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Early 2023 Note

Markets broadly are off to a very strong start here in 2023. As of this writing, high grade taxable and municipal bonds are up over 2%, high yield corporates and municipals are up ~4%, and US and international equities are up 7-9%. Alternative assets are broadly higher with listed real estate up 9%, gold up 2+% and bitcoin up 40%. This broad-based rally following a solid Q4 2022 rally has many forecasters turning more optimistic. The IMF recently raised its economic growth forecasts and several major banks have reduced their recession forecasts. Larry Summers is warming up to the potential of a soft landing and Jerome Powell mentioned disinflation fifteen times in his most recent broad Q&A.

As long-term investors we welcome the near-term rally, but still think it is wise to proceed with some added caution now. While Summers noted higher odds on a soft landing, he also noted the risks of the Fed either stopping its inflation battle too soon (no landing) or fighting the battle too long and hard into a Wile E Coyote moment for the economy and markets (hard landing). While Powell expects 2023 to be a year of significant declining inflation, he also warned about the risks of declaring victory too soon and reiterated that bringing inflation back to target will still take time and will not be painless. Economic data has also been mixed with various indicators concurrently pointing in very different directions. Powell, one of the most influential actors on markets, has noted in the past that monetary policy is often like making your way slowly and cautiously through a dark, unfamiliar room filled with furniture. This is very true today and the no landing, soft landing and hard landing scenarios all look plausible right now.

In looking at the data, one can make a solid case that there is no landing in sight and inflation is still a major concern. Last Friday, we learned that the US added 517k jobs well above expectations of 187k jobs. 2022 job gains were also revised much higher than previously published. Unemployment fell to a 53-year low of 3.4%. Average hourly earnings grew at 4.4% from last year. Despite media reports of tech layoffs, jobs were added across a range of sectors with strong gains in both services and construction.

On top of this report, we learned that the ISM Services PMI rebounded from a contracting level to a level consistent with continued growth. One would think these data points are great news for the economy and thus should be cheered by a market deeply concerned with recession. We actually saw broad losses in stocks and bonds Friday as investors worried that the no landing scenario was intact, that the job market especially on the services side was too strong, and that inflation especially in wages is still an issue. Adding fuel to the inflationary no landing fire, we are also seeing the Chinese consumer unleashed into the global economy with a vengeance and ample savings from the 2022 COVID lockdowns. We don't think we can declare victory on inflation yet and plan to keep some dry powder for this no landing scenario.

We also do see a decent amount of evidence that Powell may be able to deliver a soft landing by cooling inflation without tipping us into a deep or long recession. Stock markets tend to lead the economy and since the end of Q3 we've seen a strong rally. The rally has also been broad based with most stocks, even in the most troubled sectors like tech, trading above their 200-day moving average. Many analysts see this "breadth thrust" as evidence that a new bull market has begun.

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Furthermore, although we are seeing layoffs in higher paying tech jobs, we are seeing strong job gains and still considerable job openings in lower paying jobs in leisure and hospitality, health services and construction. The employment to population ratio for workers with disabilities, something the Fed cares about, is near an all-time high. While companies like Ford recently cut pay given weak auto deliveries, they focused on the highest earners while still seeking to ramp up production (I am still awaiting my Ford Lightning after 1.5 years). While wages did grow broadly, the pace of wage growth has slowed. This type of movement with lower paid workers easily finding work and experiencing solid wage gains while their higher spending and higher earning peers pull back would certainly help the Fed deliver a soft landing.

As long-term investors we'd certainly welcome a soft landing, but must also consider the hard landing scenario and the data giving credence to this scenario. First, while the recent rally has been strong and broad, we've seen similar bear market rallies in the 1999-2001 tech bubble and the 2008-2009 Great Financial Crisis. Today we are seeing vastly more leveraged options contracts and particularly very short-term speculative options contracts traded than ever before. These trades can help amplify and broaden the rally we've seen, but can also work the other way. Investor sentiment has recently improved, and this often tends to be a contrarian signal.

The yield curve in the US remains deeply inverted and this has been a solid recession indicator in the past. Bond market participants continue to believe the Fed will be cutting rates in 2023, whereas most Fed speakers including Powell have noted they plan to keep rates near 5% or above through the end of the year. While economic growth in Q4 was positive and we appear to have avoided the most predicted recession of all-time for now, much of this growth came from inventory re-stocking and we are now seeing orders to inventory levels at recessionary levels.

While wage gains have been solid, they generally have not kept pace with inflation and many consumers are falling behind. Retail sales are off in three of the past four months. Credit card balances with high interest rates are on the rise along with hardship 401k withdraws and delinquencies and defaults in autos and other consumer loans. While as noted above, the services PMI moved back into expansionary territory, the manufacturing PMI and the composite PMI remain in deeply contractionary territory. These readings tend to coincide with recessions and 10-20% declines in equity earnings. While the bond market appears to be pricing in a recession with interest rate cuts expected in 2023, equity investors seem to be buying the soft-landing scenario full heartedly with earnings growth expected in 2023 and 2024.

Finally, we'd note one last risk to the markets. Geopolitical risk remains quite high. The war in Ukraine continues and may in fact be escalating. Just when it seemed China was moving more toward pragmatism and that the US and China might meet to make efforts to work together, the meeting was cancelled following the balloon debacle. Democracy broadly is on the decline with unrest and populism on the rise across the world. One of India's largest firms is facing an accounting scandal leading investors to question opaque reporting, entangled structures, and poor corporate governance. In the US,

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yet another debt ceiling debate is on the horizon with political acrimony and gamesmanship elevated. Any one of these events or some unknown event certainly have the potential to tip the scales toward a hard landing.

In sum, and so as not to end on a low note, we are still cheering the 2023 rally and remain nearly fully invested. We continue to find opportunities in various markets but were much more excited about the opportunities at the end of Q3 when bearish sentiment was extreme, markets were oversold, and the hard landing scenario was more consensus. While we continue to place a decent probability on a soft landing, we think now is a good time to pause and proceed with a bit more caution just as the Fed is doing with their monetary policy. Toward the end of January, we took a few chips off the table and for the near-term and are happy to have an overweight to cash yielding north of 4%.