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2023 Outlook

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Economy: Hollencrest expects close-to-trend economic growth for most of 2023 with recession risk increasing late in 2023 and into 2024.

- Despite what has become clear consensus in public opinion that the US economy faces imminent doom, economic growth in the second half of 2022 was actually quite strong. Per the official updated December estimate from the BEA, Q3 Real GDP growth came in at a 3.2% annualized rate, and per the most recent Atlanta Fed GDPNow forecast, Q4 Real GDP growth is expected to hit a 3.7% annualized rate. This demonstrates momentum in economic growth, and we see no catalyst that will cause an immediate change as we enter 2023. Anecdotally, CEOs and corporate decision makers all the way down rank-and-file employees have been speaking matter-of-factly about a coming recession as if it is unavoidable or has already begun, which is a striking contrast in sentiment to the data. The psychology of a recession is such that people and businesses are generally caught off guard at a time when they are very comfortable with taking risk, so there is a chance that such widespread expectations could limit the potential for a recession or its severity.

- "Pivot" - referring to some unexpected change in Fed policy from continued tightening - replaced "transitory" as 2022's biggest (and most annoyingly ambiguous) market buzzword. Fed policy will likely act as a headwind for growth, but, as illustrated above, it has not yet become the disaster that consensus opinion assumes. We still maintain that continued liquidity injections for most of 2021 were not necessary, that it was fairly obvious at the time, and that it certainly contributed to this year's excessive inflation that impacted so much of the population. However, the jury is still out on if the sharp change to a tighter stance and high rates of 2022 and 2023 will cause long-term damage and a painful recession. With so many market participants focused on the Fed's potential for going too far, most reports of bad economic data through most of 2022 perversely caused the market to have an opposite reaction. We urge those predisposed to those reactions to be careful what they wish for as any data that would truly cause a change in Fed policy would likely represent or foreshadow widespread job loss and corporate bankruptcies that would overwhelm any benefit from slightly lower terminal interest rates. Fed policy and the financial conditions that have resulted, particularly an extremely inverted yield curve, are generally predictive of recession. However, it can take many quarters, or even years, for these conditions to eventually push the economy into meaningful contraction. Based on these financial conditions, it seems most likely that a recession would not unfold until close to the end of 2023, or possibly well into 2024.

- A "rolling recession" - one that moves from industry to industry without a moment in time where the entire economy comes under extreme pressure - has already begun. Industries that are interest-rate sensitive have seen pullbacks. Housing, with 30-year mortgages briefly moving above 7% in Q4 per Freddie Mac's weekly survey, has seen some drastic changes as homeowners are increasingly stuck in houses that they may not be able to afford at today's rates, meaning there are fewer potential participants in the market. Liquidity available to high-growth and more speculative tech companies has evaporated. Private market VC capital that was allocated in what some may describe as an irresponsible manner the past few years has become harder to obtain while public market valuations have collapsed, increasing the cost of capital to finance payrolls and invest in growth across all market caps. Financials have also begun to show signs of adjustment as well, with some notable layoffs announced in that sector late in 2022. These all represent healthy readjustments across the broader economy and do not portend the imminent economic destruction so many expect.

- Inflation has peaked, at least for now. Non-sticky prices in durable goods (such as used cars and appliances, for example) have completely rolled over and are now showing year over year declines. Stickier prices such as those for housing and services have also slowed, with our observation being that some are even in decline on a month over month basis. Data shows that supply chains are no longer completely broken down - whether it be shipping costs that have reverted to normal levels or the anecdotal evidence shown by the lack of cargo ships loitering off California's coast - and this has been a huge factor in inflation's apparent peak. The headline figures are not yet to a level where the Fed can declare victory, but we expect these readings to get down to the necessary long-term trend levels sooner rather than later. Maybe those in 2021's "transitory" camp weren't completely wrong.

- "Re-globalization" is the likely result of the recent de-globalization trend. Companies will continue to seek out the lowest cost provider, but with more emphasis on doing so on a risk-adjusted basis. The change will be in counterparty. Companies will increasingly avoid doing business with China largely due to the unreliability created by their erratic and extreme policies. Instead, companies will establish factories domestically as well as in Southeast Asia, India and Latin America while also creating redundancies. For a time, this could continue to provide inflationary pressure as investment and development occurs, but in the long run will improve the overall functioning of the global economy while providing a disinflationary force.

Stocks: The S&P 500 ended 2022 at 3,840, down approximately 19.4% for the year. To the extent a recession does begin to unfold, markets will price in the decline in GDP and corporate earnings well in advance, creating risk that the market could fall meaningfully from here before making its ultimate low. If widespread recession is avoided, the market's return potential could comfortably get the S&P 500 back to 4,300.

- We still view the decline in stocks throughout 2022 as a valuation reset, which is a view that corroborates our economic forecast. A recession, and the resulting decline in earnings, has not been priced into the stock market. While the Fed continues to tighten and the market finds its footing in early 2023, a retest of 2022's lows, which happens to equate to the market's pre-pandemic highs, is likely. A move below that level would likely need to be joined with signs of a recession and a significant reduction in forward earnings estimates.

- We see a rally to new all-time highs in 2023 as unlikely. The potential for multiple expansion is limited by the interest rate environment and reduced liquidity. It will take a couple years of strong earnings growth - with profit margins staying at very high levels - for the S&P to once again reach 4,800 with P/E multiples staying below 20x, which we believe will be the case.

- Hollencrest is committed to staying disciplined and sticking to our investment process during these volatile times. As we began to see signs of the market peak in early 2022, confirmed by our system of market indicators, we reduced equity exposure significantly for our clients to avoid full participation in the market's larger drawdowns. As the market began to rally off lows in mid-Q4, the nature of the rally that unfolded was different than rallies earlier in the year and indicated a higher probability of a more sustained advance, causing Hollencrest to reinvest cash that was raised earlier in the year. Breadth was improved and a much larger number of stocks were in uptrends despite a handful of mega-cap tech stocks masking this action in the cap-weighted market indices. However, after December's hawkish Fed meeting, the market reaction signaled fresh deterioration that caused us to once again raise cash, selling what we had reinvested at a nominal gain. We exit 2022 with strong cash-equivalent balances in our client accounts available to redeploy opportunistically or with confirmation that a sustainable advance is likely.

Bonds and Rates: We see the 10-year as likely testing the 4% level once again early in 2023 before its yield falls back towards 3.5%, with the expectation its yield will move back to 2%-2.5% if and when a recession begins to unfold.

- The Fed is showing great resolve in its quest to stifle inflation. As such, it is hard to forecast anything other than the target rates they have guided toward in 2023. It doesn't seem like much will stop the Fed from increasing Fed Funds to their forecasted 5%-5.25% range, but certainty around how long Fed Funds stays at that level remains elusive. Not even the Fed can accurately predict how rates at that level, particularly given the speed with which they have moved rates higher, will eventually impact demand, consumption and markets. Inflation should be well enough under control to begin moving rates back toward 2.5% in late 2023 or early 2024, but the catalyst for the Fed beginning to cut is unclear.

- Some of the most important data points we track on a daily basis are corporate credit spreads. Notably, credit spreads have been on a sustained tightening trend since this summer, indicating continuing ease in financing for large corporations of varying credit quality. Painful recessions and credit crunches go hand in hand. Without significant widening in spreads, corporate defaults are far less likely, meaning bankruptcies and massive layoffs are also less likely. This data alone is enough to refute the view that recession in early 2023 is inevitable. Certain companies, such as private equity backed companies that borrow from private debt funds, could soon be at a higher risk as the interest expense on their loans, which are generally floating rate, will likely have doubled by the time the Fed is done. It's likely some of these companies will face challenges and that could represent the tipping point where credit markets start to show stress.

- The interest rate environment is creating opportunities for investment. Although high-yield and certain asset-backed categories appear to be at risk with spreads not adequately compensating for a recessionary outcome, Treasuries and high-grade corporates could provide returns that compare favorably with other asset classes as yields potentially drift lower from here. Fixed income investments with longer duration and limited credit risk would see gains as longer-term Treasury yields fall from 4% back to 3% or below, and the yield generated would provide compensation while waiting. Potential allocations would have to be managed dynamically, especially as risks involving credit and duration evolve. Short-term Treasuries serving as cash-equivalents are also providing strong risk-adjusted relative returns as we enter 2023, and placement of our cash within the short end of the yield curve continues to be an important focus as Hollencrest also evaluates extending duration and credit risk as we enter 2023.