2023 Themes & Outlook
Sailing Into a New Era

Our 2022 Themes and Outlook title, “A Paradigm Shift,” was on the mark! Global Central Banks’ complete shift on monetary policy rapidly unwound a decade of easy monetary policy and wreaked havoc across nearly all asset classes last year. The most aggressive tightening cycle since the 1980s sent bond yields surging and delivered bond investors equity-like losses and the worst annual decline on record. Equity markets shared in the pain with the first bear market since the pandemic and the MSCI AC World Index posting its worst annual decline since 2008. The beloved U.S. technology sector collapsed with the NASDAQ Composite Index posting its fourth worst annual decline on record. The most momentum-driven names of the past decade (e.g., Apple, Facebook, Google, Netflix, Amazon) fell demonstrably and caused the U.S. large cap growth sector to underperform the value sector by the widest margin since 2000. The brutal war between Russia and Ukraine threw the global commodity sector into a frenzy while China’s zero—and then not zero—COVID policy contributed to a volatile year for the international equity markets.

Unfortunately, 2023 will be the year the global economy feels the effects of the aggressive tightening taken by central banks, the dwindling of COVID savings, the ongoing war between Russia and Ukraine and decades high inflation. In our themes for 2023, we try to navigate investors through this new era of higher interest rates, an unstable geopolitical climate, a likely recession, the rapid valuation correction across many areas of the market and the downfall of the traditional 60/40 portfolio. Most importantly, that while the economic environment may be challenged in 2023, most asset classes felt the brunt of this in 2022. Often markets swing too far to the downside when pessimism takes over rational evaluation. Therefore, instead of selling into the expectation of a weaker growth climate, we see opportunities for the long term, especially from a contrarian perspective.

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Theme #1 – In Search of a Soft Landing but Clouds are Rolling In

The U.S. economy did enter a technically defined recession last year (negative GDP in 1Q22 and 2Q22). While not officially confirmed as a recession by the National Bureau of Economic Research since nearly every other segment of the economy was strong, we do not think we will be as lucky in 2023. Unfortunately, the effects of such an aggressive tightening cycle and multi-decade high inflation are finally weighing on the consumer, manufacturing and particularly the housing sectors. Recessions sound scary but they are healthy and warranted to clear out excesses and there is no other time in history that we can say we need to clear out excesses than in the aftermath of the COVID pandemic. The exorbitant amount of stimulus distributed by the Federal Government and exceptionally easy monetary policy has caused the money supply combined with the Federal Reserve balance sheet to exceed 100% of nominal GDP. **(Chart 1).** The Fed needed to aggressively tighten policy (and will continue to raise rates) to reign in the massive amount of liquidity that is causing inflation to be a persistent problem for the economy. In fact, their aggressive rate hikes have sent the yield curve, which is a common recession leading indicator, to the most inverted level seen since the early 1980s. **(Chart 2).**

Chart 1

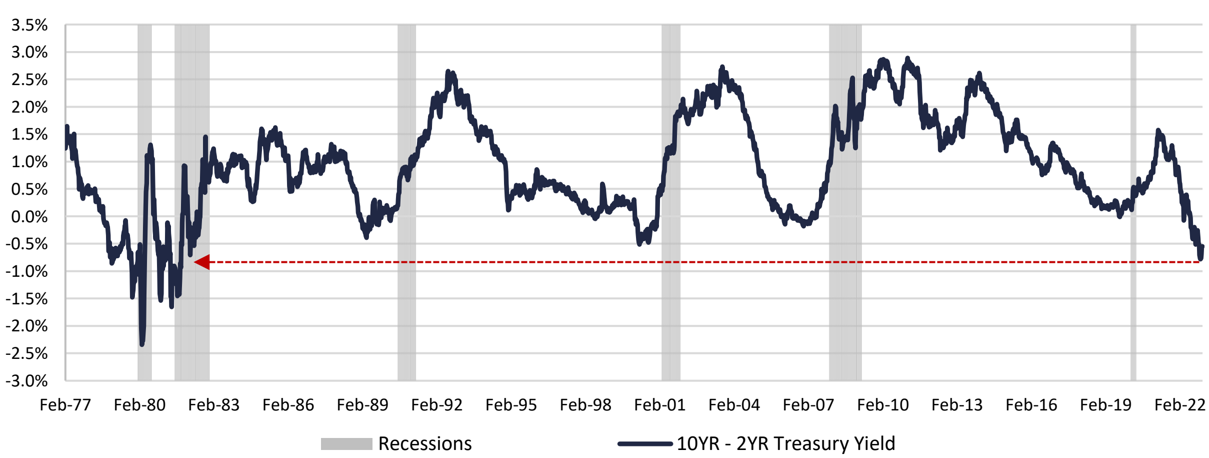
Excesses Need to be Drained

Data is most recent as of December 31, 2022.
Data Source: Bloomberg Finance LP, Verdence Capital Advisors.

Chart 2

Yield Curve Flashing Recession Signal

Data is as of December 2022. Data Source: Bloomberg Finance LP, Verdence Capital Advisors.



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While the Fed may be influential in causing the economic weakness in 2023, unfortunately the consumer will likely be the driving force for the downturn. The consumer makes up ~70% of GDP and there are signs that inflation is taking a toll on their spending ability. The personal savings rate had dropped to the lowest level since 2005 and consumers are turning to credit cards to fund their spending habits. **(Chart 3).** This is dangerous because credit card rates are at the highest level in recorded history, dating back to the 1970's. In addition, the excess savings that consumers accumulated due to COVID-related stimulus is likely to be depleted in 1Q23 at the current rate of spending. **(Chart 4).**

Chart 3

Consumers Turning to Credit With Low Savings

Data is most recent as of December 31, 2022. Revolving credit includes credit card debt.
Data Source: Bloomberg Finance LP, Verdence Capital Advisors.

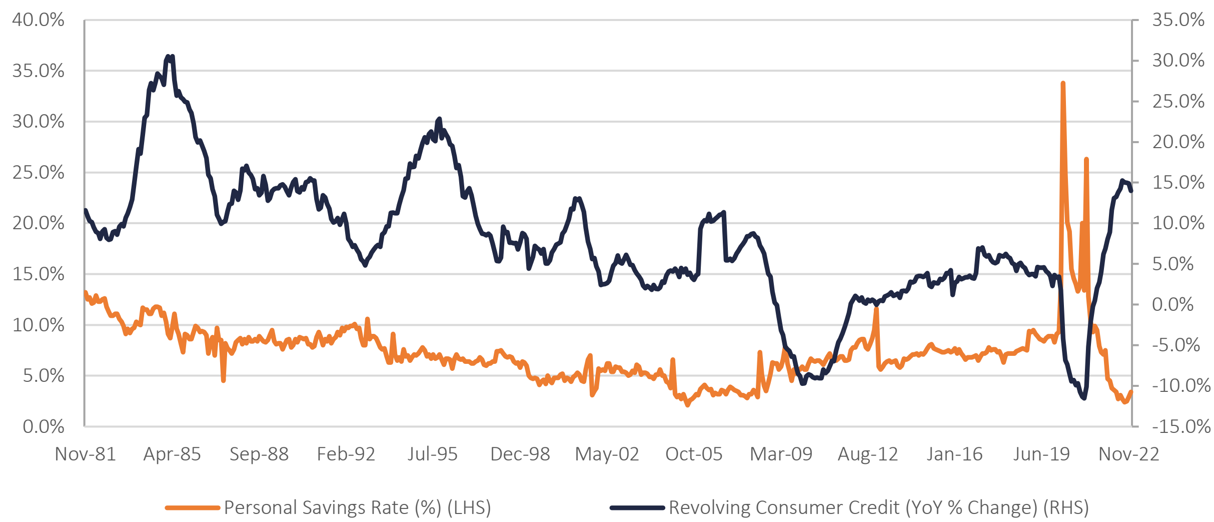
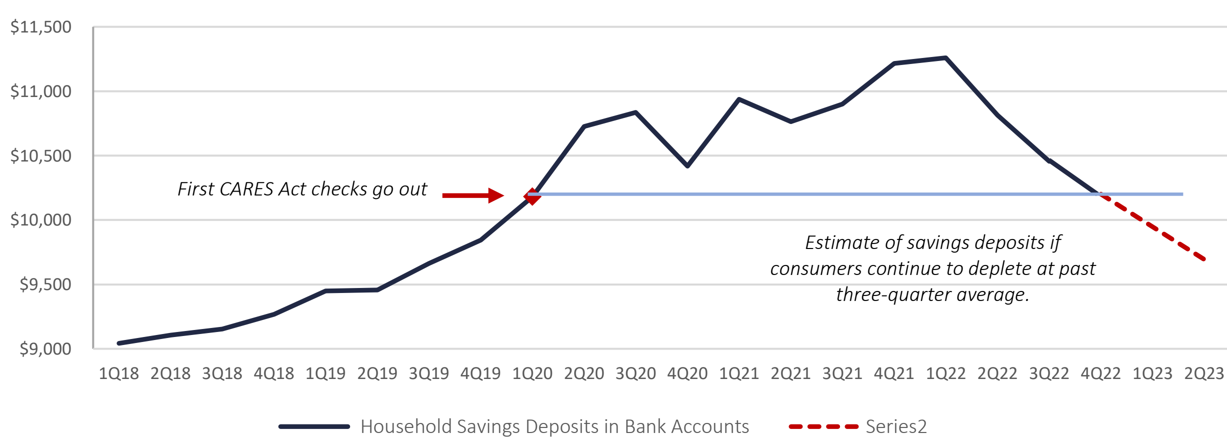


Chart 4

COVID Savings Being Drained

Data is as of 3Q22 and estimates for future are using past three-quarter average as of 3Q22.
Data Source: Bloomberg Finance LP, Verdence Capital Advisors.



As the supply chain continues to be repaired and inventories are being replenished, the manufacturing sector is slowing, and the ISM Manufacturing Index has been in contraction territory (a level below 50) for the past three consecutive months. What is more concerning is the weakness in the ISM Services Index since Americans spend most of their personal consumption on services as opposed to goods. **(Chart 5).** In fact, the ISM Services Index has only fallen into contraction territory on one other occasion (2003) that did not coincide with a recession.

Lastly, the housing market was one of the first shoes to drop because of higher interest rates but also felt the most pain from COVID-related economic disruptions. The 30-year mortgage rate has increased to the highest level since 2001 and as a result homebuyer affordability has plummeted **(Chart 6).** In addition, due to the surge in the cost of materials because of the supply chain disruptions during COVID, building homes has also become an expensive endeavor. Permits to build new homes have fallen for four consecutive months and are hovering near COVID levels. Aside from the drop during the pandemic, pending home sales are near a record low. In addition, prospective buyers' traffic is basically non-existent, and the NAHB Homebuilder Sentiment is hovering near the low seen during the pandemic.

Chart 5

Manufacturing and Services Signal Recession

Data is as of December 31, 2022. Data Source: Bloomberg Finance LP, Verdence Capital Advisors.

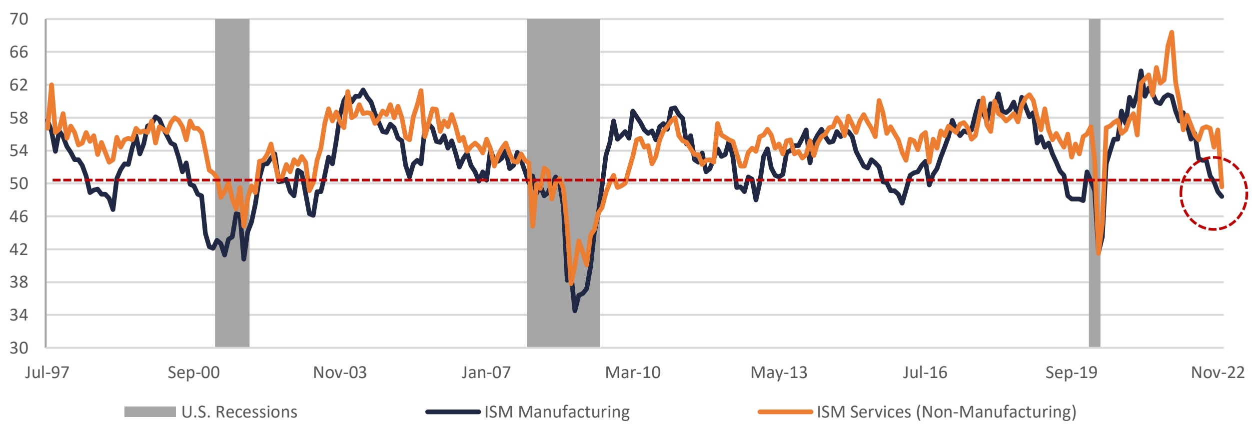
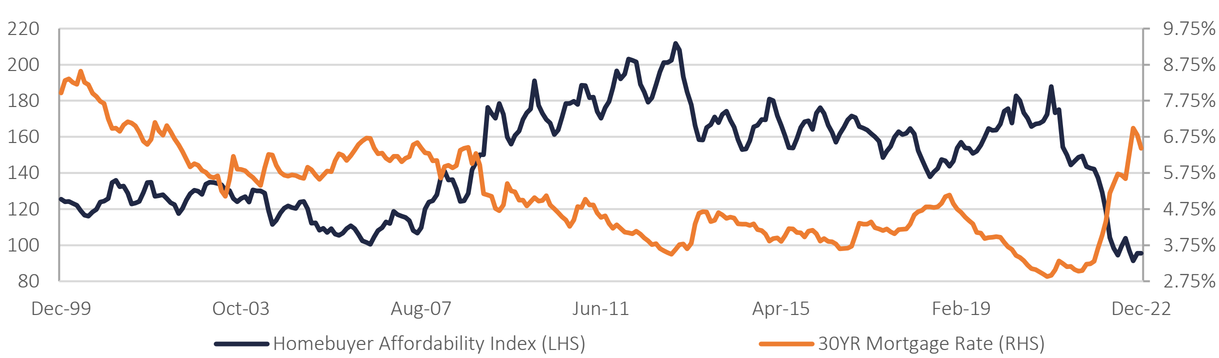


Chart 6

Housing Market First Shoe to Drop

Data is as of December 31, 2022. Data Source: Bloomberg Finance LP, Verdence Capital Advisors.



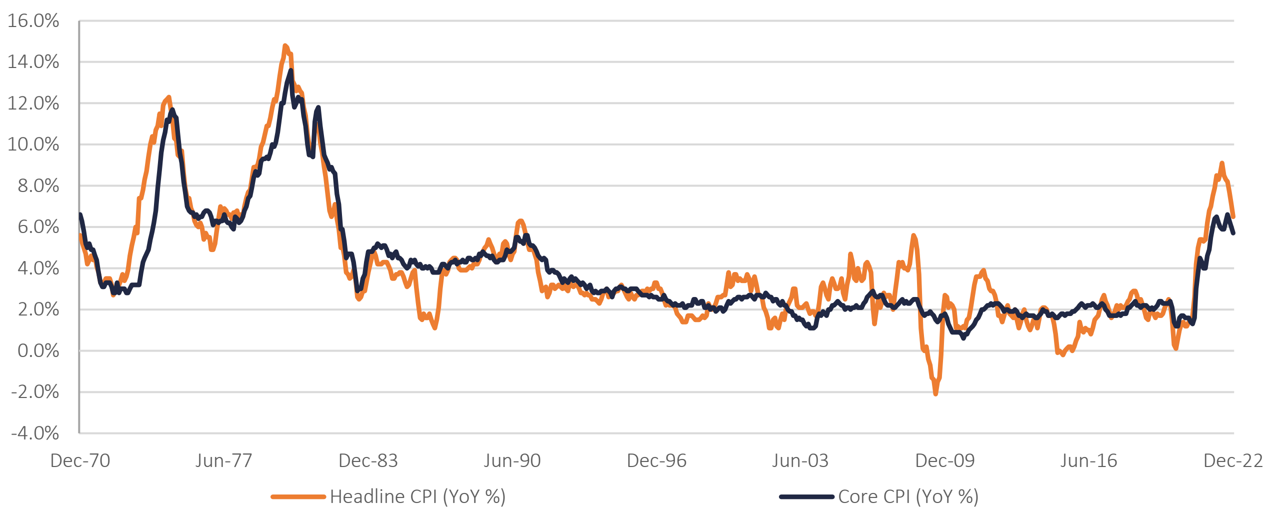
While we have outlined our base case for why a recession is likely in 2023, we are optimistic that a recession can be short and shallow and very different than past recessions that have been longer and deeper in magnitude. Some of our reasons include:

- **Inflation is better; not great:** Inflation likely peaked in 2022 and we expect the gradual decline to continue through 2023. **(Chart 7).** We admit we have a long way to go to officially declare the fight against inflation over. However, there are several indicators that suggest the trend is for the growth in prices to slow in 2023. There has been a dramatic reduction in COVID-related items (e.g., used car prices). In addition, manufacturing prices paid have plummeted and service prices are finally coming down. The last two areas that present the largest risk to inflation remain rents and wages. Rent prices tend to act with a lag so the moderation we have seen in home prices should help alleviate some of the pressure on rents. Wages are also a "sticky" inflation component. As the economy slows, we expect this to turn into an increase in the unemployment rate that can help the wage component of inflation.

Chart 7

Inflation Slowly Improving

Data is as of December 31, 2022. Data Source: Bloomberg Finance LP, Verdence Capital Advisors.



We are optimistic that **a recession can be short and shallow** and very different than past recessions that have been longer and deeper in magnitude

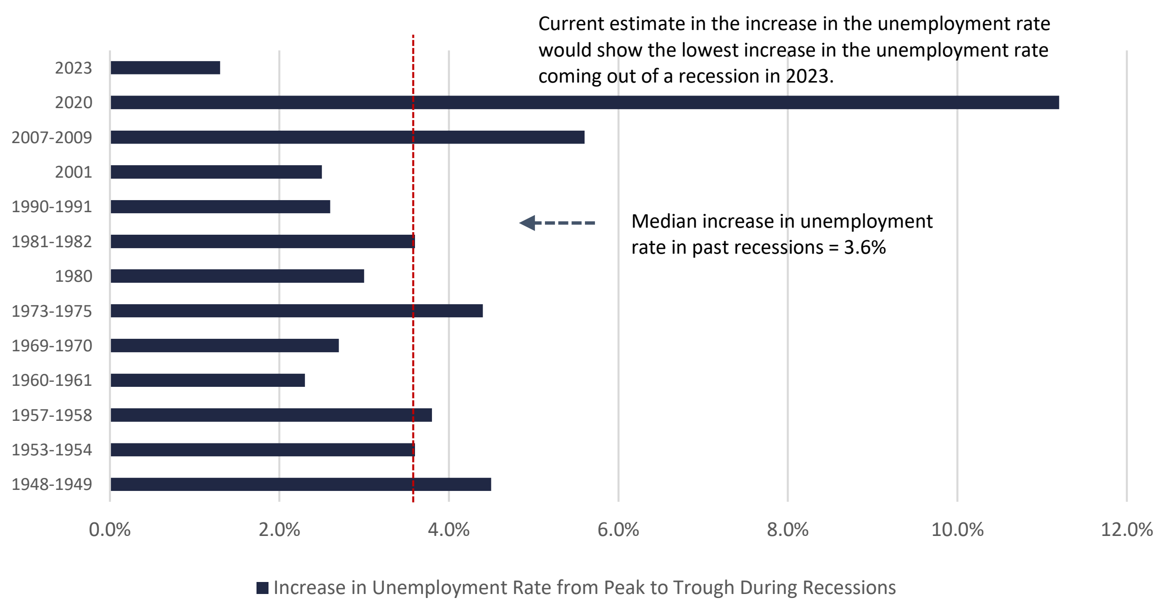
- **Labor market stronger versus past recessions:** We continue to have structural issues in the labor market due to COVID. The labor force participation rate has not fully recovered, and it is estimated that the U.S. has three million less workers than before the pandemic.[1] In addition, there continues to be many more job postings than those unemployed. While this will change as economic growth slows, the unemployment rate remains historically low heading into a recession. As can be seen in **(Chart 8)**, the estimate is for the unemployment rate to rise from 3.4% to 4.8% by the end of 2023. If that were to materialize that would be the lowest increase in the unemployment rate from peak to trough during a recession in history and much lower than the median average.

- **Consumers borrowing but overall healthy:** While consumers have been turning to credit and have been winding down savings accounts, their overall balance sheet is healthier than in past recessions. Net worth as a percent of disposable income is over 700% and near a record high. In addition, the household debt service ratio, while modestly rising, is still well below the level historically seen in past recessions.

Chart 8

Labor Market Much Stronger than Past Recessions

Data is as of January 2023 and data is using all recessions from 1948-2020 and the trough is the low 12 month before the recession starts and the peak is the high 18 months after the recession starts. For the 2022 time period, the trough is considered to have been reached in January 2023 and the estimate is for the peak to be reached in 1Q24 at 4.9% according to estimates by Bloomberg Finance as of January 25, 2023. Data Source: Bloomberg Finance LP, Verdence Capital Advisors.



- **Interest rates are getting restrictive but still low compared to history:** The Fed has inflicted a lot of pain on the economy to get inflation under control. However, when you consider real long term interest rates, they are still historically low compared to history. **(Chart 9)**.

While we believe these rates will rise further this year, there is a long way to go before they can be considered restrictive. In addition, if the economy takes a sharper turn lower, the Fed has flexibility with monetary policy if necessary.

Summary: Economic growth is slowing rapidly, and we believe 1H23 will present the greatest challenge for the economy as consumers pull back after two years of rapid pent up demand spending. It is important to remember that recessions are an important part of all economic cycles as they clear excesses. If we do not slow the economy, inflation will be a persistent issue and the Federal Reserve is going to avoid that at the expense of economic growth. However, we think the recession will be short and shallow as the underlying fundamentals of the economy are stronger going into this expected downturn than in the past.

Chart 9

Real Interest Rates Still Low Compared to Historical Tightening Cycles

Data is as of December 2022. Data Source: Bloomberg Finance LP, Verdence Capital Advisors.

Theme #2 – Fed Pivot vs. Time Out

The first official Fed "pivot" was earlier in 2022 when the Federal Reserve did an about face on monetary policy and admitted that inflation was not "transitory." This caused volatility to surge and fueled the equity bear market. Now investors are anxiously looking for the next Fed "pivot" where they begin cutting interest rates. In fact, using the Fed funds futures market, investors are still anticipating rate cuts as early as the middle of this year. **(Chart 10)**. We think this is too optimistic. Instead, we believe the Fed will continue to raise rates, albeit at 25 bps moves as opposed to 50 bps or 75 bps, through 1H23.

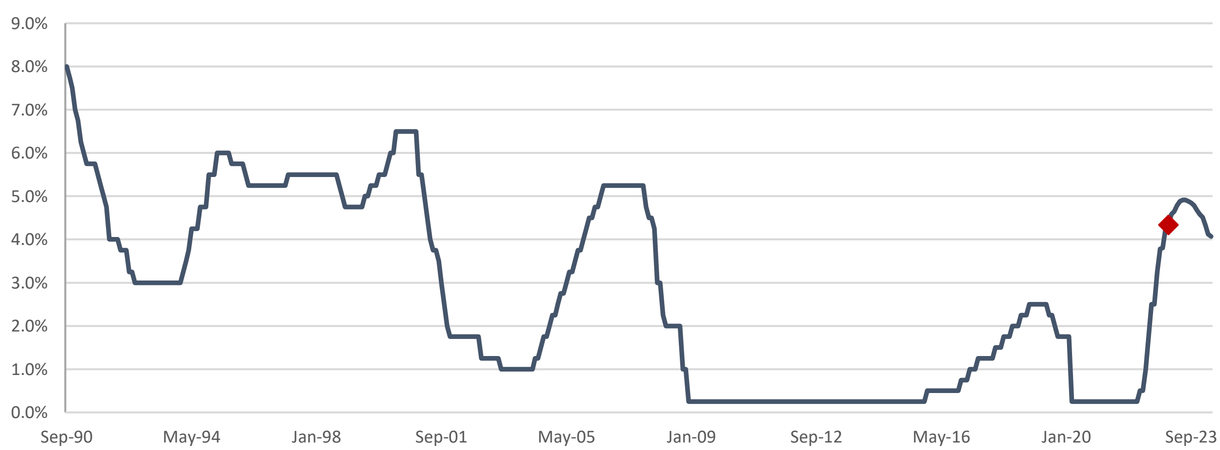
Despite the weakness we expect in economic growth, we think the Fed will pause for the remainder of 2023 instead of cutting rates which is something investors were accustomed to over the past decade at any sign of economic weakness. The Fed has clearly stated they do not want to get into a stop and go tightening - easing cycle like they did in the 1970s and 1980s. This damaged the credibility of the central bank; they did not beat inflation and it severely damaged the labor market. Unfortunately, the Fed is walking a fine line because the underlying positives in the economy as mentioned above (e.g., labor market, household balance sheets, interest rates) could end up fueling inflation if the central bank turns too dovish too quickly. Lastly, the Fed does not have the ability to get too accommodative with policy when they need to unwind a massive balance sheet (over $8 trillion). Therefore, we expect them to keep interest rates higher for longer and investors should accept a higher terminal rate than what we have been accustomed to over the past decade.

Summary: We believe the bulk of the Fed tightening is behind us, but they are not done yet and we think investors may be complacent as to how far the Fed may raise interest rates in 2023. We do not see rate cuts on the horizon despite the expectation for weaker economic growth. Instead, we expect gradual rate hikes in 1H23 and then a pause to reassess the economic and inflation climate.

Chart 10

Investors too Optimistic About Rate Cuts

Data is as of January 27, 2023. Data Source: Bloomberg Finance LP, Verdence Capital Advisors.



Fed funds futures contract
Red dot is current rate

Theme #3 – Global Equities: In the Sea of the Unknown Multiple, be a Quality Contrarian

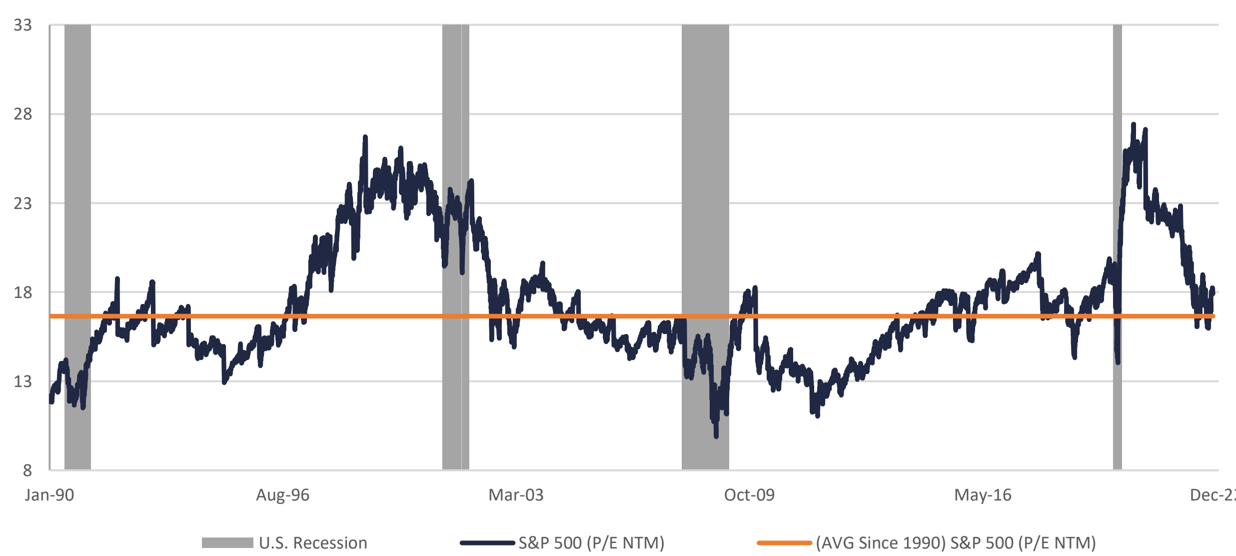
Extraordinarily easy monetary policy and extremely low inflation have fueled a decade of mispricing of equity sectors. Those areas of the market that could promise the best long-term earnings growth prospects because of historically low interest rates led the global equity market in prior years (e.g., large cap growth and technology). Investors never believed we could see a secular reversal in interest rates and paid whatever premium (aka multiple) the market demanded to buy these sectors that offered long term growth in a growth scarce environment. However, what we unpleasantly witnessed in 2022 was the complete reversal of this mentality. Instead of paying historically high multiples (i.e., price to earnings multiple) for these sectors, investors fled these areas at a rapid pace. There was no better illustration than to see the deterioration in the high multiple technology sector with the NASDAQ posting its fourth worst annual decline on record. In addition, the price to earnings multiple on the S&P 500 collapsed by ~40%. **(Chart 11)**. While we think the bulk of the damage was done in 2022, as the Fed continues to raise interest rates and economic growth weakens, there may be more downside in some areas of the market (e.g., technology and growth). Investors are still unclear about the earnings outlook as they try to pinpoint the appropriate multiple given the new interest rate paradigm ahead.

However, even as we navigate the uncertainty about future earnings as well as appropriate multiple valuations, it is important to remember that much of this uncertainty was already priced in last year. For example, as soon as the Fed took a more aggressive stance on monetary policy, the market quickly adjusted, and we saw a rapid move into

Chart 11

Collapse in S&P 500 Multiples

Data is as of January 27, 2023. Data Source: Bloomberg Finance LP, Verdence Capital Advisors.



bear market territory. Going back to all the bear markets since 1945, it only took 162 days for the S&P 500 to drop 20%, compared to the historical average of 213 days. (Chart 12). Other areas of the equity market saw even sharper declines. The Russell 2000 and the MSCI EAFE (developed international markets) both fell more than 30%. Therefore, we see a lot of value in select areas of the market as investors wait on the sidelines for clarity to emerge on earnings or growth to get better. It may seem counterintuitive to look to be buying into what is expected to be a challenging economic environment, but history has shown that being a contrarian when valuations are historically cheap can prove to be a good long-term investing strategy. Our recommendations for global equities this year include:

- **Small and midcap stocks:** Small and midcap stocks underperformed last year as investors grew wary of the economic outlook and rising interest rates. This is not abnormal leading into a recession. However, what has historically been proven is that small and midcap stocks outperform by a wide margin in the year and two years after a recession. (Chart 13). In addition, from a valuation perspective small cap stocks are trading historically cheap compared to large cap stocks.

Chart 13

Small Caps Lead out of the Recession

Time period is all recessions from 1980 - 2020. Data Source: Bloomberg Finance LP, Verdence Capital Advisors.

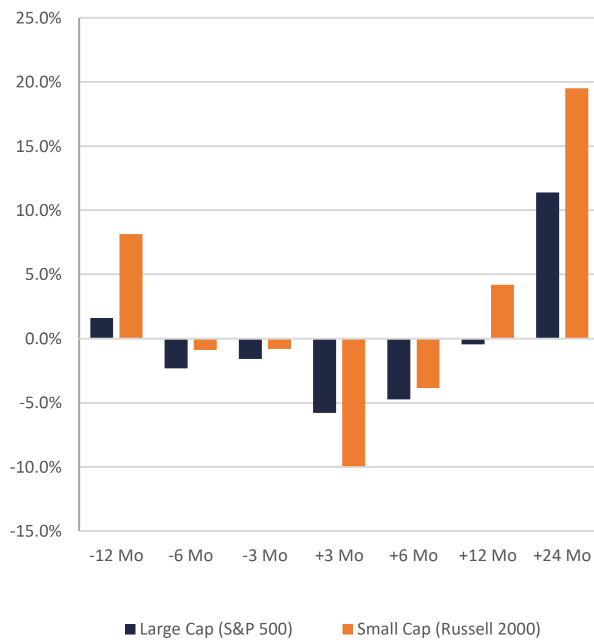
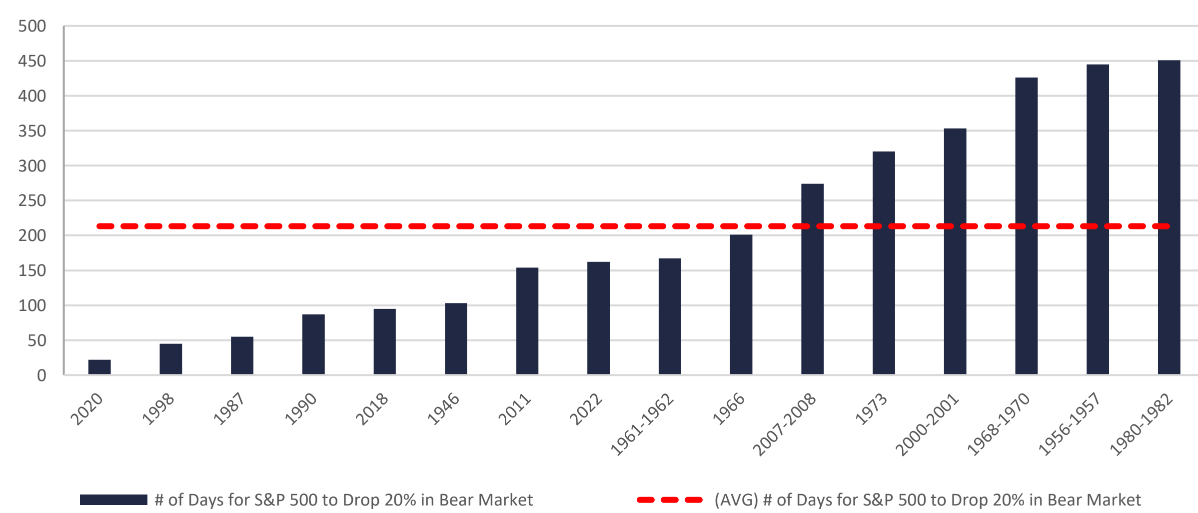


Chart 12

Rapid Move into Bear Market Territory

2022 bear market assumes trough of June 14, 2022. Data Source: Bloomberg Finance LP, Verdence Capital Advisors.



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- **Look internationally for opportunity:** Despite a very rocky start to 2022, developed international equities (i.e., MSCI EAFE) were able to outperform U.S. equities (S&P 500) for the first time in five years by the end of the year. However, over a long-term time frame, the MSCI EAFE has been underperforming the U.S. on a rolling five-year time frame for more than a decade. Many of the factors that have resulted in the developed international equity market lagging the U.S. are unwinding, which include:
  - **Sector exposure:** The developed international equity market has less exposure to some of the sectors that have benefitted from the historically low interest rate policy. For example, the S&P 500's biggest sector is information technology, but it comprises a small portion of the MSCI EAFE. Financials dominate the MSCI EAFE Index and should benefit as the Eurozone finally emerges from a negative interest rate policy.
  - **Currency weakness:** The Euro and pound have significantly underperformed the U.S. dollar for years due to interest rate differentials, the war in Russia/Ukraine, energy challenges and political uncertainty. As a result, these currencies were trading at historically low levels and pricing in a worst-case scenario for these economies. However, with these central banks joining in the global rate hiking cycles and economic growth proving not to be as bad as expected, fund flows are returning to these regions, and we expect that to continue.
  - **Valuations compelling:** The underperformance and lack of high multiple sectors in the developed international space has pushed the relative valuation between international equities and U.S. equities to a record low. (Chart 14).

Chart 14

Internationally Equities Historically Cheap

Data as of January 26, 2023. Data Source: Bloomberg Finance LP, Verdence Capital Advisors.

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Summary: After a tumultuous year for global equities in 2022, we believe the bulk of the damage is done and 2023 will open opportunities for investors that are patient and willing to take a contrarian view for the long term. We expect volatility will emerge in 1Q23 as positive seasonality fades, investors absorb the weaker growth climate and earnings get more realistic. However, we will look at these opportunities to put dry power to work in those areas that we believe are already reflecting the worst-case scenario and look attractively valued. As we move into this new higher interest rate regime, dividends and earnings will make up more of the total return than the past decade of price to earnings multiple expansion. We will favor sectors, styles and regions that have good dividend payout ratios, growth, and attractive earnings potential (e.g., small cap, mid cap, international, and large cap value).

We believe the bulk of the damage is done and 2023 will open opportunities for investors that are **patient and willing to take a contrarian view**.

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Theme #4 – Fixed Income: Storm is not Over yet but Tides are Turning

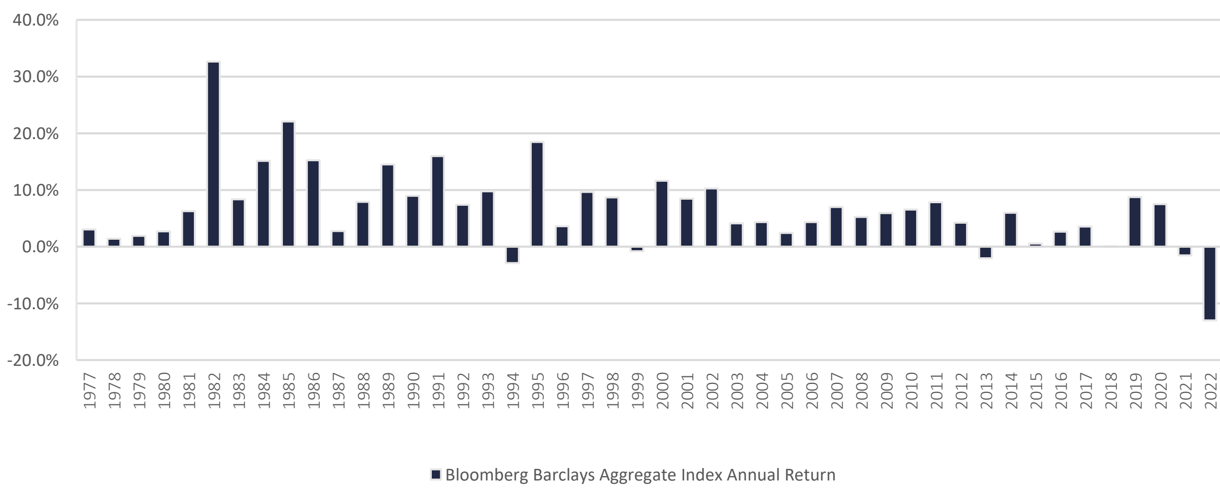
Bond investors have seen two consecutive years of negative returns in bonds. This is something they have not experienced since at least the late 1970s when the Bloomberg Aggregate Index was developed. **(Chart 15).** Every major sector, except for short-term Treasury bills and floating rate notes, delivered investors negative returns last year. Unfortunately, in our view, the interest rate storm is not yet over. The Fed is still raising interest rates and long-term interest rates do not reflect the change in interest rate policy, inflation environment or the fact the Fed must unwind a balance sheet the size of the economies of Japan and Germany, combined! We do not expect the same double-digit losses as seen last year, primarily because the bulk of the Fed tightening is behind us, but we do expect volatility and challenges for bond investors this year. However, these challenges can ultimately bring ample opportunities that we will be ready to capitalize on. Our recommendation for fixed income in 2023 includes:

- **Defensive in a rising rate environment:** We believe the Fed will continue to raise interest rates through 1H23 and long-term interest rates are still historically lower (on a real yield basis considering inflation) than they should be in a tightening cycle. While some of that will change as inflation moderates, there is still more downside risk in long-term bonds than upside (price down and yields higher). Even with the expectation that economic growth will weaken, long-term yields do not offer an attractive risk/reward at current levels. Instead, we continue to remain focused on short maturing bonds. There may be an opportunity to look for longer term maturity bonds at some point this year but not when long term real yields (10YR Treasury note) are negative.
- **Credit does not reflect risk; but likely to get an opportunity:** While credit offers some extra yield over Treasuries and the absolute yields have risen alongside Treasuries, we still do not see investors being rewarded for the additional risk. That extra yield (aka spread) for both investment grade and high yield credit is still too low considering the economic challenges we are forecasting. We realize that corporate America may be

Chart 15

Bonds Deliver Equity Like Losses

Data is from 1977-2022. Data Source: Bloomberg Finance LP, Verdence Capital Advisors.



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healthier today compared to past recessions, however, every recession or major economic challenge leads to yield spread widening to some degree. **(Chart 16).** This is something we have not seen but do believe will see in 2023. One of the concerns around credit is that spreads are also not reflecting the refinancing of existing debt into higher yield debt given the Fed's rate hikes. In the years 2025-2029, there is a massive amount of high yield debt that needs to be refinanced. Investors will start pricing that risk well before that date, so we expect volatility this year and next.

Summary: Fixed income is unlikely to offer the same diversification benefits as investors have been accustomed to as the Fed is raising rates and still needs to unwind a massive balance sheet of Treasuries, mortgage-backed securities, and agency debt. While we do not think it offers the same diversification benefit, we would not abandon it altogether. Instead, we believe it is prudent to stay in short maturing bonds, especially as the Fed is raising rates. These offer the most attractive yields we have seen in decades with minimal credit risk (3 Month T bill at highest level since 2007). We will look for opportunities to invest in longer-term bonds but only when the risk is rewarded. Also, we are ready to be a contrarian when credit spreads begin to widen and offer an attractive risk adjusted return.

Chart 16

Credit Still Not Reflecting the Risk

Data as of January 27, 2023. Data Source: Bloomberg Finance LP, Verdence Capital Advisors.

Theme #5 – The Hunt for an Uncorrelated Portfolio

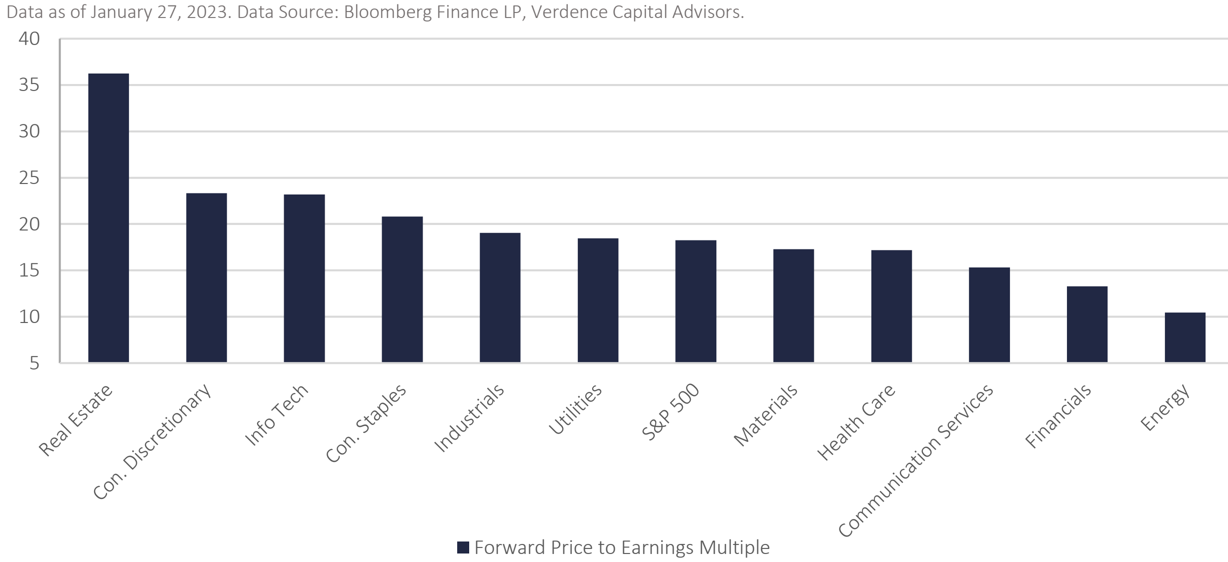
Traditionally investors want to diversify portfolios by filling in an asset allocation with several uncorrelated investments. However, in 2022, the major asset classes (equities and bonds) saw themselves positively correlated and unfortunately to the downside. The only major asset class to deliver a positive return for the year was commodities and that did not come without its challenges as crude oil saw two separate bear markets during the year and industrial metals declined due to economic softness. Unfortunately, the hunt for the appropriate dispersion amongst asset classes will continue to be challenging in 2023. The generic 60% equity/40% bond portfolio may very well be a thing of the past. In addition, passive investing with index funds is going to continue to face challenges as the end of the easy money regime gets priced into valuations. Instead, we believe that active management is crucial. The dispersion between equity sectors and their valuations (price to earnings multiples) illustrates how expensive some sectors are compared to others. **(Chart 17).** This environment favors active management to decipher what has the best long-term return potential.

In addition, for those investors where private investments are suitable, we recommend having at least a portion of your overall portfolio allocation in the private markets to seek more favorable risk adjusted returns. Investing in the private market not only removes the daily volatility, but also typically offers low correlations to traditional asset classes, provides cash flow in some instances and may be a better way to hedge against inflation. However, due diligence is crucial in the private markets as excess liquidity has reduced risk premiums and opportunities across a broad range of segments of the private markets. We favor real assets that can hedge against inflation pressures, small to middle market private equity and select private credit in the current environment. In addition, traditional low volatility hedge funds can offer another layer of diversification and serve as a hedge for an investor's public market equity exposure.

Chart 17

Dispersion in Valuations Benefits Active Managers

Data as of January 27, 2023. Data Source: Bloomberg Finance LP, Verdence Capital Advisors.



Bottom Line:

We sympathize with how challenging the environment has been for all investors in 2022 and fully understand the skepticism around investing in anything but cash at this time. We do not expect an easy ride this year and volatility will continue but letting emotions override long term investment objectives would be dangerous at a time when the current bear market has already experienced a decline that is relatively close to the historical average seen in all bear markets. In addition, the Fed is on the back end of their tightening cycle, inflation is coming under control, and we are working out excesses in the economy that are crucially needed for long term prosperity. Plus trying to time a market (by capturing losses now and waiting to get in when the market drops) has historically proven to be nearly impossible. Instead, remain patient, we will continue to look for opportunities from a contrarian perspective that we believe may have gone too far in pricing downside risks and offer good long term upside potential. We are also not complacent about the risks from a policy perspective that could alter our view of a short and shallow recession this year. While we still think equities offer better long-term potential, we are not opposed to holding some dry powder to be able to put to work as volatility intensifies.

As always, if you have any questions about our perspective, please do not hesitate to reach out to your advisor.

1:https://www.uschamber.com/workforce/understanding-americas-labor-shortage#:~:text=Workforce%20participation%20remains%20below%20pre,compared%20to%20February%20of%202020.&text=Photo%20by%20Ian%20Wagreich.

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