Economic Forecast Webinar
17 February, 2023
Economic Forecast Poll

The US Economy in the Next 12 Months:

1) Recession (GDP declines 2 qtrs)
2) Soft Landing (GDP slightly positive for 2 qtrs)
3) No Landing (GDP grows at or above long-term trend)
Commodities were the only positive asset class for 2022
Be Humble When Forecasting!

"Forecasting is difficult, especially when it’s about the future."
— Niels Bohr, Nobel Prize-winning Physicist (1885-1962)
(Popularized by Yogi Berra)

2023 Ahead: Proceed with Caution!
Many Headwinds Today

1) Global Growth Mixed Bag
   a) From Globalization to Regionalization
   b) Impact of China’s return to normal
   c) Will Europe and U.S. avoid recession?

2) U.S. De-Levering
   a) Fed policy, balance sheet unwinding
   b) Fiscal stimulus (ending?)
   c) Debt Ceiling Crisis

3) Inflation
   a) Has eased but..
   b) Will it persist and stay above Fed 2% target?
Some Recent Humbling Examples

One Example: February 2022

“U.S. economy is expected to continue to expand at an above-trend pace [of 4%] in 2022”

Actual ’22 growth was below trend, 2%

..And another: Jerome Powell (July ’21)

“Some inflation, but it’s transitory”

Source: Kansas City Fed, BEA, Feb, 2022
Kansas City Fed’s Current View

Kansas City Fed Forecast slowing economy ’22-’23

World Bank GDP forecast for ‘23
• US +0.5%
• Global +1.7%

Will the widely-anticipated soft landing be achieved?

Source: Kansas City Fed, BEA, Jan, 2023
In fall of 2007, the Fed and others were calling for a soft landing.
Will Global Economy Achieve Soft Landing?

Global leading indicators signal a likely further slowing in global GDP

Global GDP is available on a quarterly basis, while the LEI is available on a monthly basis; Global GDP is aggregated using weights based on nominal GDP converted using purchasing power parities; Shaded areas represent global recessions as defined by the World Bank and IMF, with the monthly dating derived from The Conference Board Global Business Cycle Chronology.

Source: The Conference Board • Created with Datawrapper

• Leading Indicators currently pointing to a recession in ‘23
• LEI has not been wrong in over 40 yrs…
• Only time will tell of course
• In meantime, as always, stick with a data-driven decision-making process!
What is Fed saying about Inflation?

A History of Inflation

Will Inflation persist?

Inflation expected higher than Fed target, 2.0%....

Until 2025!

Source: FRED
Rates Higher for Longer?

- FOMC expects Fed Funds to decline rapidly 2nd half ’23
- And the market agrees
- So, bond market is pricing in certain recession, right?
- NOT necessarily!
- Why?
- Because the neutral Fed Funds Rate = 3% (per Jeremy Siegel)
- So Fed still restrictive through 2024!

Source: Kansas City Fed
What Does All This Mean for Markets?

…Depends on Drivers of Market Returns

1) Global Economy and Interest Rates
2) Corporate Profits
3) Asset Valuation Levels
Corporate Earnings Slowing

Markets had predicted *Strong* earnings growth for 2022

Avg EPS decline during recessions: -30%

* Time-weighted average of consensus estimates for current year and next year. Note: Shaded areas are recessions according to the National Bureau of Economic Research. Source: I/B/E/S data by Refinitiv and Standard & Poor’s.
P/E for Large/Mid/Small Cap Stocks

- P/Es improving following 2022 market declines
- Small/Mid cap stocks relatively cheaper vs large cap stocks
- Shiller S&P500 CAPE still relatively high vs history

Source: Yardeni Research Inc
Mighty Swings in Growth vs Value Performance

Relative Performance of Growth Stocks vs Value Stocks

Source: yardeni.com.
International Equity Valuations

International stocks are currently on sale.
International Equities Due to Outperform?

MSCI EAFE and MSCI USA relative performance
U.S. dollar, total return, cumulative outperformance*

-50% 0% 50% 100% 150% 200% 250% 300% 350% 400%
'71 '74 '77 '80 '83 '86 '89 '92 '95 '98 '01 '04 '07 '10 '13 '16 '19 '22

"Diversification is the only free lunch in investing"
— Harry Markowitz, Nobel Laureate in Economic Sciences**

“Asset allocation policy is by far the most important investment decision.” *
— Roger Ibbotson

** Source: https://caia.org/blog/2020/08/06/putting-2020-into-perspective-diversification-may-work-better-than-you-think


2) Invest for the Long-Haul
This is (Humble) Diversification

Global Diversified Portfolio

Uses major global asset classes:
- Stocks
- Bonds
- Real Assets

Publicly traded, liquid assets

Hypothetical Global Diversified Portfolio
60% Riskier Assets / 40% Safer Assets

- BarCap US Agg 25%
- BarCap Glb Agg 15%
- BarCap EM Bond 6%
- BarCap Global HY 6%
- MSCI EM 5%
- EAFE 5%
- S&P500 25%
- US REIT 7%
- Gold 6%

Hypothetical portfolio only. Whenever you invest, you are at risk of loss of principal as the market fluctuates. Past performance is not indicative of future results. Purchases are subject to suitability. This requires a review of an investor’s objective, risk tolerance, and time horizons. Investing always involves risk and possible loss of capital.
Global Diversification: LT Performance

Source: Author analysis, data from Bloomberg. Returns shown are annual total returns for various indexes and do not represent any actual Vesteer portfolio or strategy. The results are hypothetical, and are NOT an indicator of future results and do NOT represent returns that any investor actually attained. Indexes are unmanaged, do not reflect management or trading fees, and one cannot invest directly in an index. Whenever you invest, you are at risk of loss of principal as the market fluctuates. Past performance is not indicative of future results. Purchases are subject to suitability. This requires a review of an investor's objective, risk tolerance, and time horizons. Investing always involves risk and possible loss of capital.

### Risk and Return Comparison
Jan 1994-Dec 2022

<table>
<thead>
<tr>
<th></th>
<th>60/40 Stock/Bond</th>
<th>Global Diversified Port</th>
</tr>
</thead>
<tbody>
<tr>
<td>Avg Annual Return</td>
<td>6.7%</td>
<td>7.0%</td>
</tr>
<tr>
<td>Standard Dev Return (ann)</td>
<td>9.3%</td>
<td>8.1%</td>
</tr>
<tr>
<td>Sharpe Ratio</td>
<td>0.55</td>
<td>0.69</td>
</tr>
</tbody>
</table>

### Growth of $1
Jan 1994-Dec 2022

- **60/40 Stock/Bond**
- **Global Diversified Portfolio**
Global Diversification May Help Soften the Blows

Annualized Portfolio Returns Comparison
30 Yrs (Jan 1994 - Dec 2022)

Global Diversified Port
60/40 Stock/Bond
Gold
US REIT
BarCap Global HY
BarCap EM Bond
BarCap Glb Agg
BarCap US Agg
FAIF
MSCI EM
S&P500

Global Portfolio Drawdowns vs Stocks

Source: Author analysis, data from Bloomberg. Returns shown are annual total returns for various indexes and do not represent any actual Vesteer portfolio or strategy. The results are hypothetical, and are NOT an indicator of future results and do NOT represent returns that any investor actually attained. Indexes are unmanaged, do not reflect management or trading fees, and one cannot invest directly in an index. Whenever you invest, you are at risk of loss of principal as the market fluctuates. Past performance is not indicative of future results. Purchases are subject to suitability. This requires a review of an investor's objective, risk tolerance, and time horizons. Investing always involves risk and possible loss of capital.
3) Gently Rotate Asset Weights Over Time

- Harvest opportunities – Like truffle hunting!
- Sow seeds of success now for 3yrs from now
- Be Humble! – Balance portfolio risks
Yet, Labor Market Remains Strong

- Unemployment at 50-year lows! Jan ’23 = 3.4%
- Powell has said Fed will keep rates “higher for longer”
- Services sector still very strong, putting upward pressure on wages
Housing Slowing Rapidly

Higher interest rates pulling down some sectors

- Housing market is slowing rather dramatically
- Single family housing starts weaker than multi-family

Source: Kansas City Fed, Jan, 2023
Consumers Are Stretched

- Stimulus money is now running out...

- ...and consumers are borrowing heavily again
Are Bond Markets Forecasting Recession?

- Yield curve is most inverted in 40 yrs!
- So, bond market is pricing in certain recession, right?
Credit Spreads Are Not Expecting Recession

- More consistent with a soft landing.
- Will this forecast be correct?
A Disinflation Story

- Inflation is indeed falling rapidly

Source: CharlieBilello
Higher Prices Not Just Food and Energy

PCE Excluding Food and Energy

Source: FRED

Shaded areas indicate U.S. recessions. Source: U.S. Bureau of Economic Analysis fred.stlouisfed.org
What are Markets saying about inflation?

- Expected future inflation falling rapidly as well

Source: CharlieBilello
Fed’s “Grand Experiment” Continues Now Rapidly Draining Liquidity

- Quantitative Tightening (QT)
- What will impact be on economy and markets?
Treasury is Dampening the Liquidity Drain, for Now

- UST removing $300B from the TGA, softening the negative impact of QT
- How much longer can TGA dampen the blow?
- Will this lead to a nasty surprise reduction in liquidity (bank reserves)?

Source: The Macro Compass
Will Investor Risk Appetite Fade as FRB Removes Liquidity?

With less reserves in the system, investors will be more prudent when taking risks.

- Will risk appetite among investors wane?

Source: The Macro Compass
Another Debt Ceiling Crisis?

A History of the US Debt Ceiling

- The U.S. federal government has reached its debt ceiling.
- The cost of insuring against a U.S. default has jumped.
- Will the U.S. actually default?
- What are consequences for the markets?

Source: CharlieBilello
Debt Ceiling Crisis: What is Market Saying?

Previous debt ceiling events have always made headlines, but they have never had a major impact on medium/long-term stock performance.

In episodes of debt ceiling debate, including 1995, 2011 and 2013, markets reached higher levels in the 12 months following the debt ceiling resolution.

Markets are driven more by economic fundamentals and earnings than by the vagaries of U.S. politics.
Corporate Earnings Slowing, More to Come?

7% YoY EPS Growth Expected ‘23

Avg EPS Decline During Recessions => -30%

Source: Factset, data pulled Jan 28, 2023

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Corporate Earnings During Recessions

<table>
<thead>
<tr>
<th>Economic Peak Month</th>
<th>Economic Trough Month</th>
<th>Quarters of EPS Decline</th>
<th>EPS Change</th>
</tr>
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<tbody>
<tr>
<td>August-57</td>
<td>April-58</td>
<td>4</td>
<td>-17.0%</td>
</tr>
<tr>
<td>April-60</td>
<td>February-61</td>
<td>7</td>
<td>-11.7%</td>
</tr>
<tr>
<td>December-69</td>
<td>November-70</td>
<td>5</td>
<td>-12.9%</td>
</tr>
<tr>
<td>November-73</td>
<td>March-75</td>
<td>4</td>
<td>-14.8%</td>
</tr>
<tr>
<td>January-80</td>
<td>July-80</td>
<td>4</td>
<td>-4.6%</td>
</tr>
<tr>
<td>July-81</td>
<td>November-82</td>
<td>4</td>
<td>-19.1%</td>
</tr>
<tr>
<td>July-90</td>
<td>March-91</td>
<td>10</td>
<td>-36.7%</td>
</tr>
<tr>
<td>March-01</td>
<td>November-01</td>
<td>5</td>
<td>-54.0%</td>
</tr>
<tr>
<td>December-07</td>
<td>June-09</td>
<td>7</td>
<td>-91.9%</td>
</tr>
<tr>
<td>February-20</td>
<td>April-20</td>
<td>4</td>
<td>-32.5%</td>
</tr>
</tbody>
</table>

Average # of Quarters EPS Declined: 5.4
Average EPS Decline: -29.5%

Source: TheMacroCompass.com

Average Decline During Recessions - 30%
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- EPS estimates continue to fall
- Down revisions on the rise

Source: Factset, data pulled Jan 28, 2023
Current Market Valuation (Shiller P/E)

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Market CAPE valuation falling back to earth

But is still elevated
Growth vs Value P/E Valuation

Relative Valuation of Growth vs Value

* Price divided by 12-month (52-week) forward consensus expected operating earnings per share. Monthly data through December 2005, weekly thereafter. Note: Shaded red areas are S&P 500 bear market declines of 20% or more. Yellow areas are bull markets. Source: I/B/E/S data by Refinitiv.