses 25% (as occurred earlier this year), has been a remarkable 21.6%. Obviously, the past is not necessarily prologue, and we do have our doubts regarding the current market's ability to achieve this remarkable average.

Insight into 2023 does not improve much if you look at the forecasts from some of the major wirehouses, where you will find similarly divergent outlooks for the equity markets. For example, on December 16th, Bank of America Global Research declared that the recent move out of gold and cash and into stocks and bonds marked the end of "extreme bear sentiment"[2], while only three days later, on December 19th, Mike Wilson, who is the Chief U.S. Equity Strategist and Chief Investment Officer for Morgan Stanley, predicted that an earnings recession in 2023 "by itself could be similar to what transpired in 2008/2009," and could catalyze new stock market lows that are "much worse than what most investors are expecting".[3]

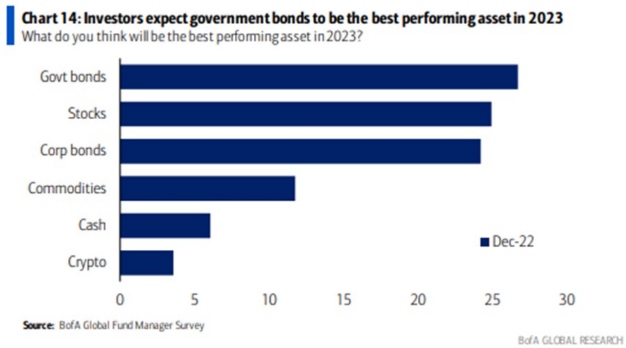
When the S&P 500 is Down 25% or Worse Since 1950

Peak	Trough	% Decline	+1 Year	+3 Years	+5 Years	+10 Years
12/12/1961	6/26/1962	-28.0%	31.2%	69.2%	94.8%	171.1%
11/29/1968	5/26/1970	-36.1%	32.2%	44.3%	27.9%	97.5%
1/11/1973	10/3/1974	-48.2%	1.4%	23.8%	42.0%	188.4%
11/28/1980	8/12/1982	-27.1%	43.9%	81.2%	238.6%	403.9%
8/25/1987	12/4/1987	-33.5%	14.7%	34.1%	96.8%	387.1%
3/24/2000	10/9/2002	-49.1%	0.2%	1.9%	21.5%	38.3%
10/9/2007	3/9/2009	-56.8%	-6.9%	3.7%	61.2%	209.6%
2/19/2020	3/23/2020	-33.9%	56.4%	???	???	???
1/3/2022	9/30/2022	-25.2%	???	???	???	???
Averages		**-37.6%**	**21.6%**	**36.9%**	**83.3%**	**213.7%**

Data: Ycharts

It is perhaps also noteworthy that the November CNBC survey of millionaire investors reflected the highest level of bearishness since the 2008 Global Financial Crisis, with fifty-six percent of the millionaire investors surveyed expecting the S&P 500 to decline by 10% in 2023, and almost one-third expecting declines of more than 15%. The survey was conducted among investors with $1 million or more in investible assets. While this level of pessimism could also be considered as bullish from a contrarian perspective, this survey may be deserving of particular credibility when one considers that millionaire investors own more than 85% of all individually-held stocks.[4]

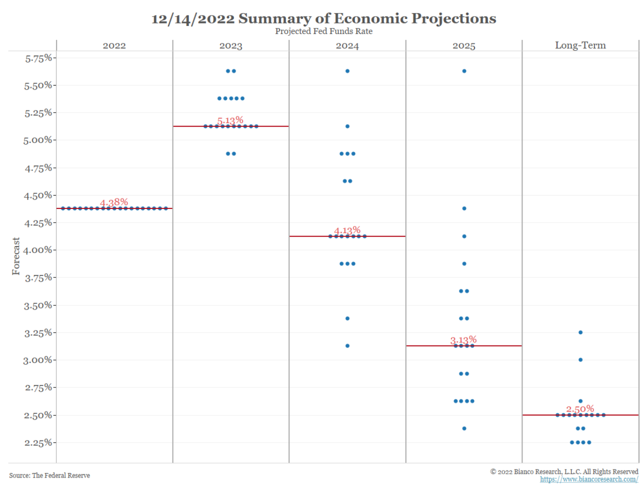
In sharp contrast, one area where we are finding consensus is in the bond market where, for the first time in the history of the Bank of America Fund Manager Survey, respondents are expecting bond yields to decline (bond prices to rise) over the next twelve months.[5] In addition, the plurality of managers surveyed expect for government bonds to be the best performing asset class in 2023.



Importantly, that opinion applies to intermediate and longer-term interest rates that are set by the markets, and not the ultra-short interest rates that are set by the Federal Reserve.

That said, the Fed-set, ultra-short rates are not immune to this general theme. If anything, there actually seems to be tremendous uncertainty, and on two different fronts. To start with, as this report will later discuss in depth, there is a huge divergence between the guidance that the Federal Reserve is giving the markets about their future plans for short-term interest rates, and what the markets themselves are signaling about what they expect for the Fed to actually do in regard to rates. However, the divergence of opinions does not stop there.

The Federal Reserve itself is experiencing an enormous difference of opinion among its members, in regard to the future outlook for short-term interest rates. As is reflected below in the Fed's "Dot Plot", while there is broad consensus on where rates should be today (each dot represents the opinion of one voting member of the Fed), opinions start to differ regarding policy in 2023, and the divergence in expectations for rates in 2024 and 2025 are actually the widest in this measure's 10-year history.[6]



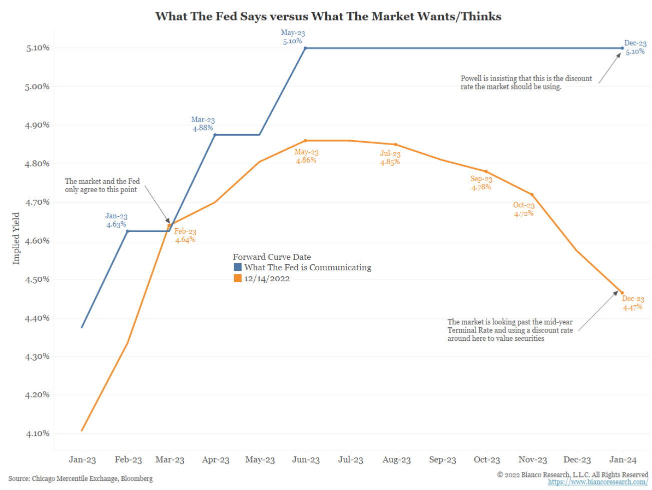
One other area of consensus is that the economy will experience a recession in 2023, which we believe to be a very justifiable expectation. Indeed, the latest survey of the chief economists from global financial institutions done by the U.S. Securities Industry and Financial Markets Association (SIFMA) revealed that 83% of economists expect a recession in 2023. However, of important note, 89% of those anticipate that the recession will be only mild.[7]

In the current topsy-turvy environment, this has the potential to be very good for the capital markets, which appear to be operating under the premise that the Fed will reverse course and return to its previous easy-money policies once inflation is brought under control, and that a recession is ultimately a requisite to bring inflation under control.

It is no wonder that investors are confused, and markets are so volatile. After all, investors tend to hate uncertainty even more than they hate bad news, as they at least know how to discount bad news into prices, but have no way of pricing-in uncertainty.

For our part, we believe there are a variety of factors, including earnings, the employment picture, inflation, and even the implications of the presumptive "reopening" of the Chinese economy (as the government makes a sudden pivot away from its "zero-covid" policy), that will heavily influence both markets and monetary policy in 2023. That said, we believe that, more than anything else, the below chart of Fed guidance versus market expectations needs to be at the core of any attempt to make projections about markets in 2023 and 2024.

The blue line reflects the forward guidance that the Fed has provided regarding their projected interest rate polices. It shows their plans to raise the Fed Funds Rate to just over 5%, and to hold it there through 2023, at minimum. In sharp contrast is the gold line illustrating the Fed Funds futures contract, which shows that the market does not believe that the Fed will be able to fully implement its plan, and that some issue like the emergence of a severe recession or liquidity problems in the financial system will ultimately force them to abandon their plans for tighter monetary policy.



Indeed, the market is expecting the Fed Funds Rate to peak at less than 4.9%, and that the Fed will actually be cutting short-term interest rates by summer of 2023.

At some point, these two lines will need to converge, and we are concerned that market expectations are on the wrong side of this trade. Indeed, we believe that investors are pricing securities based upon overly dovish assumptions about future monetary policy, and that investors are essentially "fighting the Fed".

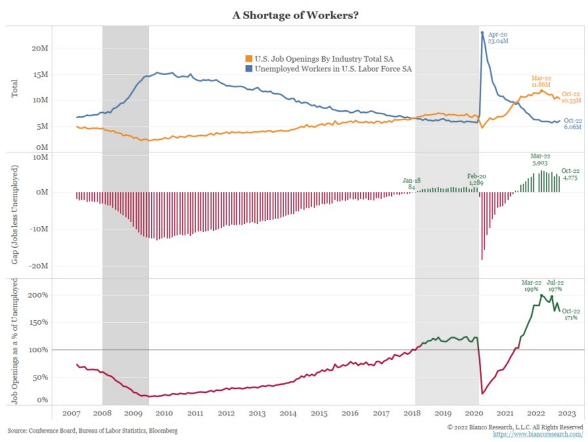
If investors are correct, and the Fed is forced by circumstances to reverse course and lower rates, it could potentially be very bullish for markets. However, if investors are wrong, and markets ultimately need to adjust their interest rates expectations upwards towards Fed guidance, it could cause the bearish trends of 2022 to extend well into 2023.

History teaches us that "fighting the Fed" is rarely profitable, and we suspect that the current willingness of investors to ignore Fed guidance is largely attributable to a lingering (and we suspect misguided) belief in the continued existence of a "Fed Put". The market also seems to think that the Fed will lower rates as soon as inflation gives indications of a significant and sustainable decline. However, we suspect that this expectation is overly optimistic, and that Fed Chairman Powell would prefer to keep monetary policy fairly tight over the foreseeable future, at least until the Fed has good and justifiable reason to reverse policy.

In our opinion, the Fed's future path will likely be very different than the accommodative monetary policy that has been dominant over recent decades, when recessions or sell-offs in financial assets like stocks, bonds or real estate were almost certain to be countered by the Fed through lower rates, jawboning or asset purchases. We believe that, because of high inflation, this can no longer be the Fed's reflex response, thus making it more likely to take substantial job losses, a more than garden-variety recession, or a disruption in the financial system itself to force a reversal by the Fed, and a transition towards lower interest rates.

Importantly, our more cautionary perspective has much less to do with inflation in 2023 than has been the case in 2022, as we believe that inflation has clearly peaked, at least for the time being. We say "the time being", as there are still several lingering risks, including the reopening of the Chinese economy. According to Bloomberg Economics, if China is fully open by mid-2023, "energy prices will increase by 20% and the US consumer price index, which they believe may drop to 3.9% by midyear, may jump to 5.7% by yearend".[8]

In addition, while the Fed seems to agree that inflation has peaked, current Fed commentary continues to reinforce their concerns over the tight job market, particularly with wage growth of 5.1% and 1.7 jobs available for every one person looking for a job. Their concern is that the tight job market will keep inflation from falling below 4% or so, which is well above the Fed's 2% target. It is a target that the Fed has committed to in the strongest possible terms, which suggests that the Fed ultimately needs to moderate today's very strong jobs market before they can even consider lowering rates.



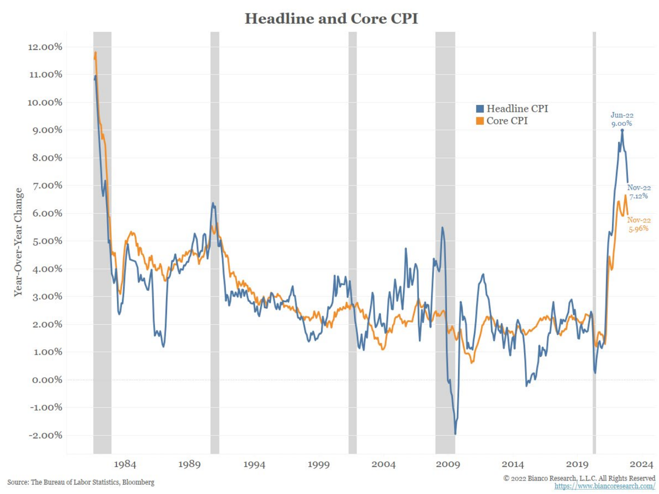
Indeed, there are a growing number of analysts that we respect, who are suggesting that the U.S. economy is facing a secular labor shortage that may force the Federal Reserve to keep rates high and economic growth relatively low for the foreseeable future.

To explain, there are currently 10.3 million unfilled jobs in the United States.[9] There are various causes for this, including early pandemic-related retirements, a largely dysfunctional immigration system, and even an estimated 3.5 million people who are still out of work due to long Covid.[10] As this issue increasingly seems more secular than cyclical, it is very possible that the Fed may be forced to keep the economy in low gear to prevent this secular shortage of labor from causing sustainable wage-push inflation.

Further exacerbating things is the fact that the Fed faces a conundrum of sorts. As inflation falls and economic data weakens, interest rates are likely to decline and stock and bond prices are likely to rally, in anticipation of a dovish pivot in Fed policy. However, any such rebound is also likely to increase economic liquidity and create a wealth effect, each of which would likely exacerbate inflation. As such, it is very possible that the Fed has little choice but to keep rates high (or even move them higher) even in the face of falling inflation and a weakening economy. Such a response would almost certainly aid the Fed in attaining its almost singular objective, which is a dramatic reduction in inflation. However, it could also very easily turn a "soft landing" or mild recession into something more severe.

So, what will catalyze a change in Fed policy? We believe that the Fed will pause its rate hikes once they believe that monetary policy is sufficiently restrictive to return inflation to the Fed's 2% target over time, and that inflation is making a substantial and sustainable move in that direction. However, we do not think that this alone will be sufficient to motivate the Fed to reverse course and actually lower rates. Instead, we think that they will wait until they actually see either a significant surge in unemployment or a substantial contraction in domestic economic growth.

The good news is that inflation is falling even faster than expected, which is ultimately the key to the capital markets returning to a more bullish environment. That said, getting inflation back within range of the Fed's 2% target will take time, if even fully attainable. This likely means that rates will stay higher than expected for longer than expected, which should serve as a headwind in the face of the markets. In addition, the stock market still needs to adjust to what we expect to be a serious deterioration in corporate earnings, which will be further complicated by already high equity valuations and tightening monetary conditions.



As former credit analyst Ed Hart used to say, "this is a time when the demand for certainty far exceeds the available supply". That said, with deference to both Ed Hart and Yogi Berra:

We believe that the U.S. will experience a rather mild recession in 2023, which will further assist the Fed in bringing inflation back under control, and ultimately drive interest rates lower and stock prices higher.

Even so, we believe that the markets are misguided to think that the Fed is going to return to the days of excessively easy monetary policy simply because inflation returns to more acceptable levels, particularly since such policies helped to create not only the 2022 surge in inflation, but also numerous asset bubbles since the start of the new millennium. As such, we expect for the next bull market to look very different than most recent bull markets.

We believe that higher quality bonds offer reasonable value at current yields, and that the global bear market in equities is already quite long in the tooth. We do believe that U.S. stocks are trying to put in a bottom, with the lower boundary potentially being formed in the range of this year's June or October market lows. Importantly, we also believe that at least one more retest of those prior lows is likely and, as we have maintained for months, that we are still very likely to see a bout of panic selling and capitulation before a final bottom is formed and a new bull market is born. Panic is common to almost all bear market bottoms.

In addition to high-quality debt, we believe that this environment favors high-quality equities with low valuations, strong balance sheets, high free cash flow, and a commitment to shareholder-friendly policies like paying dividends and repurchasing shares, as opposed to long-duration growth stocks with high valuations, or whose best potential and earnings are likely years into the future. We also see value in many foreign equity markets.

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Definitions

The Standard & Poor's 500 (S&P 500) is a market-capitalization-weighted index of the 500 largest publicly-traded companies in the U.S with each stock's weight in the index proportionate to its market. It is not an exact list of the top 500 U.S. companies by market capitalization because there are other criteria to be included in the index.

The Consumer Price Index (CPI), which is produced by the Bureau of Labor Statistics, is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services. Indexes are available for the U.S. and various geographic areas. Average price data for select utility, automotive fuel, and food items are also available.

Core CPI refers to inflation based on the consumer price index (CPI), covering the inflation of all the goods and services except the volatile food & fuel prices, excise duties, income tax, and other financial investments.

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