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Q1 2023 Outlook

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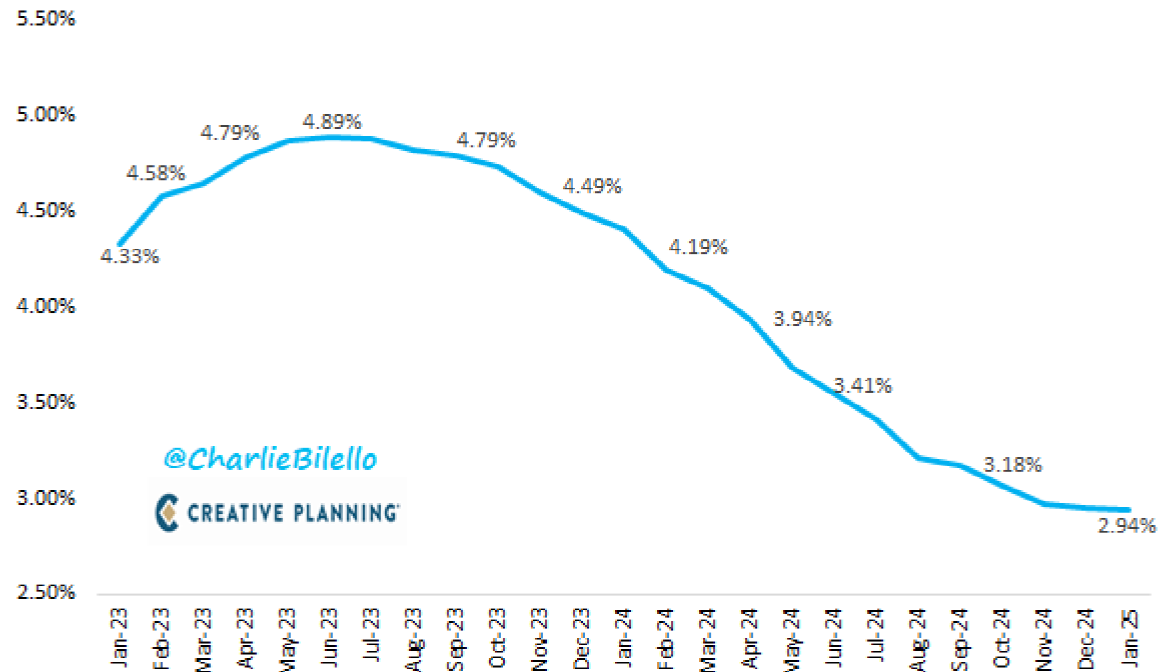
Economic Outlook

- Equity and Fixed Income markets ended the year lower as investors anticipated a Fed induced recession that has yet to materialize. After waiting too long to address inflationary concerns, the Federal Reserve took an aggressive posture to push rates higher to prevent inflation from getting unmanageable as it did in the 1970's. Coming into 2023, strategists see the Fed pushing rates up further in the first half of the year and then forced to cut in late 2023 or early 2024. As we have mentioned in previous updates, the forecasting track record of Wall Street strategists is abysmal. Even with such a poor track record, forecasts do serve a purpose. Forecasts give insight into the consensus view of what is being priced into markets. The challenge of forecasting is primarily from the number of variables that are constantly changing. For example, in 2022, the war in Ukraine was not heavily considered when forecasts came out in December of 2021.
- For 2023, the consensus view is that the effects of higher interest rates will reduce growth considerably with a better than even chance of a recession. The bookend views: 1) the Fed will over-tighten, and inflation will come down faster pushing the economy into a typical recession; and 2) higher rates will be around longer as the hot employment market will be hard to weaken, and the economy will avoid a recession. The first scenario is not too dissimilar to the consensus and markets are starting to price in lower rates in late 2023 and early 2024 as investors have increasing doubts that the Fed will keep rates higher in the face of a recession. The second scenario is not being priced in with any significant probability. While markets have adjusted to rates being higher, they have not adjusted to rates going higher and staying higher for very long.
- The following charts will give insight to where economic indicators are today and how the consensus could be wrong in one way or the other. We are long-term investors and do not put considerable weights into forecasts when building out our asset allocation. We do utilize the consensus to understand how markets may behave and adjust appropriately.

Rate Expectations

- Market expectation is for Fed Funds to be 50 bp's higher by June and then to be cut 25-50 bp's in the fourth quarter.
- After peaking in November, 2-year and 10-year U.S. Treasury yields have come down over 50 bp's.
- Market does not believe the Fed will hold rates higher for more than a quarter or two.



Source: @CharlieBilello

Coincident Indicators Have Not Turned Down

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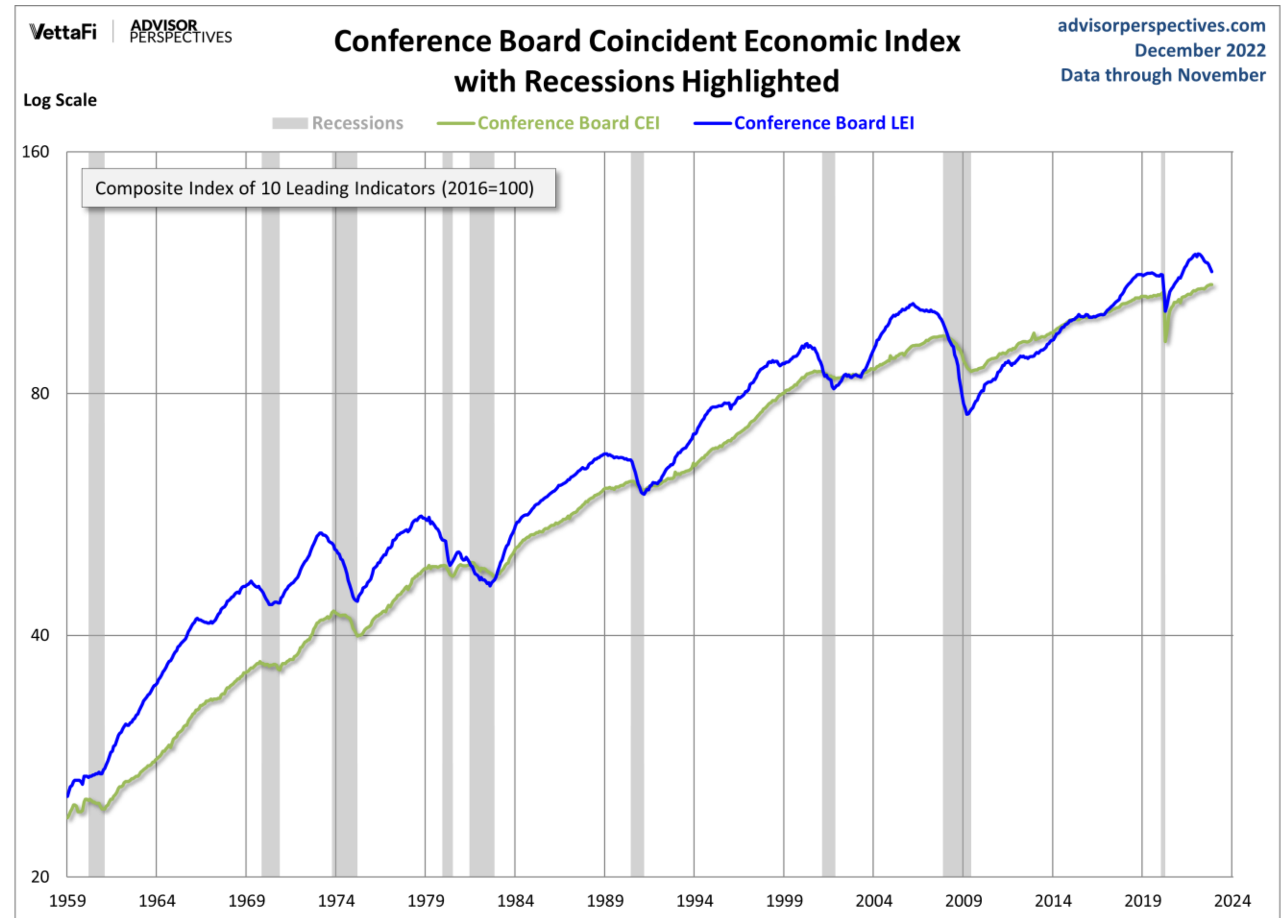
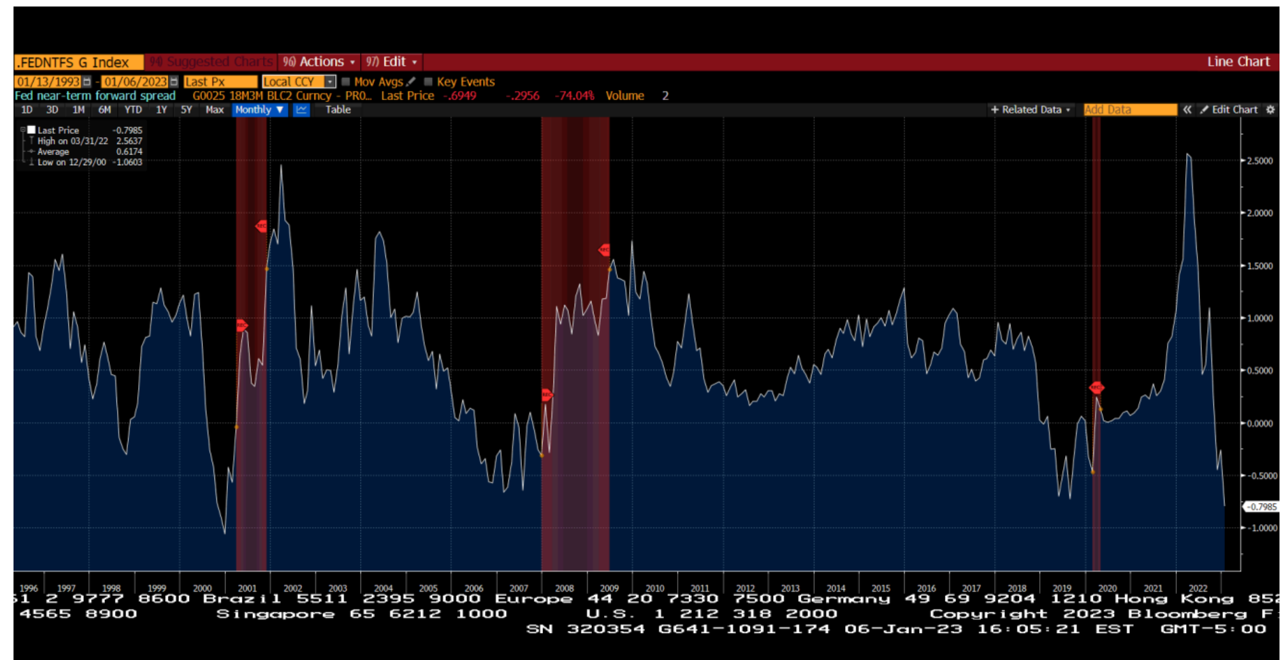
- While leading economic indicators continue to anticipate a recession, coincident indicators have not turned negative.
- Coincident indicators turn negative as a recession is underway. Leading indicators on average turn lower 7-10 months before the start of a recession.



Fed Near Term Forward Spread

- The most accurate yield curve finally inverted. The Fed Near Term Forward Spread measures the expected three-month Treasury yield eighteen months in the future minus the current three-month Treasury rate.
- Yield curves invert then steepen into a recession. No steepening yet.



Source: Bloomberg

Unemployment and Recessions

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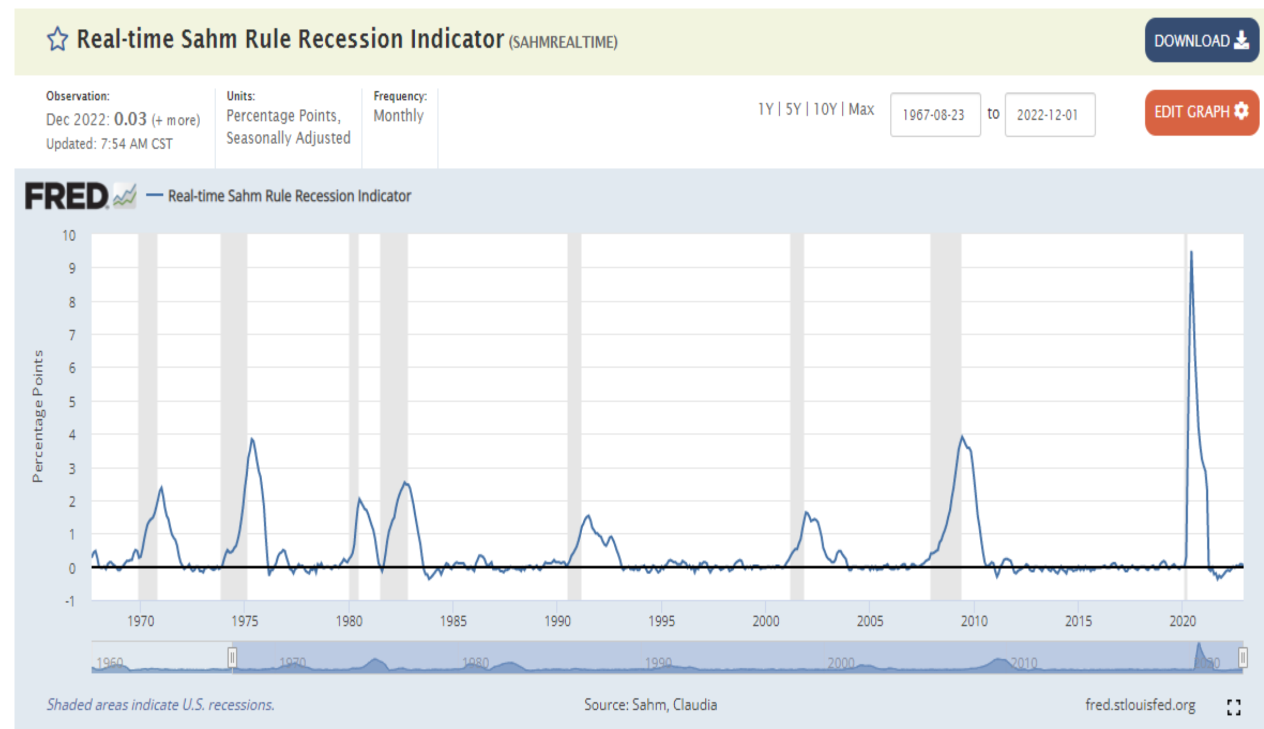
- The strong employment market continues to keep the economy from declining.
- The Sahm Rule is named for former Fed researcher Claudia Sahm. Here research shows that a recession typically starts after the unemployment rates rises .50% or more from its cycle low.
- Unemployment would need to rise to 4% before the Sahm Rule flashes that a recession has begun. Not there yet.



How Strong Will Employment Stay?

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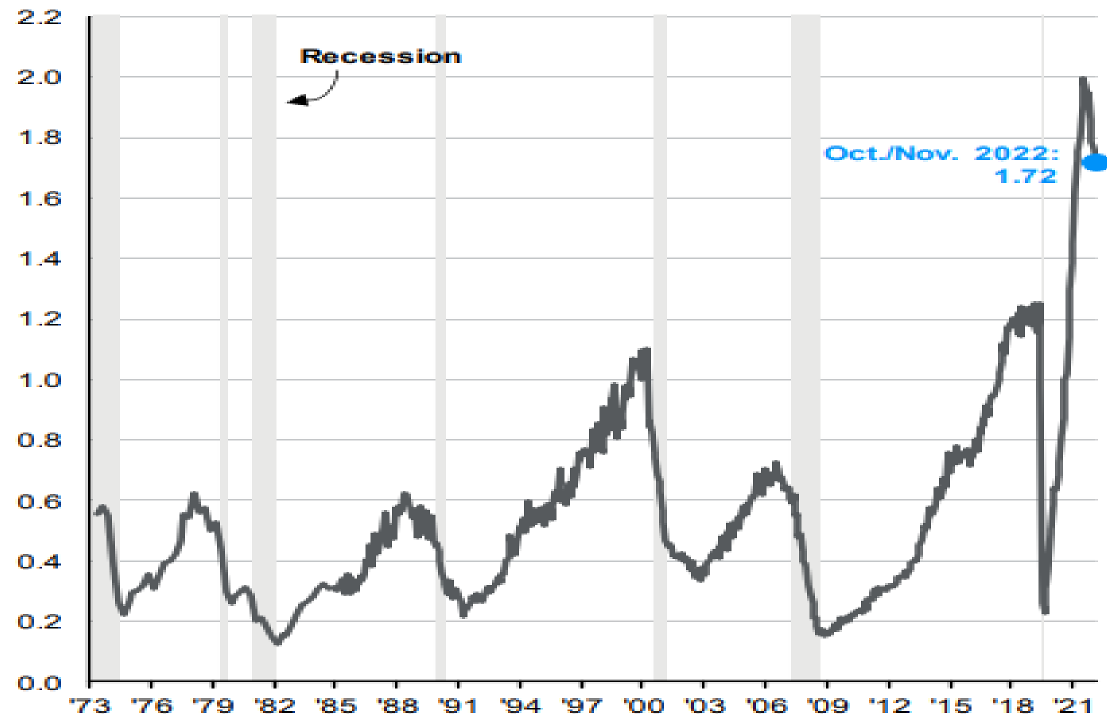
- The ratio of job openings to job seekers peaked significantly above levels we saw in previous cycles.
- While the ratio has come down from its peak it still indicates a tight labor market where wages can continue to move higher.



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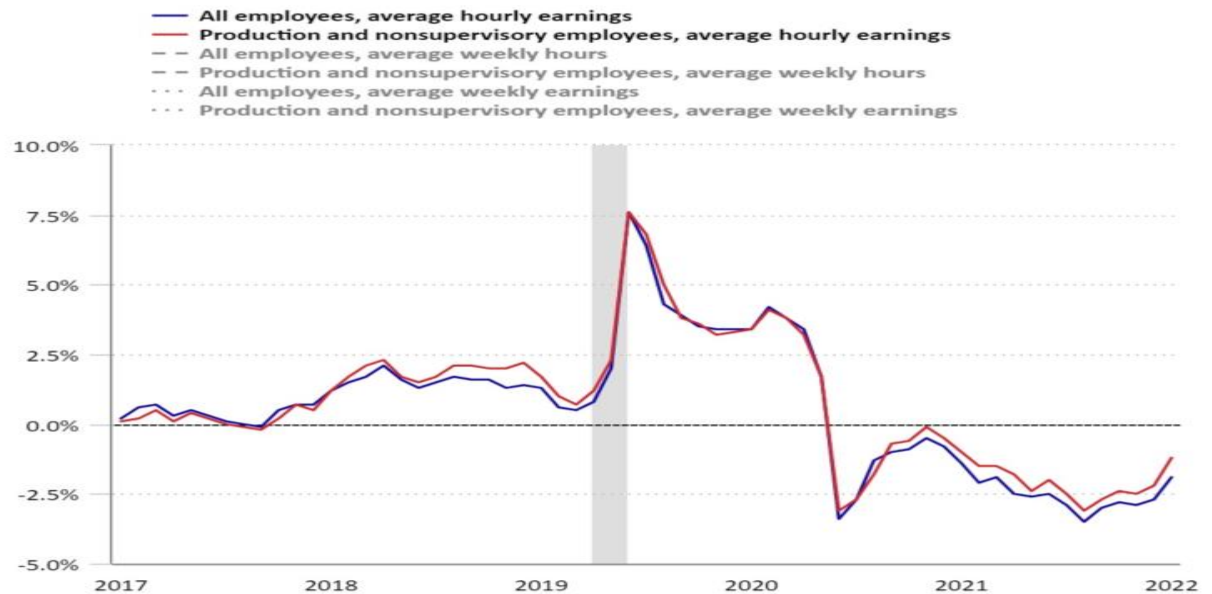
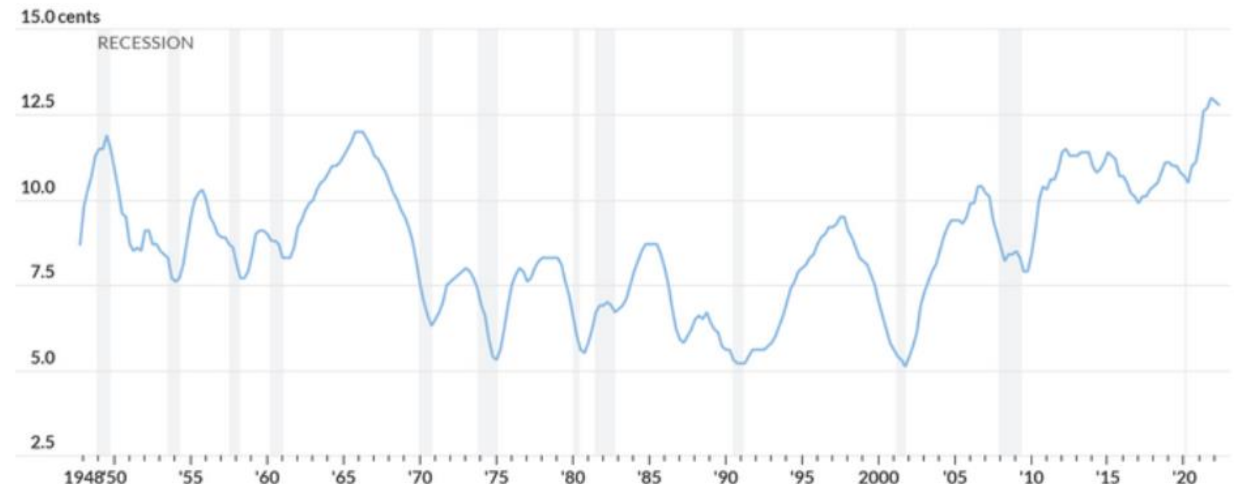
Wages Have Not Kept Up With Inflation

- While employment remains strong, average earnings have not kept up with inflation.
- The Fed is looking to prevent a wage spiral where workers demand and get increasing wages that push inflation higher for longer.



Profit Margins

- We saw equity valuations come down in 2022, but we continue to see earnings estimates for 2023 remain elevated.
- Corporate profits as a share of the economy have been at record levels, and have benefited from lower interest rates and lower tax rates.
- It is unlikely that profit margins stay at elevated levels, bringing into question the likelihood of earnings increasing as much as expected.



Earnings During a Recession

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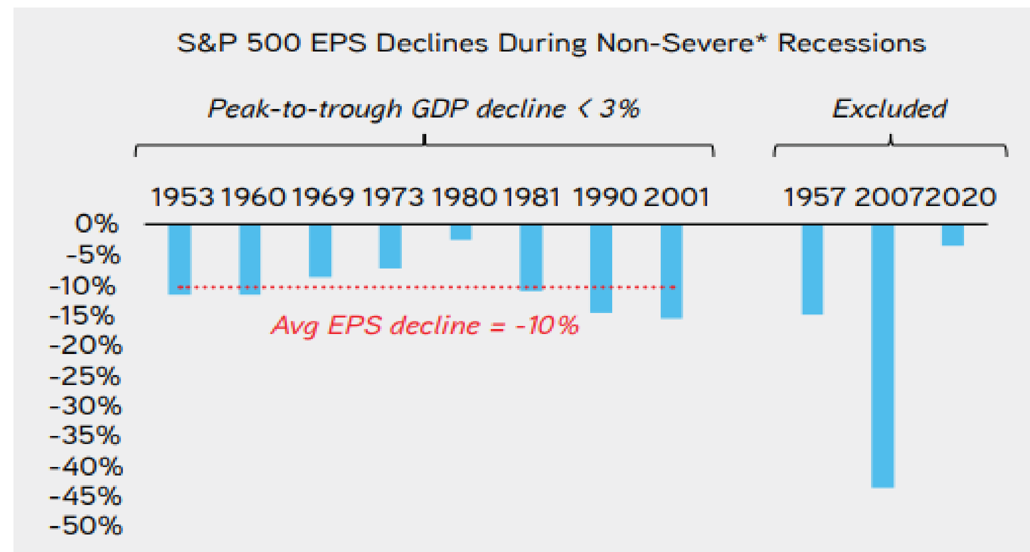
- Current estimates are for S&P 500 EPS to be up between 10%-15% for 2023.
- If history is precedent, then EPS will decline during a recession. Outside of major recessions, earnings decline on average about 10%.
- With inflation running higher than average, earnings can move higher as they are in nominal and not real terms.
- We expect to see continued volatility as markets adjust to where inflation settles and to what extent the economy slows.

Since World War II, Mild U.S. GDP Recessions Have On Average Resulted in About 10% Peak-to-Trough EPS Drawdowns



We define a mild U.S. recession as a peak-to-trough GDP decline of 3% or less. Data as at November 30, 2022. Source: Bloomberg, Haver Analytics, KKR Global Macro & Asset Allocation analysis.

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What To Own During A Slowdown/Recession

- As long-term investors, we know that market timing does not work. That doesn't mean that there are no adjustments that can be made to an equity allocation.
- Certain factors tend to perform better than others during an economic slowdown/recession.
- We have continued to move towards active managers who are quality oriented and take profitability into consideration.
- We have swapped small cap exposure from an index that is made up of all profitable companies.
- We have trimmed value and added to momentum.

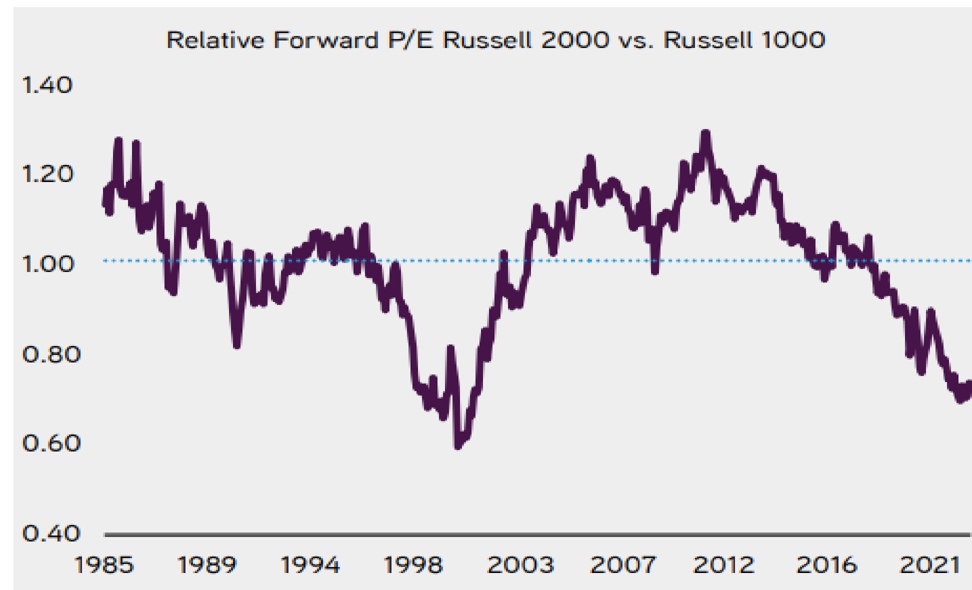
Factor Return Prospects over the Four Economic Stages, ending June 2020

	Recessions	Slowdowns	Recovery	Growth
Best	Profitability*	Momentum**	Market**	Momentum*
Performers	Low Beta	Profitability**	Size***	Market
	Investment	Low Beta	Value	Value
	Momentum	Value	Illiquidity	Profitability
	Illiquidity	Investment	Investment	Investment
	Value	Market	Momentum	Illiquidity
Worst	Size	Illiquidity*	Profitability	Size
Performers	Market**	Size***	Low Beta***	Low Beta

Note: Standard errors are adjusted for the correlation structure across region factors and across time by the double-clustering method of Cameron, Gelbach, and Miller (2011). ***, **, * indicate the statistical significance of the factor's return difference to the mean factor return in the economic stage at the 1%, 5%, and 10% level, respectively.
Source: Research Affiliates, LLC, using data from CRSP/Compustat and Worldscope/Datastream for strategy returns, and from OECD and FRED database of the Federal Reserve Bank of St. Louis. The data period for the United States begins in 1968, for other developed markets in 1989, and for emerging markets in 2002.

Small Cap vs. Large Cap

- U.S. large cap stocks, led by technology, have significantly outperformed small cap since 2012.
- We see opportunity in small cap, especially with active managers, over the next 2-3 years.
- Within our hedge fund strategies, we are looking to add to small cap long/short managers.



Data from 1985 through October 31, 2022. Source: Factset, BofA U.S. Equity and Quant Strategy.

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Market Positioning

- We have seen a tremendous benefit to holding alternative investments in a year like 2022.
- We continue to see value in overseas markets relative to large cap U.S.
- We continue to be focused on high quality Muni's and Corporates, while slightly increasing duration.

- **Equity**: Overseas markets cheaper relative to U.S. With the geopolitical environment and government incentives, we are looking at the industrial sector (Materials, Automation/Robotics, *etc*.), as well as adding to small cap exposure.
- **Fixed Income**: Have increased duration slightly as rates have increased. Continue to focus on highest quality within municipal and corporate bond allocation.
- **Hedge Funds**: Increase exposure to Absolute Return strategies that can benefit from rising rates and provide diversification away from equity and fixed income risk. Add small cap long/short managers.
- **Private Equity**: Focus on Small-Mid Buyout strategy, which is less frothy than Venture. Balance out smaller emerging managers with those that have persistent track records.

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Summary

Our crystal ball on where markets are going is just as hazy as most Wall Street firms. What we do have confidence in is our long-term investment approach which seeks to utilize market consensus to find areas that are priced inefficiently and to diversify risk to stay fully invested through market cycles. We see a high probability of the U.S. tipping into a recession and have added exposure to areas we believe will hold up better. Active management, quality balance sheets, and international equity exposure are areas that we have added to in our equity allocation. In fixed income, we have moved our duration target up slightly (5-6 year duration) and remain in high quality assets, not chasing high yield. In Alternatives, we continue to invest in quality small/mid buyout managers, while being selective in investing in growth and venture managers. Within hedge funds we benefited significantly from our global macro managers in 2022 and see opportunity in distressed and small cap long/short strategies in the next 2-3 years.

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Disclosures

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