Market Strategy
by STRATEGAS A BAIRD COMPANY

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As we enter the new year, there are several major changes across the policy landscape that will undoubtedly impact financial markets. The Strategas Washington Research team kicks off 2023 by discussing some key themes and items for investors to watch in the year ahead.

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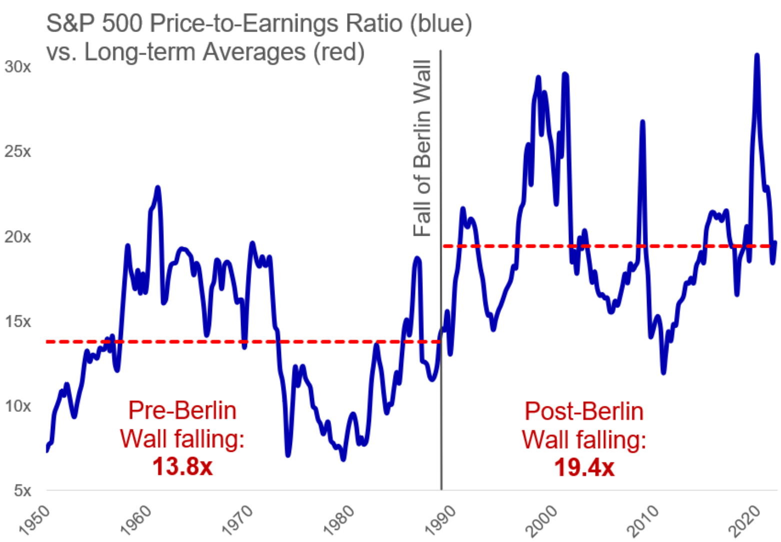
POLICY THEMES FOR 2023

Last year was marked by a complete upending of our long-standing monetary, fiscal, and geopolitical frameworks. The Federal Reserve had to fight inflation for the first time in 40 years, the US experienced its largest fiscal contraction since 1947, and China and Russia formally challenged the Western world order. This year will be shaped by how policy responds to the aftershocks of 2022's events. Below, we present three of our most important themes for 2023:

National security is becoming more important than economic efficiency. Last year, China and Russia vowed to challenge the Western world order, and Russia's attack on Ukraine forced companies to rethink their supply chains. Policymakers are now prioritizing national security and resilient supply chains over economic efficiency. We are seeing greater use of export controls, incentives to bring supply chains home, and increased scrutiny of US investments in China and other countries of concern. We are moving to a more deglobalized world, one in which investors need to anticipate higher inflation (3%), slightly higher interest rates, and lower price-to-earnings ratios on stocks. We have not experienced such an environment since the period before the Berlin Wall fell in 1989, an event which accelerated globalization.



Deficit politics return in 2023. Deficit politics are set to stage a comeback due to the Federal Reserve raising interest rates and a coming political fight over raising the debt ceiling in 2023. Higher interest rates will increase US debt-servicing costs, which will come just as tax revenues are decelerating. When interest costs as a percentage of tax revenues hit 15%, financial markets begin to impose discipline on policymakers. This has not happened in 32 years, but is on our radar for 2023. In addition, members of the House are demanding spending cuts in exchange for raising the debt ceiling later this year. We could see market turmoil over the course of the year due to political fights over spending cuts and the debt ceiling.

The energy transition is inflationary and bolsters fossil fuels, commodities, and renewables. President Biden came into office pushing for greater adoption of electric vehicles and renewable energy. After Russia's attack on Ukraine, energy security took on greater precedence than emissions reductions, but it did not ebb the push for clean energy. In 2022, Congress passed the Inflation Reduction Act, which includes $300 billion in spending and clean energy tax credits over the next 10 years. However, renewables require key commodities such as lithium and cobalt, which are largely produced in China and other countries where geopolitical tensions are growing. Taken together, fossil fuels, mining, and renewables will all continue to be in demand, and the energy transition will continue to be inflationary.

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