Weekly Market Flash

Our 2023 Investment Thesis

January 6, 2023

2022 was a bad year for most kinds of core investment assets, from the least-risky Treasury securities to the most volatile corners of the equity market. Persistently high inflation forced central banks to adopt an increasingly hawkish posture on interest rates as the year progressed. The Fed funds rate rose more sharply, in a more compressed window of time, than at any time since the early 1980s. By late summer it seemed that both headline and core measures of inflation were peaking; yet the Fed's unswerving insistence on rates remaining higher for longer took the wind out of the sails of sporadic attempts by the market to sustain a rally. The focus turned to what many see as the increased likelihood of a recession in 2023. Companies in some industry sectors, notably tech, started announcing layoffs. Those haven't shown up yet in any meaningful way in the unemployment numbers (this is being written before the release of the BLS jobs report today), but that is probably not too many months away. Meanwhile, household finances are not looking great as the economy heads into a cooling-off period, and businesses are drawing down inventories in anticipation of a slower demand environment.

Our Thesis

We expect there will be a recession in the US at some point in 2023, driven by a combination of cyclical factors. Household savings are low, debt levels are elevated, and higher interest rates are starting to have the effect of dampening demand (which, after all, is the entire point of an inflation-fighting tight monetary policy). Europe may already be in recession, China's growth remains hampered by Covid, and there are few other bright spots in the global economy. We also expect this recession, if there is one, will be relatively brief and shallow – a standard-issue cyclical downturn rather than the collateral damage of a global health or financial crisis, which were underlying drivers of the 2008 and 2020 recessions.

In the absence of unforeseen threats not known at this time (and which by all means could materialize), we expect that the US equity market will find its footing sometime in the first half of the year and eventually deliver a positive performance. In the bond market we expect to see some widening of credit risk spreads, while Treasuries should stabilize once the Fed reaches the terminal rate in its tightening cycle. We believe that terminal rate will be somewhere within the range of 5.0 to 5.5 percent. However, bond market stability will also depend in no small part on the pace at which the Fed reduces its balance sheet, which at $8.5 trillion remains elevated and not far off its $8.9 trillion peak.

Equities: A Question of Leadership

Historically, equities have done relatively well in the twelve-month periods after reaching their recessionary lows. But past is seldom prologue, and every downturn has its own unique tale of woe. One of the main questions we are thinking about in looking ahead is equity market leadership. For most of the past decade that leadership has been virtually unquestioned, in the form of the major technology platforms. But the so-called "FAANG" complex (Facebook (Meta), Apple, Amazon, Netflix and Google (Alphabet)) all underperformed the S&P 500 in 2022, by either a little (Apple) or a lot (Meta). It turns out that even dominant tech platforms are not immune from old-fashioned economic cycles. At their peak, these five companies commanded more than twenty percent of the total market value of the S&P 500; today, that figure is just 13 percent.

If not FAANG, then what? If this really is an old-fashioned cyclical recession, as we opined above, then we are probably right now in the latter part of the phase where slow, predictable earnings and high dividends dominate; witness the massive outperformance of the Dow Jones Industrial Average over both the S&P 500 and the tech-heavy Nasdaq in 2022. As prices more fully bake in the economic downturn, we could imagine a momentum shift back towards cyclicals sometime before the end of the year. Semiconductors, one of the most beaten-down sectors last year, in particular could be in the forefront of a pro-cyclical shift. As always, however, we caution that there are plenty of lurking X-factors out there that could scramble any scenario for market leadership and overall market performance.

Fixed Income: Yields and Spreads

Bond yields offer something in early 2023 they have not offered for at least two decades: a satisfactory income stream. This is good news particularly for income-oriented portfolios. Yet two other issues present challenges for the bond investor. The first is safety: in 2022, bonds in general did not provide an adequate hedge against declines in the equity market. The Bloomberg-Barclays Aggregate US Bond index, a widely-used benchmark, fell 13.01 percent in 2022, while the index for 10-20 year Treasury securities fell 25.2 percent – more than the S&P 500! Bond prices decline when yields go up, and the magnitude of the price decline increases, all else being equal, the longer the bond's duration or maturity. In 2023 it is unlikely, we believe, that high-quality bond prices will fall as much as they did in 2022, simply because the Fed is closer to its terminal rate than it was a year ago. Nevertheless there is still room for yields to rise.

The second challenge is the potential for risk spreads to widen. The bond market today seems to be telling us two conflicting things at the same time. The first, based on the inverted Treasury yield curve, is that a near-term recession is likely. For much of the past six months the curve has been more steeply inverted than at any time since the early 1980s. The 10-year Treasury yield has in recent weeks traded as low as a full percentage point below the Fed funds rate, which was raised to a range of 4.25 – 4.5 percent after the Federal Open Market Committee's December policy meeting.

We are getting a different picture from credit risk spreads, however. The risk spread between Baa corporates, the lowest tier of investment-grade securities, and the 10-year Treasury remains relatively tight: 2.11 percent today versus the three-year average of 2.26 percent. If a recession is as imminent as the yield curve tells us, we should be expecting wider credit risk spreads than we are currently seeing. Investors need to weigh the likelihood of widening spreads against the opportunity of locking in relatively attractive yields for investment-grade corporates today. We see a good argument for doing both: allocating a portion of one's fixed income portfolio to fixed-rate corporates today while keeping some powder dry for further opportunities as and if spreads widen.

No Free Lunch in Private Markets

Private equity funds, VC managers and other stewards of the $10 trillion private investment market may make a lot of hay touting their – on paper – relatively successful experience in 2022 versus the travails of public equity and debt markets. The US Venture Capital index operated by Cambridge Associates was down by less than half of the Nasdaq Composite losses around the midpoint of last year, the last available data point. Anecdotally, private equity buyout funds have been reporting flat or slight single-digit gains to their limited partners. These apparently benign numbers come with some major caveats, however.

The first of these caveats is liquidity. Investors in most types of pooled private investment structures are locked in for as many as 10 years, with very limited interim avenues for redemptions. The second caveat

is accounting conventions. The value of holdings in a VC or private equity fund do not reflect any kind of real-time market assessment; they are accountants' book entries based on assumptions that may be one or two years old, simply at the discretion of the accountant. Consider that comparison cited above of the VC index versus the Nasdaq: both indexes house early-stage tech companies with years of cumulative losses and unproven business models. There is no reason to think the returns discrepancy between the two indexes reflects anything other than the vagaries of discretionary accounting for private VC holdings.

The third caveat, though, is perhaps the most important. The ultimate success of any of these private investment vehicles depends on two critical ingredients: first, easy access to large amounts of low-cost debt; and, second, a vibrant exit ramp for their holdings via either M&A or public markets. Neither of those avenues is looking particularly robust today – M&A activity is well below the hectic pace of the previous couple of years, and the market for equity IPOs is moribund. In recent months private equity investors have been trying to fudge their way around these constraints by essentially buying and selling among themselves – a silly game that can only last so long. As for cheap and easy debt – yep, that ship sailed at the beginning of 2022 and it's doubtful that it will be coming back into port any time soon.

Don't Panic, But Don't Expect Unicorns Either

Summing it all up, our overall takeaway message is that a conventional, cyclical recession is likely to bring with it some ongoing volatility from last year's key market trends, but as the year plays out we see a strong case for stabilization and a return to a growth trend for core risk assets. That being said, it cannot be stressed enough how important the presence of higher interest rates is in keeping a check on growth potential. As long as we remain far away from the zero interest rate policy of yesteryear – and we believe that will be for some time to come – the market will not be kind to the sort of things that soared in 2020 and 2021, whether that be cryptocurrencies, "Uber of X" venture plays or covenant-lite private debt offerings. For portfolios that stay away from those parts of the market there should be good opportunities in companies with healthy free cash flows and relatively conservative debt-to-equity ratios.

On the fixed income side, the opportunity to lock in relatively attractive yields is good for portfolios with moderate or high income needs. Investors who choose to lock in these yields should do so with the mindset of holding onto the positions through to maturity, and worry less about mark-to-market paper returns in the meantime. Interest rates will go up and down over the next two to ten years for reasons we cannot even foresee at present; what matters is the predictability of the timing and magnitude of the income stream based on the conditions prevailing when you purchased the asset.

The year ahead will no doubt present its challenges, and the twin impulses of fear and greed will always be there, ready to drive poor decisions. Patience and discipline will get us through the tough times, and help us to see both the danger and the opportunity in each crisis we confront.

Masood Vojdani
President & CEO

Katrina Lamb, CFA
Head of Investment Strategy & Research

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