# INVESTMENT STRATEGY OUTLOOK

January 2023

## THE ECONOMY

### Lots Of Stuff May Or May Not Happen In 2023

As far as 2023 outlooks go, that's about as clear and concise, not to mention precise, as we can be. Consider it the triumph of experience over hope. Really, if the experience of the past three years hasn't been enough to dissuade one from making detailed predictions as to how the coming year will play out, nothing will. A year ago at this time we found ourselves wondering whether we'd settled into a new normal in which the only thing normal is that nothing is normal. In hindsight, thinking that 2022 would help answer that question was, well, hopeful, naïve, or just downright foolish, take your pick. Then again, that we're still asking that question may in and of itself be the answer to that question. Either way, 2023 is likely to be quite challenging for the U.S. economy.

With the caveat that making a forecast and having a high degree of confidence in that forecast are two different things, we offer this outline of how we see the economy playing out in 2023. After what we expect will be full-year 2022 real GDP growth of 2.0 percent, our baseline forecast anticipates real GDP growth of around 1.0 percent in 2023, with even slower growth in private domestic demand – combined business and household spending. We do not have a recession as our base case, putting us at odds with many of our counterparts. The last time we found ourselves so out of step with recession calls was 2019 when, coming into that year, many thought that the age of the expansion which started in 2009 meant that it was destined to end. That was of course nonsensical, but we will concede the case for recession in 2023 is much stronger.

There is no denying that a period of significantly elevated inflation and rising interest rates has soured consumer and business sentiment. Indeed, many CEOs have been making recession calls of late, which is not a trivial point in that we believe it is possible to talk yourself into a recession. One issue firms across a wide swath of industry groups are struggling with is trying to gauge the strength of demand, both near-term and long-term. While many firms faced extraordinarily rapid growth in demand over much of 2021 and 2022, that growth was in many cases a function of two factors. One, firms rushing to fill in the gaps left by production having been disrupted by the effects of the pandemic on the labor market, supply chains, and shipping networks, and, two, firms building up inventories to levels higher than were considered normal prior to the pandemic as a hedge against further supply chain/labor supply disruptions. Much of that catch-up/precautionary demand began to wane in late-2022, leaving firms trying to right-size production plans. If firms are gearing up for a slower trend rate of demand growth, they will have less need to engage in capital spending. Indeed, leading indicators of business investment as reported in the GDP data weakened markedly in late-2022, leading us to downgrade our forecast of 2023 real GDP growth.

If enough of those with ultimate responsibility for calls on hiring and capital spending act accordingly, the effects will certainly be felt throughout the economy, particularly to the extent that consumers begin to doubt their job and income prospects and act accordingly when making spending decisions. As it is, we expect growth in consumer spending to slow considerably in 2023. Much as the rush of spending on consumer goods seen in the early phases of the pandemic has faded, we expect that will be the case with the rush of spending on services seen over the back half of 2022. Though households are still sitting on elevated buffers of savings, we expect them to try to preserve at least some of these buffers, particularly with the incentive offered by higher interest rates.

While we look for further declines in construction and sales of single family homes, we think that the housing market having been chronically undersupplied for the better part of the past decade puts a floor under demand. Indeed, applications for purchase mortgage loans were quick to respond to the dip in mortgage rates in late-2022, and we think that will also be the case as lower prices and falling mortgage rates ease affordability constraints as we move through 2023. That isn't to say we expect a surge in home sales such as that seen in mid-2020, but instead a more gradual increase. Even if we are correct on this point, sales may come more out of current inventories of new homes under construction, which rose sharply over the latter half of 2022, as opposed to triggering significant increases in new single family housing starts.

Though there are signs it has begun to cool off, the labor market is still characterized by a glaring imbalance between labor demand and labor supply. As of November, there were over 10.4 million open jobs across the U.S. economy, down from a record of over 11.8 million in March 2022 but still roughly fifty percent above pre-pandemic levels and equivalent to 1.7 open jobs for each unemployed person. What is puzzling is that, even with the economy having slowed and at best modest expectations for 2023, job vacancies remain so high, particularly as they remain elevated across all industry groups. The manner in which labor demand and labor supply become more balanced will be a key determinant of how the economy fares in 2023. We expect falling job vacancies and reductions in hours worked to be the prime components of that rebalancing, as opposed to significant and widespread layoffs. If we're wrong, however, and firms are more aggressive in laying off workers, the jobless rate will rise further and growth in personal income, consumer spending, and, in turn, real GDP will be lower than we now expect.

We anticipate the FOMC raising the Fed funds rate by twenty-five basis points at their January 31-February 1 meeting, with another like-sized increase possible at their March meeting. With clear, and at least to us convincing, evidence of the economy slowing, the labor market cooling, and inflation decelerating, we expect the FOMC to wind down its series of rate hikes. Winding down rate hikes, however, does not by any means suggest rate cuts are soon to follow and, with inflation lingering above their 2.0 percent target through most or all of this year, we do not expect the FOMC will cut the funds rate in 2023. There are obviously risks both ways – higher and more persistent inflation would surely lead to further rate hikes, while a more severe slowdown in the broader economy could be the catalyst for rate cuts.

As we all by now know well, stuff happens and things change, to use highly technical language, and our forecast can and will change as the year progresses. About the only thing we can be certain of is that by the end of 2023 the economy is unlikely to look as we now expect it to. What we don't know right now is why that will be the case. ▲

*Source: Bureau of Labor Statistics; Institute for Supply Management*

## STOCKS

### Putting Some Stakes In The Ground For '23

With this being our first outlook piece of the new year, we thought it an opportune time to make a few predictions for 2023 - some mainstream, others less so - and highlight a few broad themes we believe are worth monitoring that could factor into portfolio positioning. At a high level, we expect the coming year to again prove challenging for stock returns as a weakening global economy and elevated labor costs/falling goods prices lead to lowered earnings estimates while valuations remain pressured by higher for longer short-term interest rates. Investors should be rewarded by taking a more active approach in '23 as dispersion at the industry/sector level as well as between the U.S. and the rest of the world (RoW) could rise materially in the coming year given the wide range of potential outcomes facing the global economy and with central bankers in the U.S, Europe, Japan, and emerging markets set to take distinctly different paths regarding monetary policy.

**More Modest Drawdowns, And Rallies, As Volatility Ebbs:** Equity bulls and bears were equally confounded by price action last year. Inflation hitting a four-decade high, rising interest rates, and geopolitical unrest gave investors ample reasons to de-risk and reduce exposure to stocks, while hopes of a Fed pivot to more accommodative policy allowed the 'buy the dip' mantra that served bulls well over the past decade to remain alive. To put numbers around how volatile 2022 was, the S&P 500 ended the year lower by 18.1% on a total return basis – a painful outcome, but investors were forced to endure peak-to-trough selloffs of 11.7%, 20.8%, and 18.9% to capture trough-to-peak gains of 11%, 17.4%, and 16.8% along the way. As the FOMC winds down its rate hiking cycle, volatility should subside from 2022 levels, lessening the magnitude of equity drawdowns relative to the prior year, but economic, monetary policy, and geopolitical uncertainty aren't going anywhere, and the ride is unlikely to be a smooth one.

**'Quality' Outperforms Again:** We entered 2022 with a strong preference for 'quality' given our outlook that central banks would tighten monetary policy and slow economic growth, which they did at an even more aggressive pace than we anticipated. However, the U.S. economy proved far more resilient than expected given the pace of rate hikes experienced, limiting the magnitude of outperformance from 'quality' factors as the S&P 500 Quality index outperformed the S&P 500 by just 2.5% in 2022. With a higher for longer Fed funds rate expected throughout 2023 raising the probability of a U.S. recession, stocks exemplifying 'quality' factors such as high profitability, low leverage/debt, low earnings variability, and dividend growth should fare relatively well in the coming year, perhaps even better than during a tumultuous 2022. Conversely, high beta, high leverage, and high earnings variability are less desirable factor exposures and should generate underperformance on a relative basis in 2023.

**U.S. Dollar Weakens In '23:** We expect the U.S. Dollar Index, or DXY, to remain relatively strong into mid-year as additional Fed funds rate hikes are likely in the first quarter, followed by a pause, not a pivot. However, the Bank of England (BoE), Bank of Japan (BoJ) and European Central Bank (ECB) will not be afforded such a luxury as inflation in Europe and Japan remains uncomfortably high and is unlikely to moderate quickly without central banks tightening policy

further. In contrast to the BoE, BoJ, and ECB, emerging market central banks could, on balance, be in rate cutting mode, stimulating economic growth as signs inflationary pressures are subsiding emerge. Inflows into EM assets could increase demand and strengthen local currencies, a dynamic that could lead to a weaker U.S. dollar versus not just the euro and Japanese yen, but also against select EM currencies in the back-half of the year. A weaker U.S. dollar would benefit developed and emerging markets abroad on a relative basis, another potential tailwind for improved performance out of the RoW.

**Emerging Outperforms Developed:** On the heels of Russia's invasion of Ukraine last February, our belief that the euro area would experience a prolonged period of elevated inflation and economic weakness led us to take down exposure to international developed equities. While higher energy and electricity prices have proven problematic, a worst-case scenario for Europe has so far been avoided as unseasonably warm winter weather has pushed natural gas prices lower, and euro area equities have outperformed meaningfully over the past three months. While recent price action is encouraging, the worst may lie ahead for Europe, and we remain comfortably underweight. Japan has understandably received less attention given what has been going on in Europe, but in December the Bank of Japan (BoJ) altered its yield curve control program to allow for a higher 0.50% yield on 10-year Japanese Government Bonds, an acknowledgement that sales of U.S. Treasuries to support the Japanese yen and the prior 0.25% 10-year peg were too costly to maintain. Should the BoJ allow yields to rise further, Japanese stocks would bear the brunt of such a move and weaken. Emerging market central banks moving to ease monetary policy, a reopening of China's economy, and the prospect of a weaker U.S. dollar increase the appeal of emerging market stocks and bonds. However, the potential for China's reopening to boost inflation and force EM central banks to remain tighter for longer, is a possibility, and given this unknown, a more constructive stance on EM may be justified later in the year. ▲

## BONDS

### High Grade Over High Yield

2022 was a historically bad year for bonds, the Bloomberg Aggregate Bond index ending the year lower by 12.8% and turning out its worst calendar year since the index as we know it was constructed in 1976. Despite carrying a modestly higher yield than the Agg, investment-grade (IG) corporate bonds fared even more poorly, the Bloomberg Corporate index falling 15.6% as longer duration bonds underperformed. Perhaps surprisingly given the markets risk-off tone throughout 2022, the Bloomberg U.S. High Yield index outperformed the higher quality Agg and IG corporate index as it fell 11.2%.

With recession fears likely to remain top-of-mind as the FOMC tightens monetary policy further in 1Q23, riskier, higher yielding credits could be in for a more challenging year relative to higher quality Treasuries and investment-grade corporate bonds. Supply of high yield corporate bonds is expected to remain tight in the coming year as many issuers floated debt offerings in 2021 or 2022 and will not likely need to do so again until '24, a dynamic supportive of prices. However, should the FOMC hike rates further into restrictive territory, recession risks will rise, leading to higher yields and wider credit spreads to appropriately compensate investors for default risk.

We expect inflation to subside in '23 as the lagged impact of 2022's rate hikes are felt. While difficult to gauge what is truly a consensus call versus an out of consensus one, inflation downshifting year over year is a widely held view and one unlikely to get much pushback. However, what is still not a consensus call, surprisingly given the FOMC's steadfast position to the contrary, remains our belief that the Fed will not be quick to come to the economy or market's aid and pivot to more accommodative monetary policy, i.e., cut the fed funds rate, in the coming year despite falling inflation. A higher for longer Fed funds rate raises the likelihood of a recession and will impact our preferred credit quality and duration positioning within fixed income portfolios in the coming year.

After the back-up in Treasury yields in 2022, bonds are, broadly speaking, more attractive than at any other point in the past decade, both on an absolute basis and relative to stocks. The equity risk premium, calculated as the S&P 500's earnings yield (earnings/price) minus the yield on the 10-year U.S. Treasury, is at 1.9, a level that in isolation means very little, but which was last seen in the wake of the Global Financial Crisis in late 2009/early 2010. Historically, a reading of 2 or less has been a good indicator of relative value in bonds, while a reading of 4 or above has been a sign that stocks are relatively cheap versus bonds. Bonds are not yet a table-pounding buy relative to stocks but should stocks rally and/or bonds sell off, the equity risk premium will shrink and provide investors with a better tactical entry point to overweight bonds relative to stocks. ▲

## ALTERNATIVES

### Back To Playing A Supporting Role

The HFRX Global Hedge Fund Index, our preferred barometer for broad liquid alternatives performance, posted a -0.6% monthly return in December relative to a balanced portfolio's (50% stocks and 50% bonds) return of -3.11%. For 2022, the excess return for the HFRX Global Hedge over a 50/50 portfolio was 11.8%, highlighting the potential drawdown benefits of implementing alternatives within a portfolio of stocks and bonds during periods in which correlations rise. While the magnitude of alternatives outperformance relative to traditional asset classes is likely to moderate, the prospect of a rising CBOE Volatility Index, or VIX, from current subdued levels, combined with elevated monetary policy uncertainty on a global basis present a compelling argument for additional diversification.

At the strategy level, contributors to the HFRX Global Hedge Index during December included some of the usual suspects able to exploit downturns in risk assets, specifically, equity market neutral and merger arbitrage strategies. Merger arbitrage funds could be constrained by a more onerous regulatory backdrop for mergers and acquisitions (M&A) but investors are being well compensated for the possibility that deals break as acquisition premiums are at two-year highs. Merger arb also benefits from higher short-term rates and the potential for increased year-over-year deal volume as CEOs consider acquisitions to combat earnings/margin compression. The backdrop in December proved too choppy for systematic trend strategies using longer-term signals, as we observed sharp, short-lived shifts across asset classes, specifically commodities and currencies, during the month. Systematic managers could continue to give back some of 2022's relative performance in a trendless market, reinforcing our desire for consistency over excess returns when evaluating trend following strategies.

Going forward, defensive strategies could take a backseat to areas most depressed in 2022. Convertible arbitrage comes to mind as annual issuance approached a ten-year low in 2022 and led to a limited opportunity set that could revert should serial issuers return to the market for financing needs. Hedged equity could also see renewed interest coming into the year as an appealing risk-conscious way to put capital to work for more apprehensive investors. While we expect alternatives to shift from what proved to be a leadership position in portfolios last year back to their historical supporting role in the coming year, the volatility dampening and drawdown limiting benefits of the asset class remain appealing to us. ▲

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