Financial Markets Perspective
January 2023

Looking Back, Looking Ahead

It's time again for us to review our forecasts from last year and attempt to make predictions for the next twelve months. Below is a review of the predictions we made in January 2022 which had mixed outcomes due to the continued negative impacts of Covid on the global economy, Russia's ruthless invasion of the Ukraine and interest rate hikes by the Federal Reserve in the U.S.

The U.S. economy likely will have grown at an above-average rate for the fourth quarter of last year. We expect growth to slow to an average of somewhere between 3-5% for the year on the back of receding Covid-related concerns and declining pent-up demand and supply concerns. Foreign economies will likely grow on average by more than 4% with individual countries showing different growth levels.

We were correct in forecasting a strong fourth quarter of 2021, but the economy subsequently experienced two quarters of negative growth in the first half of 2022. The third quarter saw growth of more than 3% and Atlanta Fed's GDPNow report is showing a fourth quarter gain of more than 4%. European economies grew for three quarters last year on the back of a rebound in tourism. On the other hand, growth in China disappointed because of continued lockdowns resulting in forecasts of 2.7% for full-year 2022 -- down sharply from a high of nearly 8% in 2021.

Fiscal policy could tighten under the administration's desire to tax large corporations and "wealthy" individuals. The Build Back Better plan is on the back burner for now and further fiscal stimulus is unlikely unless another variant surfaces that threatens economic growth.

Fiscal policy turned out to be a mixed bag last year. Higher tax collections, especially from 2021's capital gains, produced a surge in both federal and state revenues. Through the fiscal year ending September 2022, the federal government collected $1 trillion more in taxes than the previous year. State and local governments were also flush with tax monies and many states decided to reduce tax rates or give tax rebates to its citizens. Another big fiscal surprise was a huge stimulus package as the year ended with a $1.7 billion omnibus spending bill that could be seen as a counterpunch to the tight monetary policy of the Federal Reserve.

Monetary policy will likely tighten as interest rates could be raised by up to 50 basis points to yield 1.75-2.00% for the 10-Year Treasury. As a reminder, this rate was 2.71% on January 14, 2019. The Fed could also reduce its balance sheet by suspending the purchase of mortgage-backed securities.

As a result of the surge in inflation, the Fed initially took a wait-and-see approach. However, as inflation data continued to rise, the Fed radically changed policy and accelerated tight monetary policy by raising interest rates seven times during 2022, leaving the target range at 4.25% to 4.50% by year-end. This move was a profound change in policy and appeared to be a key factor in sending both bond and stock markets lower in 2022.

Inflation will likely be higher than expected a year ago due mainly to the political pressure to reduce domestic production of oil and gas and the continued spike in prices. Logjams at major seaports will gradually recede and consumers will slow their buying frenzy once they realize that there are plenty of goods to go around. We expect inflation to start out high and end lower by yearend. Average inflation for the year should be around 3-4%.

There is a big difference between direction and magnitude. We were right on with spiking prices as evidenced by a peak in oil prices over $123 in the first half of the year and a similar surge in natural gas prices to $9.68 per million British thermal units. By year's end, the global supply chain logjams receded, consumers slowed their buying behavior and headline inflation finished out the year at 6.4%, down from a high of 9% in September.

Corporate profits will continue to rise, albeit at a slower pace, and the overall stock market should benefit even though we have had three good years where equity returns were in the high double-digits. This year could produce a similar experience but with low double-digit returns as company profits could be squeezed by higher wage costs, interest rates and, potentially, taxes. Yet, companies could continue along the path of buying back stock and increasing dividends that should contribute to higher equity prices.

Despite being squeezed by higher wage costs, continued supply-chain disruptions and rising interest rates, corporations in the United States made profits of nearly three trillion dollars in the third quarter last year. These results represent a slight decrease compared to the record-breaking second quarter of 2022. We have just entered earnings season for the fourth quarter of last year…Stay Tuned!

We concluded the review by saying: *"We see consumers with high levels of wealth due to a strong stock market and increased real estate values, a corporate sector that is flush with cash, and a world that is generally at peace (give or take a few outliers). And despite the Omicron variant, the outlook for the economy and financial markets is generally positive."*

So, even though some of our prognostications were on target, the two variables that were not in our forecast were a major change in Fed policy and a war in Ukraine. The Fed's change in policy really upset the apple cart and led to major declines in global markets. The only place to hide was in the energy sector, a sector that has seen its share of volatility in both 2016 and 2020 when collapsing oil prices encouraged forecasts of a financial market meltdown.

Where do we go from here? As is the case of the Ukraine war, there are numerous minefields to watch out for among financial markets in 2023. Tight money does more than slow the economy, tight money also tends to unravel speculation. Years of record low interest rates encouraged investors and speculators alike to borrow and invest in investments of all sorts – especially risky ones. Cyber assets became the tulip bulbs of the twenty-first century. By the way, at least you could touch and smell a tulip bulb! Many COVID-related companies faded away as the temporary demand for their products and services lost demand or were already implemented. However, the pandemic did change the way many of us live and work which will likely be a more permanent fixture in our society going forward.

With that review, here are our broad predictions for 2023:

There will not be a recession in 2023. The fundamentals of the underlying economy are too strong to fall into a traditional recession forecasting trap. Unemployment declined in December to 3.5%, job openings are estimated in the tens of millions and minimum wages have surged. As a result, there will likely be continued demand for at least basic provisions, i.e., food!

A newly elected Congress will be antagonistic as each party has a very different agenda. The outlook is likely to be continued gridlock with few major policy decisions to be made over the next two years. As a result, fiscal policy will become less expansive and reduce the pressure on prices caused by the excessive government spending programs related to COVID.

Inflation is unlikely to be a problem in 2023 as prices have been softening since mid-year 2022 and will now be compared to elevated year ago levels. Watch out for a downside blip that will take inflation below zero for one or two months as the economy moves back toward equilibrium from a government-induced period of financial exuberance.

From the war in Ukraine to the threats over who governs Taiwan to pending tensions between North and South Korea, the world is becoming a more dangerous place. These are one-offs that are difficult to incorporate into economic and financial market forecasting. On the other hand, the emergence of Russia's aggression has changed the global defense and energy landscapes as the attitudes and actions of major European nations unite under the European Union. Japan has also decided to up their defense game by engaging in a major rearmament program. These global developments in defense spending will discourage aggression against countries that could otherwise not defend themselves.

Global energy tensions will benefit U.S. energy producers. A dramatic increase in exports of liquified natural gas to Europe is expanding our favorable trade balance. Europe will continue to buy energy from the U.S. to replace the natural gas that was imported from Russia. Domestic oil production, via fracking, continues to expand and is returning to record levels—a trend that is likely to continue in 2023 and beyond.

Corporate profits should continue their rebound this year as companies take precautions against a decline in margins due to a slowdown in demand. While layoffs are likely to increase, the demand for labor continues to be strong and competent workers will not find it difficult to stay employed. The latest data on personal income showed that the median level hit a record high in November 2022. With state governments having experienced overwhelming amounts of tax inflows, there will also be growing demand for workers in state and local municipalities.

COVID and all its variants will continue to be a problem, this year and in the foreseeable future. There will be increasing need for healthcare resolutions related to the disease and drug companies will remain committed to developing new solutions to prevent further infections among the world's population.

The speculation that characterized financial markets from 2019 to 2021 appears to be winding down. Some cyber assets and related companies are gradually going bankrupt or melting down. This trend is likely to continue in 2023 as we do not see new speculators entering the cryptocurrency, DeFi (De-centralized Finance) or NFT (Non-fungible Tokens) blockchain-related markets.

Lastly, the stock market has exhibited a P/E ratio over the past four years with Euphoria leading the way. After rallying in the double-digits for 2019, 2020 and 2021, last year brought the bursting of that bubble with the Panic. Stock prices are now back at reasonably valued levels in price-to-earnings terms. In fact, for most of last year, the S&P 500's P/E ratio was below its pre-COVID high. The bear market likely bottomed in October last year when the value of the U.S. dollar peaked—- probably not a coincidence. Yet, the S&P 500 has been basically range-bound for the last six months and market internals have been steady. This environment sets up for some stabilization in the stock market for this year.

We think we have covered all the bases for 2023 but there is always some unidentified event that could pop up to upset the prognostication. Stay Healthy and Happy!

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