2023 YEAR AHEAD
2022 YEAR BEHIND

THE/BAHNSEN GROUP

"Stability leads to instability. The more stable things become and the longer things are stable, the more unstable they will be when the crisis hits."

~ Hyman Minsky

2022 was, all at once, one of the most challenging years for markets on record, but also one of the most gratifying years of my career. While a plethora of conditions were unavoidable for any investor (for example, the mathematical impact of rising interest rates), certain investor behaviors and philosophies played an outsized role in how 2022 went. For an experienced professional investment manager, gratification never comes from merely having a good result at a certain period of time; markets are too volatile and conditions are too susceptible to change to ever feel solace in short term results. Rather, gratification flows from thoughtful implementation of a cogent philosophy. At TBG we believe that was the case in 2022.

Gratification should also not be confused with a victory lap. One of our key cultural beliefs is that we repudiate the very idea of such! Our clients have ongoing financial needs and the burden of delivering financial solutions is equally ongoing. Put differently, there is no chance to take a victory lap in our business because the race is constantly going. The task of extracting risk premia from financial assets towards the achievement of goals and needs real human beings have is not easy, is not intermittent, and is not subject to very many "easy periods." And if one did find the post-crisis era of financial repression an "easy period" for money management, that era is most certainly over. And that story is essentially the story of 2022.

But financial repression did not make for an easy period in managing money; it created the illusion of an easy period. Seeds were being sown throughout that made for certain instabilities that persist today. Geopolitical events were hardly stable, either, and the ongoing drama of an unsettled world continues whether one is looking at Russia, China, Saudi Arabia, or any number of other known unknowns. The problem with apparent stability is that it breeds instability (Minsky's Financial Instability Hypothesis). "Speculative euphoria, increasing financial leverage, and excessive debt" replace healthy and prudent investing, and the end result is a purge of bad assets.

The doctrine of the Minsky Moment is mostly about investor behavior and propensities but it is deeply connected to the monetary policy of our day as well. Our recap of 2022 and thematic expectations for 2023 address both of these dynamics, and more. Some aspects of this era have now reached their conclusion (for example, the funeral of the SPAC craze has come and gone) but many other questions persist. Whether it be with specific asset classes or macroeconomic conditions there are plenty of things that remain in a state of flux.

This paper intends to address them, and to provide commentary and application, but not to predict the inherently unpredictable.

You will see in the report card for 2022 themes offered a year ago that there are some things we got very wrong and other things we got very right. If I were a betting man I would guess the same for our 2023 themes, too. But what is more important to us than the grades on the report card of various themes and trends is that our portfolio management stay faithful to our underlying philosophies, and that we execute with discipline and rigor. An investing worldview is needed in moments of instability, and the very important reality of investing is that there is always instability. I happen to believe there is built-up excess instability that will be with us for a long time, and I happen to feel very confident in our approach to navigating such. But if the Fed balance sheet was right-sized tomorrow, interest rates were at the "neutral rate" tomorrow (whatever that means), and Russia's imperial aspirations ended tomorrow, we would not believe the need for an "investing worldview" had subsided at all.

This is the source of our gratification – that we have a set of beliefs that are grounded philosophically and empirically, that stay with us even when the challenges of the headlines change. 2022 presented challenges and 2023 will, too (some of them being the same) – and yet the hardest work has already been done. We are not investment schizophrenics adjusting our beliefs to the seasons and the weather. The seasons do change and the weather does change, but our beliefs are not formed in the rear view mirror.

So with a sense of gratitude, anticipation, and humility we look back at 2022 and forward to 2023, knowing that the needs of the hour are always the same in this business: Truth, conviction, and discipline. No matter what you read in this year's white paper, the values of truth, conviction, and discipline will trump anything else. To that end, we work.

2022 IN REVIEW:

I am not one who believes 2022 "flew by" – as people like to say, especially as they get older (like I now am). The Bahnsen Group opened two new offices in 2022 (Nashville, TN and Bend, OR), added significant expansion to our Newport Beach office, effected billions of dollars of trades, added over $900 million to the assets we manage, added 13 new employees, replaced two department directors, and created 51 Dividend Cafes, 196 DC Todays, and 261 Podcasts. We ran over fifty internal research reports and made over ninety individual investment changes with over one hundred thousand trades across client accounts. It was a busy year, it did not fly by quickly, and it was filled with geopolitical and economic turmoil.

The market did not begin dropping when Vladimir Putin invaded Ukraine on February 24. Indeed, markets were already down -8% when that event shocked the world, and in fact markets rebounded +3.5% in March. The Fed Funds rate was effectively 0% when the year started out, and the very first rate hike of 2022 was a whopping +0.25% increase on March 16. Six weeks later they increased another +0.50%, but as late as June of this year the Fed Funds rate was still below 1%. Then in mid-June, late-July, late-September, and early November, the Federal Reserve increased their Federal Funds rate by 0.75% per meeting, bringing the Fed Funds rate up to 3.75%. In mid-December they modestly slowed that pace of rate hikes, increasing this time by 0.50%, leaving the Fed Funds rate in a range of 4.25-4.50%.

That increased monetary tightening was coupled with the beginning of quantitative tightening where we have seen the Fed reduce their balance sheet by $400 billion since the high level of Q2. This movement from roughly $9 trillion to $8.6 trillion hardly leaves the Fed where they want their balance sheet to be, and the direction of quantitative tightening will surely be a big question mark for financial markets in the year ahead.

Q1 and Q2 saw GDP growth drop into negative territory behind a sharp reduction in inventory build-up and a large drop in exports as U.S. manufacturing dealt with labor reductions during Omicron. Q2's GDP drop was more muted and still centered around inventory reductions, yet the occurrence of two consecutive quarters declining in GDP growth did heighten calls of a recession. Q3 saw GDP fly higher as the consumer remained strong and 16 of 22 industries saw growth in business investment. At press time, Q4 forecasts are all notably positive and the total real GDP number for the year is expected to come in somewhere around +1.2% - not recessionary, but a real indicator of muffled and underwhelming economic growth.

Elon Musk's purchase of Twitter, attempted back-out of said purchase, and eventual closing of the deal, certainly stands out as one of the most dramatic stories of the year, even if it is less relevant on a macro or systemic basis. Most market stories tended to revolve either around monthly inflation readings (to the extent they provided guidance on what market actors expected the Fed to do), or intermittent Fed meetings (to the extent they increased interest rates, and provided guidance on how much more rates would go up in the future).

The Russian invasion of Ukraine would be the biggest international story of the year if it were not for Ukraine's shocking defense from that invasion taking the prize instead. A land war in Europe was not something anyone was predicting a year ago, and Ukraine defending its own sovereignty this long was certainly not predicted. The economic implications have mostly been felt in the energy sector, with growing skepticism that it is in a country's best interests to lack access to fossil fuels either domestically or from a friendly actor.

Energy prices responded to inadequate production, made worse by the Ukraine war, and saw the Strategic Petroleum Reserves dwindled down to forty-year lows. Energy stocks did not have a problem with the high volatility of oil prices, as our Market Summary covers well. The U.S.-Saudi relationship is as shaken as it has been in decades. Gas prices hit new highs in the middle of the year before coming down to the low levels of the year in recent weeks.

The aforementioned Fed rate hikes have been rationalized by the persistence of high price inflation, and the headline readings have been problematic for nearly two years. What began as growing goods inflation in the COVID re-openings of early 2021 ran into a perfect storm of supply challenges that proved stickier than anticipated. Goods inflation has steadily come down and services inflation has been distorted by high housing and rent prices in late 2021 and early 2022 that have not yet "rolled off" the price indices.

Economic data has been mixed for most of the year, with consistently strong labor data up against weakening ISM surveys (where manufacturing and services went into contraction late in the year). Retail sales did not soften the way many expected yet many consumers shifted some of their buying habits, with e-commerce slowing from its high levels of 2020. Supply chains have largely improved over 2021 activity but remain below pre-COVID levels, adding to inflationary concerns and aspirations for improved economic productivity.

The basic themes that we believe in at The Bahnsen Group were on display in 2022, and we do not believe they are going away any time soon. The hangover from years of excessive monetary intervention commenced, with many market participants hoping for a "smoother" to re-launch a binge. Changes in globalization habits began in 2022 but were not at the center of economic news. Those changes are coming and will be key themes in the years ahead. Economic growth may prove recessionary in 2023 but even if a recession is averted the very muted "1-handle" GDP growth of 2022 is here to stay. This "Japanification" theme in the U.S. economy is our major theme for the decade ahead. 2022 provided no reprieve from this primary macro expectation – muted growth treated with excessive policy intervention for years to come.

2022 MARKET SUMMARY:

The S&P 500 closed 2022 down -19.44%, the Dow Jones Industrial Average closed down -8.78%, and the Nasdaq closed down -33.10%. The drawdown in the Nasdaq of -35.1% from its November 2021 high now leaves the Nasdaq with a compounded annual return of just 3% per year for the last 23 years, the golden era of technology. Booms and busts do nasty things!

Source: FactSet, Gabriel Cortes/CNBC.com, Dec. 31, 2022

What ought to stick out as much as equity performance in 2022 is bond market performance, where rising rates caused the basic bond aggregate indices to decline -15%, marking only the fourth time both stocks and bonds have declined in about a hundred years. More unprecedented is the degree to which both are down, with this being the **only year in history that both stocks and bonds declined by over -10%.**

Within the stock market there was a wide dispersion of results amongst sectors. Energy once again led the way to the upside (as it did in 2021, where it was up +48% on the year), delivering a +59% return in 2022. Utilities tried to join Energy as the only other positive-performing sector but came up just short. Communication Services (down -40%) and Consumer Discretionary (down -38%) fought for the worst-performing sector honors.

2022 SECTOR PERFORMANCE

Energy	59.04%
Utilities	-1.44%
Consumer Staples	-3.17%
Health Care	-3.55%
Industrials	-7.10%
Financials	-12.35%
Materials	-14.06%
Real Estate	-28.45%
Technology	-28.91%
Consumer Discretionary	-37.58%
Communication Services	-40.42%

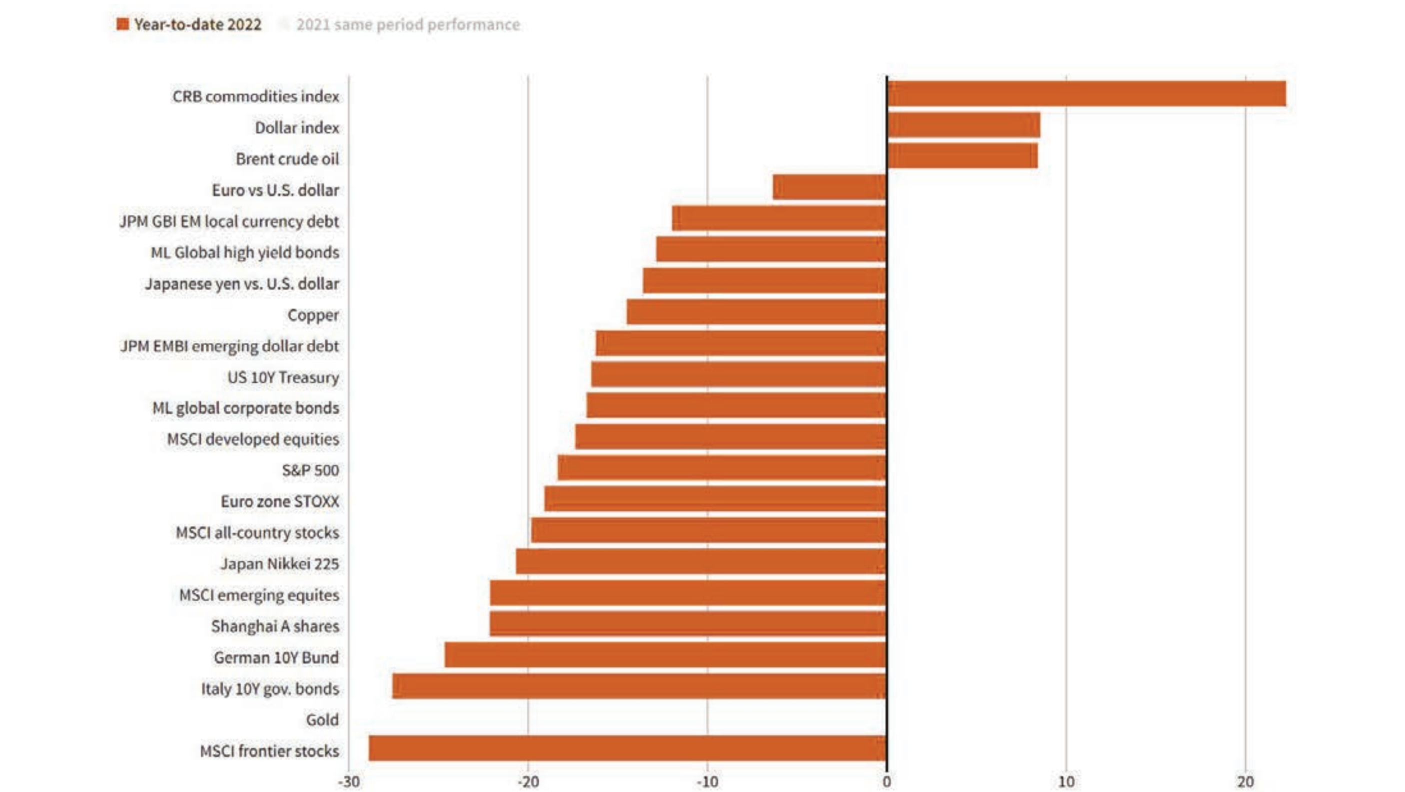
Source: Fidelity Investments, Dec. 31, 2022

A deeper dive into sub-sectors shows particular strength in Iron and Steel companies but real weakness from Plastics and Rubber companies. Aerospace and Defense rallied but most Industrials suffered. Consumer Discretionary names were almost all down, but the downside in Auto and Truck was far worse than anything else. Social Media and Internet Services companies dragged Technology down even as Technology Equipment landed in positive territory. The Advertising Services sector was up on the year as was Security Services, but Media Services and Publishing were crushed. Insurance companies did quite well even as Banks and Asset Managers were down. Even in Consumer Staples we saw an odd divergence, with Beverages and Food Processing doing very well, but Household Products struggling.

Commodities presented a high dispersion of results, with heating oil, natural gas, corn, and nickel up huge, while coffee, cotton, zinc, aluminum, and copper had significant declines. Energy commodities were almost all up and Industrial metals were almost all down. Precious Metals were pretty flat and Livestock and Agricultural commodities were moderately higher.

Outside of commodities, the U.S. dollar, and oil, it was hard to find broad asset classes that were up in 2022. Stocks, bonds, non-dollar currencies, domestic, international – there was simply no place to hide.

2022 ASSET PERFORMANCE



Source: Thomson Reuters, December 2022

2022 BOTTOM LINE:

1 Higher interest rates and the ascending dollar were the lead financial story of the year (obviously)

Rising interest rates brought down the value of high-quality bonds issues with a lower coupon, they brought down the P/E ratio of stock valuations, and they increased mortgage rates weighing on the valuation of real estate. That investment-grade bonds performed worse than high-yield and credit-sensitive bonds is a stunning reinforcement of how rate-sensitive this year's bear market was. Recession fears were clearly a backseat concern to the basic math of bond duration and stock valuations as interest rates rose and assets were re-priced accordingly.

2 Energy prices shocked by skyrocketing higher, then shocked by coming back down

I don't think many would have predicted $120 oil in the middle of the year, and I don't think in the middle of the year many would have predicted $78 oil at the end of the year.

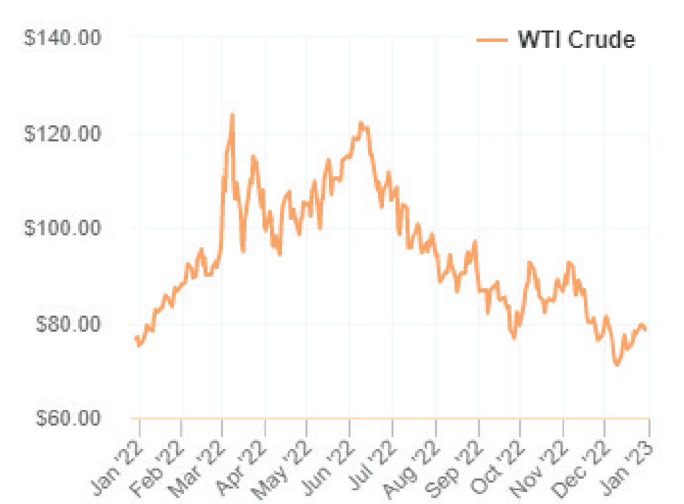


Chart Source: OilPrice.com, 2022 WTI Crude Futures

3 Multiple contraction- not earnings contraction

The S&P 500 started 2022 at 4,778, having just kicked off $211 of earnings the year prior (a 22.6x P/E ratio). Now, at the time, expectations were for higher earnings in 2022 than we ended up getting, but regardless the forward valuation was still above 19x earnings - and by many analyst expectations still north of 20x. The year-over-year earnings growth was highest in Q1 (+9.4% annualized), then second highest in Q2 (+5.8% annualized), but then just +2.5% annualized in Q3, with year-over-year profit growth expected to be negative for Q4 by -2.8% annualized. When all is said and done we have a S&P 500 down -19.4% on the year but with earnings up about +5.1% from the year-prior. In other words, the entire story of the market decline is the move from a 22.6x PE to a 17.2x PE. Investors gained 5% of earnings but gave up -24% in valuation to net out the -19% return of 2022.

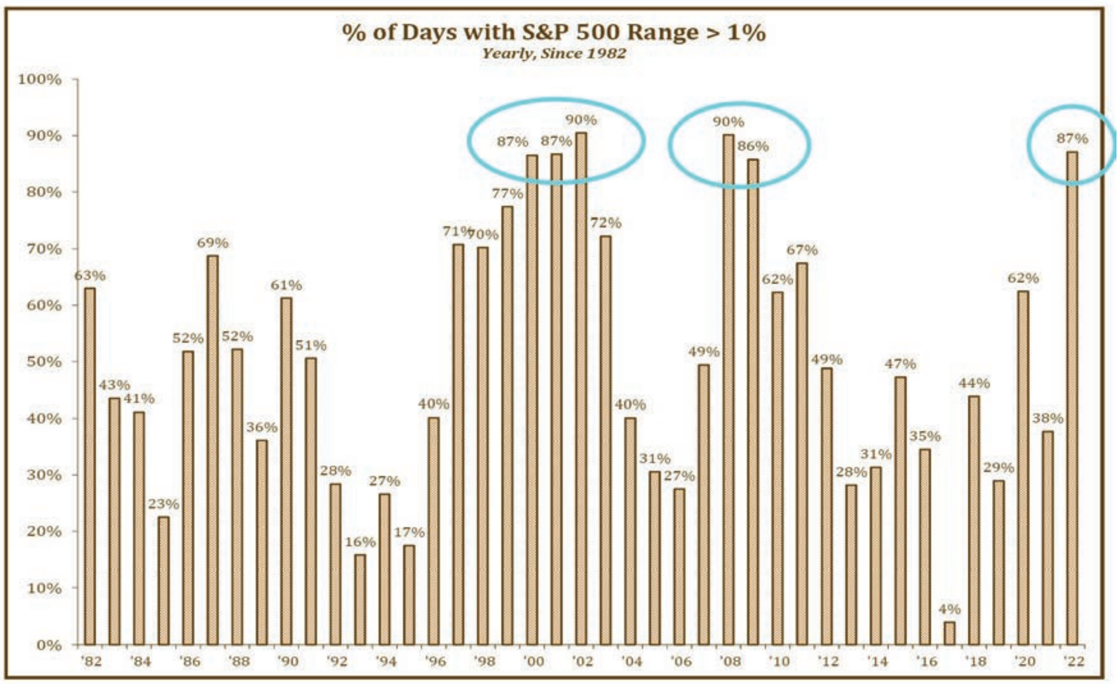
One thing that has to be said – much of the earnings growth that did not happen in 2022 is only because of the fact that earnings growth in 2021 was so much more robust than had been expected. In other words, 2021 "pulled forward" a lot of the earnings growth that had been expected for 2022. This had the effect of boosting returns in 2021 and contracting returns in 2022 – an entirely predictable outcome unless one's projection was for excess earnings growth in 2021 that did not recalibrate earnings growth expectations for 2022.

It should also be said that revenues grew in the S&P in 2022 by nearly +12%, so if earnings were only up by +5%, we mathematically know that profit margins declined (in fact, they declined by -13% on the year). In 2022, more revenue than expected created less earnings than expected that were then valued at a much lower valuation than has been the case for broad market indices, yet still higher than historical averages.

4 Elevated day-to-day volatility

87% of market days saw the S&P 500 go up or down by more than 1%. By comparison, only 38% of days experienced such intra-day movement in 2021, only 29% in 2019, and an insanely low 4% in 2017. Even in the hyper-volatile year of COVID, only 62% of market days saw >1% intra-day movement. This elevated day-to-day volatility combined with bear market returns for broad indices made the index experience even worse. Periods of high uncertainty exacerbate volatility and make market timing decisions all the more futile.

HIGH VOL YEARS TEND TO COME IN BUNCHES



Source: Strategas Research, Daily Macro Brief, Dec. 5, 2022

5 The Humiliation of Cryptocurrency

When Bitcoin and other forms of "digital currency" first came on the world stage they were small, barely investible, and represented no real diversion of capital from other sources. By 2022, the crypto universe saw nearly $3 trillion of capital invested in it, and by the end of 2022 more than $2 trillion of that money had evaporated.

As this space represented a "shiny object" in our worldview it was not something we ever invested in, or were tempted to invest in, but it did require a significant amount of time and resources invested in research and understanding. The central argument around the digital currency was instability from central banks and inflationary practices from global governments. That the cryptocurrency space imploded is noteworthy, but that it imploded in what were supposed to be its ideal conditions (high inflation, high skepticism about governments and central banks) is doubly noteworthy.

2022 REPORT CARD:

This report card has become an annual tradition – to either humiliate myself, explain a nuance, or inadvertently take a bow. Really it is all meant for fun but also to do an honest assessment of where things were a year ago and how that played out in real life. As we are not in the prognostication business (see the Introduction to this paper) we don't put a lot of weight on the grades, but nevertheless, traditions are important.

1 Equity Returns will not be what they have been

B

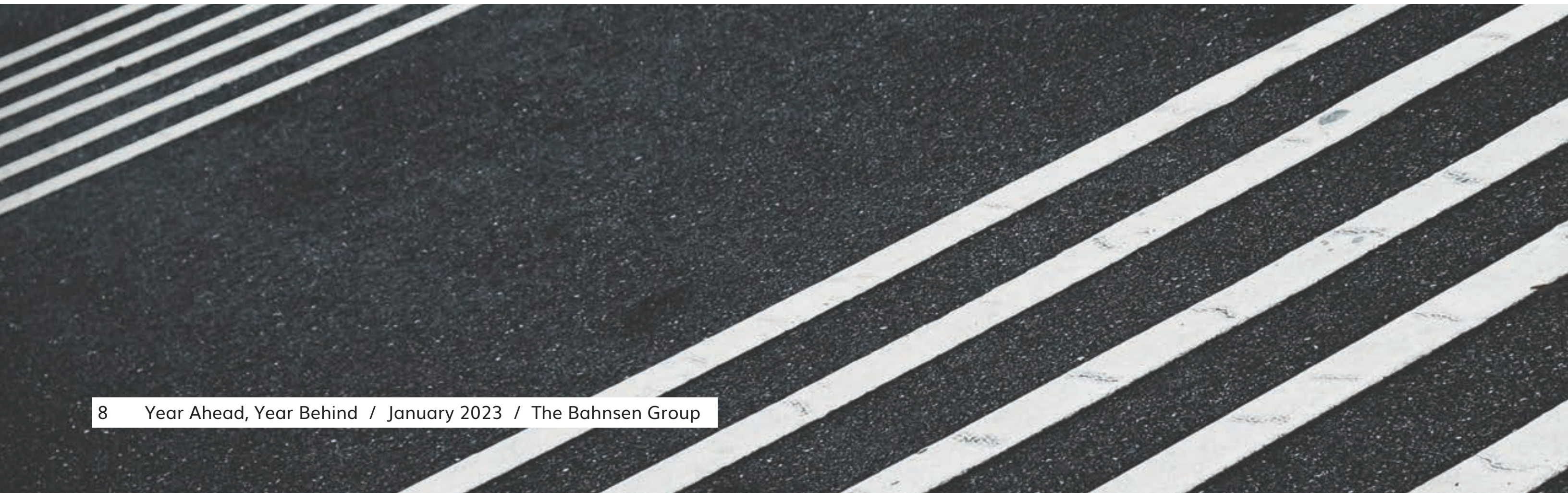
A part of me believes I deserve a better score than a B for this. I mean, equity markets had been on fire, and in 2022 they got hammered – so how could the statement that they "will not be what they have been" be more true? But in reading the context of what I actually wrote a year ago, I think there is a slightly mixed bag here. I said markets were way too euphoric, that equity inflows were too high, and that margin debt was too complacent. I lambasted "shiny objects" (meme stocks, cultural antics, euphoric dynamics). And I predicted bad things for select pockets of the market. That all came true. But, I also said that "if the 10-year Treasury yield stays below 2.5% it is hard to bet against risk assets." Well, the 10-year did not stay below 2.5%. Now, I thoroughly explained the valuation argument for why the index return was not likely to do well (earnings growth would be muted – it was; valuations were too high – they were), but the context reads to me like I was discussing "muted returns" – not a bear market in the S&P 500, so I ding my grade one letter grade on this item.

2 The Fed Focus is Overdone

D

In a sense, I feel I am being too hard on myself with this grade, because I very much do believe the focus on the Fed is overdone, ill-advised, and counter-productive. But when I re-read the details of what I wrote last year I think I was right in theory but wrong in practice. In other words, there are all sorts of things I said that I fully stand by and that I do not believe were wrong in 2022, but the spirit of the practical forecast was off. I believed the Fed would tighten (they did), I believe it should tighten (they should have), and I believed it was the right thing for long-term investors (it is). But why would I give myself a D here? Because the context of what I was saying was that they would get to 2% or so and then flatten out, which is what I believed at that time. Now, I may believe the same thing applies at 4% or 5% now, but I can't state with a straight face that that is what I meant a year ago.

I believe those who think the Fed needs to cure inflation are wrong (because the Fed has no such power and was not the primary agent of cause in the inflation of 2021-22). I believe those who think Jerome Powell and this Fed are more like Volcker than Bernanke are wrong. And I would take the under on whatever consensus forecast of the terminal rate ends up winning the day in the months ahead. But at the end of the day, the Fed went tighter than I expected in 2022 and I think the narrative they used to rationalize this posture lasted longer than I expected, so therefore I am giving myself a D despite the portions of this I believe were and are correct.



3 Political Reality will Underwhelm

A+

2022 started with predictions of a huge red wave coming in the November midterms, it moved to a vastly moderated view of Republican success by the summertime, but then to a resurgent red wave optimism going into the election and ended with a real thud on election night as Republicans outperformed in Florida, and nowhere else. The gridlock I discussed a year ago was exactly what the market knew was coming and that gridlock is exactly what came (even if it came in a different magnitude than a red wave would have provided).

What do these two things have in common in today's political environment? A Democrat in the White House, a slight Democrat majority Senate, and a Republican majority House – versus a Democrat in the White House, a slight Republican majority Senate, and a Republican majority House? Gridlock. They are both one and the same from the vantage point of market-relevant legislation. We got exactly that, and it had no market impact along the way or in the aftermath at all.

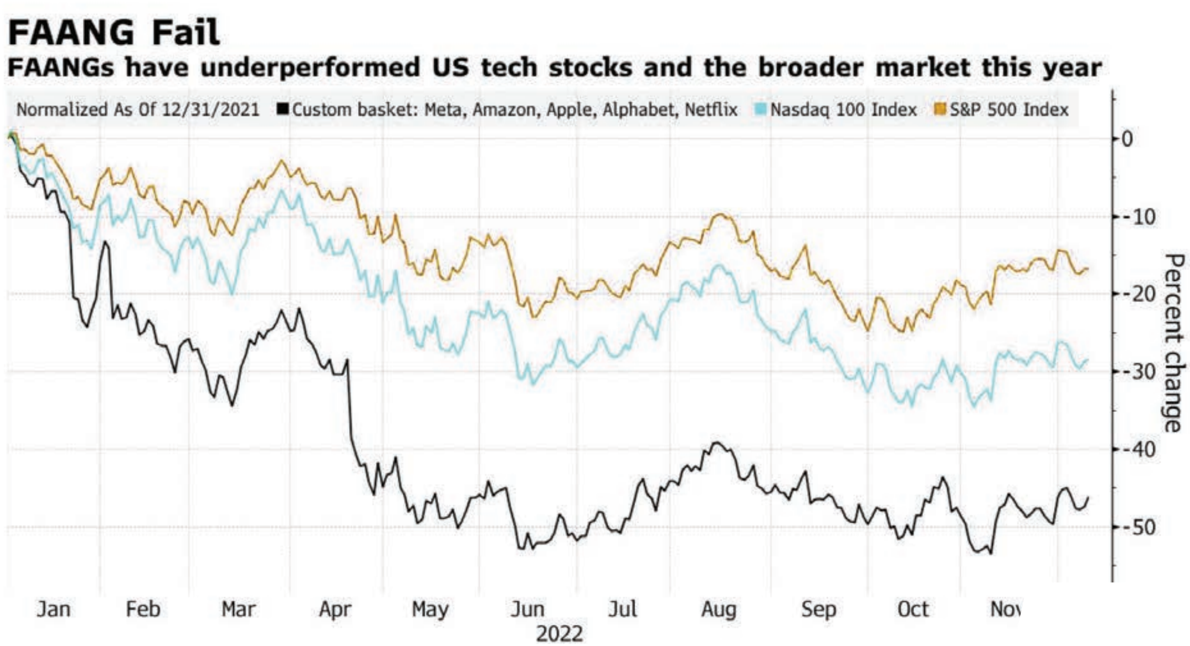
I also predicted the Democrats would pass a form of their "Build Back Better" – downsized to the point of irrelevance – and by late summer they did. I said it would not be "remotely similar to the vast array of policy prescriptions we heard about throughout 2021" – and indeed, that proved prescient. The tail risk of dramatic change to corporate tax code or investment income was off the table in 2022 as predicted.

By the middle of 2023, we will start hearing about how 2024 is "the most important election of our lifetimes", and how the future of the market, or the planet, the human race, or whatever else, is on the line. I'll leave it there with the eye roll I assure you took place as I typed this.

4 A Reckoning with Big Tech

A+

The idea that valuations and the symmetrical realities of cap-weighted index funds could pull down Big Tech in 2022 proved a beneficial prediction, and merely not owning this sector of the market was enough to create significant out-performance versus those who did own it. What I would not have counted on was the degree of fundamental pressures that accompanied re-pricing in big tech – from changes in business model to competition in streaming to declining growth in e-commerce to pressures around China-based supply chains. My 2023 themes below update my perspective on this issue.



Source: Bloomberg, Dec. 10, 2022

5 This is Value's Year

A+

The growth index declined over -25% this year while value was barely down at all. This was a call I have made previously but this was the year it played out in spades. The spread between the normal relationship of growth and value has not yet normalized, valuation concerns remain around growth, and short of the Fed drastically cutting rates and re-pursuing a zero-bound monetary policy, it is hard to see what assists the growth space this year.

The theme a year ago was simple valuation, risk-reward trade-off, and belief about historical ratios. All of those metrics speak to a "longer than one year" story here, and I will reiterate the theme in 2023's outlook later on.

6 Inflation will not be the major economic story of the year

D+

I believed at the beginning of 2022 that inflation would be lower than it was at the beginning of the year, and indeed it is. Goods inflation has come down for over six months, and real-life housing and rents are well on their way down. Energy inflation has been highly volatile, at one point adding several hundred basis points to headline inflation on the year but deflating significantly in recent months.

At the end of the day, the inflation story stayed prominent enough that it allowed its cousin story – the Fed – to stay prominent throughout 2022. My updated call for 2023 is noted in 2023 forecasts.

VALUE VS. GROWTH - 2022 IN REVIEW

Source: YCharts, Value vs. Growth: 2022 in Review, Dec. 29, 2022

7 Housing to Slow Down in 2022 and Roll Over in 2023

A+ This call was not looking good in Q1 of 2022 as the monstrous momentum in accelerating housing prices continued, as inventory languished near record lows, and sellers held 100% of the cards in getting a house sold. The momentum slowed by spring as rising mortgage rates began to cool the excessively hot sector, and by summertime it was evident that transactions had slowed substantially. I was careful to sequence my forecast around a "slowing down" in 2022 (led first by a declining volume of activity and then by declining prices), and I am not sure it could have played out more in line than that forecast.

It was not just a rise in mortgage rates and a freeze in sales volume that impacted housing in 2022, but a substantial change in homebuilder sentiment.

By late in the year contracts for sale were canceling at a record pace, new business traffic had collapsed, and the basic indicators for sentiment around new home purchases were going to the lowest level of the decade. This subject is also revisited in our 2023 themes.

8 Bond Yields will be higher, just not that much higher

F I did a good job proving my own point in this call for 2022. I provided a chart showing the extraordinarily low batting average of Wall Street analysts predicting bond yields over the last 30 years, then I went on to make a prediction, and then I went on to prove that first point. I did expect the 10-year to close the year above 2% (a whole year ago the 10-year was still well below that!) but said I would be "surprised if it finished the year above 2.5%." Well, a few months ago I was surprised and now it is old news. The 10-year has been inverted to the 2-year for much of the year, as essentially the Fed did the lifting here at the short end of the curve. The 10-year bond yield closed the year at 3.879%, below its earlier high of 4.23%, but above what I expected and well above where it started.

US: NAHB Housing Market Index Components

Homebuilder sentiment fell every month of 2022

Source: Oxford Economics/Haver Analytics, Dec. 19, 2022

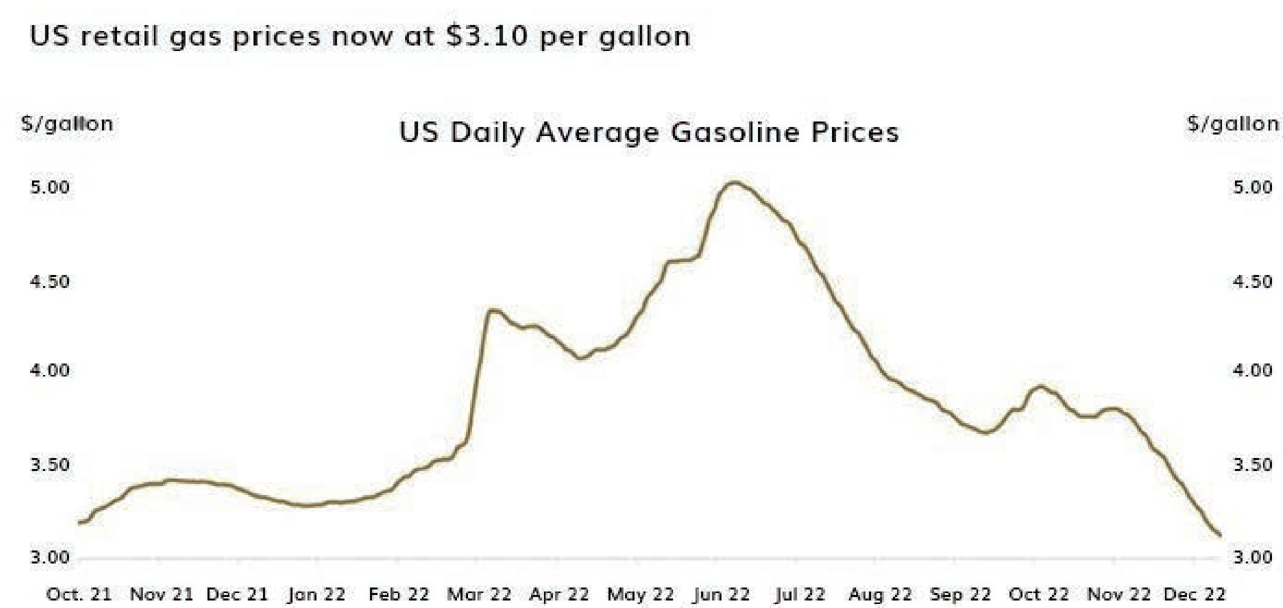
2023 THEMES:

1 THE GUTSY CALL – INFLATION IS HEADED WAY LOWER

Maybe this feels like one of those "double or nothing" calls after last year but it really is a mere extension of the thinking last year, just giving myself an overtime period. I believe it is rather obvious that inflation peaked about six months ago, with the volatility in food and energy prices and the persistence in shelter inflation reporting (i.e. the lag factor) distorting that reality. Core goods inflation has not just stopped going higher, but collapsed as supply chain circumstances have improved.

Source: Bloomberg, Boock Report, Dec. 16, 2022

The exact movement of food and energy prices will be volatile around a variety of geopolitical factors, but for now, gas prices have come back down to planet earth.

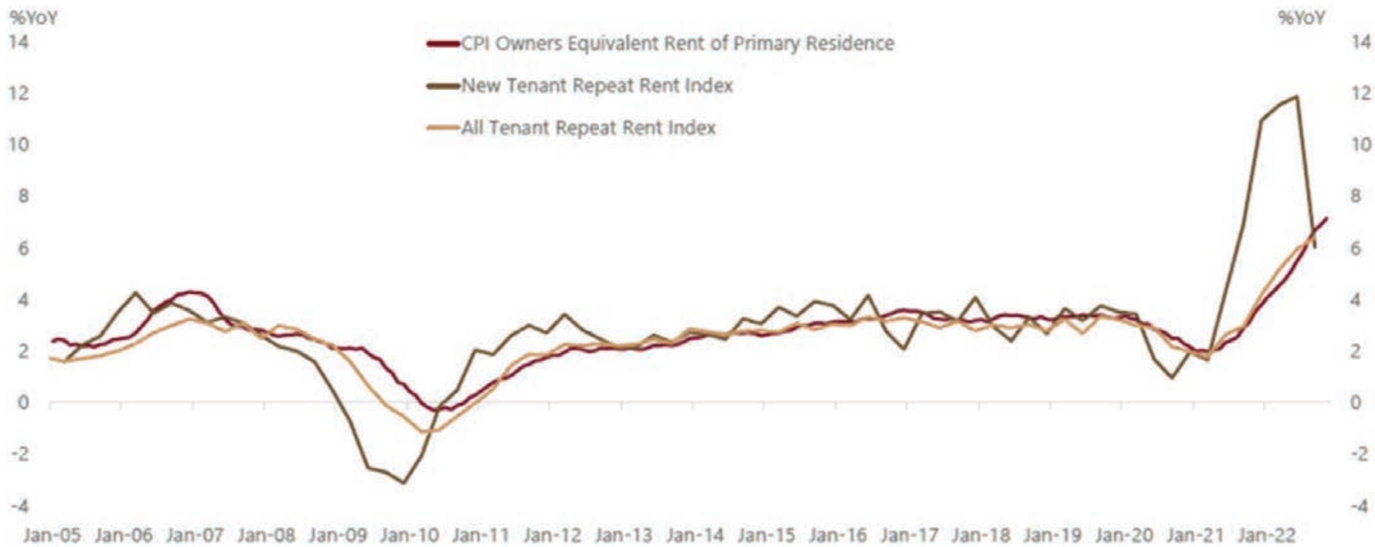


Source: Bloomberg Apollo Chief Economist, Dec. 2022

The stubborn fact in the reporting data (particularly in CPI) has been "shelter" where their metric for "owner's equivalent rent" keeps current leases at a weighting 3x that of new leases, therefore holding rent levels from a year ago in the data for a disproportionate amount of time. That lag will price itself out in the months ahead, and in the meantime, the "new tenant" index that anyone looking past CPI can see shows the facts on the ground.

All of this leads me to say that disinflation will be the predominant theme in 2023, and that the story of an economy that is "too hot" will soon be no story at all. Those who have followed my "Japanification" theme for years now know that I am hardly saying this as a positive commentary on expectations for the U.S. economy.

New Fed Measure Of Rental Inflation Shows Housing Inflation Rolling Over

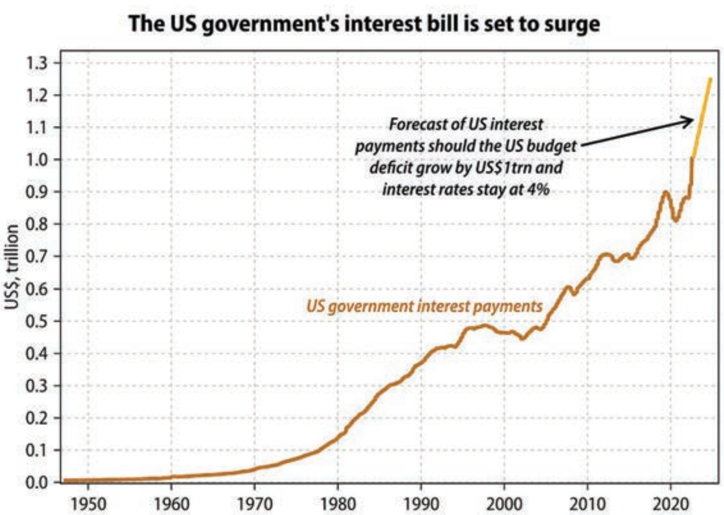


Source: Cleveland Fed. BLS Bloomberg Apollo Chief Economist, Dec. 26, 2022

2 THE GUTSIER CALL – THE FED FUNDS RATE WILL BE LOWER AT THE END OF THE YEAR

The Fed Funds rate presently sits at 4.25%, and futures action expects the rate to get as high as 5% by the middle of the year. I do not know when or at what level that "terminal" rate is hit, but I accept the consensus view that there will be a "pause" somewhere between 4.5% and 5% on the fed funds rate, followed by a period of no activity (hikes or cuts).

Many have used the impact of higher rates on the P&L of the federal government to argue for more damage coming to our bond market and to our nation's economic health. It is a fair and partially correct argument. But it also begs the question – couldn't the damage higher rates create to national spending be an argument for why such higher rates will not be allowed to persist?



Source: Gavekal Research/Macrobond, Dec. 22, 2022

That is, in fact, exactly my argument. Quoting the ghost of Herb Stein seems fair here – "if something can't happen, it won't." I would first argue that the longer end of the yield curve sees excessive government indebtedness as a sign of weaker economic growth and therefore puts downward pressure on the long end of the curve (for more support of this position see: all countries everywhere on earth, for 35 years). But we are talking about the short end of the curve here, and I simply do not believe that the Fed is apathetic (in the myriad of factors they have to consider) to the impact of short-term borrowing costs on the biggest short-term borrower on the planet.

I am not going to get into specific predictions as to what the rate will be and at what meeting and all of that – I am simply saying that I anticipate a Fed Funds rate lower by the end of 2023 and a categorically different posture from the Fed chastened by the side effects to this excessive tightening and emboldened by the disinflationary reality I describe in point #1. But this is not the same as forecasting Bernanke/Yellen/Powell dovishness… The Fed now knows that their prolonged zero-bound and QE-forever policies came at a cost. They may [wrongly] believe it was all worth it, but if they could get it in a 2-4% world versus a 0-2% world I believe that is what they would prefer. Quantitative tightening may be the easier tightening tool to sacrifice than the federal funds rate given the optics, politics, and media realities at play.

So if you want a summary of what I am forecasting for 2023 it is: A Fed Funds rate that is lower than its mid-year terminal rate by the end of the year, a balance sheet reduction that underwhelms expectations, and a new forward direction that does not settle at a 4-6% level in the future, or re-discover 0-2%, but rather the more "moderate" range of 2-4%. (And if you must know, I expect the post-2023 to push the lower end of that range for the governmental reasons previously cited).

3 S&P EARNINGS WILL TELL YOU THE TRUTH ABOUT THE RECESSION

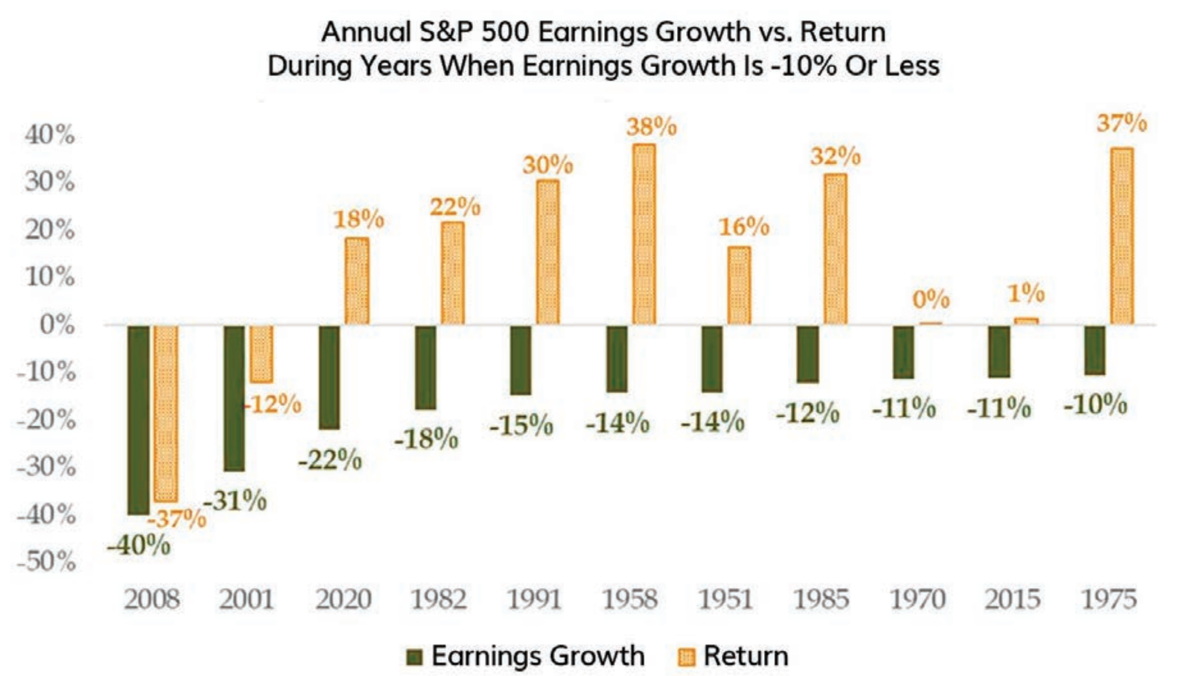
I do not accept this new talk that we can have a recession without unemployment ticking higher, any more than I accepted the idea that we can have a recovery where jobs do not return. At the core of the definition of economic expansion and contraction is the activity around jobs, wages, and profits. If we are going to have a recession in 2023 then expectations for profits are currently too high, period. A few things to keep in perspective...

In 2021 the S&P created $211 (per share) of profits, up from the COVID-induced calamity of $108 in 2020, but also way above the stellar profit record of $162 in 2019. As discussed earlier, the market's decline in 2022 was entirely related to multiple contraction as overall earnings came in roughly +5% higher than the year before.

Current estimates still have the S&P kicking off $225-230 of profits in 2023, somewhere around a 2-4% increase in 2023 versus 2022. I am not predicting that the earnings level will materialize, nor am I predicting it will not; I am merely stating that if earnings do not contract from the 2022 level in 2023, then 2023 did not see a recession. Now, my own guess is that we do see a recession, and I am perfectly fine believing it may be a contained and mild one. But we will not see $230 of earnings in 2023 if we have a recession. $200 of earnings is extremely likely if we enter a recession, and that could be optimistic (that is only a -10% decline in earnings).

The S&P 500 delivered a positive return in 9 of the last 11 times we saw negative earnings growth year-over-year. I am not making a prediction on what the market will do. But note this: Even in those nine positive years where earnings growth was negative, there was a drawdown (on average) of -14% along the way. In other words, whether markets end positive or not, we expect downside volatility along the way in periods where earnings growth is stunted.

But the theme here is that we are not talking about earnings growth with a recession or earnings contraction without a recession. As one goes, so goes the other...



Source: Strategas Research, Daily Macro Brief, Dec. 16, 2022

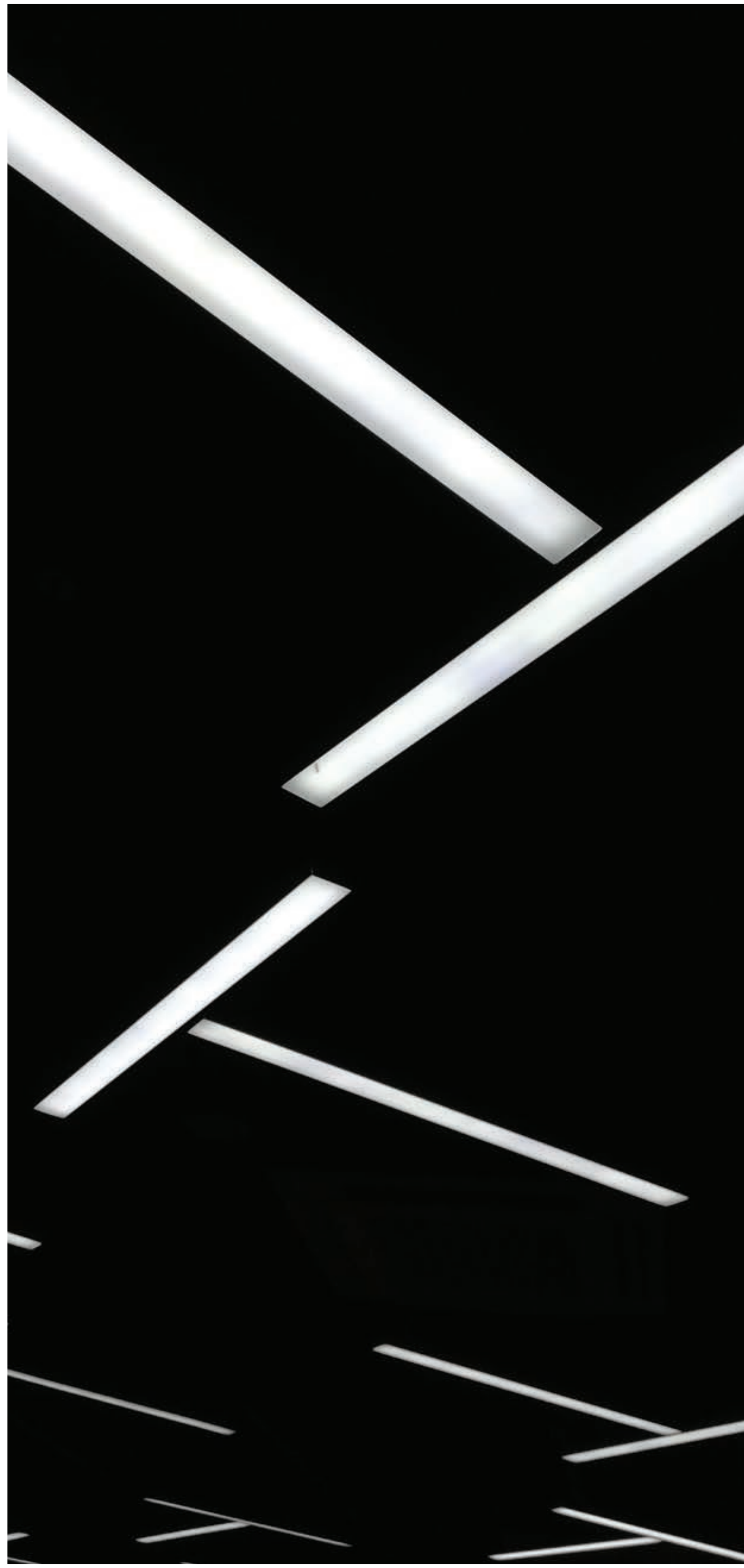
4 VALUE OVER GROWTH, AGAIN

I generally do not predict what raindrop is going to fall down the window fastest each year in these themes. For one thing, we are agnostic about it in investment execution – dividend growth deals with the growth of distributable cash flow from an underlying business and doesn't have a dog in the fight of different segments of P/E ratios and such. But additionally, as bottom-up security analysts, we care about companies, meaning "value" companies that are unattractive to us remain unattractive, and "growth" companies that are attractive remain attractive. I have never been "rooting" for value over growth, but rather have been an objective observer of the reality of stretched valuations in the growth space post-financial crisis and a widening delta between what our industry indexes as "growth" vs. "value" in recent years.

As for the 2023 forecast (and perhaps well beyond this next year), I offer you this nugget from famed hedge fund manager, Dan Loeb:

> ***I tend to be more of a bottom up analyst but 2023 should prove to be a year of a battle of two narratives. Rates and inflation on one hand versus GDP growth, margins and ultimately earnings on the other. Markets will be further determined by participant's outlook from current company performance versus '24 and beyond. I don't think camping out in the last decade's darlings, with rosaries in hand, hoping for a comeback, will be the winning strategy. We have already seen the revenge of the value nerds. I think more to come.***
>
> ~ Daniel Loeb, Third Point LLC

One of the reasons to be less sanguine on "growth" than "value" is that "growth" still primarily refers to the "technology" sector, and the technology sector still relies quite heavily on just a few names. Broadly speaking, the technology sector has had historical periods of becoming too large a percentage of the overall marketplace, and when reversion to the mean takes place there it is usually a mathematically significant and time-prolonged event. What took place in 2022 does not scratch the surface of what historically plays out from those market levels.



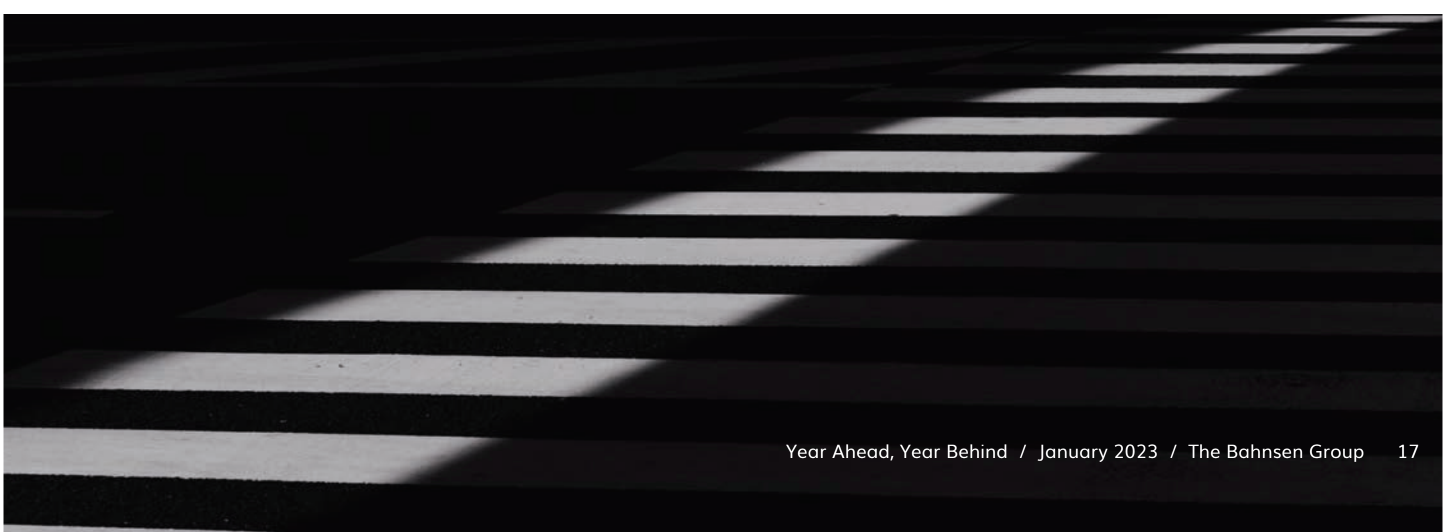
Long term charts of tech...
Tech vs S&P 500 price relative

Source: BofA Global Investment Strategy; Bloomberg, Global Financial, Apr. 2022

None of this means that the major FAANG names or mega-cap software and cloud names are obsolete. They remain, in many cases, the biggest and most profitable companies in America. But the cyclical reality of markets makes it very hard to stay on top forever, and normally desirable growth rates that are now more realistic for big tech are far less stratospheric than the returns 2013-2021 provided.

The argument for a continued prioritization of valuation (which creates a bias towards value over growth) is also found in history. Broad market bottoms generally see lower valuations than we see now, with the forward multiple on the S&P 500 right now of 17x marking a premium to the median P/E ratio, not a *cyclical low*.

But at the end of the day, much of this just has to do with a basic philosophy of investment finance. Cash flows are what matters for investors, period. Even if one doesn't need any cash flow and is totally focused on "price appreciation" – the idea of large price appreciation for a company with no cash flows is based on a belief in its future cash flow generation. That requires a risk tolerance and a favorable environment for speculation that generally comes and goes in secular periods. The secular period of multiple expansion, of seeing stock prices reflect rapid growth today based on optimism of rapid growth in years or decades, of easy access to debt and equity capital to fund a long period of low or no cash flows – all of these things are, best case, on hiatus, and worst case, gone for a long, long time. Even when the Fed stops tightening monetary policy, they are highly unlikely to resume systemic stimulation of risk assets any time soon. That backdrop favors a value orientation over growth.



5 DO NOT UNDER-ESTIMATE CHINA RE-OPENING

We now have an extended precedent to evaluate pent-up demand when a major country re-opens. From the U.S. to Europe to any other massive population center, basic human dynamics have stayed constant – a serious demand for services, recreation, automobiles, and consumer spending – has followed. Where one points out that "China is different" it may very well make the opposite argument of what is intended, as China's pent-up demand may even transcend other countries where restrictions, as draconian and ill-advised as they may have been, were not as severe as China's. Interest rates are down in China – unlike most of the world – and there is ample reason to believe China's re-opening will have a profound effect on their own domestic consumption and therefore activity in global trade.

I expect global oil demand to increase substantially out of a China re-opening, and I expect this to happen in concert with the U.S. stopping its withdrawals from the Strategic Petroleum Reserve. The global supply-demand balance seems likely to swing and put upward pressure on pricing, at least absent a significant recessionary pull the other way. The major factor I expect holds supply-demand equilibrium in check out of the China re-opening is that China is very used to using a lot more coal than the rest of the world as an energy source and may very well see lower increases in oil demand than anticipated.

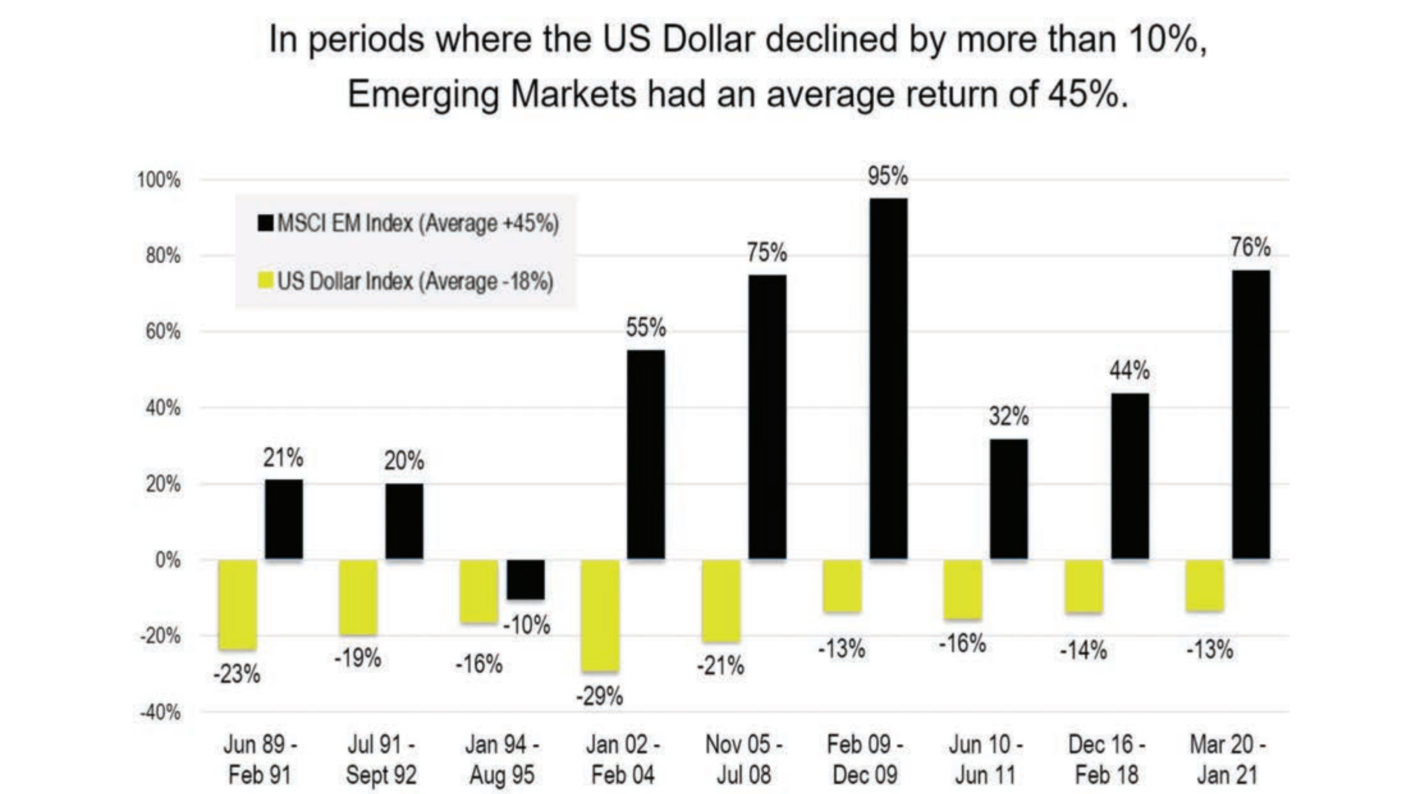
Fundamentally, the re-opening of China serves as an important moment in the process that many are referring to as de-globalization, and others (ourselves included) see as more of a "regionalization" of economic activity. In theory, it would seem that China's re-opening works against regionalization and de-globalization in that it opens more doors and restores more avenues for global interdependence on China. Our contrarian view is that theories around increasing regionalization of economic activity remain purely theoretical until China is fully re-opened, as the counter-narrative to regionalized activity (that it was due to China's COVID impositions) has been non-falsifiable. As China re-opens in 2023 I believe the world gets a substantial offset to global recessionary fears, it risks a renewed supply-demand imbalance on the energy front, and as ongoing changes to global supply chains play out (2023-2026), the cover of this changing dynamic being "China/COVID" related goes away.

6 EMERGING MARKETS TURN IN THE SUN

I try to include emerging markets as the "smarter growth" play every year, because we have been in a secular period of reasonable valuations for EM growth and excessive valuations for U.S. growth. Macroeconomic worries, geopolitical pressures, and a rising U.S. dollar have all disrupted the thesis, but it is that latter point that may very well create a growth surge for emerging markets in the year ahead.

The average return for Emerging Markets equities in periods of a U.S. dollar decline is +45%, with a positive return in eight of the nine periods of analysis.

Now, should a global recession take hold that proves tighter and more punishing than anticipated, this thesis has to be reworked. Should China reverse course on its post-COVID re-opening, this thesis may have to be reworked (though our EM investing lacks the China-centric approach many EM investors take). But at 10x forward earnings, a more favorable macro backdrop should the Fed's tightening pause or pivot, and with a favorable tailwind from a declining U.S. dollar, we see Emerging Markets as a favorable target for growth equity investing.



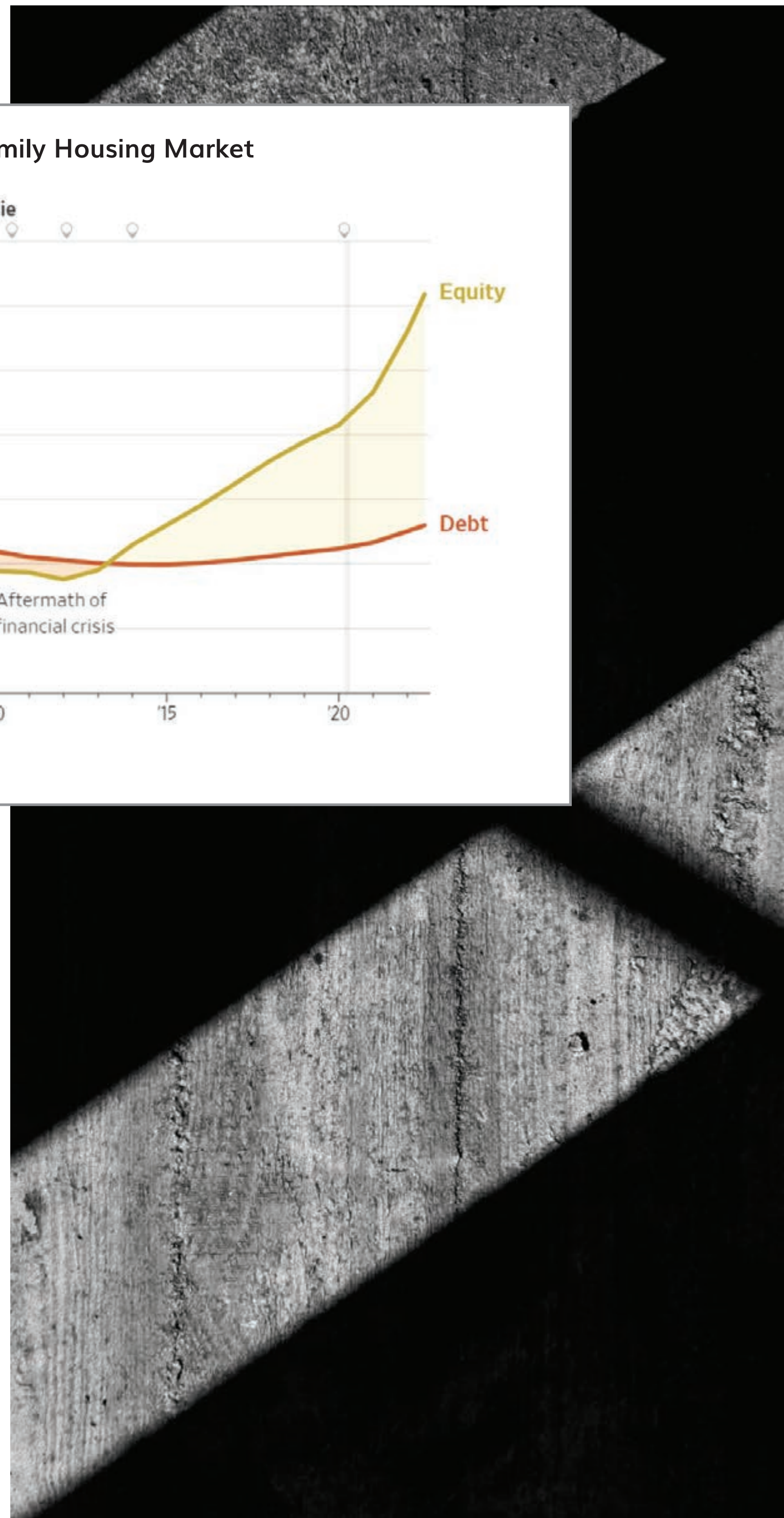
Source: Schafer Cullen, Time to Add to Emerging Markets, Dec. 2022

7 HOUSING: IT'S GOING LOWER, AND I FEEL FINE

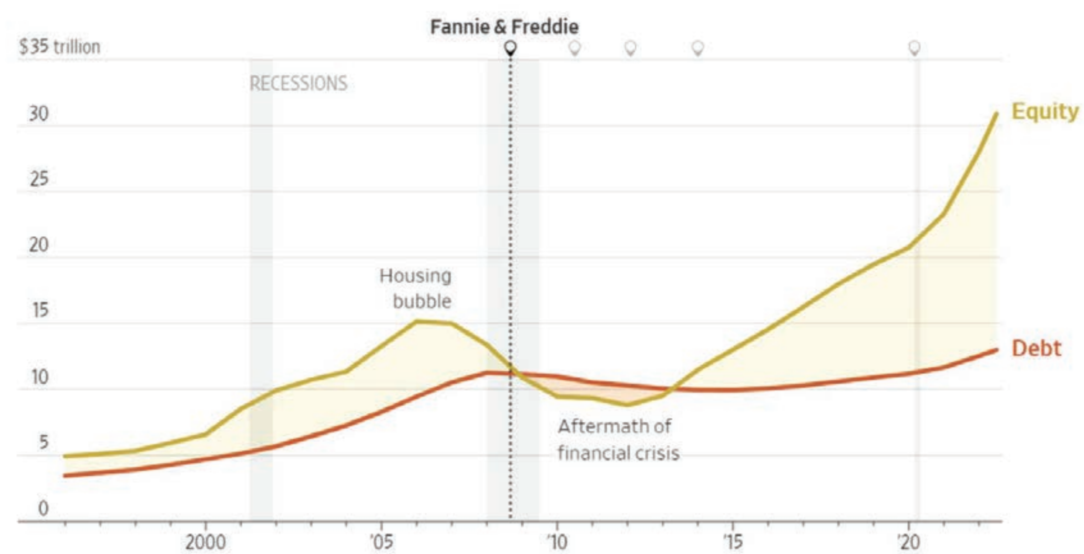
This chart sums up both of my beliefs about the housing market all at once: First, housing prices moved up too much and too quickly post-COVID (2020-21) and therefore need to come down. Second, the debt-to-equity ratio in the housing market makes this categorically different from 2008's housing collapse.

There is a camp of housing bears who are consistently seeking to find parallels to the 2008 housing collapse. In fact, the same can be said of equity bears, as well.

relative unaffordability compared to household balance sheets, income ratios, wage growth, and other practical budgetary realities. Prices matter, and when something becomes too expensive it has to become less expensive to make a market. But back when 25% of home sales were to people with credit scores below 659, well, that is a different kind of problem all together.



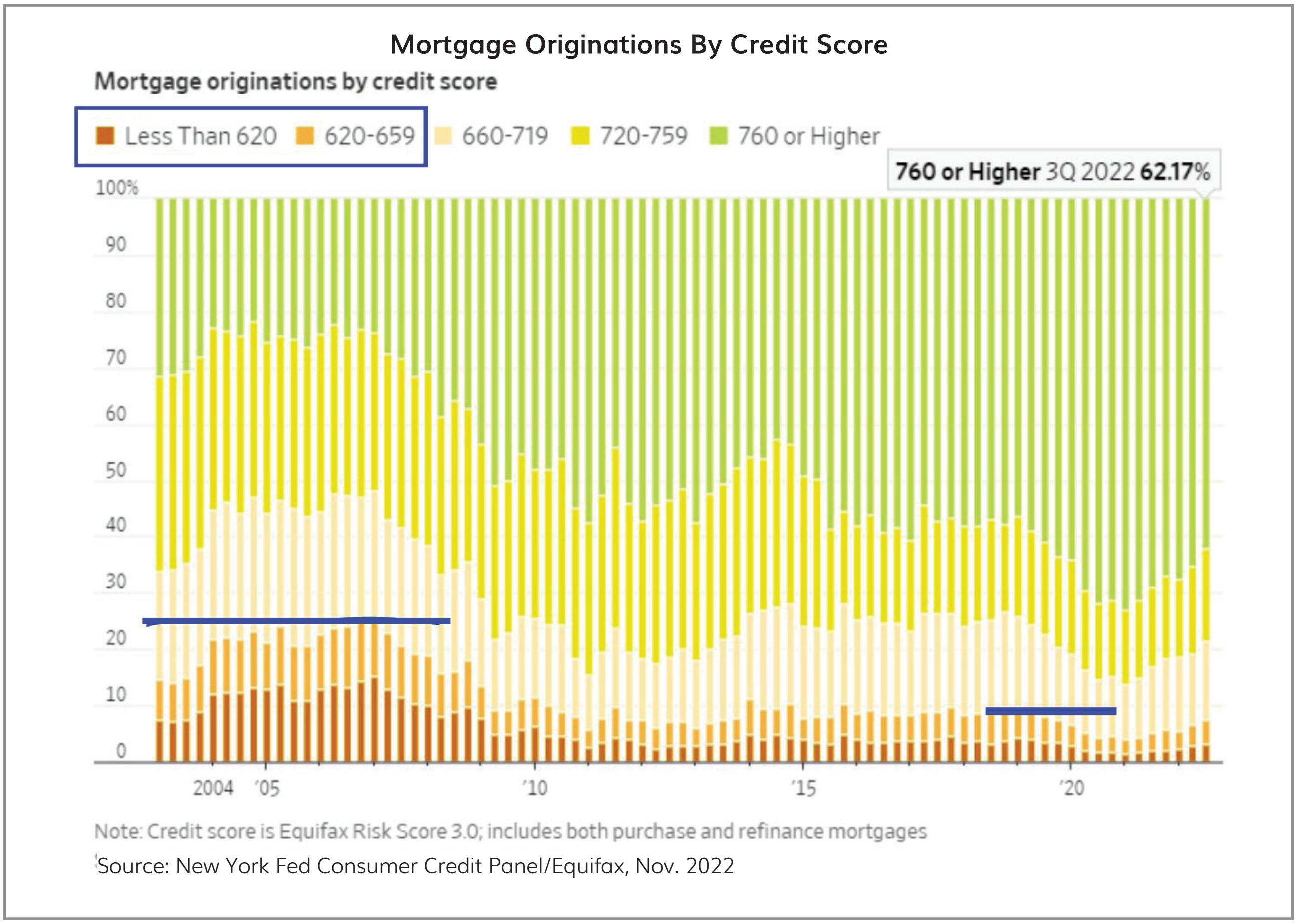
Value Of US Single Family Housing Market



Source: Urban Institute, Peter Santilli, WSJ, Dec. 2022

This 2008 obsession reflects not just a poor understanding of present circumstances but a poor understanding of history as well. The above chart reflects the vast improvement in protective equity in the current housing over-valuation versus the bubble in 2008. If housing came back down to 2020 pre-COVID levels, the debt-to-equity ratio is still just half of what it was in 2008 (stated differently, the protective equity would still be double what it was).

Additionally, the credit quality of home buyers is substantially better than it was in the years leading up to 2008. We had a systemic problem in 2008 of people who had no business buying a home at any price purchasing a home for a ridiculous price. Out of 2020 and 2021 our problem is merely one of prices and



I am not suggesting that housing prices will revert to pre-COVID levels, and in fact the limited supply of new housing causes me to believe that is probably the floor. But a -10% contraction in median housing prices would merely take the housing price level back to October 2021 levels and a -20% contraction would bring housing just to March 2021 levels - that is how dramatic (and overdone) the 2021 upside moves were. A needed correction is playing itself out and an extended period of buyers having an upper hand over sellers is not the same thing as predicting another 2008.

8 CHINA, RUSSIA, AND GEOPOLITICS WILL LEAVE US WITH WEAKER GLOBAL STABILITY AT THE END OF 2023 THAN WE HAVE NOW

Talking about foreign policy in the investing context is very difficult. Very few get this right, and far less than that are able to translate foreign policy realities into an investment thesis.

A major theme of my economic writing has long centered around macro instabilities (monetary, fiscal, and yes, geopolitical) driving a need for larger investment stabilities (free cash flow, balance sheet strength, dividend growth). This is the thrust of my perspective on (a) A strengthening relationship between Russia and China, (b) A weaker relationship between the U.S. and Saudi, and (c) A questionable commitment to global alliances like NATO from the west ... None of these things speak to a definable moment, none carry specificity, and none are remotely "investible." And yet, each speak to a reaffirmation of macro instabilities that command more investment stability.

To quote my friend, Rene Aninao, of Corbu,

> "*The increasing trajectory of Sino-Russian bilateral relations comes at the expense of the 'collective West' particularly on the economic / "decoupling" front.*"

The global security apparatus we have enjoyed since the end of the cold war will look different if Xi and Putin believe they can mutually out-muscle the west. I cannot think of a single thing on the global stage I will be watching more intently than the China-Russia alliance in 2023.

9 CONSENSUS SKEPTICISM ON PRIVATE MARKETS IS WRONG

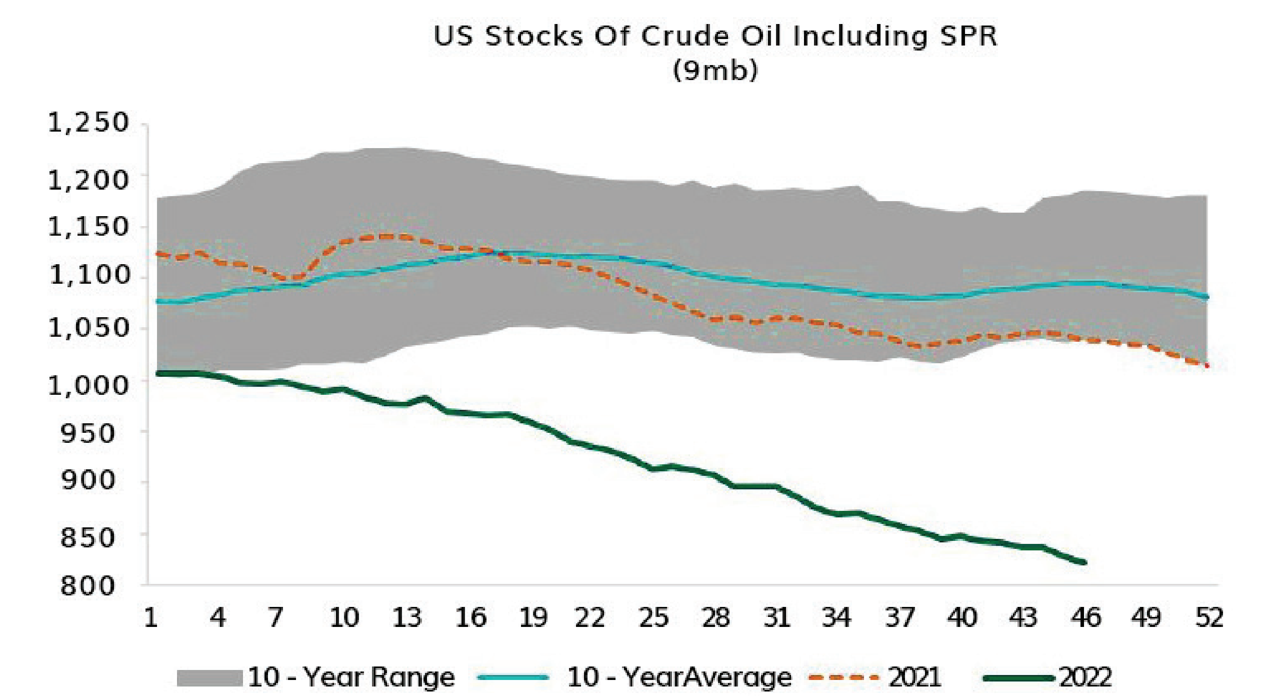
Are there over-leveraged stories of value destruction waiting to surface in private equity out of this post-easy money era? Certainly. And are there poorly underwritten private credit tales about to remind investors of the risks in senior lending? Sure. But do I believe that a black swan of wealth evaporation is coming in the opaque world of private markets? I do not.

The higher rate world in which we find ourselves does, indeed, add risk to the levered buyouts of recent years, and surely some companies will (a) Fail to execute, and (b) See their financial models prove unworkable. But the higher rate world also offers good investors a very desirable return with less reaching for risk. High single digit yields to be at a higher place in the capital structure improves the risk/reward trade-offs for well-underwritten private credit. Significant dry powder in the hands of strong asset managers is a benefit to investors in private equity

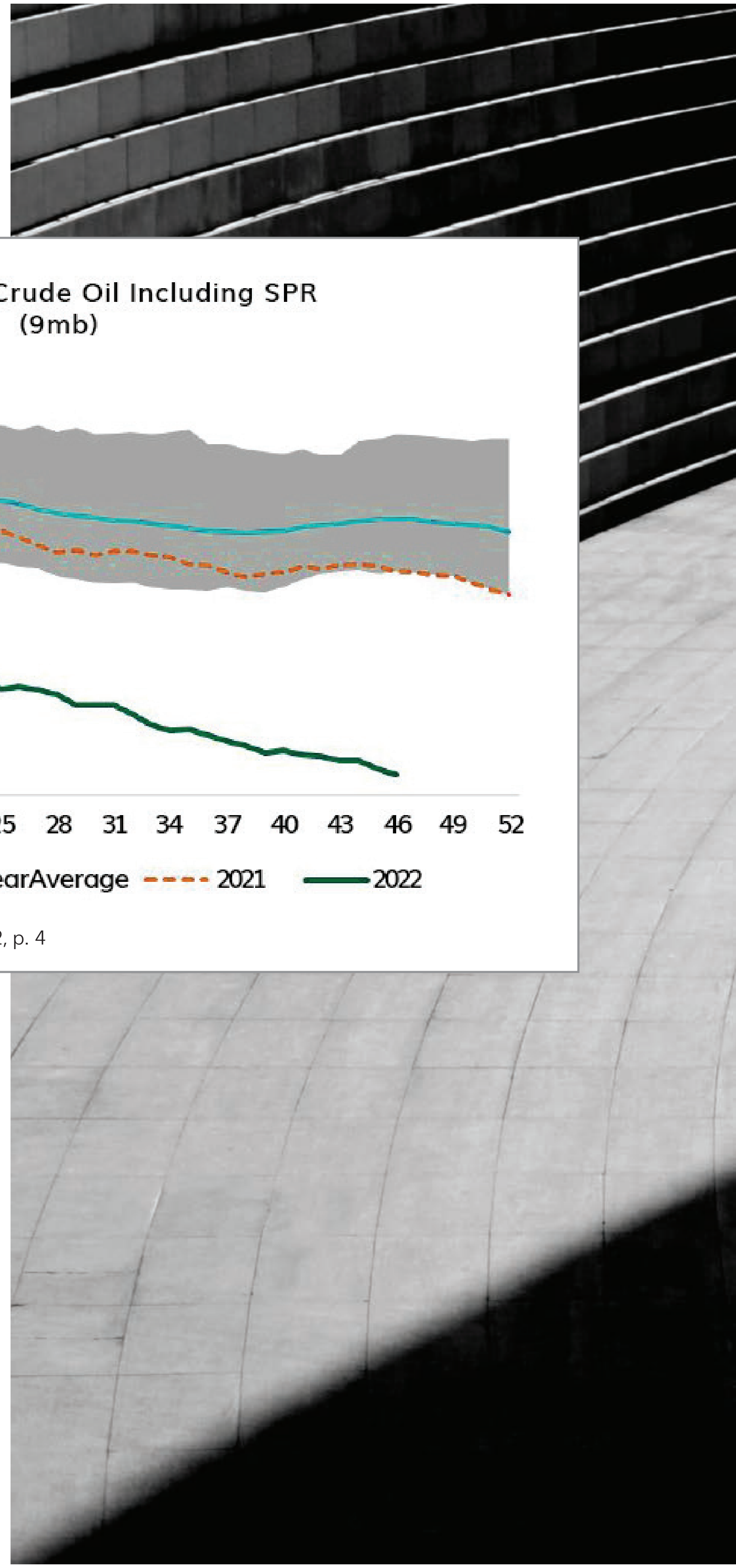
The consensus views can sound smart in this environment, but under the hood there is always a messy Darwinian truth – some private asset managers are better than others, and what is true for bottom decile firms is rarely true for top decile firms. I will let you draw your own conclusions.

10 THE ENERGY STORY IS NOT DEAD

Energy was the #1 performer in the stock market in 2021 and the #1 performer in 2022, and it was our highest sector exposure in both of those years as well. I offer no projection that Energy will be the top-performing sector in 2023, as well (though I wouldn't bet against it, either). What I will say is that demand for energy is not going down at the



Source: Strategas Research, Investment Strategy, Dec. 12, 2022, p. 4



moment, and we see no signs of over-supply suggesting a cyclical reversion is imminent. Instead, we see the fruits of greater capital discipline across the U.S. energy sector and a strategic petroleum reserve at its lowest level since 1984. U.S. production is back to 12.3 million barrels per day, a healthy level of volume at drastically higher prices and margins than the pre-COVID era, and yet even this volume is lower than pre-COVID levels! Capital expenditures are significantly reduced as well, lowering debt ratios and increasing free cash flow, while still amply providing for needed development and investment.

Energy does not need to be the best-performing sector again to maintain its place as a valuable part of one's equity portfolio. The midstream and upstream sector continue to benefit from structural imbalances in supply and demand and an investment landscape that boosted risk premiums and benefited capital providers to this vital space.

CONCLUSION

We do not enter 2023 on the precipice of a "new era" versus 2022. Rather, there will be continuity into 2023 from where 2022 left off – with the primary narratives being recession uncertainty and debate over Federal Reserve intentions. The major stories in financial markets a month or so ago seem likely to be the major stories in another month. The calendar turns the page but markets just wake up and continue their daily routine (actually, they don't even wake up, because they don't really ever sleep).

The year following a bad year in the stock market can be good or it can be bad. We know nothing about what will happen in 2023 based on what happened in 2022. Good luck looking at this historical reality for any predictive benefit:

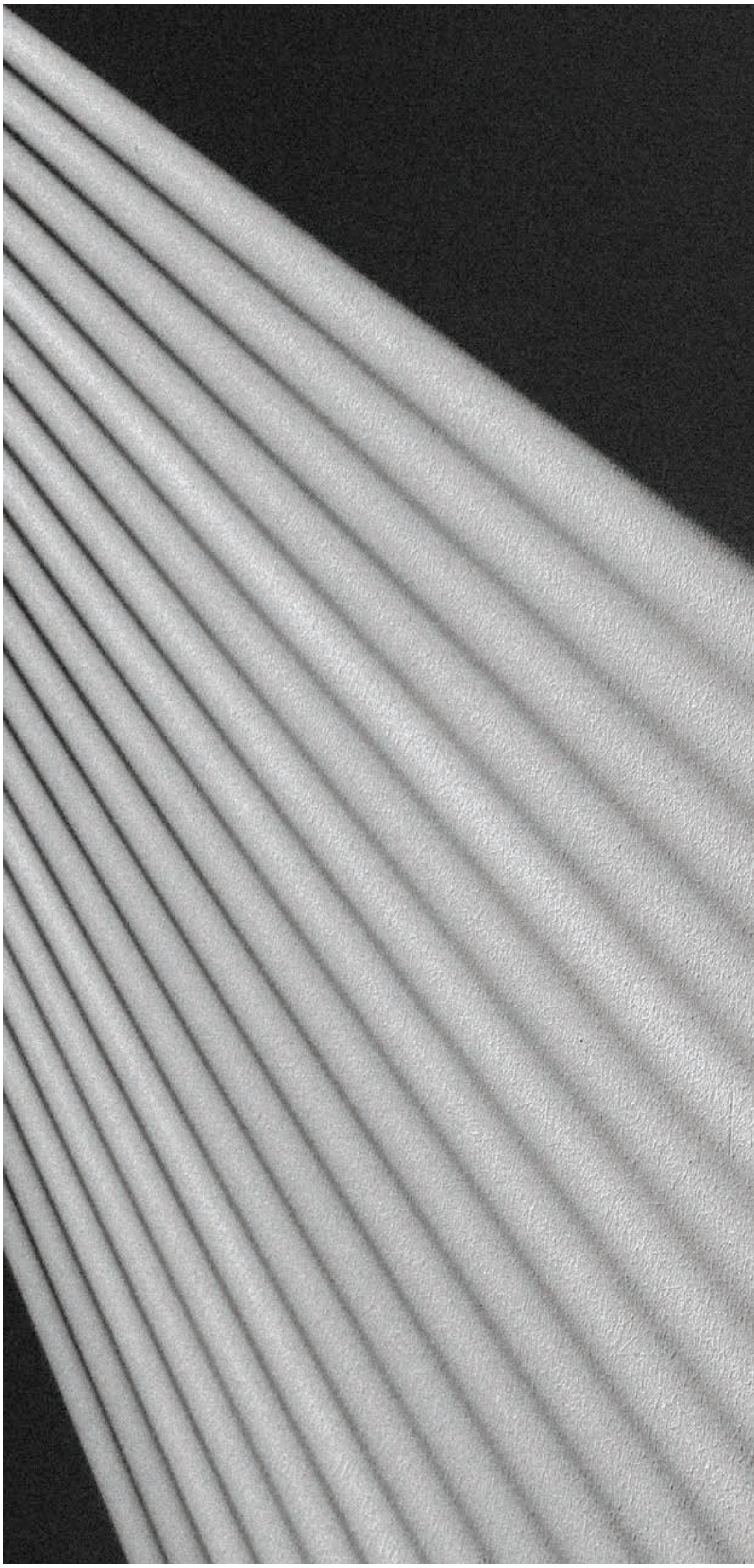
The Positive Spin

Year	Loss	Next Year
2008	-36.6%	25.9%
1937	-35.3%	29.3%
1974	-25.9%	37.0%
2002	-22.0%	28.4%
1941	-12.8%	19.2%
1957	-10.5%	43.7%

The Negative Spin

Year	Loss	Next Year
1931	-43.8%	-8.6%
1930	-25.1%	-43.8%
1973	-14.3%	-25.9%
2001	-11.9%	-22.0%
1940	-10.7%	-12.8%

Source: NYU, Dec.2022



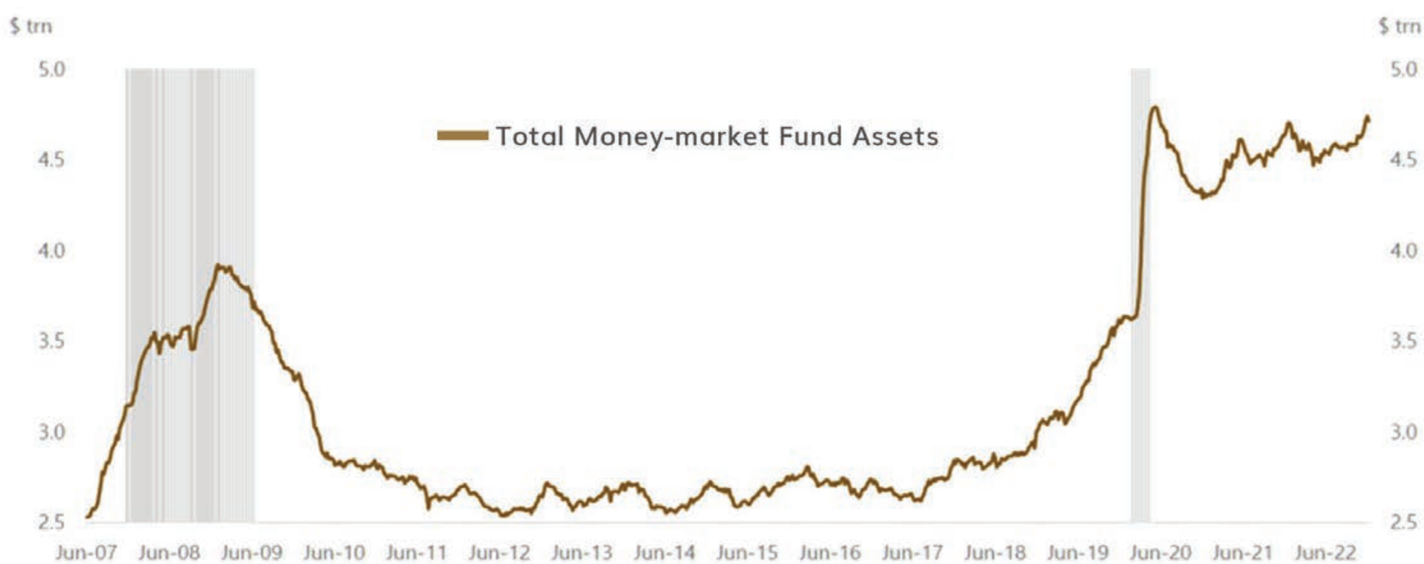
Some have asked if the political cycle provides any clues, as indeed the third year of a Presidential term has historically been the best-performing year in the stock market (in fact, going back to World War 2 the only "year 3" of a Presidential term that was negative was the flat year of 2015; since 1928 the market has been up in 82% of all "third year" periods). I am happy to present this data for what it is but totally unwilling to draw any predictive conclusions from it. Correlation is not causation and markets have bigger fish to fry than various anecdotal trends from history.

I expect ongoing volatility as the lack of clarity around economic reality continues. A leg down is likely if recessionary fears take over, even as the Fed likely gets forced to "fix what it broke" in that circumstance. A leg up is likely if the soft-landing thesis becomes apparent. No one can say right now with any certainty that either scenario is impossible.

One could argue that when a catalyst for market improvement comes, there is ample dry powder to accelerate that improvement (see chart below).

being popular makes it more attractive has never been true, and has, in fact, always been the polar opposite of truth. But human nature is a dangerous thing in times when capital is flowing, sentiment is positive, and the most powerful force in all of investing takes over: Seeing someone else make a return or say they made a return in something you are not doing. The FOMO dynamic (fear of missing out) has been proven to be both an institutional and private investor reality, and it is destructive to the core. That it also reflects a fundamentally corrosive element of human nature is another story all together (FOMO comes from believing one can have easy money, quickly, period).

Last year we cautioned people against a FOMO approach to investing. This year we are doing the same. But that is not because of something unique about 2022 or 2023. In all years past, present, and future, investing requires certain principles, disciplines, beliefs, and behaviors, that are timeless, universal, and true. I was struck by this line in a recent Strategas Research report...



Source: Bloomberg, Apollo Chief Economist, Dec. 28, 2022

But markets do not go higher just because there is cash available to go in them. The fundamental uncertainties discussed in this paper will dictate the way markets go in 2023. As more clarity is provided on those fundamentals, other factors (like dry-powder cash, the direction of interest rates, etc.) will add fuel to the fire of how markets perform.

A consistent theme in this white paper and in last year's was our aversion to "shiny objects" or to additional risk beyond the standard market risks we all take just being in the arena. The idea that an investment

> *"With this in mind, and with our conviction that monetary conditions will continue to get more restrictive, we believe the biggest unforced error an investor can make today is to make long-term investments in companies that have come to rely on the kindness of strangers for capital."*

The kindness of strangers. Put differently, investments that work only so long as people keep believing, hoping, and envying. They don't work because they are productive, or profitable, or proven – they work only as long as someone else keeps putting money into it. The period of time that the "ponzi" like dynamic being described here can work is extended in times of easy money and excessive monetary accommodation. When that punch bowl gets taken away, the inevitable fate of such malinvestment is accelerated.

My concluding thought in the analysis of 2022 and looking forward to 2023 is to never be tethered to the punch bowl of FOMO, monetary excess, or ill-advised speculation again. History is filled with manias and speculations, and in just the last 25 years we seem to have gone through an unprecedented amount of truly dramatic ones. 2023 and the years beyond it will present enough challenges in terms of economic health, geopolitical stability, and monetary policy that investors need not invite excessive risks to the party. Winning a race is hard enough without tying ankle weights to yourself.

We will embrace 2023 with the same principles that have guided us for over twenty years and will surely guide us for over twenty more to come. Volatility is assured. Cash flow generation trumps speculation. Predicting economic specifics is a fool's errand. And investor behavior is the primary determinant of results.

To these ends, we work.

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