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2023 OUTLOOK LETTER & 2022 REVIEW

"***History provides a crucial insight regarding market crises: they are inevitable, painful and ultimately surmountable***."
I think this old quote from Shelby Davis (founder of Davis Mutual Funds) is appropriate after a year like 2022. This could have been said in 2020, 2008-9, 2001-2, or pick your crisis in the past 100 plus years. If history follows, and I can say with almost 100% certainty based on history, inevitably we will overcome the current inflationary driven market crisis and stocks will climb to new highs in time.

With that introduction, **Happy New Year** to all and again wishing you and your families a blessed and healthy year ahead! What a year it was and thank goodness for the fourth quarter which although volatile at least provided a positive return for the only quarter this year. The good news was that the stock market (S&P 500) climbed over 7.5% in Q4, the bad news is that we needed that for the S&P 500 to finish the year with a total return of -18.2%. And if you thought you could hide in bonds you were sorely mistaken as the Barclays Aggregate Bond Index returned -13%, its worst since 1976, as the yield on the 10-Year US Treasury climbed from 1.50% to 3.83%. (Bond prices move inverse to yields.) So, the classic 60/40 balanced portfolio of stocks and bonds that is supposed to provide a hedge careened off course and produced a -16% return for the year due to the rare occurrence of both asset classes falling. Currently however, bond yields above 4.5% are looking like an attractive alternative as TINA (there is no alternative) is now on vacation. 2023 was the worst year for stocks since 2008, the year of the Lehman collapse and beginning of the financial crisis. **2023 was a year where stocks tumbled, bonds bumbled and crypto crumbled.** The highly touted FANG+ stocks got defanged, dropping over 40% combined – Tesla got smoked as Musk bought Twitter, dropping over 60%, and Bitcoin's value was destroyed by 64% due to the collapse of FTX and Sam "Frankenstein" Bankman-Fried. Below is a table of price returns for various assets in 2022. It ain't pretty.

ASSET	% RTN	ASSET	% RTN	ASSET	% RTN
S&P Energy	59.0%	Euro	-5.9%	SP Small Cap 600	-17.4%
Nat Gas	20.0	SP Industrials	-7.1	**S&P 500**	**-19.4**
Nymex Gasoline	10.4	Dow Jones Industrials	-8.8	Russell 2000 SC	-21.6
Crude Oil	6.7	Nat'l Muni Bond	-9.3	SP Real Estate	-28.5
Silver	2.3	Nikkei 225	-9.4	SP Technology	-28.9
FTSE UK	.90	France CAC 40	-9.5	Nasdaq 100	-33.0
Gold	-.43	German DAX	-12.4	I-Shares 20+ Yr Treas	-32.8
S&P Utilities	-1.4	SP Financials	-12.4	SP Cons Discretion	-37.6
S&P Cons Staples	-3.2	Euro Stoxx 600	-12.9	SP Communic Svcs	-40.4
SP Healthcare	-3.6	SP Materials	-14.1	Bitcoin	-64.7
I-Share 1-3 Yr Treas	-5.1	SP Midcap 400	-14.5	Ethereum	-70.4
Ibex Spain	-5.6	**Vang Tot Bond**	**-15.2**		

A few highlights -- Energy stocks rode oil prices as high as $130 a barrel during the year to be the hottest group up 59% while crude oil only increased 6.7% by YE, artificially low due to Strategic reserve releases. Gasoline after rising to over $6 a gallon finished the year up 10%. Gold was down .4%, surprising as it is considered an inflation hedge. On the downside, I can go on and on about the remaining market carnage but we talked about a lot of this throughout the year already, so I won't rehash all the ugly details. Let's just say that there weren't a lot of places to generate return.

CAPITALIZATION AND STYLE

Value stocks had huge outperformance versus Growth across capitalization but especially in Large Cap land with Value outperforming by over 17%, one of the largest variances for Value in years. Small and Midcap Value also bettered Growth by about 10% margins. In terms of size performance, Large Caps underperformed as the S%P 500 declined -19.4% compared to the Midcap 400 drop of -14.5% and the Small Cap 600 drop of -17.4%.

SP 500 Value	-6.9%	SP 400 MC Value	-9.0%	SP 600 Sm Cap Value	-13.0%
SP 500 Growth	-23.5%	SP 400 MG Growth	-19.9%	SP 600 Sm Cap Growth	-22.1%
SP 500	-19.4%	SP MC 400	-14.5%	SP Sm Cap 600	-17.4%

SECTOR ANALYSIS

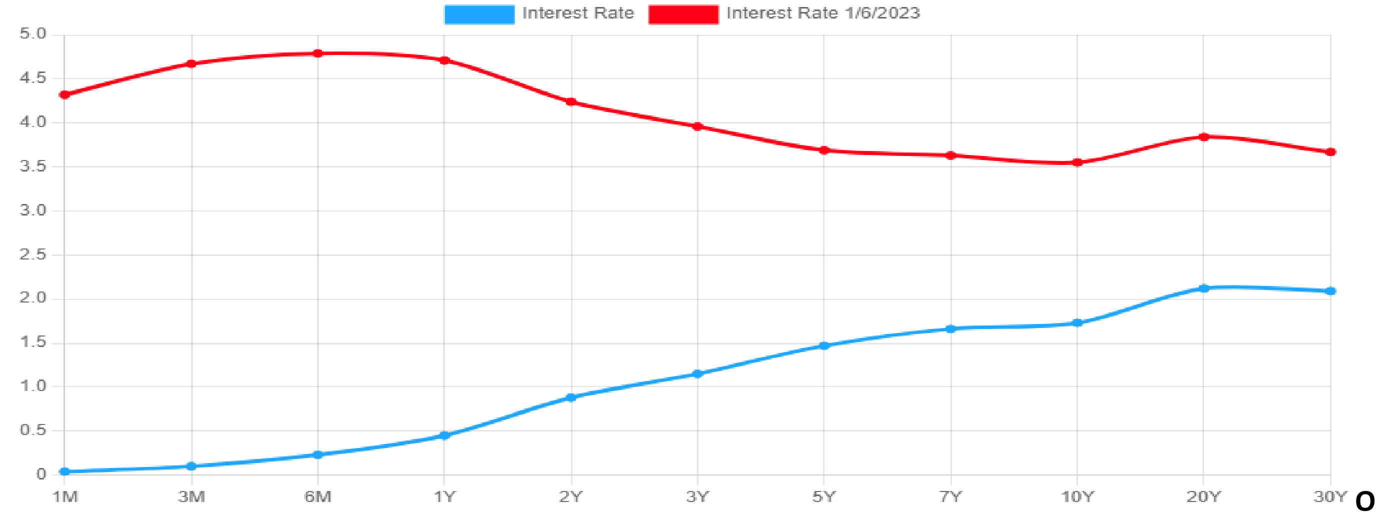
Among S&P sectors, the Energy sector by far had the best year increasing 59% while the next closest sectors were negative including Utilities at -1.4% return, Consumer Staples -3.2% and Healthcare -3.55%. On the flip side Communication Services declined -40.4%, Consumer Discretion dropped -37.6%, Technology -28.9% and Real Estate -28.5%. Rounding out the sectors were Materials -14%, Financials -12.5% and Industrials -7% which all fared better than the SP 500 Index.

KEY TAKEAWAYS LOOKING AHEAD

The last 2 quarters I gave you my arrow map of what is going on in the market. It is still pretty much the same. ***High inflation is triggering → aggressive Federal Reserve rate increases and tightening monetary conditions, this will hopefully reduce inflation but also → slow economic growth, which will in turn → lead to a recession, which means → lower corporate profits and lower earnings for the stock market***. The overwhelming consensus view for 2023 is that the first half of the year will be very difficult as the US heads to recession, rates rise, and corporate profits are lowered. As a result, stocks will tumble possibly retesting prior lows. Then, the 2nd half will be better as the Fed stops raising rates and looks to even pivot to lower rates as inflation stabilizes and they stimulate the economy. Stocks will rally strongly and finish the year ahead of where we started. **Because everybody expects this to happen, I can almost guarantee this will not happen.** So, what are some alternative scenarios? I'll got to that later. First, here are some key takeaways as we look ahead to 2023:

1. The Risks causing high market volatility are likely to persist, but our call for a milder recession still stands for now. This is not a financial meltdown like 2008/9, it actually has the potential for now of a soft landing. The Fed has never done this, could it be the first time?
2. Inflation is still the single biggest factor affecting the market and world economies as global central banks raise rates to fight it off. The CPI and PPI readings going forward continue to be must-see TV. Any jump in inflation beyond expectations is going to send stocks down as a kneejerk reaction. Core CPI is likely to be up near 5-6% near-term which means the Fed will keep raising rates.
3. Corporate profits will be key to stock performance. Profits are expected to have decreased in Q4 by -4% for a full year 2022 increase of 4.7%. Although there is a low bar for companies to beat in Q4, more pressing will be their 2023 outlooks. Currently analysts are projecting a 4.8% increase in 2023 EPS for the S&P 500. Economists on the other hand are projecting a 2.7% decline. Most likely is that EPS will be down in 2023, but by how much and will it be front or backloaded? Consensus calls for declines in Q1 & Q2.
4. As mentioned earlier bond yields are above 4% and an attractive alternative to our girlfriend TINA (There is No Alternative) for a while. But the treasury yield curve starts inverting beyond 2 years and the 10-Year bond yield is about .70% lower than a 2-year bond and 1% below a 1-year bond. This inverted curve points to a recession and is 13 of 13 in predicting recessions.

TREASURY YIELD CURVE TODAY (INVERTED) VS 1 YEAR AGO



5. The US Economy is slowing. The ISM services index dropped below 50, matching the manufacturing index which means a contraction. The unemployment picture is somewhat misleading. The rate is still at 3.5% the lowest since 1969 and nonfarm payrolls are increasing. And there are 1.7 jobs per unemployed worker. But the pace of gains is decelerating, and we are seeing headlines of mass layoffs especially in technology. Home prices are dropping, and existing sales are in decline due to higher mortgage rates. Existing sales are down 38% in November from a year ago. Still, US GDP is estimated at around 3.8% growth in Q4. But 2023 should see a material slowdown if not negative growth as we potentially enter recession and then hopefully climb back out later in the 2nd half. Overall GDP growth in 2023 is estimated around 1% give or take.
6. The Fed has raised rates 7 times to 4.25% . It signaled that it is slowing down rate hikes but still sees about another 1% increase until they stop sometime this year at around 5-5.25%. Then it is a matter of how long rates stay there.
7. The Russian war and China's economy are the 2 biggest outside geopolitical risks. The ongoing war continues to affect energy prices, grain supply chain and other humanitarian issues. China's covid policy and economic reopening will have major repercussions on world economies, especially in technology. A reopening will help with growth worldwide. A pandemic escalation and closure are obviously negative.
8. Recession Risk is high. This is one of the most anticipated recessions in some time. It's like watching a slow-motion car crash anticipating the severity. Based on current trends it is likely to be much milder than the 08/09 crisis recession in terms of GDP and corporate profits decline. How much is already baked in equity and bond prices? It depends on the severity question. Right now, a mild recession is anticipated.

BONDS

Bonds had an awful year (worst in 35+ years) and negative return for the second year in a row. Yields are certainly more attractive now and short-term yields should move a little higher as the Fed continues to increase rates. The yield curve inversion shows that investors think a series of rate cuts will happen sometime in the 2023 second half after the Fed Funds rate peaks around 5%. However, the FOMC Board members are forecasting that rates will peak a little higher than 5% and then stay there through 2023. Who's right? The answer to that question will determine what return bonds can generate. At the very least, buying 1-3 year bonds should return their coupon rate of 4% to 5%. Buying longer-term bonds should return a lower coupon as the 10-yr is around 3.6% but there is principal risk if rates actually move higher and the curve normalizes without short rates declining. The higher probability seems to be that the Fed will eventually need to lower rates but not until inflation remains in a 2%-3% range. We recommend short to intermediate bonds (1-3 Yr) but would buy longer term bonds if those rates move above 4%. Alternative fixed vehicles like preferred stock and short-term high yield bonds also can be owned. Muni bond yields are also attractive for taxable accounts.

EQUITIES

The consensus for equities is for a weak first half to be followed by a stronger second half mostly based on the Fed possibly cutting rates to re-stimulate the economy. It just seems too simple for that to happen. Personally, I don't believe we will retest the lows of 2022 unless the recession is more severe. I do believe it is better to be a bit cautious and defensive still as it is early in the year, and we will start getting corporate profit reports this week and following. The market valuation is somewhere around a Price/Earnings (PE) ratio of 16.5x current forward earnings. But those earnings are expected to come down making the market a bit more expensive. Still, the 5-year average PE of 18.5x and the 10-year average of 17.2x means stocks are in their historical range. I still recommend a diverse portfolio with Large, Mid and Small caps represented. My preference is still Value over Growth but Growth will come back in favor as the year progresses. International, specifically European equities are finally attractive to me on valuation and could continue to outperform US stocks near term. On a sector basis I would own most sectors but must be stock specific and own the attractively valued stocks in the various sectors. Energy should continue to do well as the price of oil may rise as countries must replenish their strategic reserves and China comes back. I'd be underweight Consumer Discretion stocks as the economy slows and be careful with Technology. However, I want to own quality tech stocks especially if they get hit on near-term earnings concerns. Healthcare, consumer staples and utilities although fairly valued, should provide portfolio stability.

FINAL THOUGHTS

As I've talked about, the investment community is very single-minded in the outlook for 2023. As a long-time investor who has lived through booms and busts over the years, this tends to bother me as consensus generally doesn't happen. Is it different this time? I'm going to assign some probabilities to scenarios.

- First, my highest probability and base case is as follows: I'm going to go out on a limb and say I think given how much this potential recession and rate hiking cycle is being pre-broadcast, the Fed can actually pull off a softer landing type mild recession. There will continue to be market volatility and although I don't think we will retest 2022 lows, we could see another correction decline in the coming months that will feel difficult. I do subscribe to higher equity prices this year and am forecasting an eventual increase of 8%-12% with 2024 setting up as a stronger year. We are forecasting Bond returns to be in the 4% to 6% range in 2023.
- My bear case I assign a 25% probability that the recession is more severe as inflation continues at a high level and the Fed must keep rates higher for longer. Corporate profits decline about 10% and stocks decline through prior lows, over 10% until a Q4 rally, much like 2022. Stocks finish the year down 5-10%.
- My best-case scenario is my contrarian scenario, in a positive sense. That is, no recession and better profits. I assign a 15-20% probability that corporate profits are actually better and more resilient than forecast, inflation continues to decline, and the Fed stops cutting rates after 2 more hikes. The market rallies as a result in anticipation of stronger future profits and growth. The S&P returns 15-20% this year. Tech stocks lead the rally.

A balanced portfolio of 65% Equities and 35% stocks should also have a much better year as bond returns are positive in 2023 helping to cushion any equity weakness. As I mentioned I do like international stocks too so would include those in my equity allocation. So, I guess I am sort of buying into a slower first half, better 2nd half scenario even though I kind of guaranteed it wouldn't happen earlier in my letter. The difference is I don't expect a big downturn in stocks in the first half as inflation declines and the Fed relents on increases. Don't fight the Fed in reverse either!

Have a great 2023 and feel free to contact me with any comments. I will be out soon with the 2022 Survey Results and the 2023 Survey so keep an eye on your inboxes.

Bob