# Insights: January 2023

## Market Overview and Performance

2022 was not a good year for investors. That is a simple statement but it by no means captures the historic nature of the challenges faced during the year. The broad equity market as defined by the S&P 500 declined by about -18%, which at first blush seems like a severe drawdown. However, that year end result, while disappointing, is not entirely unexpected. Since 1928, the average intra-year decline has averaged a little more than -16%. More importantly, consider the last 3 annual returns for the S&P 500 index which registered as +28.7% in 2021, +18.4% in 2020 and +31.5% in 2019. Clearly, these results were well in excess of the roughly high single digit expected returns from equities over time. Without question however, the declines in fixed income assets in 2022 will define the year. The -13% drawdown in the Barclay's Aggregate Bond Index was the most severe on record – worse than the Great Depression. It is difficult to comprehend why these declines occurred for the majority of investors who hold a balanced asset allocation. Unfortunately, humans tend to extrapolate past trends out linearly. As a result, the overwhelming consensus heading into 2023 was for a slowing economy throughout the first half of 2023 before the inflation numbers and Fed rate increases stabilized by mid-year which would potentially set the stage for a year-end rally. While certainly plausible, thus far in 2023, both hard economic data and soft survey data have surprised to the upside. As a result, a scenario has emerged where the elusive "soft landing" outcome has become more realistic. The labor market within the United States has remained incredibly strong, while inflation and wage growth has remined muted. In addition, US corporate fundamentals and earnings have not collapsed as predicted. To the surprise of almost all investors, risk assets have started 2023 with remarkably strong returns. Without question, there is solid evidence on both the recession and non-recessionary sides of the argument. Time will tell. As always, thank you for reading our market Insights.

| | ***Quarter to Date December 30*** | ***Year to Date December 30*** |
|---|---|---|
| ***Equity*** | ***Total Return % (USD$)*** | ***Total Return %*** |
| S&P 500 Index | 7.56 | **-18.11** |
| Russell 2000 Index | 6.23 | **-20.44** |
| MSCI EAFE Index | **17.34** | **-14.45** |
| MSCI Emerging Markets Index | **9.70** | **-20.09** |
| ***Fixed Income*** | | |
| Barclay's U.S. Aggregate Bond Index | 1.87 | **-13.01** |
| Barclay's U.S. Aggregate Credit Index | **5.30** | **-25,29** |
| Barclay's U.S. Aggregate Corporate High Yield Index | **4.17** | **-11,19** |
| Barclay's Municipal Bond Index | **4.10** | **-8.53** |
| ***Macro Measures*** | | |
| Gold | **9.22** | 0.67 |
| Crude Oil | 0.97 | 6.71 |
| CBOE Volatility Index | -26.27 | **-25.84** |
| USD Dollar Index | **-7.38** | **8.66** |

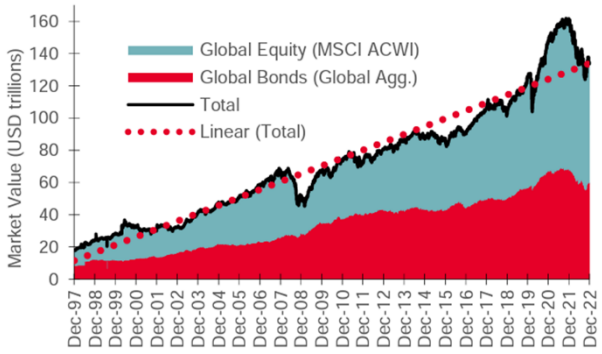
## **Current Theme –** Recession, Slowdown, Growth Surge, None of the Above? Conflicting Signals Leave Investors Guessing.

### Without a Doubt, the Consensus View Heading into 2023 was for a Sharp Slowdown Followed by a Notable Rally in Risk Assets in the Second Half of 2023

As we have discussed in our Insights letters over the past year, 2022 was a significantly painful but extreme outlier in terms of returns for investors. That being said, we are long-term investors and 2022 could easily be characterized as a clearing of excess and a return to long term growth trends for global assets.

***Excess of 2020/21 Has Been Removed From the System***

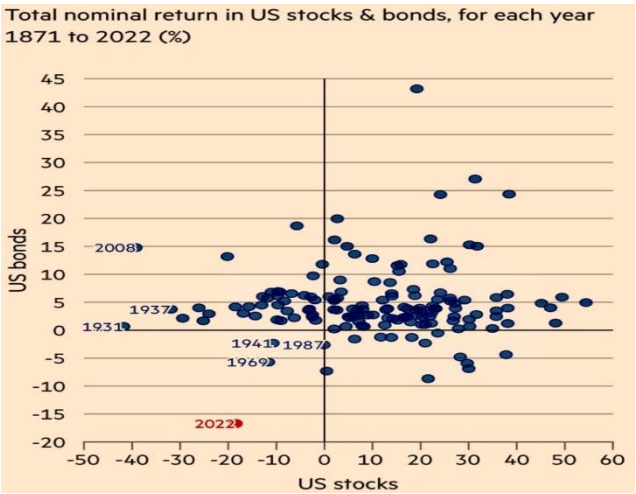
**2022 was all about removing the market excesses of 2020/21 (total market capitalisation of global equities and bonds)**




*Source: SG Cross Asset Research/Equity Quant, Bloomberg*

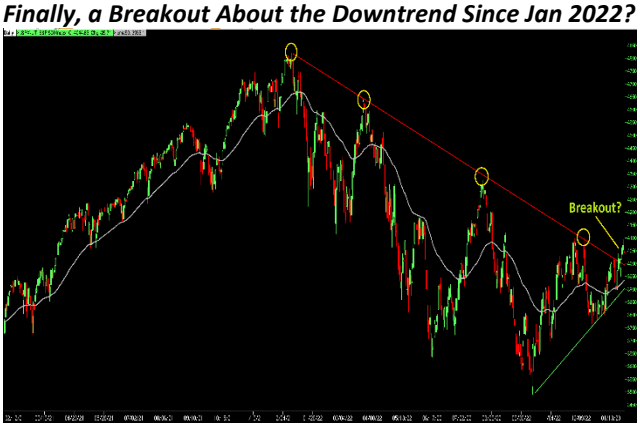
As one can see above, the total market capitalization of global stocks and bonds had inflated beyond reasonable growth expectations. Consequently, both bonds and equities cascaded lower by some -18 percent as measured by the 10-Year Treasury and S&P 500 Index. This is an extreme outlier event as highlighted in the previous chart. Going back some 150 years, this type of severe decline within both risk (stock) and safety (fixed income) concurrently has never taken place. Asset allocation and diversification therefore provided no buffer against market volatility.

***10 Year Bond -18% While Stocks -18% is Historic Outlier***




*Source: Robert Shiller; TS Lombard; Financial Time*

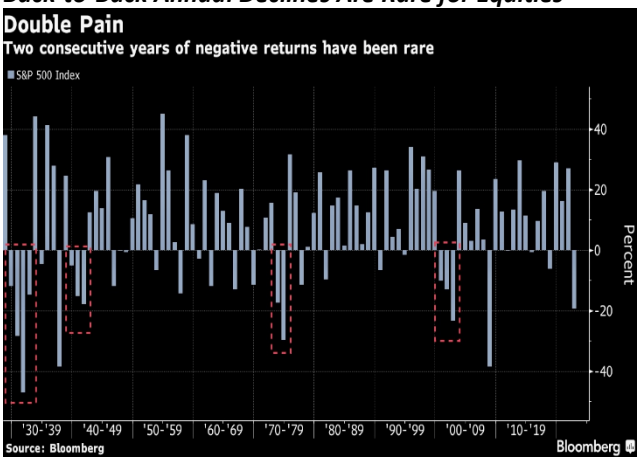
***Finally, a Breakout About the Downtrend Since Jan 2022?***




*Source: Refinitiv*

More optimistically though, equities have in fact rallied since mid-October. As the chart above illustrates, a downward trendline in "lower highs" has perhaps been broken this January. As one can see, the trend upward since October has broken above the not only the statistically significant 200 day moving average, but also above the downward trendline which has been repeatedly tested.

***Back-to-Back Annual Declines Are Rare for Equities***



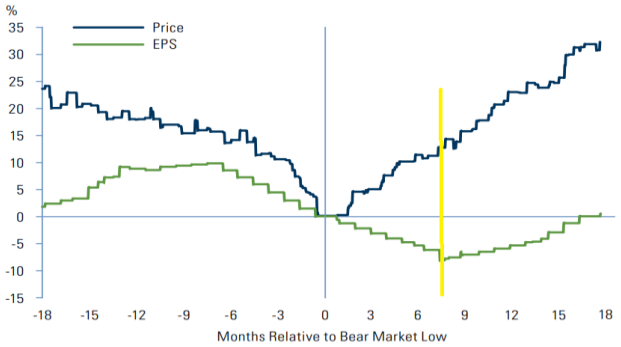

*Source: Bloomberg*

Additionally, history is on the side of a risk asset rebound after a sharp drawdown in a calendar year.

Going back to the 1930's back-to-back annual declines for equities has only occurred 4 times.

***Equity Prices Trough Well Before Earnings Bottom Out***

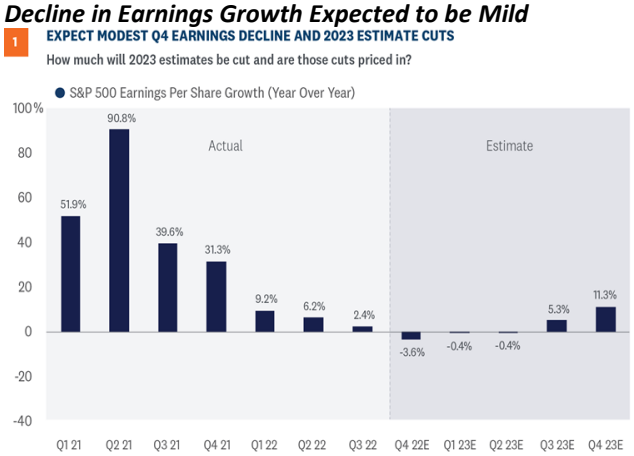
Equities have typically troughed 6–9 months before earnings reach their low in past bear markets.




*Source: Goldman Sachs Global Investment Research*

One of the primary concerns in the market however, is that corporate earnings will decline. That is certainty likely to be the case. It should be kept in mind however that 2023 S&P 500 earnings estimates have already been adjusted by almost -10% since their peak in June of 2022 from $252 to $226. More importantly, as the chart above highlights, stock prices historically trough roughly 6-9 months before earnings hit bottom.

***Decline in Earnings Growth Expected to be Mild***



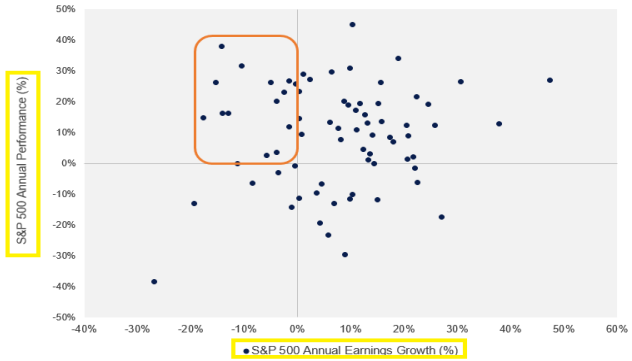

*Source: LPL Research; Factset*

This would be consistent with stocks having traded at their lows in October of 2022 while earnings are not anticipated to halt their decline until June of 2023. Even if that proves to be the case, as the chart above demonstrates, the decline in earnings is estimated to be quite shallow. This is partly because the comparisons against the strong 2021 post-COVID earnings periods distort the growth picture somewhat. By the second half of 2023, year over year comparisons start to become healthier once again, with a strong rebound forecast by year end.

***Stock Returns Are Frequently Positive When Earnings Fall***

Earnings Declines Don't Necessarily Mean Falling Stock Prices

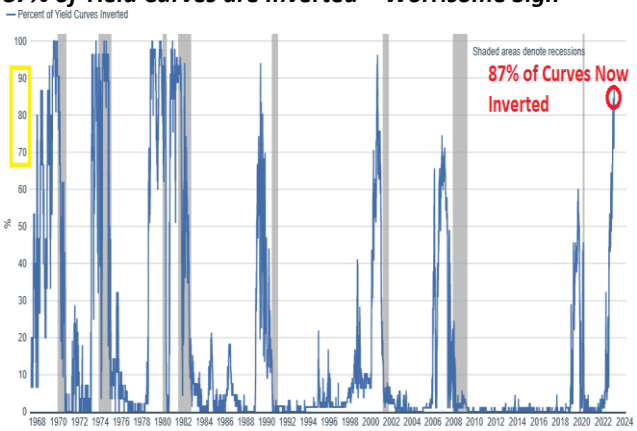
S&P 500 Index Annual Earnings Growth vs. Price Performance




*Source: LPL Research, Factset; Refinitiv*

And in fact, counterintuitively, stocks historically are more likely to post positive returns when earnings are trending lower than they are to fall. That is due to the fact that the equity market is forward looking and has already incorporated the future shift to the improving trend as witnessed in the previous trough chart.

***87% of Yield Curves are Inverted – Worrisome Sign***

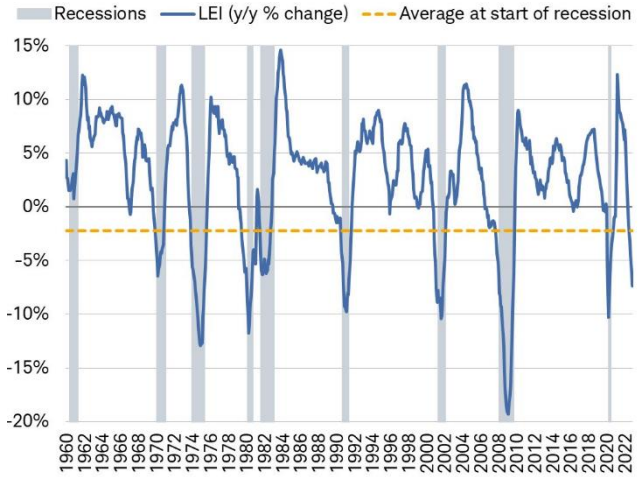



*Source: Charles Schwab; MacroBond, US Department of Treasury*

Without a doubt however, concerning signs of an imminent recession do exist. The most frequently cited is the inversion of the yield curve. While arguments can be made about the validity of one point or another to focus on, the fact remains that 87% of the various yield curves are inverted. As seen above, over the past 50 plus years, when basically the entirety of the curve inverts as is the case now, a recession has always followed within a few months time.

Further, many prognosticators point to the fact that the US Leading Economic Indicators Index, essentially a measure of overall economic activity in the US, has declined sharply. It should be clarified that the indicator is not truly "leading" since it is based off of backward-looking data. Nonetheless, when the Index has experienced similar declines in the past, recessions have developed soon after in every case.

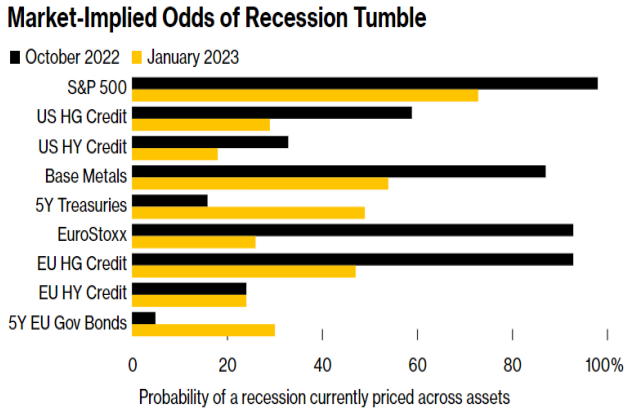
***Leading Economic Indicators Suggest Weakness Ahead***




*Source: Charles Schwab; Bloomberg; The Conference Board*

Many market participants take these type of warning signals to heart since they have proven reliable in the past. However, we are at a curious point in time where the global economy is still recovering and evolving from the effects of the COVID shutdowns and the resulting policy actions. As such, we see many conflicting data which makes the path forward less certain. For example, consider the market-based indicators of a recession tracked by JP Morgan.

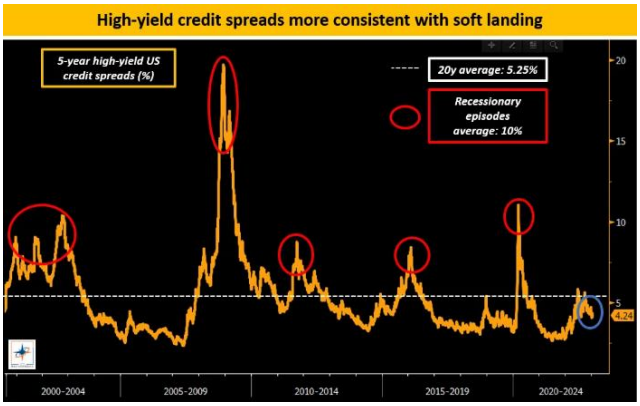
***Some Market Based Recession Indicators Have Receded***




*Source: Bloomberg; JP Morgan*

In their estimation, the market implied odds of a recession have fallen substantially since October of 2022. Within their data, they are looking across several asset classes, but in general, market participants have always relied on the credit market as the most trustworthy indicator of potential trouble within the system either now or in the near future.

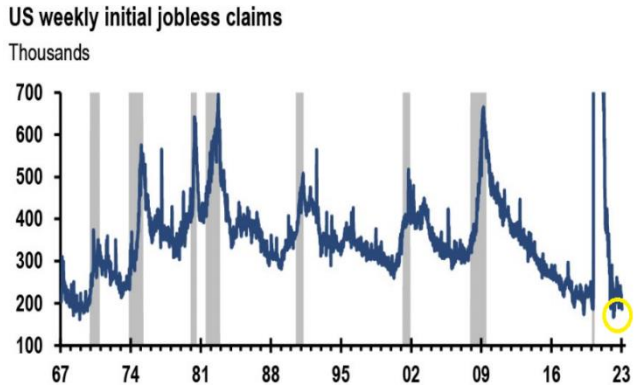
***Credit Markets (High Yield) Showing No Signs of Distress***




*Source: The Macro Compass; Bloomberg*

As one can see above, credit markets, as measured by the most vulnerable segment, high yield, is showing almost no signs of distress. This is a reflection of companies with the poorest quality balance sheets and yet their yields are well below the 20-year average and nowhere close to the recessionary peak levels seen in past episodes.

***Jobless Claims Near All-Time Lows - Lowest in 50+ Years***

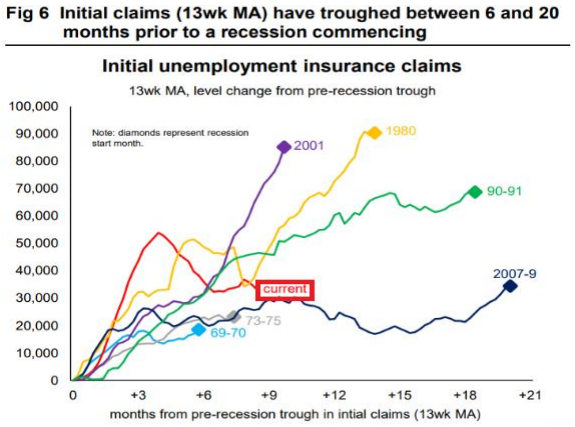



*Source: US Department of Labor; JP Morgan*

Somewhat conversely to the inverted yield curve, those who believe that a recession will not take hold point to the labor market. During past recessions, jobless claims have always spiked higher before the actual recessionary period becomes apparent.

As one can see in the previous chart, current jobless claim levels are at their lowest point in over 50 years.

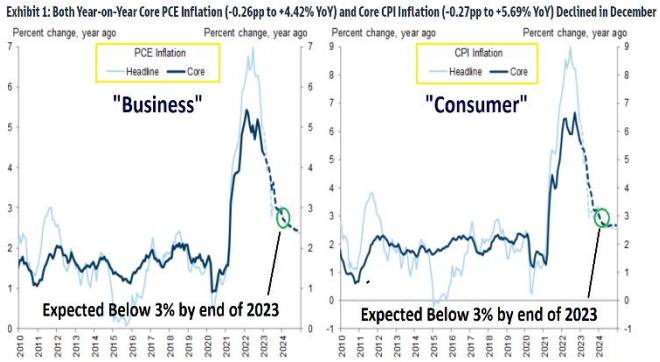
***Jobless Claims Not Following Recession Path***




*Source: Macrobond; Macquarie Macro Strategy*

That fact is very hard to square with an economy that is in contraction. In the chart above from Macquarie Macro Strategy, the path of claims during past recessions has steadily climbed higher in the months following its lowest reading. That is simply not the case at the moment with the current level if anything, still in decline or at the very least, holding flat.

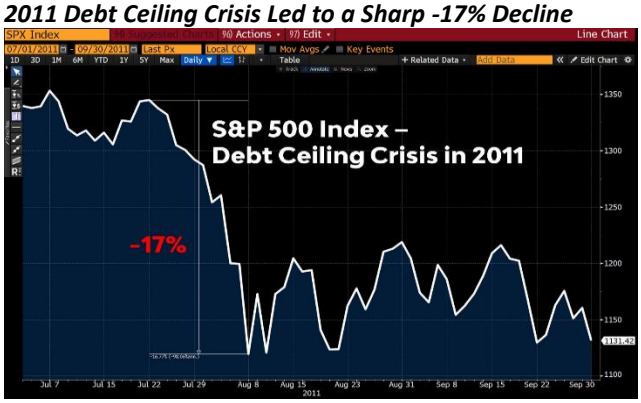
***Both PCE and CPI Inflation Measures Have Peaked***




*Source: Goldman Sachs Global Investment Research*

Another strong element in the non-recessionary narrative is the fact that inflation levels have clearly peaked. In the chart above from Goldman Sachs, both PCE, essentially business impacted inflation, and CPI which is more consumer influenced inflation, are in decline. In fact, both measures are anticipated to fall to below 3% by the end of 2023. If that were to be the case, the Federal Reserve certainly would not be required to continue raising interest rates. This eases financial conditions and would set the stage for stronger growth in the economy rather than a contraction throughout 2023.

***2011 Debt Ceiling Crisis Led to a Sharp -17% Decline***




*Source: Bloomberg*

Clearly, both sides of the recession debate have merit and can point to historically accurate data. However, one additional "unknown" to consider as the year evolves is the need to raise the debt ceiling in the US. As seen above, when this issue came to a head in 2011 with a downgrade of the US credit rating, it proved to be an unpleasant time in risk markets. The S&P 500 Index for example, fell over -17% in a matter of weeks before a resolution was found. It should be noted however, that the Index went onto to have a very difficult remainder of the year.

***Outside of 2011, Other Debt Ceiling Episodes Were Mild***

**Exhibit 1: The impact of debt limit episodes on equity markets is usually limited**

| Debt ceiling episode | Equity peak to trough drawdown: S&P 500 | Equity peak to trough drawdown: Gov't exposure basket (GSRHGOVT) | VIX: Rise (pts) | VIX: Peak level | Rise in 1m T-Bill yield (bp) |
|---|---|---|---|---|---|
| 1995-96 | (3)% | NA | 6 | 21 | NA |
| 2011 | (17) | (25) | 32 | 48 | 16 |
| 2013 | (4) | (2) | 7 | 20 | 34 |
| 2015 | (2) | (4) | 6 | 20 | 10 |
| 2021 | (4) | (8) | 14 | 31 | 6 |
| **Median** | **(4)%** | **(6)%** | **7** | **27** | **13 bp** |
| **Average** | **(6)** | **(10)** | **13** | **29** | **17** |

*Source: Goldman Sachs Global Investment Research*

Thankfully, as the table above from Goldman Sachs highlights, previous episodes have not proven to be as volatile. Most estimates seem to be that the Government has enough resources to get through August before some sort of conclusion must be reached. Let's hope that the trajectory of the economy is not impeded by political drama.

## Going Forward

As we discussed, the overwhelming consensus outlook heading into 2023 was for a very challenging first half of the year as the Fed continued on its path of raising interest rates, followed by a more constructive environment in the second half of the year. At that point, expectations would be looking for lowered inflation data combined with easier financial conditions which allow for a more business friendly environment. Without exaggeration, virtually every Wall Street strategy and research piece we have read suggest that this will be the likely path in 2023. In our experience, when essentially everyone believes that the same outcome will unfold in the market, that outcome is in fact very unlikely to occur.

So if we assume everyone is looking for a fairly benign "mild recession" environment, what would diverging paths look like? The bearish scenario would include the Fed pushing rates too far, high Inflation fails to decline or even increases, consumers significantly reign in spending, and the global economy falters. On the other hand, a more bullish outcome would entail the Fed basically pausing rate increases near current levels, inflation falling dramatically, robust consumer behavior buoyed by a strong jobs environment, and a global spurt of growth driven by the re-opening of the Chinese economy. Both are possible, so we will not lean in either direction until we see confirming data.

Due to the uncertainty of the market this year, we have maintained a higher than normal cash allocation. However, as the shift in sentiment evolved in mid-October we began to aggressively put capital to work namely in the information technology, financial, energy, industrial and consumer sectors. We continue to do so and have used the most recent earnings reports to opportunistically add to selected names. More defensive sectors that proved to be the strongest relative performers in 2022 like Healthcare and Consumer Staples, have become somewhat expensive in our view. Our exposures within those segments are therefore more concentrated in the highest quality businesses who continue to successfully execute.

Small and mid-cap stocks have suffered more than their large cap alternatives throughout much of 2022. However, given that these companies generate almost all of the of their sales domestically and are therefore not harmed by a strong Dollar, they are poised to benefit from an improving inflation and rate scenario. Valuations for both small and mid-cap stocks are very attractive when compared to their large cap counterparts and fund flows have therefore been attracted to theses areas at the start of 2023. For example, the year-to-date return for the Russell 2000 Index of small cap US stocks has retuned approximately +8.3% through the end of January while the S&P 500 has returned +5.2% over the same time.

Regions outside of the US which were challenged by a very strong US Dollar throughout 2022 have seen a change in the headwinds. Valuations outside of the US are very compelling on a historical basis after a difficult 2022. Additionally, the US Dollar appears to have peaked near the end of September last year. If that trend continues, along with the improving fundamental data we have seen globally, non-US markets could potentially do well in 2023. Assets have sought out his opportunity as well with the MSCI All-Country World ex-US Index up +8.4% so far this year and the Emerging Markets Index up +8.7%.

Within fixed income, we continue to place our emphasis on shorter duration exposures and unconstrained strategies. We also continue to find opportunities within municipal bonds. More recently however, we have taken advantage of the climb in treasury yields to allocate a portion of our exposure into laddered short-term treasuries as a way to capture risk-free yield for fixed income portfolios. As rate increases by the Federal Reserve are projected to wane something this Spring, we would anticipate taking advantage of slightly longer duration exposure that stand to benefit from a more stabilized rate environment combined with falling inflation.

We believe that commodity exposure including both gold and non-precious metals (agriculture, industrial metals, energy) will continue to be additive due to the nature of the current supply constraints. Gold in particular has served its purpose as diversifying asset quite well, returning +6.4% in January thus far.

Thank you for taking the time to read our thoughts on the markets and we look forward to speaking soon.