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Anything But Ordinary, Expecting the Unexpected in 2023

The last three years investors have faced a number of unusual circumstances, moving from pandemic shutdowns and a bear market in 2020 to all time equity market highs in 2021 with a sporadic recovery, rising inflation, and supply-chain disruptions. In 2022, major market reaction to macro events has been devastating with the worst U.S. stock market performance since 2008. International conflicts increased, highlighted by the Russian invasion of Ukraine and its consequence of an energy crisis. Heightened inflationary pressures this year led to aggressive rate hikes from central banks causing the equity price valuations to plummet. Volatile markets continued throughout 2022 to a bear market and steep drawdowns. A contentious U.S. domestic political environment also continues, with unprecedented government spending programs and record-setting budget deficits. This past year, both stocks and bonds performed poorly with bonds offering no safety net. In 2022 the S&P 500 Index had a total return of -18.11% for the year and 7.56% for the fourth quarter of 2022. The MSCI EAFE (USD) Net Index returned -14.45% for the year and 17.34% for the fourth quarter of 2022. The return of the MSCI World (USD) Net Index was -18.14% for the year and 9.77% for the fourth quarter in 2022. Not surprisingly, 2023 may become another atypical year for investors in both stock and bond markets.[1]

In this period of disruptions, global growth going forward may be challenged or, at least, desynchronized by region, which could lead to disparate corporate behavior and outlooks across the globe. For example, after 2020 the U.S. dollar was strong because the fiscal response to COVID resulted in the U.S. economy recovering faster than the rest of the world, and U.S. interest rates rose faster in 2022.[2] In 2022, the impact of a strong dollar was felt globally. Governments and central banks may no longer be able to rescue their economies as was done in the Great Financial Crisis and the COVID pandemic. Massive stimulus, provided to lessen these crises, may not occur as present debt levels are unsustainable. Government pension payments and health care costs as well as increased defense spending costs are escalating.[3] Central banks are attempting to maintain economic growth and escape the damage inflation can inflict. Easing up on rate hikes can help economic growth for a time and eventually ensure inflation later, whereas tightening too much, too quickly can possibly rein in inflation but cause a recession.[4]

To respond to both demand-pull and cost-push inflation of easy money, the Federal Reserve has raised the federal funds rate by 425 basis points in the space of nine months in 2022. This is the second fastest hiking cycle since World War II. The only faster rise in rates occurred under Chairman Paul Volcker in late 1980 and 1981, when the Fed hiked the discount rate by 400 basis points in eight months.[5] In September 2022, the Federal Reserve began a program of quantitative tightening, shrinking its roughly $9 trillion balance sheet by almost $100 billion a month, hindering liquidity conditions.[6] The Federal Reserve is unlikely to stop raising rates until the Fed funds rate is above the core inflation rate. While the Fed controls the short end of the curve, the markets and the economy control the long end. Weaker equity markets and housing markets have already helped to tighten financial conditions and end speculative excesses in financial assets.[7] If employment remains strong, unemployment does not rise, and wages continue to increase and offset inflation pressures, then it is possible to avoid a recession. The problem for the Fed is the labor market. Strong employment and wage growth add to inflationary pressures. Over the last year, unit labor costs increased 6.1% with a significant decline in labor productivity.[8] Rising interest rates negatively impact corporate profits as the cost of borrowing increases.

New taxes will also begin to dent corporate profits. R&D tax credit will move from full expensing to amortization over five years, starting in 2022. This will raise corporate taxes by $35 billion immediately. Additionally, companies will have a less generous interest deduction for corporate debt moving forward, and they will only be able to write off 80% of their capital investment, down from 100 % since 2018. The tax increases while manageable in isolation, will be in addition to the corporate tax increases enacted as part of the Inflation Reduction Act summer of 2022. Those tax increases included a new 15% corporate minimum tax and a 1% tax on stock buybacks. Approximately $100 billion of new taxes will be paid in 2023 at a time when equity markets are worried about earnings and a possible recession. The EU also signed off on a global minimum tax in 2022, adding further pressure to global profits. The situation could be far worse if the statutory corporate tax rate and taxes on multinational income were raised as initially proposed. Investors need to factor in the effect of these tax changes on their equity holdings.[9]

In the eurozone, the outlook has improved marginally as it now appears energy rationing will not be required and forced shutdowns of energy-intensive industries are unlikely. A recession still appears unavoidable. The European Central Bank (ECB) tightening seems likely given the labor market pressures at a little over 6.0%, the lowest unemployment rate since the start of the common currency. In the UK, a prolonged recession appears likely, as monetary tightening, fiscal tightening, the energy price shock and supply-side constraints from Brexit combine to create a challenging outlook. Similar to Europe, the drivers of inflation in Asia are, to a large extent, food and energy. Japan is set for softer economic growth in 2023. Domestic demand is weakening, and there is slowing demand for Japanese exports. Unlike the rest of the world, Japan is still operating below capacity, which means it does not face the risk of monetary overtightening. A less aggressive central bank suggests a lower risk of recession in Australia. A Canadian recession is possibly unavoidable in 2023 as the lagged effect of very tight monetary policy will affect overindebted households. In addition, a slowing global economy will be a drag on commodity prices, challenging exports. China's government intends to stimulate by improving confidence in the bloated housing sector and to boost consumer spending.[10]

As 2023 begins, investors differ on their outlook for the equity markets. Bulls hold that growth will surprise to the upside in 2023 while bearish investors believe the effects of monetary policy tightening will be felt in 2023 dragging down corporate earnings and profits, resulting in a recession and a bearish first half of 2023. Thus far, the U.S. equity market has not priced in a U.S. recession as aggregate earnings per share (EPS) have yet to fall in line with what happens in a typical recession.[11] If there is a recession in 2023, it may be one of the most widely anticipated recessions of all time. A variety of market indicators in the current market are inconsistent with past bear market bottoms. Earnings multiples and inflation are much higher while interest rates, credit spreads, the VIX, and the unemployment rate are all much lower. The market appears to hope for normalcy, but absent a decline in inflation, lower job openings, and consumer and corporate savings, a recession may occur.[12] Debt must be addressed in 2023. There is a possibility that global quantitative tightening has already reduced liquidity in the capital markets, creating risks that are difficult to foresee. These risks should not be underestimated in 2023.[13]

Two unpleasant choices for central banks remain for 2023, to crush growth and jobs achieving a 2% inflation target or to validate a higher inflation target and risk a new round of destabilized inflationary expectations.[14] On the positive side a global slowdown has reduced the need to rebuild inventories, reducing supply chain pressures and inflation related goods. Transportation costs have begun to fall sharply.[15] Interest rates on nominal bonds are still below the annual rate of increases in the Consumer Price Index (CPI) and core (CPI) excluding food and energy. Corporate and consumer balance sheets are quite strong. Not only have many corporate profits been high in 2022, but corporations took advantage of historically low rates to refinance debt and lengthen maturities. Perhaps most importantly, equity valuations are much lower, reflecting the heightened economic and geopolitical risks. Fundamentals are reconnecting to prices with important implications for investors. However, managing risks in uncertain times will continue to be equally important as returns on invested capital.[16]

How does one invest in an economy and market that makes little sense and is under no obligation to do so? Investors do not get to choose the economy or the overall market valuations we find ourselves experiencing. When dislocations like this happen, the economy will never go back to where it started. As global debts exceed $300 trillion, the markets are now more serving as capital refinancing systems to pure capital raising mechanisms. The cost of rolling over debt globally has risen substantially in 2022 and poses financial risks from increased debt servicing costs.[17] The uniqueness of the current market is that certain segments of the global economy have already entered into recessionary territory while other segments like travel remains more robust. Martin Investment Management, LLC does not pretend to know how the stock market will respond in the short-term to macro shocks, nor do we want to set inappropriate expectations. There is a difference between the understanding of economics and the understanding of future stock market returns. The only part as investment managers that we can control is our strategy, and how we execute it.

As economies seek to stabilize, we continue to emphasize quality-based fundamentals, not only balance sheet liquidity, but also positive earnings revisions and surprises, strong free cash flow, and lower volatility.[18] We will patiently and methodically keep building portfolios of reasonably valued, high quality companies that have pricing power and should get through a tougher economy. If growth turns more positive in 2023, our investment philosophy will continue to prioritize the preservation of capital. Our goal is to find investment solutions that have a greater probability to preserve capital and to outperform in most market cycles with resilient companies. What is important is that each of our clients is respected for their individual investment differences, some with longer-term goals, and others with a shorter-term horizon. In our separately managed accounts (SMAs), we attempt to make adjustments for investor differences and always try to generate competitive returns in both bull and bear markets.

Cheers to a better 2023!

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