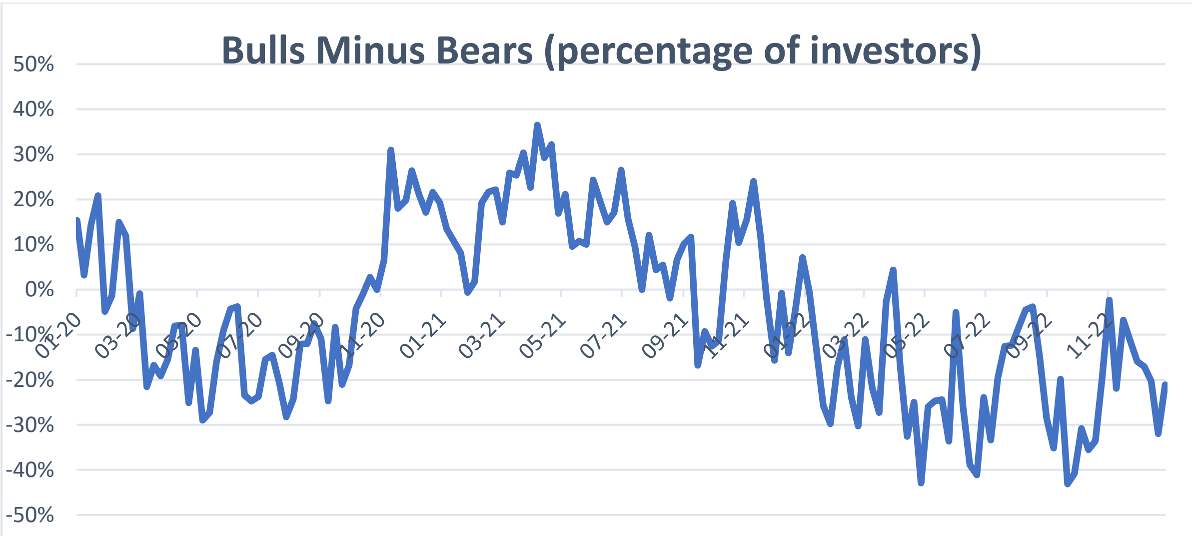
COGENT INVESTMENT ADVISORS

Outlook 2023

“Sour Mood on Wall Street”

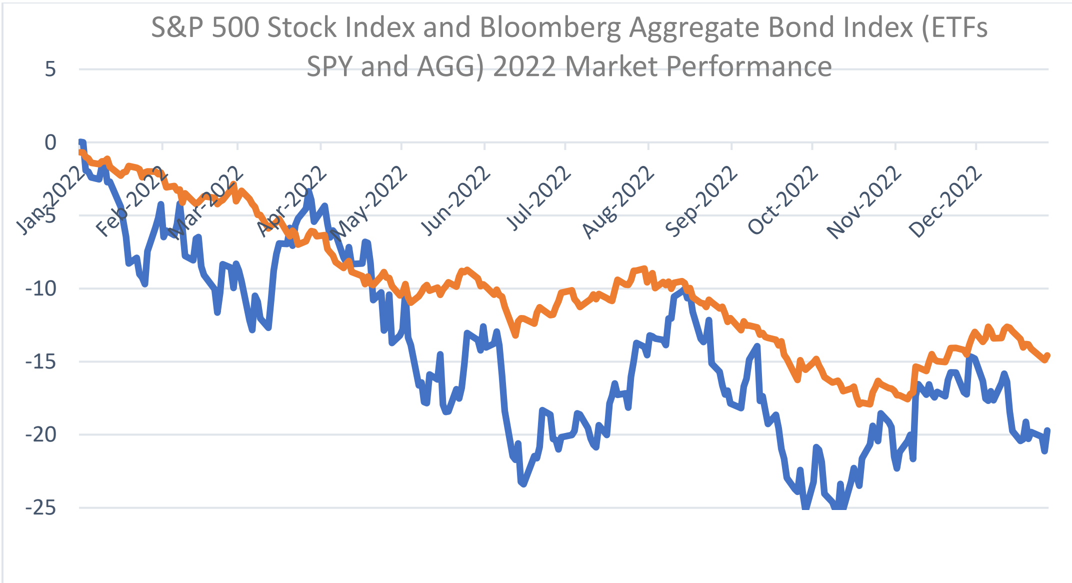


Source: AAII.com

- About a year ago, FOMC members including Chairman Jerome Powell thought that the Fed Funds rate would finish 2022 at 0.25%. Instead, it finished near 4.50%.
- Admitting a policy error (in their original thinking that inflation would be transitory), the Fed raised rates 7 times in 2022:1 small hike (0.25%), 2 larges hikes (0.50%), and 4 “super-sized” hikes (0.75%) for a total of 4.25% of interest rate hikes. Additionally, the Fed has been executing “quantitative tightening” for most of the past year – a program aimed at reducing the supply of dollars in the economy. Their two-pronged tightening campaign has been aggressive, and has and will continue to slow the economy markedly though I still believe that a mild recession or no recession in 2023 is most likely.
- An aggressive Fed-lead inflation fighting program was clearly needed, and waning inflation should ultimately encourage sidelined investors to reenter still dicey stock and bond markets. Very little new money has been entering risk markets (stocks and bonds) recently; on the other hand, bank deposits, CD, and money market funds have seen inflows - but that could change in 2023 as the valuation reset in stocks, bonds, real estate, and other assets is delivering a better starting point to the year relative to 2022.
- Alongside the work done-to-date, FOMC members continue to talk tough, telegraphing further rate hikes and promising no interest rate cuts for years. But since early 2022, unanimously sticking to an uber-hawkish script has proven effective for the Fed by keeping a lid on asset prices like stocks, and keeping the front end of the interest rate curve elevated, which has helped to slow down interest

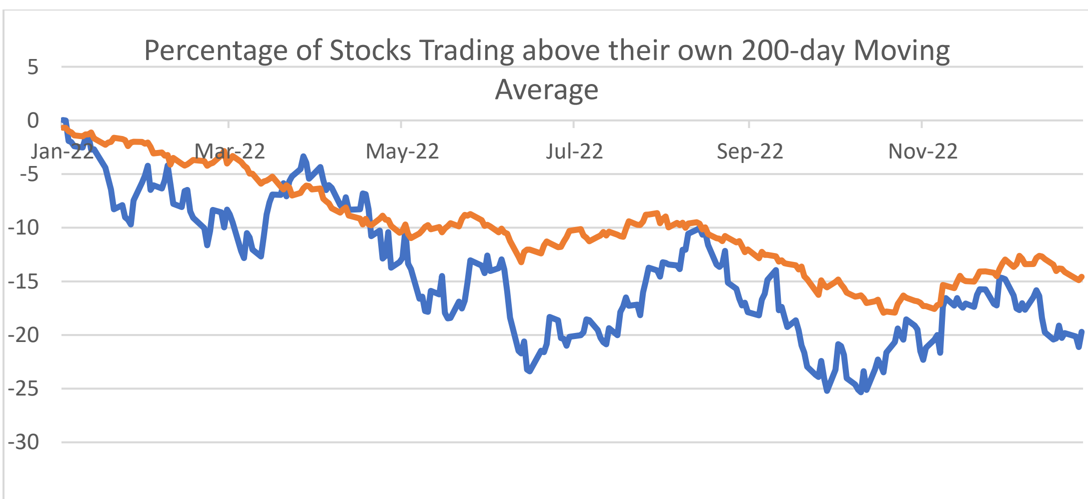
sensitive spending on real estate, durables, and corporate capex, and slowed down hiring (and encouraged layoffs) in the labor market.

- The Fed will keep talking tough for as long as they can, but they now probably largely believe that inflation has peaked and the economy is slowing. So, they may be able to stick to their hawkish message for a few more months, but once net job gains turn negative, they will be forced to admit the job is done and that a recession is the bigger risk than inflation. In my opinion they may be able to raise rates by another 0.75% at most, and more likely by either 0.50% or even just 0.25%. We shouldn't forget that election cycle will heat up in 2023 and that Jay Powell has gotten an earful *already* (and a letter) from some in the Senate.
- As for inflation, the CPI peaked in June of 2022 and is likely to return to a more normal rate of about +3.0% per year by the middle 2023. In practical terms, this means that a combination of normalizing supply chains, softer energy prices, and the Fed's tightening campaign have tamed (for now) CPI inflation that was nearing a 10% annualized growth rate in the middle of last year.
- Alongside the Fed, the ECB, the BOE, and some Asian central banks have been raising rates and proposing quantitative tightening. Coordinated global tightening by Central Banks ("CBs") is not unprecedented, but is relatively rare during a slow growth environment as is the case today. Only China, among major economies, seems to be easing policy by backing away from "Zero COVID" and lowering borrowing rates. Of course, tightening CBs are more concerned about inflation relative to growth right now and may be willing to live with negative global GDP growth in order to tame inflation before it becomes entrenched in economic expectations.
- As I said in my mid-year outlook and above, I believe either a mild recession or no recession is in the cards for the U.S. this year as I expect the labor market to remain reasonably strong and services spending to hold up reasonably well. Don't forget also that the social security COLA adjustment will be huge in 2023, putting dollars into the economy. Additionally, legislation passed over the past several years encourages onshoring of manufacturing capacity.
- 2022 was a bear market year for both stocks and bonds – one of the worst combined "60/40" portfolio "drawdowns" ever. The good news is that stock market valuations have come down to near their long-term average here in the U.S. and are below their long-term average internationally. Also, after relatively high inflation of the past several years, stocks have lost significant ground in real terms. Yet, over time, stocks should prove to be a decent inflation hedge.
- Unfortunately, U.S. stock market breadth remains poor: for example, the percentage of industry groups within the market that are in medium or long-term upwardly sloping price trends remains weak/low. Also, the S&P 500 continues to trade below its 200-day moving average, and that moving average itself is sloping-down. And volatility remains elevated, with the percentage of trading days with big moves of plus or minus 1% at a very high level, suggesting that investors are unwilling to hold stocks for more than short-term stretches.



Source: Yahoo Finance

- That said, breadth has improved relative to the June 2022 lows and some technical indicators are starting to improve. A good technical sign for the bulls would be if the [100-day moving average could cross above the 200-day moving average].



Source: Yardeni Research

- Under the surface of the market, some major shifts have been occurring. For example, value stocks significantly outperformed growth stocks last year, and international stocks had a decent year relative to domestic stocks. Small cap stocks began to exhibit better relative strength versus mega-cap stocks. “Hard assets” like oil and materials companies outperformed “soft-assets” companies like software. The spread between energy and commodity sector gains and, say technology company losses was huge, for example. These trends are likely to continue in 2023 but I would not be surprised to see a counter-trend move in the first quarter as tax-loss selling is done for now in growthier names.

- Breadth and trend have improved for markets outside the U.S., however. And these markets are cheaper as well. On pullbacks in, say, SPY (U.S. stock market ETF) relative to EFA (international stock market ETF), investors should consider adding some EFA.
- Commodities were a relative winner in 2022 and while it's unlikely that we have entered another commodity "super cycle" where prices "go to the moon", the outlook for commodities remains pretty good given years of underinvestment in hard assets in favor of software and tech investments. Additionally, commodities can offer good portfolio diversification as we saw in 2022.