2 KNIGHTS
WEALTH MANAGEMENT

Market outlook as of January 2023

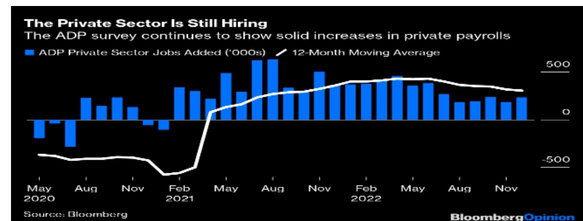
"I cannot forecast to you the action of Russia. It is a riddle, wrapped in a mystery, inside an enigma; but perhaps there is a key. That key is Russian national interest."

Sir Winston Leonard Spencer Churchill (30 November 1874 – 24 January 1965) was a British statesman, soldier, and writer who served as Prime Minister of the United Kingdom, from 1940 to 1945 during the Second World War.

Investor resolve was tested in 2022 with a vicious return of a bear market especially in speculative areas. Who could have predicted a war between Russia and Ukraine which generated huge shifts in the demand for commodities raising inflation readings across the globe. The continued disruption of global supply chains and aggressive central bank monetary policy actions all combined to create a perfect storm that propelled the markets lower. Higher interest rates took their toll on highly valued growth stocks and started curing many bubbles that developed due to excess liquidity and very easy money. The S&P 500 lost 18.2%, while more speculative tech stocks lost 32.5% as represented by the Nasdaq 100. Bitcoin was down 66.6%! even corporate bonds lost 17.7% while gold held up relatively well, only losing 0.8%. Our dividend growth strategy fared relatively well compared to the market.

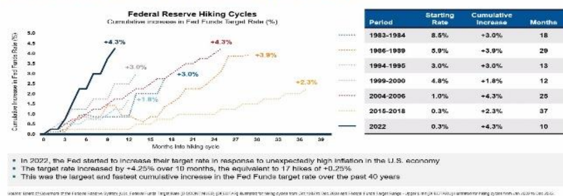
The Fed is laser focused on the tight jobs market as a key target in bringing inflation to heal. We feel strongly that the tight labor market conditions are not just a matter of cooling off the economy, but we must understand what is actually going on that is creating the shortage. Even after raising rates aggressively, unemployment levels remain stubbornly strong. There is a **riddle** to be solved here too and the Fed could be pushing on a string.

A recent economic release showed that 2022 was the second-best year on record in terms of raw job growth, behind only 2021. Virtually all the growth in the labor force between the end of 2008 (The Great Recession) and the start of the pandemic a decade later came from workers 55 and older who have now either retired due to covid concerns or are retiring now in droves due to their age.



Policymakers are in fact trying at best to manage the economy with limited, often out-of-date information and using imprecise tools. We have learnt to take a Wall Street maxim, "Don't fight the Fed" seriously and ignoring what they are saying and do, is acting at your own peril. Fed Chair Jerome Powell said at a speech in Jackson Hole on Aug 22, 2022 **"While higher interest rates, slower growth, and softer labor market conditions will bring down inflation, they will also bring some pain to households and businesses. These are the unfortunate costs of reducing inflation. But a failure to restore price stability would mean far greater pain."** He still provides little to no hope for those looking for signs that the Fed may be ending its tightening cycle soon. The last time that the Fed funds rate was at 4% was in 2008.

Much like when a submarine launches its torpedo's, it takes time for the Fed's actions to fully ripple through the economy, and they have launched an unprecedented amount (see chart below). Market experts, CEO's, economists, and the media are all predicting a mild recession in the latter half of the year. When it does happen, it will be the most telegraphed in history, but it's not at all guaranteed. While much of this has already been priced into the markets, a more severe recession is not.



Period	Starting Rate	Cumulative Increase	Months
1983-1984	8.5%	+3.0%	18
1986-1989	5.9%	+3.9%	29
1994-1995	3.0%	+3.0%	13
1999-2000	4.8%	+1.8%	12
2004-2006	1.0%	+4.3%	25
2015-2018	0.3%	+2.3%	37
2022	0.3%	+4.3%	10

- In 2022, the Fed started to increase their target rate in response to unexpectedly high inflation in the U.S. economy
- The target rate increased by +4.25% over 10 months, the equivalent to 17 hikes of +0.25%
- This was the largest and fastest cumulative increase in the Fed Funds target rate over the past 40 years

Most economists expect a **mild recession** later in the year as this is a monetary policy-induced recession instead of a recession driven by an overextended credit environment. This key distinction allows us to approach 2023 with caution, but also with a warning that it could get a lot worse if the Fed is intent on damaging the economy to kill inflation.

The economy is proving to be very resilient despite the Federal Reserve's efforts to deflate it. Tight labor markets are one of the key targets of the Federal Reserve, wanting to see unemployment go up, enough to cool higher wage demands, but not enough to cause mass unemployment. People who have lost jobs are still finding it very easy to replace them, even high-end technology employees report taking an average of only three months.

The average price of gas is back to where it started the year. The plunging cost of diesel fuel is a welcome expense cut for businesses in a wide range of industries. A worst-case hard landing has also become less likely, given consumer strength, persistent hiring demand in most industries and strong evidence that inflation has peaked

Rents were also part of this bubble. And now, look at the turnaround in rental prices (blue lines below). The Zillow and ApartmentList National surveys lead CPI/PCE official rent inflation by about a year.

While anyone in the prognostication business knows, if you are going to predict, predict often as things change. Everyone predicted an extremely tough winter for Europe. Currently, a combination of a warmer winter, robust gas imports from other suppliers, and ongoing buildout of wind and solar explain why Europe has surprisingly plentiful natural gas storage. On November 1, the traditional start of heating season, average EU gas storage stood at 95% of capacity. As of this week, it is 84%. It is also a remarkable that absolute gas stores are higher than they were one year ago.

A recent swift reversal of China's covid lock down policy is constructive for global markets.

Monetary policy will continue to be a key driver of stocks, bonds, the dollar, commodities, and the housing markets.

Investment managers and investors will need to adjust to certain shifts in paradigm. The next 10 years will unlikely be like the last.

- Globalization is evolving not ending but is being rationally reevaluated especially due to our dependence on China. Semiconductor and healthcare products are being moved back for strategic reasons.
- Banks are tightening lending standards, and some layoffs/hiring freezes are being announced which we think is prudent by most companies. (Particularly in the Tech sector).
- Interest rates will stay higher than before. The era of cheap money and extreme government stimulus is over due to already high debt levels. Based on studies, companies and stock market returns have been able to adapt fairly fast to a higher rate environment. Stock market 5-year returns were 12% p.a. even with interest rates in the 8-10% range second only to 12.1% with rates at 0 to 2%. It is important to remember that many companies don't need borrowings and furthermore generate cash, and pay dividends.
- Certain "bubble" stocks and manias will not come back. SPAC's, Crypto and EFT's etc. Most were created by the massive fiscal stimulus during Covid and the stay-at-home craze.
- Bond investors should see a better real rate environment going forward.

Investment Implications.

We expect to be more active and nimbler than normal to navigate events as the year unfolds.

While the Feds stance on fighting inflation are driving the market over the short-term, we continue to be focused on the fundamentals of our portfolio companies and their long-term compounding potential. In our view, equities are still the best long-term bet as they provide ownership in the innovation, skill and productivity of able management and workers.

A mild recession is also not the worst thing in the world. Like a good thunderstorm, it clears the air, weaker "plants" die, while new ones sprout roots and vibrant business continue to thrive while weaker competitors fall by the wayside. We believe a higher cost of capital will lead to fewer market entrants and less competition, which should benefit companies that have already establishes a valuable business brand, strong management team and a competitive "moat" position.

As companies see signs of a revenue slow down and higher operating expenses, they are starting to focus on cost cutting including reducing bloated headcounts – this is what you want to see from good management.

We continue to focus on high-quality dividend growers with pricing power regardless of the market backdrop. Among these our favorite areas are critical software services and the defense sector (especially for the government), quality assured health care companies that possess a strong pipeline of drugs and will be the beneficiary of an aging boomer population. Banks unlike 2008 are in good shape, well capitalized and will benefit from higher interest rates. The sharp compression in the valuation of higher-growth stocks has created opportunity to add some new names to the portfolio

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