OUTLOOK 2023 – DEAR ROBERT: WHY SO BEARISH?

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My dear son Robert, it was great to see you over the holidays and to continue our conversations regarding the state of the economy and markets. I must say, 2022 was one of the worst years for global markets in anyone's memory. According to Deutsche Bank, for the U.S. 10-year treasury market (a core global benchmark that impacts valuations of most global financial assets), it was the worst-performing year since 1788! For the S&P 500 Index, it was the fourth-worst return in the post-war era, returning -18% (USD), while U.S. Treasury 10-year bonds returned -17% (USD). What was truly unusual was having both fixed income and equity markets down substantially at the same time. As dire as markets were in 2022, it's important to keep the longer-term context in mind and last year's correction followed what had been three years of double-digit positive returns. Time in the market matters more than timing the market.

Coming into 2023 after such a trying 2022, perhaps it's understandable that the mood is a little sombre, as reflected in the CBC article you had sent, titled: "If you thought 2022 was bad, wait till you see what 2023 has in store for the economy." But while challenges do lie ahead for the economy and markets in 2023, my reaction to the story is, "Why so bearish?" Let's discuss.

DISCOMBOBULATION

Before we dive into what might be in store for 2023, I feel it's important to put the current state of the global economy into context. The economy remains in a fragile state of severe disequilibrium, with elevated macroeconomic volatility and elevated data measurement volatility, following three years of ongoing and unprecedented exogenous shocks. In 2020, in the face of the global COVID-19 pandemic, we locked down the global economy and the U.S. lost roughly 20 million jobs. This was followed by the most aggressive fiscal and monetary policies ever, with roughly US$5 trillion committed to various pandemic relief payments in the U.S. alone, while interest rates dropped to zero. Through 2021 and into 2022, we tried to reopen the global economy amid the ongoing COVID-19 waves, such as Delta and Omicron. If that was not enough, in February 2022, Russia's invasion of Ukraine sparked an actual war in Europe, pushing energy and food prices significantly higher. The cumulative and ongoing effect of these shocks was a discombobulated global economy trying to regain a sense of balance. Achieving equilibrium takes time and different segments respond at different speeds, etc. Global supply chains are continuing to normalize but are not fully there. Oil, having spiked above US$120, is back around US$80. In addition, the summer 2022 peak in pent-up travel demand is subsiding and the labour market, particularly in the services area, is slowly rebalancing, although clear scars and questions remain.

“It’s Tough to Make Predictions, Especially About the Future” – Yogi Berra

When an economy has been as severely destabilized as over the past three years, ongoing economic patterns no longer conform to their usual trends and cycles. This makes any forecast of the economic trajectory more challenging than usual, resulting in a much broader range of potential outcomes with considerably more noise in the models used to capture the data. Most models fundamentally assume the economy tends to fluctuate around a state of equilibrium, a condition in clear violation today. Any forecast today comes with a lower-than-normal degree of confidence and wider range of potential outcomes. Such elevated degrees of uncertainty dictate that portfolio managers and, particularly, policymakers should adopt a more risk-first approach, should remain humble and be flexible and adaptable to changing environments. While the glass-half-empty view of the world encompassed in the CBC article you sent may indeed come to pass, Robert, there are many reasons to see 2023 with a glass-half-full perspective, and importantly for investors, some very positive messages for 2023.

2022 REDUX

One word ruled them all in 2022: Inflation

In 2022, nothing dictated market outcomes more than inflation, although to be fair it was really about the interaction of inflation with central banks’ reaction functions that mattered. Interestingly, U.S. headline Consumer Price Index (CPI) inflation is lower today, at 6.5%, than it was a year ago, at 7%. What changed was the perception or narrative around the path of inflation. A year ago, it was about transitory inflation driven predominantly by pandemic-related supply-chain challenges and excess goods demand tied to COVID-19 fiscal support. With both drivers having ended, it was expected that inflation would decline as quick as it rose, and that central banks had the luxury of time. They could raise interest rates off the zero floor and head toward a neutral stance as inflation subsided back toward their 2% target. In January 2022, markets expected interest rates to increase toward 1% by year-end. With overnight rates currently sitting at 4.5%, this was a several-orders-of-magnitude miss in the forecast and highlights the previous point regarding the challenge with forecasts when in a state of disequilibrium.

From transitory to “Kill Bill”

If that was the expectation, what changed? One factor that did matter was the Russian invasion of Ukraine and spiking energy and food prices. With elevated inflation already a clear problem, adding an energy supply-side shock on top of the existing supply-chain-related goods inflation supercharged the inflation outlook and effectively killed the transitory narrative. By spring (May/June), inflation was reaccelerating to new highs and central banks pivoted aggressively from a “transitory” to a “public enemy #1” view on inflation, adopting what I termed the “Kill Bill” approach to fighting inflation. Kill it now and ensure it’s dead so it cannot get back up and bite you! This was a truly global affair as many central banks pivoted in a similar fashion. In both Canada and the U.S., the clear message was the need to accelerate interest rate increases to get well beyond neutral and into a tightening stance for monetary policy, at least into the 4% range. With U.S. inflation data continuing to surprise on the stronger side right into the fourth quarter, the U.S. Federal Reserve Board (Fed), having started from incredibly accommodative policy levels, had no options but to aggressively raise interest rates, which they did at a pace of 75 basis points (bps) per meeting before slowing to 50 bps in December.

CONCERNS INTO 2023

We entered 2022 with inflation running hot and monetary policy at maximum loose. Today, we start 2023 with moderating yet still-high inflation, and monetary policy at the tightest level in over a decade. Today is a very different set up versus last year, with very different implications for what might transpire in the coming year.

Recession

Fears of a recession are everywhere, and rightly so. The degree of monetary tightening in 2022 was designed to slow down an overheating economy. That usually entails a period of negative growth (i.e., a recession). But recession is not a four-letter word and given the starting point of an overheated economy, a slowdown is required to bring the economy back into balance. While almost all current economic data portray a significant slowdown underway, the surprise so far has been the economy's resilience. Record-low unemployment and strong wage growth are signs of a robust economy and continue to support resilient consumption, even in the face of rising interest and mortgage costs, but that also feeds through to stronger inflationary pressures. Simply put, wages are a key driver of domestically driven inflation and aggregate wage growth in excess of 4% is fundamentally inconsistent with achieving a 2% price stability target (2% inflation + 2% productivity growth puts you in that ballpark, although 3.5% is a more realistic upper range for wage growth).

A recession driven by tighter monetary policy with the aim of slowing an overheating economy and restoring labour market stability is not a bad thing. Long-term prosperity is best achieved by an economy growing around its potential, with broad price stability. A slowdown or recession aimed at returning the economy toward equilibrium is not the same as a recession driven by the collapse of a levered asset bubble, as was the case in both 2008 and 2000. Recessions from bursting asset bubbles are far more damaging and tend to have longer-term balance-sheet scarring implications that take years to rebuild. Today, no such imbalances are evident at the aggregate macroeconomic level. There are always challenges and pockets of pain at the microeconomic level, but that is a different issue versus looking at the overall aggregate macroeconomic picture. For example, rising unemployment from record-low levels back toward higher, yet still-low levels may restore labour market flexibility and is a healthy macro development, but it's still devastating if you're the one losing your job.

We do expect a recession to unfold in 2023, but also expect it to be generally mild. As the economy and inflation slow, we believe the Fed (and the Bank of Canada) will be loosening policy in the back half of the year. To the extent that tighter financial conditions have driven the slowdown, a subsequent easing of financial conditions later in the year should also enable a reacceleration of the economy out of the slow patch. If higher rates drive the slowdown, lower rates will enable a rebound. This is not 2008.

Black swans

Another concern for markets in the face of historically aggressive policy tightening pertains to what might break. What are the "black swans", or unexpected consequences of the interest rate increases? This is a good question and clearly a risk factor to remain alert to. In any tightening cycle one expects something to break, usually those who have become most leveraged and caught up in the prior period's euphoria. While the most recent pandemic-driven zero-rate period has seen some excessive activities, in genera, the party didn't last long enough to drive truly excessive behaviour. Nonetheless, we have seen few breakages, which is a good sign. Examples include:

- Credit Suisse, a major global investment bank whose shares declined from US$13 pre-pandemic to US$3. It seems there is always at least one bank on the list.
- The U.K., following a massive proposed unfunded tax cut into an overheating economy, saw its currency collapse and interest rates spike, threatening to collapse several U.K. pension plans and forcing a removal of the Truss government and full policy reversal. There is usually a sovereign crisis to contend with, but we normally expect to see an emerging markets country and not a developed one like the U.K.
- Cryptocurrency, which was a clear source of speculative and fraudulent activity, as evidenced by the collapse of FTX and other smaller players in the space.

As Warren Buffett is alleged to have said, "when the tide goes out, you see who has been swimming naked." Clearly, some of those naked swimmers have begun to surface and I'm pretty certain there will be more over the course of 2023, but it doesn't appear likely that any will be systemically important players in the overall macroeconomic or financial worlds. Black swans are, by definition, events that we don't see coming, so we are cognizant of the risks. But they're also supposed to be rare events, particularly if considering those with broad global macro implications.

WHAT REALLY MATTERS IN 2023

While recession and black swan concerns will likely be material drivers in 2023, and particularly for the economy, in my opinion there remains one driver that still rules them all: Inflation.

Fed is back to data dependency

As in 2022, so it will be in 2023. Inflation will retain centre stage in determining outcomes – to some degree for the economy, and most definitely for asset markets. It will hinge on how the unfolding inflation trends influence the narrative around monetary policy, the Fed's policy reaction function and evolving financial conditions more broadly. One essential difference to note between 2022 and 2023 is that last year, the Fed's policy settings were wildly inappropriate (in hindsight), such that when they abandoned the 'transitory inflation' outlook they ceased to be data dependent. Inflation was so far above target; policy rates were so far below neutral that they were forced into an autopilot aggressive rate increasing mode. There was no policy optionality. Today, with interest rates well above neutral and inflation moderating, they are once again data dependent. They have restored policy optionality to either tighten or loosen as they see fit. We are at the end of the tightening cycle. Whether the terminal rate ends up being 4.75% or 5.25% is immaterial in comparison to moving from 0% to 4.5%. It will influence short-term market volatility, but the job of normalizing rates is done. They will be monitoring closely to understand how the impact of policy tightening will unfold and will adapt accordingly, knowing full well that economic impacts unfold with significant lags.

The Cinderella best-case setup would see inflationary data fall faster than expected, including softening in labour and wage data, but the economic data remains more resilient than feared despite still slowing. The evil stepsister outcome would be more persistent inflation and weaker economic data feeding stagflation concerns. The most likely outcome will be between the two scenarios, but there's reason to be hopeful that it tilts toward the best versus the worst case. This is predicated on emerging evidence of inflation easing more rapidly than expected. I would caution that such easing must continue and, given the above-mentioned data volatility, it could be several months before the data is conclusive.

My base case is that the Fed will increase rates once more by 25 bps in February and pause thereafter before signalling cuts in the back half of 2023. I do assume that the inflation data continues to surprise on the soft side and there's emerging evidence of easing labour market conditions. It's important to recognize that in the rush to raise rates aggressively, the Fed deliberately adopted and spelt out a policy aimed at over-tightening rather than under-tightening. By extension, once they conclude the cycle of rate increases, they expect to have gone too far in the knowledge that they can easily backtrack. Assuming they reach 4.75%, then cutting rates even back toward 3.5% would still leave them above the estimate of the long-term neutral rate at 2.5%, and therefore still tight overall. As we saw last year, I expect significant swings in the narrative around monetary policy in 2023 and, as was the case last year, it'll have market implications, so stay tuned.

Disinflation

In support of the above thesis, it's worth looking a little closer at current inflation trends. There are multiple inflation series that matter, and all tell slightly differentiated stories. The nuances do matter but, ultimately, they will be correlated. For illustrative purposes, let's look at headline U.S. CPI, which includes food and energy. As mentioned, headline CPI entered 2022 at 7% year-over-year (y-o-y) and exited at 6.5% y-o-y, so already heading down. Following the Russia invasion and spiking energy and food prices, U.S. CPI peaked at 9.1% in June before starting its descent. But until the October release, the data continued to surprise to the upside. October was the first time we saw CPI falling faster than expected, a trend that has continued for both November and December. While one month is not a trend, three consecutive prints below expectation starts to tell a story. From a timing perspective, it is also when initial impacts of monetary tightening should begin impacting the data, which also helps.

Taking a closer look, using month-over-month (m-o-m) data rather than y-o-y, is instructive as the y-o-y number is the sum of the previous 12 months. Much of the headline CPI has been influenced by two factors: first, the transitory pandemic-related supply-chain inflation, which really has been transitory even if slower to reverse than what was originally expected; and second, food and energy prices that rose sharply given the war. Both were big factors in the first half of 2022 but have been fading ever since. If we simply look at the m-o-m CPI over the last six months of 2022, U.S. headline CPI was only up by 1.8% annualized following a decline of 0.1% in December. Short-term CPI inflation is already running below the Fed's 2% target. If we extrapolate and assume headline CPI continues to come in at a 0.2% m-o-m rate in the first half of 2023, then the June CPI number will be a mere 1.4% y-o-y, which is

far below target. Now, those are some pretty heroic assumptions and much of the recent softness has been energy related, which will unlikely be repeated. But it illustrates how quickly the data can evolve; just as it surprised on the upside, so can it surprise to the downside.

Inflation is an immensely complex issue. The above simple example does not address many key nuances, such as the impact of housing inflation (still very strong but set to fall with a lag) and wage inflation, the key focus for policymakers (remains too strong, heading in the right direction but with many distortions in the data). All of these are aspects we're watching and will serve to confirm or caution our expectation for weaker-than-expected inflation.

The Fed's bluff: Note what I do, not what I say

As it relates to monetary policy and the Fed reaction function, it's worth pondering the possibility that by June, headline CPI is below their 2% target, and the overnight interest rate is around the 5% range currently forecast. We know the Fed is independent, but there are limits. Imagine the political narrative of inflation being below target and the Fed keeping rates at an elevated level designed to slow the economy, increase unemployment and costing people their jobs. It's not going to happen. Under such a scenario, the so-called pivot will have already arrived, even if rates remain well within the tight zone. The year 2023 marks the end of the monetary tightening cycle – it's a question of when, not if.

China

China deserves a special mention here as the recent decision to completely remove all of their zero-COVID restrictions overnight is an unexpected development. The immediate implication is that COVID-19 is ripping through China at an astounding pace with hundreds of millions catching the virus in recent weeks, and an expected continuation of infections through the Chinese New Year celebrations. Embracing a "cold turkey" approach to herd immunity will have significant near-term implications for infections and casualties, but fast forward a few more weeks and most of the population will have recovered. Following some of the strictest lockdown policies on the planet, we expect to see one of the biggest pent-up demand booms in domestic consumption, travel, etc. China GDP growth is likely to accelerate far faster than previously anticipated under the gradual reopening approach, as was seen across most developed countries. In turn, this will be a welcome support to global growth expectations and offset at least some of the slowdown in developed markets.

ASSET MARKET OUTLOOK

Equities

Equity markets should respond favourably to the end of interest rate increases, and particularly to signals of impending rate cuts. But they also face headwinds on concerns around earnings as the economy slows into recession. I expect the first few months of 2023 to remain volatile as the competing forces of rates versus earnings battle for supremacy. I believe equity markets already saw their lows last October, but will likely remain range-bound before climbing higher once fears of recession ease. Markets always move in advance, so no need to wait until a recession is ending, but the ideal timing is likely closer to being on the doorstep and being able to anticipate the recovery on the other side. This will simultaneously drive expectations for monetary easing, not just pausing. This may be trying to cut it a bit fine on the timing, and I don't want to be too underweight in equities given the correction already seen, the still-soft positioning and reasonable valuations on a global basis. There are also parts of the market we have been adding to, such as China, with the anticipated domestic consumption boom following the end of zero-COVID policies.

Fixed income: The war on savers is over!

Simple story here: Buy fixed income now! As painful as fixed income markets were last year with interest rates going from zero to 4.5%, interest rates have been reset and are offering the most attractive yields in well over a decade. For more than 10 years, we have been blasting the "war on savers" or negative real interest rates on offer in the fixed income market following the Great Financial Crisis. Negative real rates left no viable options to generate income for risk-averse investors and was by far the

biggest challenge to the retirement savings industry. It ended in 2022. That's cause for both celebration and a table-thumping recommendation, at least in my view, to buy fixed income and income products for clients or portfolios needing income. At 3.5%, U.S. 10-year bonds are once again offering positive real yields (given long-term inflation at 2%) and duration protection as interest rates once again have room to fall (bond prices rise) in a downturn. On top of government bonds yielding 3.5% to 4%, investment grade offers 5% and high yield 8%+. Our fixed income tools are back, and we have been adding to exposures through 2022.

CONCLUSION

I believe 2023 will remain a bumpy ride for the real economy as it recovers from the shocks and adjusts to the monetary tightening of the past year. This year should be much better for asset markets that adjust at a far quicker pace. The true silver lining of the past year has been a normalization of interest rates. Zero interest rates, common over the past decade, are not a sign of a healthy economy and are a significant burden on savers. Following the great rate reset of 2022, asset market valuations have normalized. Economies are also normalizing and should continue to rebalance toward a sense of equilibrium over the course of 2023 – it just takes time. Economic adjustments can cause unease and a sense of dislocation, but unlike the past few years of discombobulation, the current trajectory is one of recovery from extreme shocks back towards a morebroadly balanced and healthy economy. Robert, this is cause for cautious optimism, not the time to be a bear.

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