NORTHEAST SEQUOIA
PRIVATE CLIENT GROUP

2023 Outlook

Great Expectations

"Take nothing on its looks; take everything on evidence. There's no better rule."

Charles Dickens

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Executive Summary

- We can't remember a time over the last 20 to 30 years when consensus expectations for capital markets and global economies have been so synchronized. So in our '23 Outlook, we try to avoid the herd mentality of the great consensus expectation unless we can find the evidence to support it.
- 2022 started on solid footing. Shares of Apple (ticker: AAPL) reached an inter-day all-time high of $182.94 per share on January 4, 2022, making it the first publicly traded company with a $3 trillion market capitalization. At the same time, the S&P 500 also made an all-time high, recovering almost 120% from its pandemic low. However, by February 1, shares of APPL fell by over 10%, while the S&P slid by as much as 9%. These price movements were just a harbinger of what would come in 2022.
- The S&P 500 was down by 18% in 2022; at its worst levels, the S&P 500 was down by over 24%. However, we found that, on average, in the year following a drawdown (negative return), the S&P was up by 13.2%.
- Last year was one of the most volatile years in history. Overall, the S&P gained and lost roughly $103 trillion in market capitalization. Moreover, we found that years coinciding with excess volatility ('01, '08-'09, and '20) ultimately led to recession.
- Since the pandemic, central bankers have taken unprecedented steps to resuscitate the global economy. As a result, inflation backed up to a 40-year high. In response to this, the Federal Reserve course corrected by embarking on the most aggressive rate-tightening cycle since the '70s.
- Moving forward, we would not be surprised to see inflation fall more dramatically than the consensus expectation. In much the same way that the combined impact of demand-pull and cost-push factors turbocharged inflation to the upside, the compound removal of these forces could have the opposite impact.
- Still, in an attempt to not repeat the mistakes of the early '80s, we fear that the FOMC will continue to raise rates too high and keep monetary policy too restrictive for too long. As a result, we expect a US recession within the next 12-18 months

commensurate with a pullback in economic activity, compounded by the potential for another policy mistake.

- If a recession, in some form, were to occur within the next 12 months, it would be the third double-dip recession experienced in the US in the last 100 years. Still, we believe the US economy is in a strong position relative to prior tightening cycles and/or pre-recession periods. As such, if a "soft landing" is not achievable, we believe the next recession will be shallow and short compared to the typical peak-to-trough duration, which averaged about 11 months (post WWII).

- Given the overwhelming political, economic, and geopolitical uncertainty, we believe Defensive Value-oriented sectors may continue to outperform through late Spring '23. Depending on the depth and length of any potential US recession in '23, Technology may take on more "defensive value" characteristics, especially given 2022 returns.

- Fixed-income investors have already witnessed a significant backup in real yields. With a potential FOMC pause and cut, bonds currently offer attractive total-return prospects. We feel that fixed-income investors should consider longer-duration bonds with solid credit ratings alongside Preferred Equities. Even High-Yield Corporate bonds potentially provide attractive total returns, assuming a recession is avoided (soft-landing) and/or the duration of any recession is shallow and short as corporate balance sheets are strong.

- Our earnings yield construct implies a 12-month price-to-earnings multiple of approximately 17x. If we assume equity investors begin to "discount" a potential Fed pause/cut, alongside a more relatively shallow earnings recession, we expect a price-only expectation for the S&P 500 in the $4,100 to $4,200 range by the year's end of 2023.

2022 Year In Review

Great Expectations

Our 2023 Outlook is entitled "Great Expectations" to remind investors, as the great novel suggests, "take nothing on its looks; take everything on evidence."

We can't remember a time over the last 20 to 30 years when consensus expectations for capital markets and global economies have been so synchronized. Never has there been a time when analysts, portfolio managers, financial advisors, CEOs, and pundits have possessed such uniform and one-sided views on recession, corporate earnings, interest rates, and asset allocation. In fact, a recent article in the Wall Street Journal cited that more than two-thirds of the economists at 23 large financial institutions believe the US will enter a recession sometime in 2023.

We are always suspicious when the consensus expectation is so strong and one-sided, which we touched upon in our note published two years ago entitled "The Punch You Don't See Coming." Given the current market and economic forecasts, it is as though we are all on the same sailboat that is heeling[1], and to stop it from toppling, everybody rushes to one side to counterbalance the force of the wind. But, unfortunately, if the wind unexpectedly changes direction, everyone is exposed to the exact risk we are trying to avoid. Our great expectation of cutting a boat through the water with the wind in our sail and sun in our faces is upended as the mast collapses into the sea, and our journey is cut short.

So, as we review the past 12 months and look forward to the next year, we try to avoid the herd mentality of the great consensus expectation unless we can find the evidence to support it. We hope you enjoy this year's Outlook.

[1] Heeling is the term used for when a sailboat leans over to either side (port or starboard) in the water by the excess force of the wind. Heeling is normal and counterbalanced by the sailboat's keel or the crew's weight distribution.

Tale Of The Tape

2022 seemed to start on solid footing, as shares of Apple (ticker: AAPL) reached an inter-day all-time high of $182.94 per share on January 4, 2022, making it the first publicly traded company with a $3 trillion market capitalization. The S&P 500 also made its all-time high in early January 2022, recovering almost 120% (or 53% annually) from its pandemic low of $2,191 on March 23, 2020. However, by month's end, shares of APPL fell by over 10%, while the S&P slid by as much as 9%. These price movements were just a harbinger of what would come in 2022.

While the principal talking point in early 2022 was the war between Ukraine and Russia, there would be no shortage of headlines to roil markets through year-end. Exhibit 1 below quickly reviews the more salient economic and geopolitical events that impacted capital markets throughout the year.

Exhibit 1: 2022 Tale Of The Tape

NEPCG and FactSet, data as of 12/31/2022

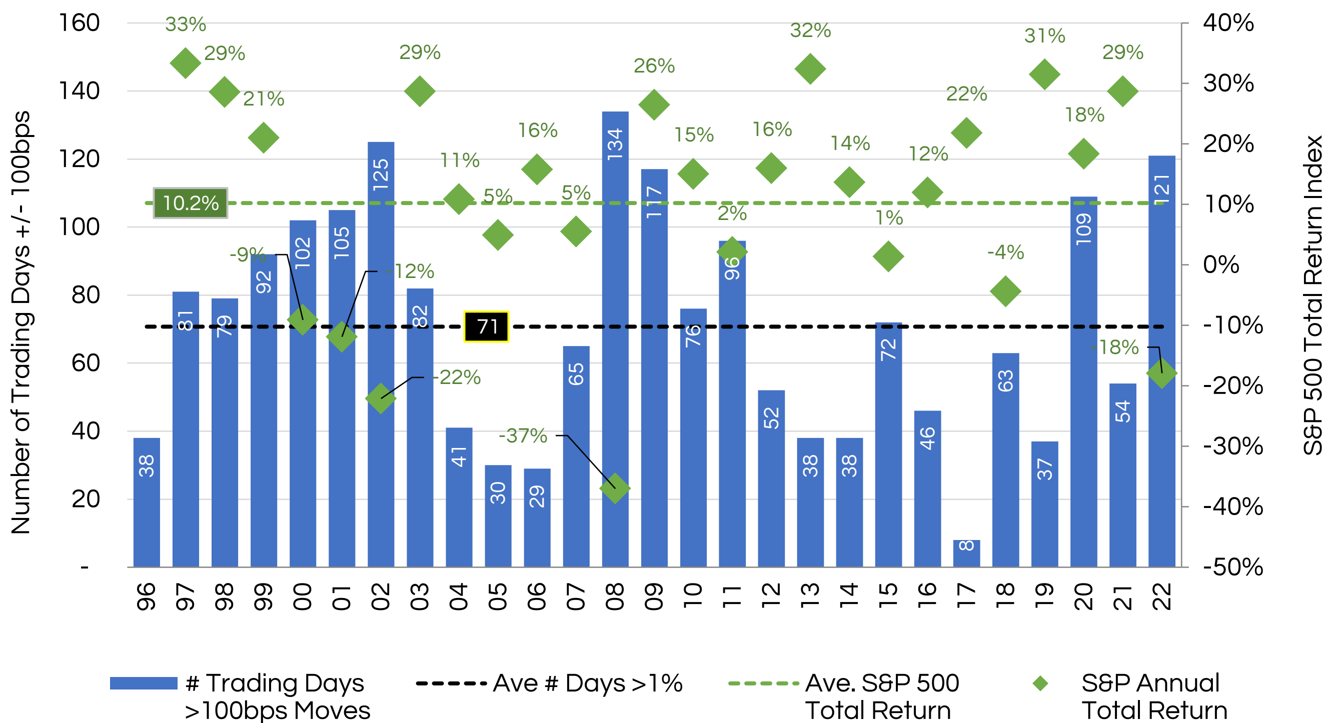
Increasing Volatility, Increasing Correlations

2022 was one of the most volatile years for the capital markets on record. After reaching its best levels for the year (and all time) within the first two trading days of 2022, the S&P 500 began a sharp retracement through year-end. At its worst levels, the S&P 500 was

down by over 24% (on a total return basis) through mid-October. The S&P finished the year at 3,839 on a price-only basis and 8,178 in total-return terms. These levels implied a 12-month return of negative 19.4% and 18.1%, respectively. All told, the S&P gained and lost roughly $103 trillion in market capitalization during 2022. While we expected volatility to be in vogue during 2022, as pointed out in our 2022 Outlook entitled, "[Two Roads Diverge,"] we had no idea how rough and tumbled 2022 would be for capital market investors.

While there are several measures of market volatility (which we explore later in this report), we found the most straightforward and intuitive approach is to simply count the number of trading days during the year in which the S&P 500 traded up or down 1%. In Exhibit 2, we present our analysis.

Exhibit 2: Plus/Minus 100bps Day Moves | S&P 500



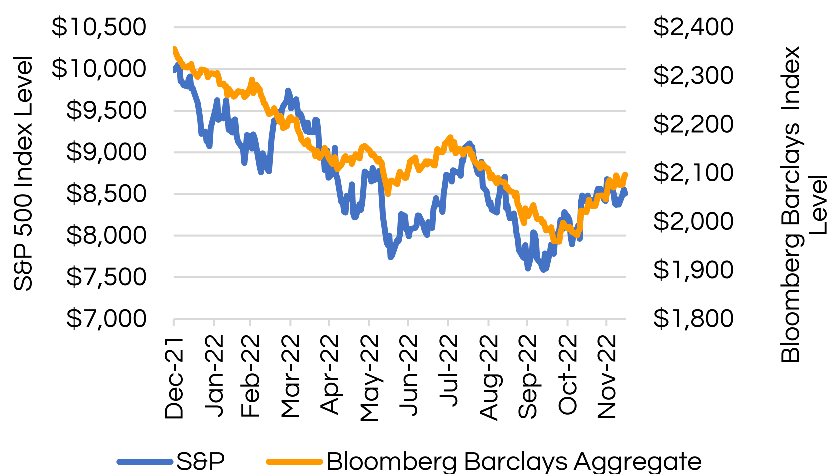
NEPCG and FactSet, data as of 12/30/2022

As the chart suggests, 2022 tallied 121 days, whereby the S&P 500 traded up or down by at least 100bps (1%) in absolute terms. This was the most significant annualized trading day volatility since 2008 (134 days). For comparison purposes, since 1996, the average number of +/- 100bps trading days was only 71. ***Further, we found***

<u>that during bouts of excess volatility whereby the number of days the S&P traded up or down more than 1% ('01, '08-'09, and '20) coincided with recessionary periods.</u>

Bond investors found 2022 equally disappointing. At its worst level (through late October 2022), the Bloomberg US Aggregate Bond Index[2] was off by almost 17% on a total return basis. During the same period, an index[3] representing the 10Yr US Treasury Note was down by nearly 20%, while an index representing the 30-year US Bond was off as much as 35%.

Exhibit 3: Stocks vs. Bonds Indexed Returns



NEPCG and FactSet data as of 12/31/2021

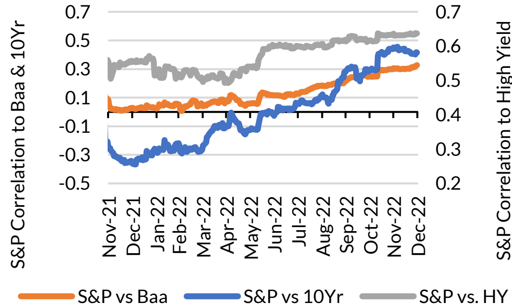
While the 2022 bond sell-off may have caught many retail, fixed-income investors by surprise, we were not entirely shocked to see such price action given the increasing correlations between fixed-income and equity indices which began in earnest during 1Q22.

As we illustrate in Exhibit 4, the 52-week rolling correlations[4] between bonds and equities began to increase (become more positive) during the Spring of 2022. Most significant, in our opinion, was the positive correlation move between the US 10 Yr. Note and the S&P 500 (blue line). However, by the Summer of '22, correlations

[2] The Bloomberg Aggregate Bond Index or "the Agg" is a broad-based fixed-income index used by bond traders and the managers of mutual funds and exchange-traded funds (ETFs) as a benchmark to measure their relative performance.
[3] Past performance is not a guarantee of future results. Indices are unmanaged, and one cannot invest directly in an index.
[4] Correlation, in the finance and investment industries, is a statistic that measures the degree to which two securities move in relation to each other. Correlations are used in advanced portfolio management, computed as the correlation coefficient, which has a value that must fall between -1.0 and +1.0. Correlation is closely tied to diversification, the concept that certain types of risk can be mitigated by investing in assets that are not correlated.

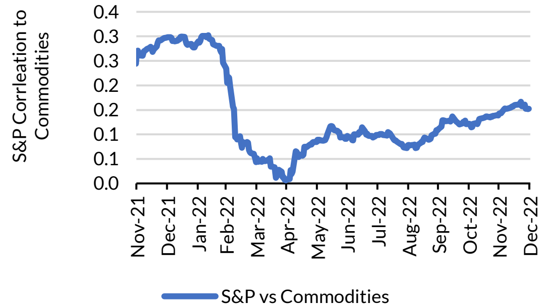
increased across both Investment Grade Corporate Bonds (Baa) and High Yield Bonds.

Exhibit 4: Correlation to Bonds



NEPCG and FactSet

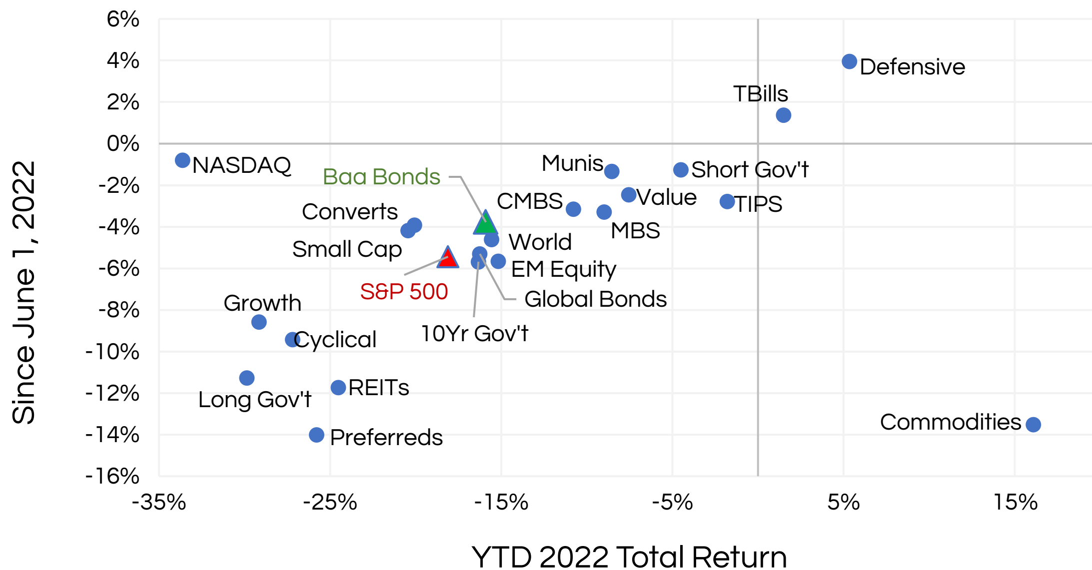
Exhibit 5: Correlation to Commodities



NEPCG and FactSet

Rising equity correlations also impacted the "belle of the ball" commodity sector, which saw its own great expectations vanish by mid-year 2022.

Exhibit 6: 2022 vs. June 1, 2022 | Capital Market Total Returns



NEPCG and FactSet, data as of 12/31/2022

By early June 2022, equity investors began to acknowledge that inflation may have peaked and started to discount any further unanticipated price spirals associated with either cost-push or demand-pull inflation factors[5]. Exhibit 5 illustrates that after

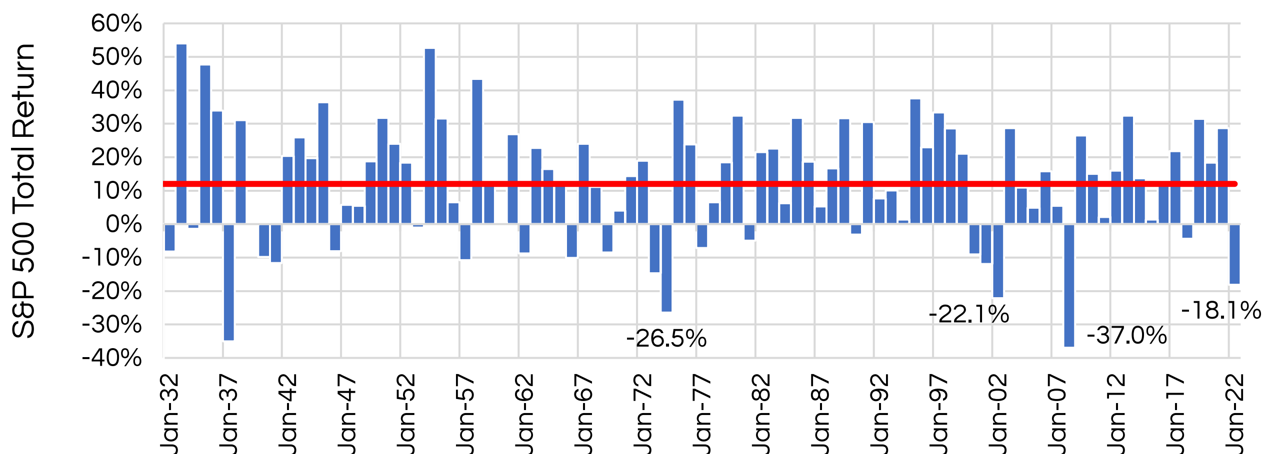
[5] Demand-pull inflation pressures are typically a result of policymakers' intent to resuscitate a faltering economy by spurring aggregate demand. In contrast, cost-push factors emerge as consumers bid up raw materials and labor costs

exhibiting negative rolling correlations to the S&P through mid-year 2022, commodity[6] price momentum reversed as correlations to the S&P 500 began turning positive. As a result, a positive 34% total return displayed by the Bloomberg Commodity Index **through** June 1, 2022, was complemented by a negative 14% total return for the remainder of 2022. Still, Commodities provided investors with the best overall returns for 2022, an expectation that fits squarely with our Interest Rate Regime construct, which we unpack later in this report.

2022: Good Riddance

Not only was the S&P 500 down 18% on a total return basis, but 2022 was also the worst year for the S&P 500 index dating back to the Global Financial Crisis[7] (GFC) in 2008 when the S&P was down by roughly 37%.

Exhibit 7: S&P 500 Annual Returns

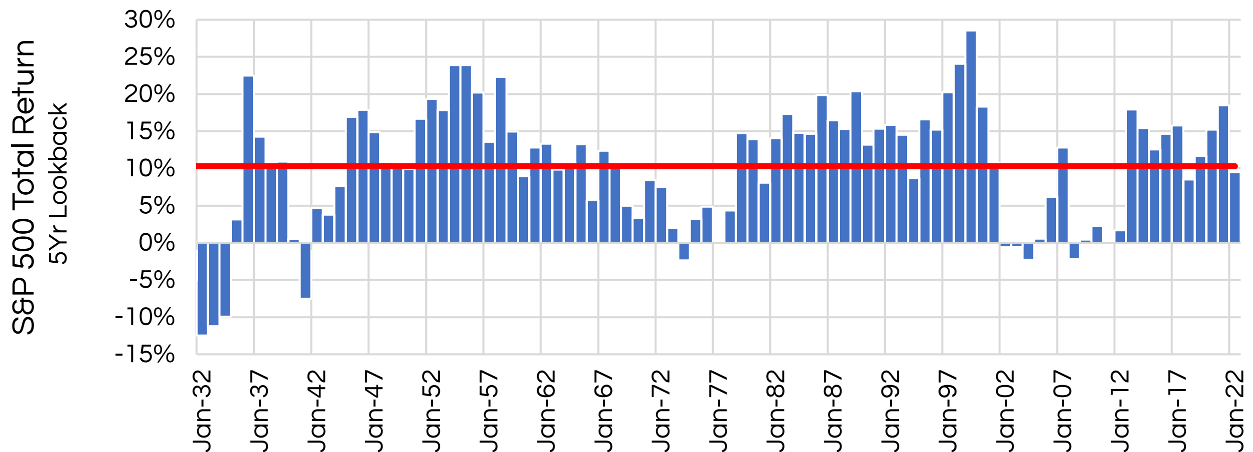


NEPCG and FactSet, data as of 12/31/2021

In addition, as we illustrate in Exhibit 8, the 5-year look back total return[8] for the S&P 500 as of 12/31/22 was 9.5%. This compares to the long-term 5-year average return dating back through the Great Depression of 10.5%.

[6] Measured by the Bloomberg Commodity Index.
[7] The global financial crisis (GFC) refers to the period of extreme stress in global financial markets and banking systems between mid 2007 and early 2009
[8] A 5-year look back is the annualized return an investor would earn, or average annual return for the preceeding five (5) years.

Exhibit 8: 5Yr Compound Annual Total Return Look Back



NEPCG and FactSet data as of 12/31/2021

However, there is a potential silver lining herein. ***<u>We found that, on average, in the year following a drawdown (negative return), the S&P was up by 13.2%.</u>*** Further, we observed that during the 17 instances (68% of the time) of positive returns following a single drawdown year, the S&P was higher on average by 28.7%. Conversely, in the eight instances when there were back-to-back negative annual returns, the S&P lost, on average, 19.8%.

In addition, when analyzing historical 5-year look-back periods for the S&P 500 dating back through 1926, there were 80 positive instances (87% of the time), whereby the annualized return averaged 12.5%. On the flip side, there were 12 instances (13%) whereby the S&P was down only 4.6% per year. ***<u>All of this data supports our view that equity investors who are patient and disciplined are typically rewarded through market cycles. In contrast, traders who respond to emotions generally are punished</u>***.

Sector And Style Recap

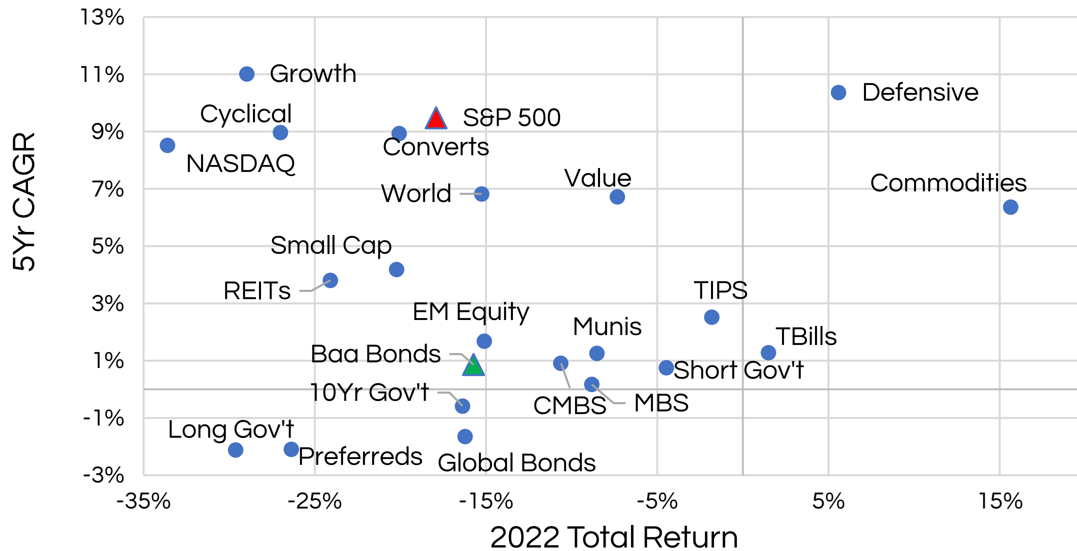
In our 2022 Outlook, we suggested that 2021 equity market returns could be described, to a certain degree, as a "bull-market rotation." In other words, an equity market backdrop whereby investors shifted from winning sectors, securities, or styles to those underperforming throughout the year. However, investors still maintained their equity exposure versus moving to cash or other asset classes like bonds or commodities.

This resulted in 2021 equity market returns being somewhat clustered. However, as we illustrate in Exhibit 9, 2022 returns across equity and fixed-income allocations, sectors, and styles were more diverse.

Commodities was still the best-performing sector in 2022, higher by roughly 16%, despite retracing as much as half of the year's returns after June 1, 2022. Defensive[9] names (stocks) were the best-performing class in 2022, higher by 5.3%. On the downside, the NASDAQ and Growth oriented styles provided investors with the worst returns, down by over 33.6% and 29.6%, respectively.

Across the fixed-income capital market, T-Bills were the best performing style, higher by 1.5%, followed by Treasury Inflation-Protected Securities, or TIPS, down by 1.8%, on a total return basis. Conversely, the worst-performing fixed-income styles were Long Government Bonds, or government-backed securities with maturities over 10 years, down 29.6%, followed by Preferred Equities (-25.8%) and Convertible Bonds (-20.1%).

Exhibit 9: 2022 vs 5Yr CAGR | Capital Market Total Returns



NEPCG and FactSet, data as of 12/31/2022

As we have already pointed out, Growth-oriented equities experienced a challenging 2022. Since the start of 2022, Growth

[9] A defensive stock is a stock that provides consistent dividends and stable earnings regardless of the state of the overall stock market. There is a constant demand for their products, so defensive stocks tend to be more stable during the various phases of the business cycle. Defensive stocks should not be confused with defense stocks, which are the stocks of companies that manufacture things like weapons, ammunition, and fighter jets.

generally underperformed Value except during discrete periods in early March 2022 and late Spring through to mid-Summer.

The contrast between Large-Cap and Small-Cap equities was less disparate than the Growth v. Value comparison. In aggregate, Large-Cap equities outperformed Small-Cap names for most of 2022. However, the margin of outperformance generally oscillated between 5% and 10% for most of the year. Still, from mid-May 2022 through early November 2022, ***Small Cap names enjoyed consistent outperformance as we believe investors bid up Small Caps to combat spiraling inflation prints.***

Exhibit 10: Growth vs. Value

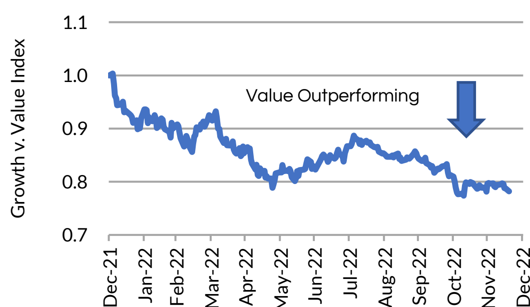


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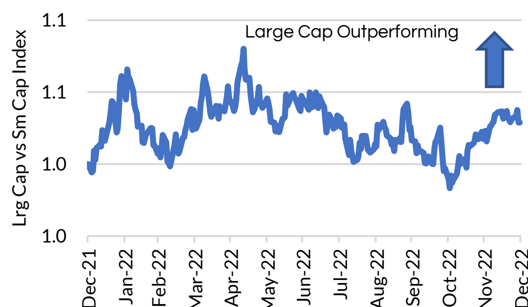
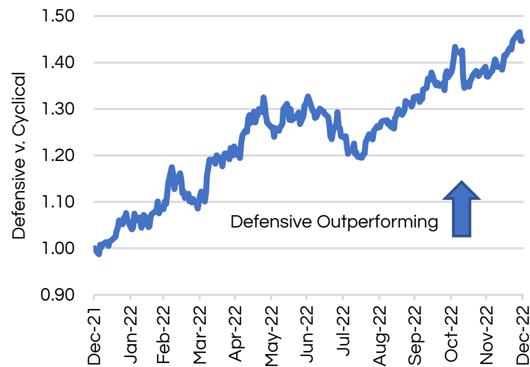
Exhibit 11: Large Cap vs. Small Cap



FactSet and NEPCG

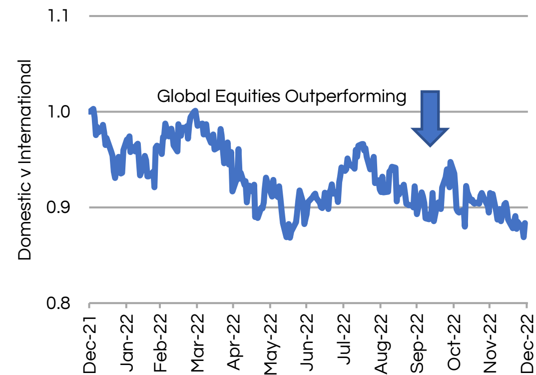
Also noted earlier, Defensive names provided equity investors with the best relative returns for 2022. We counted on this expectation as Defensive Value sectors and styles typically outperform when the economy and capital market move from a Bear Flattening interest rate regime into a Bull Flattening regime. Going forward, we would not be surprised if Defensive names continue to outperform Cyclicals in the near term. We feel several factors will drive this relative outperformance, including investors' attempt to hedge against a recession, the potential for weaker-than-expected corporate earnings, geopolitical uncertainty, and expectations for "higher for longer" interest rates.

Exhibit 12: Defensive vs. Cyclicals



FactSet and NEPCG

Exhibit 13: Domestic vs. Global



FactSet and NEPCG

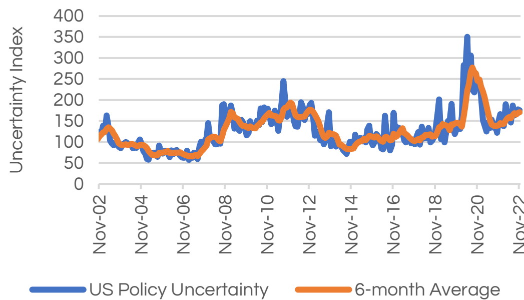
One of the more surprising results of 2022 was the resilience of International equities versus their Domestic counterparts. Given the Russian/Ukraine war, resulting energy crunch, spiraling Eurozone inflation, expectations for a global recession, and relatively hawkish BOE, ECB, and BOJ central banking moves, we expected US equities to provide investors a port in a sea of geopolitical turmoil. However, in aggregate, International equities, as measured by the MSCI All Country Ex-USA Index, provided investors with only a negative 8.6% total return in 2022, while the MSCI USA Index tallied a negative 19.3% total return for 2022.

Geopolitical Backdrop

A year ago, we expected geopolitical uncertainty to subside over the ensuing 12 months. However, the idiosyncratic nature of a global pandemic would continue to result in unpredictability and further test our resolve. ***Still, at the time, we did suggest that Russia's potential invasion of Ukraine topped our list of geopolitical risks that could upend global capital markets and economic growth***. Unfortunately, we had no idea how long any potential conflict would be drawn out, as we incorrectly expected a much shorter one.

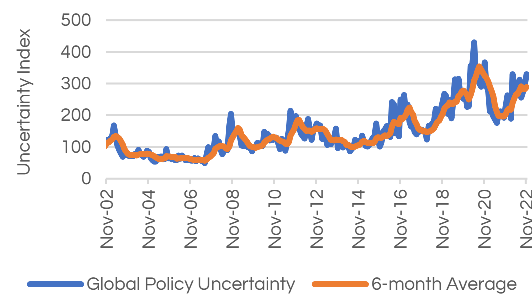
And twelve months after publishing our 2022 Outlook, we find ourselves no closer to understanding how long this war will last or its impact on our 2023 expectations. Just as the COVID pandemic was idiosyncratic, so are the potential conclusion scenarios associated with an autocratic leader, with seemingly no regard for humanity and even self-preservation.

Exhibit 14: US Policy Uncertainty



Policyuncertainty.com and NEPCG

Exhibit 15: Global Policy Uncertainty



Policyuncertainty.com and NEPCG

We can never entirely discount black swans and other events. And now global capital markets are focused on a new COVID variant, potential over-tightening by global central banks, fall out from the crypto-crash, or the possible nuclear aspiration of Iran because these types of risks will always be present in speculative markets. However, ***we have observed empirically that rate-tightening cycles typically coincide with some adverse geopolitical or economic event (for example, the collapse of FTX).*** And although geopolitical risks may have subsided since the high-water mark of 2020, as Exhibits 14 and 15 suggest, more recent trends in the US and globally bear monitoring.

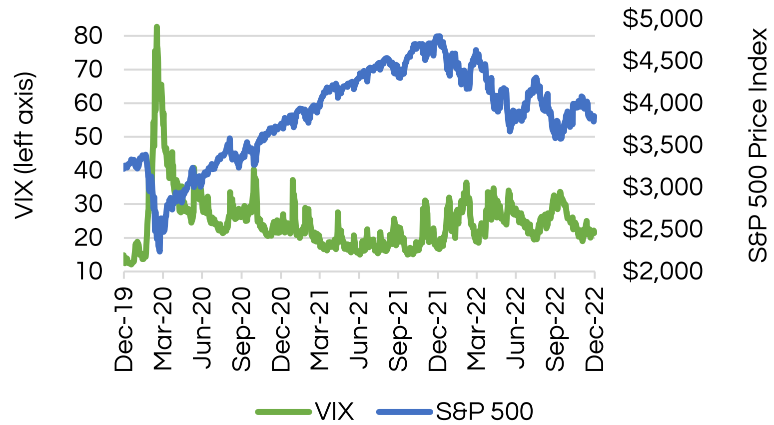
Red Wave Turns Into Red Swash

Historically, risk assets and equity markets, in particular, have enjoyed robust returns during periods of limited volatility. We began to unpack this concept earlier in this report when we illustrated the number of trading days the S&P has historically moved +/- 100bps. Below we illustrate this relationship more formally by looking at the VIX[10], or the CBOE Volatility Index. Exhibit 16 shows a ***negative correlation***[11] between the VIX and the S&P 500, or in the simplest terms, a relationship between two variables, such as when one moves up, the other moves down.

[10] The VIX is a widely accepted measure of the equity market's overall volatility, employing a complicated algorithm using S&P 500 index options

[11] Correlation, in the finance and investment industries, is a statistic that measures the degree to which two securities move in relation to each other. Correlations are used in advanced portfolio management, computed as the correlation coefficient, which has a value that must fall between -1.0 and +1.0.

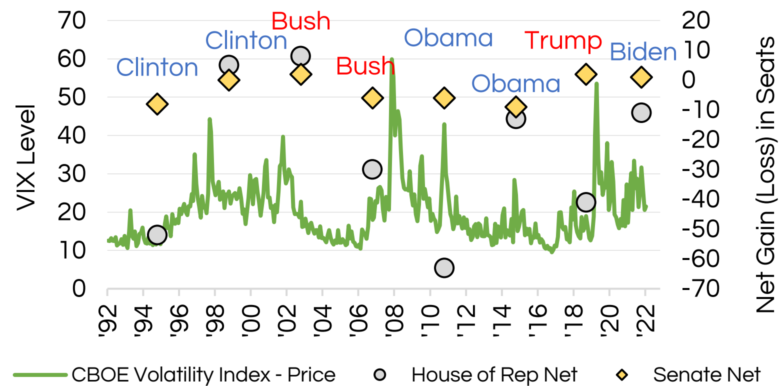
Exhibit 16: VIX and the S&P 500



FactSet and NEPCG

In our 2022 Outlook, we suggested investors should anticipate increased volatility leading up to the 2022 Midterm Elections, an expectation that came to fruition. We came to this conclusion based on historical research we conducted looking back at past election cycles and capital market returns. Exhibit 17 illustrates how the VIX trended with a ***six-month lead into Midterm Congressional elections*** dating back through 1994. Overall, we found the incumbent President experienced an average loss of 24 House seats and 3 Senate seats during the Midterms. For comparison purposes, a Democratic incumbent President lost an average of 31 House seats, and 4 Senate seats following Midterms, while a Republican President lost, on average, 21 House seats and 1 Senate seat.

Exhibit 17: VIX and Midterm Results



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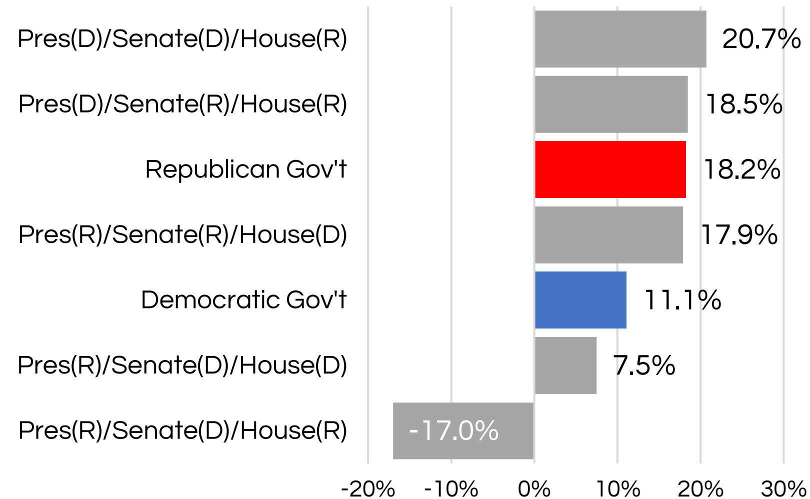
But borrowing from our overall "Great Expectation" thesis, in the months leading up to the November 2022 Midterms, the political sailboat was heeling almost entirely in one direction, with expectations that Republicans would take control of both chambers of Congress. Even up until election eve, Predictit.com forecasted there was over a 70% probability that Republicans would take over the Senate and an even higher chance of winning the House of Representatives. However, the great consensus expectations proved wrong again, as Democrats were victorious in a few key battleground seats (Georgia and Pennsylvania). In the end, President Biden lost only nine House seats[12] and gained one Senate seat.

Exhibit 18: Dems, the GOP, and S&P 500



FactSet and NEPCG

Still, despite the never-ending posturing and politicking in Washington, DC, we continue to suggest a divided government is not necessarily bad for equity markets. ***For example, in Exhibit 18, we illustrate that based on our analysis, the two best governing outcomes for equity market returns were a Democratic President and either: 1) a Democratic Senate and a Republican-controlled House, whereby the S&P increased by 20.7% over the next 12 months, or 2) an entirely Republican Congress, whereby the S&P 500 increased by 18.5% over 12 months.***

[12] Assuming Representative Santos retains his Republican seat in New York's 3rd congressional district following any potential special election in 2023.

Economic Outlook

2022 Review

Following the human devastation and economic turmoil caused by COVID-19, the US economy closed the chapter on the longest economic expansion since WWII. However, global economies and capital markets still experienced the related hangover through early 2022.

Exhibit 19: US Economic Expansions

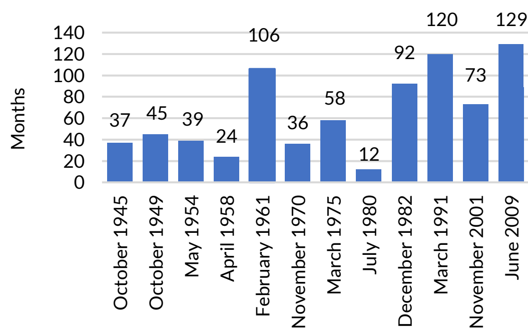


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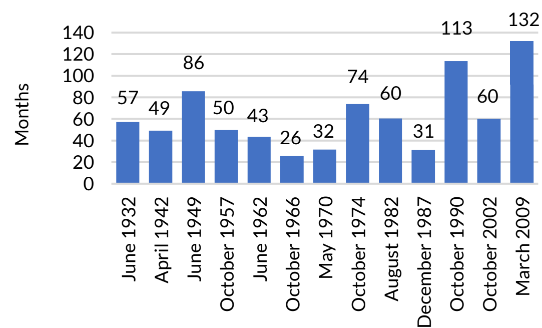
Exhibit 20: U.S. Bull Markets



FactSet and NEPCG

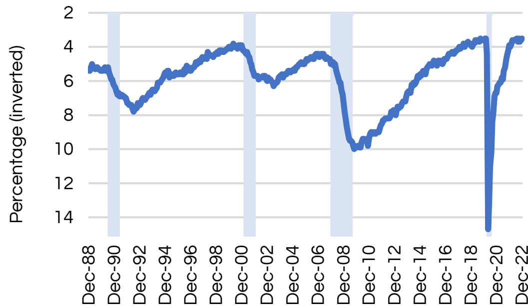
As we have pointed out in previous notes and reports, the resulting global lockdown triggered by the COVID-19 pandemic caused US GDP to contract at an annualized rate of over 31% in 2Q20. This ended the US economy's 129th consecutive month of economic expansion[13] and the 132nd month of an equity bull market. In the end, COVID-19 was responsible for almost a 4% annual contraction in global GDP for 2020[14].

And as we highlighted back in our 2021 Mid-Year Update entitled "Simply Unprecedented," the US enjoyed a strong snapback in economic growth, which validated an aggressive FOMC easing cycle. However, we are now seeing the Federal Reserve course correct by embarking on the most aggressive rate-tightening campaign since the Volker years[15]. Over the last nine months, the FOMC has increased its target rate seven (7) times from an upper range of 25bps to 4.5%, with the most recent 50bps increase in December 2022. These moves have pushed overnight borrowing costs to the highest point in

[13] Defined herein broad terms as positive GDP growth.
[14] Source: FactSet consensus estimates
[15] Paul Volker (September 5, 1927 – December 8, 2019) was an American economist who served as the 12th chairman of the Federal Reserve from 1979 to 1987. During his tenure as chairman, Volcker was widely credited with having ended the high levels of inflation seen in the United States throughout the 1970s and early 1980s.

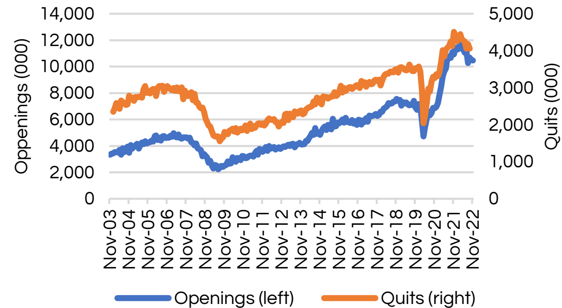
15 years, in an attempt to cool inflation levels not seen in 40 years. However, the ongoing concern among Fed officials seems to be the economic costs of doing too little versus too much. ***While we share this concern, we believe the response lag[16] embedded into such unprecedented monetary policy moves may potentially trigger another policy mistake.***

Exhibit 21: Unemployment Rate



FactSet and NEPCG

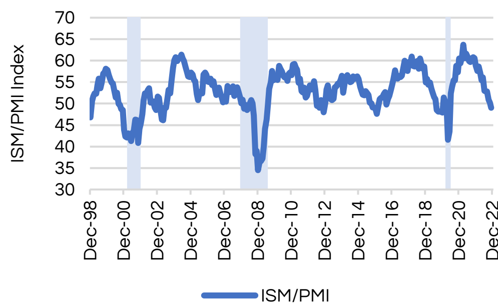
Exhibit 22: US Job Openings



FactSet and NEPCG

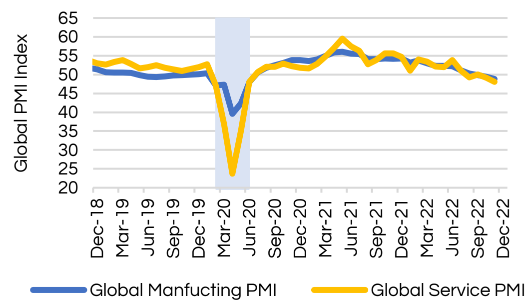
Exhibit 21 shows that the Unemployment Rate has bounced (inverted scale) from almost 15% to 3.5% as of December 2022. But now it appears to be rolling over.

Exhibit 23: ISM/PMI Manufacturing Index



FactSet and NEPCG

Exhibit 24: JP Morgan Global PMI



FactSet and NEPCG

In Exhibit 22, we illustrate that the overall level of job openings[17] have also rolled over from 11,855 in March of 2022 to 10,458 as of

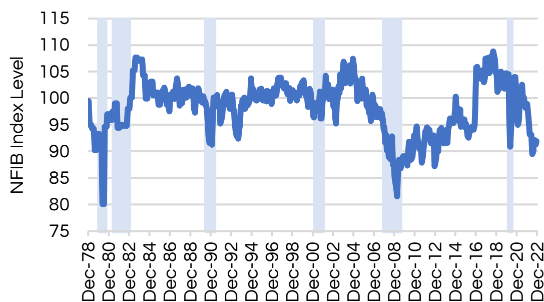
[16] Response lag, also known as impact lag, is the time it takes for monetary and fiscal policies, designed to smooth out the economic cycle or respond to an adverse economic event, to affect the economy once they have been implemented.

[17] The Job Openings and Labor Turnover Survey (JOLTS) tells us how many job openings there are each month, how many workers were hired, how many quit their job, how many were laid off, and how many experienced other separations (which includes worker deaths).

November 2022. At the same time, Quits have also moderated, from 4,449 in March 2022 to 4,173 in November 2022.

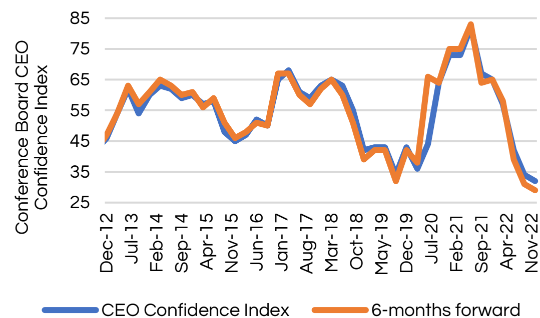
We have also witnessed manufacturing trends soften significantly both here and abroad. For example, Exhibit 23 illustrates data from the Institute for Supply Management's PMI[18] survey. Following a rapid recovery post the 2020 pandemic and resulting recession, November's reading printed below 50, which signals economic contractions. And Exhibit 24 illustrates a similar trend for global manufacturing and service PMIs with data provided by J.P. Morgan[19].

Exhibit 25: Small Business Optimism



FactSet and NEPCG

Exhibit 26: CEO Confidence



FactSet and NEPCG

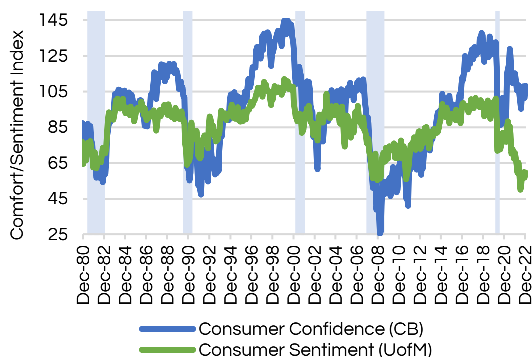
We have also witnessed more dire business optimism across small businesses and large corporations. Exhibit 25 illustrates that after an initial recovery in the National Federation of Independent Business, Small Business Optimism Index, it has since rolled over and retraced pandemic lows. The current state of affairs and expectation is equally as ominous among larger corporations. Exhibit 26 illustrates the trends in the Conference Board's CEO Confidence Index. Here, not only does the current environment point to a more sobering business backdrop, but 6-month forward expectations offer little optimism.

Next, we turn our focus to the consumer. Exhibit 27 compares the trends in the University of Michigan's Consumer Sentiment Survey and the Conference Board's Consumer Confidence Survey. The Consumer Confidence survey centers on questions emphasizing employment and labor market trends, while the Consumer Sentiment

[18]The ISM manufacturing index, also known as the purchasing managers' index (PMI), is a monthly indicator of U.S. economic activity based on a survey of purchasing managers at more than 300 manufacturing firms. It is considered to be a key indicator of the state of the U.S. economy.
[19] The JP Morgan Global composite Purchasing Managers' Index (PMI) is an indicator of economic health for manufacturing and service sectors. The purpose of the PMI is to provide information about current business conditions to company decision makers, analysts and purchasing managers.

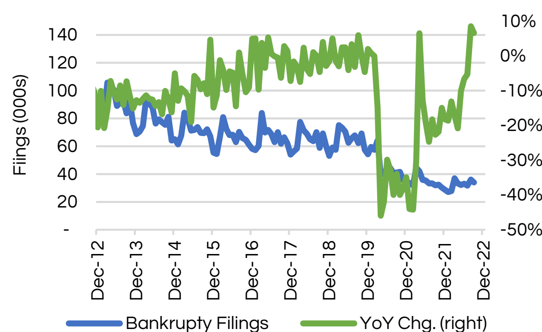
survey highlights individual household finances. This suggests that the Consumer Confidence survey generally reflects consumer expectations towards the overall economy, while Consumer Sentiment reflects expectations regarding their own personal circumstances. In our opinion, this is a distinction without a difference, as both trends are moving in the same direction.

Exhibit 27: Confidence & Sentiment



FactSet and NEPCG

Exhibit 28: Bankruptcy Filings



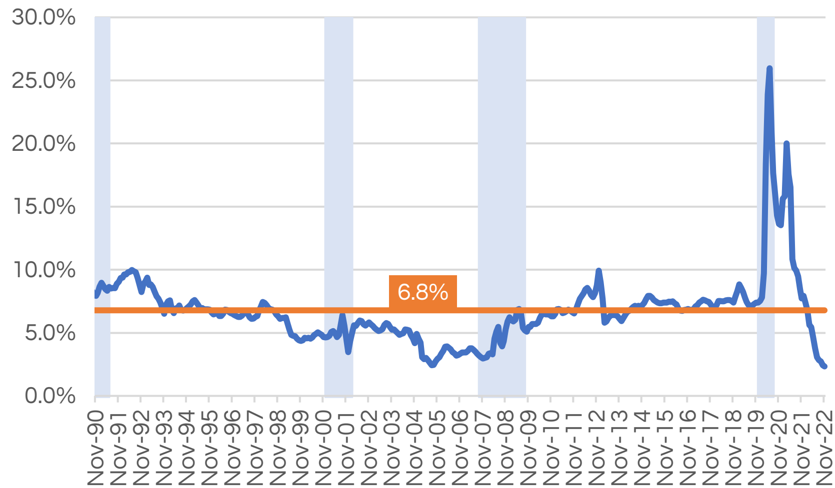
FactSet and NEPCG

And in Exhibit 28, we illustrate the recent trends in bankruptcy filings. While we witnessed positive trends leading into and just following the pandemic, starting in 1Q22, bankruptcies began to rise, increasing by as much as 9% year-over-year by August 2022. We believe tracking bankruptcies provides insight into corporate solvency and broader macroeconomic trends and is worth watching.

As we pointed out in previous reports, the consumer was both beneficiary and benefactor of the pandemic. But their ability to continue to support economic growth is now in question. Exhibit 29 illustrates recent trends in the US Domestic Savings Rate[20]. After reaching an all-time high of 26.0% in April 2020, the US Savings Rate has plummeted. As of November 2022, the US Savings Rate was 2.4%, a level last observed just before the Great Financial Crisis of 2008. As a result, with consumers exhausting much of their pandemic-related savings, it should be no surprise that retail sales have also begun to show cracks.

[20] The U.S. personal saving rate is personal saving as a percentage of disposable personal income. In other word, it's the percentage of people's incomes left after they pay taxes and spend money.

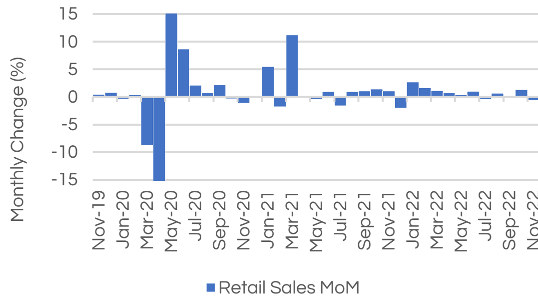
Exhibit 29: US Savings Rate



FactSet and NEPCG

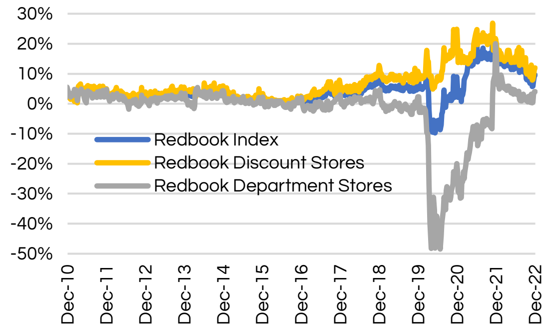
Exhibit 30 illustrates the recent trends in US Retail Sales, released monthly by the Commerce Department. Following relatively solid growth for much of 2022, retailers are now bracing for more cost-conscious spenders, despite the excess retail inventories. In November, the Commerce Department reported that retail sales fell by 0.6% after averaging about 1% per month over the previous two years. Further, according to data collected by MasterCard, while holiday shopping increased 7.6% year-over-year (YoY), the overall retail sales trend is sobering compared to previous years. Exhibit 31 illustrates data compiled by RedBook. Redbook Indices track sales-weighted, year-over-year same-store sales growth across a large sample of large US general merchandise retailers representing about 9,000 stores.

Exhibit 30: Retail Sales



FactSet and NEPCG

Exhibit 31: Redbook Retail Sales

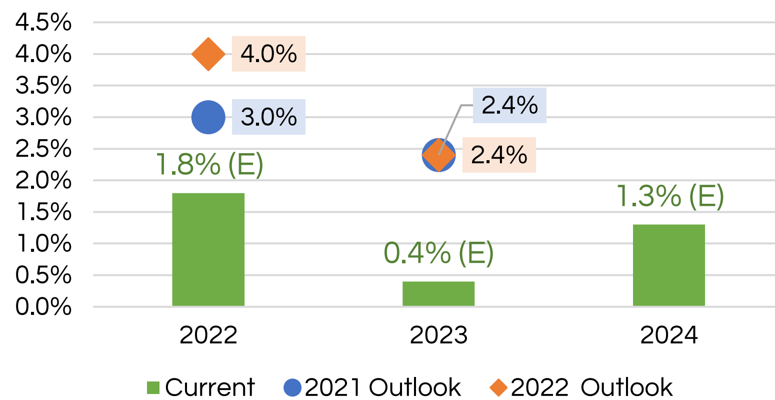


FactSet and NEPCG

Expect A Global Slowdown

Last year's Outlook noted how the unprecedented fiscal and monetary response to the COVID-19 pandemic significantly increased the FactSet[21] expectations for real GDP growth. However, fast forward 12 months and capital markets are now observing a reversal in growth prospects as consumer demand is waning and the Federal Reserve is steadfast in raising interest rates.

Exhibit 32: Consensus GDP Growth Expectations



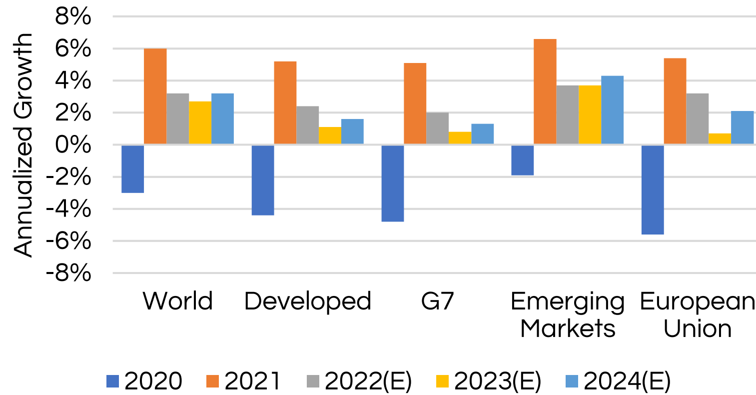
FactSet and FactSet consensus estimates as indicated by (E)

For example, in Exhibit 32, we illustrate that at the time of publishing our 2021 Outlook, the FactSet expectation for 2022 GDP growth was 3.0%. This estimate was subsequently increased by 33% to 4.0% by the time of publishing our 2022 Outlook last January. However, the

[21] FactSet Research Systems Inc., or FactSet, is a financial data and software company that provides integrated data and software solutions to investment professionals across the world. FactSet monitors economies, industries, and companies with FactSet's fully global economic data, accessing 1.9 million economic series with economic data readily available alongside in-depth company and market statistics enabling streamlined, centralized analysis and economic intelligence.

current FactSet consensus expectation for 2022 Real GDP growth is now 1.8%. We observe similar re-ratings for 2023 Real GDP growth. While there was no change to the consensus expectation for 2023 Real GDP growth of 2.4% when publishing our 2021 and 2022 reports, the current expectation for 2023 Real GDP growth is now only 0.4%.

Exhibit 33: Global GDP Growth Expectations



IMF estimates, as indicated by (E)

We notice similar re-ratings for Global GDP growth. Exhibit 33 illustrates that global economies expect lower sequential growth prospects through 2023.

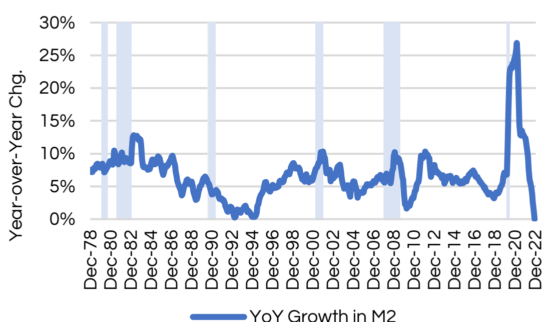
These data should provide additional evidence that global central banks' restrictive monetary policy initiatives are taking hold. However, in an attempt to not repeat the mistakes of the '80-'81 double-dip recession, we fear the FOMC here in the US will continue to raise rates and/or keep monetary policy too restrictive for too long.

Inflation, Interest Rate, And Recession Expectations

Everything Everywhere All at Once

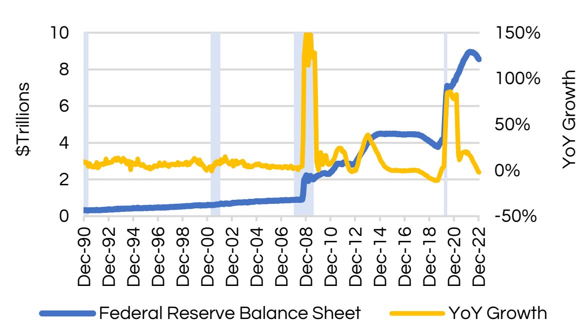
Following the pandemic, policymakers and central bankers worldwide took unprecedented steps to resuscitate a faltering global economy. Here in the US, the Federal Reserve continued along the path of Quantitative Easing[22], an atypical monetary policy intended to support market liquidity and lower borrowing costs. The overall monetary policy response resulted in an 80% increase in the Fed's balance sheet to almost $9 trillion, while M2 [23] grew by nearly 27%. As a result, consumers and businesses found themselves awash with liquidity, and thus, the seeds of inflation were sown.

Exhibit 34: M2 Growth



FactSet and NEPCG

Exhibit 35: Federal Reserve Balance Sheet



FactSet and NEPCG

In our opinion, the period between late 2021 and early 2022 could be characterized as a "perfect inflation storm," whereby cost-push and demand-pull forces were simultaneously working within the US economy. And at the time of publishing our 2022 Outlook, we suggested that the Federal Reserve Open Market Committee (FOMC) was on the verge of yet another policy mistake. We feared that any subsequent normalization of interest rates would be too dovish regarding timing and scale. And unless the FOMC moved with intent, the result would be soaring inflation, a challenging economic backdrop, and potentially negative capital market returns,

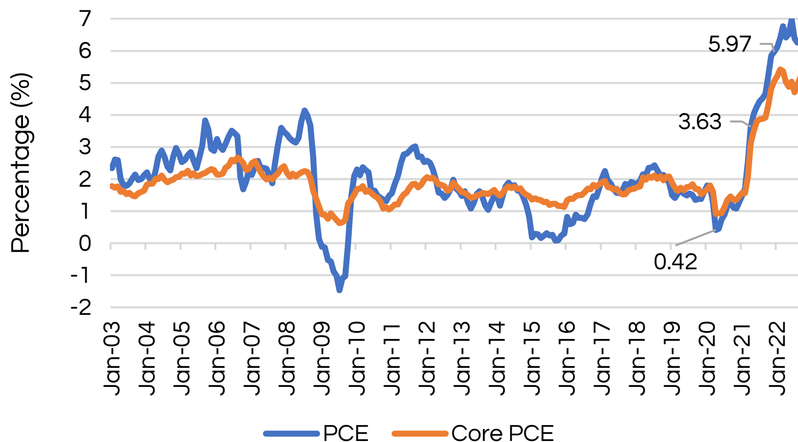
Exhibit 36 illustrates the year-over-year growth in Personal Consumption Expenditures (PCE), the preferred Federal Reserve

[2222] Quantitative easing (QE) is a form of monetary policy in which a central bank, like the U.S. Federal Reserve, purchases securities from the open market to reduce interest rates and increase the money supply.

[23] M2 is a measure of the money supply that includes cash, checking deposits, and other types of deposits that are readily convertible to cash such as CDs. M1 is an estimate of cash and checking account deposits only. The weekly M2 and M1 numbers are closely monitored as indicators of the overall money supply.

measure to gauge inflation. As the chart shows, inflation pressures in the US rose from 0.42% in April 2020 to 3.63% in April 2021 and finished 2021 at 5.97%.

Exhibit 36: Inflation Trends



FactSet and NEPCG

As a result, at their March 2022 meeting, the FOMC raised the overnight Fed Funds rate by 25bps with an upper range of 50bp (effective rate of ~33bps). However, inflation trends continued unabated. Therefore, at their May 2022 meeting, the FOMC raised the Fed Funds rate by another 50bps with an upper target range of 100bps, implying an effective rate of only 83bps.

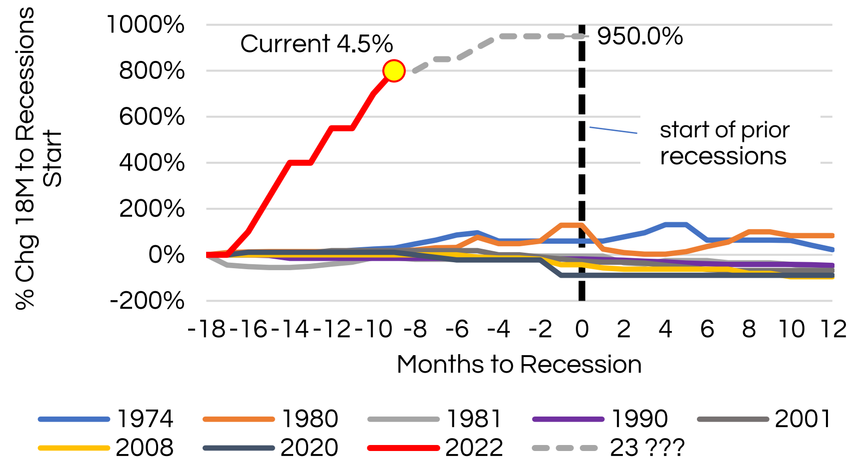
Still, PCE continued to trend aggressively higher. Consequently, the FOMC could no longer stand idly by as inflation reached levels last seen in the 1970s. At this point, the FOMC initiated a series of four successive 75bps rate hikes through November of 2022, with a final year-end December hike of 50bps, bringing the target rate to an upper bound of roughly 4.5% and an effective rate of 4.3%.

In retrospect, while our fears regarding a more dovish FOMC seem substantiated in early 2022, by mid-year, the Federal Reserve turned meaningfully more hawkish than many market participants, and we probably expected. Moreover, as we now know, these rate increases were the most aggressive in history.

In Exhibit 37, we illustrate the current rate hike cycle. For comparison, we also illustrate the last seven hiking cycles that ultimately ended with a recession. We established a baseline for our analysis dating back 18 months from the official start of each NBER-

acknowledged recession. Exhibit 37 also indicates the ***current*** upper target range for Fed Funds (4.5%). This data implies the FOMC has already increased rates by 800% ***since*** its first rate move in March 2022.

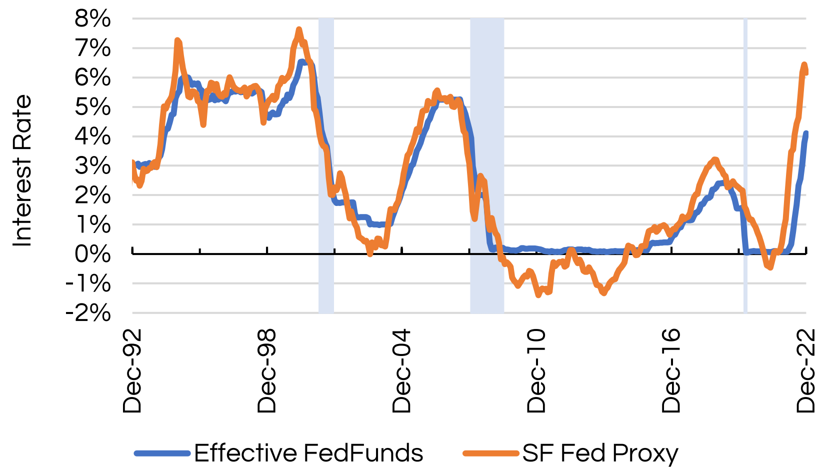
Exhibit 37: Rate Hike Comparison



FactSet and NEPCG

Further, Exhibit 38 compares the San Francisco Fed Proxy Rate to the effective Fed Funds rate dating back to 1992.

Exhibit 38: San Francisco Fed Rate Proxy



FactSet and NEPCG

The San Francisco Federal Reserve's Proxy Funds Rate can best be interpreted as the prevailing effective Federal Funds rate, void of any monetary or fiscal policy stimulus. In other words, this rate-proxy attempts to eliminate the impact that Quantitative Easing may have

had on the nominal Fed Funds rate. Exhibit 38 shows that the "true" Fed Fund rate may be as high as 6.2%, implying a monetary stance over 200bps more restrictive than the current nominal Fed Fund rate.

Taken together, we believe these analyses infer that the FOMC may have already tightened financial conditions enough to combat run-away inflation prospects. Further, we feel that much of the current cycle's tightening has already occurred. We believe the current market pricing and probabilities support this assumption.

Exhibit 39: Rate Hike Probabilities

		CME Market Expected Fed Fund Rate Levels @ Meeting Date										
	Meeting Date	3.75%	4.00%	4.25%	4.50%	4.75%	5.00%	5.25%	5.50%	5.75%	Wgt. Rate	Prob Hike
Probailbity	2/1/23	0.0%	0.0%	0.0%	0.0%	77.2%	22.8%	0.0%	0.0%	0.0%	4.81%	100%
	3/22/23	0.0%	0.0%	0.0%	0.0%	15.7%	66.2%	18.2%	0.0%	0.0%	5.01%	100%
	5/3/23	0.0%	0.0%	0.0%	0.0%	10.1%	48.1%	35.3%	6.5%	0.0%	5.10%	100%
	6/14/23	0.0%	0.0%	0.0%	0.0%	9.0%	43.9%	36.7%	9.7%	0.7%	5.12%	100%
	7/26/23	0.0%	0.0%	0.0%	2.2%	17.6%	42.1%	30.0%	7.5%	0.5%	5.06%	98%
	9/20/23	0.0%	0.0%	0.9%	8.2%	27.2%	37.4%	21.2%	4.8%	0.3%	4.96%	91%
	11/1/23	0.0%	0.4%	4.0%	16.3%	31.5%	30.5%	14.2%	2.9%	0.2%	4.84%	79%
	12/13/23	0.3%	3.7%	15.1%	30.1%	30.6%	15.8%	4.0%	0.4%	0.0%	4.48%	51%

CME and NEPCG as of 1/11/2023

In Exhibit 39, we replicate a probability matrix with data from the CME Group. The CME Group constructs and publishes its CME FedWatch Tool, which helps investors analyze and determine the future path of interest rates. Based on this data, we believe the effective terminal rate[24] for Fed Funds of roughly 5.12% will be reached sometime by mid-year 2023. Further, the data also suggests that following peak levels, market participants are actually pricing the potential cut in Fed Funds by approximately 50bps (0.5%) to 4.48% by year-end 2023.

Moving forward, we would not be surprised to see inflation fall more dramatically than the consensus expectations. In much the same way that the combined impact of demand-pull and cost-push factors turbocharged inflation to the upside, the compound removal of these forces could have the opposite impact.

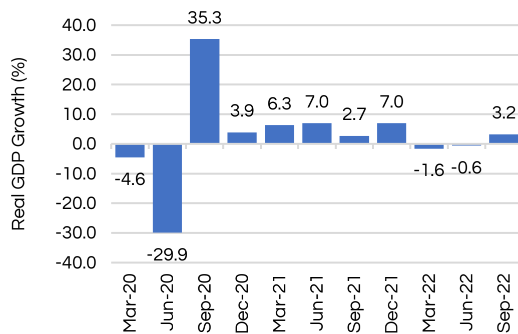
[24] The terminal rate is the rate that's equal to the neutral rate so that the economy is in stable equilibrium.

Recession Obsession

After reaching an all-time inter-day high of $4,819 on January 4, 2022, the S&P 500 began to incorporate a glut of negative headlines facing the global economy and capital markets. Among the headlines were the raging spread of the Omicron variant of COVID, an escalating war between Russia and Ukraine, surging oil prices, a 40-year high of US inflation, a generational slowdown in China's economic activity, and perhaps the unintentional consequences of a series of historical 75bps increases in the Fed Funds rate by the FOMC. Further, fears of a global economic slowdown were amplified following two consecutive quarters of negative Gross Domestic Product (GDP) growth here in the US. By many accounts, this is the technical definition of a recession. As a result, pundits, analysts, portfolio managers, and even corporate CEOs began earnestly to suggest that the US has already suffered a minor recession, or one should be expected sometime in 2023. And while we strive to be suspect of herd mentality, we find no shortage of recession evidence.

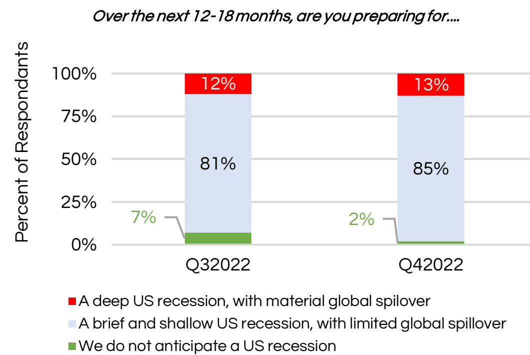
Exhibit 41 illustrates recent survey results published by the Conference Board concerning CEO recession expectations. As of Q3 2022, corporate CEOs assigned a 93% probability of recession in the US sometime within the next 12-18 months. However, following the most recent survey, CEOs increased that probability to 98%. While the percentage of respondents expecting a severe recession did not materially change, those CEOs that once believed there would be no recession now feel that a shallow recession is ahead.

Exhibit 40: Historical Real GDP Growth



NEPCG and FactSet

Exhibit 41: CEO Recession Expectations



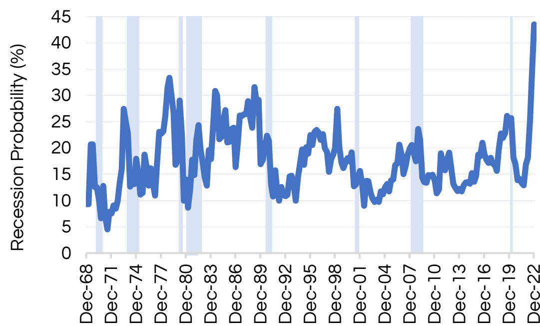
The Conference Board and NEPCG

However, the National Bureau of Economic Research (NBER) is the official arbiter in determining if the US is in a recession. To do this, the

NBER analyzes several key economic indicators and trends, not just GDP. Most significant, we believe, are labor market data and the overall level of US aggregate demand, both of which remained somewhat resilient, albeit volatile, through year's end 2022.

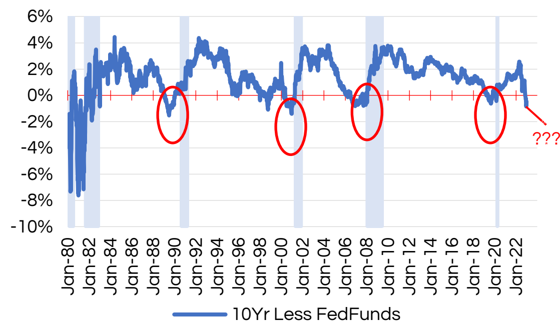
As we follow the evidence below, we believe there is an increasing likelihood that the US may experience a recession, in some form, within the next 12-18 months.

Exhibit 42: Recession Probability



FactSet, Philadelphia Federal Reserve, and NEPCG

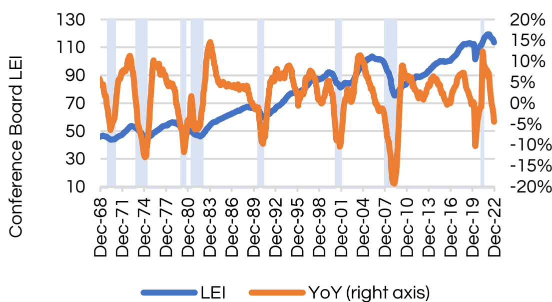
Exhibit 43: 10Yr / Fed Funds Spread



FactSet and NEPCG

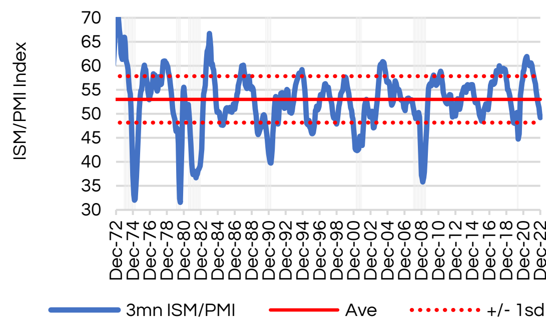
Firstly, in Exhibit 42, we illustrate data accumulated by the Philadelphia Federal Reserve, which surveys several professional forecasters for various economic and capital market expectations, including recession probability. As the chart indicates, data provided by the Philadelphia Federal Reserve Bank has increased to over 40%. In addition, as illustrated in Exhibit 43, when we plot the historical spread between the 10yr Treasury and the nominal Fed Funds rate, we observe that the US enters into a recession within 12-18 months.

Exhibit 44: Leading Economic Indicators



FactSet and NEPCG

Exhibit 45: ISM Recession Indicator



FactSet and NEPCG

Next, Exhibit 44 illustrates recent trends in the Conference Board's Leading Economic Indicators[25]. When we focus on the year-over-year trends, we found when the YoY trend moved markedly negative, the US entered a recession. Further, additional data we are watching is the Institute for Supply Management's Purchasing Manager's Index. Here, we observe that the US enters a recession whenever the 3-month average PMI level falls below its one standard deviation.

Two Scoops…

If a recession, in some form, were to occur within the next 12 months, it would be the third double-dip recession[26] experienced in the US in the last 100 years. The first was the 1937-1938 double dip following the recession of 1929, and the second occurred between July 1981 and November 1982, after the January 1980 recession.

Following the Great Depression (1933), US unemployment fell from roughly 25% to 14% by 1937, while at the same time, the overall economy grew by approximately 9% per year[27]. And much like today, the Federal Reserve and then US President Roosevelt were very concerned by the potential for run-away inflation caused partly by deficit spending. While tools were different back then, a more restrictive monetary/fiscal backdrop was achieved by ceasing the WWI Veterans' Bonus in 1936 and doubling the reserve requirements of banks by the Federal Reserve in 1937. Further, to combat fiscal deficits, the US instituted the Social Security payroll tax in 1937. As a result, higher taxes, crimped credit, and reduced government spending were enough to derail the recovery following the Great Depression. Collectively, these actions thrust the US into a double-dip recession lasting from May 1937 until June 1938. During this period, unemployment increased to 19%, and GDP fell by 4.5%.

The double-dip recession of 1981 was triggered by similar circumstances to the 1930s, requiring tight monetary policy to stave

[25] The Composite Index of Leading Indicators, otherwise known as the Leading Economic Index (LEI), is an index published monthly by The Conference Board. It is used to predict the direction of global economic movements in future months. The index is composed of 10 economic components whose changes tend to precede changes in the overall economy. Businesses and investors can use the index to help plan their activities around the expected performance of the economy and protect themselves from economic downturns.

[26] A double-dip recession refers to a recession followed by a short-lived recovery, followed by another recession. For whatever reason, after the initial recession has passed, the recovery stalls and the second round of recession sets in just as, or even before, the economy has fully recovered from the losses of the initial recession. One good indicator of a double-dip recession is when gross domestic product (GDP) growth slides back to negative after a few quarters of positive growth. A double-dip recession is also known as a W-shaped recovery.

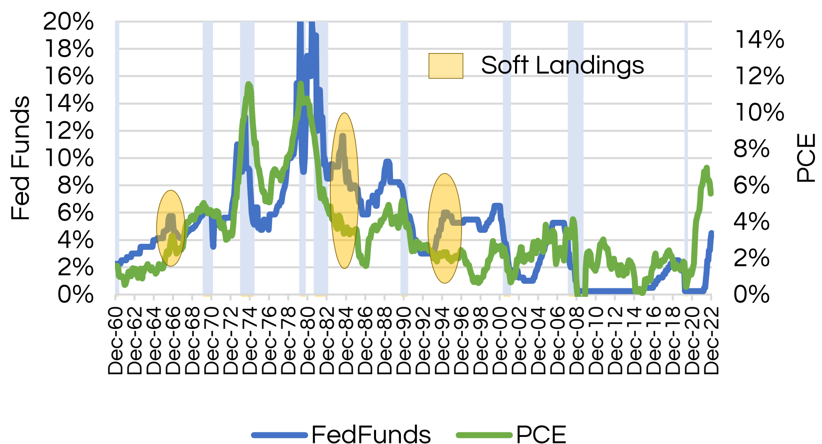
[27] See Double-Dip Recession: Pervious Experience and Current Prospects

off spiraling inflation following a brief period of economic recovery. However, in a perhaps more similar fashion to the current environment, then Fed Chairman, Paul Volker[28], believed that the Federal Reserve suffered from a credibility problem in keeping inflation constrained and sided with monetarists[29]like Milton Freidman. As such, the main focus of monetary action was to reduce the money supply. ***And herein is the historical context that we believe the current Federal Reserve Chairman, Jerome Powell, is taking his cues, as he and other FOMC members are torn between the risks of doing too little versus too much.***

...Or Soft Serve?

However, history shows us several instances in which a "technical recession" does not necessarily overlap with an official, NBER-defined recession. One reason this could occur is that the Federal Reserve acts swiftly, with foresight, to raise interest rates enough to retard growth, restrain inflation and avert a recession.

Exhibit 46: Soft Landings



FactSet, Alger and NEPCG

Given the evidence we have presented up to this point in our 2023 Outlook, we believe there is a chance the FOMC could navigate a soft landing. However, as we illustrate in Exhibit 46, a soft landing has occurred only about 30% of the time, dating back through post-WWII. In addition, it is our opinion that the FOMC continues to suffer from a

[28] See Recession of 1981–82 | Federal Reserve History

[29] Monetarism is a macroeconomic theory which states that governments can foster economic stability by targeting the growth rate of the money supply. Essentially, it is a set of views based on the belief that the total amount of money in an economy is the primary determinant of economic growth

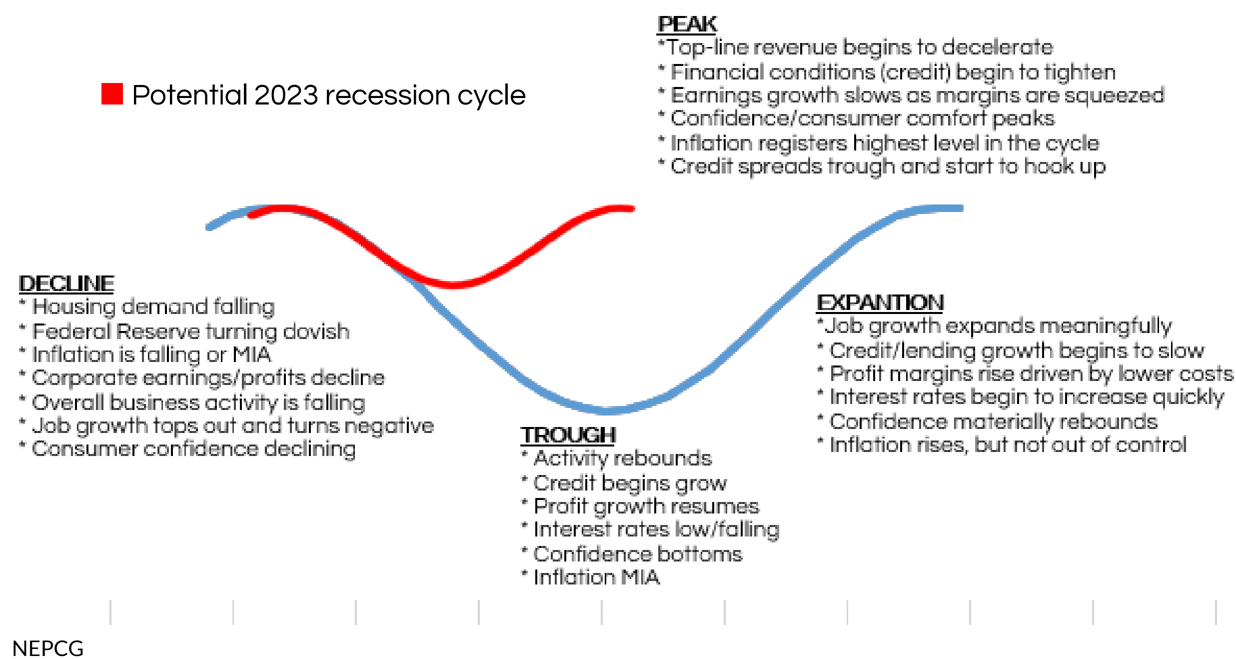
credibility problem, which may compel voting members to continue along a path of aggressive tightening, regardless of the data backdrop or potential near-term harm to the US economy. ***As a result, we believe the FOMC may be on the verge of yet another policy mistake by keeping monetary policy too restrictive for too long.***

2023 Positioning

Soft Landing Versus Hard Landing

In our 2022 Outlook, we suggested the US economy was operating roughly halfway to its peak. However, the exact location on the economic life-cycle curve was unknown, given the idiosyncratic nature of a global pandemic, the resulting supply/demand imbalances, and the unprecedented fiscal and monetary response from international central bankers.

Exhibit 47: Typical Economic Life Cycle



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As we look into 2023, our expectations are clouded by just how "hard" or "soft" the US economy touches down. To this point, we have made the case that a recession in the US is inevitable. We have also suggested that the hawkish nature of recent rate increases provides the opportunity for a soft landing. However, we believe, like in most instances, the Federal Reserve will become its own worst enemy. And unless there is clear and indisputable evidence to the contrary, the

FOMC will raise the Fed Funds rate at least another 75-100bps and likely leave rates elevated for as long as the market can bear.

Still, we believe the US economy is in a strong position relative to prior tightening cycles and/or pre-recession periods. As such, if a "soft landing" is not achievable, we believe the next recession will be shallow and short compared to the typical peak-to-trough duration, which averaged about 11 months(post WWII). Therefore, if a recession were to manifest itself within the next 12 months, we believe the duration could be as little as 6-9 months. The implications for capital market positioning are further discussed in the following sections.

Interest Rate Regimes

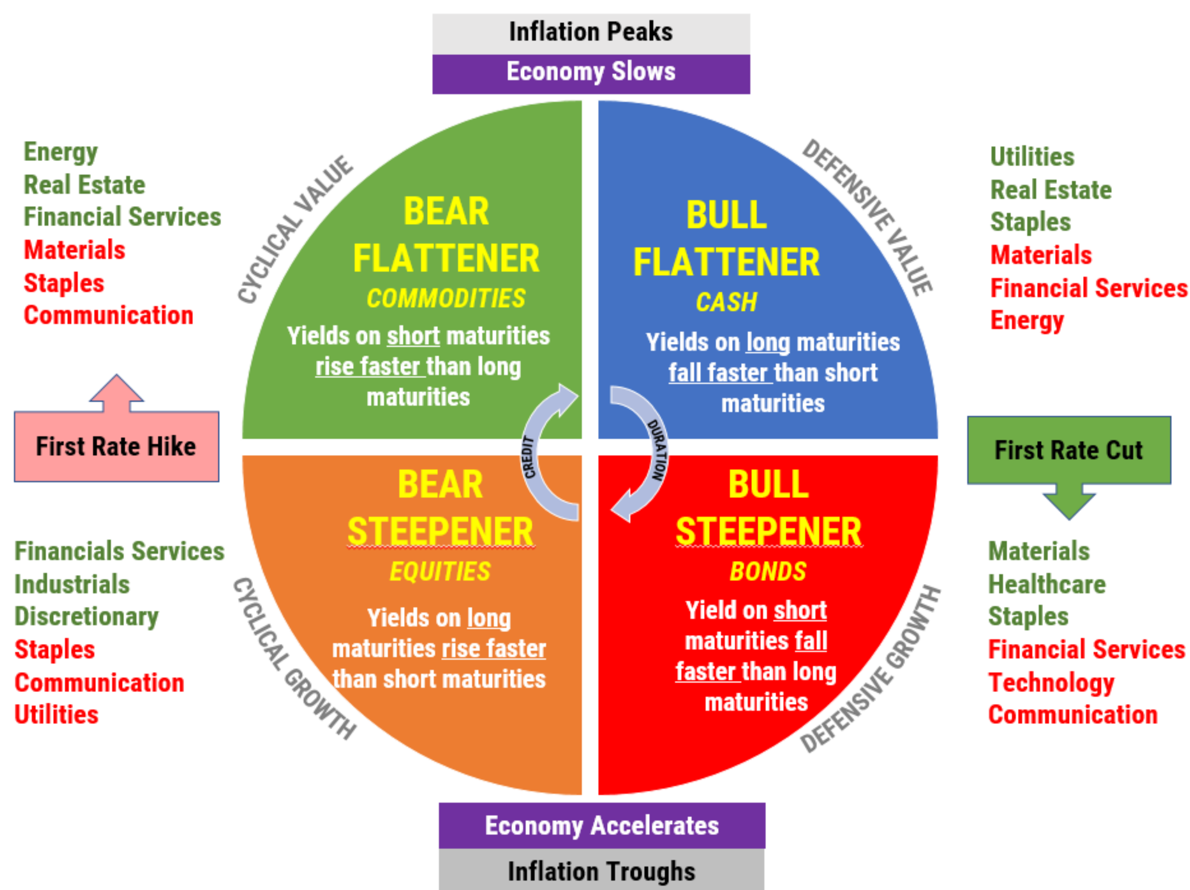
Our readers continue to hear us say, "bonds see around corners." While equity analysts would indeed find an exception to this, we believe fixed-income managers typically need to better understand and react to credit concerns and considerations to help protect bond investors against default. But understanding Credit also helps in positioning equity portfolios.

In our 2020 Outlook entitled, "What Goes Up," we introduced our **Interest Rate Regime** paradigm, which we review herein. In our opinion, by understanding historical relationships between bond prices and yields, aka the yield curve [30], we can help better understand economic and capital market trends. But first, we need to review each of the four interest rate regimes; Bull Flattener, Bull Steepener, Bear Steepener, and Bear Flattener.

In a **Bull Flattener** (blue-shaded area), yields on long-maturity bonds fall faster (price increases quicker) than yields on shorter-maturity bonds (prices increase slower). This historically happens after inflation peaks and the economy begins to slow. At the same time, central banks become more dovish[31], ultimately leading to the cycle's first-rate cut.

[30] A yield curve is a line that plots yields (interest rates) of bonds having equal credit quality but differing maturity dates. The slope of the yield curve gives an idea of future interest rate changes and economic activity.
[31] A dove is an economic policy position that promotes monetary policies that usually involve low interest rates, which may promote inflation.

Exhibit 48: Interest Rate Regimes and Preferred Sector Positions



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During these periods, we find that defensive-oriented equities tend to perform well, led by Utilities, Staples, and Real Estate (later in the cycle). While underperforming sectors typically include Materials, Financial Services, and the Energy complex (removing any idiosyncratic occurrence like a war in Ukraine, or China coming back online). Also, during this interest rate regime, we find that duration[32] may begin to outperform Credit, meaning that credit spreads start to widen as the economy begins to cool. In other words, investors may opt to invest in the full-faith and guarantee of US government bonds (or cash) over corporate bonds, increasing their yields and thus lowering corporate bond values.

[32] The duration of a bond is the weighted-average period of time before the cash flows involved are received. We use the term "Duration" to describe U.S. Government bonds with like maturities to that of Corporate bonds. Being that Governments typically have yields lower than Corporates, we suggest that their duration is longer, hence posing greater interest rate risk.

In a **Bull Steepener** (red-shaded area), yields on short-maturity bonds fall faster (prices increase quicker) than yields on long-maturity bonds (prices increase slower). This historically happens as the economy moves toward recession with a bottoming in economic activity and inflation prospects. During this interest rate regime, central banks may be in full rate-cutting mode, resulting in a preference for risk-free[33] duration (government bonds over corporates or high yield), with the Materials, Healthcare, and Staple sectors historically outperforming. On the downside, we typically observe Financial Services, Technology, and the Communication sector lag the overall market.

In a **Bear Steepener** regime (orange shaded area), yields on long-maturity bonds rise faster (price falls quicker) than yields on short maturity (prices fall slower). At the beginning of this regime, the economy emerges from an economic trough, and inflation may begin to drive growth, ultimately moving toward the first rate hike of the cycle. During this period, cyclically-oriented growth sectors, including Financial Services, Industrials, and Consumer Discretionary stocks, historically tend to outperform the overall market. On the downside, underperforming sectors typically include Staples, Communication Services, and Utilities. In addition, lower-credit quality fixed-income investments usually begin to recover and outperform government and other relatively low-risk bonds.

A **Bear Flattener** Regime (the green-shaded area) historically begins with the first-rate hike of the cycle. It is characterized by yields on short-maturity bonds rising faster (prices falling quicker) than long-maturity bonds (prices falling slower). During this regime, inflation may accelerate, and the economy typically peaks. Especially toward the latter stages, cyclical-value-oriented sectors and stocks may outperform. We observe that Energy, Real Estate, and Financial sector have historically done well, while the Materials, Staples, and the Communication Services sectors have lagged behind the overall market.

[33] The term "risk-free rate" is an accepted axiom in finance describing the 10yr bond, or other "guaranteed" security backed by the full-faith of the U.S. If you buy a US bill, bond or note, you will get 100% of your principal back, so there is no principal risk. The "risk-free rate" is the basis of several financial theories but is theoretical.

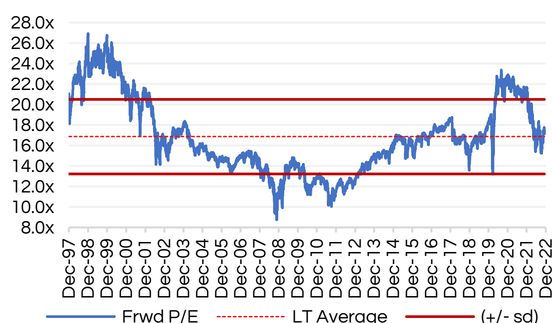
Our "Not-So-Great" 2023 Expectations

In our 2022 Mid-Year Update webinar entitled "Keep Calm and Carry On" (published in May 2022), we lowered our 2022 S&P 500 expectation to the 4,350-4,500 range. As a reminder, our forward valuation expectation for the S&P 500 is driven by our earnings-yield framework in combination with our P/E construct

When publishing our 2022 Mid-Year Update, we were still optimistic that the FOMC could navigate a "soft landing" for the economy without aggressively increasing rates. Accordingly, our expectations were for the 10yr TSY of roughly 3.25% and a historical earnings yield spread of 2.84%, implying an earnings yield of approximately 6.10%. This implies a forward P/E ratio of approximately 16.5x (reciprocal of 6.10%). We also assumed forward 12-month S&P earnings of $265 per share.

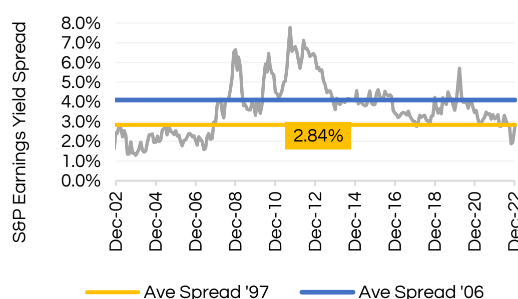
However, by year's end, the 10yr TSY had moved to 3.88%, or roughly 60bps higher than our original expectation. In addition, the consensus expectation for S&P earnings dropped by 13% to approximately $230. The higher-than-expected 10yr TSY alone accounted for almost 370 S&P points to our forecast range, equating to a presumed S&P 500 price-only level of $3,926, compared to the 12/30/22 close of $3,939.

Exhibit 49: S&P 500 P/E Multiple



FactSet and NEPCG

Exhibit 50: Earnings Yield Spread



FactSet and NEPCG

(a) Earning yield = 1/(S&P Multiple less 10Yr Note yield)

As of 12/30/2022, the 12-month forward consensus estimate[34] for the S&P 500 was $230, or roughly 4% greater than expected in

[34] Source: FactSet estimates as of 12/30/2021

December of 2021. This annualized growth rate compares to the long-term average of about 7.6%.

Given the market uncertainty driven by increasing geopolitical risk, the unclear path of future rate increases, the negative impact from quantitative tightening, and the potential for a recession during 2023, we are currently assuming S&P earnings over the next 12 months, in line with the consensus.

However, as we move through and potentially past a recession backdrop in 2023, we believe the equity market will begin to discount FY 2024 S&P earnings, which are currently expected to be close to $250 per share. As a result, following the potential for additional near-term equity volatility, we believe modeling S&P 500 EPS between $240-$250 is not an unreasonable expectation. Further, we believe the FOMC may actually begin to cut the Fed Funds rate in late 2023, after pausing come late Spring '23 into early Summer '23. As a result, we feel the 10yr TSY base rate from which we start building our earnings yield construct could average between 3.0% and 3.25% over the next 12-18 months.

Under these assumptions, our earnings yield model implies a 12-month price-to-earnings multiple of approximately 17x. If we assume equity investors begin to "discount" a potential Fed pause/cut, alongside a more relatively shallow earnings recession, we expect a price-only expectation for the S&P 500 in the $4,100 to $4,200 range by year's end of 2023. These assumptions imply a roughly a 9% price increase for the S&P 500 and a 1.75% dividend yield, which may produce a 10.0%-11.0% total return from January 3, 2023, price levels.

Further, we remain skeptical about perpetuating the "buy-the-dip" mentality for "any and all" sell-offs until the FOMC has signaled, once and for all, a pause. We continue to suggest a disciplined approach focused on quality companies, balance sheet strength, and discrete buying opportunities across capital market allocations, styles, and equity sectors

Therefore, we believe Defensive Value-oriented stocks may continue to outperform through late Spring '23, given the overwhelming political, economic, and geopolitical uncertainty. Depending on the depth and length of any potential US recession in '23, Technology may take on more "defensive value" characteristics, especially given 2022 returns.

From a fixed-income perspective, with a significant backup in real yields behind us and the potential for the FOMC to pause and potentially cut short-term rates in late '23, bonds currently offer attractive total-return prospects. Moreover, we believe any recession will not lead to an increase in corporate defaults. Corporate balance sheets are in a stronger position than prior recessions, as many companies have already termed out maturing debt at lower interest rates. Hence, we feel that fixed-income investors should consider longer-duration bonds with solid credit ratings alongside Preferred Equities. In addition, as we strongly feel inflation concerns are behind us, investors exposed to short-term Treasuries and TIPS should consider rotating away from these limited-duration positions. Even High-Yield Corporate bonds potentially offer attractive total returns, assuming a recession is avoided (soft-landing) and/or the duration of any recession is shallow and short.

Thank you for reading our 2023 Outlook. We'd love to hear your thoughts.

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