INVESTMENT PARTNERS ASSET MANAGEMENT

10 Station Place, Metuchen NJ 08840 Tel: 732-205-0391 Fax: 732-205-0395

OUTLOOK 2023

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Proceed with Caution… But Do Proceed

You may remember that last year's Outlook report was presciently entitled **"Curb Your Enthusiasm, But Don't Lose Your Optimism."** In it, we correctly cited a number of economic uncertainties, geopolitical risks, megatrends, and headwinds – many of which did indeed play out during the year. However, most professional investors, ourselves included, perhaps underestimated that any positive developments in the economy or the markets would be outweighed by the impacts of inflation, tightening monetary conditions, higher interest rates, China's slowdown/lockdown, upheaval in the Ukraine, protectionism, energy supply constriction, and soured investor sentiment. Despite efforts to diversify, there was little an investor could have done when an unprecedented rise in interest rates assailed both the fixed income and equity markets. Normally, bond investors cushion the impact of falling equities prices because the returns of those two asset classes tend to have low correlations. In a balanced portfolio, this approach historically serves to manage risk. In 2022 though, virtually all asset classes became both correlated to one another and biased to the downside. So, while diversification may have helped soften the blow only marginally in 2022, the reality is that most portfolios declined last year no matter how they were allocated.

Specifically, in 2022, the overall US equity market experienced almost a 20% drop (seventh worst of all time), intermediate-term investment grade bonds declined about 13%, the 20-year US Treasury bond posted almost a 30% drop (worst in the modern era), and a basket of passively-managed investments (consisting of 60% stocks and 40% bonds) generally lost in the mid to high teens, depending on the underlying asset mix. Market results like those were not only enough to curb one's enthusiasm but were more than ample to crush one's optimism as well.

This year, we think an appropriate title for our report is – **"Proceed with Caution… But Do Proceed."** We chose this theme because we think, despite an uncertain economic and investment climate, the market in 2023 could present investors with an opportunity to allocate assets actively and strategically with a focus on quality at a reasonable price.

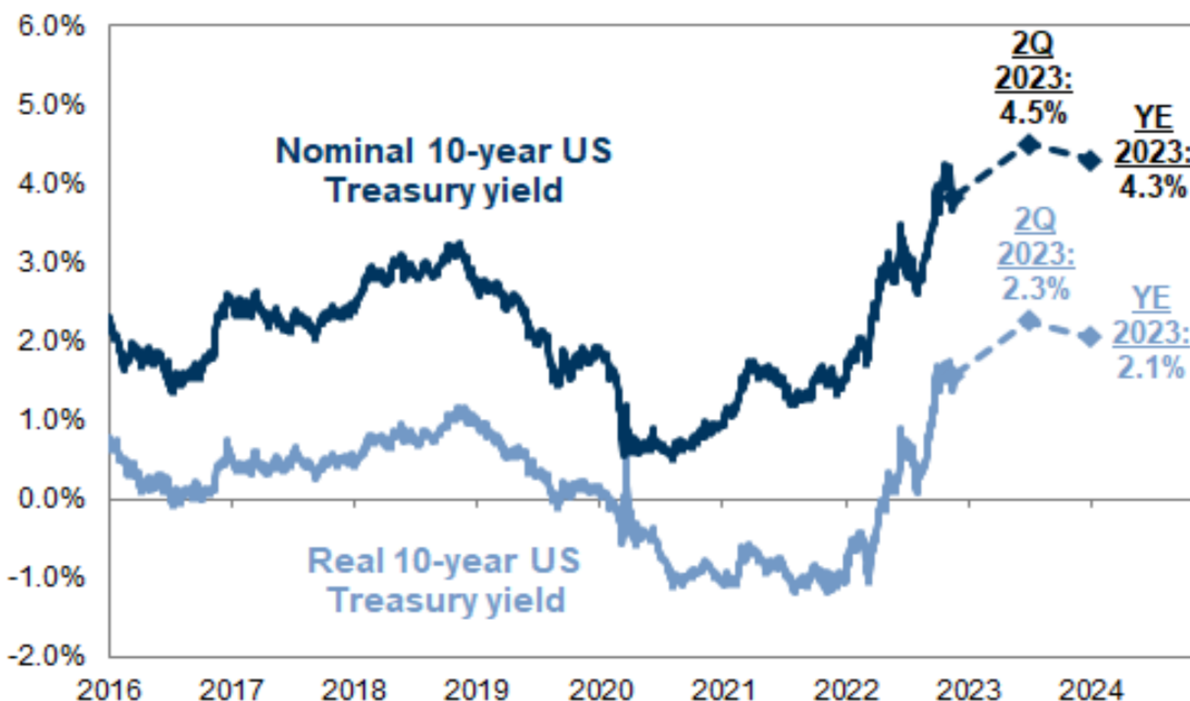
Said another way, conditions set in motion last year have served to depress certain asset classes to such an extent that long-term investors may be able to capitalize on these inefficiencies in an effort to obtain higher future expected returns. In roaring bull markets, many different strategies and asset classes perform well – sometimes with seemingly little effort. In an environment like the current one, however, we believe that adherence to fundamental investment principles, disciplined analysis, and thoughtful portfolio construction should prepare portfolios to make it through this market cycle and, we hope, achieve long-term results when more favorable market conditions return.

The question now is, when will things become more *normal*? We think that depends on what one considers *normal* to be. If one's definition of *normal* includes zero percent interest rates and outsized

accommodation from the Federal Reserve, then we think the answer is that *2023 will not be normal*. And perhaps 2% inflation and Gross Domestic Product (GDP) growth back to the historical trendline are not in the cards for this year either. Energy and trade imbalances (along with a resurgence of nationalism and upheaval around the globe) will likely keep prices elevated for some time to come. What might be more *normal* in 2023, though, is that the *rate of change* stemming from the surprise outcomes from 2022 might moderate, and thus securities markets could, at some point, stabilize and behave more in line with historical asset-class performance and correlations. First, a perception that interest rates are peaking this year could put a floor under bonds. And second, steadiness of corporate revenues and earnings relative to interest rates could perhaps give investors confidence that valuations in the equity markets have reached attractive entry points, creating a base for stocks.

RATE / FIXED INCOME BACKDROP FOR 2023

To expand upon the above, if rates on the 10-year treasury bond were to peak at 4.5% in Q2 of this year, that would be a 62 basis point move from where rates began the year (3.88% at 12/31/22). While that is a considerable move (16% increase), it is a smaller increase by degree of magnitude than during 2022 when the yield on the 10-year bond increased by 156% from 1.51% to 3.88%. We believe the lower rate of change may translate to a muted market reaction when compared to 2022, and maybe that would be enough to spur demand for fixed income securities during 2023.



Source: Goldman Sachs Global Investment Research

EQUITY BACKDROP FOR 2023

With respect to equities, we believe that the S&P 500 index could be range bound until inflation and interest rates become stable. This year will be a proving ground for corporations to right-size their operations, control expenses, and pass input-cost increases along to their customers. As a result, market-watcher Yardeni Research is projecting modest earnings growth of 4.7% for companies in the S&P 500 for full-year 2023 - with negative earnings growth in the first half of the year. (1) With that as the assumption, we think that the S&P 500 could trade in a range between 15x to 20x its estimated $225 of earnings, or 3375 to 4500, until there is more clarity on earnings growth for the second half of 2023 and into 2024. (As of 01/10/2023 the S&P 500 index is approximately 3919.) In the event of a hard landing for the economy, however, we think corporate earnings could contract further with the S&P 500 index trading at an even lower PE multiple e.g. the low 3000 level.

	Yardeni Research		Analysts' Consensus	
	Level	YOY %	Level	YOY %
2023	**225.00 e**	**4.7**	**229.24 e**	**4.3**
Q1	53.00 e	-3.3	53.97 e	-1.6
Q2	55.00 e	-5.1	56.40 e	-2.7
Q3	58.00 e	3.5	58.50 e	4.4
Q4	59.00 e	8.3	59.51 e	10.6
2024	**250.00 e**	**11.1**	**253.37 e**	**10.5**

e=estimate.

* Historical earnings growth rates and earnings are not adjusted for accounting and index composition changes.
Source: Yardeni Research, Inc. and I/B/E/S data by Refinitiv.

Current forward PE Multiple for S&P: 17.41x @ 1/10/2023

Clear Sky S&P YE 2023 20 x 225 = 4500

Current S&P YE 2023 17.41x 225 = 3919

Mean Reversion S&P YE 2023 15.99 x 225 = 3598

Median S&P YE 2023 14.91 x 225 = 3355

Hard Landing S&P YE 2023 14 x 225= 3150

Mean:	15.99	
Median:	14.91	
Min:	5.31	(Dec 1917)
Max:	123.73	(May 2009)

Sources: Yardeni Research, Inc., multipl.com, IPAM

OPPORTUNITIES

So how are we going to invest in 2023, and what are the themes? We view the following as some of the potential opportunities for the coming year:

- Lower valuations and higher yields mean that the current market environment may offer attractive potential long-term returns for investors.

- Companies with strong cashflows, e.g. Telecom, Healthcare, Infrastructure, Software, and Financials, remain in focus.

- Bonds may return as an attractive risk hedge and income provider if inflation eventually retraces back toward central bank targets.

- So-called *Alternative* and *Satellite* strategies may offer appealing diversification benefits, inflation protection, and income production.

- Globalization and development will require continued innovation and automation, creating demand growth in new markets over the balance of the 2020s.

- Split Congress may put a halt to further regulation and tax initiatives, which may incent resumption of consumption and capital expenditure.

- The third year of Presidential Administrations tend to be favorable for equities markets (up 81.8% of the time since 1928).

- International valuations seem compelling relative to domestic markets.

- Investment opportunities to service a fast-growing population of emerging market consumers in their home countries are abundant. An increase in educated global population tends to lead to boosted demand for resources and infrastructure.

Income, Income, Income

As previously mentioned, rates will likely rise until inflation falls. This may seem like investment limbo for at least the first half of the year, however we see it as an opportunity to engage in a total return strategy, (i.e. income and possible capital gain potential) where reinvestment can compound long-term returns.

The market is focused on the *terminal rate* – i.e. the level at which the Fed will *pause* or *pivot* from it's current tightening bias While most players want to win in the short run, we don't see the Fed sacrificing its credibility by undoing the rate increases. The Fed is playing the long game - even inducing a recession if necessary – to quell inflationary pressures. Wall Street believes a pause in tightening will happen in the Spring or early Summer and possibly the economy will avoid falling into a recession. Since the yield curve is currently inverted (historically a harbinger of economic contraction when short term bonds earn higher interest than long dated bonds), a recession may or may not be looming. A recession would be no surprise, since traditionally Fed tightening measures have resulted in wringing out excess capacity from the economy and markets. While stock and bond prices have certainly fallen, we have not seen a dramatic universal reset. Corporate defaults remain near historic lows, and employment has remained very robust. Furthermore, we see signs that certain markets, like housing, are only beginning to feel the effect of Fed policy.

Because inflation has run hot and the Fed has been raising rates at the front end of the curve aggressively for a year, we think excellent opportunities are emerging across the spectrum in fixed income. Prior to 2022, due to unsustainably low interest rates, investors had difficulty achieving a meaningful income objective for their portfolios, especially on the short-term end of the duration curve. Now there are many candidates within the asset classes of bonds, dividend-paying stocks, and multi-strategy funds which attempt to generate income. At our annual event this past fall, for example, we discussed with panelists from JPMorgan and Blackstone several income-oriented strategies which attempt to generate significant cashflow within diversified portfolios. Since we generally believe in compounding income as a key component in the mission of obtaining a total return, we are encouraged by the opportunities evolving in the current environment.

Growth Companies at a Reasonable Price

In the periods subsequent to market corrections, active portfolio managers can sometimes obtain attractive returns for clients by selecting high-quality growth companies. As valuations come down in the current environment, we think such opportunities should abound. Our research will be devoted to identifying managements that reflect on their profit picture while maintaining their corporate balance sheets. We are already seeing evidence of this, and we expect this trend to continue. For example, if corporate management and boards act responsibly with respect to internal spending, many former high-flyers could regain investor confidence. Further, if interest rates stabilize but inflation remains sticky, we expect that companies with pricing power may actually be able to grow top-line revenue and profits - rewarding patient investors over the long term. Finally, returns could be exceptional if these corporate developments result in equity prices reverting to the mean. Said another way, even if these stocks eventually regain levels half of what they were at their highs, the increase from their trough valuations could represent handsome returns.

Companies with Solid Cashflows

Companies with stable free cash flow, strong balance sheets, modest growth in revenues, and diversified product offerings may make sense in the current market environment as well. We think this is particularly true of companies that are vertically integrated and can take advantage of their size and scope to grow through accretive acquisitions. Companies with stable cashflows and solid balance sheets not only have sustainability in bad economic conditions, but they have flexibility to pay (or increase) dividends, buy back stock, and maintain their credit ratings.

Industries with Staying Power

As many of you remember, with uncanny timing we hosted a panel in October 2021 in which we brought in portfolio managers from Goldman Sachs and Brookfield Asset Management to discuss the global energy industry and the transition to renewables. As it turns out, energy was one of the main drivers impacting the economy and the markets in 2022. After our careful study of this industry over a long period of time, we must conclude that a) the world will continue to consume large amounts of energy both from traditional and renewable sources); and b) because of physical laws, geological realities, and limitations of financing options, renewables have a long way to go before they can replace traditional energy methods. As such, we envision the concept of energy transition remaining a theme for 2023. We believe other essential industries with long-term staying power are also vital to societal infrastructure – namely telecom (including equipment), software (particularly data management and cybersecurity), healthcare, and financials.

RISKS

On the other side of the ledger, we view the following as some of the risks for 2023:

- Geopolitical concerns – Russian Invasion, China / Taiwan Conflict, North Korea
- Persistent inflation and monetary tightening
- Decreased corporate profits from higher commodity and interest expense
- Higher energy prices effecting consumer spending
- Market liquidity and strains
- Financial system shocks, defaults
- Domestic recession
- Eurozone recession
- Emerging Market recession
- Sustained China lockdowns, Covid resurgence
- Overvaluation of US dollar vis a vis other currencies
- Supply chain disruptions

Political Risks

The world is a dangerous place. We sometimes lose sight of that fact when our domestic economy is strong, and markets are upwardly biased. Russia's invasion of the Ukraine brought to the fore that macro issues are indeed real risks. The war's grave human toll, and its atrocities, harken back to a period not experienced in Europe since World War II. Sadly, it makes one wonder if humankind has learned anything at all from history. Our hope is that the war in the Ukraine eventually concludes at some point in the next 12-24 months as pressure from free world nations remains resolute, and Russia's resources and willingness to carry on weaken over time. It is not clear, though, how the conflict will end, what the terms will be, or what after-effects could ensue. Other global hotspots of concern are that China maintains its ambition to bring Taiwan under its control, Iran's hardline leaders grapple with domestic unrest, and North Korea periodically launches test missiles as if just to send us all a friendly reminder that they're still *out there*. In our own backyard, political turmoil also remains on the front page. There is a wide gap between the agendas of the Democratic party and the Republican party, with the latter conducting a contentious 15-round vote to approve a Speaker of the House. The lack of unity among the members of the majority party in the US House of Representatives gives us pause when considering that important issues, such as increasing the debt ceiling, come up for vote in mid-2023.

Economic Risks

According to the International Monetary Fund, GDP growth in many developed economies is projected to be flat or even negative in 2023. (3) The post-Covid economic snapback was met with significant and unexpected inflationary pressure. Central banks throughout the globe have responded by rapidly tightening monetary policy to slow inflation, with economic expansion over the short run being the natural casualty of that effort. The risk is that monetary policy has become too restrictive too quickly, and that global economies will tip into a deep recession – i.e. experience a hard landing. Thus far the evidence of recession has primarily manifested itself in financial asset price reduction, but oddly the job market has remained surprisingly resilient in the face of higher inflation and rates. At the beginning of the last decade, economists were bewildered by the prolonged *jobless recovery*, and now they are equally puzzled by the current *full-employment contraction*. As the impact of higher rates trickles through the world economy, it will become evident during 2023 whether or not global growth slows or stalls out, and the over-heated job market eventually retraces back to historical norms.

Financial Risks

One of the indicators of a weakening economy is the rate of corporate defaults on financial obligations. According to Fitch Ratings, high yield defaults are expected to increase from 1.3% in 2022 (up from 0.5% in 2021) to 2.5%-3.5% in 2023. Their projection assumes that the US economy will contract modestly during 2023. (2) If defaults, however, were to accelerate, it could mean that there would be additional strain on financial markets as borrowing costs could increase, particularly for non-investment grade credits, and equity valuations could decrease – especially for companies in need of ongoing financing. This is something that market participants will be evaluating carefully during 2023.

SUMMING IT ALL UP

Although we are coming off of a year where investments in most asset classes did not produce a positive return, we are approaching 2023 with enthusiasm and optimism about the market's long-term prospects. We recognize we are operating in an environment with many risks and uncertainties, and that the market might remain volatile for longer than we would like to see. However as long-term investors we believe that lower asset prices tend to translate into higher levels of future return over the years. We will be looking for opportunities to invest in quality companies and funds at reasonable prices, and to take advantage of higher interest rates to generate portfolio income. Our team has invested through many cycles, and each bear market is different. One thing that all market downturns have in common is that they do eventually give way to a more favorable investment environment in the future. Time will tell if that next phase of positive returns will begin in 2023, but in the meantime, we are honored and privileged that you have entrusted us to guide you in your pursuit of achieving your long-term financial goals. Speaking of which, it's always a good time to reassess your risk profile and objectives. If they have changed, or you would like to modify risk in your portfolios, please let us know.

1) Yardeni Research "YRI S&P Earnings Forecast" 01/09/23

2) https://www.fitchratings.com/research/corporate-finance/us-euro-corporate-default-rates-to-continue-ascent-in-2023-2024-15-12-2022#:~:text=F%20%E2%80%93%20Forecast.,fall%20into%20a%20mild%20recession.

3) International Monetary Fund "World Economic Outlook" October 2022

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