2022 Review & 2023 Outlook

Recap of 2022: An Extremely Difficult Year to Navigate

Imagine we had prior knowledge of this year's major events — Specifically, that we were told that in the course of 2022:

Major Event	Logical Investor Response	Outcome
Europe would experience a major land war and inflation in the US would reach 9%.	Buy Gold	Roughly Flat for Year
Nord Stream pipelines would be blown up, French nuclear plants would shut down, the US/Saudi relationship would break down and Iran would flirt with a revolution.	Buy Crude Futures	Down Marginally for the Year
Oil prices heading into late December would be down.	Avoid Energy Stocks	Energy was the best performing sector in 2022 by a wide margin
In addition to war, Europe would face an energy shock, the rise of the populist right in both Sweden and Italy, and political chaos in the UK.	Underweight European equities and overweight US equities	Developed Europe outperformed US
Leading indicators and ISM surveys would both swing into negative territory.	Buy Developed Government Bonds	Face drawdowns not seen for a Generation
Knew in advance that the S&P 500 would shed roughly 20% of its value	Buy VIX Futures (VXX) & Overweight Long-Duration US Treasuries	VXX was down over -20% and Long-Term Treasuries faced drawdowns not seen for a Generation
Big Tech would suffer significant losses.	Likely expect a bloodbath in global equity markets.	Mexico and Brazil experienced gains, while Indonesia and India delivered gains in local currency terms

In short, 2022 was an extremely difficult year to navigate as the relationships and trends that investors have come to rely on either broke down or, worse, reversed—for example, the inverse correlation between the outperformance of Big Tech and US equities in general.

Source: Bloomberg and Morningstar Direct

Recap of 2022: Themes that Dominated the Markets

The Fed's Fight Against Inflation

After a 7.1% YoY CPI reading in November (the lowest reading in 2022), the Fed slowed down its level of rate hikes to 50 basis points (from 75 bps). Beginning in 2023, the Fed is expected to slow its rate hikes down to 25 basis points, starting at the first Fed meeting on February 1st. Despite the slowdown in the size of rate hikes, Fed Chair Powell has been firm in his stance of expecting higher rates for longer. While the market expects rate cuts in 2023, the FOMC's latest quarterly projections highlight the Fed Funds Rate ending 2023 at a level of 5.00-5.25%

China's COVID Policies

China maintained strict Covid-policies in 2022, resulting in a slowing of the world's second-largest economy and even civil unrest. Late in Q4 2022, reports surfaced that China was planning to significantly roll back these strict policies in early 2023. Since then, China has scrapped its 8-day inbound quarantine for travelers, facilitated visa applications for foreigners, and stated there would be no limit to gathering in public. These early attempts to reopen have been met with a surge in COVID cases throughout the country, testing the government's commitment to this shift in policy.

Russia-Ukraine War

The Russia-Ukraine War continues with no end in sight. Along with geopolitical concerns, the War has destabilized the energy & commodities market, particularly in Europe. Further escalation with nuclear weapons remains the biggest threat. A ceasefire remains unlikely in the short-term. Russia remains adamant that Ukraine recognize annexed territories such as Donetsk & Luhansk, while Ukraine refuses to cede territory to Russia in any negotiations. Longer-term, the health of the Russian Economy, Army, and Vladmir Putin could be a catalyst for an end to the War.

A resolution to 2 or 3 of these lingering issues could be Bullish for the overall market

Source: The Federal Reserve, the Bureau of Labor Statistics, and Bloomberg

Recap of 2022: “Don’t Fight the Fed”

The most recent November CPI report showed inflation rose just 0.1% month-over-month to hit 7.1%, its lowest level of 2022 (*see Table 1*). Inflation is down from a peak level of 9.1% in June 2022, as the Fed has undergone one of the fastest hiking cycles in 40 years (from roughly 0% to 4.25-4.50%). Goods Inflation has continued to decelerate (i.e. Used Autos), but Rent prices and Wages are proving to be sticker. Wage inflation is of particular focus to the Fed, as it attempts to cool down a tight labor market.

Along with raising rates, the Fed is draining liquidity in the system through Quantitative Tightening. In previous shocks to the financial system (2008 & 2020), the Fed responded with “Quantitative Easing”, which essentially flooded the financial system with new money and dragged down interest rates. As a result, the Balance Sheet ballooned from less than $1 Trillion in 2008 to roughly $9 Trillion. In June 2022, the Fed officially reversed course and turned to Quantitative Tightening by letting Treasuries & Mortgage-Backed Securities mature without reinvestment.

Finally, another tool at the Fed’s disposal is the use of forward guidance. At its December 14th meeting, the Fed released projections that showed FOMC participants expected rates to finish 2023 at a range of 5.00-5.25% (*see Chart 2*). This was higher than anticipated, but perhaps even worse, this forecast implied no rate cuts in 2023 (differing from market expectations). This forecast was a major catalyst for the year-end selloff.

Table 1: 2022 CPI YoY

Month	YoY CPI	
Jan	7.5%	
Feb	7.9%	
Mar	8.5%	
Apr	8.3%	
May	8.6%	
Jun	9.1%	**Peak CPI in 2022**
Jul	8.5%	
Aug	8.3%	
Sep	8.2%	
Oct	7.7%	
Nov	7.1%	**Lowest CPI in 2022**
Dec	-	

Source: US Bureau of Labor Statistics

Chart 2: Fed Funds Rate in 2022 (Upper Range)

Source: The Federal Reserve

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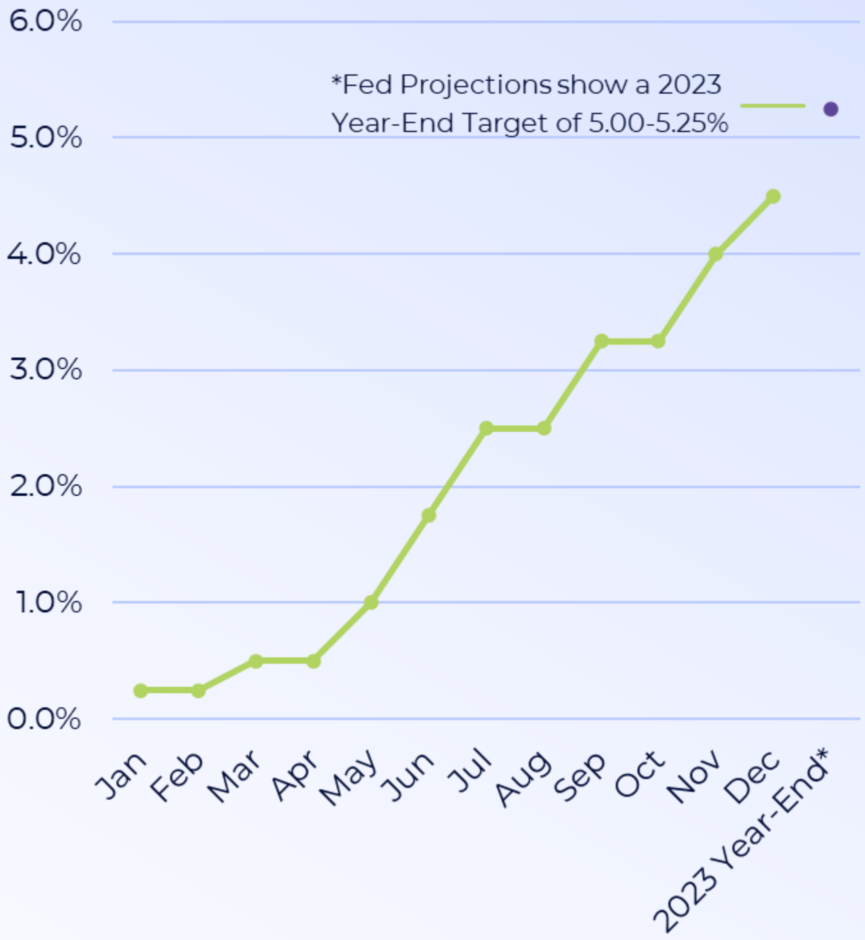
Chart 2: Fed Funds Rate in 2022 (Upper Range)



Source: The Federal Reserve

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Recap of 2022: “The Good, The Bad, and The Ugly”

The Good: Labor Market

One constant strength in the overall economy in 2022 was the Labor market. Nonfarm Payrolls have been resilient all year *(see Table 1)*, with the November Jobs report showing the economy added 263,000 jobs (versus expectations of 200,000). Despite negative headlines regarding layoffs (specifically in the Tech sector), Job Openings still outnumber the Unemployed by roughly 4 million.

Table 1: 2022 Changes in Nonfarm Payroll Employment (000’s)

	Jan.	Feb.	Mar.	Apr.	May	Jun.	Jul.	Aug.	Sep.	Oct.	Nov.	Dec.
Change in Nonfarm Payrolls	467	678	431	428	390	372	528	315	263	261	263	-

Source: US Bureau of Labor Statistics

The Bad: Equity Market

Equity markets were quite resilient in the face of geopolitical worries, lockdowns in China, and the fastest tightening cycle in decades. Still, 2023 earnings expectations have been revised downward, and dispersion remains high. Large Value (-7.5%) outperformed Large Growth (-29.1%) in 2022 by the widest margin since 2000, and Energy was the top performing sector (up 65.7%), while Communications was the biggest laggard (-39.9%).

Chart 2:
10 Year Yield Minus 3-Month Yield

Source: St Louis Fed

The Ugly: Bond Market

Bond markets experienced one of its worst years in history, as treasury yields surged. The 2-year Treasury yield spiked in 2022 from 0.73% to 4.41%, while the 10-year yield rose from 1.52% to 3.88%. Even more concerning, a large majority of the Treasury curve is inverted. While not every yield curve inversion signals a Recession, the 10 year-3 month yield curve is deeply inverted by 54 basis points – which is its most inverted level since the Financial Crisis and Tech Bubble (*see Chart 2*).

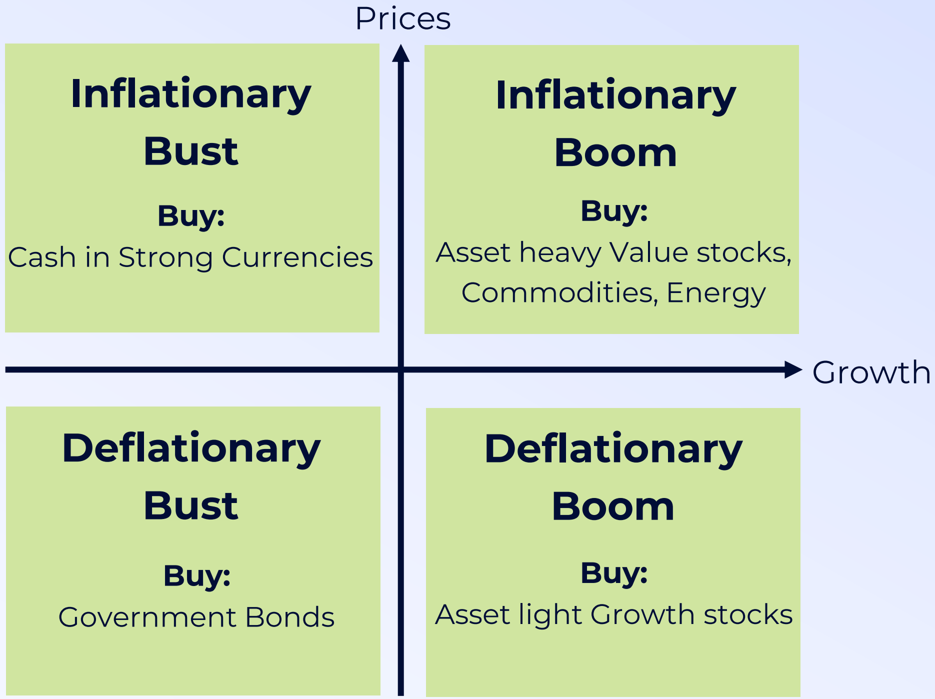
Source: US Bureau of Labor Statistics, St Louis Fed, Bespoke Investment Group and Morningstar Direct

Transitioning to 2023: Now What?

Asset allocation is about identifying which quadrant we are in (to the right), understanding the monetary and fiscal headwinds or tailwinds associated with big trends and making the best risk/reward decisions by combining this macro framework with positioning, sentiment and money flow dynamics. Oh, and above all, two helpings of humility - this is a tough game.

Investors could take the view that the trends of the 2011-2021 decade remain in place, and 2022 just marked a pause to shake out the “weak” or “leveraged” players.

Or, as we believe, we conclude that there is a deeper reason for the current Bear market; namely, to mark a structural shift in the global economy and facilitate a shift in leadership from one group of stocks to another.



Source: Dynasty Financial Partners

2023: A Fork in the Road…

In 2023 (most likely mid-year), we expect the US Federal Reserve will reach a fork in the road where they will face a choice between accepting a higher level of inflation (3.5-4.0%) or drive the US economy into a severe recession by sticking to their 2% inflation mandate. By contrast, most other major economies have already passed this junction, and have made their choices. In Europe, the choice was a Recession, and it was not made by governments or central bankers but imposed by Vladimir Putin. In China, the choice of Recession was driven not by economics but by the draconian politics of Covid. Japan's 30 years of deflation made inflation the obvious choice. Britain, meanwhile, has zig-zagged from Liz Truss's tolerance of inflation to recessionary austerity under Rishi Sunak, and will probably suffer the worst of both worlds.

The US is unique in having a central bank, a government and most major sell-side Economists all assuming a painful choice will not be required between high inflation and severe recession. If this is right, and the US reduces its inflation without experiencing a severe recession—and without even imposing positive real interest rates—it will be an unprecedented achievement. But if the belief in painless disinflation is wrong, the US economy and financial markets will need to adjust when this choice between recession and inflation becomes unavoidable (probably around the middle of next year). By that time, in other major economies where tough policy decisions have already been taken, the biggest economic troubles may be receding.

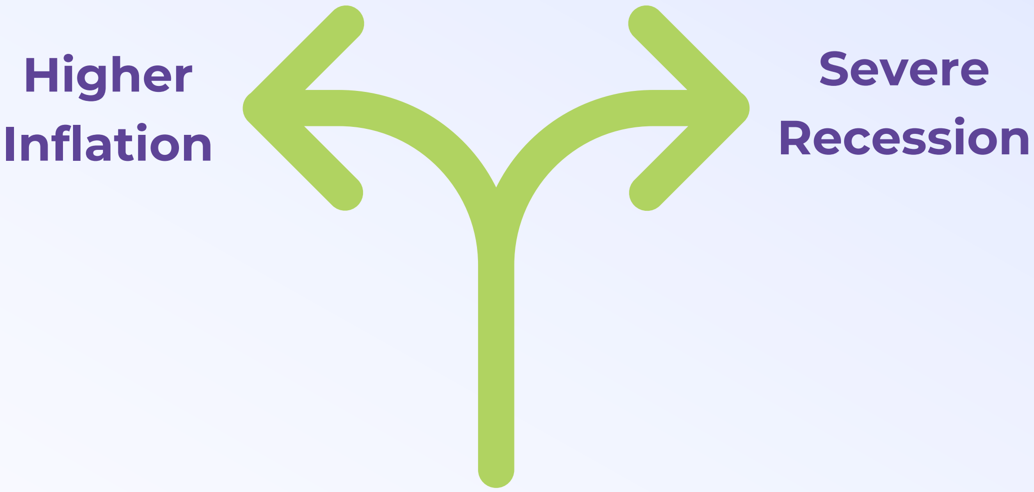
We believe the Bear market in most US assets is still evolving. And it is why we think that 2023 will be the year when the US dollar starts losing value and when non-US assets, especially in Asia (but also perhaps in Europe), start to outperform.

The biggest challenge for financial markets is that the prospect of 2.0-3.5% inflation is not in the foreseeable future.

Markets keep expecting a dovish Fed, but the Fed has told us they will tighten to a terminal rate of 5.00-5.25%. Ultimately the big question is whether the Fed will accept a higher plateau of inflation of 4+% vs the original 2% target? The Fed is trying to project an image of hawkishness but also looking to avoid a severe recession at all costs.

"When you Come to a Fork in the Road, Take it"

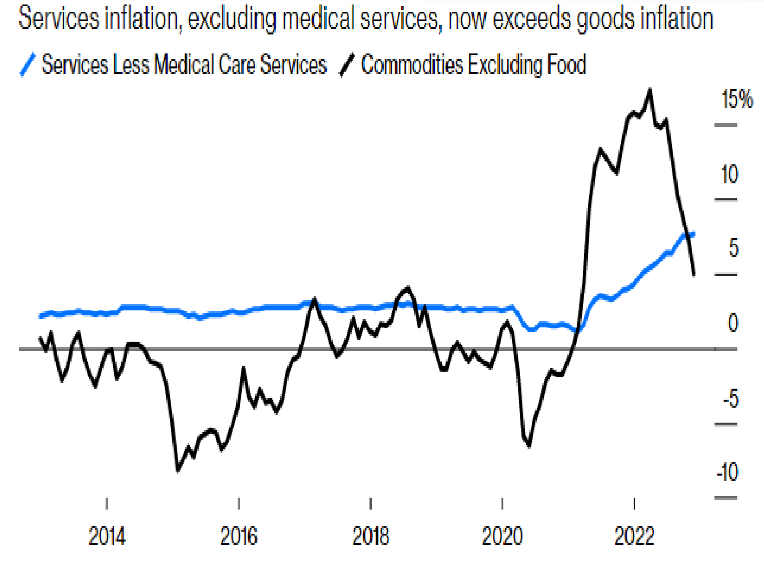
-Yogi Berra



Source: The Federal Reserve, Bloomberg and Dynasty Financial Partners

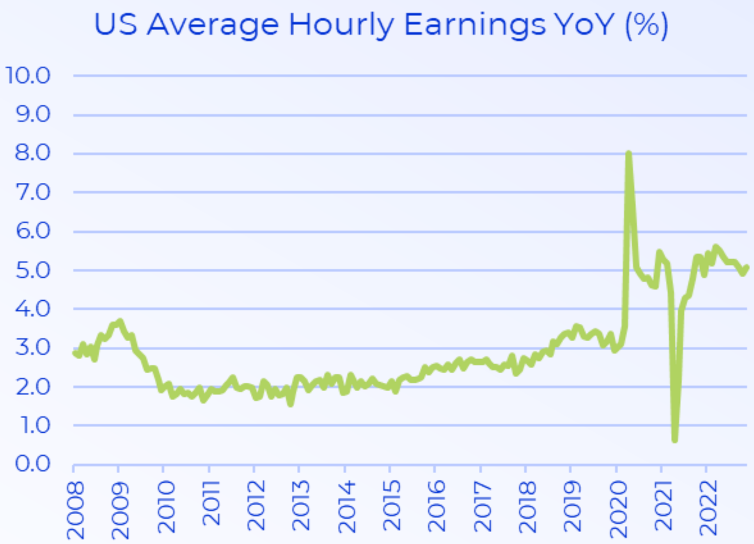
2023: How Far will the Fed Go?

Goods inflation is coming down…



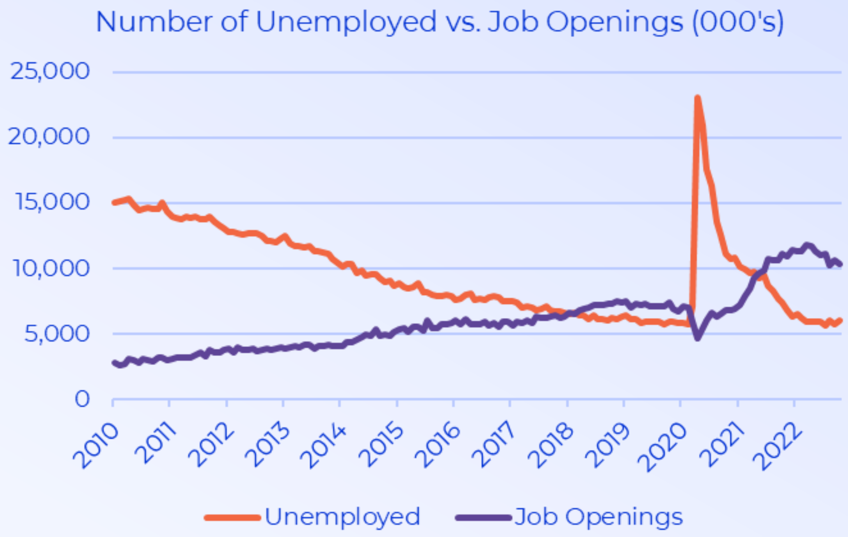
Source: US Bureau of Labor Statistics and Bloomberg

…but Wage Inflation remains too high…



Source: St. Louis Fed

…from a tight Labor Market caused by structural imbalances



Source: St. Louis Fed

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2023: How Far will the Fed Go?

Most market pundits still think the big risk today is of overtightening. Bond market also reflect this mindset. Expectations are for the 10-year Yield to settle in a range of 2.5-4.0% *(see Chart 1)*.

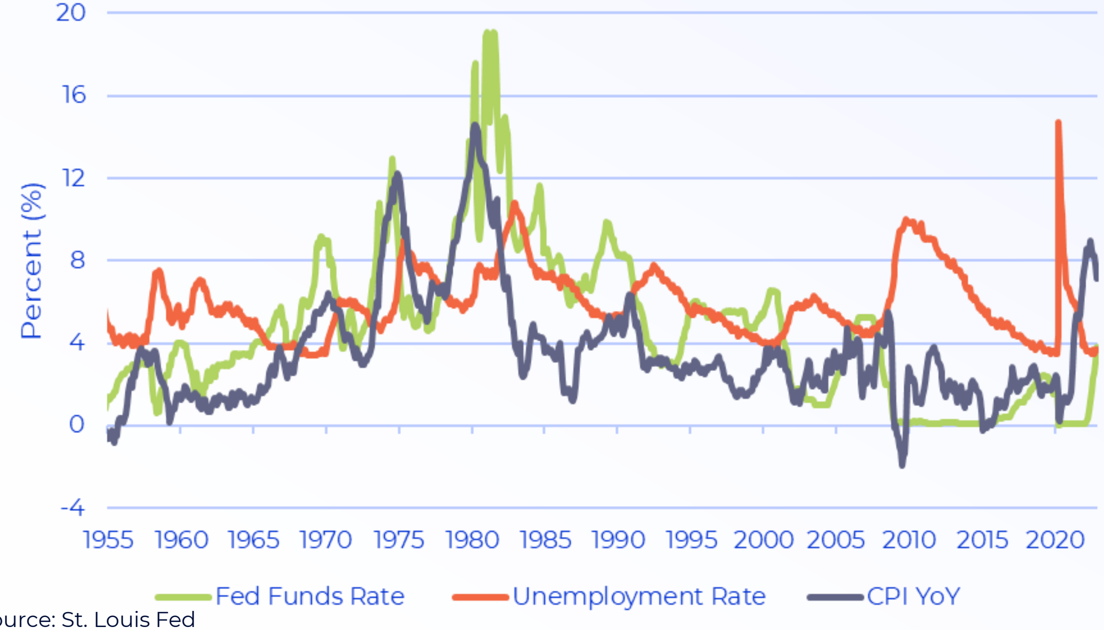
Markets seem to be betting on a disinflationary miracle *(see Chart 2)*.

We are being asked to believe that core inflation will come down substantially before a shallow recession while monetary policy is maintained in negative real terms. Could it happen? Yes. Is it likely? I don't believe so. Historically US inflation has never declined of this magnitude without a surge in unemployment *(see Chart 3)*.

Reluctance by the Fed to accept a higher plateau of inflation is a function of a regime change the likes of which most have not seen in their careers.

Chart 3:

A Surge in Unemployment is Historically Needed for US Inflation to Decline Significantly



Source: St. Louis Fed

Chart 1:

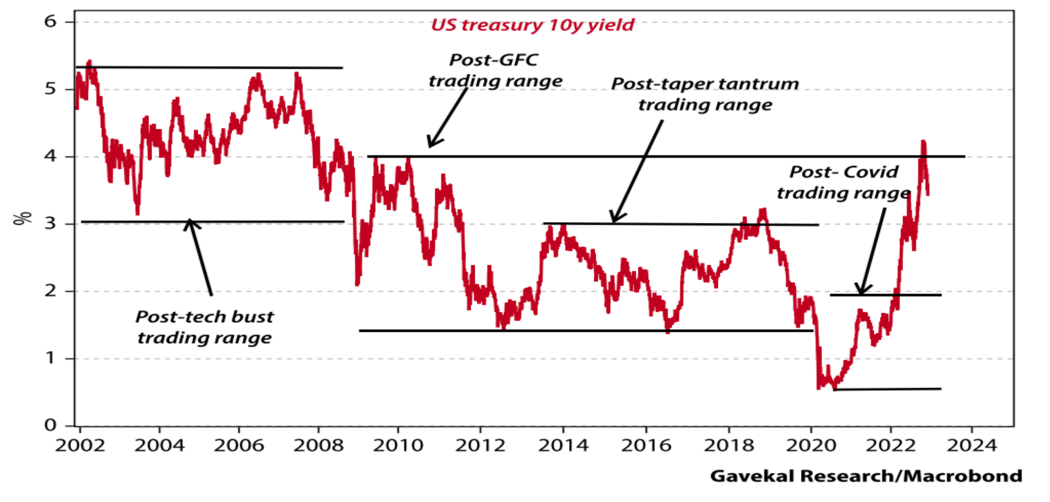


Chart 2:

5-Year Breakeven Inflation Rate

Source: St. Louis Fed

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2023: Growth or Price Stability? US has not Decided; Europe and China Have

The Investment Team Believes:

- Inflation is deeply imbedded throughout the US economy
- Inflation shock is due to war, sanctions and deglobalization, not just monetary policy and COVID
- It will take a major Recession to bring US inflation back to 2%. Will the Fed allow that?
- US Recession not likely until after Fed Funds Rate reaches a terminal rate (5.0-5.5%), maybe as much as a year after
- Europe is different, as labor markets are weak and a deep Recession inevitable
- In China, Japan and many Emerging Markets, inflation is not a major problem right now
- UK faces worst of both worlds; Recession and imbedded inflation
- David Tepper said it simplest and best: “Sometimes they just tell you what they are going to do”. The Fed is going to a range of 5.0-5.5%. With the German 2yr at 2.68%, LaGarde told us she is going to 3.5%. We now have coordinated tightening (Fed, ECB, BOE and now Japan).
- Fed doesn’t want asset inflation. They are happy to see the Stock Market & Housing Prices go down (to a reasonable degree). Junk spreads down 150 basis points is not helping the Fed. 10yr US Treasury Yield coming down 70 basis points also does not help the Fed.

Big Picture: Themes for 2023 & Beyond

- We have a regime change that requires a new and flexible approach to global macro and asset allocation. US valuations are still expensive and Fixed Income will be tough with the Fed's "higher for longer" policy. We see a higher plateau of inflation amidst record stimulus and savings yielding a different kind of recovery.
- We Prefer Credit over Duration in Fixed Income as the economy stays stronger for longer and Central Bank's push short rates higher.
- Private Credit offers a unique way to play the new rate regime while still generating income.
- Within equities, we advocate continuing to shift away from larger-cap technology in favor of value, yield and free cash flow profitability.

Energy Transformation is a Major Theme - This theme could be as large an opportunity as the Internet was around the turn of the century and will most likely lead to the same bifurcation and results. However, the generosity of the recent Inflation Reduction Act should lead to more winners than losers in the US. Importantly, **while the Internet was a deflationary global force, the energy transition is an inflationary one**. Most commodities required to support growth in onshore wind, offshore wind, batteries, etc., need a lot of energy to mine and process. Moreover, many of these commodities are sourced from unstable areas of the globe. Around 65% of the total global refining of such commodities, including lithium (72%), cobalt (71%), and manganese (99%) is now done in China at a time when the U.S.-China relationship is strained.

We like companies with strong free cash flow profitability for both late-cycle and a Recession (see below Table)

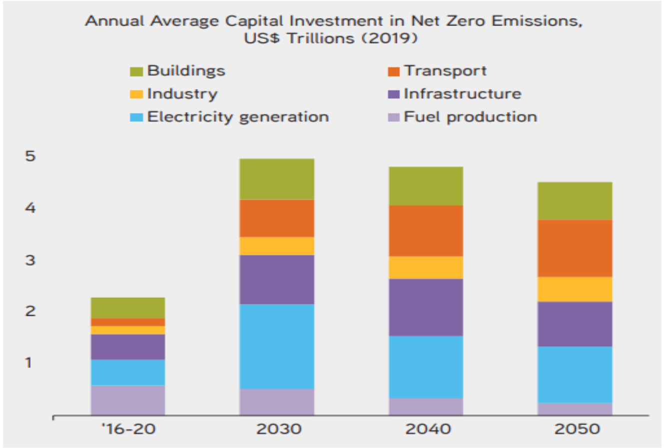
Rank IC of Free Cash Flow Profitability in A Market Cycle
Russell 1000 Universe, 08/31/1996 to 03/31/2022

State	Rank IC	Stdev (Rank IC)	Risk-Adjusted IC
Recovery	-1.80%	6.66%	-0.27
Expansion	0.91%	6.91%	0.13
Slow Down	3.17%	7.75%	0.41
Recession	7.78%	6.34%	1.23
Average	1.88%	7.42%	**0.25**

*IC = Information Coefficient

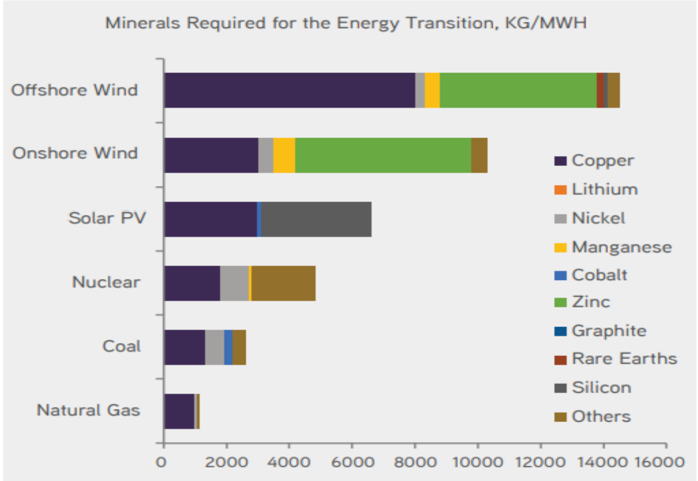
Source: Chen, Q (2022) A Better Approach for Quality Factor Exposure. FCF Advisors Research.

Total Annual Capital Investment in a Net Zero Global Emissions Scenario for Energy Will Rise From 2.5% of Global GDP to About 4.5% by 2030



2030-2050 are estimates. Data as at April 2021. Source: Goldman Sachs Global Investment Research, IHS Global Insight.

Critical Components Needed for the Energy Transition Will Likely Make This Transition a Bumpy One



Data as at May 4, 2022. Source: IEA.

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Investment Implications

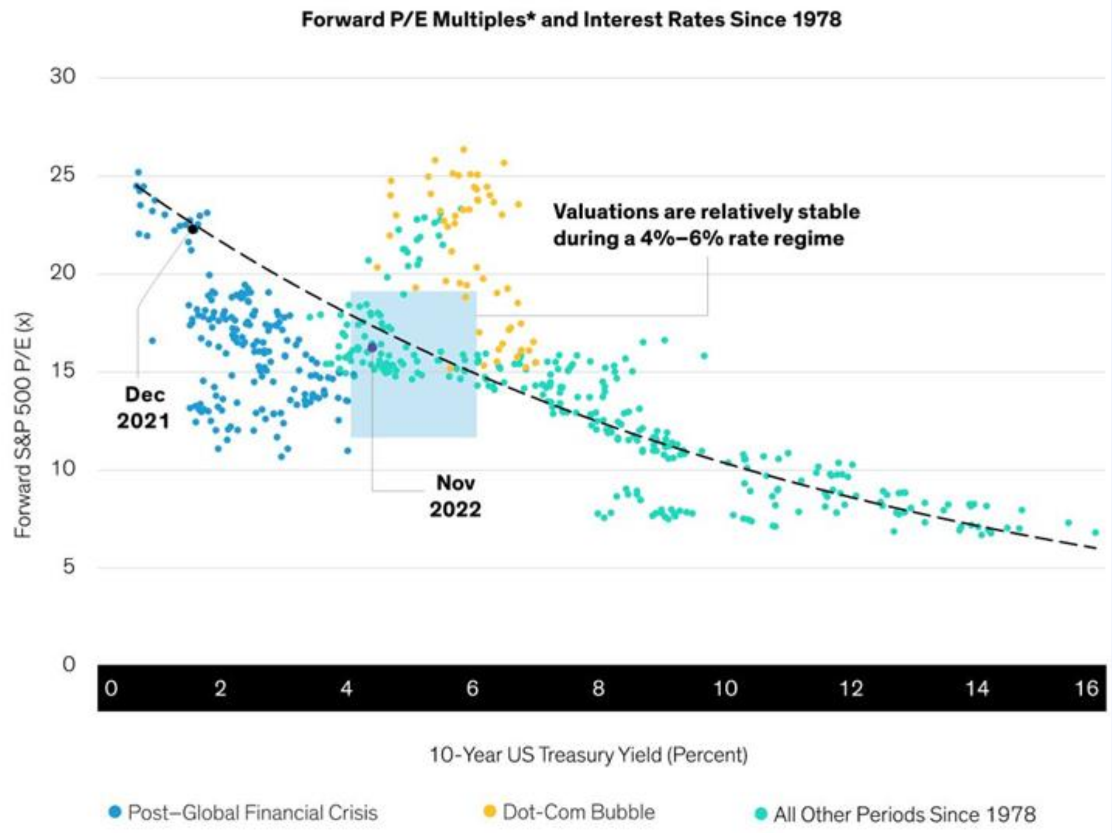
1. Higher US inflation plateau means more tightening, higher US 10-year yields

2. Fixed Income: Simple Credit looks attractive. While spreads have not blown out like in 2008, the risk-free rate now embeds a lot of bad news and absolute yields look extremely attractive within a macro environment that points to lower overall returns for most portfolios during the next 5-10 years.

3. U.S equities have seen severe multiple compression – especially in the Tech sector. Given the move in short risk-free rates, we believe this multiple compression is rational and justified. For 2023, we believe the "E" becomes equally important in the P/E equation. Two widely respected names in the industry, David Tepper and Jeremy Siegel, have vastly different forecasts for 2023. On the bullish side, Jeremy Siegel believes the market deserves a 20x multiple and there will be upside to 2023 Earnings (i.e. $240), which would result in a possible S&P 500 price of 4,800 (20 * 240 = 4,800). David Tepper, on the other hand, is bearish and believes the market deserves a 12x multiple on lower 2023 Earnings. If we use $225 for 2023 EPS, this would result in a S&P 500 price of 2,700 (12 & 225 = 2,700). These two examples show the discrepancy in forecasts for next year. **Ultimately, we believe a market multiple of roughly 16x next year's earnings is fair based on interest rate levels (see chart), but 2023 Earnings Expectations may continue to be revised downward as higher interest rates take their toll on the economy.**

Have US Stock Valuations Fallen Enough for New Inflation Era?

Significant Multiple Compression from Here Is Likely Limited



Historical analysis and current forecasts do not guarantee future results.
Tech bubble is December 31, 1996 through September 30, 2000. Post-global financial crisis is December 31, 2007, through the present. Chart trend line is 1978–2007.
*Forward P/E multiples represent earnings estimates for the next 12 months.
Through November 30, 2022
Source: Bloomberg, FactSet and AB

Source: AllianceBernstein, David Tepper, Jeremy Siegel and Dynasty Financial Partners

Investment Implications (cont)

4. Equity rotation from Growth to Value as US economy stays stronger for longer and China reopens.

5. Major long-term rotation continues from Growth stocks/COVID gainers to winners from Energy Transition. We remain cautious on Large Cap Technology. This sector is valuation-challenged at a time when fundamentals, especially around online advertising and social media, are still deteriorating and competition is increasing. Additionally, we continue to think that globally, greater government regulation of Tech is increasingly on the table at a time when global geopolitical competition is heating up. Once a sector peaks at over 20% of an index, it tends to badly underperform over the next three to five years.

    - Roughly every decade or so, financial markets fall in love with a new narrative.
    - The narrative inherently "makes sense." But over time, the market pushes valuations to extremes. How could almost all of the top 10 companies in the world by capitalization be driven by exactly the same factor? Can one factor account for that much of global GDP?
    - Unpleasant as they are, Bear markets exist for a reason: to shift market leadership from one group of stocks to the next. Hence, once the Bear market has started, investors should be spending most of their time trying to identify the next winning trend instead of trying to time their reentry into the previous trend.

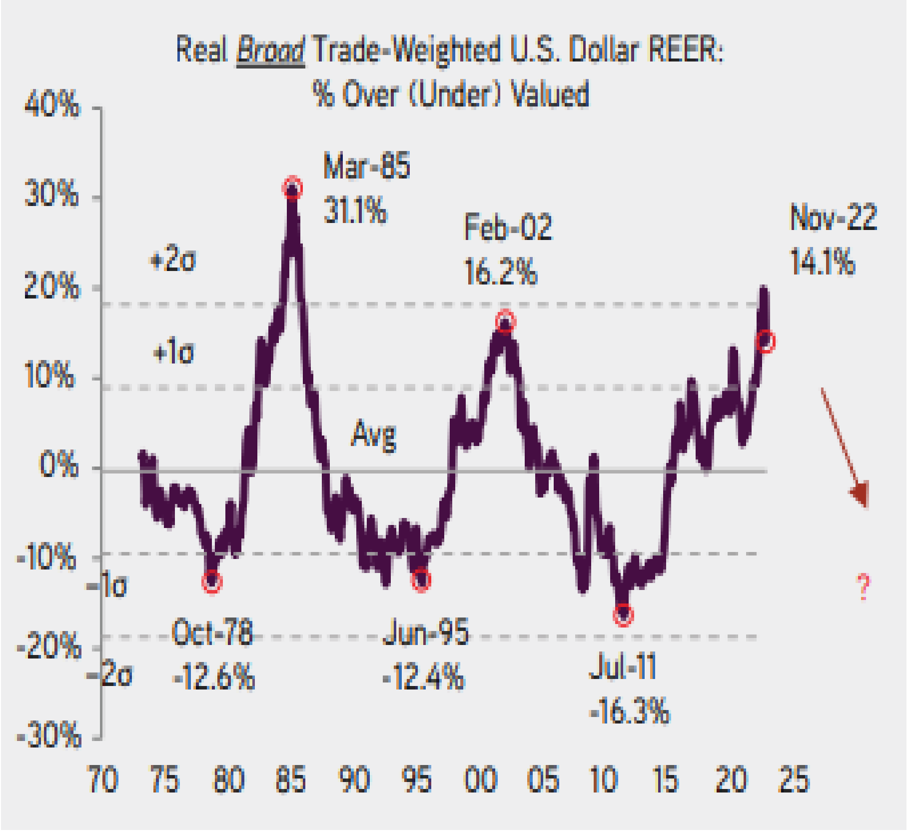
World's Top 10 Largest Companies by Market Cap (ex Saudi Aramco)

1980: Peak Oil	1990: Japan will Take Over the World	2000: TMT Bubble (Tech-Media-Telecom)	2010: China will take over the World	2021: Only Tech can Deliver Growth
IBM	NTT	Microsoft	Exxon Mobil	Apple
AT&T	Bank of Tokyo-Mitsubishi	General Electric	PetroChina	Microsoft
Exxon	Industrial Bank of Japan	NTT DoCoMo	Microsoft	Amazon
Standard Oil	Sumitomo Mitsui Banking	Cisco Systems	ICBC	Alphabet
Schlumberger	Toyota Motors	Walmart	Walmart	Facebook
Shell	Fuji Bank	Intel	BHP Billiton	Tencent
Mobil	Dai Ichi Kangyo Bank	NTT	China Construction Bank	Tesla
Atlantic Richfield	IBM	Exxon Mobil	HSBC	Alibaba
General Electric	UFJ Bank	Nokia	Petrobras	Berkshire Hathaway
Eastman Kodak	Exxon	Deutsche Telekom	Apple	TSMC

6. US Small Caps are getting interesting for long-term investors. The Russell 2000's forward 12 months P/E ratio has fallen to 10.8x, its lowest level since 1990 and 30% below its long-term average. On a relative basis, the Russell 2000's forward 12-month P/E is trading at the lowest level versus large-cap stocks since the Tech Bubble.

Investment Implications (cont)

7. The US Dollar should decline but mostly Vs the Yen. Despite the USD backing off 6% in recent weeks, we still think the US Dollar is overbought and over-owned (*see Table*). It clearly has been the right call to own dollar assets for the last several years , but we feel this trade has begun to turn. For most of 2022, currency markets were clearly driven by differences in short-term interest rates. The Fed was perceived as more hawkish than anyone else and the US dollar soared vs major currencies. However, over the fourth quarter, the US dollar's outperformance stalled. It could be that the market no longer expects the Fed to be more hawkish than the European Central Bank, the Bank of Japan or the People's Bank of China going into 2023. Or it might be because the foreign exchange market has entered a transition phase in which differences in short-term interest rates are no longer the dominant factor driving currency performance. If the latter, it is bad news for the US Dollar, since on pretty much every other factor—purchasing power parity, trade balances, fiscal policy, etc.—the US dollar looks worse than most of its peers. Entering 2023, the US dollar appears to be overvalued, over-owned, and losing momentum. This is a tough combination.
8. China and commodity producing EM's should outperform the US and Europe. Cyclical hedges that might work as the dollar weakens, including select EM and Commodities (such as Oil and Copper). Our conversations with CIOs lead us to believe that most investors, regardless of region, are overweight dollar-based assets. This decision has been the right one in recent years, but the technical picture makes us want to add some 'spice' in the form of select EM equity exposure.
9. Interest rate volatility is now extended. I seriously doubt that the Fed Funds Futures will experience a 400 basis point upside surprise in 2023 like it did in 2022.



Data as at November 30, 2022. Source: Bloomberg.

Downside/Upside Risks to Our Outlook

Downside

Risk #1: Growth Slows Sharply Towards More of a 2008-Type Downturn

- Our forecasts are predicated on growth slowing but not collapsing in a 2008-like fashion.

Risk 2: We go Back to Secular Disinflation

- Our macro calls could be wrong if inflation crashes towards pre-pandemic levels (to “Deflationary Boom: Buy Asset Light Growth Stocks”). In this scenario, the ‘right’ playbook is to go back to what worked in 2010-2016 (when average inflation was just 1.6%). Said differently, if there is not a higher resting heart rate for inflation this cycle, then investors should lean into high growth, low cash flowing equities and long-duration US Treasuries.

Upside

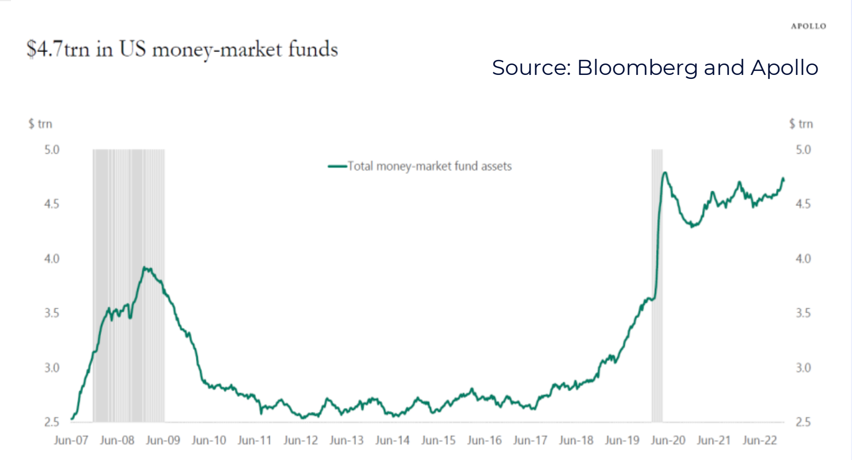
Source: Bloomberg and Dynasty Financial Partners

Q1 2023: Too Many Bears on the Bow of the Boat

Despite all the uncertainty across today's global capital markets and our belief that the US economy and markets are unwinding zero-interest rate policy and COVID excess, we are poised to enter Q1 2023 with a positive bias for risk assets. After the initial decline in 2022, the S&P 500 has gone sideways since May *(see Chart 1).*

Chart 1

Chart 2



Strategists at major banks/firms (13 of 16) are looking for a down year and most everyone is looking for a down 1H2023. The contrarian in me wants to fade this consensus and I think stocks can rally in Q1 2023 – especially with a significant amount of cash on the sidelines (i.e. money market funds – *see Chart 2*).

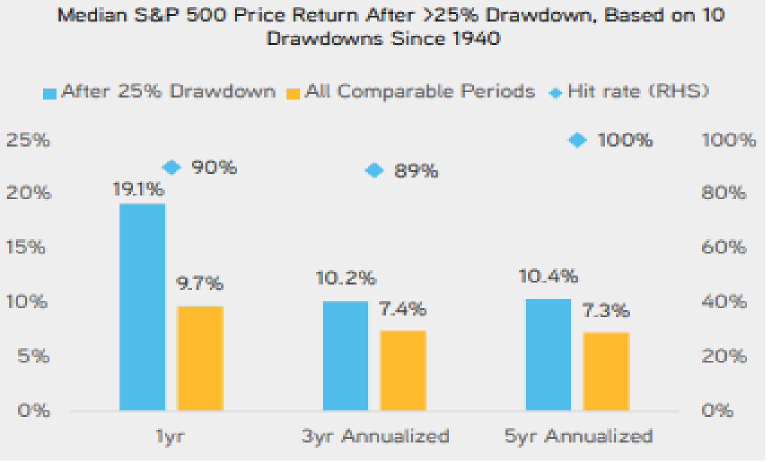
I think the economy stays stronger and 2023 EPS estimates stay higher for longer than most people are forecasting. I also think 2023 growth fears will be easier to navigate than 2022 inflation surprises.

Our simple premise is that it will be easier to navigate inflation's negative impact on corporate earnings and balance sheets in 2023 than it was with inflation continually surprising central bankers and investors to the upside in 2022.

Markets took a major punch in 2022. Investors are still bearish and well-hedged for the very valid longer-term concerns I outlined in this outlook. History suggests forward returns are quite good after equities suffer a 25% drawdown and with High Yield credit trading below 85c *(see Charts 3 & 4).*

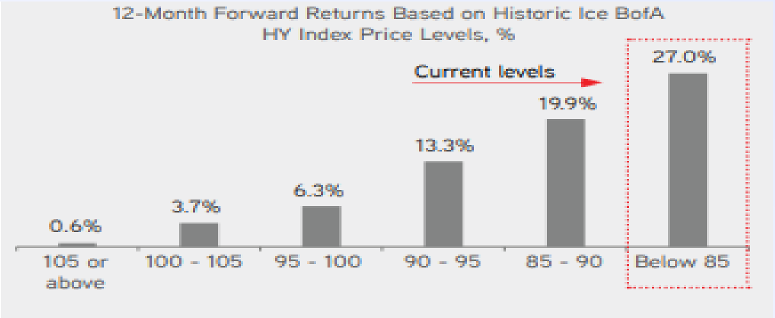
Bob Shea, Chief Investment Strategist
Dynasty Financial Partners

Chart 3



Note: 3-year and 5-year annualized returns are based on nine episodes only since the 2020 drawdown was too recent. Data as at September 30, 2022. Source: Bloomberg, KKR Global Macro & Asset Allocation analysis.

Chart 4



HY Index Prices Over the Past 10 Years. Number of Days at Each Range, % for Each Period

105 or above	100 - 105	95 - 100	90 - 95	85 - 90	Below 85
184 days	1,220 days	896 days	190 days	101 days	20 days
7.0%	46.7%	34.3%	7.3%	3.9%	0.8%

Data as at October 31, 2022. Source: Bloomberg.

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