

2023 Outlook: It hinges on how inflation comes down and peace is found



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IN A NUTSHELL

- Higher Fed overnight interest rates and at best flattish S&P EPS limit upside
- Investment themes and views for 2023

Higher Fed overnight interest rates and at best flattish S&P EPS limit upside

2022 brought the highest inflation in 40 years, swelling recession, interest rate and valuation risks. How this inflation comes down, demand vs. supply-side, and how much longer until it returns to target will influence whether it scars economic potential/productivity and financial market risk premiums. 2023 outcomes are likely to influence overnight real interest rates, longer-term inflation risk premiums and cycle longevity expectations and thus equity risk premiums for the rest of the decade. This struggle with inflation is compounded by a war entering its second year that is dangerous and the most divisive between the great powers of the east and west since the rise of the Berlin Wall. How and what kind of peace Russia and Ukraine find will affect Europe and US-China relations for the rest of this decade.

Investment themes and views for 2023:

1. Shallow recession in the US & Europe, but no deflation and benign credit costs are likely: We expect a small US & European recession in 1H23 led by declines in goods consumption and manufacturing and marked by disinflation, not deflation, and a relatively soft landing in the US jobs market owing to resilience in services and tightness in labor supply given demographics. Because we expect limited damage to employment and household assets (w/ good equity cushions), we think 2023 presents opportunities in credit investing and banks. We stick with short duration bonds and net interest income sensitive banks until more economic clarity and stable 10yr Treasury yield.

2. How high will the Fed go? We think 5.0-5.25%: Since 1982, the average hiking cycle was near 300bp over about 15 months. Last cycle, the overnight rate plateaued at 2.25% in 2019 and before that at 5.25% in 2007. We expect the U.S. Federal Reserve (Fed) Funds rate to plateau in 1Q23 between 5.0-5.25%, a 500bp+ climb in a year. This should slow inflation and the economy. Unless the recession is deeper or longer than we expect, rate cuts are unlikely until 2024 to ensure inflation embers are extinguished. Thus, investors have a good risk-free alternative while watching how 2023 develops.

3. Long-term interest rates rise to pre financial crisis range. What's the norm for the 2020s?: We expect 10yr Treasury yields to rise to 4.20% at 2023 end with long-term inflation expectations and breakevens at about 2.5%. Thus, 10yr TIPS yields at 1.50-1.75%, up from about 1.25% today. This is a big difference from our nominal and real yield expectations from this time last year. This is because inflation climbed higher and for longer and broader in 2022 than we expected last year. Uncertainty remains very high for Treasury yields. The basics of reasonable inflation assumptions and inflation risk premiums remain unsure and so does risk asset hedge value of Treasury bonds given the large simultaneous losses in fixed income and equities in 2022.

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Moreover, the deficit remains high and the Fed will likely sell over \$1 trillion of its Treasury and mortgage-backed security (MBS) holdings next year.

4. How to tame inflation in 2020s? Productivity is key: Taming inflation will be a challenge; owing to global conflict, smaller trading blocs, reshoring, demographics, environmental considerations, other regulations and the challenge of raising productivity at mature service oriented economies. Such challenges should affect real growth more than inflation if there is monetary and fiscal policy discipline. But, because such policy decisions will be tough, it's important to stay on guard against elevated inflation risk. Most commodity and goods prices declined from early 2022 highs, but while oil is in a lot of things, labor is in everything. Thus, improved labor productivity is the key to healthy real growth and easing some difficult policy choices ahead. We expect employment, income and equality to become even more controversial ahead. Meanwhile in 2022, productivity is very weak at -1.3% y/y YTD with wages up 6.0%, boosting unit labor costs (ULCs) by about 7% y/y.

5. S&P sector strategy: Under a weak macro backdrop, we embrace robust secular trends resistant to cyclical disruptions, such as: Healthcare solutions for an aging world, productivity enhancers for a tight labor market (selectively in Tech Services, Industrial Capital Goods), experience providers for in-person social and business gatherings (Hotels, Airlines), Aerospace & Defense (A&D) to get to and defend people and places we cherish, clean energy and electrification plays offering fair equity returns (Utilities, Elec. Equip.). Our preferred high beta industry remains Banks on higher interest rates and higher normalized Earnings per share (EPS) and Return on equity (ROEs). We over-weight Communications as an overlooked value play, as the risk of profit decay appears more priced here than elsewhere.

6. A better relative decade likely for small vs. large caps: Competitive US corp tax rates, strong dollar, higher interest rates and reshoring supports better small vs. large cap secular performance this decade. Banks and Industrials are big sectors at profitable small caps. We shop in small Tech.

7. Keep foreign equities in the portfolio, search for value and lower correlations: Foreign DM is value tilted. Europe & Japan could outperform the S&P in 2023. We maintain exposure to China as it gradually reopens; including its premier digital enterprises heavily discounted for gov't risk.

8. 2023E S&P EPS \$225: Flat S&P EPS, assumes \$80-100/bbl avg. oil, stable dollar, benign credit costs at banks. Tech, Health Care and Financials are the 3 largest S&P 500 earnings contributors at 21%, 16%, and 15%, respectively. We expect EPS at these 3 to be flat to slightly up. But down at Energy, Materials, Consumer Discretionary ex. Restaurants/Hotels and Industrials ex. A&D.

9. A more reasonable PE: 18x supported by still low (albeit positive) real yields, high quality growth tilted S&P composition and low investment fees. Our S&P real cost of equity estimate is 5.5%: 1.5% 10yr TIPS yield + 4% Equity Risk Premium = 5.5%. This supports a fair price-to-earnings (P/E) ratio of $1/5.5\% = 18.2$.

10. Signs to watch in 2023: Positives: Real S&P EPS Growth despite a small recession or below 4% 10yr yield without a recession. Negative: Still high ULCs and loan growth feed wage-price spiral.

Glossary

Breakeven rates provide a useful measure of average inflation expectations derived from inflation linked sovereign bonds

Correlation is a measure of how closely two variables move together over time.

Deflation is a sustained decrease in the general price level of goods and services.

describes a slowing of the pace of price inflation.

Duration is a measure expressed in years that adds and weights the time periods in which a bond returns cash to its holder. It is used to calculate a bond's sensitivity towards interest-rate changes.

Earnings per share (EPS) is calculated as a company's net income minus dividends of preferred stock, all divided by the total number of shares outstanding.

Equity risk premium is an excess return earned by an investor when they invest in the stock market over a risk-free rate. This return compensates investors for taking on the higher risk of equity investing.

Fiscal policy describes government spending policies that influence macroeconomic conditions. Through fiscal policy, the government attempts to improve unemployment rates, control inflation, stabilize business cycles and influence interest rates in an effort to control the economy.

Inflation is the rate at which the general level of prices for goods and services is rising and, subsequently, purchasing power is falling.

Monetary policy focuses on controlling the supply of money with the ulterior motive of price stability, reducing unemployment, boosting growth, etc. (depending on the central bank's mandate).

A **mortgage-backed security (MBS)** is a special type of asset-backed security where the holder receives interest and redemption payments from pooled mortgage debtors, secured by the underlying mortgages.

The **price-to-earnings (P/E) ratio** compares a company's current share price to its earnings per share.

Productivity measures how much economic output is produced for a given level of inputs (such as capital and labor).

A **recession** is, technically, when an economy contracts for two successive quarters but is often used in a looser way to indicate declining output.

The **Return on equity (ROE)** is the amount of net income returned as a percentage of shareholders' equity.

The **risk premium** is the expected return on an investment minus the return that would be earned on a risk-free investment.

Small cap firms generally have a market capitalization of less than \$2 billion.

A **soft landing** is when an economy's rate of growth slows in a controlled fashion without major disruptive effects on employment, external balances etc.

Treasuries are fixed-interest U.S. government debt securities with different maturities: Treasury bills (1 year maximum), Treasury notes (2 to 10 years), Treasury bonds (20 to 30 years) and Treasury Inflation Protected Securities (TIPS) (5, 10 and 30 years).

The **U.S. Federal Reserve**, often referred to as "the Fed," is the central bank of the United States.

Unit labor costs (ULC) measure the average cost of labor per unit of output.

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