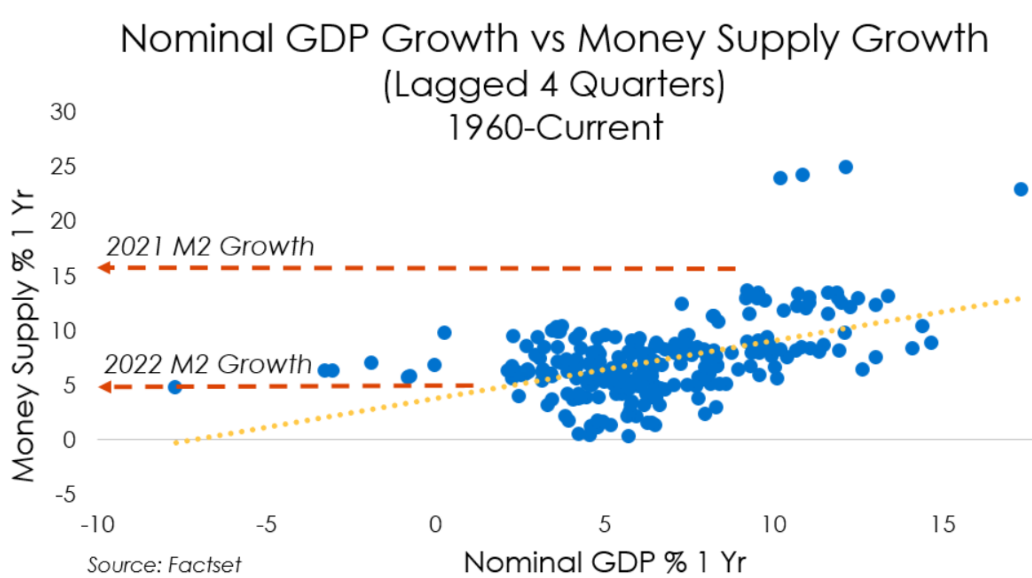
New Faces, Same Places

"Same as it ever was, same as it ever was (letting the days go by)."

– *Once in a Lifetime* by TALKING HEADS (1980)

This month's inspiration comes from the 2002 Rock and Roll Hall of Fame inductee *Talking Heads*. Their song, "Once in a Lifetime" was initially more of a US obscurity – recorded back in 1980 – only to later become listed in 2021 by Rolling Stone as the 27th greatest song of all time. Suffice it to say, the song has aged much better than this author.

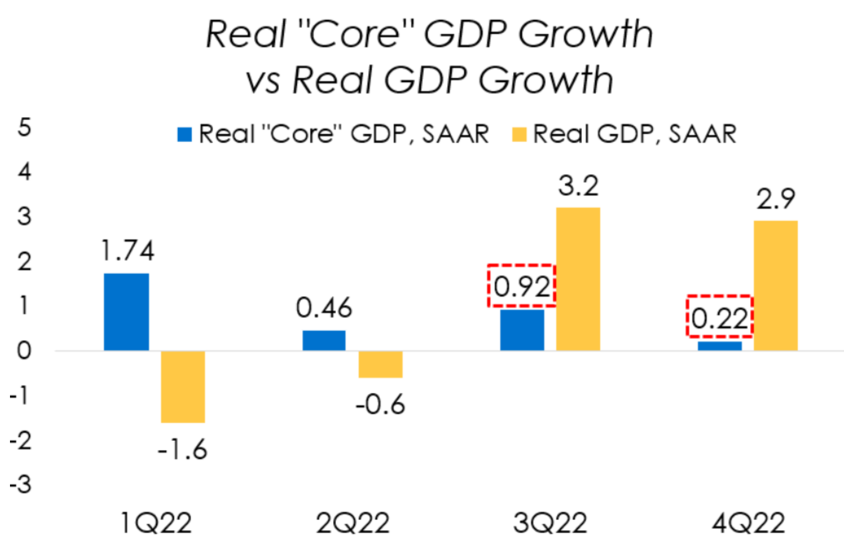
The market tone has changed rather dramatically to begin this year as leadership from the old regime has outperformed and investors have seemingly reasserted the "same as it ever was" mantra. Driving this notion has been a focus on the broad moderation in the inflation data. Prior highs in many of the headline measures (CPI, PPI, PCE) were registered in the first or second quarter of last year. While some underlying components have been stickier – like core service inflation – many regional pricing surveys point to a continued moderation ahead in these headline measures. As such, the markets are anticipating a pause in Fed rate hikes – the FOMC further slowed their rate hikes from 50 bps to 25 bps this month – and an eventual pivot. Because inflation was the biggest risk to markets last year, it's understandable that investors would cheer this news, however, we think that perspective misses the other critical signal. As inflation slows, so too may growth. We've referred to this as trading one cyclical risk (Inflation) for another cyclical risk (Recession) or "New Faces, Same Places".



This idea of slowing inflation (and growth) is very much related to the Fed's aggressive rate hike policy that's been needed to catch up to inflation. Higher interest rates make it more restrictive for companies to finance growth. That's the point. Monetary policy works (typically with a lag) to influence both inflation and employment. While higher interest rates are one indication of a liquidity drain, a slow down of growth in the money supply (M2) is another. M2 is a measure of cash both in circulation and sitting in checking accounts, savings accounts and/or money markets. Logically, the more cash in the system, the more stimulative it is for inflation and growth. While the relationship isn't perfect (as there's other factors that drive nominal GDP growth), the chart on the prior page suggests there's a positive correlation between nominal GDP growth and money supply growth (when lagged by a year). Note the material step down in money supply growth from 2021 to 2022. In fact, at the end of last year, M2 actually contracted on a year over year basis – which was the first time in history over this 60 year data series.

From our view, this puts us on a lower path for nominal growth this year. That's not great for earnings growth – another nominal growth measure – which is being confirmed by a number of our leading profit cycle indicators suggesting the odds of a profits recession have increased. To be clear, nominal growth doesn't have to slow along with inflation so long as real growth accelerates to the fill the gap. If real growth accelerates as inflation slows, then nominal growth can be maintained. Some would suggest that's exactly what's happening given that we've now printed two quarters of accelerating real GDP growth of around 3% following two prior quarters of negative annualized growth. However, we're less sanguine about the last two quarters of real GDP growth when looking at the underlying components as seen in the chart below. That's because, the most volatile components – including trade and inventory – drove the vast majority of the growth. In fact, when you look at only the "core" components – personal consumption, capital investment and housing – real "core" growth has slowed to a crawl averaging only a little better than about 0.5% of annualized growth.

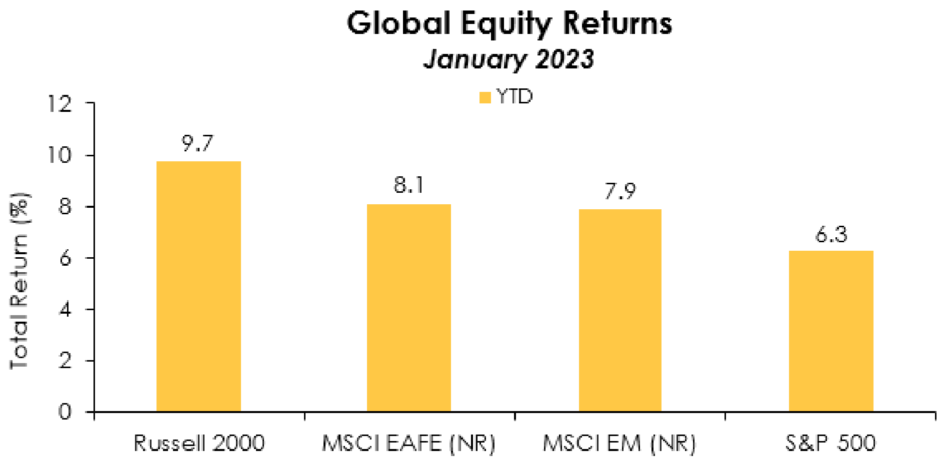
The bottom line is that we think slowing nominal growth is driven by both a slow down in inflation and in real "core" growth. Inflation was the risk of last year – pressuring valuations across the market landscape. We think recession (profits or otherwise) is the risk of this year – pressuring earnings on risk assets. This continues to leave us with a more cautious view despite the "same as it ever was" tone to begin the year. In short, the risk this year has a new face but we still think it may ultimately take us to the same place.



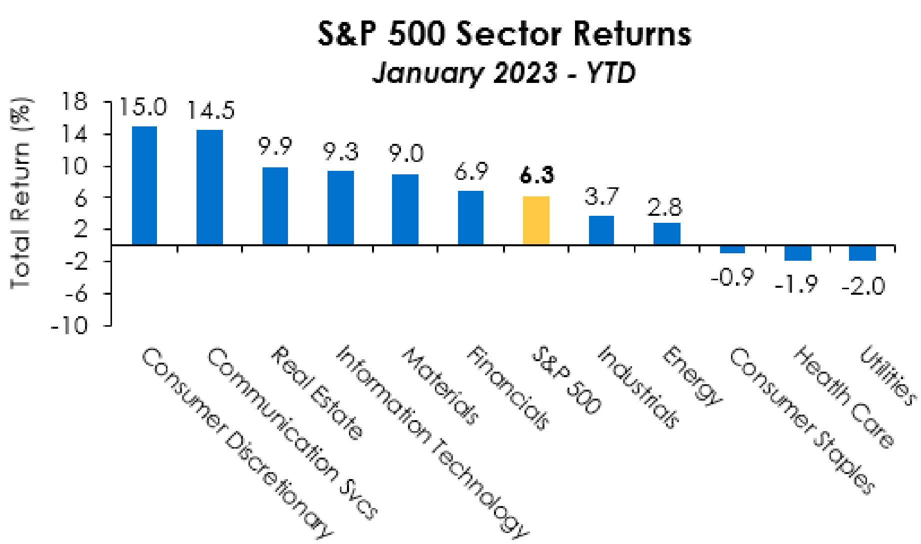
Source: Factset; "Core" GDP defined by personal consumption, non-residential investment and residential investment.

In a complete reversal from a tough 2022, every major market segment finished positive in January except for commodities. This reflexive "Worst to First" bounce in risk markets is not uncommon, in fact it has its own name, "The January Effect". However, the degree to which the most "beaten-up" areas have bounced YTD was a bit impressive. To that point, the early cycle/growth heavy NASDAQ was up almost 11% in January following a decline of 33% in 2022. That's the index's best start since 2001.

Stocks

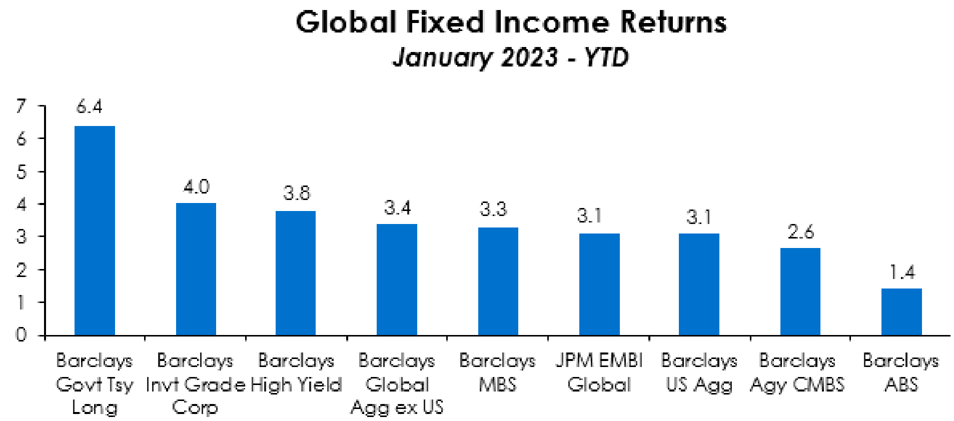


Stocks followed through on their 4th quarter rally with the most cyclical parts of the equity markets leading the way in January. Small Caps outperformed Large Caps and sector performance generally favored higher priced, early cycle groups (Technology, Discretionary and Communication Services) along with Real Estate which were among the worst performing sectors in 2022. Conversely, defensive equity sectors (Consumer Staples, Health Care and Utilities) were the only group to finish with negative absolute returns in the month. Meanwhile, the US dollar continued to weaken after falling in the fourth quarter. These currency impacts benefited returns for International markets (MSCI EAFE and MSCI EM) in January, resulting in outperformance relative to US Large Cap stocks (S&P 500) despite lower exposure to early cycle sectors (which led domestically).



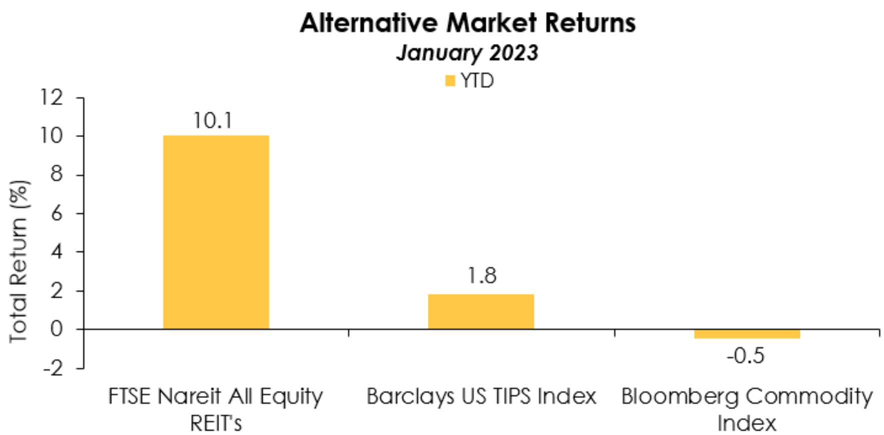
Bonds

Following aggressive moves by the Fed – having now hiked rates by 450 basis points (to 4.50-4.75%) amid ongoing balance sheet reduction – policymakers continue to "hold the line" on rate policy while slowing the pace of rate hikes. Despite the Fed's persistence, interest rate market participants appear skeptical of a "soft landing" as long-term interest rates recently moderated off their cycle highs leaving the curve deeply inverted. Inversions of the curve (whereby long-term rates fall below short-term rates) have historically been indications of macro stress as monetary policy restricts to the point of deteriorating growth prospects. As such, duration outperformed with Long-Term Treasuries (Govt Tsy Long) leading all other fixed income market segments. Spreads, however, remained resilient with corporate credit providing solid absolute and relative monthly returns in January. Investment Grade outperformed High Yield due to its relatively longer duration. International bonds (Global Agg ex US) outperformed the US Aggregate (US Agg) bond market due to waning strength in the US dollar which began weakening in the fourth quarter.



Alternatives

Alternatives continued to generate the most disparate of returns in January. Publicly traded Real Estate (REIT's) led returns rebounding from weak performance last year. Meanwhile, Commodities posted negative returns in January held back by declining energy prices. This more than offset solid metals pricing which saw industrial metals outperform precious metals – reflective of the cyclical tone of markets in January. Finally, TIPS provided modest absolute returns but underperformed nominal Treasuries as inflation expectations continued to moderate.



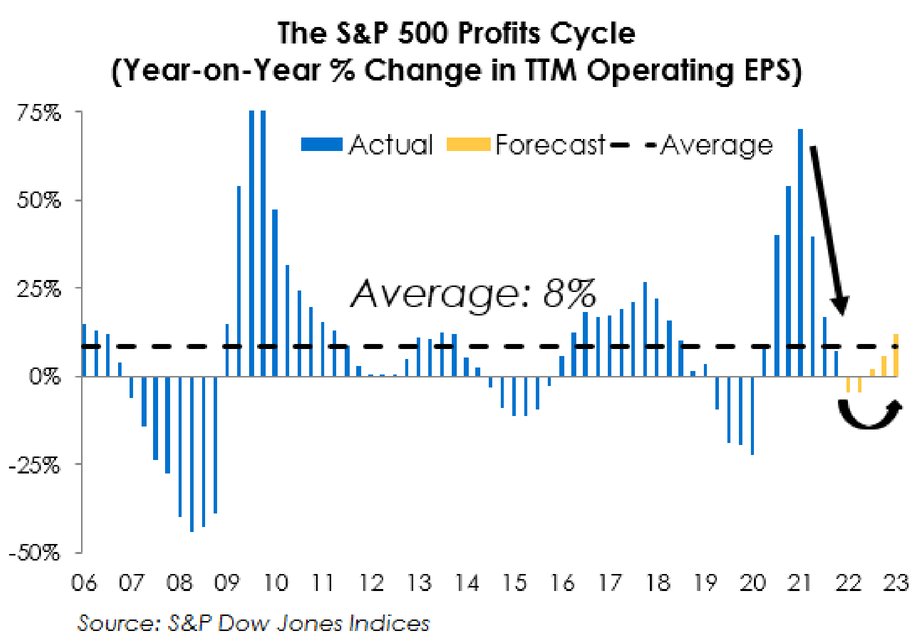
Market Outlook

"Woods are not like other spaces...Stand in a desert or prairie and you know you are in a big space. Stand in the woods and you only sense it."

– Bill Bryson, *A Walk in the Woods* (1998)

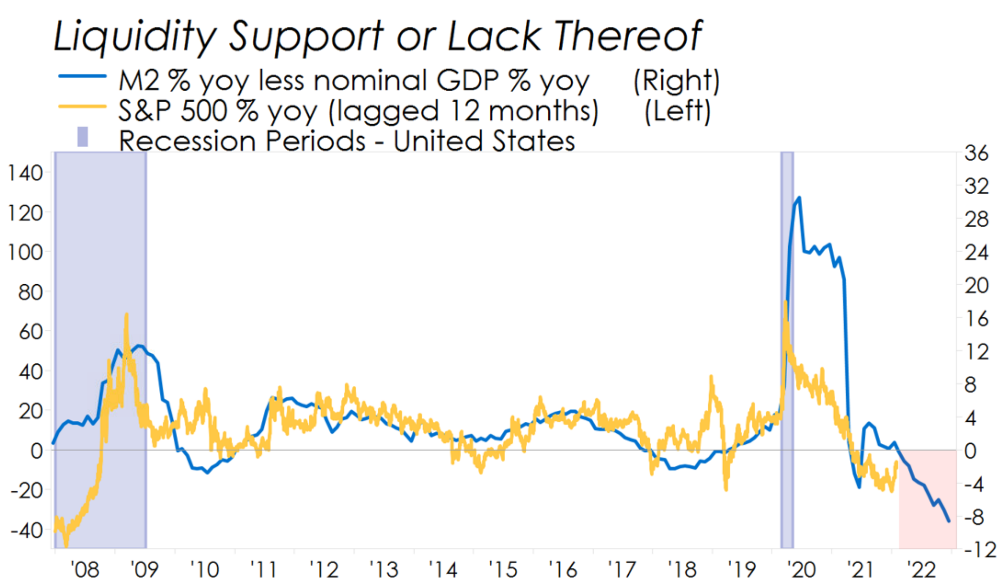
We're dubbing our main theme for 2023 as "Seeing both the Forest AND the Trees". As such, we think it's especially important to have two frameworks for managing portfolios – the cyclical (shorter-term) and the secular (longer-term). The cyclical perspective is an attempt to assess where we are in this particular business cycle while the secular perspective evaluates where the structural tendencies might be over multiple business cycles.

From a secular lens, we remain sympathetic to the notion that the economic paradigm is changing to one that ushers in the potential for more persistent inflation which is likely to result in a higher cost of capital world. We find historical parallels today to the higher inflation regime that existed back in the '60's-80's and we think the Fed is re-learning the painful lesson of falling behind inflation – one that it doesn't wish to repeat any time soon. Additionally, we believe there are structural considerations that exist today that might also support this changing paradigm including; a step change in the money supply, contracting globalization as well as structurally tight labor markets and the energy complex.



At the other end of the spectrum is the cyclical perspective, which we think currently carries more weight given its more immediacy and present divergence from the secular view – at least for a time. For much of this past year, we've used the phrase "Moderate Resilience" as a way to best describe the fundamentals. It's clear that growth has continued to moderate as the cycle has matured. However, growth in nominal terms has been somewhat resilient for much of 2022 given the lagged effect of well above average liquidity in '20-21. In essence, companies have raised prices on goods and services with minimal demand destruction because of the influx of cash post COVID. That may be starting to change as the Fed continues to tighten policy and as savings rates have dramatically declined. In short, liquidity is now being drained from the system which acts with a lag on growth. As we look into 2023, one question to consider is whether the emphasis will be more on moderation or resilience. In other words, will late cycle conditions lead to a "pause and refresh" or a "profits/economic recession"? As can be seen in the chart on the prior page, the consensus believes in the "pause and refresh" story as indicated by the quick reacceleration of earnings growth shown in the yellow bars. To be fair, labor markets have been incredibly healthy – strengthening in January. But with the unemployment rate now at a record low of just 3.4%, this may act as another govenor on growth because the Fed may have to do more to cool an economy at full capacity. Given the late cycle setup, we still think the risk for earnings estimates is to the downside especially in the absence of a signficant productivity boost.

To further support that view, most of our leading profit cycle indicators point to the continuation of a growth deceleration ahead. If forward earnings estimates prove to be too optimistic and need to fall further (NTM EPS is only 5% off the highs), then stocks might be more expensive than they appear (19-20X vs current 18X). This comes at a time when stocks have not quite fallen to levels where multiples have typically bottomed over the past thirty years (10-15X).



Source: Factset, M2 and GDP updated as of 4Q22.

As evidenced in the opening, we believe nominal growth is slowing as inflation moderates without any material pickup in real growth. This is a byproduct of monetary policy working with a lag which has an impact on fundamentals and risk assets alike. When money supply growth falls below nominal GDP growth, it's generally been a headwind for Stocks over the past fifteen years. As can be seen in the chart above – this relationship isn't perfect though it's still directionally informative. Over the past 12 months, money supply growth has slipped notably relative to nominal GDP growth. As such, the recent rally in Stocks looks a bit offsides according to this relationship.

While investors remain hopeful for a soft landing and Fed pivot (moderation in rates and inflation with no material impact on growth), we can't help but wonder if markets are just trading one cyclical risk (Inflation) for another (Recession). To us, it still doesn't appear to be a great set up for risk assets from a cyclical point of view.

So what are the implications and key takeaways for portfolios?

With an eye on both the Secular and Cyclical views, we think it might makes sense to keep two simple phrases in mind – *"Do the Opposite"* and *"Buy the Boring"*:

Seeing Both the Forest AND the Trees

Secular View (Longer-Term)	Cyclical View (Shorter-Term)
"Do the Opposite"	*"Buy the Boring"*

- From a longer-term point of view, if the economic paradigm is changing, then it may pay to *"do the opposite"*. In other words, the relative winners over the past 10-15 years may not be the same winners over the next decade. Businesses that took advantage of free money to leverage up their balance sheets in the hopes of high growth payoffs far out in the future might now offer greater risk in a higher cost of capital world. Conversely, the losers over the past 10-15 years might now become the new areas of opportunity. These might include companies built to be a bit more insulated from inflation with more balanced business models, more immediate cash flows and a focus on the bottom line.
- From a shorter-term point of view, late cycle conditions that might suggest we're trading one cyclical risk (Inflation) for another (Recession) argue to *"buy the boring"*. Should growth continue to slow leading to a profit and/or economic downturn, it might be more beneficial to buy the things that people need over the things that people want.

From a portfolio positioning perspective, we continue to believe that it's important to "See both the Forest AND the Trees". To us, that means managing the overall exposure and mix of risk assets consistent with a maturing cycle (i.e. Cyclical) while also being cognizant of the potential changing paradigm (i.e. Secular). Over the last several months, we've given an increased weight to the cyclical over the secular as we've reduced portfolio risk. In December we recalibrated portfolios in order to maintain an underweight to risk assets. That adjustment was facilitated by trimming equities and adding to bonds. Additionally, we further lowered our equity beta by remixing more defensively within our US Large Caps as the risk of a profits recession continues to increase. This involved increasing the overweight to the more defensive areas relative to cyclical value sectors while remaining underweight cyclical growth stocks. In essence, we continue to downshift risk in portfolios given the late cycle setup.

<u>Within equities,</u> our positioning is modestly UW and continues to favor a value sector tilt while also leaning toward the more traditionally defensive sectors (Staples, Health Care, Utilities) within our US LC exposure. We continue to be decidedly UW the most expensive, cyclical growth areas (Tech, Discretionary, Communication Services).

<u>Within fixed income,</u> we remain UW the most cyclical parts of the bond market (High Yield and Emerging Market Debt) while our US Core Fixed Income exposure remains among our biggest OW in portfolios. Our US Core Bond managers are slightly OW corporate bonds, though we've previously moved up in credit quality by adding some Treasuries and lengthening duration consistent with a downshifting of risk in portfolios.

<u>Within alternatives,</u> we're OW in aggregate with a bit more defensive skew. We remain the most OW to Diversified Alternatives which provides some hedge against market volatility (especially in an environment where there's lower correlations between stocks and bonds). We're more modestly OW to Commodities as a way to bolster inflationary hedges. Meanwhile, we're UW Real Estate as a way to further reduce overall portfolio risk.