Shelton 2023 Market Outlook

December 2022

Embracing an Inflationary Regime

2022 for investors was a year unlike any we have seen in decades. For the past 20+ years, the primary concern was the threat of deflation brought on by economic weakness. Every instance where recession threatened, central banks lowered interest rates to provide monetary stimulus.

Over the past three years a confluence of events disrupted this model:

- An accumulation of economic imbalances brought about by easy monetary conditions. Equity market concentration and high valuations. Record high profit margins. Historical wealth imbalances.

- Concerns over climate change favoring renewable energy sources and halting investment in fossil fuel extraction

- Rising political tensions reversing globalization

- A global pandemic that disrupted supply chains and triggered massive amounts of fiscal stimulus

- Russia's invasion of Ukraine, disabling major sources of agriculture, steel, petroleum and other commodities

As we make investment decisions in 2023, investors must consider a different perspective for their investment decisions, one founded on the prospects of an inflationary regime.

To begin, inflation in the US has likely peaked. Many of the shorter-term drivers of inflation have abated, providing some relief.

- With COVID under control (with the exception of China) supply chain restrictions have subsided, and trade volumes have rebounded

- Energy and industrial commodities, while still higher than their lows of the later part of the last decade, have remained stable

- Aggressive Fed rate hikes have deflated the housing market. Rental rates generally follow with a 6-month lag before they are reflected in CPI statistics.

At the same time, longer term inflationary forces remain in place, limiting how low inflation will stabilize. The labor market is tight, and wage increases continue. Pricing in the service sector, typically a stickier source of inflation, remains high even in the November CPI release. While fiscal stimulus from the central government is over (mostly – the Inflation Reduction Act is anything but), state governments have taken the baton with their own gas rebates, health care subsidies and the like.

Historically when inflation has reached the levels like it has during this cycle it takes some time to return to lower levels. There is no reason to expect anything different this time around. If inflation settles closer to 3 to 4% instead of the Fed's target of 2%, with interest rates near or above that level (and a return to positive real interest rates) and inflation returns to the forefront of investor's minds, we could experience a different set of behaviors for securities than what we have grown accustomed to in the past 20-30 years.

Growth

As it stands, the economy is in good shape – unemployment is at cycle lows, and the fourth quarter is likely to show real GDP growth around 3%. On the margin, clouds are forming. The Conference Board Index of Leading Indicators turned negative over the summer and has continued to decline through the second half of 2022. In every instance over the past 60 years, such declines have foretold a decline in economic growth, with the attendant rise in unemployment and fall in earnings growth.

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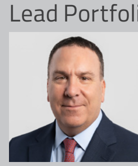

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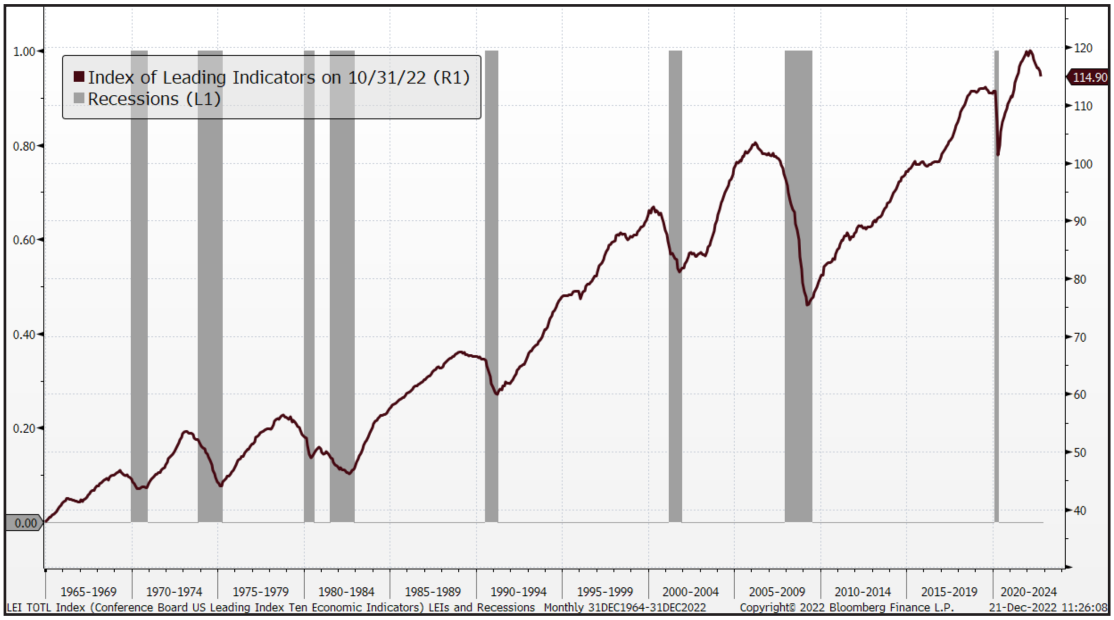
Figure 1: Leading Indicators and Recessions



Over the past 20 years, relieved by deflationary forces of their obligation to fight inflation, the Federal Reserve would lower rates to stimulate the economy out of such economic doldrums. With the shift in focus to inflation, instead of the re-assuring tonic of lower interest rates, the U.S. economy finds itself in the most aggressive rate hike cycle in history.

Fixed Income

When the final curtain closes on 2022, the performance numbers will be bad, but not nearly as brutal as they looked a mere eight weeks ago. The Federal Reserve had the unenviable task of trying to tame inflation that arose not from traditional business cycle dynamics, but rather from a global pandemic and the fiscal and monetary response thereto. Trying to win this game without running the favorite or most comfortable plays from their playbook, the results were erratic, belated and unpredictable. At the same time, the market was desperately trying to front-run a pause and eventual pivot in the relentless stream of rate increases. After several false starts during the year, the most recent rally seems to have gotten it correct. While we may have come a little too far, too fast during this recent rally, we do believe we have turned the crucial corner in the fight against inflation, and that rates generally should exhibit some stability within a reasonable range, and eventually head lower still. This eventual further decline in rates will be driven by the realization that interest rate increases, operating with their well-known lag, have inflicted too much damage on the economy and tipped it into recession. At this point the Fed will be in familiar territory and can rely on its tried-and-tested playbook to re-stimulate the economy out of this slowdown.

The Fed continued the rate hike cycle with 75 basis points in November and another 50 basis points in December. At their December meeting, the Fed updated their Summary of Economic Projections to show higher interest rates, higher PCE prices, and slower economic growth. In particular, previous Fed Funds rate estimates from September were revised upwards from 4.6% to 5.1% for 2023, and from 3.9% to 4.1% in 2024. Forward market expectations have oscillated and are currently anticipating another 50 basis points in hikes by May 2023, with rate cuts beginning in the Summer of 2023, a significant divergence from FOMC forecasts. 10yr US Treasury yields began the quarter at 3.83%, reached an intra-quarter high of 4.24% on October 24th, then rallied and reached a low of 3.42% on December 7, 2022.

A few themes seem evident in high yield: corporate fundamentals remain solid after years of refinancing and terming-out at low rates, the yields currently offered by high yield bonds are meaningful versus the macro risks, and that investors should look to quality but also search through lower quality buckets for idiosyncratic outperformance. What will prove particularly difficult is getting the timing right. How much pain will continue into the first quarter as the Fed is hiking in the face of markets?

Extremely strong performance in November brought some much-needed optimism to municipal market participants that have struggled through a very challenging year overall. Despite continued outflows from tax-exempt funds, municipal bonds took their direction from a rallying rates market and soundly outperformed Treasuries. Municipal yields on both an absolute and relative value basis attracted buying interest. The Bloomberg Municipal Bond Index and Bloomberg High Yield Municipal Bond Index returned 4.677% and 5.822% respectively for the month of November, one of the best monthly performances on record. The table below shows the change in AAA municipal yields in basis points across the curve during the quarter.

Maturity	October	November	December*	4th Qtr*
2 years	+13	-60	-7	-54
5 years	+13	-61	-18	-66
10 years	+14	-65	-21	-72
30 years	+22	-60	-9	-46

**Through 12/14/22*

Recent progress on conquering inflation gives us confidence that we are on our way towards lower interest rates. Unfortunately, because higher rates and tighter financial conditions operate with a substantial lag, we won't know the full extent of the economic damage they have inflicted. Because the Fed is more comfortable running the playbook of re-stimulating an economy out of a recession rather than trying to re-conquer entrenched inflation, we fully expect them to try and keep financial conditions tight for longer, and over-correct in the process.

While supply chain issues have certainly improved, there are still bottlenecks and shortages to overcome. Additionally, the supply side impact from the Russian invasion of Ukraine continues to have a severe impact on commodities, particularly energy and agricultural commodities.

Recent economic data and corporate commentary continues to signal the onset of economic contraction. Consumers have been facing unprecedented increases in food, energy and broader goods and services, which is weighing heavily on their sentiment. The housing market has started to roll-over, as home prices peaked in July and are declining rapidly since mortgage rates exceeded 7%. How long and deep this impending recession might be is the next key question. If it turns out to be more severe, equities and lower-quality fixed income have more downside. However, in the case of fixed income, given where all-in yields are now, we believe they are adequately compensating investors for additional spread widening all the way down to the single-B rating tier. Below single-B you better get your credit analysis and downside protection correct, and the lack of trading liquidity in that tier severely punishes mistakes.

We believe the sweet spots for future total returns are Investment Grade municipal bonds and BBB, BB, and certain single-B credits we believe are stronger and more resilient than the market. Mathematically, even if spreads widen a few hundred basis points further, BBs at yields approaching 7% would still produce acceptable returns over the next 6 to 12 months. If rates go lower and/or the recession proves to be milder, then total returns could easily eclipse 10% over that time period. There are valid reasons to believe spread widening might stop short of previous recessions, as the index has a higher quality composition (more BBs, fewer CCCs), beginning all-in yields are higher than the onset of a typical recession, and the average dollar price of bonds is much lower and much closer to recovery rates. However, if spreads were to blow-out to levels above +800 basis points that are often reached in severe recessions, total returns would likely be flat or even negative. Navigating these bouts of volatility by adjusting credit quality overall and selecting the right individual securities in particular will be the keys to success, and we are confident in our ability to thrive in such an environment.

Equities

For 2022, the change in investment regime meant a change in market leadership.

For the last several years, the global leader in equity markets has been large cap US growth stocks. With the advent of higher inflation, that trend reversed. While at the time of this writing the final numbers are yet to be completed, the S&P 500 looks to have lost about 20% of its value in 2022. The tech-heavy NASDAQ 100 is down more than 30%. At the same time, energy stocks returned over 50% for the year, even though the underlying price of oil, which spiked after the invasion of the Ukraine by Russia, has returned to the same levels as last January.

While it is hard to say where equity markets will go in 2023 after such a sell-off, we can reliably predict that in a market concerned over the threats of inflation and recession, volatility will remain high. The VIX averaged around 25 for the course of 2022, but it was mainly confined to a range of 19-37 and we didn't see the massive spike like most market participants expected. This persistent elevated level enabled covered option writing to be a superior strategy for advisors adjusting the 60/40 portfolio into the new 50/30/20 with the new 20 percent being alternative strategies like derivative income products.

LPL Financial Portfolio Strategist George Smith points out that the frequency of intraday swings of 1% or more for the S&P 500 has been "extremely elevated" in 2022. More than 87% of trading days in 2022 have experienced swings that big. Unsurprisingly, because we are in a bear market, downside volatility has been more prominent as well. The last time the market had intraday day volatility this often was in 2008 during the height of the financial crisis. We believe that this market environment will continue.

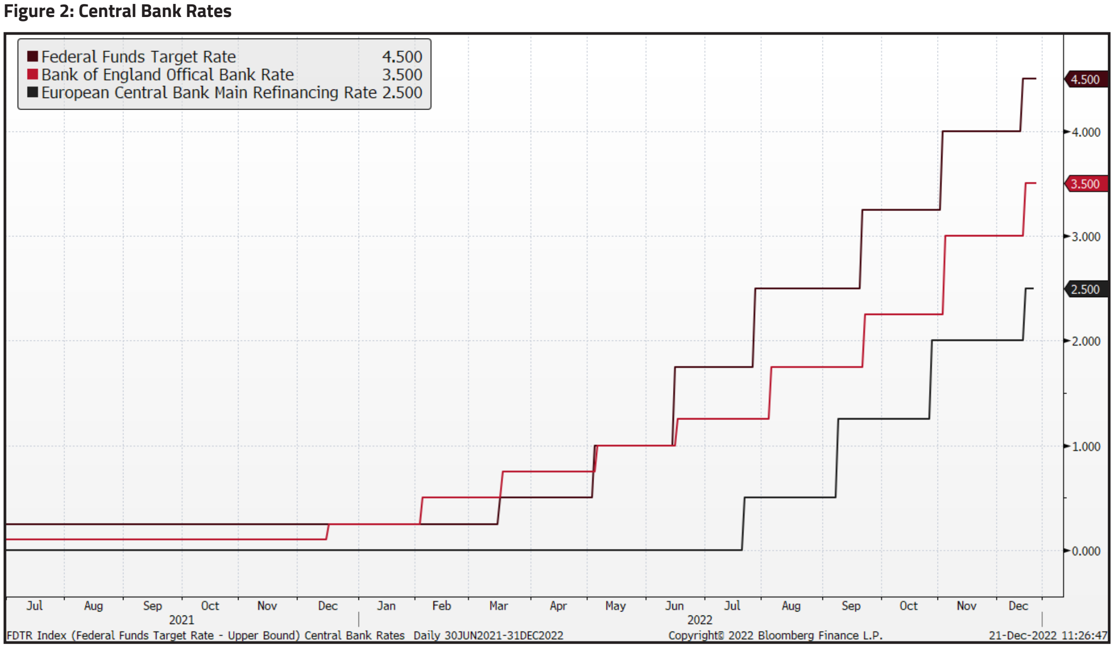
Across the Pond

The European STOXX 50 is only down around 15%, half of which can be attributed to the strength of the US dollar.

Inflation and interest rate trends in Europe are about six months behind those in the United States. The EU approach to fiscal stimulus after the pandemic was gradual and measured, employment is not as tight, price increases have been more muted. Instead, inflation was propped up to similar levels by the Russian invasion of Ukraine. Food and energy are a larger portion of European inflation and it remains to be seen whether core inflation will rise as much as it has in the US.

In a similar manner, the Bank of England and the European Central Bank (ECB) trail the Federal Reserve in their rate hike cycle by 100 and 200 basis points respectively. Recent tough talk by Christine Lagarde during the most recent ECB meeting demonstrates a similar commitment to stopping inflation.

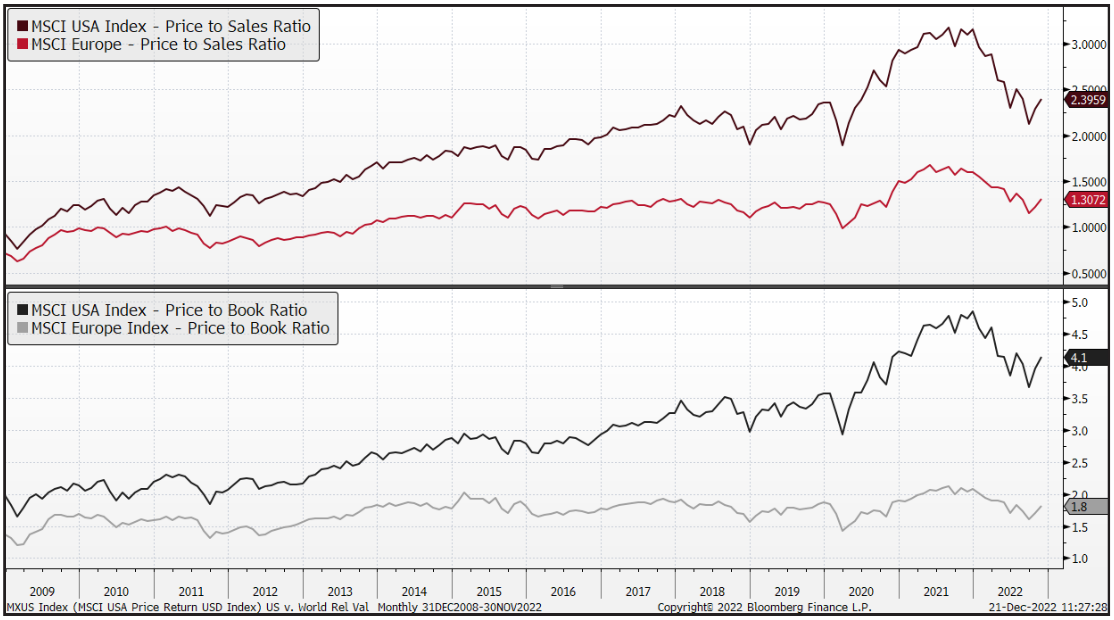
Figure 2: Central Bank Rates



While economic indicators show slowing economic growth in the future, there are slivers of light shining through. Recent Eurozone PMIs have stabilized, and the IFO German Business Expectation index rebounded sharply from a 15-month decline.

One factor in favor of European equities is their valuation. Composed of a larger proportion of energy, financials, utilities and material firms, and much lower technology, the valuation gap between European and US equities remains high despite recent regression. These industries favor higher interest rate environments and stand to continue to close that gap if rates remain elevated.

Figure 3: US & Europe - Relative Valuations



Inside look at China

For nearly two years, the Chinese equity market has been a graveyard for Emerging Market investors. Racked by a hattrick of economic crises including a zero-COVID policy that locked down much of the country, a government intent on taking down the most successful growth companies, and a credit crisis in real estate, equity investors have lost close to 25%. From the Chinese market's post-pandemic peak in February of 2021 through the end of October 2022, the MSCI China Index was down over 60%!

Figure 4: Shanghai/Shenzen 300, 2021-2022

The equity market of the second largest economy in the world, cut in more than half, was just waiting for a catalyst to rebound. And in early November it found one – re-opening. While the change in COVID policy really took shape in early December, the market sniffed out the signs a month earlier, and since that October bottom Chinese equities have rallied over 30%.

While the economic trends and demographic challenges China faces remain negative in the long run, we could see some strength in their markets in the short term as their re-opening takes shape.

Sustainable Investing

In the meantime, globally there are a lot of $20 bills laying around destined for a Green Economy.

Two major pieces of legislation are catalyzing capital into a more resilient United States. First, the Infrastructure Investment and Jobs Act (IIJA) signed into law in November 2021 and then the Inflation Reduction Act (IRA), signed into law in July 2022. Both bills seek to revitalize and decarbonize our infrastructure, from roadways to energy, water and agriculture infrastructure create jobs and clean up our distressed environment. In just one year, over $185 billion have been deployed from the IIJA and with the $369 billion is being readied for additional climate and energy programs. One interesting estimate from Bloomberg New Energy Finance shows that installed capacity of solar panels/modules will reach 38% by 2050. These funds are making that happen.

Additionally, the Securities and Exchange Commission (SEC) released its proposal for new rules to enhance and standardize Climate Related disclosure for investors. The rule includes audited Scope 1 and Scope 2 greenhouse gas (GHG) emissions as well as language regarding Scope 3 emissions disclosure. MSCI Inc, the global market index and ESG data provider, reported that over 3,000 companies have set some decarbonization targets, where 46% of the MSCI ACI IMI Index declared a Net-Zero target. All the while, according to Morningstar, actively managed Sustainability funds raised over $3 billion as of Nov. 30, 2022, out pacing the overall fund market which saw net outflows (Morningstar Nov. 30, 2022). And finally, the US Forum for Sustainable Investment (USSIF) published its biennial survey of the US Sustainable Investment Industry, showing that the U.S. manages over $8.4 trillion (~12% of all assets managed) which includes U.S. domiciled assets held by money managers as well as those managers that conduct shareholder engagement on Environmental, Social and Governance (ESG) Issues.

The increased interest and rewards of sustainable investing have not gone unnoticed by the SEC. The SEC has released a proposed amendment to the Investment Company Act "Names Rule" which will require investment management firms to specifically name and specify whether the fund's goal is ESG Factor Integration, a Focused Thematic, e.g. Green Energy, or an Impact First fund. And while greater transparency is always paramount, there still remains a gray area in the markets of understanding and interpreting what the terms "ESG" and "Sustainable" mean. Hence, the SEC proposes that firms clearly state this in their name and detail their process in the prospectus.

The green economy is not immune to broader economic dynamics. The economic slowdown across the globe in terms of trade, shipping and logistics, commodity pressures as well as the abrupt change in interest rates and inflation also affect the rate of transformation of our industries, but not the direction. Despite, some political backlash and media noise around ESG and Woke Capitalism, the transformation of our industries, from the energy sector and the "hard-to-abate" sectors is underway and generating quality earnings. The first half of 2023 these earnings will be referred to as the green shoots of the economic recovery, and these shoots are indeed green.