



# Economic & Market Outlook

January 2023

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An aerial photograph of a city skyline, likely Austin, Texas, featuring a river with several bridges and a dense cluster of modern skyscrapers under a clear blue sky. The text is overlaid on the upper portion of the image.

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An aerial photograph of a city skyline, likely Minneapolis, Minnesota, featuring a river (the Mississippi River) and several bridges. The skyline is composed of numerous high-rise buildings, including a prominent blue glass skyscraper. The foreground shows green trees and a bridge with a road. The sky is a clear, deep blue.

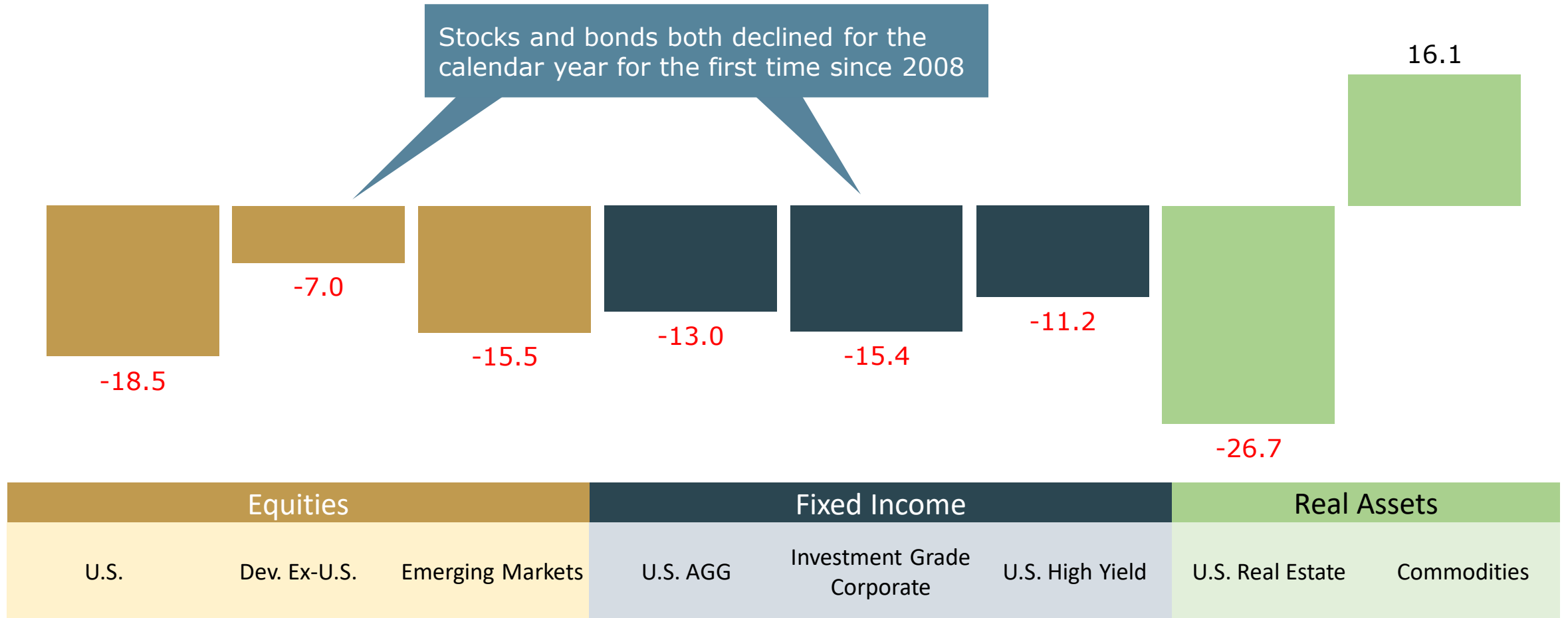
# Market Review

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# Market Review

2022 Returns (%)



# Landing in Turbulence

January 2023

- The Federal Reserve is likely to continue its rate hiking spree, then hold rates at that level, even as the lagged effects of previous monetary tightening filter through the economy
- Leading indicators suggest significant economic slowing ahead; we anticipate a recession in 2023
- Earnings estimates for the year are likely too optimistic and will have to be revised down
- Relatively robust consumer and commercial balance sheets will help prevent this downturn from becoming deep
- Heightened sovereign debt around the developed world remains a risk
- With equity and bond markets down significantly from their peaks, much of the damage of this slowing has already occurred
- Any sign of an economic soft landing could prove to be a positive catalyst for markets



An aerial photograph of a city skyline, likely Minneapolis, Minnesota, featuring a river (the Mississippi River) and several bridges. The skyline is dominated by modern high-rise buildings, with a prominent blue-glass skyscraper in the center. The foreground shows lush green trees and a multi-lane bridge crossing the river. The sky is a clear, deep blue.

# Economic Overview

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THE DUCK  
GOES...

QUACK



THE PIG  
GOES...

OINK



THE BULL  
GOES...

PLEASE,  
JAY! FOR  
GOD'S SAKE  
PLEASE!



B. Rich — HEDGEYE

# Economic Dashboard

Driven by progressively tighter monetary policy, many leading economic indicators have decelerated rapidly, pointing to tougher conditions ahead for both consumers and businesses in 2023.



## Monetary Policy



The Federal Reserve continues to increase interest rates and is winding down its bond portfolio



## Manufacturing



Manufacturing indicators have dipped into negative territory, signaling negative growth ahead



## Consumer



Consumers have spent down savings, yet balance sheets remain relatively healthy, and confidence has rebounded



## Housing



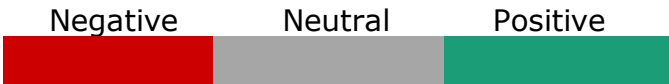
Home sales have skid to a halt and homebuilder sentiment has plummeted, pressured by higher mortgage rates and low affordability



## Labor

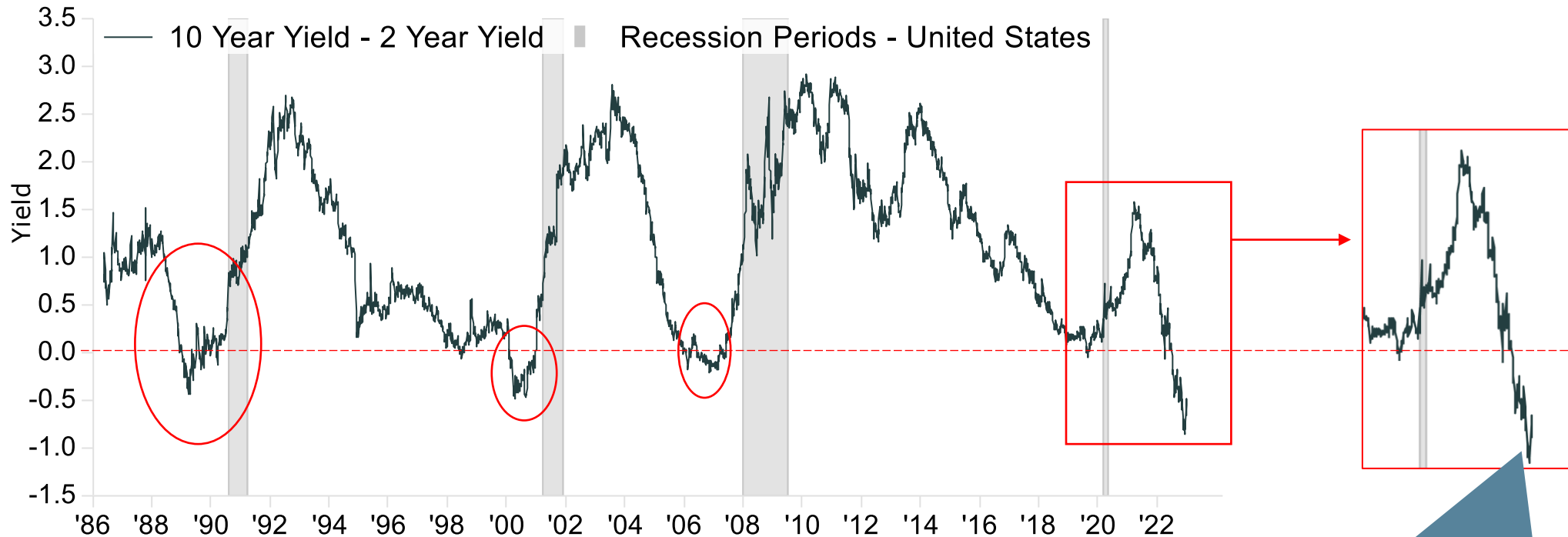


The labor market remains at its tightest levels in decades, though some signs suggest slower hiring ahead



# Treasury Yield Curve Flashing a Warning Signal

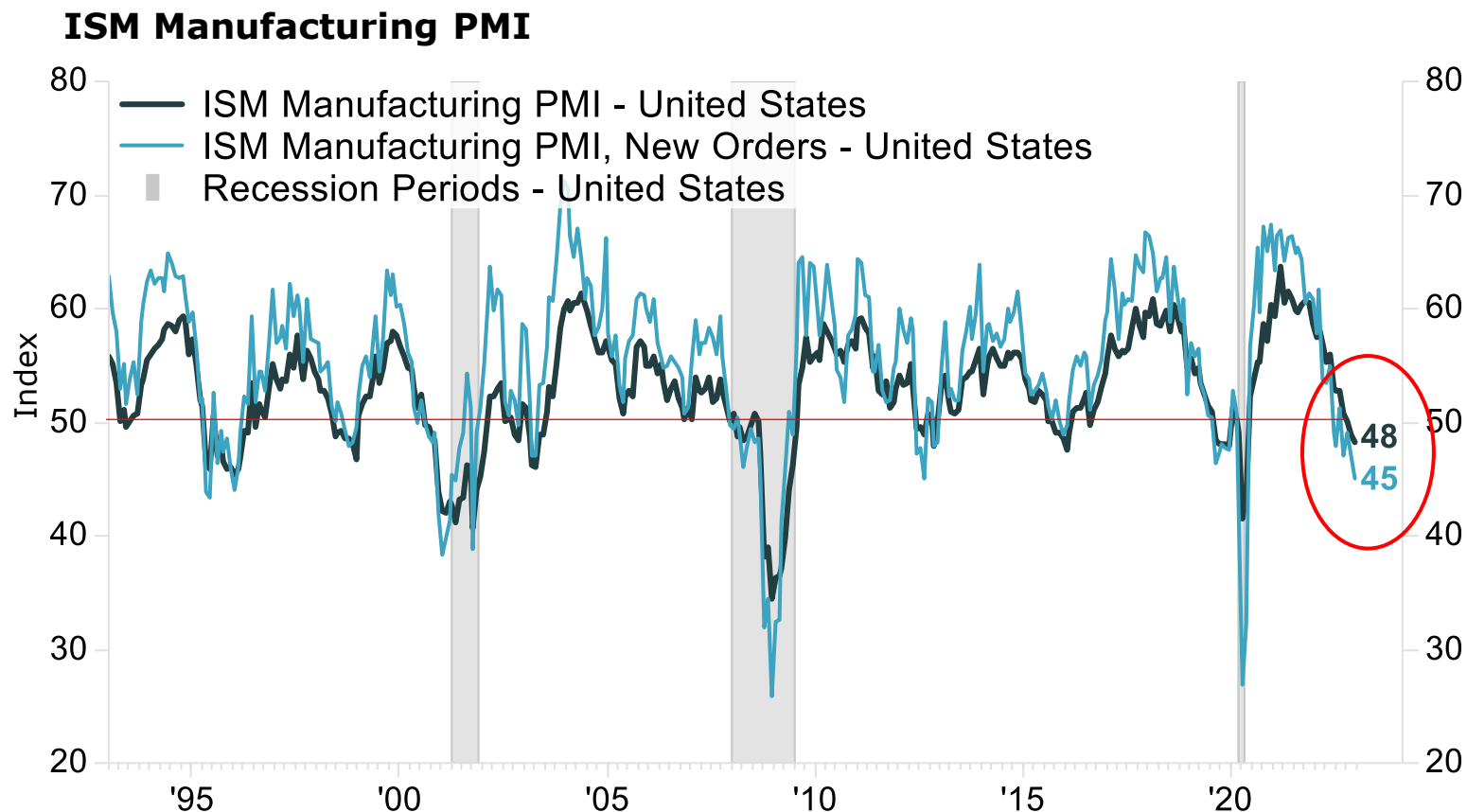
**Yields on the 10-year Treasury bond have dropped well below 2-year yields. In previous periods when this has happened, a recession has typically followed within 6 months to 2 years.**



Yield curve has been inverted since May 2022 and is currently inverted by more than 70 basis points

# Slowing Manufacturing Activity Points to Likely Recession

- The headline ISM Manufacturing Index dipped below 50, suggesting that the economy will likely soon begin to contract
- The New Orders component suggests that manufacturing activity will continue to weaken over the next few months

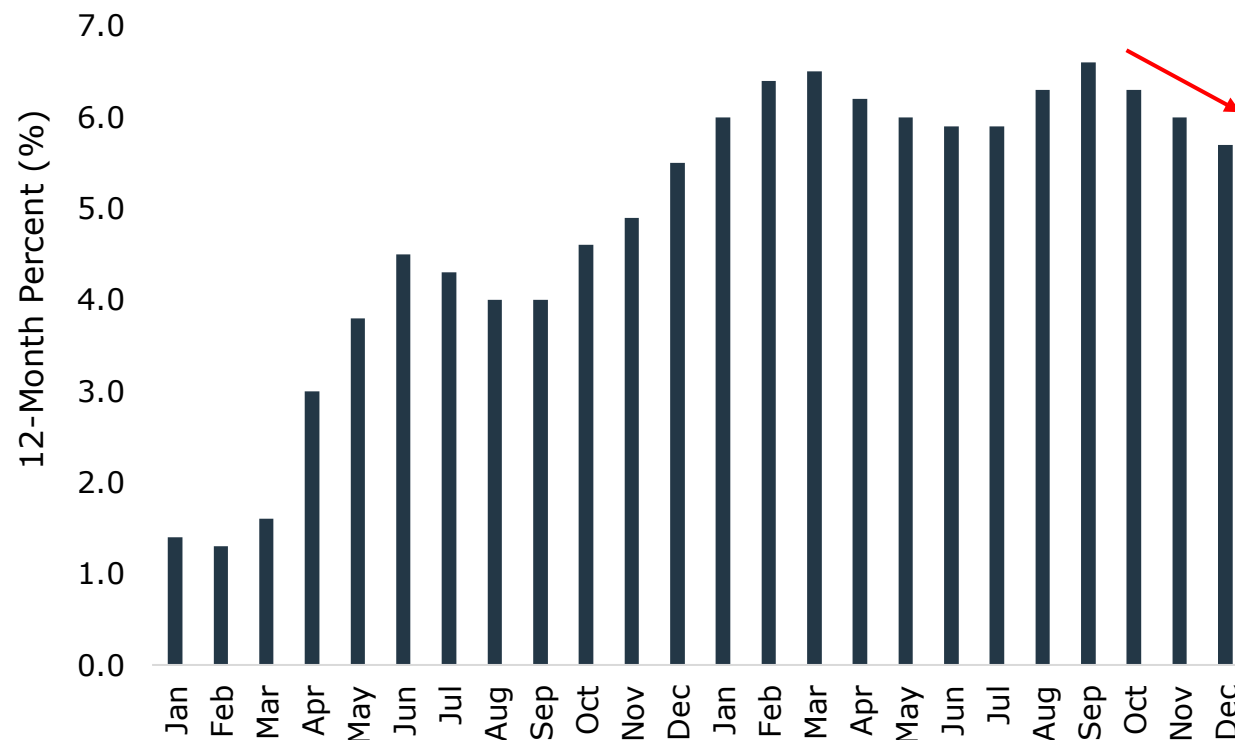




# Inflation Below Recent Highs

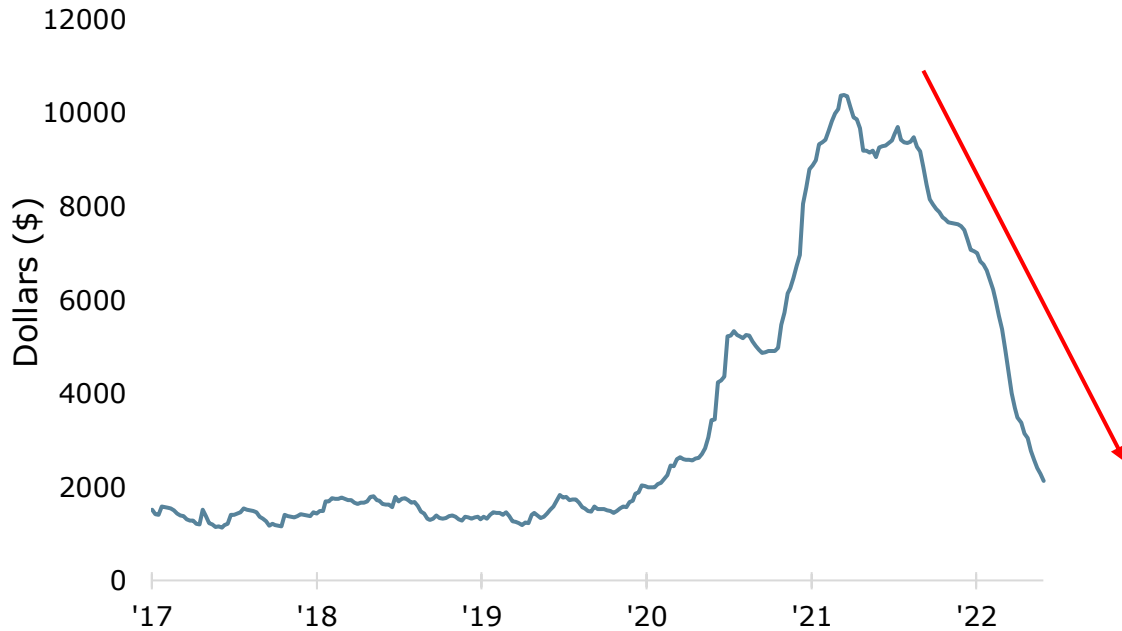
- After soaring by the fastest pace in decades, consumer price increases have finally showed consistent signs of slowing
- Food prices, particularly for fruits and vegetables, continue to rise at a rapid pace, offset by declining energy costs

**Core CPI 12-Month Percent Change  
(January 2021 – November 2022)**

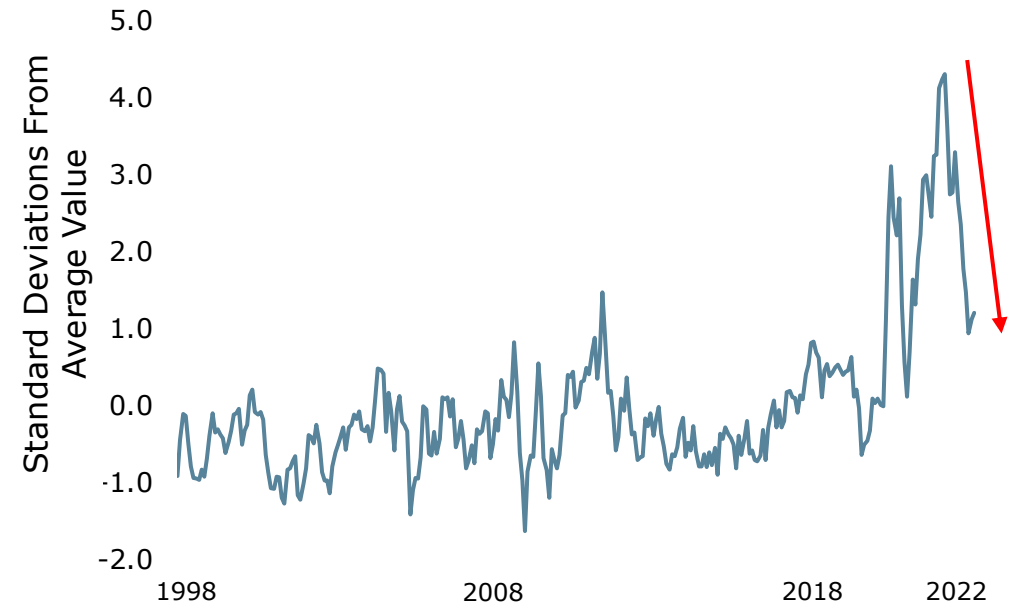


# Supply Chain Pressures Easing

## Drewry World Container Index (\$/40ft)



## Global Supply Chain Pressure Index

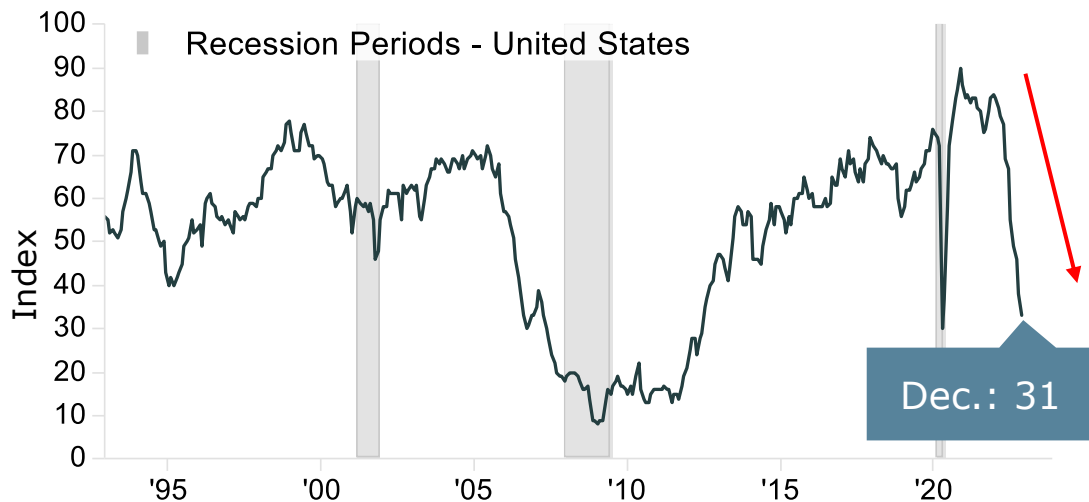


In a sign that supply chain disruptions have largely eased, the cost of shipping containers of goods from overseas is back to its pre-Covid level.

While the rest of the world's supply chains are improving, delivery times in China are still elevated

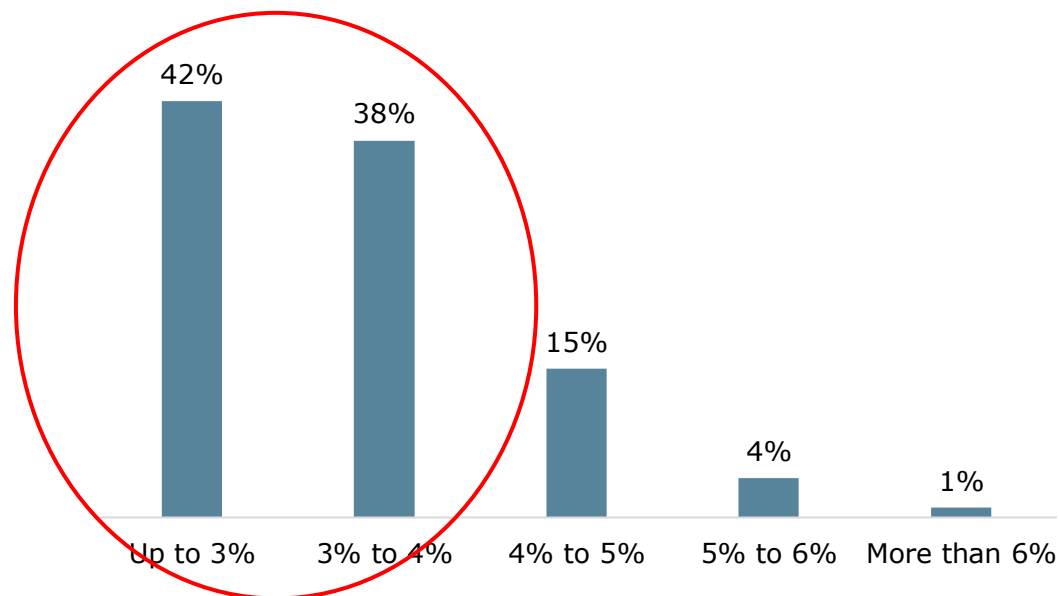
# Housing Market Weakening, But Homeowners Have Locked in Low Mortgage Rates

## NAHB/Wells Fargo Housing Market Index



After declining for 12 consecutive months, the NAHB housing market index declined to a fresh low since 2012 excluding the immediate onset of the pandemic.

## Share of Home Mortgage Loan \$ by Interest Rate



Three-quarters of American homeowners have mortgages with an interest rate below 4%

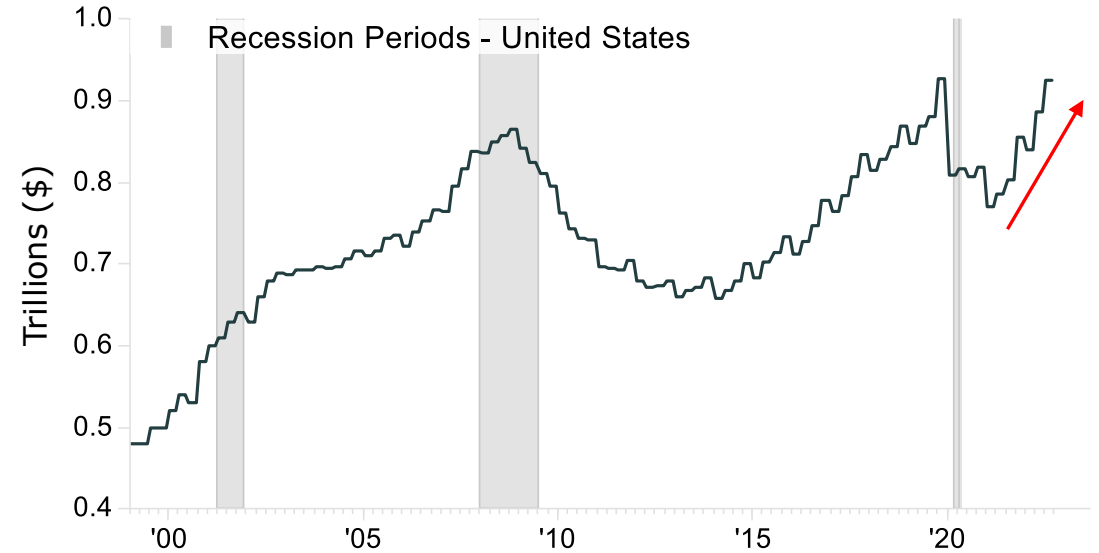
# Consumers Are Spending More than They Earn

## Personal Savings Rate



After soaring in 2020-2021, personal savings rates have retreated to new lows

## Household Debt Balance, Credit Cards

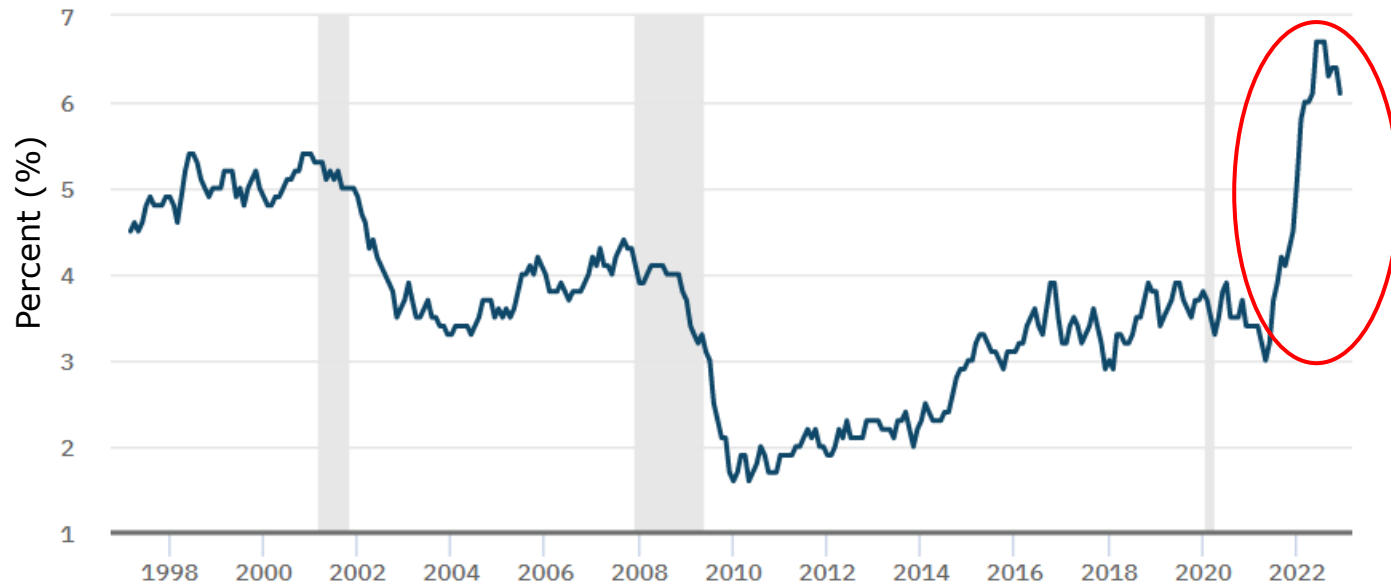


After dropping in 2020 and 2021, credit usage is back to new highs as Americans ramp up spending and cope with higher prices

# The Fed's Primary Remaining Challenge: Wage Gains

## Wage Growth Tracker

Three-month moving average of median wage growth, hourly data



- The labor market remains very tight with few Americans looking for work
- Recent data suggests that while jobs remain plentiful, wage gains are beginning to subside

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# Stocks and Bonds

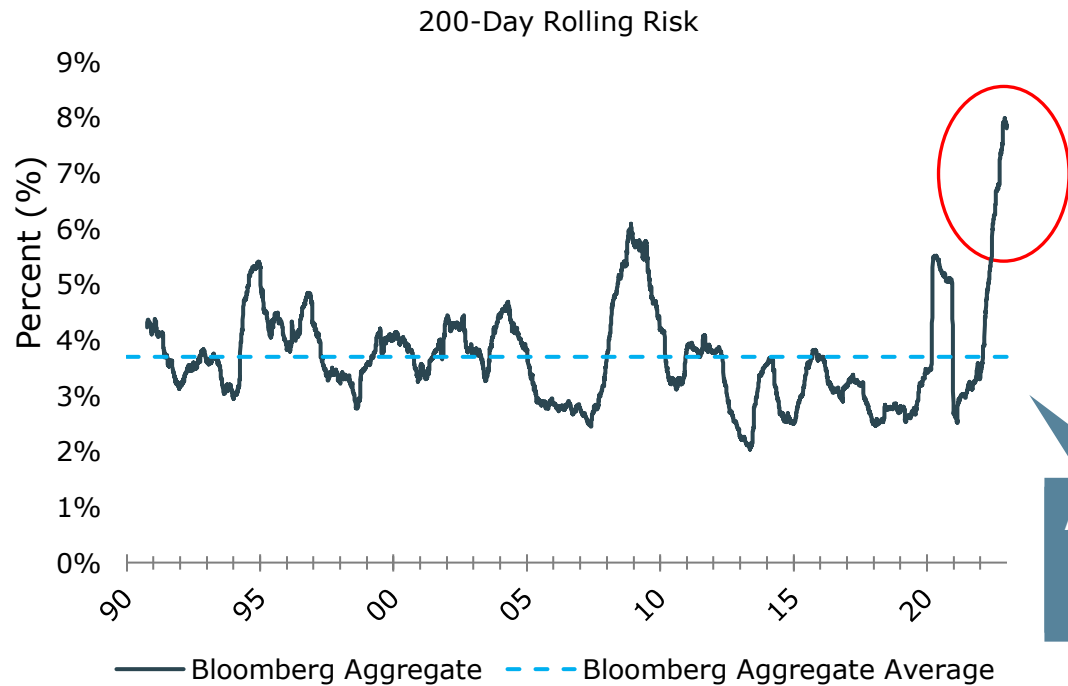
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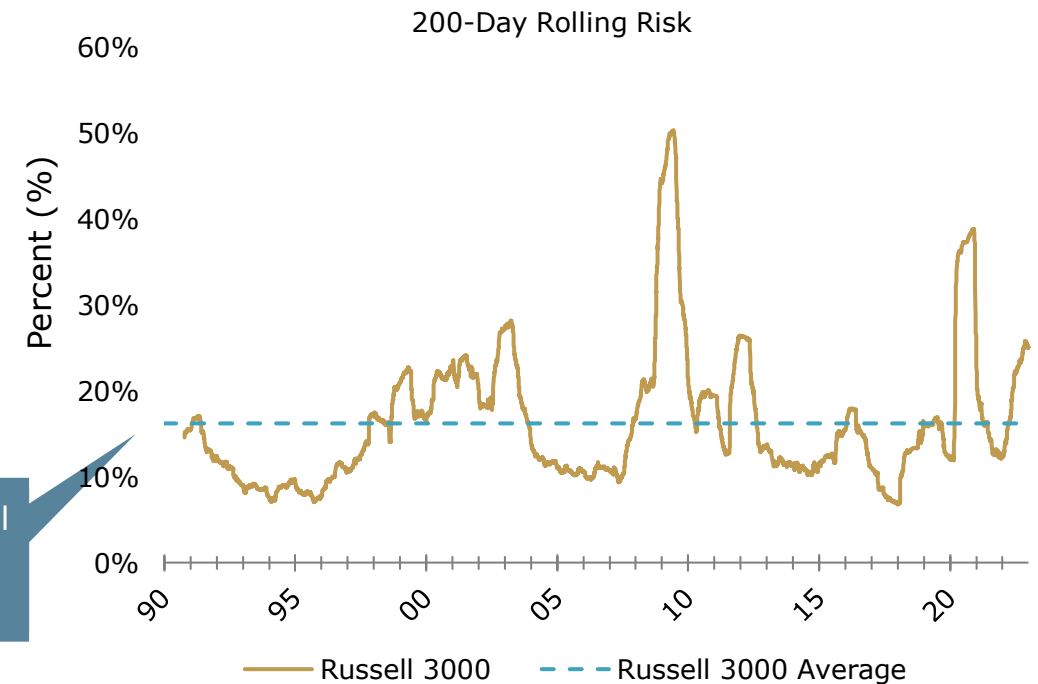
# Bond Volatility at Extremes

## Bond Volatility: Bloomberg U.S. Aggregate



Bond volatility is at extremes relative to historical levels

## Stock Volatility: Russell 3000

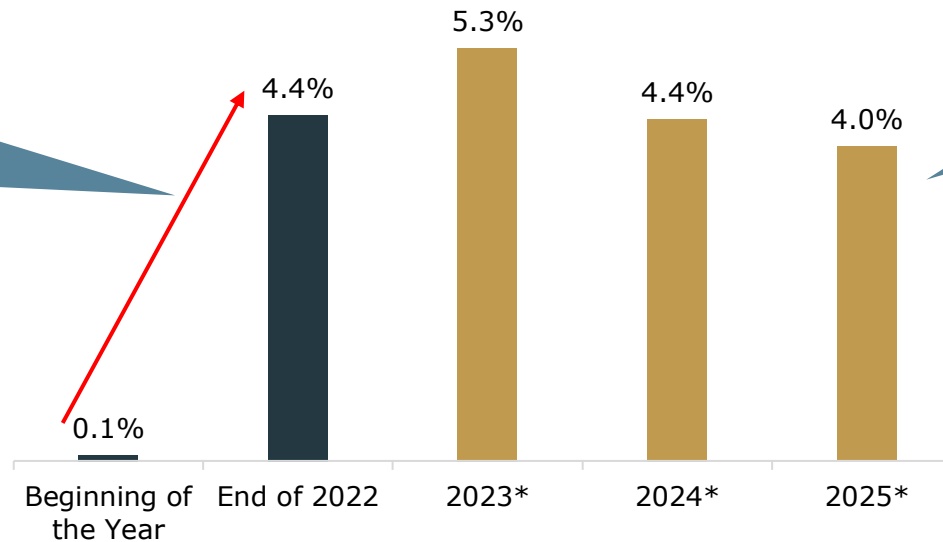


Stock volatility, while high, is not at extreme levels

# Fed Rate Hikes – Swift and Steep

**Fed Funds Rate: Current and Projected, Year End**

This rate tightening cycle is among the fastest and steepest that we have seen, forcing the market and the economy to digest an extraordinary amount of tightening in a very compressed time period



Markets still expect the Federal Reserve to begin cutting interest rates by the second half of 2023, which may prove too optimistic

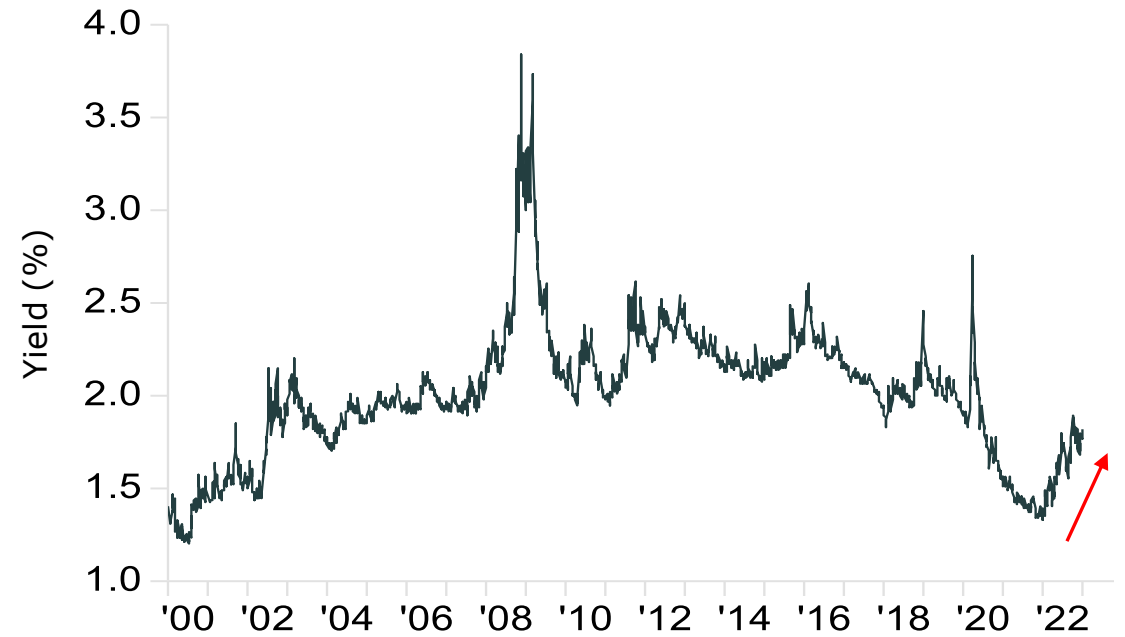
Bond prices largely reflect these higher interest rates

# Yields More Attractive

## Bloomberg U.S. Aggregate Yield to Maturity



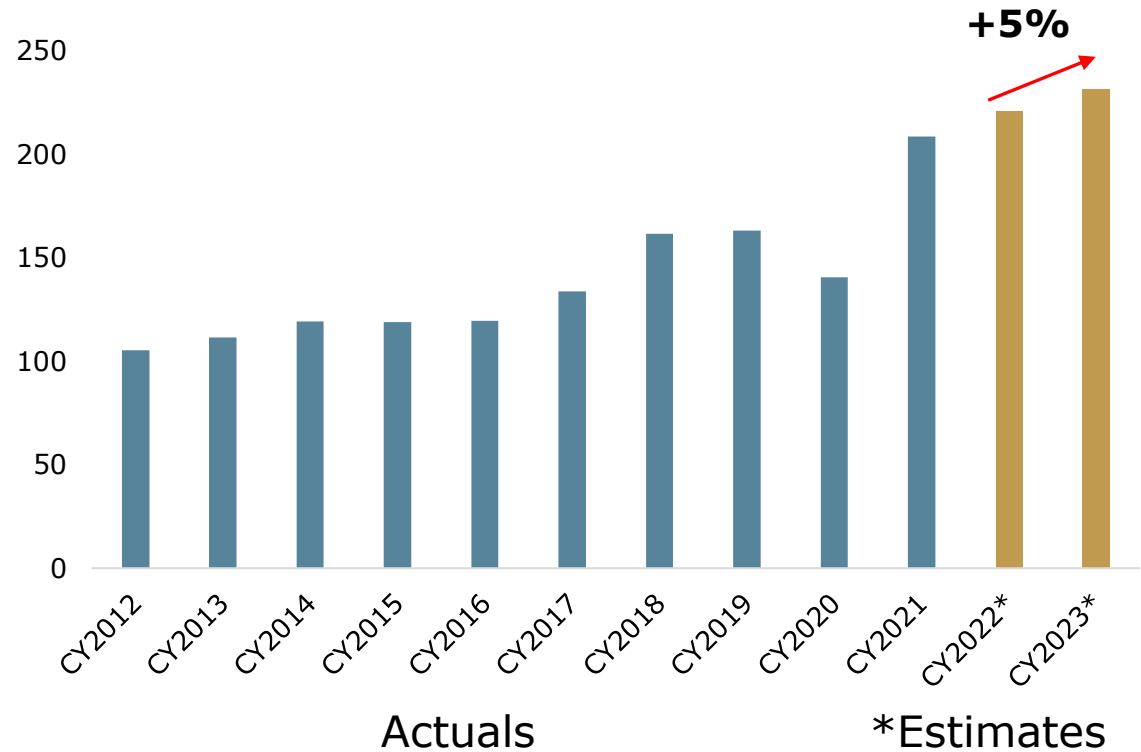
## S&P 500 Dividend Yield



# Corporate Earnings Expectations Look Optimistic

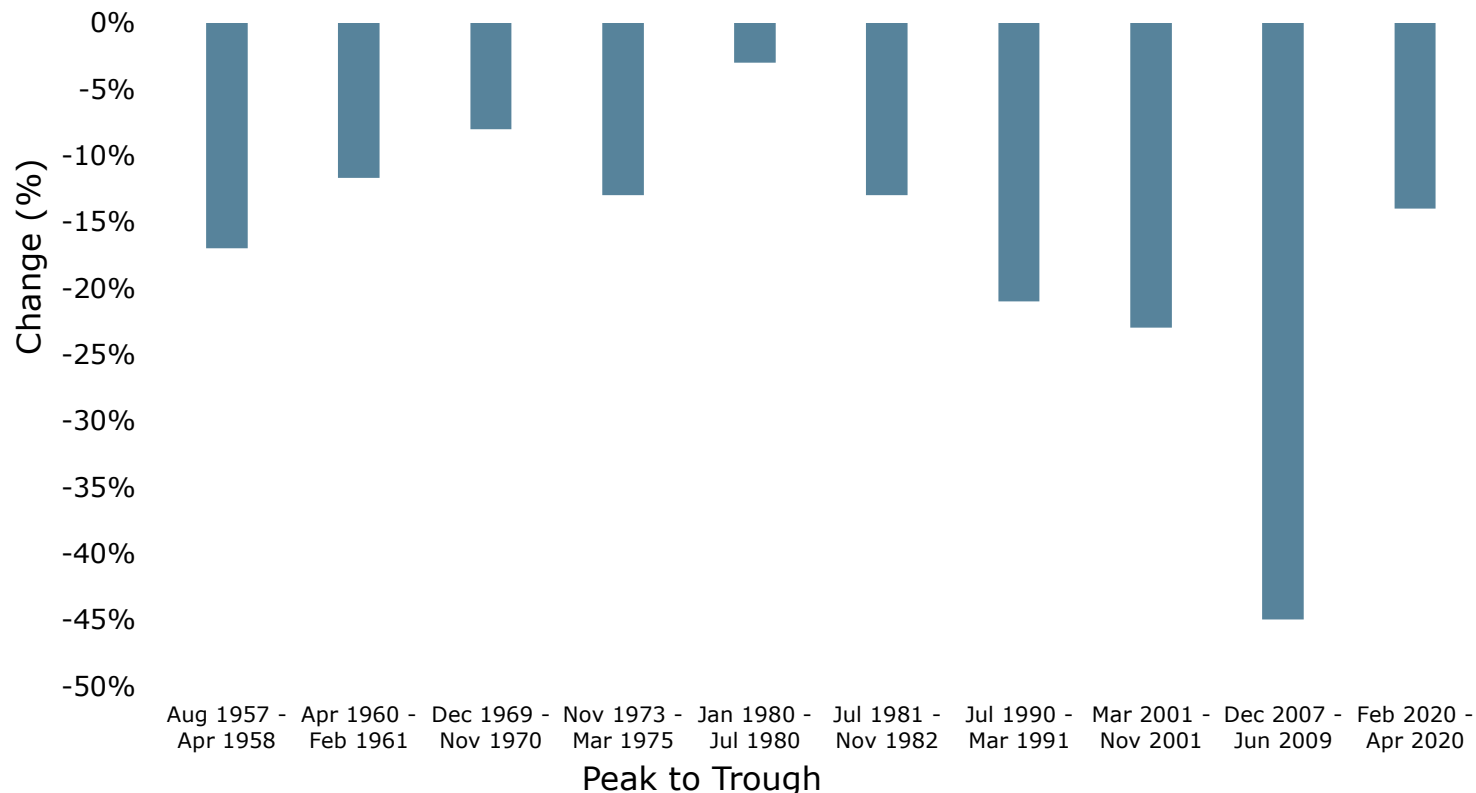
- Earnings estimates for 2023 have moderated over the last six months
- Current estimates represent 5% growth over 2022 earnings levels
- Given the continued tightening in business conditions, we expect earnings estimates to decline further

**S&P 500 Calendar Year Bottom-Up EPS  
Actuals & Estimates**



# Earnings Generally Decline Meaningfully in Recessions

**Recessions Are Usually Not Good for Earnings (1957-2020)**

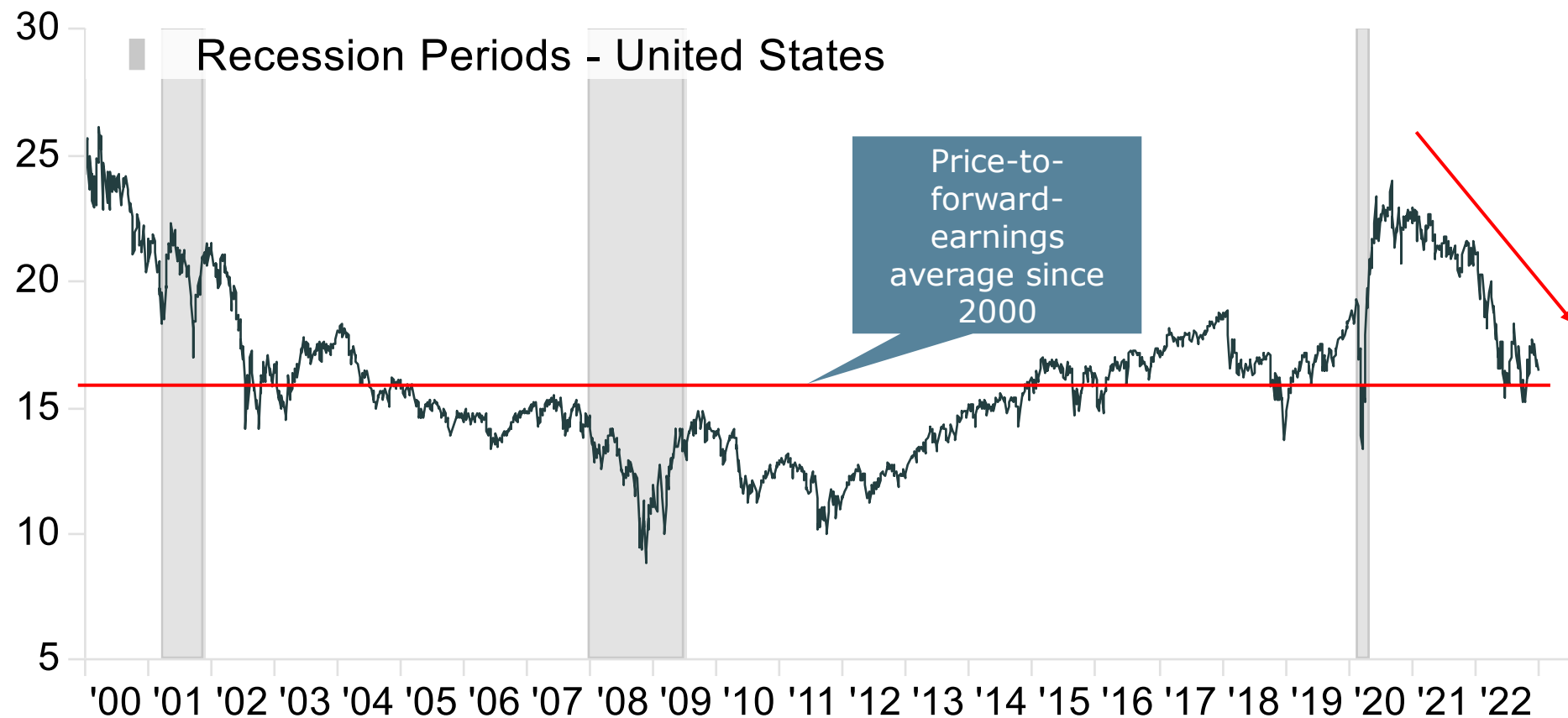


**Past performance is no guarantee of future results. Forward looking estimates may not come to pass.**

Source: Kestra Investment Management, National Bureau of Economic Research (NBER) with data from FactSet. EPS % change is calculated from the peak to trough values during each U.S. recession period. The peak EPS is defined as the largest EPS value during the recession period while the trough is defined as the lowest value in EPS during the recession period. EPS is based on last-twelve-months. Data as of December 31, 2022.

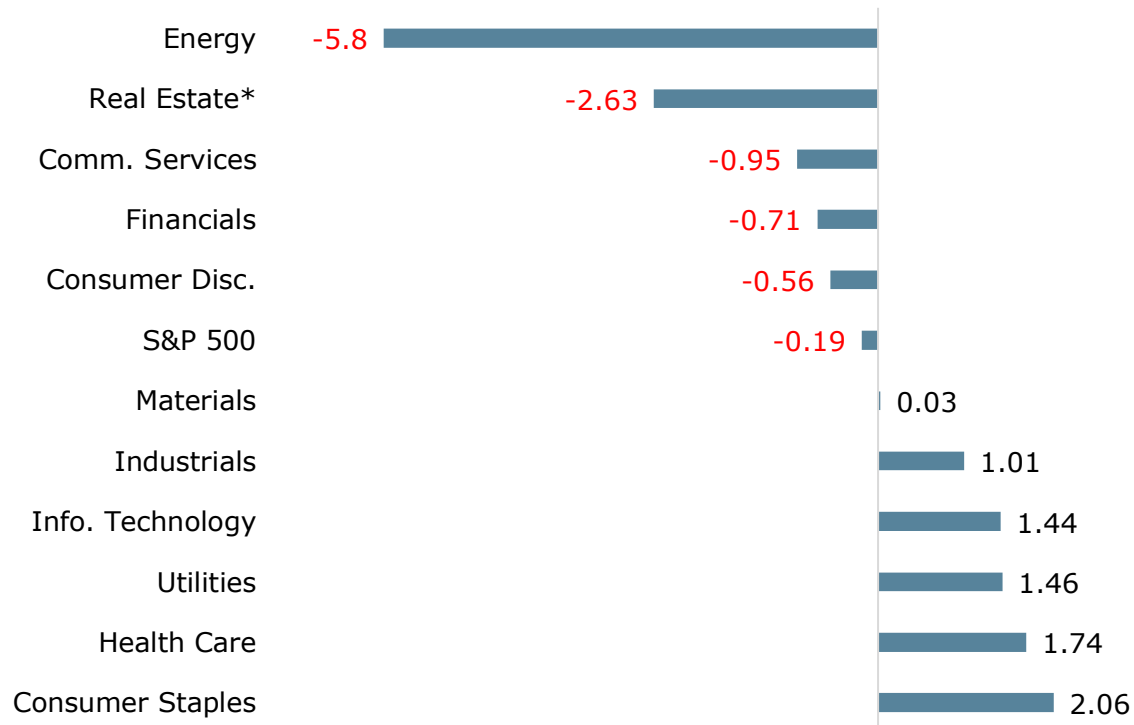
# Valuations Have Backed Off Their Lofty Heights

S&P 500 Price to Forward Earnings (Next Twelve Months)



# Defensive Sectors Are Expensive Relative to History

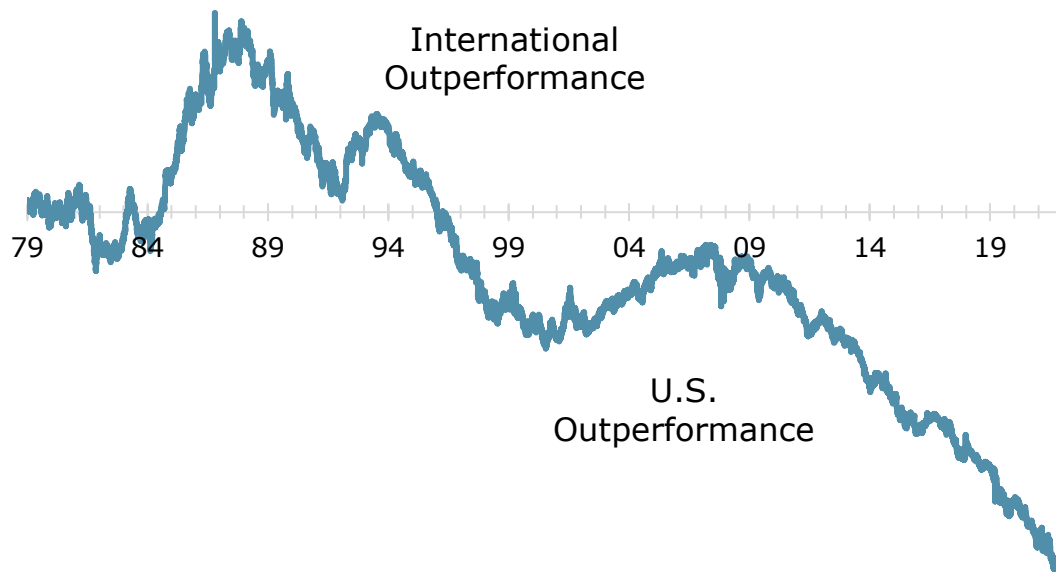
## S&P 500 Sector-Level Premium (Discount) Forward 12-Month P/E Ratios, Relative to 10-Year Average



- The types of sectors that typically do well in recessions – Consumer Staples, Healthcare, Utilities – are expensive relative to their historical valuations
- Other, more cyclical areas – Energy, Commercial Services, Financials – are likely to see additional pressure on earnings

# Non-US Stocks Have Underperformed US Stocks

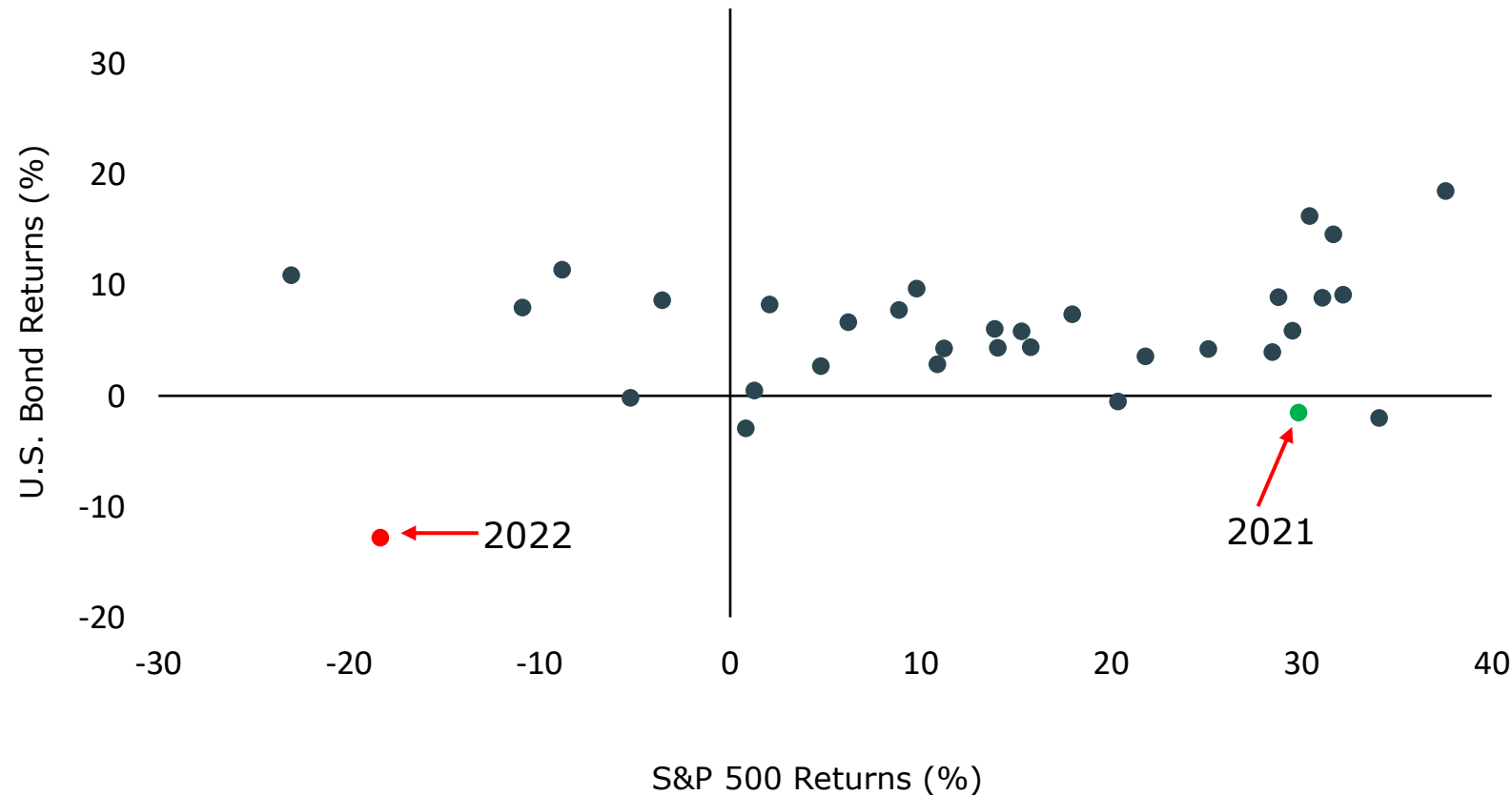
Price Ratio of MSCI EAFE Index to S&P 500 Index



After a decade of U.S. outperformance, non-U.S. stocks may offer more value

# An Unusually Difficult Year Presents Opportunities

S&P 500 vs U.S. Bloomberg Aggregate Bonds, annual returns, 1988-2022



“In its brief 232 years of existence... there has been no incubator for unleashing human potential like America. Despite some severe interruptions, our country’s economic progress has been breathtaking. Our unwavering conclusion: Never bet against America.”

— Warren Buffett 2/7/21



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