CARSON | Investment Research

Outlook '23

The Edge of Normal

A Look At the Year Ahead From Your Carson Investment Research Team

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At-A-Glance

Here we lay out our strategic and tactical recommendations for broad asset classes. These views reflect our latest views on markets, economy, and policy.

Our starting point is the secular view, which forms the basis of our strategic allocation recommendation. These are built off our long-term views for various asset classes. We then incorporate our views on the economy, technicals, valuations, and policy outlook to generate our shorter-term tactical recommendation, which are meant to adapt to the macro environment.

'23 Forecasts

STOCKS 12-15% Returns — We expect a rebound in 2023, especially as the economy avoids a recession and global growth rebounds in the back half

BONDS 4-5% Returns — We expect a less volatile year for bonds, with most of the return coming from yield

HOUSE VIEWS Asset Class Recommendations

	Strategic View	Policy	Economic	Technicals	Valuations	Tactical View	
EQUITIES	Overweight	Gray	Gray	Green	Gray	Overweight	**Rebound in 2023, especially as the Fed pulls back and the economy avoids a recession**
U.S. Equities	Overweight	Red	Green	Green	Gray	Overweight	Economic growth in US relatively better than the rest of the world
International Equities	Underweight	Red	Red	Gray	Green	Underweight	Economic growth relatively worse than US, and more hawkish Central banks
Emerging Markets	Underweight	Red	Red	Red	Gray	Underweight	Short-term uncertainty in Asia and Latin America
U.S. EQUITIES							
Large Cap	Neutral	Gray	Gray	Gray	—	Neutral	Still leans towards growth companies which are potentially overvalued
Mid & Small Cap	Overweight	Gray	Green	Green	Green	Overweight	Historically cheap relative to large cap and should do better if the economy remains strong
Growth	Underweight	Red	Red	Red	Red	Underweight	Rich valuations for Tech companies amid higher real interest rates could pressure growth stocks
Value	Overweight	Gray	Green	Green	Green	Overweight	We like Industrials and Energy, especially with global growth potentially rebounding after mid-2023
Defensives	Overweight	Gray	Gray	Red	—	Neutral	Staples and Healthcare (drugs/pharma) could provide stability amid market volatility
Cyclicals	Neutral	Gray	Gray	Gray	—	Neutral	Cautious on Financials and Consumer Discretionary as we wait for global growth to rebound
FIXED INCOME	Underweight	Red	Red	Gray	Gray	Underweight	**We prefer stocks as we expect the economy to avoid a recession**
Treasuries	Underweight	Red	Red	—	—	Underweight	Still prefer lower duration due to potentially higher rates
Investment Grade Corporate	Underweight	Red	Gray	Gray	—	Underweight	Prefer lower duration credit
High Yield	Neutral	—	Green	Green	Green	Overweight	Opportunistic overweight as we don't expect a recession
DIVERSIFIERS							
Cash	Overweight	—	Green	—	—	Overweight	Risk-reward still favors Cash and short-term bonds over long-term bonds
Real Estate	Overweight	—	Gray	Red	—	Neutral	Weak technical backdrop amid structural headwinds of higher rates
Commodities	Overweight	—	Green	Green	—	Overweight	Global recovery, including China re-opening, could boost commodity demand

Source: Carson Investment Research 12/30/2022

The Edge of Normal

After a brutal year for stocks in 2022, in fact, the worst since 2008 and the fourth worst year since 1950, we believe the market is actually primed for a robust return in 2023 – perhaps to new highs. Just as a range of headwinds pressured stocks on several fronts over the past year, we're noting positive economic indicators that could provide a significant boost in the months ahead, albeit in a best-case scenario. However, like 2022, this year could just as easily bring more surprises.

The Past Year...

The year behind us was a difficult one for stocks and bonds, and much worse than we expected in terms of asset price performance. Pressure came from a range of headwinds: the Federal Reserve's ongoing interest rate increases, the crash in cryptocurrencies, a housing recession, and the war in Ukraine, to name a few. Bonds also saw one of their worst years ever as inflation and interest rates soared.

Early into 2022, stocks had been on a nearly two-year rally, up 120% from March 2020 lows, so we naturally expected some weakness to offset the enthusiasm. What we didn't expect was the confluence of geopolitical and economic events that would tamp down the markets to such a degree. The terrible war in Ukraine brought soaring energy prices, lockdowns in China led to nightmare supply chain issues, and the Fed embarked on aggressive policies to combat inflation. Meanwhile, the housing market entered a recession due to higher mortgage rates and manufacturing teetered on the brink of contraction.

In other sectors, technology stocks had a defeating year with the Nasdaq down more than 33% in 2022, underperforming the S&P 500 as major layoffs, interest rates, and inflation took a toll on the industry. Tech giants like Amazon, Tesla, and Meta lost half their value. Meanwhile, cryptocurrencies also plunged into turmoil, with Bitcoin losing over 60% its value, in part due to the implosion of trading platform FTX, which is now bankrupt.

Of course, last year's economic trends weren't all doom and gloom. On the positive side, the U.S. economy avoided recession, consumer spending remained strong, and the labor market created more than four and a half million jobs. Meanwhile, we saw breakthroughs in AI research that have the potential for wide-ranging scientific and economic implications. But it was never enough to lift stocks into positive territory for long.

The Edge of Normal

Now, keep in mind, when it comes to the stock market, history has a habit of repeating itself. Since the Dow Jones Industrial Average (DJIA) index was first published in 1896, we've seen several cycles of wars, famines, inflation, deflation, crashes, and depressions. (Setting aside the devastating physical, mental, and economic suffering that took place, if only for a moment.) Looking at just the price of stocks at that time, as you would have expected, they took a beating. Of course, the situations must have looked and felt incredibly bleak. In dark times like that, it can be hard to see a path forward. But humans are a resilient, creative, and innovative species. So, obstacles are managed accordingly as we seek higher ground. So as the economic situation inevitably improved, stocks often rebounded to new highs (typically, much faster than you might have thought they would in the moment). This is one reason why we think stocks are poised to fare well into 2023, which we expect will be a much better environment for investors. But it's not the only reason.

We see several signs that the U.S. economy may not only avoid a recession but may see marked improvement. For one, soaring inflation trends are showing signs of easing, with the annual rate of inflation as measured by the Consumer Price Index (CPI) being 7.1% in November, down from 9% in June. In turn, the Fed has eased back on its aggressive moves to stem inflation, raising its key interest rates by 0.5 percentage points at its December meeting, compared to the 0.75-percentage-point increases it had issued at the previous four meetings.

In other positive signs, third-quarter earnings season saw the majority of companies surprising to the upside, posting both strong revenue and EPS growth. The supply chain issues plaguing the global economy have shown significant improvement in recent months, with ports no longer as congested and the cost of shipping goods declining. While the war in Ukraine is ongoing, we are optimistic that 2023 will bring a resolution, although this is just a hope based on Ukraine's success so far in holding out against Russia. Overall, we see a strengthening economy that could help stocks bounce back. Although we don't favor bonds as much as stocks, we do expect bonds to produce modest gains after their first two-year losing streak in history. At the same time, one positive from aggressive interest rate increases by the Fed means cash is paying the highest it has in more than 15 years.

As we move into this new year, many forces that were headwinds in 2022 could very well become tailwinds in the year ahead, but of course there are many risks to consider as well. Now may be an ideal time to identify key investment opportunities and take advantage of their potential growth in 2023. As Warren Buffett once said, "Someone's sitting in the shade today because someone planted a tree a long time ago." Well, we believe now is an ideal time for investors to "plant trees" toward long-term gains.

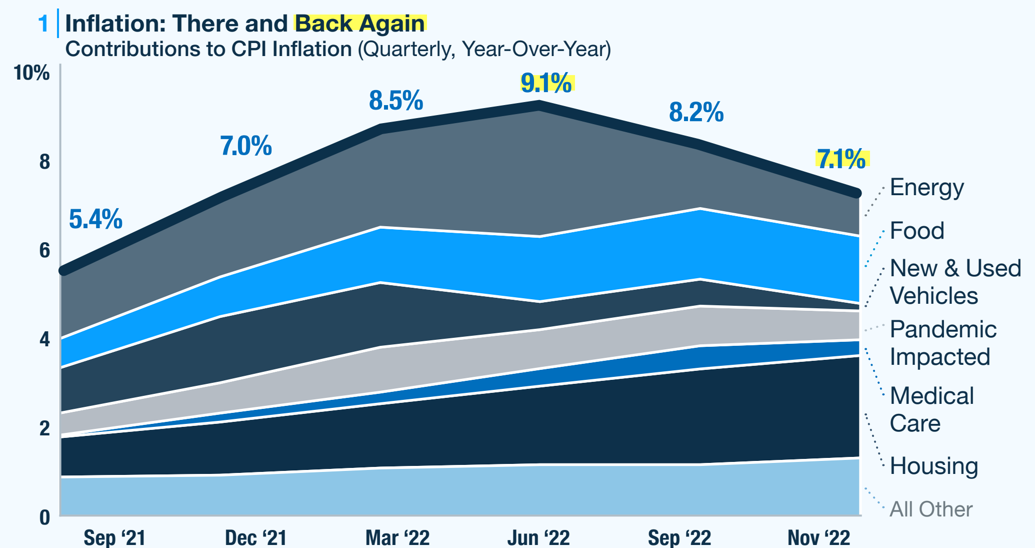
Let's look at some of the key trends in 2022, from inflation to consumer spending, and how they may shape the market in the year ahead. Inflation, and the Fed's aggressive response to it, was the major theme of 2022, and so we begin there. Particularly, what may be in store as we move into 2023.

Inflation Shows Signs of Easing

Inflation, which surged to the highest level since 1981, was top of investors' minds last year, as consumers grappled with substantially higher prices in food, housing and other goods and services. Any hopes for rapidly rising inflation to ease at the beginning of the year were dashed when Russia invaded Ukraine and energy prices spiked. In the latter half of the year, however, energy prices declined and overall inflation eased in tandem **Figure 1**.

1 | Inflation: There and Back Again

Contributions to CPI Inflation (Quarterly, Year-Over-Year)



Source: Carson Investment Research, BLS 12/30/2022

Pandemic impacted categories include car and truck rentals, furnishings and supplies, apparel, airline fares, lodging away from home including hotels and motels. Housing includes rent of primary residence and owners' equivalent rent. Medical care includes medical care commodities and services.

Inflation Shows Signs of Easing cont.

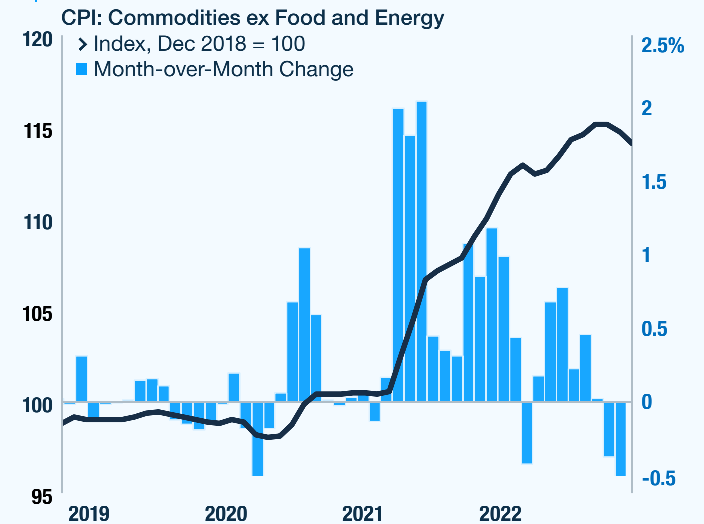
We believe there are three major drivers to lower inflation in 2023:

1

Gas prices as a deflationary force over the short term. Gas prices hit a record high national average of about $5 per gallon in June. Since then, prices have eased. The national average was $3.13 per gallon on Dec. 28, according to AAA data. What's more, gas prices are expected to continue to drop early this year, according to several estimates. However, even if prices do rise again with the summer travel season, overall lower gas prices are likely to contribute to lower inflation.

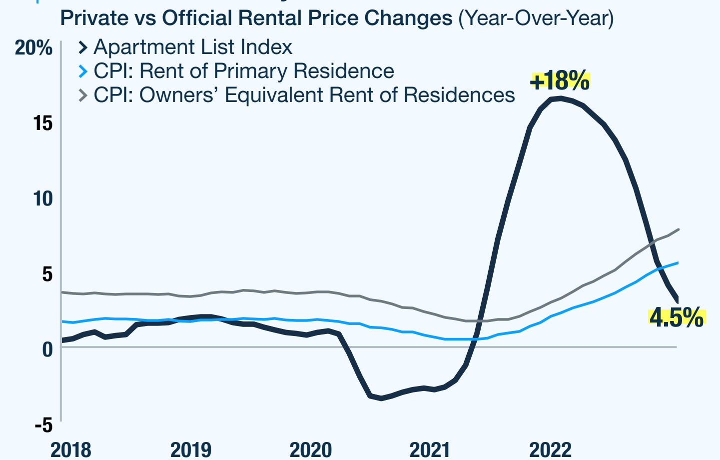
2

Core goods (excluding food and energy) prices starting a downtrend. Core goods include things like used and new vehicles, apparel, home furnishings and appliances, products that have seen steady price increases over the past year. They comprise over a fifth of the inflation basket. Just recently, falling prices in core goods are finally reflecting the improving supply chain, even as demand stays high.



3

Rentals and Owners' equivalent rents (which is also measured using rents) showing signs of rapid deceleration. Rentals and Owners' equivalent make up about 40% of the core inflation basket, and this category is why core inflation is running as high as it is. Rental prices surged after the pandemic. Official inflation data captures rental prices with a long lag, so we're seeing those prices reflected in inflation data now. The good news is that private data shows rents decelerating rapidly. That will eventually trickle into official inflation data throughout the year.



Source: Carson Investment Research, Factset 12/14/2022

Monetary Policy

The Fed's Shifting Strategy

As a result of astronomical inflation trends, we saw the most aggressive tightening cycle in monetary policy in four decades in 2022. Through the year, the Federal Reserve, in part to avoid repeating policy errors of the 1970s, raised its key interest rates seven times. The main questions on investors' minds has been how fast will the Fed will raise rates and how high will they go |Figure 5|.

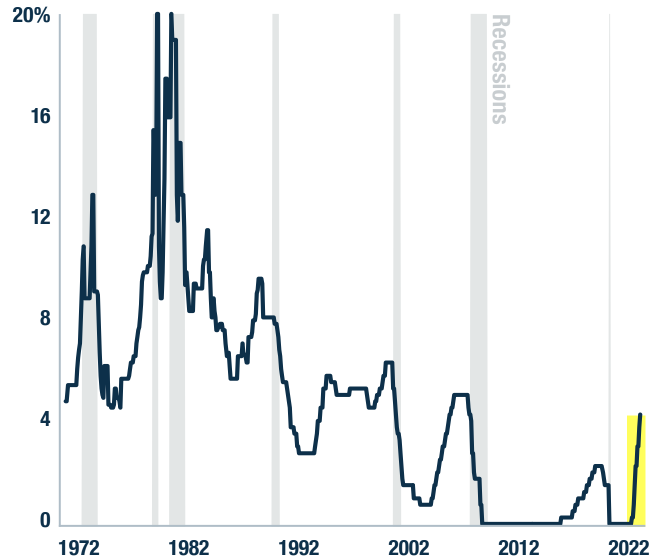
The shift in 2023 will be that Fed officials will likely focus more on the risk of tightening too much than the risk of not doing enough. So, for investors, the question will be, "How long will the Fed continue to keep interest rates high?"

We believe disinflation will kick in later this year, especially if energy prices don't spike again, core goods prices continue to ease, and official rental inflation starts to reflect market rents, which are falling. If that happens, it's tempting to assume the Fed will start to cut rates once again, and indeed we do believe that the Fed will respond to any signs of disinflation with policy easing later in the year or in early 2024. But we do have to consider the economic risks and consequences on the markets if the Fed continues to maintain its tight policy.

After all, the Fed's monetary policy with its impact on inflation affects the labor market. Raising interest rates tighten financial conditions, which in turn impacts businesses and their hiring decisions. As a result, employment growth can slow. A labor market that has more workers than jobs from employers would see wage growth stagnate. And if consumers have lower wages, they have less money to spend, which will result in less price pressure, particularly for services. Historically, wage growth

5 | **Most Aggressive Tightening in 4 Decades**

› **US Federal Funds Upper Target Rate** (% Yield)



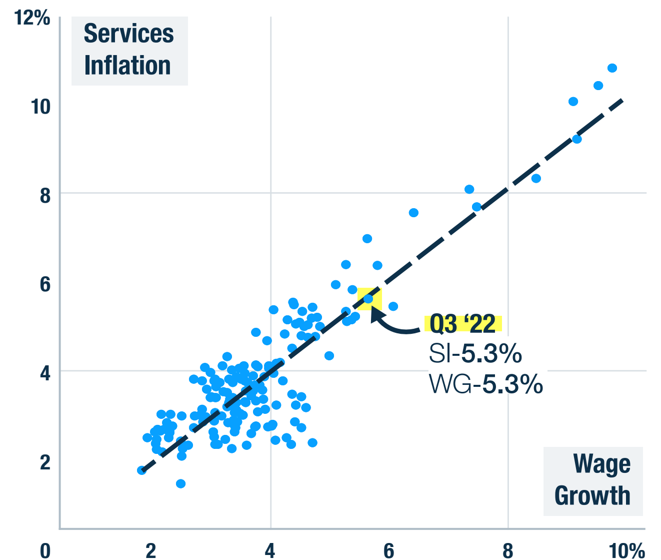
Source: Carson Investment Research, Factset 12/14/2022

6 | **Wage and Services Inflation Highly Correlated**

Services Inflation vs Wage Growth: 1981-2022 (Year-Over-Year)

› PCE Price Index: Services

› Employment Cost Index: Wages and Salaries, Private



Source: Carson Investment Research, Factset 12/14/2022

has been highly correlated with services inflation (which excludes more volatile goods inflation) Figure 6.

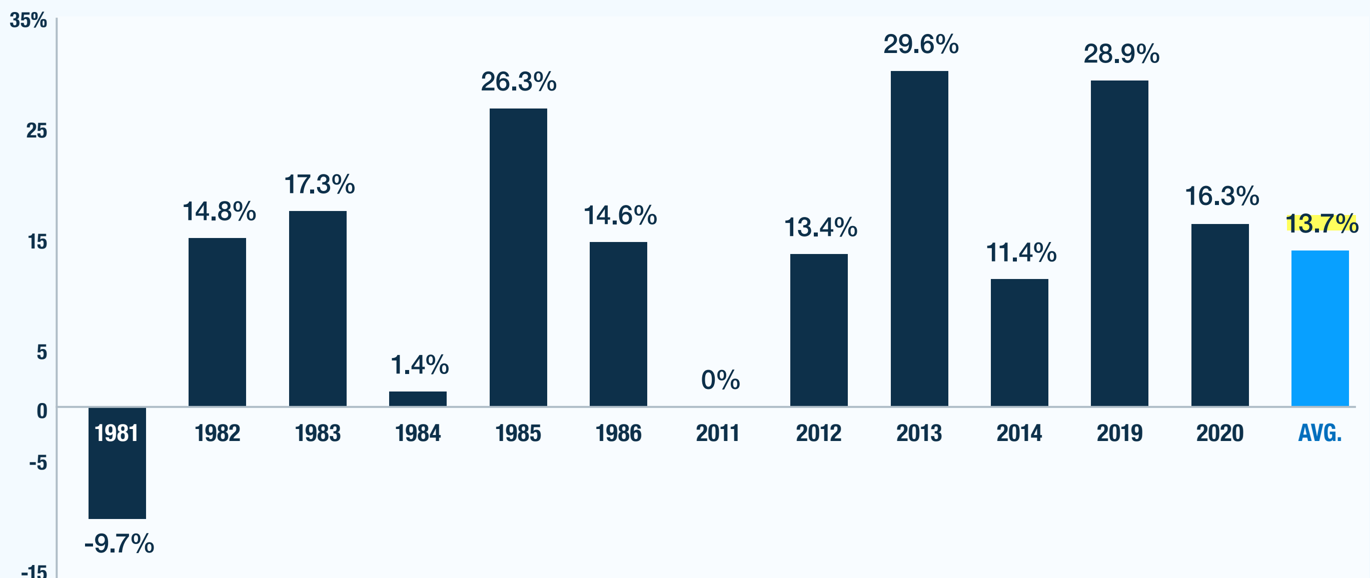
If the labor market and wage growth remain strong, the Fed may maintain overly tight interest rates, even if inflation is falling quite rapidly by the third quarter of 2023. Policymakers may argue that disinflation is "transitory," while strong wage growth implies underlying inflation trends are still too high. But, again, we believe that this is a worst-case scenario and that the Fed is more likely to respond to disinflation with looser policy.

Fiscal Policy Gridlock?

Midterm elections are over and in the end the Democrats lost control of the House, but maintained control in the Senate. There's an old saying that 'gridlock is good' and sure enough that appears to be the case. The truth is markets don't like one party in too much power, as instead checks and balances are a welcome sign. More extreme policies are likely off the table under a split Congress and that could be a good thing.

So what happens under a divided Congress?
The S&P 500 gained 13.7% on average under a divided government, with only one-year falling significantly back in 1981, while 2011 was nearly exactly breakeven Figure 7. The other years saw solid returns, with stocks higher the past five times Congress was split. With a historically slim margin for the Republicans in the House and a very small margin for the Democrats in the Senate, gridlock is indeed the word of the year.

7 | The Markets Tend to Favor Gridlock, Apparently
> S&P 500 Performance Under A Split Congress (1950–Current)



Source: Carson Investment Research, YCharts 11/16/2022

U.S. Economy

Don't Bet Against the U.S. Consumer

Last year ended with a rebound in consumer spending,

and we believe this is likely to continue into 2023. For example, the five-day Thanksgiving holiday period, which included Black Friday and Cyber Monday, saw a record 196.7 million shoppers, according to National Retail Federation estimates. This is important because consumer spending trends will play a key role in whether the U.S. will experience a recession over the next 12 months. After all, consumer spending comprises 70% of the U.S. Gross Domestic Product (GDP).

Here are three reasons we believe the consumer is now in a strong position:

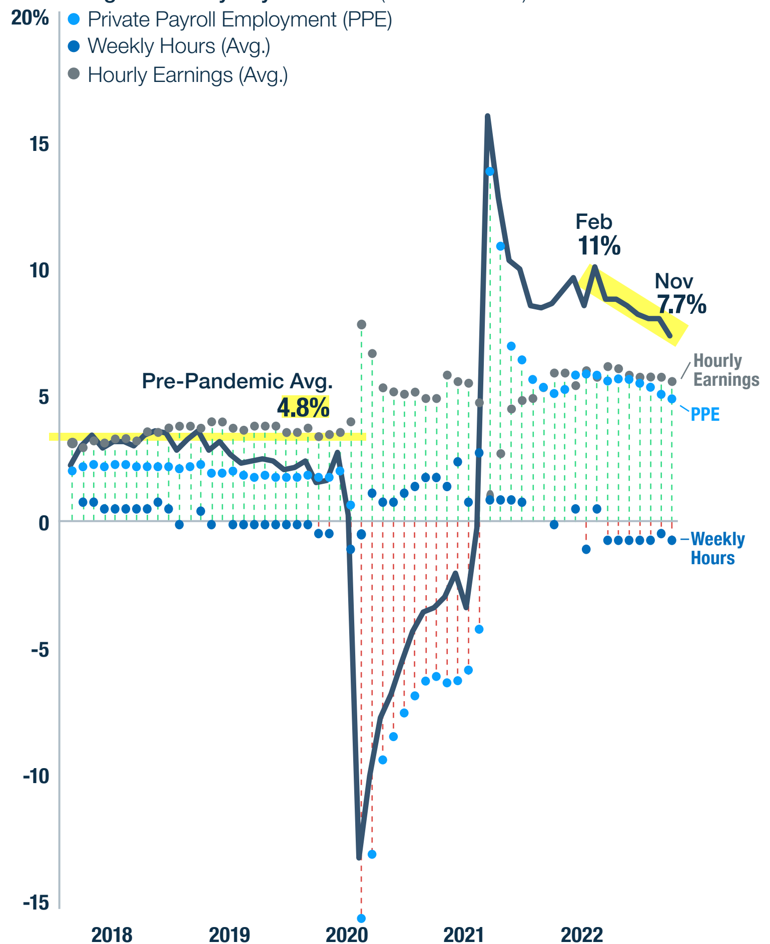
1 Rising Incomes

Income is an important metric because it impacts consumer spending. Figure 8 shows the year-over-year growth in weekly earnings, i.e., weekly earnings across all workers, which can be attributed to 3 sources:

- **Employment growth:** as more people get employed, overall income in the economy increases, driving more spending. Employment growth has been strong recently.
- **Hours worked:** as people work more, they earn more, and overall incomes go up. Hours worked have been falling in recent months, but that's mostly a reversal from the significant jump we saw amid the pandemic.
- **Average hourly earnings:** as workers earn more, overall incomes go up. Average hourly earnings have been hot over the past year, but it's been slowing recently.

Aggregate earnings slowed in 2022, from 11% to 8%; though still higher than the pre-crisis pace of just under 5%. Payroll gains have averaged about 289,000 over the past three months, but even if it halves to about 125,000-150,000 net jobs a month, we'd still be looking at solid income growth. The Fed is looking for a slowdown in income growth which could very well happen without employment reversing.

8 | Income Growth Slowing, But Still High



Source: Carson Investment Research, Fred 12/2/2022

Pre-pandemic average calculated as the average annualized growth rate between Jan 2018 and Feb 2020

2 Excess Savings

In the year and a half after the pandemic, consumers saved an estimated $2.3 trillion more than they would have based on pre-pandemic trends. A lot of this was due to fiscal policy (like checks and expanded unemployment benefits). However, for the top 25% of earners, it was almost entirely due to reduced spending amid the pandemic.

Over the past year, consumers have drawn down these excess savings by an estimated $800 billion. But what's important to assessing the health of the U.S. consumer is that excess savings are still substantial compared to pre-pandemic levels |Figure 9|.

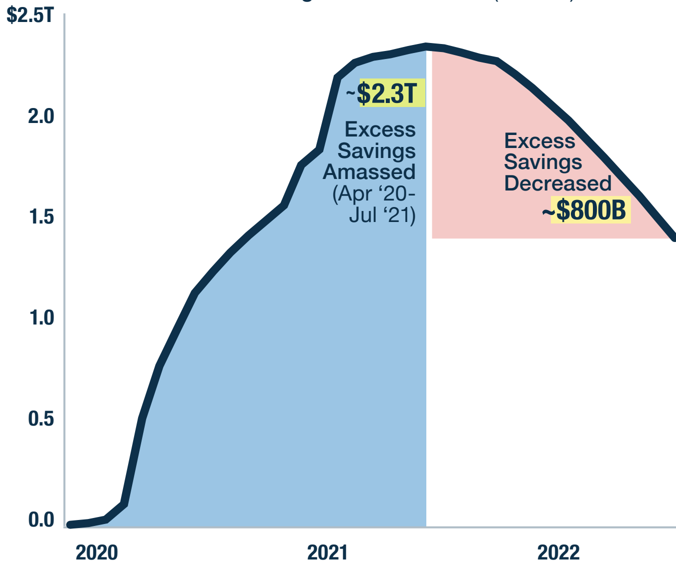
3 Borrowing Capacity

Total credit card spending rose in 2022, which, given inflation trends, is not surprising. But consider that while total credit card debt may be rising, debt service ratio for households is close to record lows. Households' debt service as a percent of disposable income was at 9.6% as of the end of the second quarter of 2022, below the pre-pandemic average of 11.2%.

Credit utilization rates are also still low. Consumers are not using their credit card lines or home equity lines of credit to the same extent they were before the pandemic hit. In fact, utilization rates are well below the average levels of the past few decades |Figure 10|.

9 | Excess Savings Being Spent, But the Pot Isn't Empty

> Estimated Excess Savings: Since Jan 2020 (Trillions)

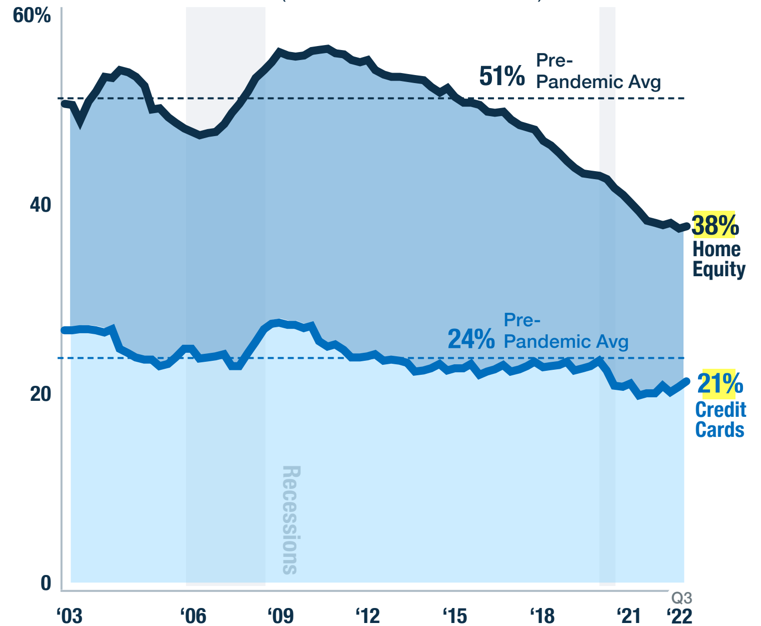


Source: Carson Investment Research, Fred 12/2/2022

Excess savings calculated as the cumulative difference between disposable personal income and personal outlays, minus pre-crisis trend (2016-2019)

10 | Consumers Haven't Stretched Their Borrowing Capacity

Credit Utilization Rate (Percent of Available Credit)



Source: Carson Investment Research, Fred 12/2/2022

Just as higher inflation is effectively a tax on incomes, falling prices are akin to a tax cut. So, easing inflation will be the icing on the cake for the U.S. consumer. The second half of 2022 already saw a pickup in real incomes, but as inflation decelerates even more in 2023, expect it to provide a bigger tailwind to consumers. Real incomes will likely start rising again, and the rate at which consumers are depleting their excess savings should slow. These trends will be positive for consumption, which is why our House View is that the U.S. economy can avoid a recession in 2023.

Global Economy: Rebound Potential After Mid-2023

With respect to the global economy, there are two major themes: energy trends in Europe and Covid policies in China.

First, we're watching whether Europe will get through the winter without a major energy crisis. The Russian invasion of Ukraine sent European energy prices skyrocketing and inflation surging. The European Central Bank (ECB) responded with aggressive interest rate hikes even amid subdued economic growth, which only created more downward pressure. The good news is that Europe has secured other energy sources (including the U.S.) and inventories have been increasing. In addition, a potentially warmer winter would bring reduced energy demand (without crushing economic activity), so Europe may see growth rebounding toward the middle of 2023.

In both the U.S. and Europe, the manufacturing sector is currently in contraction, but it's arguably more critical in Europe, with its large economies like Germany reliant on exports. We could see an inflection point for manufacturing by the second quarter, especially if economic growth in Asia rebounds Figure 11.

Our second big theme concerns China's Covid policies and their impact on Emerging Markets, especially in Asia. As 2022 ended, China surprised the world as it appeared to be stepping back from its strict zero-Covid policies. This could hurt China's economy in the short-term if Covid cases continue to rise but, when the surge in infections dies down, we can expect a significant economic boost from a reopening, perhaps by the third quarter.

A related question is how Chinese authorities will stimulate the economy. China has already started to ease restrictions in the real estate sector, on which the economy depends. We believe this will continue in 2023, as Chinese authorities start to focus on economic growth once again.

An improvement in China would also provide a boost for the countries on its periphery like South Korea and Taiwan. A rebound in China's economy would be positive for commodities, including oil and industrial metals. **Therefore, our House View (Tactical) is overweight commodities.** A rebound in commodities, along with an easing U.S. dollar, will be an added tailwind to Emerging Markets across Asia and Latin America. In short, we're expecting a global manufacturing rebound later next year.

Our House View is currently underweight International Equities, but this could shift toward neutral if global growth rebounds.

11 | Global Manufacturing May be Poised for a Rebound in 2023

› Manufacturing PMIs (Value above 50 indicates sector is expanding, while a value below 50 denotes contraction)

	Nov-22	Oct-22	Sep-22	Aug-22	Jul-22	Jun-22	May-22	Apr-22	Mar-22	Feb-22	Jan-22	Dec-21	Nov-21	Oct-21	Sep-21
Global	48.8	49.4	49.8	50.3	51.1	52.2	52.3	52.3	52.9	53.7	53.2	54.3	54.2	54.2	54.1
Eurozone	47.1	46.4	48.1	49.1	49.3	51.6	54.2	55.3	56.3	57.9	58.5	57.9	58.2	58.0	58.3
Emerging Markets	49.7	49.8	49.4	50.2	50.8	51.7	49.5	48.1	49.2	50.9	50.0	51.7	51.2	51.6	50.8
Americas:															
U.S. (ISM)	49.0	50.2	50.9	52.8	52.8	53.0	56.1	55.4	57.1	58.6	57.6	58.8	60.6	60.8	60.5
U.S. (S&P)	47.7	50.4	52.0	51.5	52.2	52.7	57.0	59.2	58.8	57.3	55.5	57.7	58.3	58.4	60.7
Canada	49.6	48.8	49.8	48.7	52.5	54.6	56.8	56.2	58.9	56.6	56.2	56.5	57.2	57.7	57.0
Mexico	50.6	50.3	50.3	48.5	48.5	52.2	50.6	49.3	49.2	48.0	46.1	49.4	49.4	49.3	48.6
Brazil	44.3	50.8	51.1	51.9	54.0	54.1	54.2	51.8	52.3	49.6	47.8	49.8	49.8	51.7	54.4
Europe:															
France	48.3	47.2	47.7	50.6	49.5	51.4	54.6	55.7	54.7	57.2	55.5	55.6	55.9	53.6	55.0
Germany	46.2	45.1	47.8	49.1	49.3	52.0	54.8	54.6	56.9	58.4	59.8	57.4	57.4	57.8	58.4
Ireland	48.7	51.4	51.5	51.1	51.8	53.1	56.4	59.1	59.4	57.8	59.4	58.3	59.9	62.1	60.3
Italy	48.4	46.5	48.3	48.0	48.5	50.9	51.9	54.5	55.8	58.3	58.3	62.0	62.8	61.1	59.7
Netherlands	46.0	47.9	49.0	52.6	54.5	55.9	57.8	59.9	58.4	60.6	60.1	58.7	60.7	62.5	62.0
Poland	43.4	42.0	43.0	40.9	42.1	44.4	48.5	52.4	52.7	54.7	54.5	56.1	54.4	53.8	53.4
Spain	45.7	44.7	49.0	49.9	48.7	52.6	53.8	53.3	54.2	56.9	56.2	56.2	57.1	57.4	58.1
U.K.	46.5	46.2	48.4	47.3	52.1	52.8	54.6	55.8	55.2	58.0	57.3	57.9	58.1	57.8	57.1
Asia:															
Australia	51.3	52.7	53.5	53.8	55.7	56.2	55.7	58.8	57.7	57.0	55.1	57.7	59.2	58.2	56.8
China	49.4	49.2	48.1	49.5	50.4	51.7	48.1	46.0	48.1	50.4	49.1	50.9	49.9	50.6	50.0
India	55.7	55.3	55.1	56.2	56.4	53.9	54.6	54.7	54.0	54.9	54.0	55.5	57.6	55.9	53.7
Indonesia	50.3	51.8	53.7	51.7	51.3	50.2	50.8	51.9	51.3	51.2	53.7	53.5	53.9	57.2	52.2
Japan	49.0	50.7	50.8	51.5	52.1	52.7	53.3	53.5	54.1	52.7	55.4	54.3	54.5	53.2	51.5
Malaysia	47.9	48.7	49.1	50.3	50.6	50.4	50.1	51.6	49.6	50.9	50.5	52.8	52.3	52.2	48.1
South Korea	49.0	48.2	47.3	47.6	49.8	51.3	51.8	52.1	51.2	53.8	52.8	51.9	50.9	50.2	52.4
Taiwan	41.6	41.5	42.2	42.7	44.6	49.8	50.0	51.7	54.1	54.3	55.1	55.5	54.9	55.2	54.7

Source: Carson Investment Research, Bloomberg 12/06/2022

Equities
Positioned for a Stronger Showing

Just because 2022 was a poor year for stocks doesn't mean the same will be true for 2023.

In fact, we think it could be better than average, as we expect stocks to produce a total return of between 12% to 15% in 2023.

Expectations for the upcoming year are historically low. No one is bullish. A Bloomberg survey of Wall Street strategists showed they expect stocks to be lower in 2023. Various polls on both the retail and institutional fronts show sentiment near record low levels. For our outlook, which runs counter to these sentiments, the low expectations actually give us more confidence because that means potential bad news is most likely already priced into stocks. There's an old Wall Street axiom that it's hard to get hurt falling out of a basement window.

With general sentiment so low, any good news could spark a rally. What if we avoid a recession? What if inflation cools? What if the Fed pivots to dovish policies? What if the war in Ukraine resolves? The stage is set for a strong rally in 2023 should any (or all) of those scenarios happen.

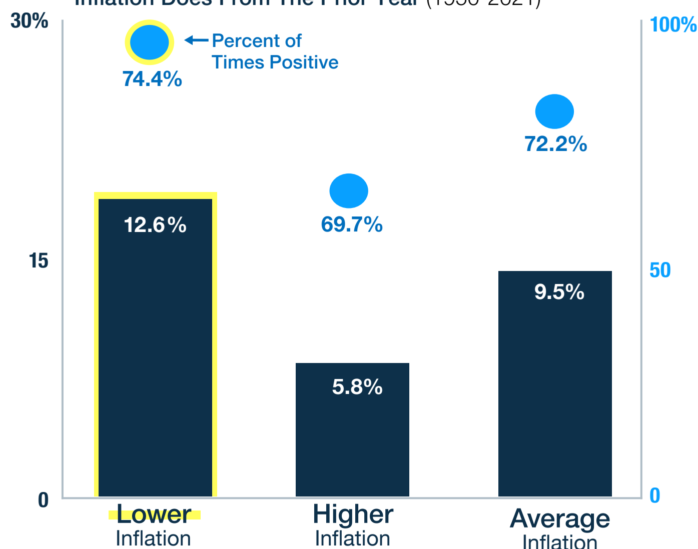
Inflation Trends Are Key

Again, with prices of consumer goods retreating, supply chains improving, and energy prices declining, we expect soaring inflation trends to ease. For stocks, the direction of inflation matters more than the absolute level. In other words, high inflation that is trending lower is a better sign than low inflation that is trending higher. If inflation continues to improve, stocks will enjoy another tailwind in the year ahead.

In another potential positive sign for stocks in 2023, we found that when inflation was lower than it was the previous year (which we expect will happen from 2022 to 2023), the S&P 500 was up 12.6% on average versus an average increase of only 5.8% in the years inflation trended higher | Figure 12 |.

12 | **When Inflation Has Been Lower, Stocks Did Better**

› **S&P 500 Annual Performance Based On How Inflation Does From The Prior Year** (1950-2021)



Source: Carson Investment Research, Factset 12/14/2022

The Earnings Bar Is Low

Average earnings from the S&P 500 companies were expected to grow about 5% (according to FactSet) in 2022 |Figure 13|. Of course, this was coming off the nearly 50% earnings gains in 2021 as the economy was recovering from the impacts of the pandemic, so estimates were a moving target. Earnings estimates slowed the second half of 2022 amid continued China lockdowns and the slowing global economy. Remember, S&P 500 companies get nearly 40% of their revenue from overseas, so a slowdown across the globe impacts their performance. Many commentators are expecting a recession and for earnings to turn negative this year. But we don't anticipate a recession and we wouldn't be surprised if we saw an upside surprise to earnings as a result.

13 | The U.S. Is Expected To Lead EPS In 2023

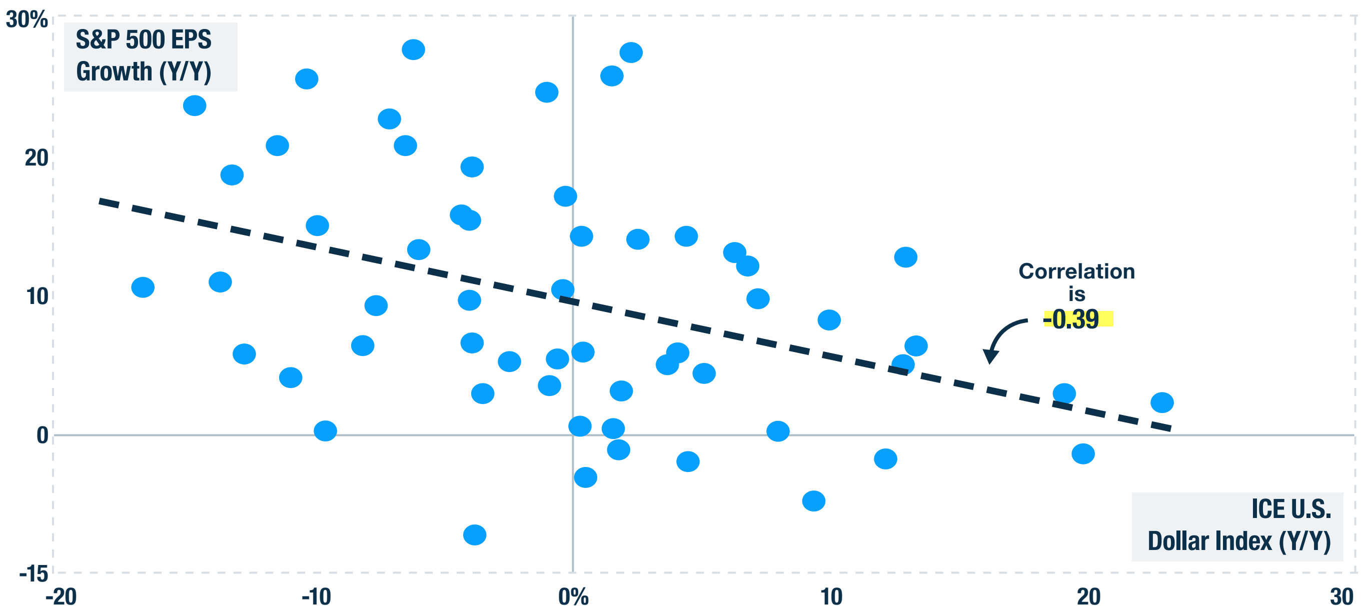
Source: Carson Investment Research, FactSet 12/15/2022
Indexes: US-S&P 500, INT-MSCI EAFE, EM-MSCI EM

U.S. Dollar Poised to Weaken

Another potential tailwind to earnings is the U.S. dollar. The greenback marked one of its largest annual gains ever in 2022, rising 19% from Oct. 2021 through Sept. 30, 2022, before it pulled back. One reason the dollar surged is likely that interest rate differentials between the U.S. and other countries rose as the Fed raised rates much faster than other central banks. When rates are higher in the U.S., it attracts more investors to hold money in U.S. dollars, which results in the dollar's strengthening.

One reason the dollar matters is that when an investor in the U.S. uses dollars to buy a basket of international stocks, the interim step is that those dollars are first

14 | Earnings Weakness Correlated with Dollar Strength



Source: Carson Investment Research, Factset 12/07/2022

Uses quarterly data from Q4 2002–Q3 2022. The periods from Dec 2007– Dec 2010 and Mar 2020–Mar 2022 are excluded to remove the impact of recessions.

converted to the local currency. This introduces currency risk. A stronger dollar acts as a headwind for international equity investments (unless hedged to mitigate currency risk). Also, for U.S. companies selling products abroad, a stronger U.S. dollar presents major challenges in competing with local companies, which can offer significantly more affordable products. Essentially, a stronger greenback erodes potential profits.

The stronger dollar likely took a toll on S&P 500 earnings growth in 2022. But if the dollar weakens this year, as we expect, earnings could get a healthy boost |Figure 14|.

The question of where the dollar goes depends on what happens to interest rate differentials. And that depends on both U.S. monetary policy and monetary policy abroad. With U.S. monetary policy, as we discussed, we expect to see softer inflation data a year from now (barring an unexpected major event like the Russia-Ukraine war). So, interest rate differentials are not likely to increase due to higher U.S. yields.

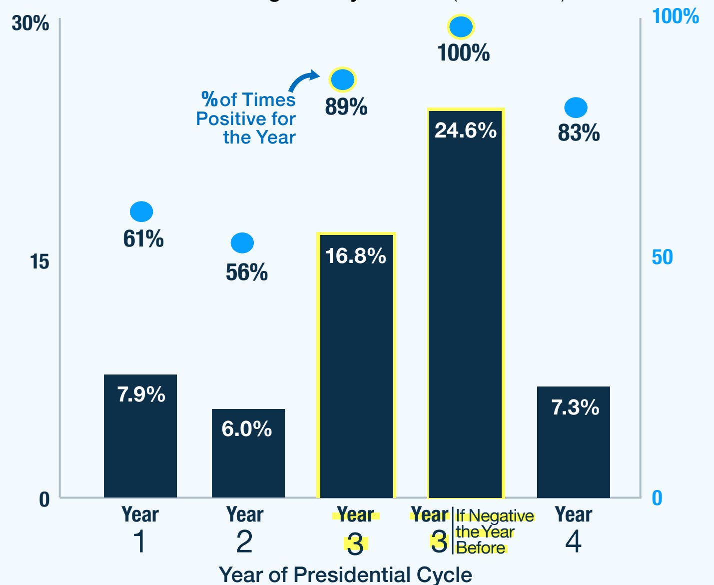
Monetary policy abroad is another big driver of interest rate differentials, and foreign central bank policies will be governed by what happens with inflation and their respective economies. Inflation is at multi-decade highs in Europe, and, while the ECB has responded, it has not been as aggressive as the U.S. has with its rate policy. Even the Bank of Japan has held firm, keeping benchmark rates below zero despite inflation hitting its highest level in more than 30 years. If various other Central Banks play catch up by hiking more in 2023, the dollar is likely to weaken this year due in part to these interest rate differentials shrinking. This would be positive for international equities and earnings.

Historical Cycles Point to a Rebound

Yes, stocks could turn lower in 2023. But if historical cycles are any indicator, it could be quite unlikely. Since World War II, the S&P 500 has only noted declines in consecutive years in the recession of 1973/1974 and then for three consecutive years during the early 2000s amid the tech bubble implosion |Figure 15|. That's it.

In another positive indicator for stocks this year, we note that stocks tend to perform the strongest during the third year of a presidential term. Last year was a midterm year, when historically stocks don't fare well, especially under a new president. However, pre-election years like 2023 tend to be very strong for stocks. In fact, since 1950, the S&P 500 gained 16.8% on average during this year. What's more, when a midterm year is negative, as it was last year, stocks perform significantly better the following year, with the S&P 500 up 24.6% on average during these years. Although we don't expect a 25% gain for stocks in 2023, these trends only suggest more support for a positive outlook.

15 | 3rd Year Of Presidential Cycle Has Been Strongest
> S&P 500 Index Average Yearly Returns (1950-2021)



Source: Carson Investment Research, Factset 11/22/2022 (1950-2021)

Fixed Income

Why Take More Risk?

Our view that the US economy will be able to avoid a recession directly leads to our estimate of interest rates remaining on the higher side. As we noted, the Federal Reserve would need a strong case to start cutting rates in 2023, so we expect short-term rates to remain around 5% for most of the year. As for long-term yields, to a first approximation, rates further out are an estimate of future short-term rates, or an estimate of future monetary policy. We do expect a more normal year for bonds, with most of the return coming from yield. Our expectation is that the Bloomberg US Aggregate Bond Index will produce a total return between 4 to 5% in 2023.

Our expectation is that inflation will eventually pull back to the 2% to 2.5% range. Once we combine that with real yields of 1.5% to 2%, we estimate longer-term rates to hover around 3.5% to 4.5%.

Of course, this begs the question of why an investor should take on more risk in buying long-term bonds, which have higher duration risk and lower yield than shorter-term bonds. **Therefore, our House View is to underweight fixed income, especially longer-duration bonds, and overweight ultra short-term bonds.** If recession odds increase this year, we would start moving the portfolio towards longer-duration bonds.

Yield Curve Inversion

The other implication of our interest rate expectations is that we expect the yield curve to remain inverted. Historically, an inverted yield curve has been one of the best indicators of a recession |Figure 16|. The yield curve inverted prior to the last 10 recessions, with just one false signal in 1965. The table below shows past yield curve inversions (as defined by the difference between 10-year and 1-year Treasury yields turning negative), along with the timing of the recession that followed. You can see why this is such a popular recession indicator—it has been reliable.

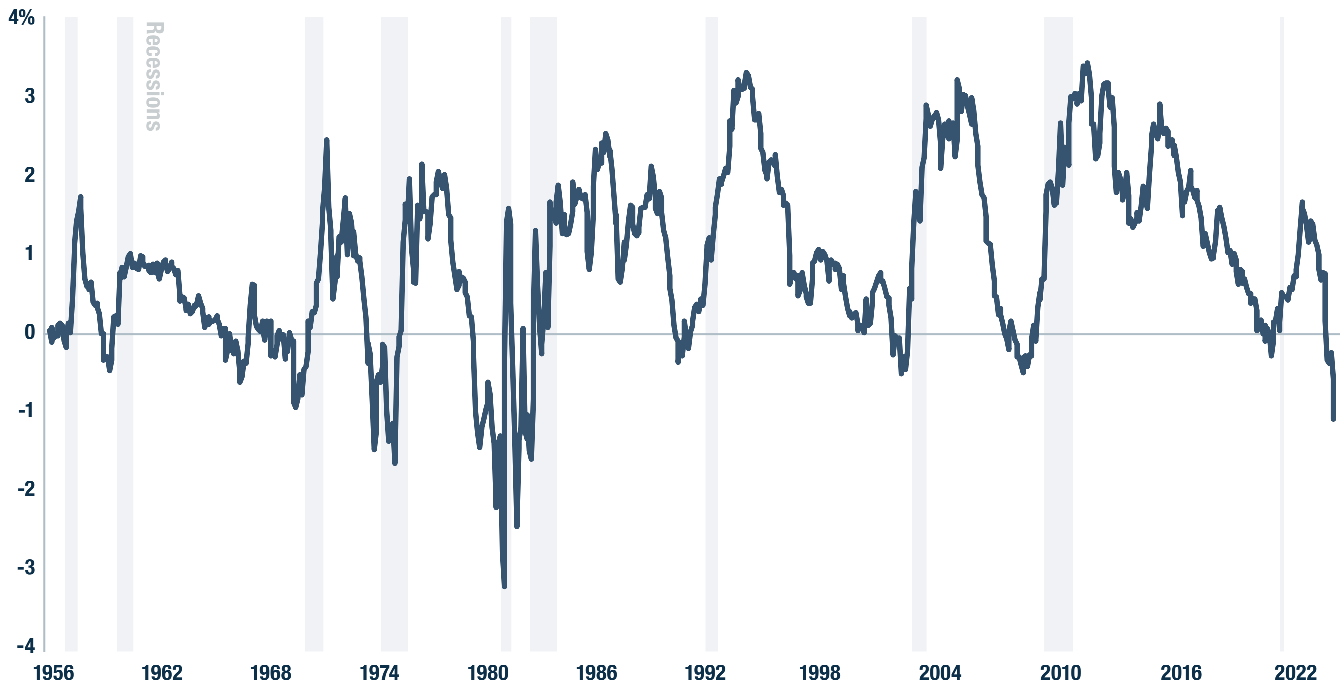
16 | **Yield Curve Inversions:** 10-Year Yield Minus 1-Year Yield

Inversion Month	Time to Next Recession	Recession Start	Recession End
Dec 1956	8 Months	Aug 1957	Apr 1958
Sep 1959	7	Apr 1960	Feb 1961
Dec 1965	No Recession		
Dec 1967	24	Dec 1969	Nov 1970
Mar 1973	8	Nov 1973	Mar 1975
Aug 1978	17	Jan 1980	Jul 1980
Sep 1980	10	Jul 1981	Nov 1982
Jan 1989	18	Jul 1990	Mar 1991
Mar 2000	12	Mar 2001	Nov 2001
Dec 2005	24	Dec 2007	Jun 2009
Mar 2019	11	Feb 2020	Apr 2020

Source: Carson Investment Research, FRED, ALFRED 12/14/2022

17 | **Inverted Yield Curves Have Foreshadowed Recessions**

› **10-Year Minus 1-Year Treasury Yield** (Monthly, %)



Source: Carson Investment Research, Factset 12/14/2022

Unfortunately, this spread inverted in July 2022 and is currently at its most negative, or "inverted state," since 1982 |Figure 17|. Considering historical precedent, a recession is on the horizon. But while recessions regularly follow inversions, the degree of the inversion doesn't say:

» **When a recession will start:** The start time of a recession from an inversion has varied from seven to 24 months.

» **How long the recession will last:** Prolonged recessions occurred in 1974 and 2008, and the degree of inversion was quite different prior to these.

» **How deep the recession will be:** The degree of inversion was similar prior to the 2001 and 2008 recessions, but these were very different economic drawdowns.

Another thing to consider is the fact that the inversion in 2019 technically preceded the 2020 recession, but it didn't really "predict" it in that it didn't predict Covid-19, which caused the economic struggles that year. Outside the U.S., the yield curve has a more dubious record, according to a St. Louis Federal Reserve study. In the U.K. and Canada, several yield curve inversions occurred that in fact did not predate recessions as they did more commonly in the U.S., France, and Germany.

Ultimately, yield curve inversion is more of a symptom rather than a cause. It's a symptom of the Fed over-tightening, which leads to an expectation of slower economic growth (recession), which leads to lower inflation expectations (there's less demand for goods and services). In turn, long-term yields fall below short-term yields. To a first approximation, long-term yields are simply the expected path of future short-term rates, or monetary policy rates. So, if inflation is expected to decline, especially in a recession, you would expect the Fed to reduce rates.

Note that higher interest rates can take a toll on the economy. For example, housing activity can decline amid higher mortgage rates (as it did in 2022) and businesses may cut back on spending and hiring if

they face higher borrowing terms. But these usually occur only with a lag – which is why a recession doesn't necessarily follow immediately after the Fed raises rates and yield curve inversions.

Yield curves inversions are essentially a result of inflation expectations. Inflation expectations can fall if investors expect a recession. However, longer-term inflation expectations can also be lower than short-term inflation expectations if inflation has surged but investors believe it to be a short-term phenomenon. This is the current situation.

Breakeven inflation expectations over the next five years (which is the difference between nominal Treasury yields and TIPS yields), surged in 2022 as prices jumped |Figure 18|. However, longer term expectations, over the five-year period after the first five years remained in the 2.0% to 2.5% range. That is not what you would expect if investors were anticipating persistently high inflation (or the dreaded "stagflation"). Nor is it what we would expect if a deflationary recession were on the horizon.

Amid increased volatility of 2022, we saw credit spreads rise, though neither corporate nor high-yield option-adjusted spreads appear to be pointing to a recession |Figure 19|. Spreads are well below levels we saw during the last three recessions.

At the same time, spreads are currently well above average levels in recent years, which presents an opportunity. Our House View (Tactical) is overweight high-yield bonds.

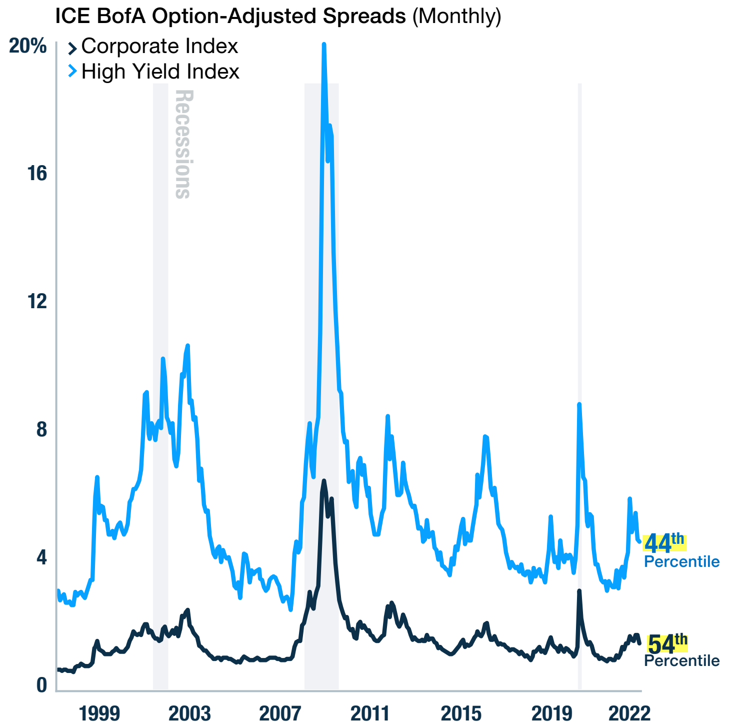
18 | Well Anchored Inflation Expectations

Breakeven Inflation

Source: Carson Investment Research, Factset 12/14/2022

19 | Credit Markets May Offer Opportunity

ICE BofA Option-Adjusted Spreads (Monthly)



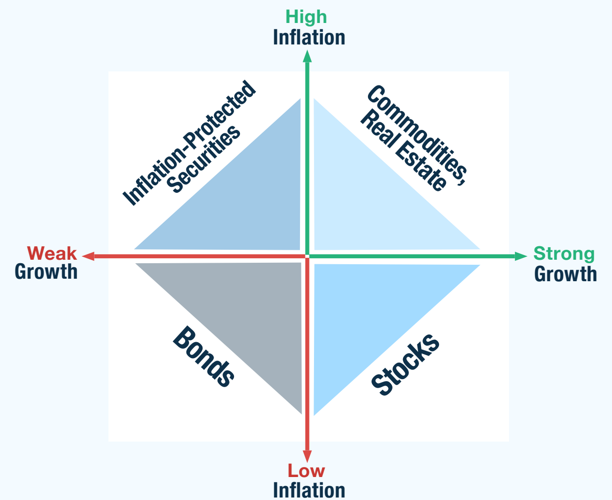
Source: Carson Investment Research, Factset 12/14/2022

Treasuries A Potential Recession Hedge

Even though short-term bonds offer higher yields than longer-duration bonds, we're not eliminating longer-term bonds from our portfolios because we don't know exactly what the economic environment will be in the year ahead.

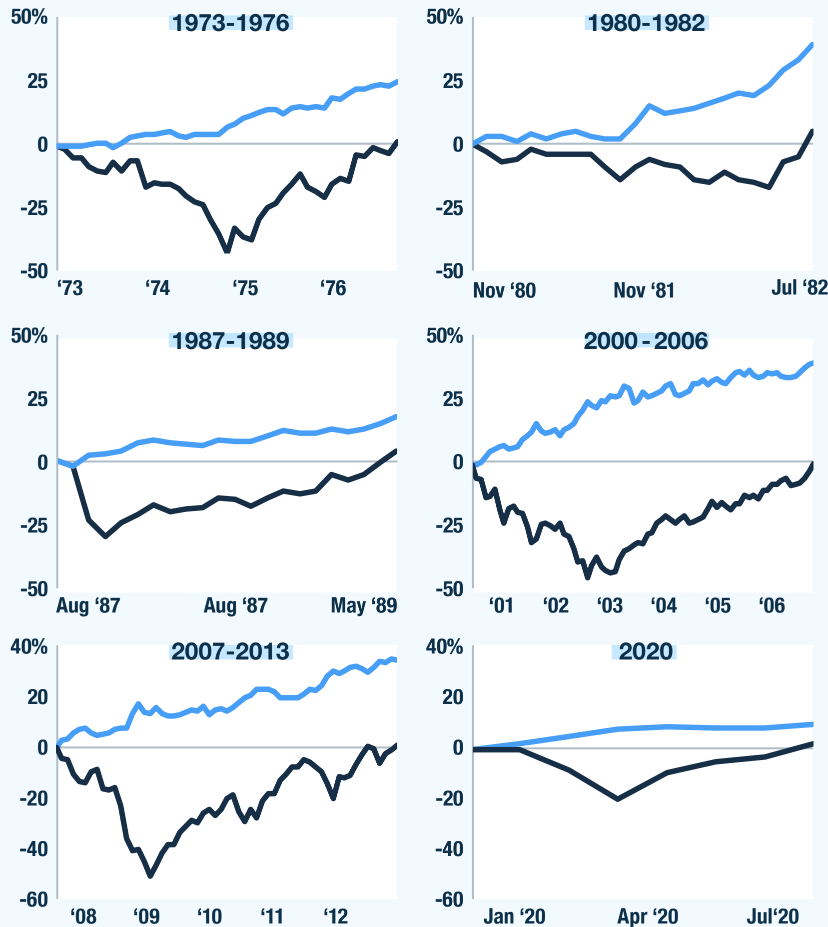
Figure 20 our general framework and the type of asset classes we would like to hold in different economic and inflationary environments. In low-growth, low-inflation environments like in the last decade, a stock-bond portfolio works quite well. But in a high-inflation environment, we would emphasize commodities and real estate if growth was high, or inflation-protected securities if growth was weak.

20 | What Macroeconomic Regime Will We Be In?



Source: Carson Investment Research 12/14/2022

21 | Treasuries Have Historically Outperformed During Bear Markets



Source: Carson Investment Research, Factset 12/14/2022

Again, we don't know what regime we will be in. A Federal Reserve that raises rates too fast and too high could very well put the economy into a recession where consumer incomes fall and inflation pulls back. Obviously, the Fed would prefer to avoid this, but it is still a risk we want to hedge against.

Longer-term bonds, especially U.S. Treasuries, have typically zigged when stocks have zagged. Figure 21 compares the cumulative performance of the S&P 500 and U.S. Treasuries amid the last six major bear markets and subsequent recoveries. Five of these coincided with major recessions (1987 was the exception). As you can see, Treasuries have had positive returns when equities were sinking.

Stocks and bonds were positively correlated in 2022. However, our House View is that the U.S. economy will ultimately avoid a recession. That could obviously change over the year, and in that event, we believe the historical evidence suggests that Treasuries will provide a ballast to portfolios.

The Bottom Line

Yes, the markets took a beating in 2022 on several fronts. But now, as we step back and maintain a long-term outlook, we see many indicators that we believe are on the cusp of returning to stability and poised for steady improvement in the months ahead. We see value in stocks over bonds and U.S. equities over international equities as inflation and interest rate pressures are likely to ease.

Of course, we may not see the soaring heights of recent years, but we do expect to see the market adapt and evolve toward growth and efficiency. After all, even as many sectors have taken a beating, they are also showing signs of forward momentum, such the technology sector with its innovative breakthroughs and promising potential. History has proven these patterns of resiliency before.

Remember, the path to steady improvement may not be entirely smooth. There is no guarantee we'll even see improvement. The key to staying on financial track on the cusp of change is to avoid emotional reactions and regularly assess your long-term plan. No matter how stocks and other assets perform this year, you'll want to maintain an actively managed financial plan that caters to your specific financial goals, circumstances, risk-tolerance level, and investing horizon.

As an investment research team, Carson Research monitors and assesses underlying factors that can affect market conditions as we deliver advice and provide portfolio management services. Our professional guidance delivers a longer-term outlook that can help you navigate an unpredictable market. That way, you have greater confidence in your plan as you work toward your financial goals and find the freedom to focus on what matters in your life.

Contact your professional advisor if you have any questions or concerns about your investing strategy for the year ahead. Meanwhile, we'll continue to keep you updated and informed about market movements and economic changes that can affect your investments.

Thanks for reading; We hope you found this helpful!

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The S&P 500 is an index of 500 stocks chosen for market size, liquidity and industry grouping (among other factors) designed to be a leading indicator of U.S. equities and is meant to reflect the risk/return characteristics of the large cap universe.

Bloomberg U.S. Aggregate Bond Index — The Bloomberg U.S. Aggregate Bond Index is an index of the U.S. investment-grade fixed-rate bond market, including both government and corporate bonds.

Russell 2000 – The Russell 2000 is a stock market index measuring the performance of
2000 small capitalization stocks. It represents the 2000 smallest companies in the Russell 3000 Index, which in turn represents the 3000 largest companies in the U.S. Thus, the Russell 2000 is a barometer of small-cap stocks. Though small, the companies represented by the Russell 2000 are not the smallest of the small as they are not penny stocks. The Russell 2000 is weighted by the market capitalization of the stocks.

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