Market Strategy
by STRATEGAS A BAIRD COMPANY

BAIRD
Private Wealth Management

Quarterly Market Update

Fourth Quarter, 2022

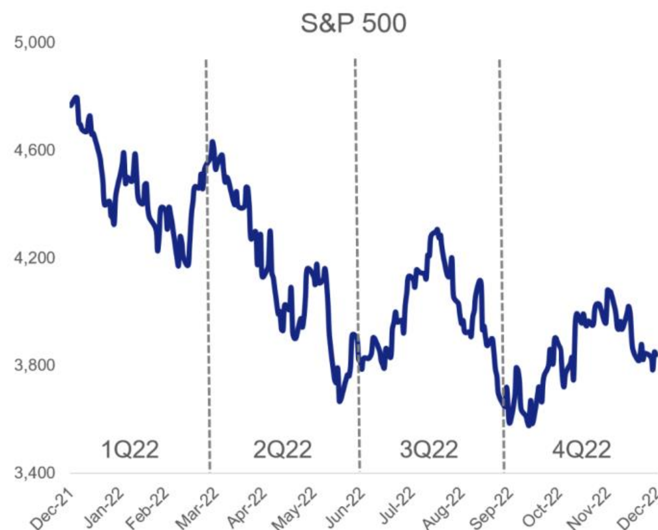
INFLATION, EARNINGS, AND THE FEDERAL RESERVE

2022 was a year for the ages. Investors of all types found few places to hide in 2022, while the ability to hedge stocks with bonds went the way of the straw hat (with few near-term prospects of its revival). All of this was the natural result of more than 12 years of quantitative easing, the central bank bond-buying tool that emerged to shore up the economy after the 2008 Financial Crisis. This monetary policy vaulted the value of the assets on the Federal Reserve balance sheet from $800 billion in 2008 to roughly $9 trillion at the start of 2022, inflating financial assets in a way that favored investors over savers for over a decade. Add trillions of dollars in pandemic-era fiscal stimulus to the equation and the bill came due – along with a nasty hangover – in the form of goods and services inflation.

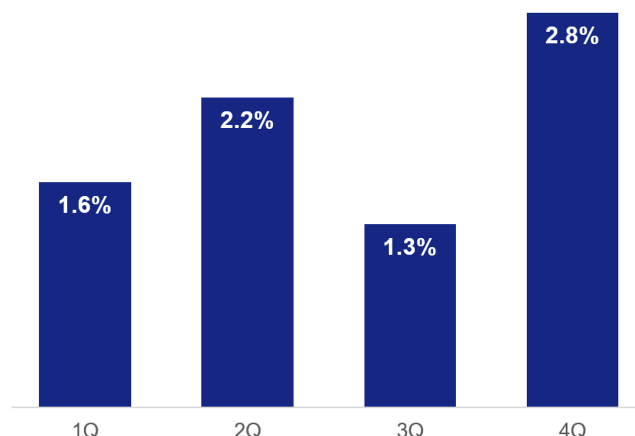
The Fed was slow to begin fighting inflation in 2021 but they marched double-time in 2022, taking the benchmark federal funds rate from roughly 0 all the way to 4.5%. Although earnings appear to have grown by 5.5% last year, the increase in inflation and consequent rise in long-term interest rates led to a big dip in stock valuations. And given the heightened prospects of a near-term recession, 2023 earnings growth looks like a longshot. There are some hopeful signs that inflation may have peaked, but higher long-term rates could be somewhat sticky given the structural nature of factors driving inflation. Chief among these are tight labor markets, the influence of environmental goals in the development of energy policies, and an end to globalization.

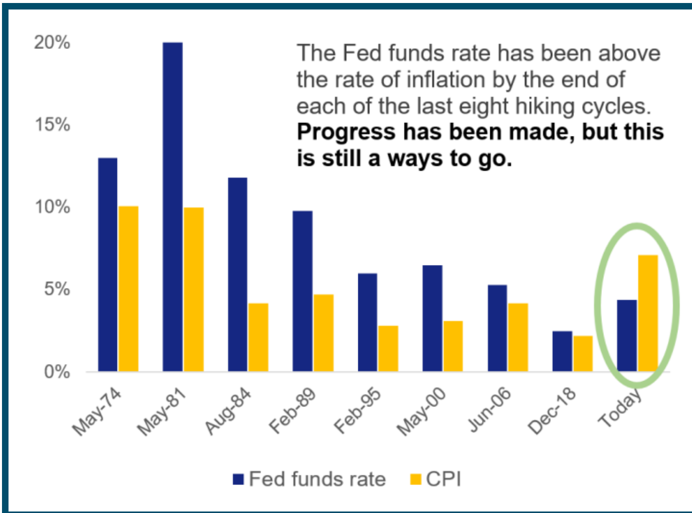
Monetary policy may be undergoing a once-in-a-generation change. The era of negative real interest rates is rapidly coming to an end, with significant implications for business models that were built to grow sales at any cost. Roughly 42% of the companies in the Russell 2000 (a small-cap stock index) have not earned a profit in the last 12 months. In our view, companies that can grow their cash flows organically (without needing to raise outside capital) should be able to survive and thrive in this new era.

We think the Fed is unlikely to pivot to easier monetary policy until it is convinced that the federal funds rate is above the rate of inflation *and* that the labor market is cooling. As such, it seems likely to remain a difficult market for bulls and bears alike. We think it is important to remember that in the midst of the 80% decline in the NASDAQ from March 2000 to October 2002, there were eight counter-trend rallies that ranged in magnitude from 13% to 44% and lasted between 8 and 76 days. Patience may remain the most valuable virtue in 2023.

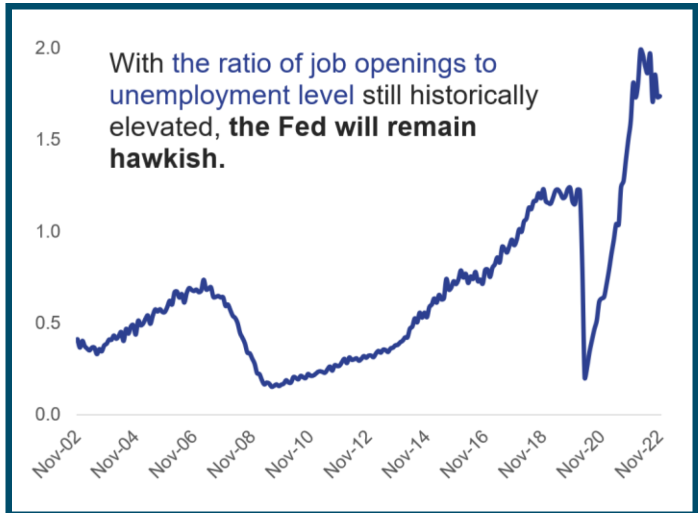


Asset Class	Representative Benchmark	Q4 Return
US Large Cap	S&P 500	7.6%
US Small Cap	Russell 2000	6.2%
International	MSCI AC World ex-USA (USD)	14.4%
Commodities	Bloomberg Commodity	2.2%
Municipal Bonds	Bloomberg Municipal Bond	4.1%
Taxable Bonds	Bloomberg US Aggregate	1.9%
Cash	Bloomberg 3-Month T-Bill	0.9%

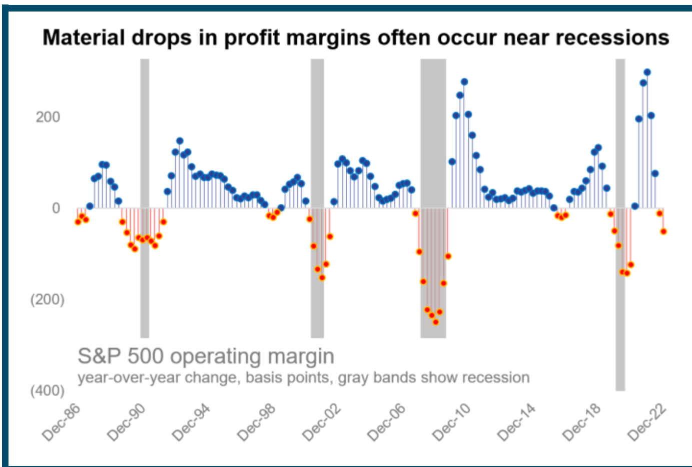




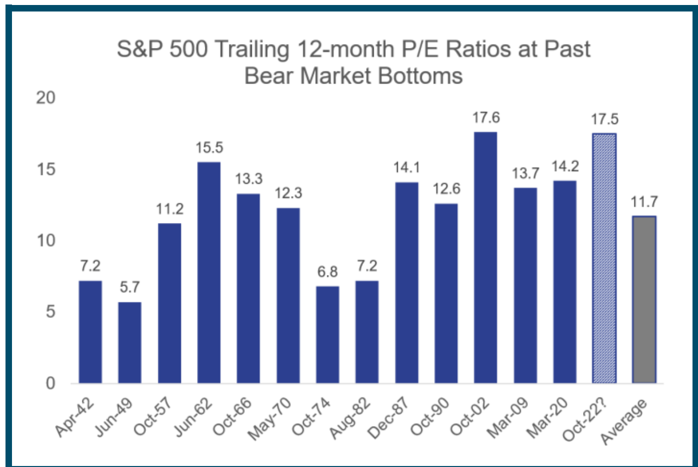
Each Federal Reserve tightening cycle of the past 50 years did not end until the fed funds rate was above inflation. As of December, inflation is heading downward and the Fed projects that it will hold its key interest rate above 5% for the entirety of 2023. Progress is being made, but the bottom line is this: Positive real rates are a minimum condition for "tight" policy. Cushions in the economy (consumer cash savings, job openings, etc.) likely need to be worked through for the Fed to be satisfied. We are still looking at policy tightening throughout 2023, and the odds of a recession remain elevated.



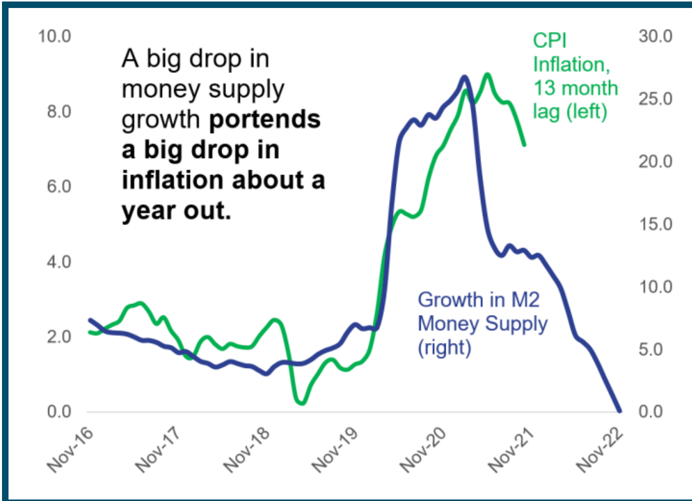
The labor market will be critical to how the coming year evolves. While there is plenty to be excited/relieved about on the inflation front, the Fed's insistence that the labor market must soften (to achieve their 2% inflation target) could weigh on markets in 2023. The unemployment rate is still below 4.0%, there are over 10 million job openings in the U.S. (with far fewer people seeking jobs), and wage growth remains north of 5%. Barring a significant jump in productivity, the Fed will want to see the labor market weaken, and until then, they may remain more hawkish than investors would like.



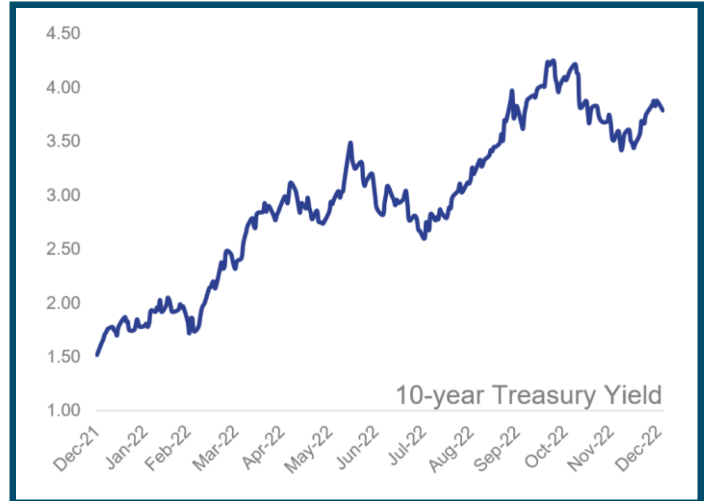
There seems to be a conflict between the idea that we'll be in a recession next year and the consensus expectation that corporate earnings will grow. And while inflation creates a "money illusion" (where the level of sales and profits remains elevated simply because prices are higher), we believe that a closer look at profit margins will reveal a more troubled landscape. We are starting to see contraction in profit margins typically only seen around recessions. We anticipate that consensus earnings estimates will keep moving lower as corporate guidance softens.



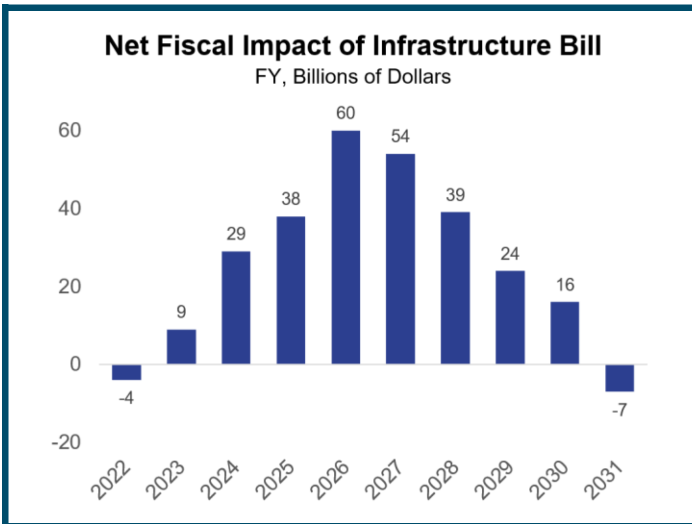
Earnings multiples (what an investor is willing to pay for a share of earnings) have been lower at past bear market bottoms than we've seen in this cycle low. In fact, several indicators today are inconsistent with market bottoms of yore; multiples and inflation are much higher while interest rates and unemployment are lower. Big rallies during bear markets are not uncommon. Ultimately, the market appears to be optimistically betting on a rapid decline in inflation in addition to a surfeit of job openings and consumer and corporate savings. Absent that, the market may have further to fall.



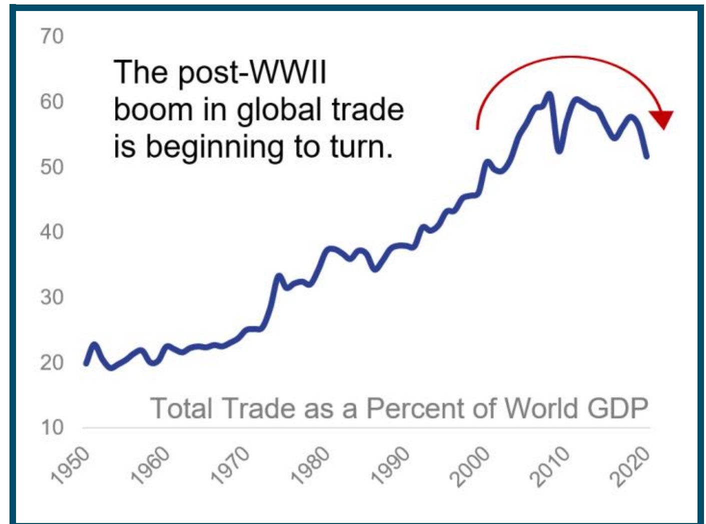
While several factors played into historic inflation in 2022, the policy-driven spike in money growth was a major factor in driving strong demand and price instability. Today, that policy is being unwound rapidly, and the Fed is draining liquidity out of the system at a faster pace than at any other time in recent history. This collapse in money growth should help rid the system of inflation (though this effect acts with a lag), but could also weigh on economic growth and 2023 corporate profits.



The 10-year Treasury had a volatile Q4 as it sought to balance rate hikes with the future path of inflation and the growing sense that a recession is inevitable. We don't expect the flight to quality (i.e., to assets seen as "safer") in the next recession to push 10-year yields below 3.00%, barring a major financial crisis. Inflation is too sticky and the fed funds rate is unlikely to move high enough to bring inflation below 3% for good. We think the 10-year Treasury yield could meander between 3.25% and 3.50% for most of 2023.



Infrastructure and clean energy spending should accelerate in 2023 and will ramp up dramatically over the next few years. We are likely to see a continuation of recent onshoring policies such as paying the semiconductor companies $75 billion to bring their factories to the U.S. Ultimately, we will likely see more companies do the same. We expect Congress to continue to push legislation to incentivize companies to locate closer to the American worker.



We've seen mounting evidence that we are moving back to a multi-polar, pre-1990 world after a prolonged period of globalization and free trade. This deglobalization trend will have profound implications for monetary and fiscal policy. Governments are beginning to prioritize national security over economic growth, with markets for critical technologies such as semiconductors being pushed toward onshoring or friend-shoring. This should result in higher inflation and interest rates as well as lower price-to-earnings multiples for stocks than we became used to over the past 40 years.

S&P 500 Index (Large Cap / U.S. Stocks): A representative sample of 500 leading companies in leading industries of the U.S. economy. These are equity securities of large capitalization (generally $7 billion plus market cap) companies having growth and value characteristics. ● **Russell 2000® Index (Small Cap / Small Core):** Measures the performance of the 2,000 smallest companies in the Russell 3000® Index, which represent approximately 10% of the total market capitalization of the Russell 3000® Index. These are equity of small capitalization. ● **MSCI EAFE Index Net (International / Developed Markets):** A free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the US & Canada. As of May 27, 2010 the MSCI EAFE Index consisted of the following 22 developed market country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, and the United Kingdom. ● **BBgBarc Aggregate Bond Index (Taxable Bonds / Bonds):** Comprised of approximately 6,000 publicly traded bonds, including U.S. Government, mortgage-backed, corporate, and Yankee bonds with an average maturity of approximately 10 years. ● **BBgBarc Muni Bond Index (Municipal Bonds):** Bonds must have a minimum credit rating of at least Baa, an outstanding par value of at least $3 million, part of a transaction of at least $50 million, issued after December 31, 1990 and have a year or longer remaining maturity ● **FTSE 3-month T-bill Index (Cash):** This index measures monthly return equivalents of yield averages that are not marked to market. It consists of the last one-month and three-month Treasury bill issues, respectively. ● **Bloomberg Commodity Index (Commodities):** Composed of commodities traded on U.S. exchanges, with the exception of aluminum, nickel and zinc, which trade on the London Metal Exchange (LME). Subindices include Petroleum, Grains, Industrial Metals, Livestock, Precious Metals, and Softs.

IMPORTANT DISCLOSURES

Past performance is not indicative of future results and diversification does not ensure a profit or protect against loss. All investments carry some level of risk, including loss of principal. An investment cannot be made directly in an index.

This communication was prepared by Strategas Securities, LLC ("we" or "us"). Recipients of this communication may not distribute it to others without our express prior consent. This communication is provided for informational purposes only and is not an offer, recommendation or solicitation to buy or sell any security. This communication does not constitute, nor should it be regarded as, investment research or a research report or securities recommendation and it does not provide information reasonably sufficient upon which to base an investment decision. This is not a complete analysis of every material fact regarding any company, industry or security. Additional analysis would be required to make an investment decision. This communication is not based on the investment objectives, strategies, goals, financial circumstances, needs or risk tolerance of any particular client and is not presented as suitable to any other particular client; therefore, this communication should be treated as impersonal investment advice. The intended recipients of this communication are presumed to be capable of conducting their own analysis, risk evaluation, and decision-making regarding their investments.

For investors subject to MiFID II (European Directive 2014/65/EU and related Delegated Directives): We classify the intended recipients of this communication as "professional clients" or "eligible counterparties" with the meaning of MiFID II and the rules of the UK Financial Conduct Authority. The contents of this report are not provided on an independent basis and are not "investment advice" or "personal recommendations" within the meaning of MiFID II and the rules of the UK Financial Conduct Authority.

The information in this communication has been obtained from sources we consider to be reliable, but we cannot guarantee its accuracy. The information is current only as of the date of this communication and we do not undertake to update or revise such information following such date. To the extent that any securities or their issuers are included in this communication, we do not undertake to provide any information about such securities or their issuers in the future. We do not follow, cover or provide any fundamental or technical analyses, investment ratings, price targets, financial models or other guidance on any particular securities or companies. Further, to the extent that any securities or their issuers are included in this communication, each person responsible for the content included in this communication certifies that any views expressed with respect to such securities or their issuers accurately reflect his or her personal views about the same and that no part of his or her compensation was, is, or will be directly or indirectly related to the specific recommendations or views contained in this communication. This communication is provided on a "where is, as is" basis, and we expressly disclaim any liability for any losses or other consequences of any person's use of or reliance on the information contained in this communication.

Strategas Securities, LLC is a registered broker-dealer and FINRA member firm, as well as an SEC-registered investment adviser. It is affiliated with Strategas Asset Management, LLC, an SEC-registered investment adviser. Strategas Securities, LLC is also affiliated with and wholly owned by Robert W. Baird & Co. Incorporated ("Baird"), a broker-dealer and FINRA member firm, although the two firms conduct separate and distinct businesses.

A complete listing of all applicable disclosures pertaining to Baird with respect to any individual companies mentioned in this communication can be accessed at http://www.rwbaird.com/research-insights/research/coverage/thirdpartyresearch-disclosures.aspx. You can also call 1-800-792-2473 or write: Robert W. Baird & Co., PWM Research & Analytics, 777 E. Wisconsin Avenue, Milwaukee, WI 53202.