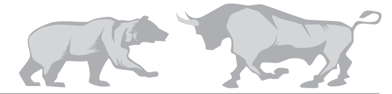

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ECONOMIC OUTLOOK 2023

An Indepth Forecast of the Year 2023

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2022 Recap

The year 2022 is shaping to be the year of superlatives. The highest inflation in forty years, the most significant Federal Reserve Bank (Fed) rate hikes in 40 years (4 consecutive 75 basis points raises), the steepest yield curve inversion in 40 years, the highest mortgage rates in 41 years, the strongest U.S. dollar in a generation, and the first major war in the heart of Europe since 1945.

Four-decade-high inflation was fueled by strong consumer demand and significant supply constraints. Easing of the Covid-19 pandemic restrictions created significant pent-up consumer demand, whereas the supply side was constrained by substantial supply chain bottlenecks along with energy and food shortages caused by the Russia-Ukraine war. The Fed and most other major central banks embarked on a series of interest rate hikes to help tame inflation.

These restrictive monetary policies had a considerable negative impact on most financial assets. All major equities indexes experienced unprecedented volatility, with near historical lows followed by sharp bear market rallies (a bear market is defined as losing 20% or more from its previous peak).

From its recent high at the end of last year to its low on October 14, 2022, the technology-heavy NASDAQ Index tumbled 34.55%. During that period (from June 16 to August 15, 2022), the Index experienced a sharp bear market rally rising 23.44%.

At the end of November 2022, the S&P 500 Index, a broad measure of the stock market, lost 13.12%, and the NASDAQ fell 26.12%, year to date.

Value stocks outpaced growth stocks by a wide margin, and defensive sectors fared better than cyclical ones. Defensive sectors are consumer staples, utilities, and health care. Both large and small capitalization stocks underperformed by the same amount. All sectors lost money except Energy, which rose by a whopping 69.34%. The Communication Services sector lost the most, down 33.22%. The year also saw a considerable spike in yields as the 10-year U.S. Treasury bond reached 4.24% in October from a low of 1.34% late last year. Bond prices and yields move in opposite directions. Rates for a 30-year mortgage surpassed 7%, a level not seen since 2008. The Bloomberg U.S. Aggregate Bond Index, a broad measure of the bond market, was down 12.26%. Cryptocurrencies tanked while the U.S. dollar shined.

Economy

Business Cycle

Last quarter we shifted our view that the U.S. economy was further along in the business cycle, moving from mid to late cycle. Despite the contraction in the first half of the year, the economy grew in the third quarter and is expected to continue expanding through the end of the year.

Our view for the beginning of 2023 is remarkably similar. The economy is still in a late cycle environment. However, the odds of falling into a recession in the quarters ahead are elevated. We see several warning signs that troubles could be on the horizon. Fears of a recession are rising as the Fed continues to raise interest rates to help fight inflation. The housing market remains in a downturn as higher home prices and increasing mortgage rates negatively impact housing affordability. As the saying goes, "housing today is the economy tomorrow."

Additionally, yield curves are inverted across several maturities and are flashing warning signals that a recession could be around the corner. For example, one of the Fed's favorite indicators for a recession is the spread between the 3-month Treasury Bill and the 10-Year Treasury Note. The spread is currently inverted (10-Year Treasury note minus 3-month Treasury Bill) standing at -0.77% through the end of November 2022. Dating back to 1985 this yield curve spread inversion has historically indicated a shorter lead time to the start of a recession, averaging about 6.5 months from the inversion.

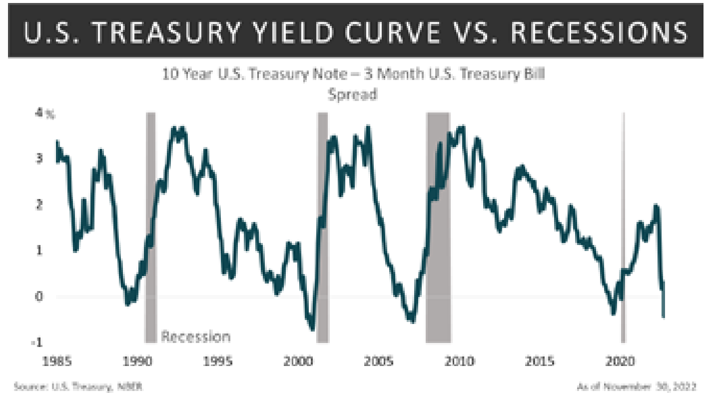


Figure 1 - The U.S. Treasury Yield Curve vs. Recessions

Moreover, higher interest rates are having a negative impact on credit too, as financial conditions worsen, and banks tighten lending standards. Additionally, inventories for retail companies are on the rise as demand for goods fades. With recessionary warning signals mounting, the odds of shifting from late cycle into a recession, especially in the second half of 2023, are increasing.

Recession Watch

Often economists evaluate several variables and indicators to help determine if the economy is in a recession. Some might say we had or are in a recession now, given that we just had two quarters of negative Gross Domestic Product (GDP) growth to start in 2022. However, the National Bureau of Economic Research (NBER) has the final say in dating economic recessions. They investigate factors such as payrolls and the labor market, real personal income, retail sales, and industrial production to determine if they see a significant decline in economic activity. The NBER did not call a recession in the first half of 2022 because many of the above factors did not see a decline. Let us explore each one of these factors.

Labor Market

The labor market remains a strong driver for the overall economy and is a primary reason the economy has not fallen into a recession. Unemployment remains historically low, and the economy continues to add new jobs. All of this is despite the interest rate increases, sluggish housing market, and slowing economic growth.

As fear of a recession in 2023 builds in the market, companies have begun to reduce costs and staff, which points to a softening in the labor market. This is especially visible in sectors that tend to be more sensitive to higher interest rates, such as technology, real estate, and financial services.

However, the labor market remains tight as the demand for workers is strong, with job listings outpacing the number of those unemployed and looking for jobs. This has also put upward pressure on inflation as workers demand higher wages, which has benefited workers in that they often find new work quickly. In fact, at the end of November 2022, the unemployment duration is just below nine weeks , down from over fourteen weeks a year ago. We understand labor can often be a lagging indicator for the economy, but for now, it suggests the economy still has some solid footing as we enter 2023.

Real Personal Income

Real personal income is strong, but it has softened compared to 2021. Wages have increased for many employees, especially for low-income earners. However, the overall wage growth has not kept up with inflation. This has forced the consumer to dip into savings, and as a result, we have seen the saving rate near historic lows. Additionally, recent credit card data shows consumer borrowing is picking up, which is a worrying sign.

Consumers

Consumer sentiment is often followed because it provides insight into consumer behavior and overall economic expectations. Unfortunately, sentiment has been disappointing since the pandemic began in 2020 and has struggled to regain ground. A few factors have contributed to the poor sentiment readings, such as energy prices, childcare costs, inflation, and wages. The latest readings from the University of Michigan Sentiment remain disappointing and remain near past recessionary levels. Consumers need to feel confident about their job, wages, and financial situation for the economy to expand optimally.

Fortunately, consumer spending is holding strong while other segments of the economy are on shaky ground. The excess savings consumers have built up during the pandemic have provided a nice safety net despite rising consumer prices.

The latest data for advanced retail sales shows demand is strong, with year-over-year growth of 8.3%, at the end of October 2022. These levels may not be as strong as the ones we saw in 2021 when retail sales averaged double-digit growth, but they remain well above levels before the pandemic. It shows that the consumer is still willing to spend even though they have seen a surge in consumer prices.

Industrial Production

Even with some weaknesses in soft data (surveys), such as the Institute for Supply Management (ISM) manufacturing surveys and reports from the various regional Federal Reserve offices, the hard data, including Industrial Production, looks to be growing at a reasonable pace. In fact, over the past year, Industrial Production has increased by 3.3%. To put that in perspective, the 10-year average before the pandemic was about 1.7%. However, the second half of the year has seen moderate growth. Some of the weaknesses can be explained by supply and demand headwinds that factories are facing in addition to the geopolitical risk in Europe and the zero-Covid policies in China. Based on the leading indicators, we see downside momentum in the manufacturing sector, which leads us to increase the odds of a recession in 2023.

Leading Indicators - Early Warning Signals

The Index of Leading Economic Indicators points to a possible economic contraction in the year ahead. The most negative contributors to this index include weakening activity in the manufacturing sector, deterioration in bank lending standards, and the inversion of the yield curve. Historically, all these indicators signal before the start of a recession.

The Purchasing Managers' New Order Index is also indicating weakness in the economy. This index measures the expectations for future business activity. Levels below 50 indicate contracting activity, and recent data has fallen below that mark. Historically, levels below 45 coincide with a recession, as seen in Figure 2 below. We have not broken this level, but as the chart shows, we are trending in that direction.

Figure 2 - Institute of Supply Chain Management (ISM) Purchasing Manager New Orders Gauge vs. Recessions

Equity Market

2022 was a treacherous year for markets. All major indices firmly entered a bear market environment. Inflation at a four-decade-high and a Federal Reserve that was late fighting it were the culprits. The result was a rapid tightening cycle, a speed of which the market has never seen since Fed Chairman Volcker's time in the 1980s. By the end of the year, the Fed will have raised the Fed Funds rate by over 4.5% in just nine months, draining nearly $500 billion of liquidity from the financial system. The stock market reacted quickly and dramatically to the Fed's hawkish communications, devaluing most stocks, especially those in the Technology and Biotechnology sectors that advanced rapidly in 2020-2021.

Investors are questioning whether the bear market is over, and it is safe to dip their toes back in the water, or if 2023 bring more pain?

Several leading economic and market indicators have historically bottomed out ahead of or at the same time as stocks. These include housing leading indicators, manufacturing new order gauge, Conference Board Leading Economic Composite, retail investor equity levels, earnings revisions, cyclical sectors outperforming, and credit spreads (when they stop widening). All of these have yet to reach a bottom.

Business New Orders Points To Further Downside To Stocks

History shows there was never a bottom in the stock market without a bottom in the leading economic indicators, such as the Institute of Supply Management (ISM) Purchasing Manager Index (PMI) for New Orders. As mentioned in the Economy section above, it is still in contraction territory and trending lower. It pays to watch this indicator closely for any upturn in the cycle.

Conference Board Leading Economic Indicator

Another leading indicator for the economy and a coincident one for the stock market is the Conference Board Leading Economic Indicator Index (LEI). The index combines data from multiple sources in a composite index, including the initial application for unemployment benefits, the volume of manufacturers' new orders for consumer goods, the number of new building permits, the inflation-adjusted monetary supply (M2), the spread between long and short-term interest rates, and consumer sentiment among others.

Historically, this index usually bottoms right before or at the stock market bottom (See Figure 3). The latest reading of the year-over-year change is at -2.7%. Since 1960, the index has never crossed below -1% without a recession unfolding in the next six months. This suggests a high probability of recession in 2023. Again, this indicates further downside to stocks, especially since stocks never bottomed out before the start of a recession.

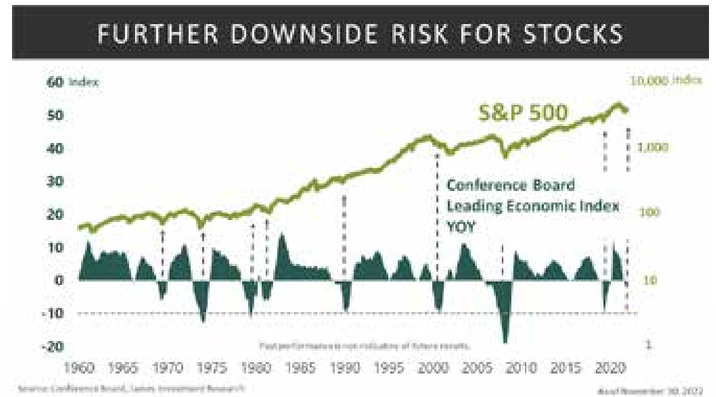


Figure 3 - Conference Board Leading Economic Indicator (LEI) Year-over-Year Growth & S&P 500

Housing Leading Indicators & Stocks

A Fed tightening cycle is typically first felt in the housing sector as it is one of the most sensitive sectors to rising interest rates. This is especially the case if home prices were at a record high before the tightening began.

Hence, housing usually is the first sector to show improvement and signs of a new economic/recovery cycle. In fact, if you plot the National Association of Homebuilders (NAHB) Index and the S&P 500 Index as a proxy for stock markets, there was never a market bottom without a bottom in housing. The homebuilders' sentiment is a leading indicator of housing, and it is in free fall which does not seem to be bottoming out yet.

Similarly, when housing starts begin to recover, the market starts to recover coincidently. Therefore, any market bottom needs to be confirmed with housing leading indicators.

Valuation

Even though valuations have reset with the 2022 selloff, they are still more expensive than all past bear market lows. At the low in October 2022, the S&P 500 Index was trading at 17.3 times profits, exceeding trough valuations from all 11 previous drawdowns and topping the median of those by 30%. Further, as 2023 earnings estimates are lowered, valuation will reset higher because at current prices investors will be paying the same amounts for lower earnings per share. This also indicates more downside risk for stocks as valuations adjust more to account for earnings deterioration.

Earnings

Earnings estimates for 2023 are coming down but are still too high as seen in Figure 4. During a recession, earnings are typically down 15% to 20% on average, depending on the recession's severity. With elevated inflation and weakening economic growth expected in 2023, profit margins will get squeezed and earnings will be lower than in 2022, with the potential for an earnings recession (more than two consecutive quarters of negative earnings growth) as the economy fully digests the negative impacts of the Fed tightening.

Even if we do not get an economic recession, an earnings recession is still highly likely as revenues react to slower economic growth, and 2022 near-record margins retreat to the historical average due to elevated input prices and consumers less willing to accept higher prices.

Figure 4 - 2023 Earnings Estimates Need To Come Down To Reflect Macro Headwinds

Additionally, one of the leading indicators of S&P 500 earnings growth is ISM Manufacturing PMI. Our research shows that the PMI index leads earnings growth by six months. PMI indices are good leading indicators for the economy and when they fall below 50 an economic contraction is usually ahead, which translates to negative earnings growth for stocks. In fact, as Figure 5 below shows, the indicator shows that S&P 500 earnings growth will be zero by the middle of next year.

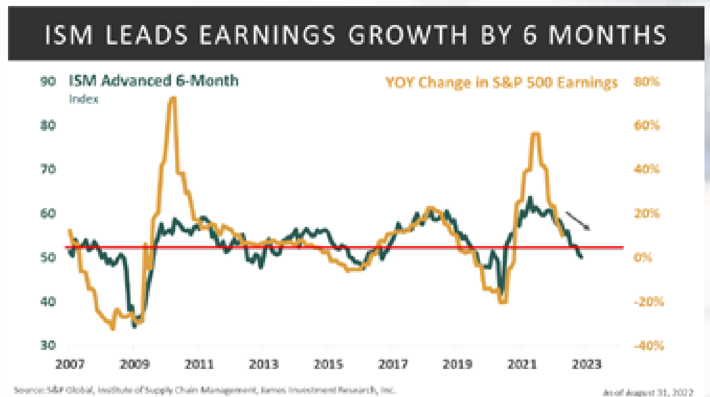


Figure 5 - PMI Indicates Lawer Earnings Growth Ahead

Quantitative Tightening Is A Headwind To Valuation

The best correlation of the stock market valuation (i.e., price-to-earnings (PE)) in the past 15 years has been with the Fed's balance sheet. That is, when the Fed embarks on a new Quantitative Easing (QE) or buys bonds, the S&P 500 PE expands. In contrast, when the Fed sells bonds (Quantitative Tightening), valuations contract. Hence, the ongoing QT program is another piece of evidence that supports the case for further declines in the PE ratio.

Another headwind for stocks is there is now an alternative asset class. The risk-free rate will soon be offering nearly 5%, and investment-grade bonds are offering even higher yields. In other words, bonds are becoming more attractive than stocks from a yield perspective.

Therefore, both the contraction of valuation multiples and the lack of earnings growth are major headwinds for stocks in 2023.

Potential Bullish Drivers For Stocks

The Case Of Falling Inflation

The case for inflation coming down significantly should not be dismissed, especially if there is a significant deterioration in aggregate demand in 2023. There are signs inflation has peaked and is about to ease dramatically. This is evidenced by the decline in producer prices, shipping rates, commodity prices, and market inflation expectations coming down from recent highs.

Additionally, real-time measures of the shelter component of the Consumer Price Index (CPI), which has 31% weight in the basket, are showing rents coming down. For example, the U.S. Zillow Rent Index All Home Year-over Year is at 9.8% as of October 2022, after registering a peak of 17% in March 2022. In other words, home prices are increasing at a slower pace, which is a positive driver for lower inflation in 2023.

Most of the decline in asset prices this year is because of the Fed's response to high inflation and the bond market repricing to higher rates to reflect the tightening. If inflation starts to show downside surprises in the months ahead and the economy trends lower but does not go into a recession, we believe risk assets, including stock and credit markets, may outperform. This is not our base case but it is a possibility.

China Fully Reopening

China has the world's second-largest economy. Hence, any development there has major implications on our equity market in this globalized and intertwined world. China has been embarking on a zero-Covid policy, which has restricted mobility in most of the country since last year. They enacted such a strict response to Covid to avoid a catastrophic human tragedy when the infection rate spiked, and their hospital system couldn't manage such an influx of patients.

Nevertheless, infectious disease experts have emphasized that what China needs is not lockdowns but effective vaccines such as Pfizer and Moderna vaccines. There was a green shoot in early November when the Chinese government allowed the Pfizer-BioNTech vaccine to foreigners residing in China. If the Chinese government extends the western vaccine to the rest of the population, their economy could fully open, and a major economic engine in the world will turn on again. This has the ramification of lifting economic growth elsewhere and would be very bullish for equities.

Resilient U.S. Consumer And U.S. Corporate Balance Sheets

As previously stated in the Economy section, the U.S. consumer is not overly leveraged and has more cash on hand from Covid fiscal spending. Consumers sit on a $1.7 trillion cash buffer compared to the 2019 level. Additionally, many companies borrowed when rates were very low and paid down debts during the high earnings year of 2021. The debt maturity wall is pushed into 2025. Hence, their balance sheets are in the best shape going into a downturn. These two factors have the potential of making any slowdown mild, which could limit the downside to stocks.

Fixed Income

2022 was a very difficult year for fixed-income investments and may go down as the worst year for bonds as the U.S. Aggregate Bond Index declined by 15.26% through the end of October. These higher yields and lower prices were undoubtedly due to the higher rates of inflation throughout the world, and the subsequent reaction by the U.S. Federal Reserve. What now must be considered is the likelihood the bond market continues down the same path.

Inflation, the nemesis of fixed income, reared its ugly head in 2021 and was at the forefront of investing for all of 2022. The Personal Consumption Expenditures (PCE), a price index favored by the Fed for measuring inflation, saw the highest levels in over 30 years. This index peaked at 7.0% at the end of June 2022 and has been moderating very slowly over the past few months. The Consumer Price Index saw more dramatic readings as it peaked at 9.1% during the summer. These extremely high readings were the root cause of the Fed's unprecedented tightening monetary policy.

There are some early signs inflation is beginning to subside. Home prices, for example, are coming down in select areas of the country. Higher interest rates for mortgages make purchasing a new home a little bit more difficult, especially for first-time home buyers. As such, for one to sell their existing home, they may need to bring down the price.

While it is very volatile, the price of oil and gasoline has also declined. Cheaper gas is very important, especially to the individual consumer. Every dollar saved on gas is a dollar that can be spent elsewhere.

It is likely too early for the Fed to begin a series of rate cuts. For that to occur, we would need to see inflation decline by a considerable amount and remain low for some time.

Inflation rates in the high 3% or low 4% range are a step in the right direction but still far too high to enact a change in Fed policy. It is likely the Fed will raise rates until an appropriate 'terminal' rate is reached to be indicative of tight lending standards. Currently, the market consensus is around 5.0% to 5.5% on the Fed Funds rate, or interbank lending rate.

While it is imperative for the Federal Reserve to see a reduction in inflation, the Fed governors must focus on jobs at the same time. With the unemployment rate near all-time lows, the Fed has leeway to raise rates further without substantially crushing the jobs market. In fact, as of November 2022, if every individual in the United States looking for a job was hired, there would still be approximately 5 million jobs left to be filled. The labor market is currently very tight.

If the unemployment rate is below 4% and Initial Jobless Claims remain below 300,000, the Fed will have no reason to fear the jobs front has been harmed.

Yields and coupons have moved up noticeably for fixed income and bonds. While this was not the best-case scenario for holders of long-dated bonds, it does create a good opportunity for those who have shorter-term issues and cash on hand.

For the first time in many years, investors can now purchase a one-year T-Bill and earn more than 4.5% as of the end of November 2022. This is a much better return than 0.25% last seen at the end of 2021. After a long wait, bonds may finally be an attractive alternative when compared to the dividend yield on the S&P 500 Index.

Looking at the types of bonds that may do well in 2023, we revert to our view on the economy. With the potential for a further slowdown in terms of GDP, history would suggest a move to the highest quality issues.

Treasury bills and notes have the full faith and credit of the U.S. Government. At the same time, there appears to be some highly rated municipal bonds in terms of quality and the ability to pay principal and interest on a timely basis. Considering these municipalities may now have more cash on hand due to the holdover from many of the Covid stimulus plans, those General Obligation issues seem to have a good safety factor in terms of credit.

An additional way to look at the relative attractiveness of different bond sectors is through their 'yield spread'. Spread is the difference in yield between any type of bond and its equivalent dated Treasury. The higher the spread, the more attractive it becomes in comparison to a U.S. Treasury. At this point in time, many corporate bonds are still at a narrow spread, an indication they are rich in price. Investors are not being compensated for the taking on additional default risk. Additionally, as bond prices decline corporate bonds are falling at a faster rate than U.S. Treasury bonds, translating to a widening of the yield spread. This is yet another reason to favor U.S. Treasury and very high-quality paper.

Conclusions

The U.S. economy is currently in a late-cycle environment. The odds of a recession are elevated and rising as we enter the New Year. Consumer spending remains resilient, boosted by a tight labor market. However, leading economic indicators are pointing to a downturn in 2023. A struggling housing market due to the Fed's rapid monetary tightening, weakness in the manufacturing sector, and falling consumer sentiment levels (now near historic lows) suggest recession fears are realistic. Overall, we forecast that 2023 will be a challenging year for the economy, with a recession more likely than not.

In our view, the market may face major headwinds in early 2023 as earnings get downgraded, and economic deterioration shows up in the hard data, such as the lagging indicators of payroll and inflation. Furthermore, there is a growing list of leading indicators that are signaling a forthcoming recession. These include tightening of credit conditions, the Conference Board's leading economic indicators contracting seven out of the last eight months, the inversion of the Fed's preferred gauge of the spread between long and short-term interest rates (i.e., 10-year less 3-month), and the Homebuilders Sentiment Index, which is now close to its pandemic lows.

All these signals typically occur ahead of a recession. While the labor market remains strong and cash in household bank accounts is high, most of the evidence supports a slowing economy.

However, we believe there is an opportunity for long-term investors to pick great buying opportunities as the market starts to price in an economic recovery. The timing of this inflection point will depend on the incoming data from the leading economic indicators previously mentioned. So, staying nimble, open-minded, and most of all humble is paramount as the uncertainty is unprecedented.

We recommend staying low in equity levels and maintaining defensive equity sector positioning by remaining overweight Healthcare, Consumer Staples, and Utilities. At a stock level, we still recommend staying with high-quality, low-leverage, high-pricing power, and moat companies.

There are risks to our outlook including the Fed pivoting in a major way, the U.S. consumer and corporations more resilient than we thought, China fully reopening soon and boosting global growth, Europe's recession not as severe as forecasted, and overall U.S. economic growth holding up better than the leading indicators projected.

For Investors:

Equities

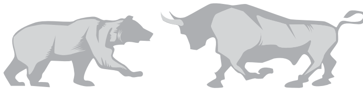
- Increasing Volatility
- Below Average Earnings Growth
- Continue To Favor Defensive Sectors: Healthcare, Consumer Staples, Utilities
- Begin To Add Selective Small Cap And Cyclical Stocks When Fed Policy Shifts
- Look For Companies With Pricing Power
- Favor High Quality Stocks

Fixed Income

- Bonds May Provide Diversification
- Inflation May Have Peaked But May Persist
- Bond Income Now An Alternative To Stocks
- Favor High Quality Treasury & Municipal Bonds

What Can Go Wrong

- Fed Pivoting In A Major Way
- U.S. Consumer And Corporations More Resilient Than Expected
- China Fully Reopening And Boosting Global Growth
- Europe's Recession Not As Severe As Forecasted
- Positive Development In The Russia-Ukraine Conflict
- Overall U.S. Economic Growth Holding Up Better Than The Leading Indicators Suggest



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Disclosure

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Investing involves risks, including loss of principal.

Past performance is no guarantee of future results.

Definitions

Quantitative Easing: a course of action undertaken by the Federal Reserve to increase the money supply by flooding financial institutions with capital in an effort to promote increased lending and liquidity.

Quantitative Tightening: monetary policies that contract, or reduce, the Federal Reserve System (Fed) balance sheet.

Basis Point: one hundredth of one percent, used chiefly in expressing differences of interest rates.

Growth: A company stock that tends to increase in capital value rather than yield high income.

Value: A value stock is a security trading at a lower price than what the company's performance may otherwise indicate.

Federal (FED) Funds Rate: the target interest rate set by the Federal Open Market Committee (FOMC) at which commercial banks borrow and lend their excess reserves to each other overnight.

U.S. 10 Year Treasury: a debt obligation issued by the United States government with a maturity of 10 years upon initial issuance.

Price/Earnings Ratio: ratio for valuing a company that measures its current share price relative to its earnings per share (EPS).

*Consumer Price Index (CPI): an index of the variation in prices paid by typical consumers for retail goods and other items.

*NASDAQ: a global electronic marketplace for buying and selling securities.

*U.S. Aggregate Bond Index: designed to measure the performance of publicly issued U.S. dollar denominated investment-grade debt.

*S&P 500 Index: S&P (Standard & Poor's) 500 Index is a market-capitalization-weighted index of the 500 largest U.S. publicly traded companies.

*Indexes are not managed. One cannot invest directly in an index.