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CIO Strategy Bulletin

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Unforgettable

SUMMARY

- 2022 was a year of turning points – for global markets as well as politics. In addition to a breakout of war in Europe and marked bifurcation of the world as China rises in power, financial markets experienced reversals. The Fed went from accommodative to restrictive policies as financial assets experienced a great revaluation.
- In our view, the Fed's boom and bust policies will not end well. We don't see a scenario where earnings remain steady – instead, they're likely to decline 10% in 2023.
- We think the Fed will need to reverse policy again in 2023 when job losses accelerate, and by mid-2024, we expect the Fed will have reversed half of its 2022 tightening steps.
- 2023 will get off to a bumpy start, but will likely mark a transition for the world economy as it enters a growth period in 2024 and beyond. We urge investors to look forward and be forward thinking too.

Unforgettable 2022

2022 will be long remembered as a turning point for global markets and politics. It has seen the acceleration of the bifurcation of the world as China rises in power and the West seeks to respond. It has seen a massively deadly and expensive war break out in Europe catalyzing the resolve of NATO, the EU and the US, forcing Russia to deal with its significant limitations as a superpower. It has seen the Covid pandemic enter its third year with unexpected ferociousness, as China embarks on a speedy, and potentially deadly, reopening of its economy.

For markets, this was a year of reversals, the biggest being the Fed's massive shift from accommodative to restrictive policies. The Fed chose to fight an exogenous inflationary spike. Markets collapsed on the deliberate actions of policymakers to slow the economy. In a year that saw a record high for corporate profits, we experienced the worst combined equity and bond market performance in history, with lasting repercussions for portfolios.

2022 may be known as the "Great Revaluation" for financial assets. In 2022, \$12 trillion of bonds went from negative yielding to positive, the Nasdaq dropped 34%, and the entire market for crypto currencies went from \$2 trillion to \$1 trillion, according to Bloomberg data. The trailing price/earnings multiple of the S&P 500 fell 24% (from 22.8 to 17.3). Even more profoundly, bond yields roughly doubled across the risk spectrum. These events changed absolute and relative value of asset classes, requiring a rethinking of how to address the opportunities and risks to come.

Covid's Coda?

Covid became endemic for much of the world in the year past. Learning to "live with it" largely allowed for a broad reopening of the global economy, but not a consistent one. Shortages plaguing services industries created a new source of inflation pressure, just as inventories of consumer goods began a meteoric, but disinflationary, rise.

As 2022 ends, China, the world's most populous country, is running a unique Covid strategy. It is flip-flopping from a two-plus year "zero Covid policy" to a "zero Covid restrictions" program. This has happened in a matter of days, with insufficient vaccination of its elderly population, a lack of preparation of medical resources to address the tidal wave of disease spreading nationwide, and without inadequate communication as to the reasons for the about-face.

The Chinese government wants to jump-start an economy stuck in a depressed state by its macroeconomic and health policies. We are seeing millions of Chinese become infected with a Covid variant for the first time. With inadequate medical supplies and facilities, the new wave of Covid in China is likely to crest and recede all within the space of three months. This all suggests a very different year for China's economy in 2023 (See our [Asian Market Outlook for 2023](#)).

A Fed for the History Books

We suspect monetary and fiscal policymaking from 2020 to 23 will be remembered poorly by economic historians. Fiscal provisions for a pandemic-stricken economy were deliberately broad and sustained rather than "targeted and temporary." In the US, household and business income supports were too broad, generating excess demand.

A THANK YOU TO OUR READERS

While 2022 may be a negative memory in markets and politics, it is the exact opposite when we think of all of you, our readers. We have engaged with thousands online and in person over the course of 2022. We have expanded our staff in investments strategy as a result of your enthusiastic response to our work. And, together, we have made it through an historic year, ready for 2023 and beyond. Our relationship with you is supremely heartening as human connections triumph market anxiety. Remember that 2022 is "just one year" and that growth, progress and prosperity remain a large measure of the human experience.

David Bailin and Steven Wieting

On the monetary side, 2022 began with the Fed continuing zero interest rate and Quantitative Easing policies, following 2021's unprecedented boom in money supply (M2) of an inflationary 25%. The Fed will end 2022 having raised rates 450 basis points, intending to increase rates further (Figure 1) while reducing its lending to the bond market by more than \$300 billion. Money supply will end 2022 with less than 1% growth.¹

An “Expected” Recession and an Imperfect Landing

In our view, the Fed's boom and bust policies will not end well. At the end of 2022, markets are still pricing a less severe slowdown than we expect, ignoring the massive scale of the Fed's tightening actions. We expect 2023 will see money and credit contract outright. Simply put, we do not see a scenario where earnings remain steady. We see a likely decline of 10%.

We estimate the US will likely lose 2 million jobs as a result of the Fed's erratic and extreme actions. In fact, we think the Fed will need to reverse policy again in 2023 when job losses accelerate. Fortunately for labor markets, there is a great deal of unmet demand with aggregate US employment having risen less than 1% since early 2020. Similarly, while the housing market will be hard hit, it never experienced a 2008-like bubble. As such, we believe the US recession will be moderate by historical standards. By mid-2024, we expect the Fed will have reversed half of its 2022 tightening steps.

The New Year: A Time to Look Forward

Investors should not be backward looking when thinking about potential market opportunities. Markets look ahead. We suggest considering 2009 to remind us why. Just as GDP was plunging at a -4.6% rate and unemployment grew consistently across the whole of 2009, US equities bottomed on March 9, 2009 -- quite early in the year.

Inflation in the coming decade could average a bit higher than the decade preceding the Covid shock. However, we believe many investors will be surprised when it recedes sharply in 2024. As a result, bond market performance in 2023 and 2024 should improve. Attractive yields now (Figure 2) may also benefit from bond appreciation in the future.

Historically, equity markets associated with recessions typically bottom halfway through the downturn (Figure 3). For example, in 2009, the bottom occurred 80% of the way through a full contraction. For 2023, investors should not expect that markets will bottom in a period of growth or optimism, but rather in the heart of contraction.

Note that median 1-year historical returns for US equities measured from the bottom of a bear market have been 37% with two-year historical returns of 57%.²

Unfortunately, 2023 will not begin with smooth sailing. But it is highly likely to mark a period of transition, a turning point for the world economy as it enters a growth period in 2024 and beyond. We urge investors to look forward and be forward thinking, too.

¹ The Federal Reserve Board as of Dec. 29, 2022.

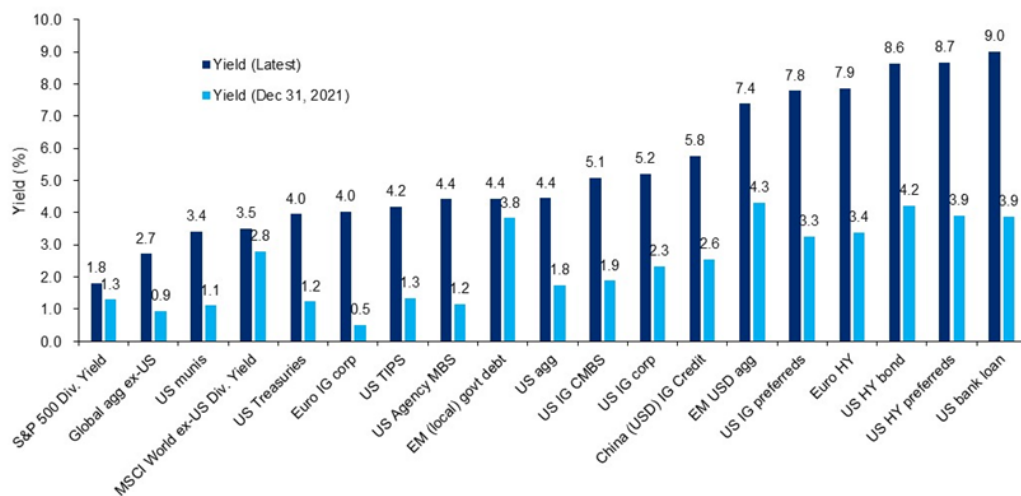
² Source: Haver Analytics as of Dec. 29, 2022; proxy used for equities is S&P 500 index. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary.

Figure 1: US 2-year Treasury yield (12-month difference)



Source: Haver Analytics as of Dec. 27, 2022.

Figure 2: Bonds are back – What a difference a year makes in bond yields



Source: Bloomberg as of Dec. 20, 2022. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary. All forecasts are expressions of opinion, are subject to change without notice, and are not intended to be a guarantee of future events.

Figure 3: How soon do equities bottom when the US enters recession?

Recession	Depth into Recession that though occurred	Recession	Depth into Recession that though occurred
Aug 29 – Mar 33	77.3%	Nov 73 – Mar 75	63.5%
May 37 – Jun 38	76.7%	Jan 80 – Jul 80	31.0%
Feb 45 – Oct 45	11.5%	Jul 81 – Nov 82	77.4%
Nov 48 – Oct 49	60.8%	Jul 90 – Mar 91	30.5%
Jul 53 – May 54	14.6%	Mar 01 – Nov 01	70.5%
Aug 57 – Apr 58	21.6%	Dec 07 – Jun 09	79.0%
Apr 60 – Feb 61	59.3%	Feb 20 – Apr 20	56.5%
Dec 69 – Nov 70	43.5%		
		Average	51.6%
		Median	59.3%

Source: : Haver Analytics and FactSet as of Oct 27, 2022. Proxy for equities data is S&P 500 Index. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future returns. Real results may vary.

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