
**Shifting Sands**

# Q1 2023 Market Update

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*"All will be well. We have, I believe, within us the life-strength and guiding light by which the tormented world around us may find the harbor of safety, after a storm-beaten voyage." Winston Churchill, 9 November 1954*

2022 has been a year most of us would like to forget. Markets brought losses, anxiety, pain and suffering to investors. The horizon currently looks very cloudy, and it feels as if it is hard to find anything to be excited about. The world, in a nutshell, feels grim. War, discord, growing wealth gap, sticky inflation, rising rates, and the specter of a recession with rising unemployment loom over the World. Both bond and stock markets were decisively negative for investors this year, with the broad bond averages looking to log their worst returns in 50+ years. While we recognize these headwinds and feel we are not out of the woods yet, we are not perma-bears for 2023. There will be green shoots and possibilities, and the best investment opportunities come in bear markets, not in bull markets. *Buy low, sell high.* Easier said than done for most. In 2023 we feel the worst will happen in Q1-Q2, then markets find their footing and we rally out to flat or slightly positive for equities on the year.

**2023 Outlook:**

- S&P 500: 4,100
- Earnings: $225
- 10-Year Treasury: 3.00%
- Year End Fed Funds rate: 4.25%- 4.50%

This outlook is in line with most of the major banks and financial institutions. While it feels uncomfortable to be siding with consensus (spoiler alert, what is popular is not often right), our outlook is where the data is taking us. Rough end to 2022, continued tough start to 2023, bottom out and rally out the second half. Until we have a market capitulation and rising unemployment to pressure the Fed into cuts, we are in a downward trending market.

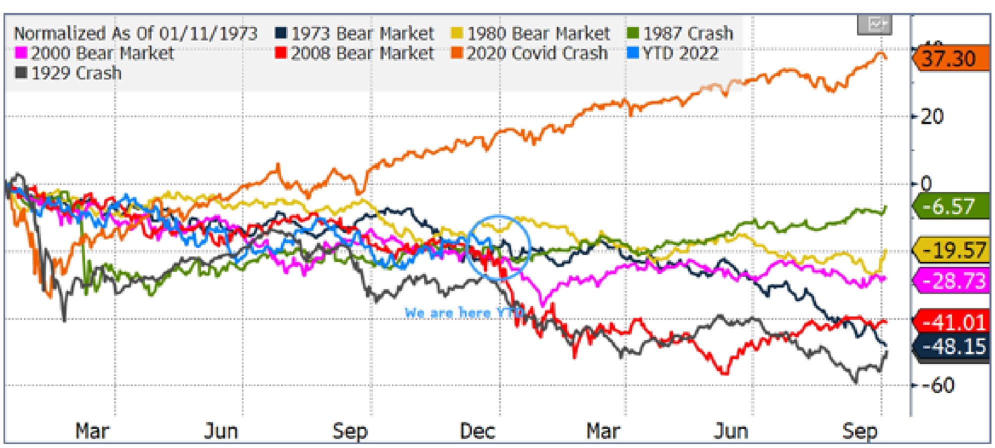
**2023 S&P 500 Year End Targets and EPS Outlook, Dec. 15, 2022**

| Strategist | Firm | YE S&P 500 Target | 2023 S&P 500 EPS |
|---|---|---|---|
| Ed Yardini | Yardini Research | 4,800 | $225 |
| Saira Malik | Nuveen | 4,300 | $205 |
| Dubravko Lakos-Bujas | JP Morgan | 4,200 | $205 |
| Chris Harvey | Wells Fargo Securities | 4,200 | $210 |
| Lori Calvasina | RBC Capital Markets | 4,200 | $199 |
| Guarav Mallik | State Street Global Advisors | 4,000 | $225 |
| Savita Subramanian | Bank of America | 4,000 | $200 |
| David Kostin | Goldman Sachs | 4,000 | $224 |
| Gargi Chaudhuri | iShares, Blackrock | 3,930 | $231 |
| Mike Wilson | Morgan Stanley | 3,900 | $195 |
| Ajay Rajadhyaksha | Barclays | 3,675 | $210 |
| Scott Chronert | Citigroup | 3,900 | $215 |
| Credit Suisse | Jonathan Golub | 4,050 | $230 |
| | **AVERAGE** | **4,089** | **$213** |

https://www.bloomberg.com/news/articles/2022-12-01/this-year-s-sour-stock-market-made-wall-street-bearish-for-first-time-since-1999?leadSource=uverify%20wall

We feel this bear market will push lower to start 2023, potentially hitting the 3,400- 3,200 levels on the S&P 500 before rallying out in the second half of 2023. The length and severity of the bear market so far is "average" as a bear market goes, but typically we see the bottom around 30-35% drop from highs. We charted other recent bear markets and how 2022 stacks up. Our charting pattern is aligning with other recent bears, and we are watching trajectory carefully, as well as data signals to gauge severity and length.

**2022 Bear Market vs. Historical Bear Markets (1929,1973, 1980, 1987, 2000, 2009, 2020)**




Data Obtained from Bloomberg, LP. Data as of close 12/16/2022

For now, the current low in this bear market has been 3,577.03 reached on Oct. 12th, 2022, which represented a -25% drop for its highs. We have not seen the downtrend invalidated, and each time we have rallied off the bottom, we have failed to break above the downtrend line. Lower highs typically beget lower lows. Therefore, we feel we will retest or push lower in Q1 2023, as the downtrend is still intact and likely to find a lower low before we find a true bear market bottom. If it walks like a bear, talks like a bear and acts like a bear, it's a bear market not a bull market rally yet.

**S&P 500 In a Bear Market Downtrend. Failed Twice to Breakout**


Data Obtained from Bloomberg, LP. Data as of close 12/16/2022

Why are we, and Wall Street, so bearish on 2023 if we feel peak inflation has been reached? There are multiple signals that a recession and a moderate to mild hard landing are coming. The Fed and inflation have been 2 major instigators of the difficult markets in 2022, and both remain a slight wild card next year. We feel the Fed will hit 5.25-5.50% terminal rate, but conditions will have deteriorated enough they will be forced to cut rates in the back half of 2023. This is contrary to what Powell and the Fed are currently messaging, and we will have to monitor how sticky and high inflation remains, even as the unemployment rate climbs. Current Fed members have referenced their desire to avoid the start-stop-start-stop cycles of the 1980's, but they also cannot ignore if the economy has entered a recession. Our base case thesis is unemployment begins to rise, reaching 4.75-5% and this forces the Fed's hand to ease further and stop the tapering of the balance sheet.

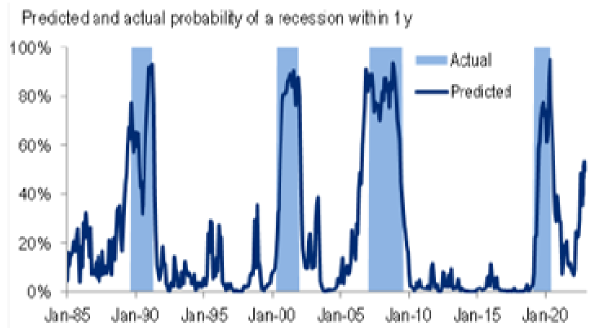
Additionally, we need to listen to what the Treasury bond markets are telling us. US Treasury bonds are considered, yes even in this day and age, a safe haven investment. As the Fed has raised rates the short end has come up in tandem with Fed Fund Rate, but the intermediate and longer end of the curve remain more anchored. When short term bonds are yielding more than long term bonds, that means the markets are concerned there is risk and downside coming to risk assets. The yield curve first inverted on October 26th, when the 3-month Treasury Bond started yielding more than the 10-Year Treasury Bond. A Yield curve inversion is a tried-and-true recession outlook signal.

**Yield Curve inversion and Recessions… Its coming**

3m10y UST inversion vs. recession: 13, lag median

| First 3m10y inversion in 1y horizon | Date on NBER recession | Inversion to recession lag (months) | Real GDP trough around recession | ISM MFg trough around recession |
|---|---|---|---|---|
| 12/01/1966 | 31/12/1969 | 47 | -0.2% | 39.7 |
| 17/12/1968 | 31/12/1969 | 12 | -0.2% | 39.7 |
| 01/06/1973 | 30/11/1973 | 5 | -2.3% | 30.7 |
| 01/11/1978 | 31/01/1980 | 14 | -2.6% | 29.4 |
| 28/03/1989 | 31/07/1990 | 16 | -0.9% | 39.2 |
| 05/04/2000 | 31/03/2001 | 11 | 0.2% | 40.8 |
| 18/01/2006 | 31/12/2007 | 23 | -4.0% | 34.5 |
| 22/03/2019 | 29/02/2020 | 11 | -8.4% | 41.6 |
| Median | | 13 | -1.6% | 39.5 |

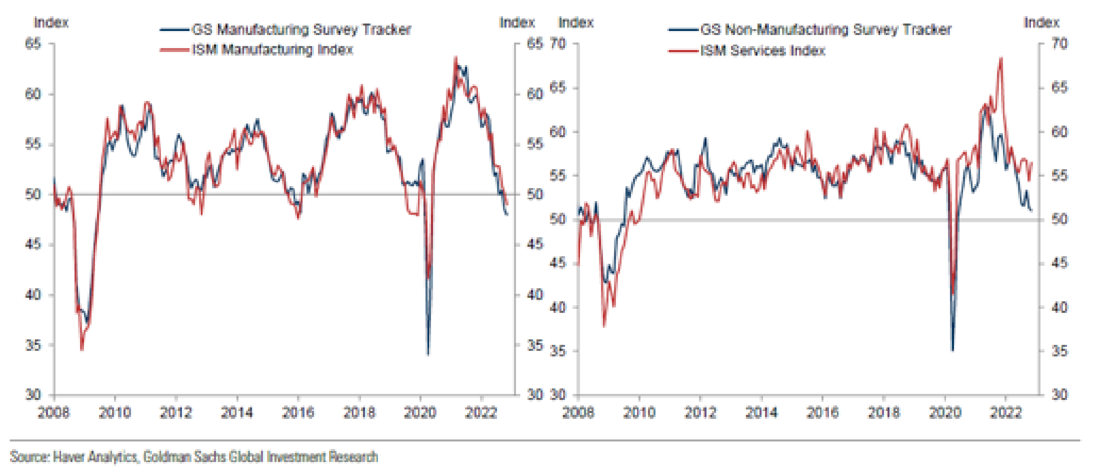
US rate strategy recession probability model




Source: Citi Research, Global Asset Allocation House views for 2023- The Recession Year. Released 12/2/2022

Second, we want to look at the trends in global activity. A common data point is the ISM Manufacturing Index, also known as the Purchasing Manager's Index (PMI). The ISM survey is conducted by the Institute for Supply Management, a non-profit formed in 1915 for providing certification, development, education and research for individuals and corporations in the supply management and purchasing progressions. Any reading below 50.0 is considered contraction, and we look at both manufacturing (goods) as well as services. Goods continues to contract, but services have seen a modest rebound in November, though seems likely to continue its downward trend.

**Manufacturing Activity Now in Modestly Contractionary Territory; Services Still Growing**




Source: Goldman Sachs, Global Views: Our 2023 Outlook: This Cycle is Different. Released 12/5/2022

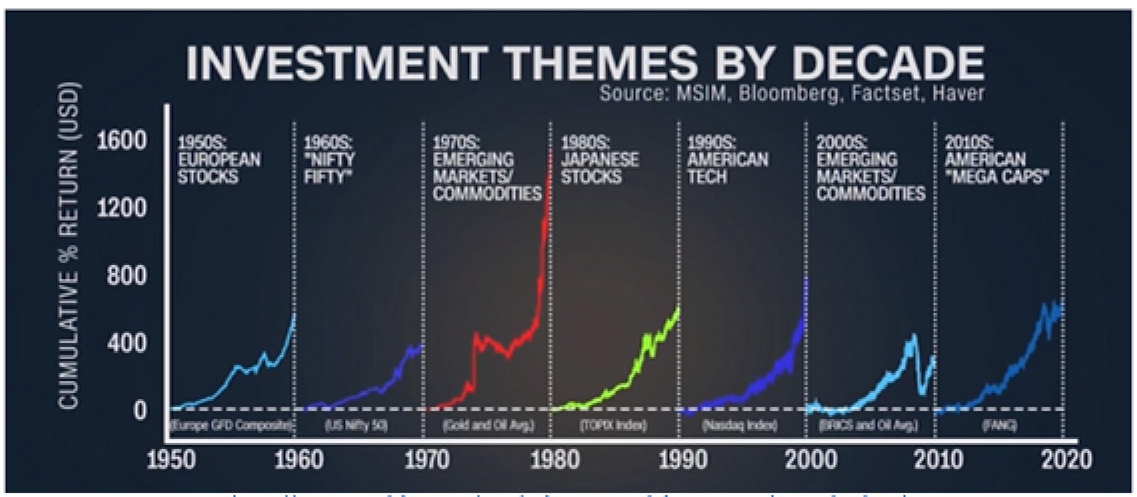
Third, we look at the labor markets. The US labor market has been extremely tight and there is a lot of upward pressure on wage growth, which has also put pressure on inflation. The data still reads as a historically strong labor market: 3.7% unemployment rate, close to a cycle low, and non-farm payrolls growing at an average of 272k over the last 3 months. The JOLTS (Job Openings and Labor Turnover Survey) reading shows we still have 4.3m open jobs.

With our thesis that unemployment will begin rising, we should see the JOLTs trend lower and eventually unemployment tick higher. Tech companies have begun the layoffs, followed recently by financial company staffing cut announcements from JP Morgan and Goldman Sachs. Historically low numbers tend to have only one direction to go: rising and normalization back to average. The labor market weakening should reduce wage growth pressure, which in turn should help ease inflation. The Fed may only stop being hawkish and restrictive when the labor market caves and unemployment starts to rise.

**What will the 2020's be known for?**

Every market cycle has its leaders. From the Nifty-Fifty to the Tech stocks of the 2000's, to the current Mega Cap Tech (Apple/Amazon/Google/Microsoft/Tesla/Meta) that led the 2010's to new highs. I don't think Mega cap tech is truly dead, they are extremely profitable companies generating billions of dollars in profit each quarter. However, I do think they were due for repricing and may find more competition and stiffer headwinds to further exponential growth in the coming years. We feel value, commodities, and, for the first time in years, we are warming up to international and emerging markets as potential opportunities to outperform the broad markets.

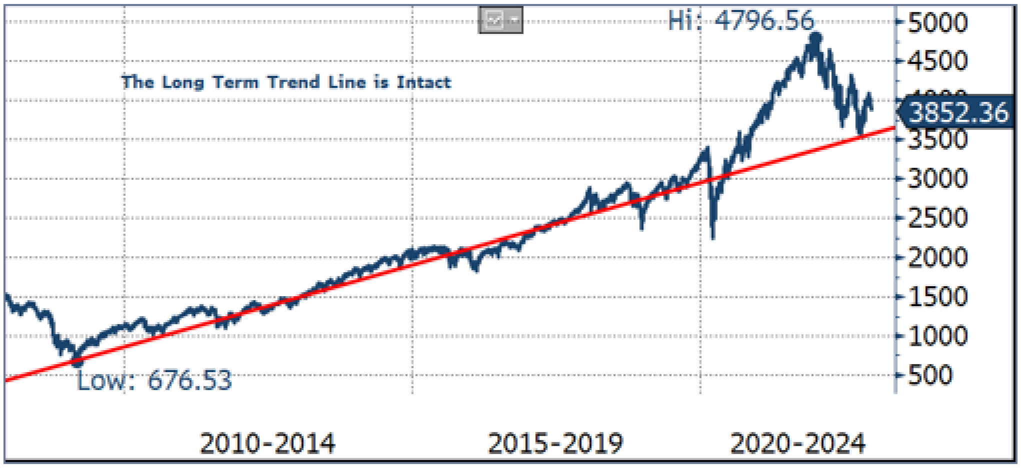
**What Will the 2020's Be Known For? Who Will Lead?**




https://www.nscadvisor.com/post/unique-research-investment-themes-by-decade

We also believe that the long-term secular bull is still alive and well. As we showed earlier, the near-term trends are bearish, however if you look at the longer-term chart of the S&P 500 it remains in its uptrend and a bullish pattern has held. A secular bull market tends to last a decade or longer. JP Morgan argues that this secular bull started in 2016, and the last 2 secular bulls ran for 24 and 26 years respectively (1942-1966 and 1974-2000)[1]. The S&P 500 went basically sideways from 2000-2012 due to the 2 bubbles that occurred with the Tech bubble and 2008 recession. 12/31/1999 the S&P 500 was trading at 1,469.25 and on 12/31/2012 the S&P 500 closed at 1,426.19. 12 years moving a total of -43.06 points, or -2.93%. Total.

**S&P 500 Long Term Trendline and Secular Bull Intact**




Data Obtained from Bloomberg, LP. Data as of close 12/16/2022

**Conclusions**

2023 will most likely be known for volatility, uncertainty, and hopefully a turnaround year. In Chinese culture, 2023 is known as the year of the Water Rabbit; the sign of the Rabbit is a symbol of longevity, peace, and prosperity. That would be a nice reversal from what we have seen in 2022. Regardless if we see a difficult start to the year, know that it is uncommon for the markets to have back-to-back negative years, as it has only happened once in the last 40-years. Keep your perspective and historical context.

There is an obscure concept called the Coastline Paradox which is the odd theory that the coastline of a landmass does not have a well-defined or measurable length. This seems absurd in the day and age of satellite tracking and GPS, but coastlines are what is considered a fractal dimension, meaning the detail in a pattern changes with the scale at which it is measured. If you measure a coastline in hundreds of miles it will be vastly different than if you measure one in 10-mile increments, or even 1-mile increments. Coastlines tend to have so many inlets, caves, cliffs, fjords, or bays comprised of all these minute inconsistencies that it has a high degree of uncertainty. NOAA measures the US coastlines at 94,471 miles while the CIA measures it at 19,924 km or 12,380.2 miles[2]. This is also why tiny Norway of only 148,728 square miles is listed as having the second longest coastline in the world. The point being, sometimes it can be difficult to quantify an ever changing and complex item and that depending on your scale, your result may be vastly different. Investing tends to be best done over a long-time horizon but zoom in to short 3-month or 1-year period and investing in the stock markets can seem wildly dangerous. The bear market made 2022 painful, but it is likely a recovery and continued growth are on the horizon for 2023. Zoom out, and the uptrend is intact. The measure of your personal "coastline" depends on your time horizon and your goals and may be constantly in flux. Perspective and scale are important!

2 https://oceanservice.noaa.gov/facts/shorelength.html#:~:text=NOAA's%20official%20value%20for%20the,how%20the%20shoreline%20is%20defined. https://www.cia.gov/the-world-factbook/field/coastline/