PCM

PEAK CAPITAL MANAGEMENT

A Tale of Two Halves

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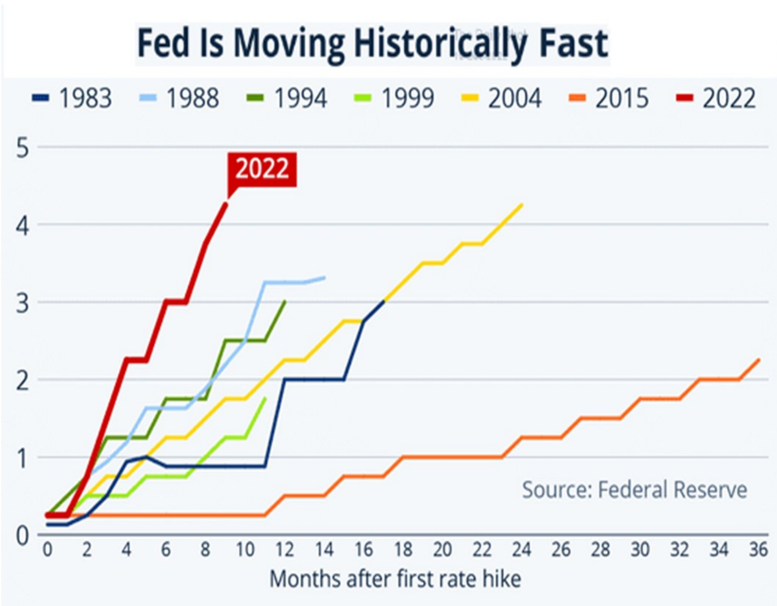
At a time when crystal balls are dusted off and market prognosticators are making their predictions for the coming year, there is as much economic uncertainty as we have seen in a long time. Forecasts for 2023 are all over the board and I sense a bit less conviction in many of the market and economic predictions.

I tend to shy away from making specific targets for the markets because it can be seen as influencing how we manage portfolios (i.e. Brian is bullish so they must be loading up on equities). Dynamic Risk Hedging has proven a very effective strategy for allocating across multiple asset classes based on each holdings risk contribution. Controlling what we can control is the focus in the portfolios we manage so my personal "forecast" of where the markets will trade has little impact on how our portfolios are allocated.



That said, any student of the markets will have opinions on what the current data is telling us and what we expect will happen in the coming year. I believe 2023 will be a Tale of Two Halves as the title of this research suggests. The first half of 2023 is likely to see a breach of the 2022 market lows as the economy tilts on the verge of contraction. The formula I see playing out over the first six months of 2023 is:

Downward Earnings Revisions + Tight Credit Conditions + Negative Wealth Effect = 20% or greater drop in Equities

You could add exogenous factors like economic crisis in China, natural gas crisis in Europe, escalations with Russia, N. Korea, etc., but the main reasons why I believe stocks will be lower through June is represented by the formula.

In my opinion, earnings are going to fall dramatically. While some analysts are still forecasting $220 in EPS on the S&P 500, I believe the number will be closer to $196. I think the Fed is also going to continue to hike rates through Q1 towards approximately 500 basis points of tightening. Lending standards are more restrictive and demand for debt is falling given the elevated rates. Tight credit conditions historically lead to corrections in equities. The Negative Wealth Effect impacts consumer spending as people feel less confident about the economy when their major assets: homes and 401k's, decline. Consumer spending has held up to this point but I expect to see that rollover in the first half of 2023.

Virtually every macroeconomic data point, with the exception of consumer spending, suggests the economy is currently contracting and a recession likely. Composite PMI, one of the best leading indicators, is a 45 and heading lower suggesting contraction in the manufacturing sector. Services PMI is also in contraction territory and the Leading Economic Indicators published by the Conference Board is dismal. A deeply inverted yield curve negatively impacts earnings of financials that compromise 12% of the S&P 500. Higher corporate borrowing costs combined with recent tax hikes are strong headwinds for earnings.

The situation might not be as dire as the data suggests when forecasting market performance in 2023 as there are positive signs on the horizon. First, it is likely the Fed will be done with rate hikes at the end of Q1 and markets are pricing in Fed rate cuts by the summer. Enough damage will likely have been done to the economy and labor markets that inflation will be under control. The Fed should also come to the conclusion that inflation has become a necessary evil. Higher interest rates raise the cost of corporate borrowing and reduce corporate profits resulting in lower tax receipts by the government. Fed tightening also hurts the markets and tax revenues from capital gains are being slashed. Prolonged high interest rates drive up the cost of servicing government debt and ultimately reduce the revenues of the government. The combination could result in a rapidly depreciating dollar and bigger inflation problem.

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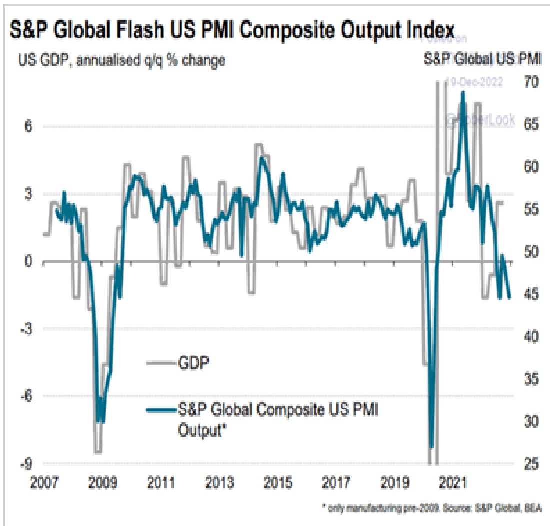
I expect the markets to bottom from this cycle during the summer and rebound strongly in Q3 and Q4. Energy and healthcare should continue to lead sectors during the first half of the year, but leadership will likely shift to information technology, financials and consumer durables in the 2nd half of 2023. If Rip Van Winkle took a nap on January 1 and did not wake until December 31st, he would likely look at the markets and yawn thinking, "nothing to see here." For investors who are awake during that period, the volatility and stomach churning might be much greater.

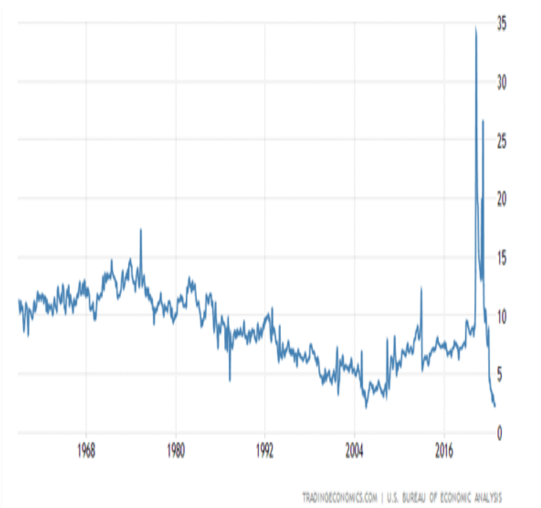
The Blink of an Eye



The Flash US PMI Composite is an early reading of corporate activity taken from a survey of 650 companies. Looking at the data series over the prior 15 years, you can see a clear positive correlation between this Index and US GDP growth. When Flash PMI drops below 45, the likelihood of recession becomes very high. The strong correlations between these data points over a long period of time suggests Flash PMI is highly predictive of the direction of GDP. While no single data point can be relied upon to forecast something as complex as the US economy, the rapid drop from a reading above 65 in late 2021 to 45 today should be alarming for investors concerned about corporate earnings growth.

- The drop from 48.2 at the beginning of October to 46.3 in November is the sharpest drop in the survey since early 2009 and trends suggest it will continue to fall in early 2023.
- The largest drag on Composite PMI has been demand conditions that worsened as the 4th quarter progressed as New Orders declined at the fastest pace since the pandemic in May 2000.
- A decline in exports gained momentum throughout the quarter as manufacturers and service providers alike saw steep declines in new business blamed on inflation and interest rates.

Personal Savings Rate



According to data from the Bureau of Economic Analysis, the personal savings rate (i.e., savings as a percentage of disposable income) reached a 17 year low in October of this year. The chart below plots the personal savings rate going back to inception. What is noteworthy is the dramatic increase in savings during the onset of the covid pandemic due to massive government stimulus. Fast forward roughly two years and collectively we are saving less now than at any point since 2005. Likewise, households have increased debt levels at the fastest pace in 15 years, according to data from the Federal Reserve.

- In large part, the drop in the savings rate is likely due to hot inflation, which is running at a 40 year high. Most households simply cannot set aside a meaningful portion of their wages, despite higher income levels overall. Inflation indeed eats away at the financial wellbeing for most households. For many working families, their financial condition is quite tenuous.
- The Federal Reserve's fight against inflation is a critical one. While we have seen a decline in CPI, prices for many common goods and services are still quite elevated, which puts a considerable strain on household budgets. If we do indeed enter a recession with persistent inflation, the outlook could get worse.

Looming Recession

2022 Fed Rate Hikes: Taming Inflation

FOMC Meeting Date	Rate Change (bps)	Federal Funds Rate
Dec 14, 2022	+50	4.25% to 4.50%
Nov 2, 2022	+75	3.75% to 4.00%
Sept 21, 2022	+75	3.00% to 3.25%
July 27, 2022	+75	2.25% to 2.5%
June 16, 2022	+75	1.5% to 1.75%
May 5, 2022	+50	0.75% to 1.00%
March 17, 2022	+25	0.25% to 0.50%

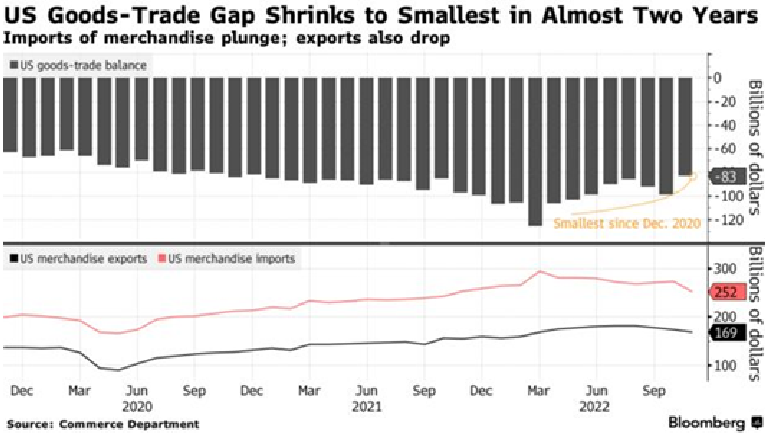
As we head into the end of 2022, and look forward to 2023, the inclination of a looming recission is on everyone's mind. Over the last few months, economists have been predicting that we will have a recession starting early next year, although the forecasted severity is still up for debate. Unlike the last two previous downturns where the Federal Reserve came to the rescue, they are actually the ones slowing the economy this time. So, if there is indeed a recession, how bad will it be, and how long will it last? Traders in the futures market expect the Fed to start cutting rates by the end of 2023. In its own forecast, the central bank shows rate cuts starting in 2024.While many are hoping for a sudden recession much like 2020, without the Fed's help, we think the probability of a similar timeline is slim.

- Since the beginning of 2022, the Federal Reserve has raised the Fed Funds rate seven times; going from 0% - 0.25% in March to 4.25% - 4.50% in December.
- The Federal Reserve's latest economic projections show the economy growing at a pace of 0.5% in 2023, and it does not forecast a recession.
- The central bank forecast indicates unemployment could rise to 4.6% from its current 3.7% in 2023.

Quinn VandeKoppel

Macro View – U.S. Trade Deficit Narrows

A report by the Commerce Department on December 27th shows that the U.S. international trade deficit in goods narrowed 15.6% to $83.3 billion in November. According to a Bloomberg survey, Economists were predicting that the deficit would only narrow to $96.3 billion in November and is the smallest deficit since December 2020. The trade deficit, which widened to a record earlier this year, has been a drag on GDP, largely due to a surge in imports. JPMorgan Chase & Co. economist Daniel Silver noted that the November Data generates "some upside risk" to growth in the Q4 and that they still think that net exports will subtract from GDP growth in 4Q on average. For now, data indicates a more modest trade drag than we had previously been anticipating".

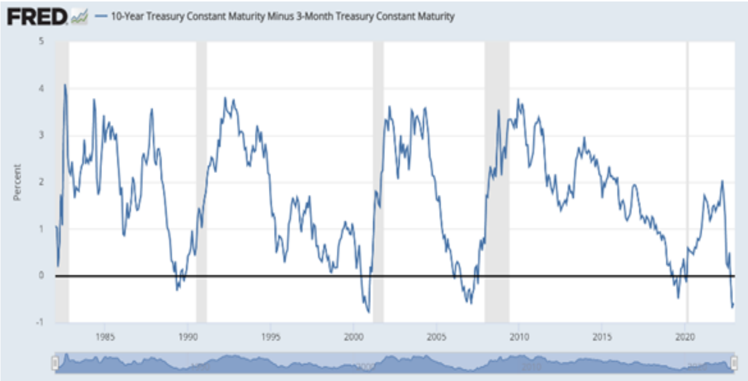


Taking Stock – Trouble on the Tarmac

The holidays can be a stressful time for those traveling. This year in particular has been a real "headache" for some travelers, especially for those flying with Southwest Airlines. As a result of severe weather on the east coast, more than 4,000 U.S. flights were cancelled the day after Christmas, and more than 8,500 flights were delayed, according to FlightAware. In a statement provided by Southwest Airlines, they said that disruptions were "unacceptable" and that its network was behind because of the winter storm. As a result, the U.S. Department of Transportation has said that they are going to look into the Southwest issue, as they were concerned by the "unacceptable number of cancellations and delays" in addition to numerous reports of poor customer service. Unfortunately, at the end of the day, the customer is the one left to suffer the consequences of policies set forth by these airlines.

Fixed Income – Recession Indicator

Since July 7th of this year, the three-month Treasury rate and 10-Year Treasury rate have been inverted. While some market participants have often looked at the yield spread between the 10-and two-year bonds when predicting future recessions, academics, in contrast, often look at the spread between the yields on the 10-year U.S. Treasury bond and the three-month Treasury bill when studying the relationship between an inverted yield curve and recessions. If you look at the chart below from Fed Reserve Bank of St. Louis, you will see that the spread between the 10-year and 3-month are at a similar inverted level as they were back in 2000 and 2007, just before the Dotcom and financial crash. And while the indicator is not fool proof as the yield curve did not invert until two years after the 1987 stock market crash, analyst consensus is that a global recession is likely to occur sometime in 2023.



Technical – Tesla RSI Reading

Tesla Inc. (TSLA), one of the darlings of 2020, has been one of the most talked about companies over the last few years. However, like many other technology companies, Tesla's stock has been hit significantly hard this year and is down more than 69% YTD as of December 27th. Not only has this year's performance wiped out all of 2021's gains, but the Relative Strength Index (RSI) has dropped to a record low of 16.56, according to Factset data. The RSI is a momentum indicator that measures the magnitude of recent declines against the magnitude of recent rallies. This indicator, which is often used in technical analysis, helps traders determine when an asset is considered overbought (at or above 70) or oversold (at or below 30). The last time Tesla was this oversold was in 2016. However, shortly thereafter, the stock rose more than 85% and the RSI hit a reading of more than 78.

Year-End Asset Class Review

Clint Pekrul, CFA

Most investors will be glad to wave goodbye to 2022. We're on pace to have our worst year since 2008 across most asset classes. Valuations have come into more normal levels as the Federal Reserve has aggressively raised interest rates. Consequently, asset values have been repriced across the board. Below is a brief performance recap across the major asset classes.

Domestic Equity Factors

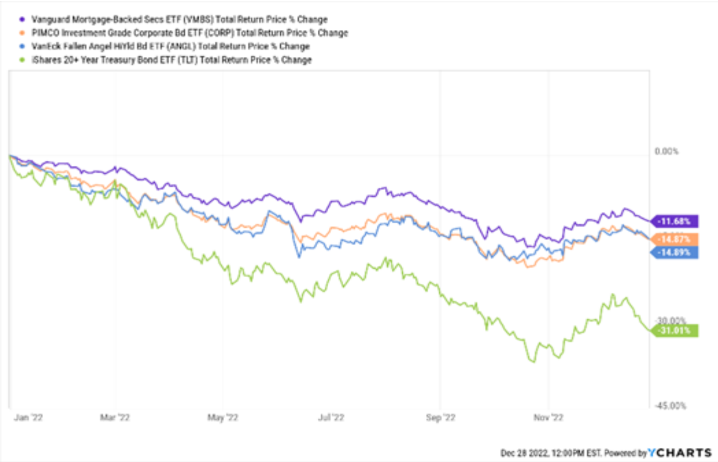
For the year, low volatility stocks proved resilient, declining roughly -4.5%. Likewise, the value factor held up reasonably well with a decline of roughly -8.1%. Conversely, momentum stocks, which delivered robust performance throughout much of the covid pandemic, have reversed course this year, having declined by approximately -18.3%. Meanwhile, small cap stocks and high-quality stocks have declined by roughly -13.7% and -16.8%, respectively.

The dispersion of factor returns has been considerable this year. This is a pattern that could persist in 2023 as investors remain defensively positioned with their equity exposure.

International Equities

As with domestic markets, international equities experienced declines for the year. Emerging markets fell roughly -21.0%, driven in large part by China. Developed markets fared somewhat better, declining roughly -15.9%. One headwind for U.S. investors allocating overseas has been a strong dollar, given the Federal Reserve's hawkish monetary policy. However, currency headwinds could subside in 2023 as the central bank slows or halts their interest rate increases. This could mean potential outperformance for international equities.

Fixed Income



For many, this year has been the worst on record for fixed income performance. After lifting off from essentially zero, soaring rates have punished bond investors. On a relative basis, mortgage-backed bonds fell roughly -11.6% but outpaced investment-grade corporate bonds, which fell by roughly -14.8%. Longer-dated Treasury bonds, which historically have hedged equity volatility, offered little reprieve after falling roughly -30.0%.

Dividend Equities

On a relative basis, dividend paying equities have outperformed for the year. Both U.S. and international dividend stocks are lower by roughly -3.0% for the year. The real estate sector (REITs) however, is lower by roughly -26.6% amid concerns over valuations due to higher interest rates.

Q: Will investors receive coal in their stockings in 2023?

The Fed has certainly played Grinch to investors in 2022 as there was no Santa Claus rally to soften the damage done on the year. While the markets have tried to rebound a bit after Christmas, at the time of writing, stocks are down about 5% for the month. Investors will have to wait 365 days to see if next year brings better results and my guess is it will be marginally better. As previously noted, my expectation is that the markets will move below 2022 lows in the first half of the year before rebounding as interest rates begin to fall and the Fed moves from tightening to accommodation.

Investors who are patient and remain hedged during the first half of the year are most likely to have the confidence to buy, or reduce their hedges, when the markets are near their lows. I also believe the markets will treat different types of investors very differently in 2023. Passive, buy and hold, investors who often utilize indices for their equity exposure are likely to again be clobbered in 2023. Investors who take a more risk-managed approach and utilize hedging and tactical strategies should outperform on a relative basis. Active management of large cap US equities rarely outperforms on a cost-adjusted basis, but I would not be surprised if 2023 proves to be a year where that occurs.

It's helpful to look at the history of the S&P 500 Index. There have only been a handful of episodes where the index posted back-to-back negative years. This is not to say that we won't experience another decline in 2023, but history suggests that the chance of a negative return year is unusual. I think equities have been sufficiently repriced such that forward returns are much more attractive today than a year ago. In other words, we aren't starting the year with a price-to-earnings multiple that is well above the historical average for the S&P 500. However, stocks now have competition from bonds, given that interest rates are no longer essentially zero. My guess is we that have positive but muted returns for stock indexes in 2023.

Investors can now find positive, minimally risky yields, albeit still below the rate of inflation. If the Fed continues to raise rates and eventually plateau, while inflation comes down, bond investors can potentially earn real interest on “risk-free” assets. It's likely the worst of the rate hikes is behind us, so bond returns will likely not be nearly as volatile as in 2022. Likewise, credit conditions remain favorable for investment grade bonds. So overall, I think there will be ample opportunity to make money in 2023.

Q: What sectors are likely to outperform in 2023?

At least through the first quarter, I expect the sectors that outperformed in 2022 to continue their outperformance. This would include Energy, Utilities, and Healthcare. I equally expect the laggards from 2022 to struggle through early 2022 that include Communication Services, Information Technology, and Consumer Discretionary. Once the Fed completes its cycle of hiking rates, it is likely market leadership will shift. Telecom and Technology could be down more than 50% from their December 2021 highs making them a compelling valuation play. The challenge for investors will be to select the right stocks. Technology exploded during the pandemic as “work from home” stocks skyrocketed. Many companies in the sector will be down 50% and probably still very overvalued while other companies will be trading at the most attractive levels in a decade.

If looking for market segments that could shine in the second half of 2023, consider companies bringing innovation in traditional business models. Many companies are providing cost saving innovation in health care that should do well when a ‘risk-on’ trade resumes. I also expect an acceleration in moving technology manufacturing from Asia to the US and companies that can demonstrate the ability to manufacture at scale in the US are likely to see their stocks bid up. Valuations still matter and next year should provide an opportunity to sell stocks at the high end of valuation ranges and buy stocks at the low end of the range.

It feels like the market overall still has a ways to fall as we continue to price in the likelihood and potential severity of a recession. Perhaps we'll have more clarity by the end of the first quarter. In the meantime, investors will likely remain defensively positioned. I generally look at the market through a factor lens and expect to see low volatility and value stocks to continue to outperform on a relative basis. This would imply that consumer defensive, financial service and utility sectors continue to hold up relatively well.

But the narrative could change throughout the year. Sector performance will be contingent on earnings and what the Federal Reserve does with interest rates. If earnings can support current valuations and we don't need a market that is largely supported by the central bank, then investor behavior could change quickly from being defensively positioned to being more growth oriented. If we indeed do have a soft landing and avoid a recession, or at least have only a modest recession, then investors could rotate into the sectors that have been decimated in 2022. In other words, there could be a significant sector rotation before the end of the year.

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