



*The dawn of a new year begins with the tight Bear Market grip firmly in place.*

The worst year for stocks in a decade-and-a-half and the worst year for Bonds in history still cast big shadows on 2023. It's a new year, but a familiar theme: It's still all about the Fed.

Recession is a big concern heading into the new year. Visibility to the immediacy is still somewhat limited as inflation is keeping the Federal Reserve in tightening mode. Assets have been under a chokehold due to spiking interest rates. The strong Dollar was constrictive too. But after peaking in the Fall, the Dollar slid into Winter, giving up half the 2022 gains. The decline helped loosen that stranglehold on asset prices.

### Strong Dollar

Rising rates tend to boost the value of the Dollar by attracting foreign investors to buy Treasuries and other American assets. The Russian invasion of Ukraine triggered a major flight to quality. Europe was very vulnerable. Investors fled from risk. Money crossed oceans. It landed in the safety of Dollars.



The Dollar remains the World's reserve currency. Its movement impacts all things financial. The rising Dollar further exacerbated the high inflation. The strong Dollar makes commodities and American products more expensive overseas. Consumers are looking for price-cuts right now. Signs of further loosening will be celebrated widely.

### Boom-Bust, Now What?

We've entered what seems like phase 3 of Covid. 2020 and 2021 brought the Boom. 2022 brought the Bust. 2023 looks like a period of new normalization. It's still not clear what that might be. After the dust settles, the Market will focus on the path ahead. You can count on that path being bumpy.

Early in the pandemic, the Fed took interest rates to effectively zero. It started buying up assets at a rate never before done. Its balance sheet cleared \$9 Trillion. The goal was to stimulate spending. The crisis commitment was, "whatever it takes." It worked. Money was effectively free. People spent. Cheap money propped up markets and fueled asset bubbles the World over. The era of free money is over.



The Federal Reserve embarked on the most aggressive rate hike campaign in a generation. The Fed raised rates seven times last year. It took the overnight lending rate from a range of 0% to 0.25%, to the current 4.25% to 4.50%. It plans to keep raising rates, potentially as high as 5.5% in 2023. The next meeting is in February. A ¼-point hike is already priced in.

The Market believes a pause in rate hikes is near. Taking it further, the Market is already pricing in rate cuts by year-end in response to an anticipated recession. The Fed says not-so-fast. The Market is calling the Fed's bluff and thinks they flinch. The Market is usually right.

### Peak Prices Possible



Inflation is global. Europe has battled spiking food and especially energy prices. Central banks around the World have been chasing inflation, trying to get ahead. Even Japan, which pioneered the negative rate path last decade, has higher interest rates. It's a problem of their own making in many respects. The Fed is trying to earn back the credibility it lost allowing for this hyperinflation and asset bubbles. Whatever it takes comes with a cost. In 2022 we got the check. We're still paying it off as we enter 2023.

Inflation is going back in the right direction as the new year begins but remains elevated. Oil and Gas prices have fallen quite a bit, providing much needed relief at the pump. Dollars saved at the gas station means more Dollars spent elsewhere. That keeps the American economic engine running, even though it's moving at a slower pace.

It takes a while for the price declines to work their way through the system. Lumber prices soared early in the pandemic as demand for furniture and remodels took off. Supply could not keep up. The cost to ship it spiked too, as lockdowns limited the number of ships sailing and workers at the ports to unload and distribute. The price of lumber has since been cut in half.

It's possible prices have peaked. Supply chain strains have experienced significant relief. Those cargo backups in Long Beach? They're long gone. In fact, shipping rates fell 90% from the Covid peak. Cheaper distribution and excess inventories have led to some serious markdowns at the stores. That's good for consumers. It's not so good for Corporate America. Earnings growth likely hits a snag in 2023.

### Americans Kept Spending - Economy Keeps Growing

Travel exploded in 2022. Pent-up demand from the Covid lockdowns nearly burst. Americans were out and about with their wallets open, craving activity. The American people were on airplanes, in hotels and at restaurants. They went to the beach, concerts and ballgames, consuming food and beverages in size. It was definitely not recessionary behavior.

The increased spending on travel and services was a major shift from early in Covid when Americans aggressively bought stuff. The lockdowns triggered stay-at-home purchases like new wardrobes, electronics and home improvements. E-commerce cushioned the required stay. In 2022, people wanted to get away. Accounting for 70% of America's Economy, consumer spending propels the engine.



### Debt is a 4-Letter Word

This increased spending was very stimulative to America's Economy. But the American people seem to have burned through the record savings built up during Covid. Credit card balances are building. In fact, a recent survey suggests nearly one-third of Americans are carrying up to \$5,000 in credit card debt. Over half of credit card holders have missed a monthly payment. That's not good. Credit card is amongst the worst kind of debt.



America's got a debt problem. The national debt topped \$31 Trillion for the first time in history. The Market doesn't seem concerned about the nation's finances yet, but the can keeps getting kicked on fiscal discipline. There's little evidence it gets treatment this year.

Eventually, concerns about the economic health of the country will grow. We don't think it's a 2023 issue, but it's likely not much further out. America has an aging population, a shrinking workforce, high healthcare and defense costs, and a tax system that simply does not bring in enough revenue to cover the excessive spending in Washington. Congressional blame games and a lack of serious action is on borrowed time. Complacency here will ultimately be a crusher.

Interest rates are the price of money. When rates were low, it was smart to borrow. Rates aren't low anymore. The cost to service the debt has risen markedly. At high interest rates, debt is indeed a 4-letter word.

### Jobs



The good news is, anybody that wants a job can get one. Unemployment is still really low. At 3.5%, it's at 50-year lows. This is not a common occurrence in a recessionary environment. The bad news is, not everyone wants to work. Many companies around the country still say they can't find enough workers. On the flipside, Silicon Valley keeps laying people off.

This is a very peculiar labor market. Free money from the government during Covid had some Americans making more money staying home than they did at their job. Excess savings have been burned off, but many Americans appear burned out. Covid fatigue and mental health are often cited as labor stressors. Service work has been hard to fill. And here's the thing: There's never been a recession with multi-decade low unemployment.

As 2022 closed, there was a slight slowdown in the pace of payroll growth with an uptick in layoffs. Unemployment claims rose while job postings fell. The housing weakness combined with soft retail hiring and spending for the Holidays are early signs that the economic slowdown is growing. But the unemployment rate remains historically low, which the Fed is watching closely. Large companies are letting workers go. Small companies have not yet. That's how 2023 begins. Something's gotta give.

### Global Economic Slowdown

Europe has been facing recessionary pressures for months now. It was exacerbated by the invasion of Ukraine. Food and energy prices skyrocketed as supplies were shut off. European dependence on Russian energy was exposed big time. Gas prices experienced inflation like never before seen. They've come down considerably. In fact, natural gas prices are back below invasion levels.

Much of the decline has to do with the vast quantities of natural gas being imported from America. Expectations of shrinking demand with a pending recession are also at play. Despite the recent price declines, Europe's energy problems will likely persist well into the new year. There's still a lot that can go wrong there.



### China's Zero-Covid No More

China put an end to its strict policy of Zero-Covid. The government gave way to popular pressure. The second-largest Economy is finally re-opening after 3 years of lockdowns. China's Economy is projected to grow by 5% this year.

China's re-opening is both a big risk and a big opportunity. With 1.4 Billion people, travel and consumption are expected to surge. It will create a positive shock to a Global Economy in need. In addition, China is the only nation that could see central bank support while the rest of the World tightens. That could lead to economic expansion early in the new year. Expectations are building for a return to normalcy by Spring.



It is far from clear how China can navigate this effectively without possessing a substantial supply of mRNA vaccines. China has been experiencing 1 Million Covid infections every day. That number could clear 3 Million by February. The Chinese re-opening doesn't appear to have been strategically planned out. Zero-Covid ended in an instant.

Within a half-hour of the Chinese government's announcement that it's ending the mandatory quarantine for international travel, searches for overseas trips shot up by 1,000%. After 3 years of isolation, China's vast population is ready to explore the World again. That said, the World might not be ready for Chinese tourists. Japan, Italy and the United States announced emergency requirements for a negative Covid test upon arrival for mainland Chinese residents. Many other countries are likely to follow. The Chinese government took issue with this approach, feeling targeted. Geopolitics have been strained for a while. The politics of Covid make things that much more complicated.

### Market Impact



The Stock Market has recalibrated big time, accounting for the higher rates and tighter lending. Growth stocks got hit the hardest. Companies that saw their stocks soar early in the pandemic with pie-in-the-sky possibilities and valuations got shot down in 2022. Profitability and low valuations became the focus.

2022 was a Dow kinda year. Value was at a premium. Mature companies paying large dividends saw their stocks perform well while the growthiest, most speculative stocks came crashing back down to Earth. There's reason to believe that this theme continues in 2023.

Bear Markets are about survival for investors. It's part of the deal where stocks correct excesses while the Economy goes through a contracting cycle. It's hard to look toward the future while the focus is on the now. Corrections are a healthy process that is no fun, but sticking to a discipline and playing aggressive defense is ultimately rewarded.

We enter the new year with the same approach as the previous; We are on the defensive. We are long-term investors equipped to deal with short-term issues. That's precisely where we find ourselves presently. Our focus is on today, but we are not losing sight of tomorrow. Here are areas we find attractive both now and later.



### Bonds are Boring and Beautiful

The 40-year Bond Bull Market came to an end. It was the longest in history. What started with 18% yields in 1982 fell to below 1% in 2021. Now what? There is a new cycle of rising rates. Historically, 5% on the 10-Year Treasury has been a headwind for stocks. That's the level where investors tend to contemplate risk/reward for owning stocks versus the predictability of Bonds. Income investors are finally getting paid without taking substantial risk.



We don't necessarily believe a new Bull Market is in place for Bonds. Higher rates seem likely over time, which means lower Bond prices. But near-term, we see yields falling, which will drive prices higher. We might not own long-term Bonds to maturity. We consider it more like renting. With uncertainty everywhere and an economic slowdown accelerating, we are seeking more predictable returns. It might sound boring, but boring works for us in the 2020s, if you get paid. Boring is beautiful right now. For the first time in years, we really like the Bond Market.

### Health Care

Health Care seems likely to lead in 2023. It has many defensive characteristics we covet. Health Care stocks are relatively cheap with predictable revenues. The Health Care industry is not economically sensitive either. Pharmaceutical and Medical Device companies produce products in stable demand regardless of recession. Health Care is a necessity. We liked Health Care in 2022. We like it again for 2023.



The growthiest area in Health Care is the Biotech space. It can be a risky venture with significant reward if right. Novel medicines and revolutionary treatments to disease are at the heart of innovation. That won't change. Like any industry, cycles play a major role in performance. Biotech stocks have underperformed for years. There are signs that a turn is in the offing. It looks poised for a catch up.

### Infrastructure

With decades of neglect, America's infrastructure is finally getting a much-needed upgrade. Roads, bridges and tunnels are about to be modernized and Congress is paying the bill. Construction and service providers are responding to the need and the \$550 Billion bipartisan infrastructure plan passed by Congress. In addition, railroads, utilities, water, broadband and energy will be targeted in this massive project. Onshoring of manufacturing and supply chains will be a focus too. That should be good for American jobs and stability.



The cost in Dollars might be greater, removing our dependence on foreign supplies. But measured in our national security, that cost may be well worth it. The funds and the needs are there. It will be paid over the next 5 years. We see opportunity for investment in America's infrastructure for the rest of the decade.

### Hot War, Cold War and Cyber

Military budgets have expanded. The War in Ukraine accelerated the increase. The North Atlantic Treaty Organization (NATO) is now more aligned than it's been in decades. The tense geopolitical backdrop has been a boost to the Defense industry. Defense stocks had a phenomenal year in 2022. We like them still in 2023.



All 30 NATO nations have agreed to spend at least 2% of their Gross Domestic Product on defense by 2025. Only a third of those members have yet met the threshold. But the momentum is building toward achieving that target. Finland and Sweden seem poised to join the alliance amid concerns that Russia might target them next. NATO has provided substantial military aid to Ukraine. That rate of aid is on the rise.

Cold War is not new. The World spent the second half of the 20th century in one. A case is being made that the US and China have embarked on a new one, with the prize of dominating the Digital Age. Fair competition is healthy. Unfair competition is not. There have been acts of war in cyberspace for years. There's a proliferation of bad actors on the World Wide Web that mean us harm. Tactics get more and more sophisticated. Staying vigilant is a constant. Cybersecurity is essential, for all Americans. We're staying invested there.

### The New Space Race

The Space Race got a kickstart as NASA partnered with the private sector. Corporate investment keeps fueling innovation. American rockets are sending astronauts back to space. We're no longer hitching rides with the Russians. This is no small deal.



Competition is fierce. China has vast visions for the future. It's looking far beyond the South China Sea. It's been said that China wants to claim the Moon and possess its vast resources. The United States will not sit idle and let that happen.

The Space Race is not just about the Moon, or Mars for that matter. It's about securing Earth and opening up new frontiers and opportunities. Satellites are essential to our daily lives. We live in a connected World and those connections need to work safely and securely. Starlink helped tip the scale in the war in Ukraine.

There's also the opportunity for supersonic speed going mainstream. Jets flying at Mach 1.7 are projected to take passengers by the end of the decade. It would cut flight time in half. That would mean New York to London in under 5 hours. San Francisco to Honolulu under 3. Innovation is happening. It's very investable.

### Energy



There are few things more important than having abundant, stable, and affordable supplies of energy. It's such a critical thing. Having cheap and reliable energy sources is essential for any functioning nation. America reduced its independence on foreign sources last decade, becoming the largest producer in the World. The Energy Boom in Texas shale and beyond drove it. The pace didn't last.

The US is producing less and importing more Oil today than it was pre-Covid. It's still producer number one though. The vast majority of imported Oil comes from Canada and Mexico, but not all. Europe is learning the hard way as it feverishly tries to unwind its tangled energy ties to Russia. There is just no way to replace fossil fuel as the primary source yet.

Saudi Arabia is the second largest producer of Oil, behind the United States, but the largest exporter in the World. Relations between America and the Saudis are complicated. They're not necessarily allies. It's more of an enemy of your enemy is your friend kind of thing. Iran is in the middle there.

The relationship between the United States and Saudi Arabia is more transactional. The Saudi Kingdom has historically relied on American military aid under "Oil for security" policies. Times are changing though.

The US shale boom eliminated the need for a surplus of Middle East Oil. China was eager to fill the void. China replaced the US as the Saudi's largest trading partner. Both nations are collaborating in their respective growth plans, known as China's Belt and Road Initiative with Saudi Arabia's Vision 2030 development. It's playing a major role in the future of commerce and energy in the East.

Energy has long been such a controversial subject. Everything is political these days. Both the planet and the people are counting on responsible decisions. Compromise is essential. The World faces an energy crisis. Failing to have a comprehensive energy plan is sending things backwards.



Coal usage increased dramatically in 2022. In fact, more coal was burned last year than ever before, erasing years of carbon footprint benefits. That's not good for the Earth. The last major refinery built in the United States came online in 1977. They're old and inefficient. The problem is nobody wants them in their backyard. We are so vulnerable to outages for our daily power.

The World needs to keep investing in both renewable and traditional energy sources to meet the demand. Over 20% of electricity produced in America now comes from renewable sources. It keeps increasing as companies innovate. It's undoubtedly the right direction. We still see great opportunity ahead. Renewable energy plays a big role today and will be even bigger tomorrow. But for now, it has never been so clear; The World still runs on crude.

### Nuclear Staging a Comeback



Nuclear Energy was set back decades after the Japanese reactor disaster in 2011. It was the second largest nuclear accident ever, after Chernobyl. But if a comprehensive energy policy is comprised of a portfolio of solutions, both traditional and renewable, then nuclear has to be back on the table. The World faces an energy crisis. A decade after the disaster, even Japan is looking at nuclear energy again.

Big news came from the Lawrence Livermore Lab. The subject was nuclear fusion. The Department of Energy announced a major scientific breakthrough, known as a "net energy gain." It could change the game for how we power the World.

Scientists at Lawrence Livermore used what's described as the World's largest laser to produce an effect known as "magnetic confinement fusion." In simple terms, a small amount of hydrogen was heated to extreme temperatures, which resulted in the fusing of atomic nuclei and 20% more energy than was used in the lasers. Ok, those terms still weren't that simple. But this is a huge deal. Like really huge.

Nuclear energy plays a significant role in electricity in America. Nearly 10% of California's energy comes from nuclear. That said, Sacramento had been talking about permanently closing Diablo Canyon, the facility that produces the majority of that nuclear energy. The White House is providing support to keep it open. It views nuclear as a key component in its green energy campaign.

The future of energy in America continues to be controversial. But it's a necessity. There is no perfect solution. A compromise is needed to account for the many stakeholders. We, once and for all, need to get serious about energy. That requires investment in new sources, new plants and training the people to operate them. Of course, it's also very investable.

### Tech Wreck



After a decade-plus of complete and total dominance, Tech stocks got taken to the cleaners in 2022. These were the darlings of the Digital Age. No nobody seems to want them anymore. So much of it has to do with the Fed and interest rates. Cheap money made growth stocks extremely attractive as investors had moonshot mentalities. It was bubblicious, as they say.

That changed big-time as the price of money got more expensive, triggering a desire for profitability with more immediate and predictable returns of cash flow. The Tech-heavy NAS erased nearly all of the Covid era gains, which were at the heart of the Stock Market bubble.

Silicon Valley companies invested aggressively early in Covid to try to match spiking demand. Many hired wildly. They went big. They went too big. They're now letting people go and trying to offload excess inventory to defend their businesses.

Tech companies are in cost-cutting mode, turning their focus to profitability. That's what's required to finally reach a bottom for their stocks. That likely happens. But not every Tech stock will recover. Some will never reach the heights of 2021 ever again. It was a sugar high. It was a bubble. But over time, some will. Like any wreckage, there will be quality assets that are uncovered, representing great future value.

### American Made

Despite the near-term pressures and cost-cutting measures, companies are still investing in growth and innovation. American Made has become a big thing again.

The Taiwan Semiconductor Manufacturing Company (TSMC) made history with one of the largest foreign investments made in the United States. The company is building a second chip plant in Arizona. This increases its investment in the state to \$40 Billion. It is expected to deliver enough chips to meet America's demand of 600K wafers per year. TSMC is building the foundation for the future of quantum computing and AI. Supply chains will be secured. Things have changed. Investments are being made. Dependency on foreign sources leaves us vulnerable. Covid taught us that.



### Bull-Bear Brawl

The Bull-Bear brawl spilled over from 2022 into 2023. **The Bull case** remains a soft-landing with perhaps a mild recession. The Bulls continue to focus on cooling inflation leading to a slower pace of Fed rate hikes, and a pause by Spring. There's optimism that earnings estimates have come down and Corporate America's cost-cutting measures will cushion the blow of a protracted economic slowdown and even recession. The re-opening of China is also considered a catalyst for an economic turnaround.





**The Bears** have been firmly in control betting on higher-for-longer interest rates from the Fed based on sticky inflation tied to jobs. The Bears still think earnings estimates are too high and a recession will be deeper than the Market has factored in.

Both sides are dug-in, but the Bears clearly have firmer footing. The Market is pricing in a Fed pause, anticipating a recession in the Summer. It gets rattled every time the central bank talks tough because it fears a policy mistake is real. That would result in a much deeper recession.



**Washington**

There's also this: Washington dysfunction. The divided Congress should result in a return to gridlock. The Market generally likes gridlock because it minimizes the risks of excess spending. But this Congress is proving to be a new kind of risk as it can't even agree on a Speaker of the House.

Our Washington sources are drawing comparisons to 2011. That was the year the US lost its AAA credit rating. The chances are rising for crisis around the debt ceiling and another fiscal cliff. If that were to transpire, it would be a September event. The Market will certainly be moving in anticipation.

Here's the thing: The whole global financial system is dependent on the United States Dollar being the universal currency and Treasuries behaving like the risk-free asset perceived. The system doesn't work without it.

Congress has made it clear it is continuously willing to mess with that. It's no wonder that 3 out of 4 Americans disapprove of Congress. There should be no question about the ability of the United States of America to pay its bills. It is indeed a AAA credit. The real problem is Washington doesn't act like a AAA government.



**Finding a Bottom**

Price discovery is very difficult in this environment. Matching buyers and sellers is tough with such volatile and negative price action. It's not clear what fair value is because investors aren't willing to pay for things at various prices. The Stock Market is driven by earnings growth. The Price to Earnings ratio (P/E) is the traditional measurement. The problem is, if you don't know the E, it's impossible to know the true value of the P. That's what the Bears and Bulls are fighting over.

Being an investor takes patience and guts. Strong hands are required. Bear Markets are notorious for sending stocks back to their rightful owners. Those are people that can see beyond the now.



For a Market to finally reach bottom, it requires the Generals to get washed out too. The undisputed leaders of the last decade have been the Tech Titans, who always held up well during corrections. They were considered relative safe havens in the Stock Market. That changed in the second half of 2022. The Generals are still under fire as the new year commenced.

A new Bull Market will likely be led by a new group. It's not anywhere clear what that might be. Sectors within Health Care and certain Industrial companies tied to infrastructure, water and Defense seem like good bets to us right now. A weak Dollar would make certain international investments more appealing, an area that has grossly underperformed for a decade. Gold and other precious metals could do well in this scenario too. This will all take shape over the course of 2023.



### Sour Sentiment = Bullish?

Perhaps the most Bullish aspect of the Market is that the masses are so Bearish. This is a contrarian sign which historically has value as a bottom finder. Entering 2023, the consensus believed that selling would continue early in the new year, leading to a second-half rally. We definitely see that possibility. But the consensus is seldom right. The Market has a way of tipping the scales when the herd is crowded in one direction.

Investor sentiment remains super sour. The number of Bulls measured by the American Association of Individual Investors fell to 20.5% the first week of January. That was down from 26.5% in the prior week. This is really low. Bullish sentiment has been below the 37.5% historical average now for 53 straight weeks. The last time sentiment was this low was in October, at the 2022 bottom.



A rally to start the year would catch most by surprise. We could see that play out: The Economy keeps slowing, the Bond Market tells us inflation is less of an issue and the Fed will ultimately end its choking rate-hike campaign. That would provide more breathing room for stocks for another Bear rally before ultimately bottoming out. That's our base case right now. We're staying nimble. One thing seems certain: The volatility will continue in 2023. We are prepared and positioned accordingly.

