2023 Capital Markets Outlook
January update
"What should we do next? Something good? Something bad? Bit of both?"

"Peter Quill aka Star-Lord"

Stanton & Castleton, Inc.
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Let's Review: A look at the world around us…

Opinions and Feelings are for traders…. Investors need results:

A new favorite fun film, Guardians of The Galaxy, ended with the hero musing on what adventures lay ahead:

""What should we do next? Something good? Something bad? Bit of both?"

This sums up our 2023 outlook for the markets and US economy. Though it's a bit cliché to say we may experience some up and down markets, it's the only reasonable expectation given the current economic climate and its main influencers. The largest influences we see for 2023 are interconnected to varying degrees. Let's address the "Big Four"; Inflation, Interest Rates, Energy and War, and examine how they may impact your 2023 portfolios.

Inflation:

Who hasn't heard the word inflation at least a thousand times this year? If you are fortunate enough to be 62 or older you will be receiving an 8.7% COLA (cost of living adjustment) in your social security checks in 2023. The younger demographic isn't quite as lucky. While price increases are to be expected each year, we have not seen such a dramatic increase in such a short period since 1980-81.

Some of our clients lived through that high inflation era. However, for most investors, this is a first exposure to how inflation can become more than just a word. As the initial shock passes, let us help reassure you away from the improbable risk of an economic system collapse and to the more probable recovery, with difficult solutions being more accepted in crisis. We see a recovery building in Q2-4 2023 as the factors causing inflation extremes are lessened (war, commodity shortages, excess liquidity via suppressed cost of capital, transfers).

Social Security Cost-Of-Living Adjustments

Year	COLA	Year	COLA	Year	COLA
1975	8.0	1995	2.6	2015	0.0
1976	6.4	1996	2.9	2016	0.3
1977	5.9	1997	2.1	2017	2.0
1978	6.5	1998	1.3	2018	2.8
1979	9.9	1999 [a]	2.5	2019	1.6
1980	14.3	2000	3.5	2020	1.3
1981	11.2	2001	2.6	2021	5.9
1982	7.4	2002	1.4	2022	8.7
1983	3.5	2003	2.1		
1984	3.5	2004	2.7		
1985	3.1	2005	4.1		
1986	1.3	2006	3.3		
1987	4.2	2007	2.3		
1988	4.0	2008	5.8		
1989	4.7	2009	0.0		
1990	5.4	2010	0.0		
1991	3.7	2011	3.6		
1992	3.0	2012	1.7		
1993	2.6	2013	1.5		
1994	2.8	2014	1.7		

[a] The COLA for December 1999 was originally determined as 2.4 percent based on CPIs published by the Bureau of Labor Statistics. Pursuant to Public Law 106-554, however, this COLA is effectively now 2.5 percent.

https://www.bls.gov/

Keeping it in perspective, inflation becomes less ominous but still a real concern. As we pointed out last time, the Federal Reserve began “taking the punch bowl away from the party” just over a year ago. Economies as large as the US are like an aircraft carrier turning in the ocean: it takes time and room. We see inflation trending towards a 2% FED target by end of 2023, as the FED rate increases take effect.

Interest Rates:

In March of 2022 the Federal Reserve began to raise interest rates to combat rising inflation. The first increase since the pandemic began was .25%. In the ensuing months we have seen five successive rate increases. The last four increases were .75% each. Historically, we have not seen such aggressive FED moves since the 1970’s and early 1980’s. If you were living through that period, you may remember the absolute peak Fed Funds Rate of over 20% in 1980-1981:

fed-funds-rate-historical-chart-2022-11-28-macrotrends

Which directly impacts all rates. Here is a Mortgage rate history:

Through November of 2022 the Federal Reserve has increased the FFR six times for a total of 3.75% after a two-year period of a 0 -.25% target.

2022 Fed Rate Hikes: Taming Inflation

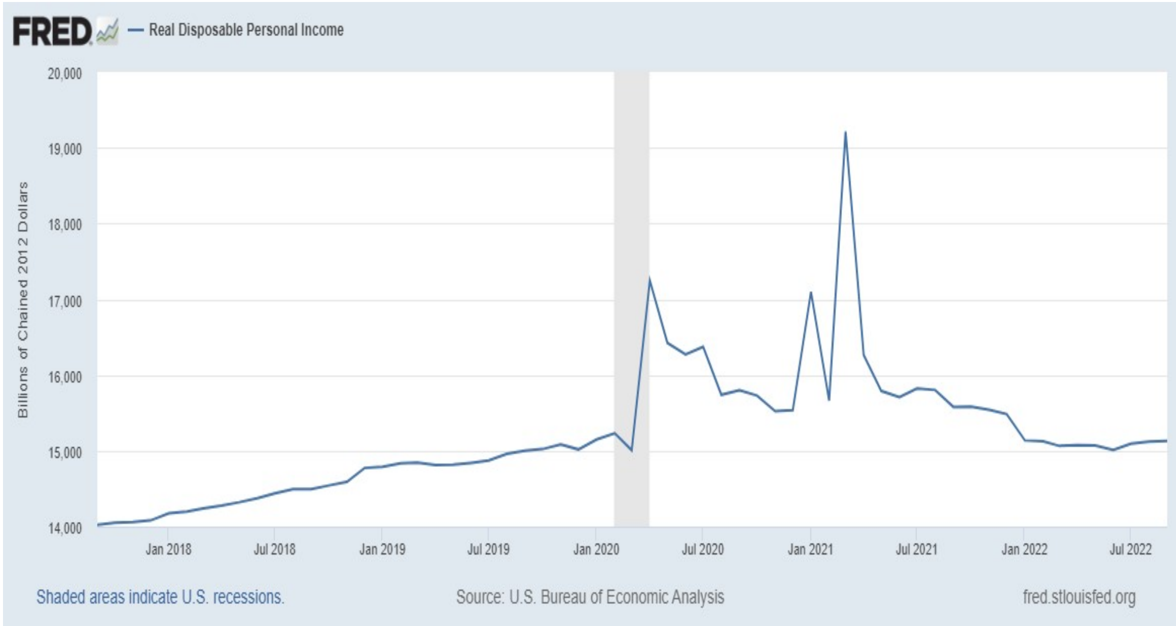
FOMC Meeting Date	Rate Change (bps)	Federal Funds Rate
Nov 2, 2022	+75	3.75% to 4.00%
Sept 21, 2022	+75	3.00% to 3.25%
July 27, 2022	+75	2.25% to 2.5%
June 16, 2022	+75	1.5% to 1.75%
May 5, 2022	+50	0.75% to 1.00%
March 17, 2022	+25	0.25% to 0.50%

https://www.forbes.com/advisor/investing/fed-funds-rate-history/

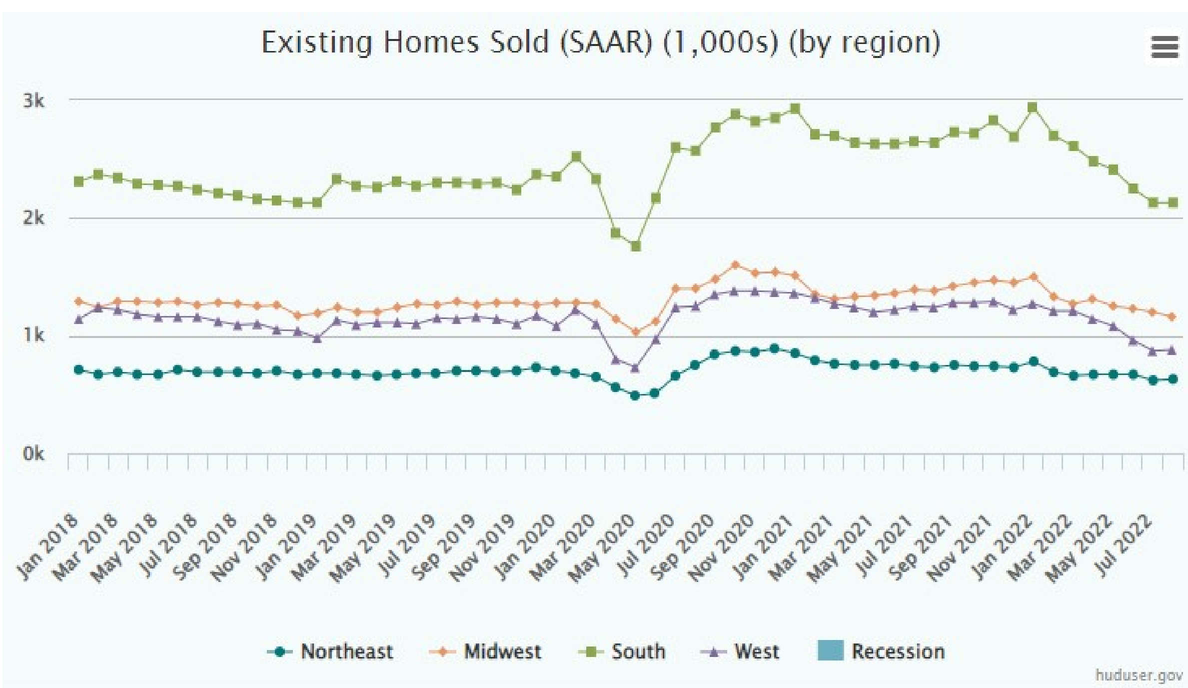
Recent minutes of the FMOC meeting may indicate the Federal Reserve will lessen the pace of rate increases to .5% increments. However, more rate hikes are likely. We currently think we could see an increase to 5-5.5% overall by early 2023. If this occurs, we feel that may be the maximum rate before the FED turns neutral. The FED understands that rate increases have a lagging impact on the economy and are working not to overshoot the level of rate increase needed to reduce the inflation trend back to a 2% target level. This is the subjective "art-form" in monetary policy. At times these actions can be one of the catalysts for a recession, especially during periods of greater global strains. While we may have been in or entering a mild recession (depends on who you ask) we believe the FED's actions have weighed this risk but feel inflation to be the greater long-term risk to our economy.

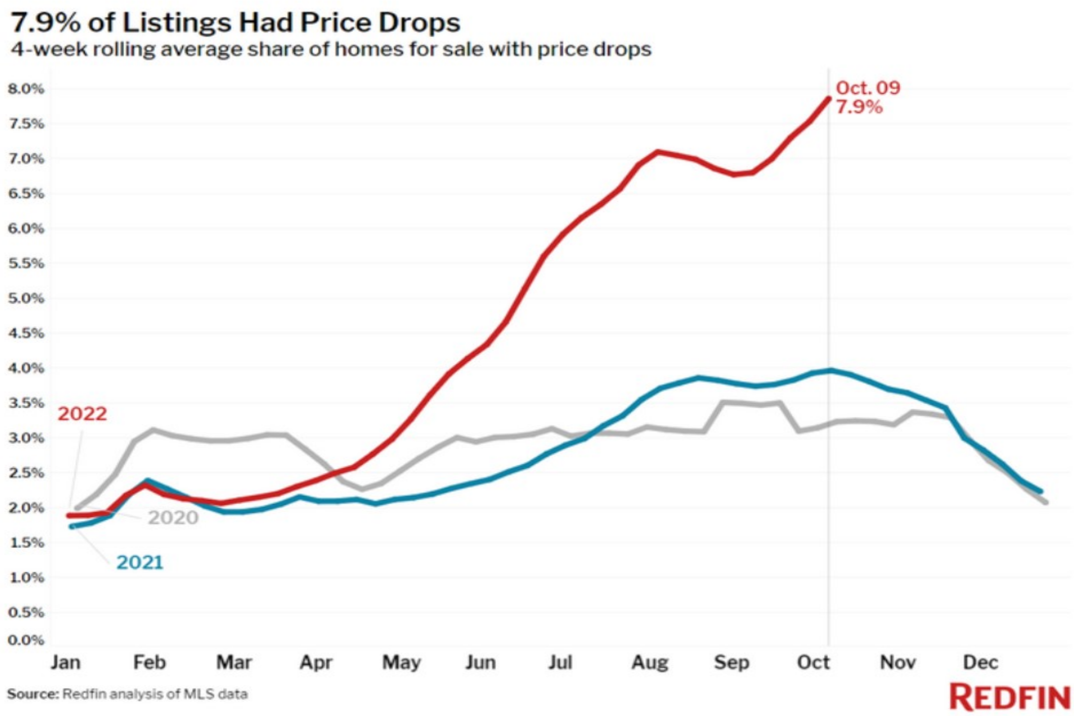
(On 12/14/2022 the Federal Reserve raised the Fed Funds Rate ½% to 4.25%-4.5%)

While painful, we currently feel the effects of higher rates will cool the economy and lead to lower price levels as consumers become more selective in spending due to income levels negatively impacted by inflation.



We can see a dramatic fall in disposable personal income as we return to the pe-pandemic trend. The surge in savings and real disposable income from direct government transfers, payment obligation deferrals and 0% interest rates has ended. Our economy, and particularly consumers, are returning to more normal spending and savings rates. This adjustment to higher costs and lower disposable income has historically helped alleviate the inflation pressures. The impact of such dramatic rate increases in such a short time are at first delayed and then felt seemingly all at once. We are seeing this most notably in the real estate market as home prices cool and demand declines dramatically.

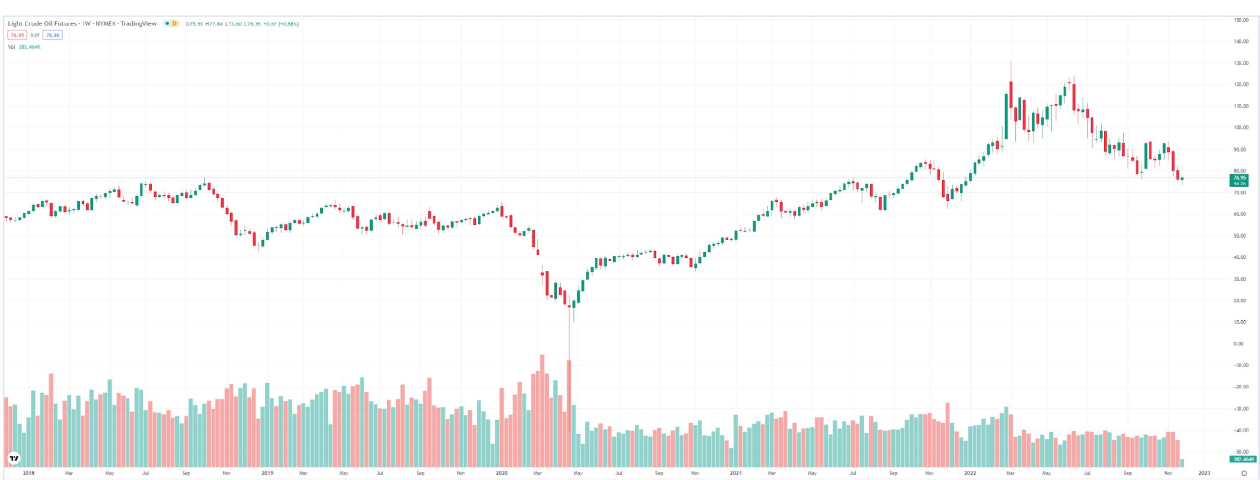




The good news is that as homes become more affordable and rates reverse the current trend, we will have the seeds for an economic recovery. Our prediction is that by the second half of 2023 we will begin to see this in some markets after the FED reins in inflation.

Energy:

At the beginning of 2022 we had felt the oil sector prices were nearing a top. However, oil companies enjoyed the higher earnings a while longer. On the heels of a global slowdown, we are now beginning to see energy decline as demand falters. The five-year chart below seems to reflect this:



https://www.tradingview.com/chart/?symbol=CL1%21

With oil in all its forms so essential to both production and transportation of goods, services and people it is clear the recent price declines (over 37% since the $120 barrel highs in Q2 2022) to below $75 should have a favorable impact on inflation. These price moves take time to work their way through the economy. We are still feeling the effects of $120 a barrel oil on products and services. However, the lower costs today should help profit margins next year and in turn allow for price declines to gain market share while holding margins in line. In effect, producers will pass on some savings to consumers as they compete for market share. This dynamic has been played out many times in the past and we once again see the potential for it to take hold in 2023 as the global economies recover.

War:

We are not versed on war. However, we have read and observed history. The current conflict in Eastern Europe is entering a difficult period as winter approaches. It is clear to us that for all parties involved, both directly and indirectly, some meaningful discussion between Russia and Ukraine must begin soon to avoid a horrible toll on the people of Ukraine. The costs to both Russia and Ukraine as well as the neighboring countries could escalate dramatically in the coming months. Although there is no way to be one hundred percent certain, history suggests the hopeful view that some humanitarian armistice is likely to take place in the next few months. Historically, people will often find a way to resolve the conflict because the alternative is too costly for all parties involved.

If the war escalates, we see the toll most felt in Europe and would likely slow the pace and strength of any recovery in the US. Clearly if the US were to become more directly involved market behavior and general economic conditions could be negatively impacted. We manage extremes thru portfolio design and diversification.

Should the war come to an end the table will be set for the global economy to begin to rebuild positive momentum. That is our hope and prediction for 2023.

Staying diligent, gathering information, updating our data, and having a process for risk management enables us to adjust as economic conditions change. We continue to be on the job and expect to come out of this current economic climate on top.

“In the end, how your investments behave is much less important than how you behave.”

Benjamin Graham
The Intelligent Investor