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INTELLIGENT INVESTMENT

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Fourth Quarter Newsletter, 2022

S&P 500 YTD (-19.44%)[4]

MSCI ALL WORLD ex US YTD (-16.14%)[4]

"Oh, let the sun beat down upon my face
And stars fill my dream"[1]

So there it is ladies and gentlemen the worst year for the markets since 2008! It feels to many the strong markets we have all become accustomed to for so many years is "Over the Hills and Far Away"[1]. Well, "Good Times Bad Times"[1] every year can't be positive; but will this particularly ugly bear market ever end? Will equity and bond markets go from bad to worse? Or dare we ask; can the markets recover in 2023?

Pessimism abounds these days and it doesn't really feel like the markets will recover anytime soon. This pessimism unfortunately allowed 2022 to be a year many investors made poor short-term decisions based on emotion that will likely cause them long term financial pain. It's hard to blame them as 2022 gave us plenty to be emotional about. We can very clearly see from the chart above 2022 was an excessively volatile year. "Excessively volatile" doesn't really come close to articulating the roller coaster it was. According to Goldman Sachs "2022 is likely to end up as the sixth-most volatile year since the Great Depression."[7]

This highly volatile year left "No Quarter"[1] for many investors. Although the S&P 500 contracted (-19.44%), it pales in comparison to the Nasdaq Composite which lost (-32.50%) . To further compound difficulties; "safe" bonds were anything but as the overall bond index as represented by the AGG fell (-13.06%), moreover

corporate bonds were completely "Trampled Under Foot"[1] nearly matching their equity counterparts contracting (-18.01%) as represented by the LQD.

What can we begin to expect from 2023? First let's take a look at the 2022 Summary of Economic Projections (SEP) published by the Federal Reserve December 2021 to give us an idea of what the Fed expected then versus what actually took place and what they are estimating now. 12 months ago, the Fed SEP estimated a modest three rate increases bringing their policy rate to 0.9%, core PCE inflation finishing at 2.7% and we were going to enjoy 4.0% in GDP growth for 2022[2]. Talk about a "Lemon Song" clearly, they were incorrect. 2022 latest figures published in December of 2022 shows the sanguine estimates of late 2021 are a distant memory. We completed 2022 with a policy rate of 4.5% and final 2022 estimates for core PCE inflation of 4.8% and GDP growth at a very meager 0.5%[2]. That brings us to the dour 2023 SEP recently released. The Fed is now communicating their policy rate will increase to 5.15%, the new year will have endured a 3.5% inflationary rate and GDP growth will match the dismal 0.5% performance of 2022[2]. These weak economic projections don't really coincide with a 5.15% policy rate. If this becomes the case it appears we will not be getting "Whole Lotta Love"[1] from the Fed in 2023.

What does all this monetary policy gobbledygook say about a potential market revival? Will equities and bonds recover in 2023? More importantly, how is a market resurgence possible when all through 2022 every instance the market tried to rally out of the bear trap we were left out like "Fools in the Rain"[1] wondering "How Many More Times"[1] would we get suckered? From Fundstrat "It would not entirely surprise anyone to say that most investors expect equity markets to "churn" in 2023. Basically, most investors believe the "crisis" environment of 2022 is spilling over into 2023. And most just see a litany of headwinds from Fed hikes to economy slowing to EPS contraction to "cash is king" to inflation "takes years to control." So most investors and pundits believe stocks will go "nowhere" in 2023.[6]

We do not share this cynicism. ARPG believes the ingredients exist for markets to recover most of 2022's losses. From Fundstrat, "The question is what are the possible factors that would enable equities to produce above average gains in 2023, versus a "flat" year. We believe there are 3 possible catalysts:

- First, we think US inflation undershoots Fed and consensus, by a wide margin in 2023. In fact, we think the December CPI report could see core CPI as low as 0.1% month over month (MoM) and bring annualized inflation to below 2%. By the way, inflation is also set to collapse in Euro-area as well falling to 2%-range in early 2023. So, this is a global "disinflation" underway. This would be a "step" function change in the path of inflation versus what the Fed expects. And as a consequence, would arguably set the stage for the Fed to lower the path of forward rates and even change the view regarding "higher for longer."

- Second, despite what look like "strong" jobs markets, leading indicators already suggest wage gains are set to slow. It is visible even in the Atlanta Fed wage tracker (3M annualized slowing) and in leading surveys, as highlighted by Goldman Sachs Economists.

- Third, equity and bond volatility are likely to fall sharply in 2023, in response to a step function downwards in inflation and a consequently less hawkish Fed. Our analysis shows this drop in volatility is a huge influential factor in equity gains.

If volatility even falls modestly in 2023, the median gain is 22% with a win-ratio of 83%. This is far higher than equity markets overall. Thus, if the trajectory drop in inflation, along with easing wage gains transpire, we expect equity and credit volatility to drop sharply. As such, this would further support a market recovery."[6]

2023 may not turn out to be a "Stairway to Heaven" but if history is any guide the new year likely won't be the "Heartbreaker" 2022 was. In any market ARPG will continue to practice our approach to value investing, "Intelligent Investment is Investment on Value"[5]. This is what sets ARPG apart from the rest. As always, we thank you for your confidence and are humbled by your trust. Please feel free to contact us at any time.

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Sincerely,
Matthew D. Dahl
Chief Investment Officer

1. Led Zepplin
2. FOMC
3. Factset
4. ARPG / Stockcharts.com
5. Matthew Dahl
6. Fundstrat
7. Goldman Sachs

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