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OUR TAKE

2023 Outlook
Thoughts, Concerns & Possible Silver Linings

December 16, 2022

We can look back at 2022 as a year of pain for investors. The biggest stories centered on inflation, the war in Ukraine, climate change, energy disruption/dislocation and China/Taiwan. Since we can't forecast the future (nobody can), we'll try to lay out some scenarios for 2023 with a focus on the above headline risks. We're more likely to be on the right side if nothing really bad (that's unforeseen) happens.

We'll begin with an inflationary outlook. The Fed wants inflation back at 2%. The era of easy money came to an abrupt end in 2022. Led by the Federal Reserve, central banks aggressively raised rates, while at the same time, reduced bond holdings on their balance sheets that were purchased during the covid crisis.

This equates to higher cost of money accompanied by increasing supply into the public fixed income markets. Predictably, bond markets have reacted negatively. U.S. short rates shot up from 0 to 4.5% over the course of the year. Keep in mind, bond prices move in the inverse to interest rates. If rates go up, prices come down and vice versa.

We think U.S. rates should peak towards the middle of the year. We expect a 25 to 50 basis point increase in February followed by another 25-basis point increase in March. After that, inflation data will tell the story. Wage inflation has been the stubborn culprit. The job market is still extremely tight. The Fed currently estimates a 3.5 million worker shortfall as compared to 2019. Blame can be assigned to covid deaths, older workers opting for retirement and a lack of adequate migration. Wage inflation, according to the Fed, makes up 55% of total inflation.

Our big assumption is moderating wage growth and higher unemployment by mid-year. Unfortunately, this may come to pass through business failure, or "right sizing" as opposed to labor force expansion. Cost of housing is beginning to roll over and the cost of goods have already begun to decline.

After the Fed feels confident that this isn't a head fake, interest rates may begin to come down as we go into the third and fourth quarters of 2023. Again, we'll watch the job numbers for greater clarity on timing.

The tragic, incomprehensible war in Ukraine exacerbated the Fed's already fraught challenge of slowing the economy and bringing down inflation without causing a recession (soft landing). With the Russian invasion, energy prices skyrocketed as Europe lost its primary source of natural gas (Russian pipelines). Western European countries were forced to scramble for replacement through new sources. The U.S., North Africa, Qatar, and others began shipping LNG (liquified natural gas) to help rebuild storage through the summer. Since then, Europe has sourced new supply from a variety of producers at highly inflated prices. Energy markets have subsequently been scrambled and realigned. Russia has since become a pariah in the energy markets for committing the unpardonable sin of becoming an unreliable supplier (not withstanding invading a neighbor). Russia will have a long, long path to regaining trust (if ever).

The green transition, already gaining steam in late 2021 and early 2022, was disrupted by the Ukraine war. With relatively low traditional energy prices and increasing emphasis on renewables, energy producers were reluctant to make new investment in exploration or infrastructure as we entered 2022. Developing new sources is staggeringly expensive (especially offshore) and requires an investment horizon stretching into decades. Some large multi-nationals took on the look and feel of royalty trusts – whereby they would extract but not replace.

A couple of things changed. Natural gas has become an important bridge from the world of carbon to the world of alternatives. With higher spot gas prices, shale producers uncapped existing wells and went back to work drilling for relatively accessible gas.

Meanwhile, in the past two years, activity, investment, and rhetoric surrounding the green transition has increased dramatically. What was niche is becoming mainstream. Who would've guessed that Ford would build an all-electric F150 at a brand new, state-of-the-art facility and there being a long waiting list of prospective buyers? The media coverage on the fusion breakthrough at Livermore electrified (no pun intended) the public as a sense of pride and can-

do spirit took hold – even though commercialization is years into the future. The Infrastructure Act will add $7.5 billion to help build a network of 500,000 EV chargers across the county.

We think natural gas will continue to play an important role in powering economies around the world. We also think that we're reaching an inflection point in renewables. As scale increases, prices are coming down. We hear an electric vehicle in Europe is cheaper to buy than a comparable internal combustion model. Battery technology is steadily advancing as new materials and form factors are moving beyond proof of concept.

The inflection looks like the proverbial hockey stick, whereby, markets are just now getting into the bend in the stick. Although early now, as public/private investment increases, opportunities for follow on investment in maturing publicly traded green tech should become abundant.

China has issues. It's not likely to be the growth driver of world manufacturing that it's been over the past quarter century. Martin Wolf, chief economist at the Financial Times, (a sage voice) predicts 3.5% GDP growth in China for 2023. That's well below its historic growth levels.

Xi has made many unforced errors. The zero covid policy clearly wasn't a winner. Saber rattling in the Taiwan Straits and the South China Sea has alarmed neighbors and adversaries while seriously damaging its international standing.

Poor Hong Kong. What a bait and switch that was.

China's population is old and getting older. The one child policy came back full force to bite it in the butt.
The Chinese property market is massively overbuilt and facing serious write downs and bankruptcies. Middle class investors stand to lose life savings as they've poured money into vaporous projects that have little chance of being built or sit virtually empty in row after row of high rises.

China's average family income is roughly a third of that of the U.S. It's certainly not a rich country by that standard.

Crack downs on free speech and business have scared away foreign capital. When we look back five years at the rapid ascension of Alibaba, Tencent, Huawei and others, we see lost fortunes and lost promise.

As investment and supply chains shift away from China, winners should include India, U.S. onshoring (if we can find enough workers), Vietnam, Indonesia, Malaysia, Mexico, Singapore, and others.

Markets always climb a "wall of worry" and there's plenty to worry about. However, … as we fret… advancements, realignments, adjustments, and green shoots are already changing the investment landscape.

As we said in our last note, it's a great time to lock in yield for the next few years. We haven't had this opportunity in fixed income for well over ten years. Avoiding obvious faddish pratfalls such as crypto, meme stocks, SPACS, and private debt is always top of our list. If we don't understand it (and we're pretty sophisticated), we don't own it. In all humility, we've made many good investment decisions and some not so good over the years. We'd like to think that we've learned from both and with the assistance of advanced data analytics and information sourcing, our investment process has never been better.

For stocks, we'll maintain the best high quality, leadership names. When the market reverses to the upside, much of the gain will occur over a short time span in relatively few trading sessions and we'll be right in place to participate in the upside.

Happy holidays to all and many happy returns going into the new year (pun intended)!

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