Q1 2023 OUTLOOK: THE YEAR DEBT STARTS TO MATTER

Do you remember where financial markets were one year ago?

We started 2022 with the Fed funds rate near zero (0.00% - 0.25%), inflation at 7.5%, and coming off a year of stellar equity returns. Markets started off strong with the S&P hitting a record high of 4,796 on January 3, 2022.

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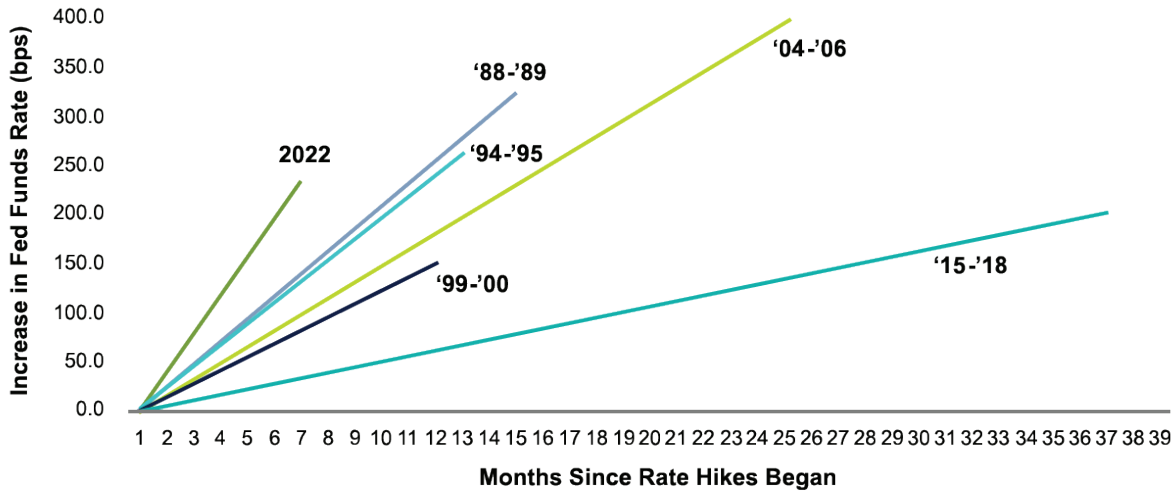
As of December 2021, most FOMC participants thought rates would be below 1% in 2022. The committee was so sure that rates would stay low that on the "dot plot" extending out to 2024 the Y-axis didn't go above 4.00%.

Investors were similarly sanguine. Futures priced a 1% year-end rate.

In other words, no one—not the Fed and not the market—thought that rates would rise so far and so fast. But in 2022, Powell switched from Dorian to Phrygian with some of the most aggressive rate hiking in modern history—425 bps in less than a year.

Tracking the Speed of Fed Rate Hikes



Source: Federal Reserve. Chart: CION

Risk assets plummeted as a result.

The Fed is now the primary driver of risk asset prices. "Good news is bad news" say traders, meaning that good economic news is bad for stocks because the Fed will keep raising. Still, there are reasons for investor optimism, including a robust economy and strong employment situation.

After a 2022 recap, we look at 2023. Our focus: (1) How quickly inflation can decline and what it means for the Fed, (2) What haunts Fed Chair Powell and why rates won't go down anytime soon, (3) Why a recession—if it occurs—will be a mild one, and (4) Why debt levels will start to matter in 2023.

2022 Annual Market and Economic Summary

Markets*

	As of 12.30.2022	Q4 Return	2022 Return
S&P 500	3,839.50	7.1%	-19.4%
NASDAQ	10,466.48	-1.0%	-33.1%
The Dow	33,147.25	15.4%	-8.8%
Global Equities		7.6%	-17.9%
Emerging Markets		8.7%	-22.4%
Energy		21.5%	57.6%
Gas	$3.85/gal	-11.9%	6.8%
Gold	$1,824.02/oz	9.8%	-0.3%
VIX	21.67	-31.5%	25.8%
10-Yr Treasury	3.875%	4.6 bps	236.5 bps

*Source: Bloomberg. *See endnotes.*

Alternatives*

	Q4 Return	2022 Return
Direct Lending	10.8%	-10.73%
CLOs	4.1%	-3.6%
Private Equity	11.6%	-38.9%
Hedge Funds	0.2%	-4.4%
Equity REITs	4.1%	-27.8%
Residential REITs	-6.9%	-33.7%
Industrial REITs	10.2%	-31.6%
Wine & Cheese	3.5%	-9.8%
Rolex Watches	-5.2%	-10.0%
Crypto Market	-19.7%	-70.2%
SPACs	-3.9%	-24.1%

*Source: Bloomberg. *See endnotes.*

U.S. Economic Performance

- Inflation: CPI peaked at 9.0% in June; now at 6.5% for December, its 6th straight monthly decline.
- Real GDP[1]: The Conference Board estimates this at 1.7% for FY 2022 and 0.0% FY 2023 (vs 5.9% 2021 actual).
- Consumer Sentiment bottomed in June 2022 and is now up to 59.7 in December (vs 70.6 in December 2021), but still 55% off pre-COVID highs.
- Unemployment rate remains low at 3.5% in December, matching pre-pandemic levels.

Monetary Policy Overview

- A summary of the Fed's actions in 2022:

	Date	Hike	Range
↑	3/16/2022	+25bps	(0.25%-0.5%)
↑	5/4/2022	+50bps	(0.75%-1.0%)
↑	6/15/2022	+75bps	(1.5%-1.75%)
↑	7/27/2022	+75bps	(2.25%-2.5%)
↑	9/21/2022	+75bps	(3.0%-3.25%)
↑	11/2/2022	+75bps	(3.75%-4.0%)
↑	12/14/2022	+50bps	(4.25%-4.5%)

- If QT continues at its current pace (rolling off $95B/month) the Fed's balance sheet will decline by $1 trillion in 2023.

Credit Market Performance

2022 FY Returns[2]

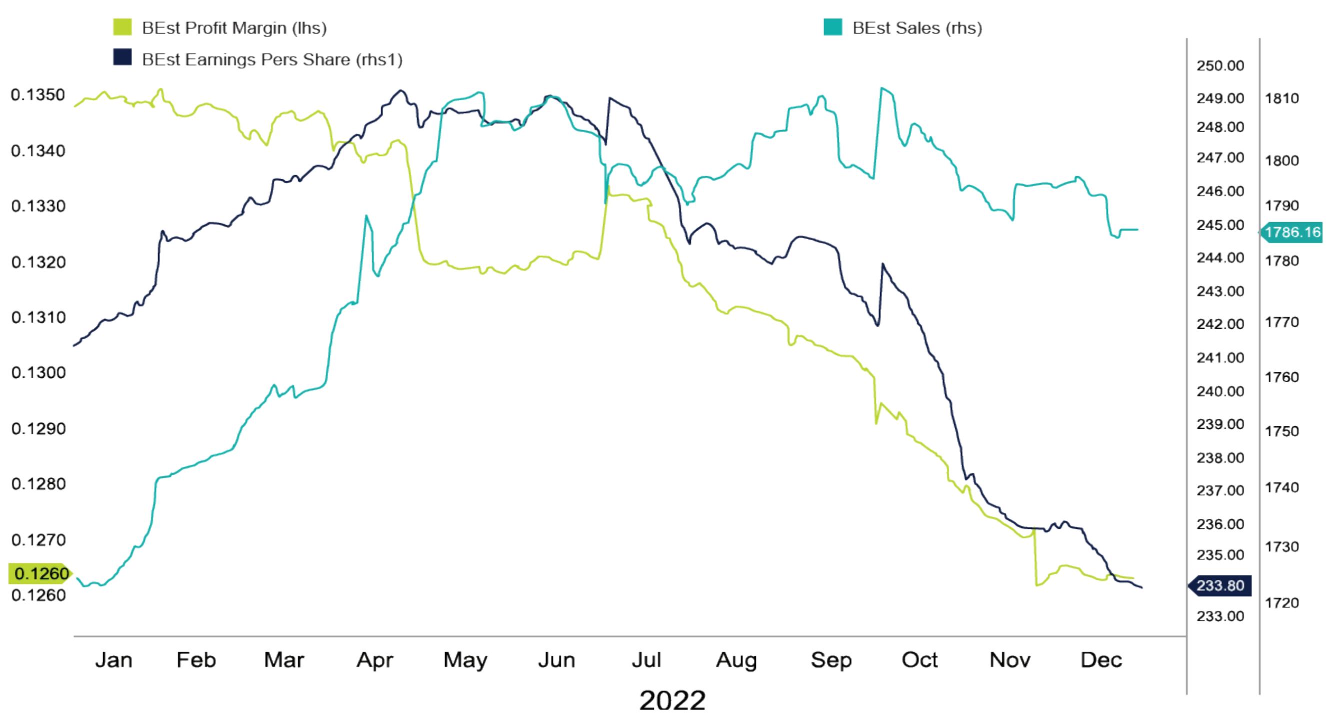
Investment Grade	High Yield	Leveraged Loans
-15.7%	-11.2%	-0.63%

- Rate increases led to one of the worst years on record for fixed income.
- Private credit continues to displace legacy banks and public markets. In Q4, the WSJ tracked 46 LBOs financed by private credit and just one by the broadly syndicated loan market.
- Defaults are predicted to increase. Fitch Ratings estimates that 2023 default rates will be 3.0%-3.5% in HY (current is 1.3%) and 2.5-3.0% in Leveraged Loans (current is 1.5%).

U.S. and Global Equity Market Summary

- Global stock markets lost a collective $18 trillion in 2022, and the S&P 500 had its 7th worst year ever. The Energy sector was the one bright spot, up 64% in 2022.
- Stock repurchases and stock-based compensation (SBC) came under increased analyst scrutiny. Expect more focus on both as higher rates persist in 2023.
- If 2022 was about multiple compression, 2023 will be about earning compression, says Michael Burry, the analyst made famous in *The Big Short*. Data shows steady sales levels with declining profits as companies are having trouble passing higher prices through to consumers.

Earnings Estimates



Source: Bloomberg

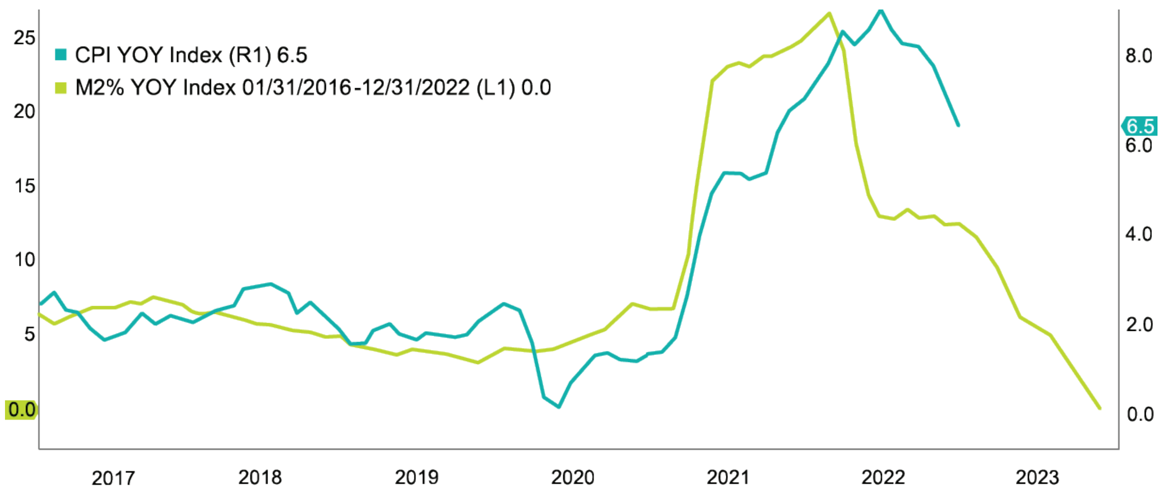
- The Bank of Japan is struggling to maintain its stated bond yields after repeated emergency purchases.

Annual Outlook – The Charts We Are Watching In 2023

I. Inflation Drops but Market Uncertainty Persists

Inflation is now slowing as money supply declines. The below chart shows CPI against a 12-month lagged M2 growth rate. If, as Milton Friedman says, “Inflation is always and everywhere a monetary phenomenon,” inflation could drop quickly.

Inflation Now



Source: Bloomberg

The consensus is for a slower decline. The New York Times recently noted that forecasters expect inflation to go down to 3 percent by the end of the year. The latest CPI release for December printed at 6.5%, in line with expectations and a decline from November's 7.1% YoY change.

Outliers think inflation will be here for some time. A recent article by *Research Affiliates* suggests that taming inflation will take years:

> "Reverting to 3% inflation, which we view as the upper bound for benign sustained inflation, is easy from 4%, hard from 6%, and very hard from 8% or more. Above 8%, reverting to 3% usually takes 6 to 20 years, with a median of over 10 years."

II. 2023 Could Bring a Renewed Focus on Volatility and Asset Correlation

Anyone holding big tech, SPACs, or cyptocurrency in 2022 learned about downside volatility. A large decline is no guarantee of a bargain, especially in a bear market.

A few examples. A security that has declined by 50% has to double to get back to even. A security that has declined by 80% has to rise 400% to get back to even. And a security that has gone down 90% is one that declined 80% and *then* dropped another 50%. Such security would require a 900% (!) return to get back to even. Large price declines are insurmountable in the short term, as multibaggers are few and far between. With uncertainty around the Fed's actions, volatility is likely to continue throughout 2023.

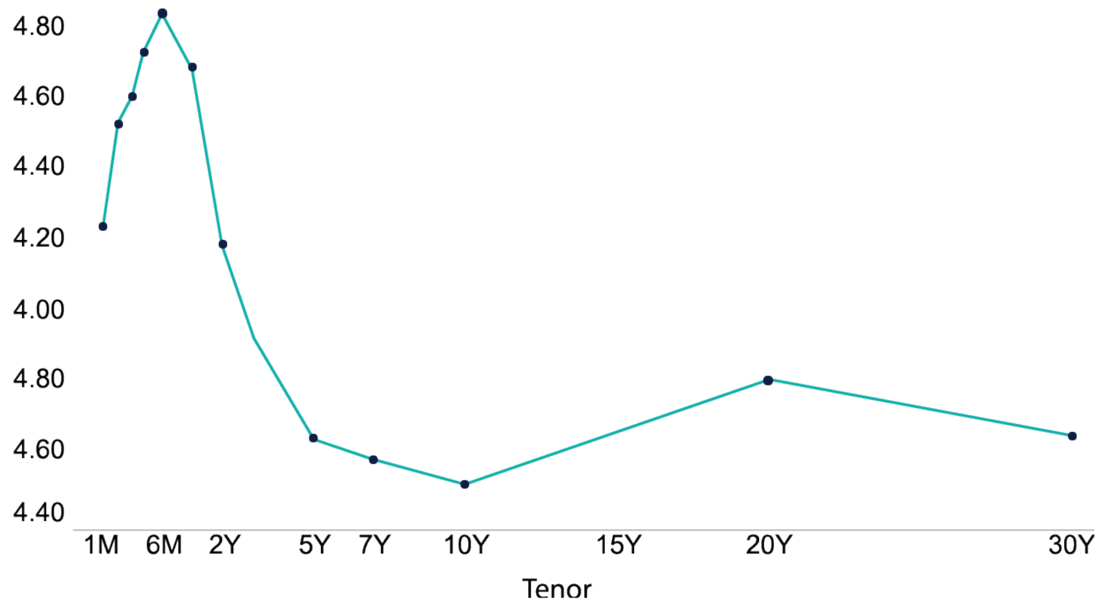
Low correlation matters too. The traditional 60% stock/40% bond portfolio had one of its worst performances ever in 2022 as stocks and bonds declined in lockstep. Stock and bond correlations remain elevated. Protection from excessive downside risk and low correlation is why capital is shifting more to private assets. Large asset managers see the benefit of larger allocation to alternative investments.

A recent '*Insights*' piece from KKR emphasized the benefits of switching from 60/40 to a 40/30/30 allocation, with the last 30% being the "alternatives sleeve." As risk assets struggle to find their footing, many will look to alts as a private shelter from the public markets storm.

III. The Underlying Economy Is Surprisingly Strong, Given the Consensus that a Recession Is Imminent.

As one cynic put it: "Possibly the most robust indicator of an impending recession is when the Fed dismisses the inverting yield curve as a predictor of an impending recession."

Inverted Yield Curve Points to Recession

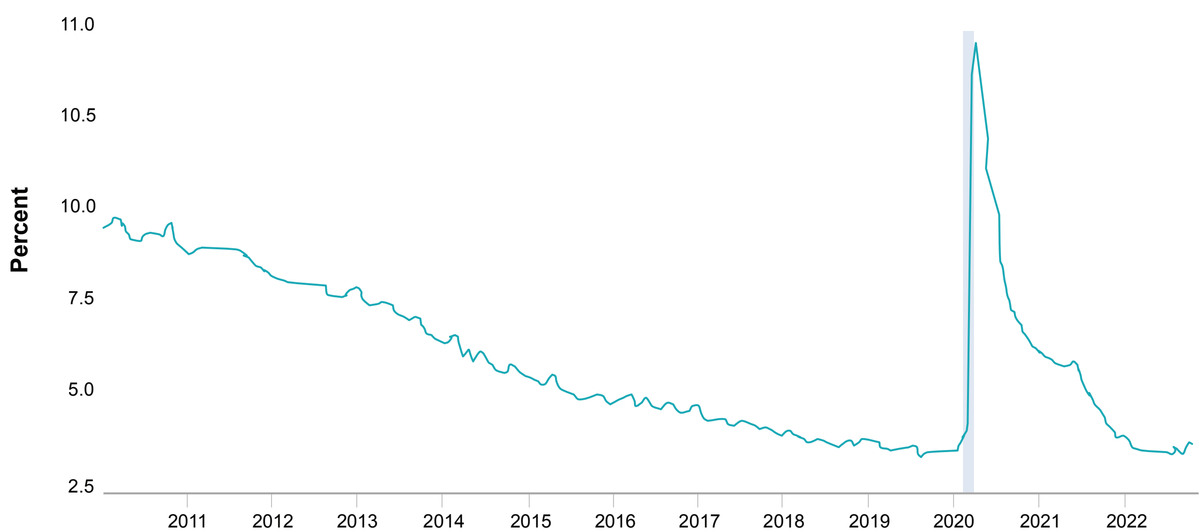


Source: FRED - Federal Reserve Bank of St. Louis

...but a strong job market and robust consumer spending suggest that any recession will be a mild one.

The unemployment rate (3.5% as of December) remains low, defying past precedent of an economy on the brink of a recession.

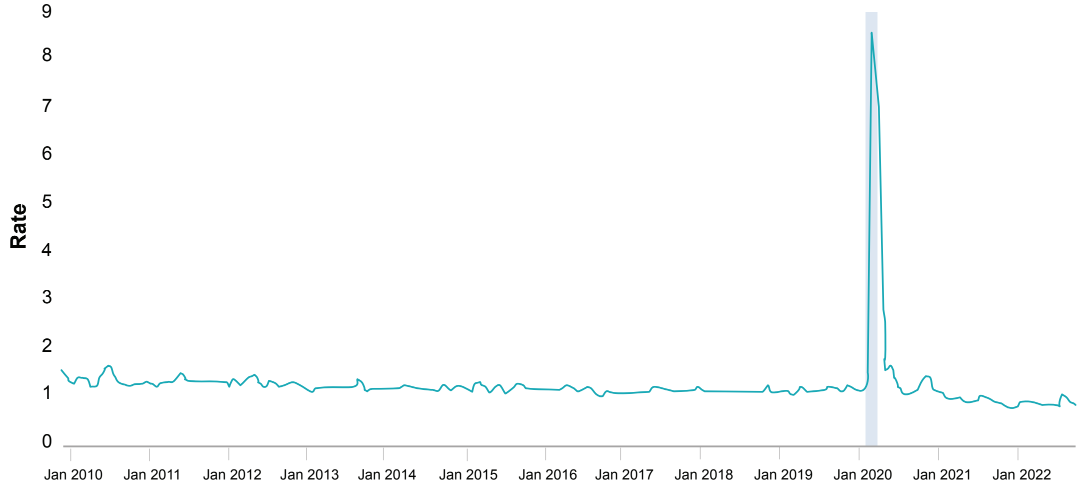
Unemployment Rate



Source: FRED - Federal Reserve Bank of St. Louis. Shaded areas indicate U.S. recessions.

Layoffs have not spiked.

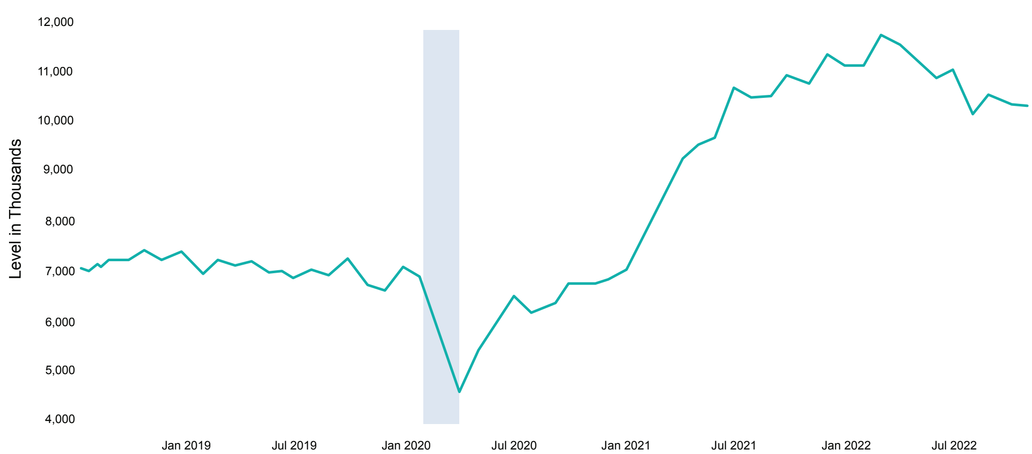
Layoffs and Discharges: Total Nonfarm



Source: FRED - Federal Reserve Bank of St. Louis. Shaded areas indicate U.S. recessions.

Job demand is strong.

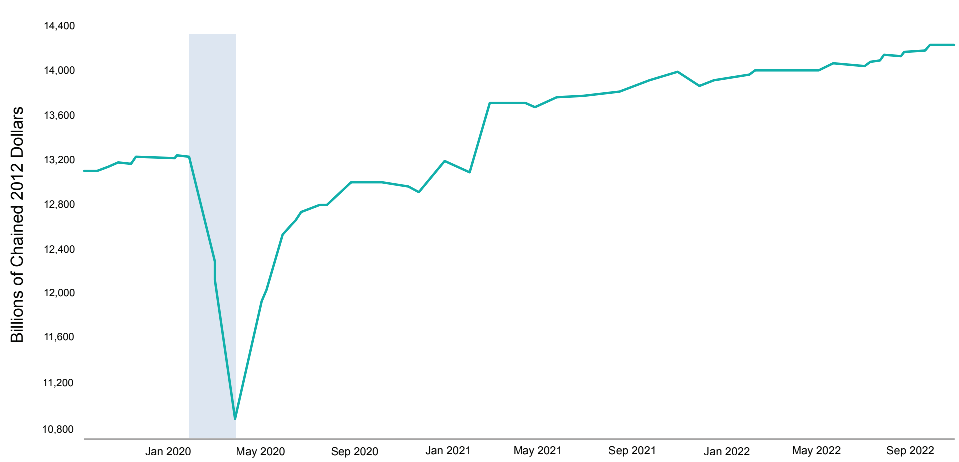
Job Openings: Total Nonfarm



Source: FRED - Federal Reserve Bank of St. Louis. Shaded areas indicate U.S. recessions.

Consumer spending is still undaunted.

Real Personal Consumption Expenditures

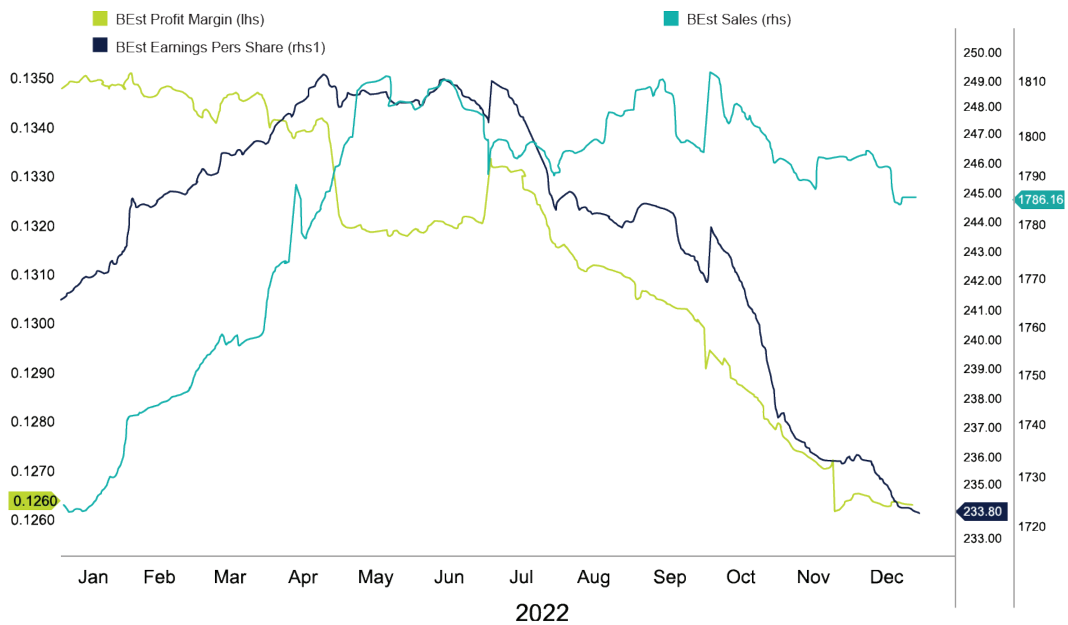


Source: FRED - Federal Reserve Bank of St. Louis. Shaded areas indicate U.S. recessions.

But, see below, we see signs that the consumers might be near their spending limit.

IV. The Fed Pauses on Rate Raises but Doesn't Reduce

January's FOMC release says that the Fed will not cut in 2023. The futures market doesn't believe the Fed.



Source: CBOT, Bloomberg

V. The Ghost of Fed Chairs Past and the Challenges Powell Faces

The current Fed dot plot shows a 5.1% terminal rate. But will that be enough to tame inflation?

Powell is haunted by the ghost of former Fed Chairman Arthur Burns. Burns failed to tame inflation in the late 1970s when inflation averaged 9%. It wasn't whipped until the implacable Paul Volcker cranked the Fed Fund rates up to 20%. It was bitter medicine, but it worked.

In some ways Powell has a tougher job than Volcker. Powell has to take heat from everyone: investors angry at losing the Fed put, elected representatives happy to have someone to blame for economic turmoil and inflation, and pundits who are convinced he waited too long to raise rates. And all of them have Twitter accounts. If a recession occurs, the pressure on the Fed to cut prematurely will be intense.

Plus, there is another complication that Volcker never had to contend with—a staggering level of debt.

U.S. National Debt	Debt Per Citizen	Debt Per Taxpayer
$31,485,883,861,883	$94,189	$246,866

Source: U.S. Treasury, U.S. Census. As of January 13, 2023

Date	U.S. Federal Debt to GDP Ratio
1960	53.40%
1980	34.48%
2000	59.72%
Now	121.51%

Source: U.S. Treasury, Federal Reserve. As of January 13, 2023

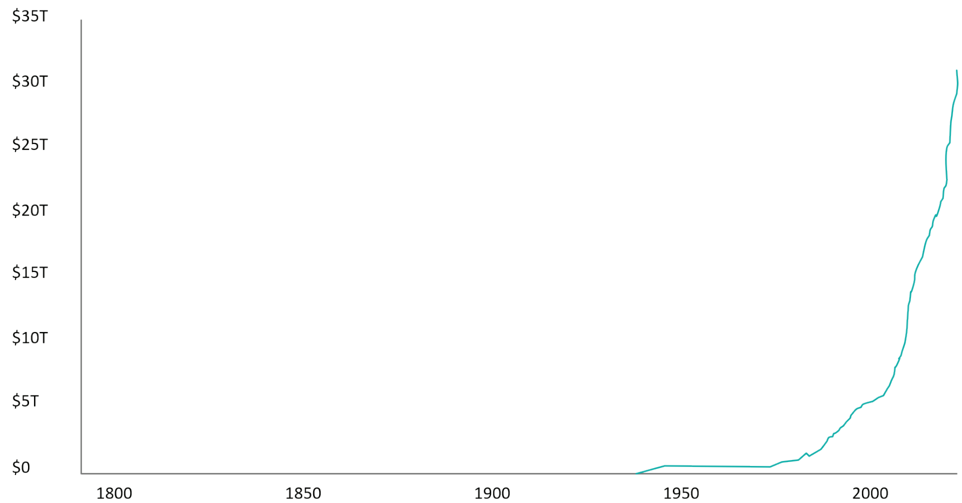
VI. Debt Levels Finally Start to Matter

When Senator Everett McKinley Dirksen uttered his famous quote: “A billion here, a billion there, and pretty soon you're talking real money" the national debt at the time was a relatively paltry $300 billion. It’s now over $31 trillion.

Volcker could break inflation without breaking the government finances. Powell can’t.

U.S. debt has increased rapidly.

Historical Debt Outstanding

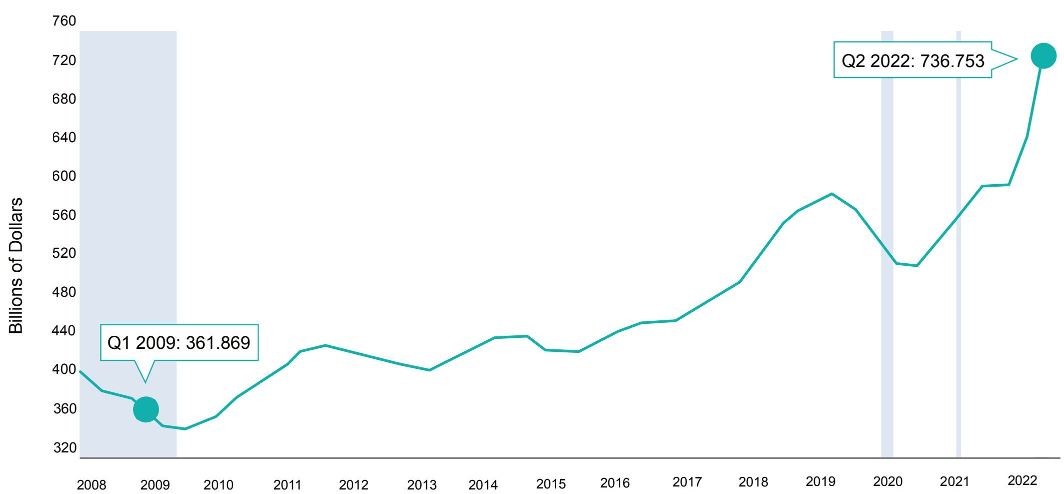


Source: FRED - Federal Reserve Bank of St. Louis

And GDP hasn’t increased nearly as fast. The U.S. debt to GDP ratio is now 120%, vs <40% when Volcker was in office.

U.S. interest expense has skyrocketed.

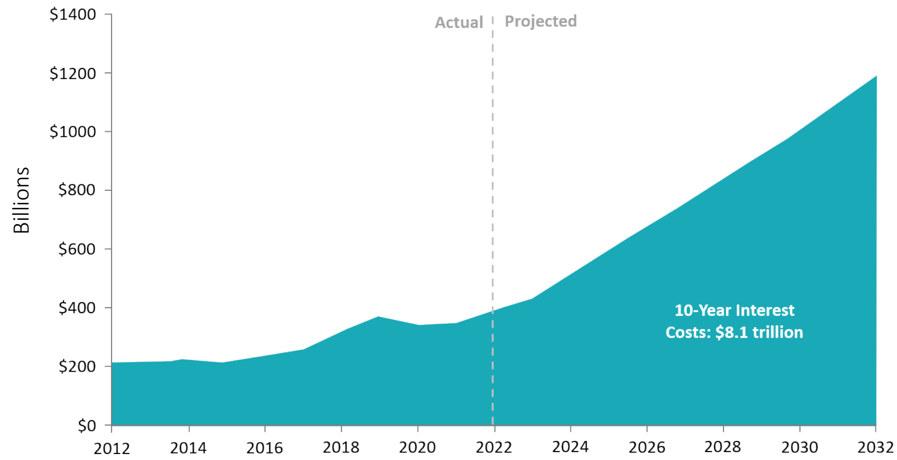
Federal Government Current Expenditures: Interest Payments



Source: FRED - Federal Reserve Bank of St. Louis. Shaded areas indicate U.S. recessions.

Current projections have the federal government’s net interest expense hitting $1 trillion annually by 2030.

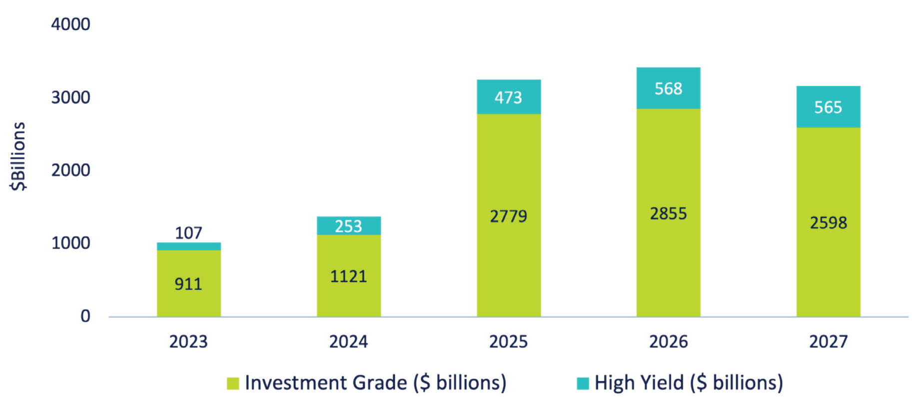
Net Interest Costs Are Projected to Rise Sharply



Source: Congressional Budget Office

For "zombie" businesses—those who don't generate enough cash flow to pay interest on their debts--higher rates will start to pinch. $1 trillion of IG and HY debt rolls over in 2023; $1.3 trillion in 2024; $3.2 trillion in 2025.

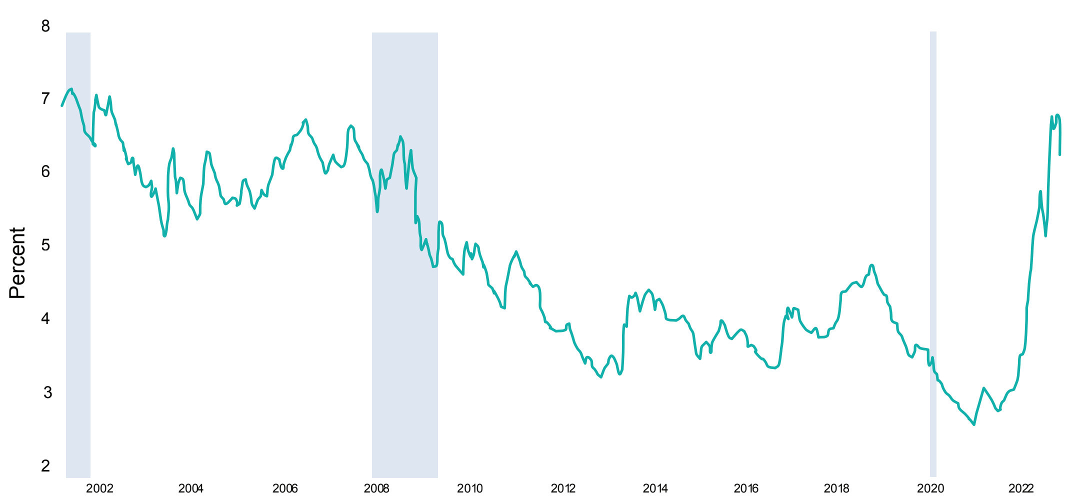
Corporate Debt Refinancing ($ billions)



Source: CNBC. December 29, 2022.

Consumers too are feeling the squeeze of higher interest rates. Mortgage rates, for example, doubled in less than a year.

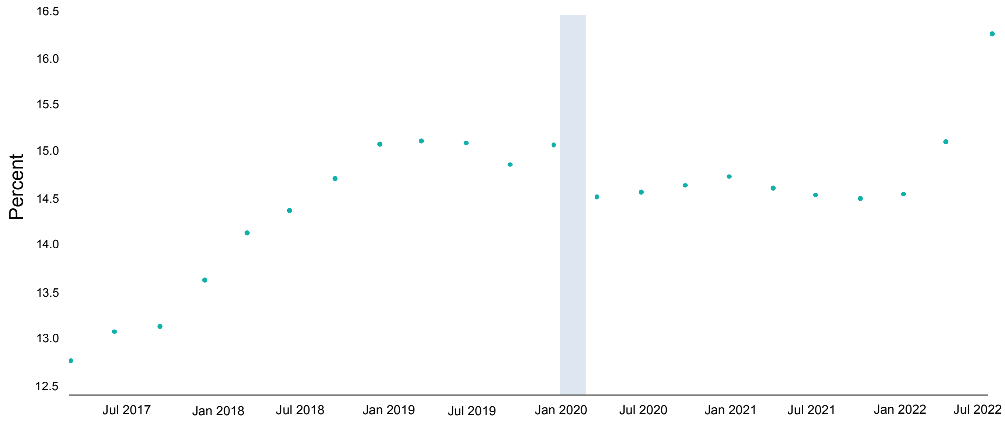
30-Year Fixed Rate Mortgage Average in the U.S.



Source: FRED - Federal Reserve Bank of St. Louis. Shaded areas indicate U.S. recessions.

Credit card rates are up:

Commercial Bank Interest Rate on Credit Card Plans, All Accounts

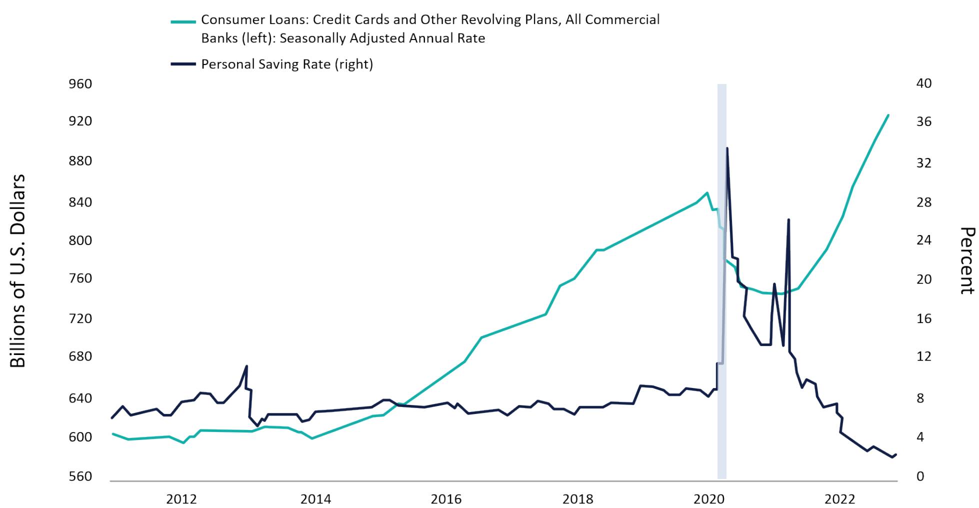


Source: FRED - Federal Reserve Bank of St. Louis. Shaded areas indicate U.S. recessions.

There are signs that higher rates and inflation are close to making consumers cry uncle.

FRED data shows savings rates have plummeted as consumer loans outstanding have skyrocketed.

Consumer Loans and Personal Savings



Source: FRED - Federal Reserve Bank of St. Louis. Shaded areas indicate U.S. recessions.

'Higher for longer' will stress credit markets and gum up the underlying economy when consumers pull back.

Repricing of risk assets continues as investors adjust to higher risk-free rates. Until inflation is tamed, until interest rates come down, until the Fed pivots—that is, it reverses policy from hawkish to dovish—only then will the stock market rally, or so it is assumed. Investors relying on a rate cut to spur price increases are ignoring decades of market history. Fed rate cuts occur before markets bottom. The Fed normally cuts rates leading into a recession, not after it has passed.

Benjamin Graham, the godfather of value investing, said: "The essence of investment management is the management of risks, not the management of returns." Long term investors don't have to worry about rates or inflation, as long as they stay invested. A focus on mitigating downside risk and inclusion of non-correlated assets is how institutions are managing their allocations and in 2022 investors saw why that mattered.

Footnotes

1. The Conference Board Economic Forecast for the US Economy, Real GDP Growth forecast, December 2022
2. “Investment Grade” represented by the Bloomberg US Corporate Bond Index. “High Yield” represented by the Bloomberg US Corporate High Yield Total Return Index Value Unhedged. “Leveraged Loans” represented by the S&P/LSTA Leveraged Loan Total Return Index.

Endnotes

“Direct Lending” represented by the DLX Direct Lending Index. “CLOs” represented by the Palmer Square CLO Debt Index. “Private Equity” represented by the Invesco Global Listed Private Equity ETF. “Hedge Funds” represented by the HFRXGL Global Hedge Fund Index. “Equity REITs” represented by the MSCI World Equity REIT Index. “Residential REITs” represented by the MSCI US Residential REIT Index. “Industrial REITs” represented by the MSCI US Industrial REIT Index. “Wine & Cheese” represented by the Bloomberg Wine & Cheese Index, tracking global producers of wine and cheese. “Rolex Watches” represented by the WatchCharts.com Rolex Market Index. “Crypto Market” represented by the Bloomberg Galaxy Crypto Index. “SPAC Market” represented by the IPOX SPAC Index. “Global Equities” represented by the iShares Global 100 ETF. “Emerging Markets” represented by the iShares MSCI Emerging markets ETF. “Energy” represented by the Energy Select Sector SPDR Fund. “Gas” represented by the Bloomberg estimated US Average Gasoline price per gallon. “Gold” represented by the gold spot price in US Dollars per ounce. “VIX” represented by the Chicago Board Options Exchange's CBOE Volatility Index.