Market Strategy
by STRATEGAS A BAIRD COMPANY

BAIRD
Private Wealth Management

Major Investment Themes for 2023

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Jason Trennert, Strategas
Chairman,
Chief Executive Officer,
Chief Investment Strategist

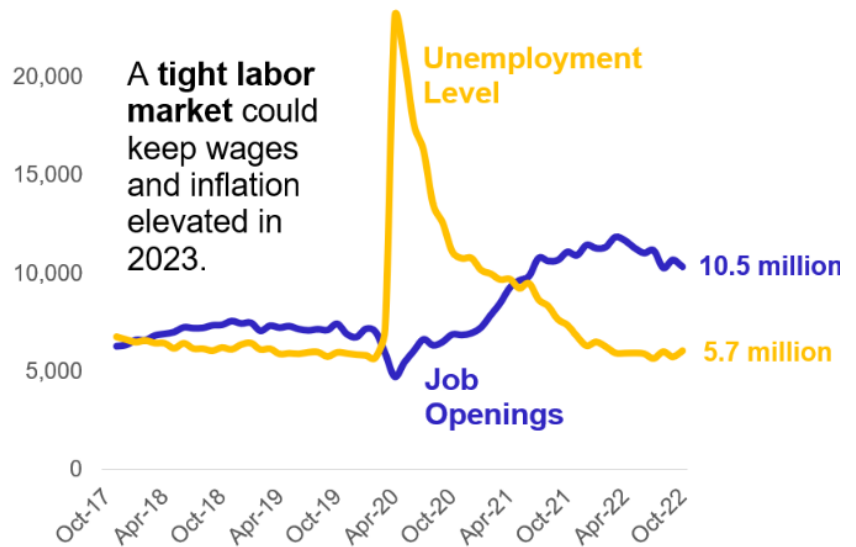
We believe eight key items will prove major themes for 2023: 1) pressure on earnings 2) sticky long-term interest rates, 3) fiscal spending constraints, 4) China reopens with a vengeance, 5) the Fed becomes a political target, 6) European energy policy shifts, 7) self-funding companies continue to outperform, and 8) cryptocurrency regulation emerges.

THEME #1: SIGNIFICANT PRESSURE ON PROFIT MARGINS AND CORPORATE PROFITS

As it stands today, consensus is forecasting 2023 corporate earnings will rise nearly 5%, but with sales growing only 2.5%. This, of course, implies an expansion in profit margins from already near-record levels, which we expect will prove difficult. A simple return to the long-term average profit margin of 11.6% from 12.4% would bring corporate profits from an expected level of $231 to $209 alone (to say nothing of a likely decline in sales growth). While it is possible for earnings to fall without the economy experiencing a recession, it has never worked the other way around. Earnings even fell during the high-inflation recessions of the 1970s. The biggest headwind for profit growth may simply be a continuation of tight labor markets that show nearly two job openings for every person without a job actively looking for work. **Since the Fed cannot control the supply of labor, their only tool would appear to be engineering a decline in the demand for labor by raising interest rates and depressing economic growth.** The average decline in earnings during recessions has been over 30%, while the median decline has been over 20%. We are forecasting a decline in S&P 500 operating earnings of about 10% to $200 per share.

THEME #2: LOWER INFLATION, STICKY LONG-TERM INTEREST RATES

With the year-over-year increase in inflation falling from 9.1% in June to 6.5% today, we would not quibble with the idea that inflation has likely peaked. By the same token, certain economic conditions still exist that lead us to believe that it will be difficult to reach the Fed's target of 2% anytime soon – labor markets are tight, 60% of the federal budget is indexed to inflation, the pace of globalization is slowing, and energy markets remain in disarray. **Our Chief Economist, Don Rissmiller, believes inflation will fall to the 3 – 4% range by the end of the year.** While that might take some pressure off the bond market, the global transition away from "Quantitative Easing" (the policy where central banks buy bonds on the open market to push yields down) will remove a significant source of demand for sovereign bonds. Profligate fiscal spending along with higher interest expenses will also contribute to a significant increase in debt issuance in the U.S. and abroad. Diminished confidence in central banking may lead investors to require a premium over the rate of inflation to lend others money, even for "risk free" government debt.

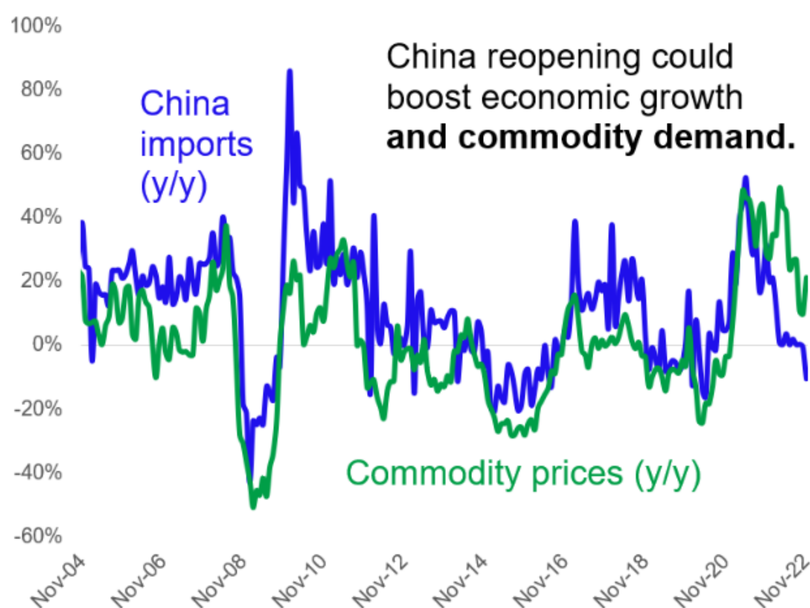


THEME #3: THE RE-EMERGENCE OF BOND MARKET VIGILANTES AND FISCAL POLICY CONSTRAINTS

Legend has it that James Carville, advisor to President Clinton, claimed that while he once dreamed of being reincarnated as a .400 hitter in the major leagues, it was only when he entered the arena in Washington that he wished he could be reborn as the bond market – because it scared everyone. Times, of course, have changed. More than 12 years of Quantitative Easing have divorced runaway government spending from its consequences on real people. That was, of course, until last year. **Last December's passage of a $1.7 trillion spending bill, along with other challenges in Washington, seems to indicate that only a crisis will provide the necessary motivation for elected officials to work within economic constraints.** The UK bond crisis last fall was the first shot across the bow for legislators who no longer can rely on the large safety net the world's central banks have so generously provided.

THEME #4: CHINA REOPENS WITH A VENGEANCE

Our simple observation of the world's second-largest economy since it joined the WTO in 2001 would suggest that the country is not particularly long on nuance; once it makes a decision, it seems to be all the way in, whether that's zero-Covid or reopening. In the years before the pandemic, it appeared as if China were on the verge of an economic crisis every three years or so; epitaphs would be written for the country's economy, only to see government policymakers use their vast currency reserves to inflate their economy further. And so it was, in a way, with China's approach to the pandemic. The country staked its national reputation that it alone could control the pandemic, only for President Xi to eventually conclude that its zero-COVID policy was both destructive and unsustainable. As much of China's population has not been able to gain any significant immunity to the virus and its home-grown vaccines have proved to be ineffective, it seems reasonable to assume that the economic situation in China will deteriorate in the short-term, perhaps creating new supply-chain issues.



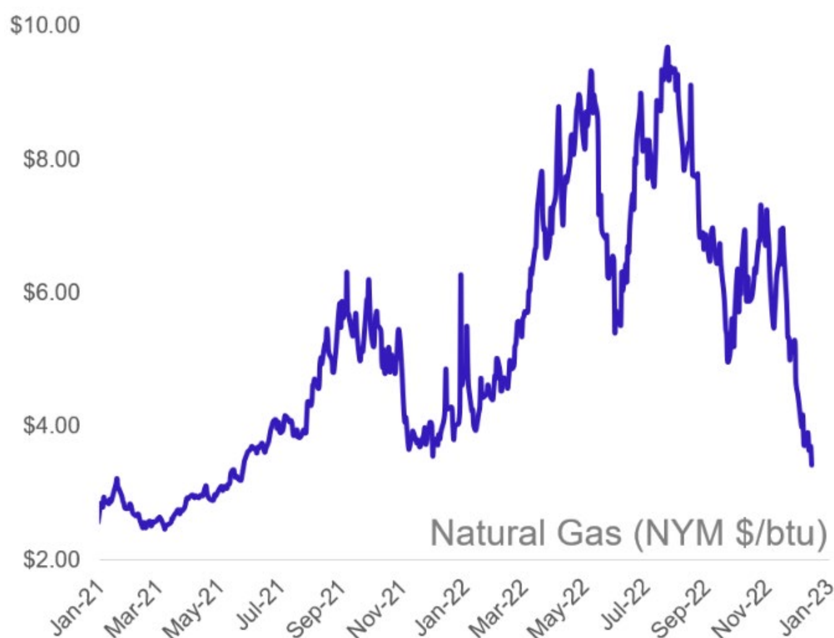
But once that process is over, it seems reasonable to assume that China will revert to type and go for growth. This is likely to have a significant impact on the prices of a variety of industrial commodities and could further complicate the Fed's job to get inflation under control.

THEME #5: THE FEDERAL RESERVE TURNS INTO A POLITICAL TARGET

Only with the benefit of time will we be able to understand why Chairman Powell wanted to be reappointed to head the central bank instead of, let's say, picking up pickleball in Naples, Florida. So far, the Chairman's reputation has emerged relatively unscathed in the eyes of the public. Inflation emerged as a top-three issue in last year's midterm elections and yet a survey of voters would suggest that most Republicans blamed higher prices on President Biden while most Democrats blamed Vladimir Putin. It is unlikely that the Fed itself will be so lucky this year. **Tightening monetary policy is one thing in the midst of a strong employment picture, but it becomes quite something else politically once people start losing jobs.** This is what makes Paul Volcker's accomplishments in the late 1970s and '80s all the more notable. Volcker was universally known to the public and, for a time, widely despised by both the left and the right for his efforts to control inflation. The unpleasant and difficult phase of Fed tightening will likely be upon us in 2023, and few politicians will be able to resist the urge to blame the Fed fully for the mess they had a hand in creating. Speculation about the possibility of a new Fed Chair is only likely to grow.

THEME #6: A MORE PRAGMATIC VIEW OF ENERGY POLICY IN EUROPE

Regardless of how noble a goal that transitioning the global economy to renewable energy may be, it would seem that 2022 provided a strong counterargument to those environmentalists who insisted on making transition before stable and robust sources of fossil fuels were established. **With few signs that the war in Ukraine is ending, it is not difficult to imagine that the world may split into spheres of influence based not necessarily on cultural values, but on access to sources of energy.** Despite the trillions of dollars spent to transition to renewable energy over the last several decades, consumption of coal reached an all-time high in 2022. Sadly, there are no reasonably inexpensive or reliable alternatives to fossil fuels for energy production today, and a rapid adoption of alternative sources of energy regardless of cost, carries with it significant economic, political, and geopolitical implications. Given this reality, it would not surprise us to see policymakers in Europe expand their use and definition of “green” energy initiatives to include nuclear and natural gas projects.



THEME #7: SELF-FUNDING COMPANIES CONTINUE TO OUTPERFORM

The days of being able to rely on the “kindness of strangers” to fund pre-cash flow or even pre-revenue companies appear to be over (dying at roughly the same time that year-over-year money supply growth peaked). The transition away from Quantitative Easing and towards tighter monetary policy represents a watershed event in which access to capital should revert back to being rationed by price. **Given our view that long-term interest rates will be stickier at higher levels than pre-Covid, we believe that shorter duration equities (stocks with more immediate cash flows) will continue to outperform in 2023.** Despite some of the massive losses in speculative stocks in 2022, there are still 8.6% of companies in the Russell 3000 (an index that seeks to approximate the entire U.S. stock market) that trade at more than 10x price-to-sales ratios, significantly higher than the long-term average of 5.3%. To the extent to which inflation remains somewhat sticky as well, it seems reasonable to expect dividends to make up a more significant portion of total return in the years to come.

THEME #8: A GREATER FEDERAL COMMITMENT TO CRYPTO REGULATION AND SEIGNIORAGE

At a Strategas conference several years ago, former Secretary of the Treasury Larry Summers described the widespread use of cryptocurrencies as a “libertarian utopia” that is “fundamentally not going to happen.” **It is not hard to understand why global policymakers hate competition for fiat currencies – they damage the ability of central bankers to conduct monetary policy and limit the ability of national treasuries to collect taxes.** Of course, if you throw enough lobbying money around, politicians are apt to forget the more inconvenient features of cryptocurrencies. Large losses in speculative schemes are apt to remind them, but the real reason that greater regulation of crypto is imminent is that a lack of discipline in fiscal policy will increasingly require governments to keep track of every dollar, euro, and yen. It is for this practical reason, rather than the principle of liberty, that it seems like a much better bet to expect the widespread use of central bank digital currencies (CBDCs) that crowd out the use of physical specie than a parallel currency that is beyond the greedy hand of the state.

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