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January 2023 Market Outlook

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Where Are We Now?

- We are in the early innings of an economic deceleration. Fed policy is lagging but will have a feedback effect on the shape of this deceleration.
- Inflation is slowing. The Fed will not be able to ignore this.
- This means "dis"-inflation.
- The old-time medicine of a Fed Funds Rate > inflation may not be realized this time around.
- This Fed, to its credit is not highly political, but its not monolithic, either. The dovish dissenting voices are getting louder.

Bull Facts

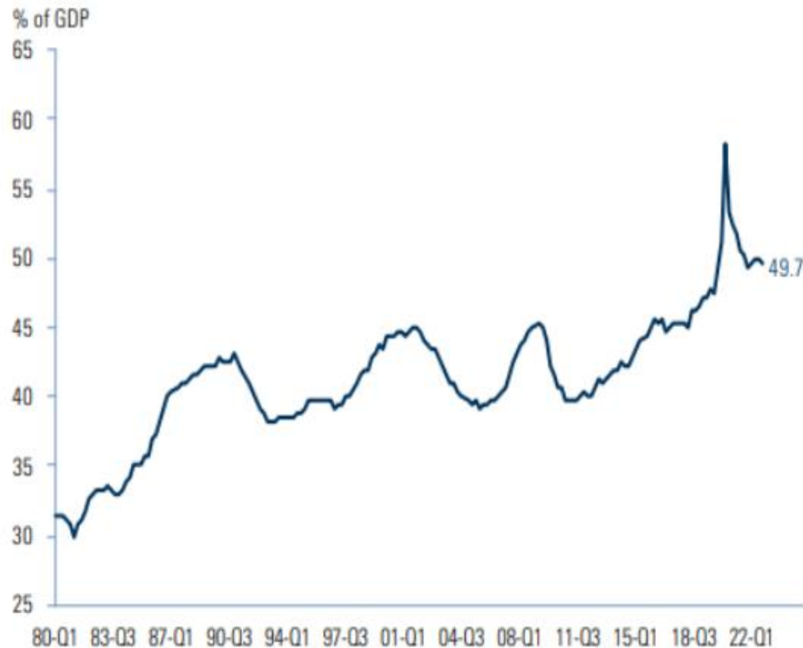
- Employment is strong (but makes the Fed's job harder)
    - New jobs >> population growth. (Last print 225K.)
    - Employment completely recovered from COVID downtown.
    - 10.5MM job openings (this is what the Fed is concerned about.)
- Balance sheets are strong
    - Corporate balance sheets (industrials and financials) both much stronger than going into other recent recessions.
    - Households have $1.7TN in excess saving. This is on the sidelines but provides a good backstop.
- Credit market is resilient
- Inflation has been broken

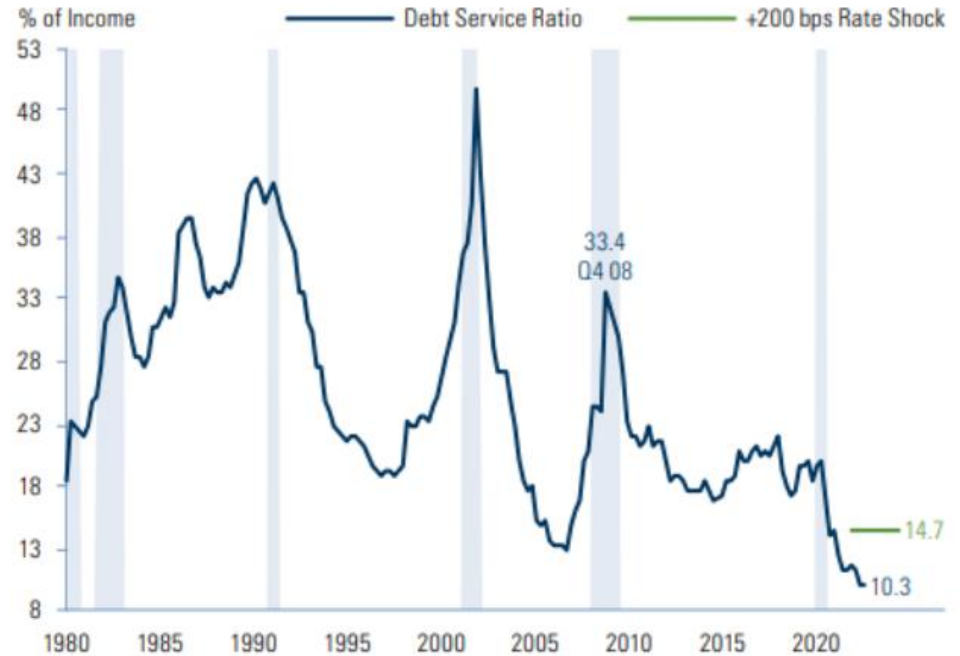
Bear Facts

- Steeply inverted yield curve (by 70 bps)
- Housing weakness: YoY sales off -35%.
- Mortgage rates higher, but not at recent peak.
- Consumer spending faltering

Balance Sheets Are Strong

Debt to GDP | **Debt Service Ratios**

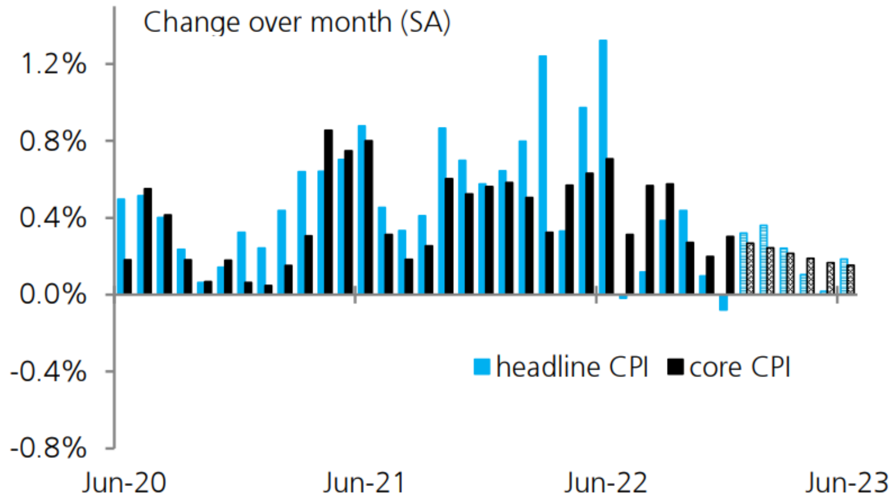


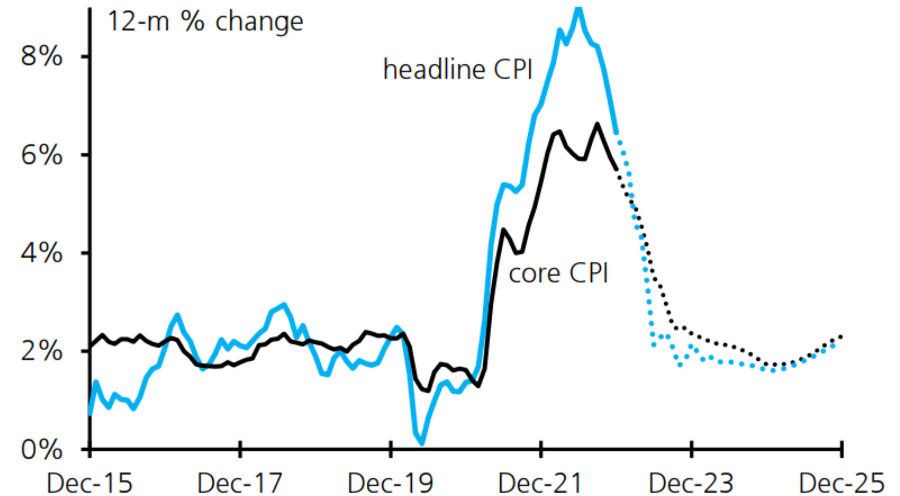


Source: Goldman Sachs and Bloomberg LP

- Debt service cost is currently at a record low of 10.3% of income.
- According to Goldman Sachs models, a 200-bps shock higher would only increase debt servicing cost to 14.7%, which is still quite low historically.

“Dis”inflation

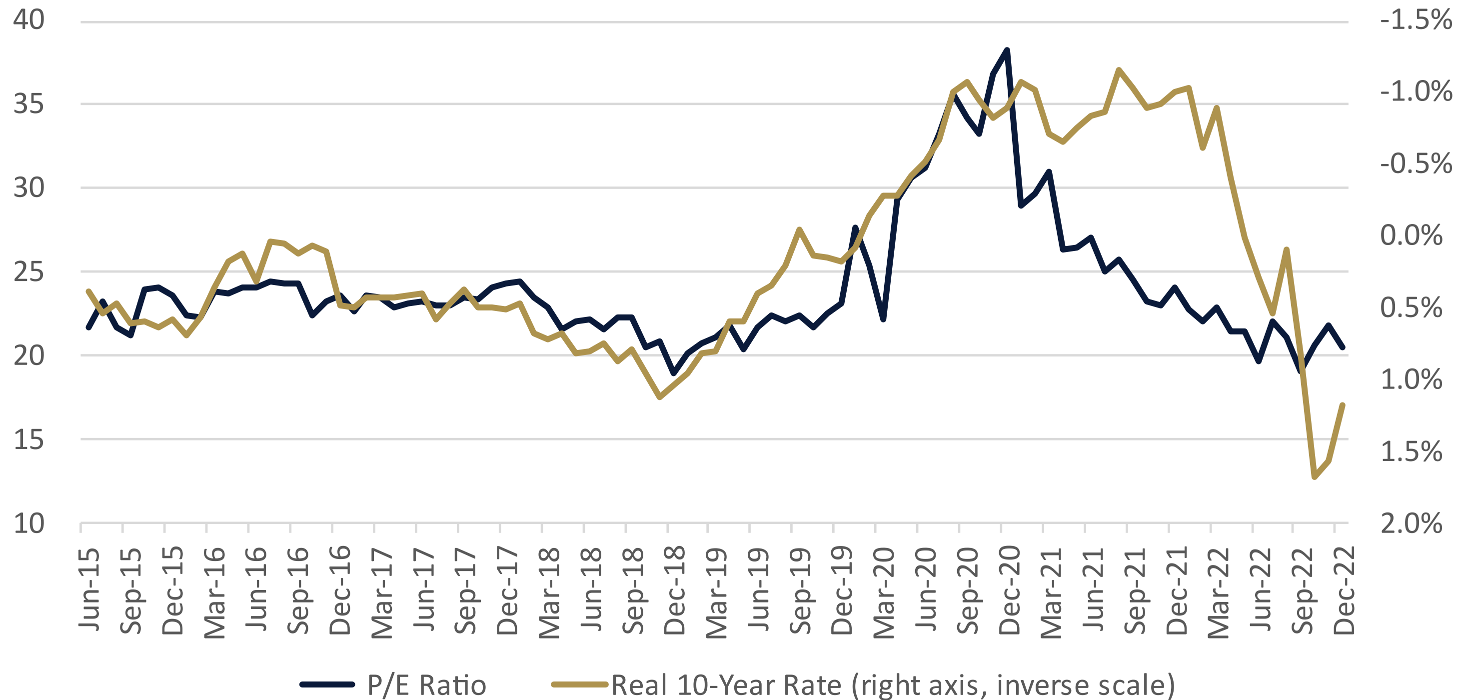




Source: UBS and Bureau of Labor Statistics

- Housing costs (rents) still has strong momentum but will abate later this year; marginal rental leases are being negotiated lower.
- Many other costs have already started to fall.
- Supply bottlenecks have eased, “core” prices falling, oil and natural gas prices have underperformed their forwards.
- Real-time data suggest the labor market is weaker than payrolls or vacancies suggest.

Rates Will Drive Valuations



Source: Federal Reserve and Macrotrends

- The real 10-year rate (I use the inflation-adjusted, constant-maturity rate from the Fed) is one of the best predictors of valuations.
- A recent decline in real rates may stave off further valuation reductions.

Potential Positioning

- Equity positioning this year should be driven by expectations of the degree of “dis”inflation and its tempo.
- Our base case argues for a small tilt towards the sectors and industries expected to benefit from a reduction in price levels and real rates.
- Consumer Discretionary, Health Care and Communication Services have historically outperformed during periods of “dis”inflation. Tech and Health Care expected revenues are the least correlated with changes to expected inflation (but have the highest beta to changes in rate expectations.)
- Underweight Energy, Industrials, and Financials.

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