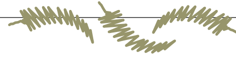


MARKET COMMENTARY **January, 2023**

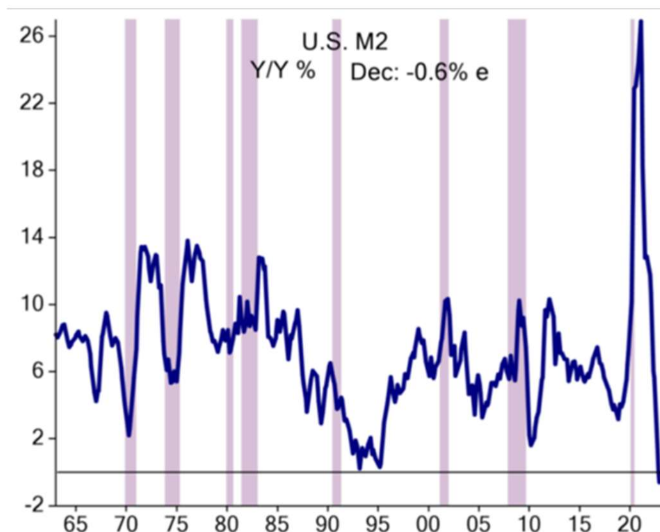
The S&P 500 fell almost 20% in 2022, the worst year for stocks since 2008, and was down 25% at its October bottom. It was not all bad news in the fourth quarter, however, as stocks rallied higher from the October lows as inflation began to decelerate, bond yields stabilized and moved lower and the dollar declined. The big question for 2023 is whether the U.S. economy experiences a soft landing or a hard landing. A mild recession or slowdown is positive for equities versus a severe recession which is positive for treasury bonds but not the stock market.

Central Bank Policy at Work

The seeds for a better market are being sown. In 2022 we saw the Fed embark on the fastest and most aggressive central bank tightening in modern history, and the world's other central banks eventually followed. We believe the Fed is almost ninety percent through its rate hike cycle and could pause by the end of the first quarter. And after a 25% correction stocks are much more attractively valued.

To give some perspective, in 2021, in the wake of the coronavirus pandemic we had an epic peak of monetary and fiscal stimulus marked by zero to negative interest rates and unprecedented liquidity that led to overspending, over hiring, and over investing and outright speculation by both consumers and businesses. Monetary theory postulates that the general price level for goods and services is proportional to the amount of money in circulation. An almost 30% surge in money supply (M2) in 2021 in response to the coronavirus pandemic largely explains why inflation took off in 2022. The equally unprecedented plunge in money growth in 2022 helps explain why it is now slowing significantly and is likely to continue to decelerate. Falling money supply is a good sign for future inflation.

MONEY SUPPLY GROWTH



Source: Evercore ISI

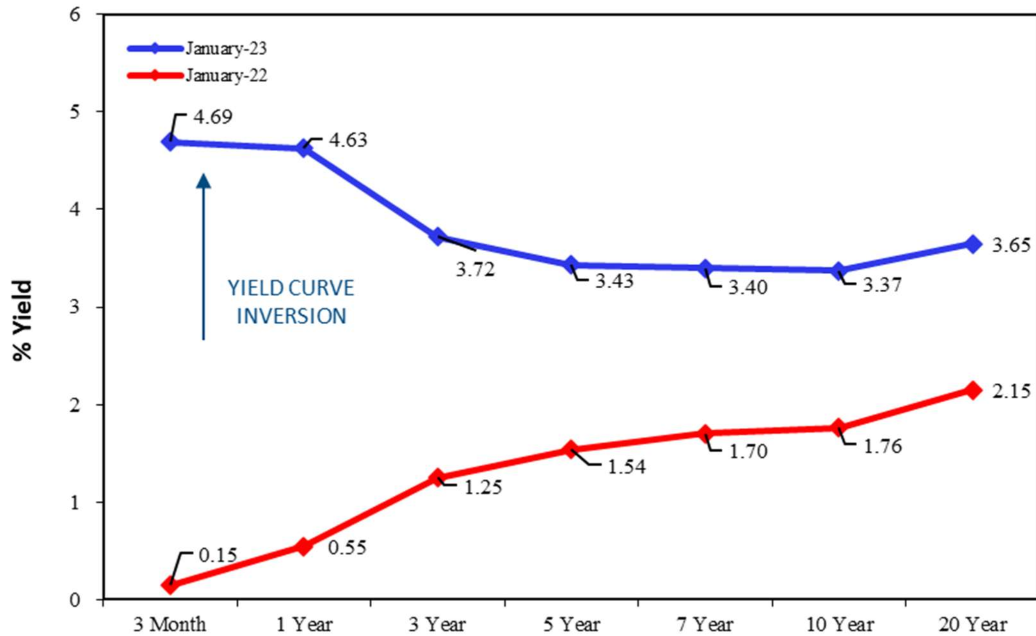
A Soft Landing Relies on Global Economy and a Pragmatic Fed

The US economy is already slowing but it is hard to have a severe recession when consumers still have generally strong balance sheets, big corporations have strong balance sheets and low debt, and our banks remain well capitalized and in good shape by most measures and the envy of the rest of the world. Another positive development for markets is China finally reopening its economy. This is a big deal for the global economy and could keep us out of global recession. It is also very significant for big international companies that comprise most of the S&P 500. The war in Ukraine remains a wild card. The European economy, after much initial gloom, has held up surprisingly well. An end to the war would obviously provide a big boost. The global economy and supply chains have adjusted to the war, but things could get worse before they get better. Putin and Russia are in a tough predicament and, like a cornered animal, remain dangerous and unpredictable.

Source: Evercore ISI

If the Fed tightens past 5%, we are going to have a recession. If not, and they stop after March, GDP growth of a half-percent to 1% plus is achievable, corporate profits will be up, not down, and stocks are attractively valued.

We believe the Fed has already done enough and risks a recession should it continue to tighten past the first quarter. Longer term interest rates have declined significantly over the past 3 months, with the 10-year Treasury bond yield down from over 4% to 3.4%, even while short rates continue to rise. The traditional yield curve (10 Year – Fed Funds rate) is now inverted by more than 100 basis points. This is the widest inversion in 25 years and harks back to the period of the 1980s when Paul Volker was Fed chair and Ronald Reagan in the White House. According to the San Francisco Fed's analysis, fed funds adjusted for QT (The Fed is reducing its balance sheet by roughly $1T per year) are already up to 6.5%. So based on the QT-adjusted fed funds rate, the yield curve is massively inverted. Historically, the Fed has paused and stopped increasing rates when the yield curve decisively inverts.



In this situation, bad economic news is good news for the stock market. Monetary policy leads by one-to-two years so continued declining inflation and slow growth are almost inevitable and self-reinforcing. Employment is a lagging but highly Fed motivating economic indicator, and wages and employment still remain relatively strong. The sooner the labor market weakens the sooner the Fed can pause and even consider second half rate cuts if necessary. Employment weakness becomes good news and key to avoiding a fed tightening recession. We are already starting to see layoffs and restructuring in the technology sector. The technology sector was the center of excessive spending and hiring in the 2021 boom times, and according to the WSJ, tech employers have cut 195,000 jobs since the Fed started to raise rates last year and more than 55,000 global tech workers have been laid off in the first few weeks of 2023.

Market Strategy: ***Return of American Industrials and Fundamental Investing***

In terms of the markets, we are in an environment that is less speculative and favors a balance of profitability, value and growth. The magic money tree is over. The days of investors chasing growth at almost any price are gone for the foreseeable future. Companies that got way over extended in the 2020-2021 global liquidity bubble must quickly adjust to a new reality, sharply reduce costs and focus investments. Leading companies in traditional prosaic market sectors like Industrials, Materials, Energy, Consumer Staples and large cap Health Care have learned over the years to be good stewards of capital and developed highly productive and cost-effective operating models. Disciplined capital spending and balancing the allocation of free cash flow between reinvestment and returning money to shareholders through dividends and share buybacks is highly valued in the current environment and likely to stay so for some time. Our Cypress portfolios are well positioned with global industry leaders across these favored sectors and they provide a strong foundation for sustainable long term returns in a difficult environment.

While the Technology and Communications Services sectors of the market may generally continue to struggle until they bring costs and spending under control, it is important not to paint with too broad a brush. The U.S. semiconductor industry is a global powerhouse and technology leader of arguably the

most important industry in the modern world. These are proven companies with decades long track records and productive and profitable business models that more closely resemble modern age industrials than glamorous tech stocks. We have been successful long-term investors in this area for more than 25 years through many economic and market cycles. Semiconductor and electronics remain a key long-term bet in our portfolio and we believe will handsomely reward our clients well into the future.

In the same vein, one of the reasons Apple's stock has thus far held up much better than its technology peers is its history as not only a software company with a unique software operating system but as a leading manufacturer of high end computers, phones and consumer electronic devices. Apple is conservative in its management and capital deployment, and it remained so relative to its peers during the pandemic boom. We believe it is particularly well positioned in the current environment and it continues to be a core long-term investment.

Finally, we would note that U.S. Industrials should see a long-term boost from the onshoring of manufacturing and production and the trend away from further globalization and outsourcing of supply. Over the past few years, we have learned the enormous cost of the decline in domestic manufacturing and loss of control over our supply chains. There is increasing agreement in a divided U.S. that we must no longer outsource the production and assembly of the basic things we need. In the new 21st century geopolitical environment even if it costs more we cannot rely on others for the physical things (from chips and electronics to steel and specialty materials and metals to medicine and pharmaceutical ingredients) or the skills that are vital to our security, prosperity, and health. Best case, we ultimately see a renaissance in American manufacturing and production that could transform our economy and workforce. Even if we don't fully get there this trend is the future.

Global Economic Outlook & S&P Earnings - January 2023

Global Economic Outlook & S&P Earnings - December 2022 (S&P 500 @ 3,840)	2016	2017	2018	2019	2020	2021	2022	2023e
Global Real GDP Growth (y/y rate)	3.0%	*3.7%*	3.8%	3.1%	-3.2%	5.9%	**3.1%**	***2.2%***
U.S.	1.6	*2.3*	2.9	2.3	-3.0	5.8	**1.7**	***0.5***
Euro Area	1.8	*2.4*	1.9	1.2	-6.1	5.2	**3.3**	***0.3***
Japan	1.0	*1.8*	0.3	0.7	-4.3	2.2	**1.5**	***1.0***
Developing Asia	6.2	*6.4*	6.1	5.2	-1.1	6.8	**4.0**	***5.0***
China	6.7	*6.8*	6.8	6.1	2.2	7.9	**3.0**	***5.2***
Latin America	-1.2	*1.2*	1.7	0.8	-6.2	6.8	**3.7**	***1.0***
Emerging Market & Developing Economies	4.1	*4.7*	4.7	3.7	-1.5	6.7	**3.5**	***3.7***
S&P 500 Aggregate EPS	118	*131*	162	165	140	218	**220**	***215***
Earnings (y/y rate)	0.9%	*11.0%*	*23.7%*	1.9%	-15.2%	55.7%	0.9%	-2.3%
PE Ratio (December 2022 price @ 3,840)			15.5	19.6	26.8	21.9	17.5	*18.0*

Sources: IMF, ISI Group, BAML