Wellington Shields

January 2023

Quarterly Market Strategy Report

Cash is No Longer Trash

The last twelve months have been a difficult time for many investors. Full year declines in the major equity indices totaled 8.8% in the Dow Jones Industrial Average, 19.4% in the S&P 500 and a whopping 33.1% in the technology-heavy Nasdaq Composite Index. For each index, this was the worst annual decline since 2008. But as we noted a year ago, 2022 would be a year that followed three consecutive annual gains in all three indices – and history shows that three years of double-digit gains are typically followed by a down year. However, 2022 was also the year in which economists, investors, and the Federal Reserve Board finally acknowledged inflation was a long-term economic risk. As a result, investors learned, or in some cases relearned, that higher inflation is detrimental to equity investors since it means higher interest rates and lower price-to-earnings multiples. And unfortunately, tighter monetary policy and an inverted yield curve have historically been precursors of an economic recession. In our view, how to deal with a recession may be the lesson to learn in 2023.

Remembering 2022

Despite the sharp declines seen in equities, it is difficult to judge how 2022 will be remembered. For some investors the collapse of FTX, the centralized crypto exchange, and the arrest of its founder and ex-CEO, Sam Bankman-Fried (aka SBF) for fraud, will be at the top of the list for the year. It clearly marked a turning point for the cryptocurrency phenomenon. But 2022 was also a turning point for "high growth" stocks and the popularity of the FAANG components. Facebook, now known as Meta Platforms, Inc. (META – $120.34) fell 64.2%, Amazon.com Inc. (AMZN - $84.00) lost 49.6%, Apple Inc. (AAPL - $129.93) was an outperformer with a 26.8% loss, Netflix (NFLX - $294.88) declined 51.1%, and Google, now known as Alphabet Inc. (GOOG - $88.73) dropped 38.7%. Also noteworthy was the 65.0% trouncing in the price of Tesla (TSLA - $123.18) which was a direct result of Elon Musk buying Twitter for $44 billion on October 27.

On the international scene, Russia's invasion of Ukraine in February had a major impact on the world in terms of the price of oil, the global economy, and geopolitics. That country's spirit and bravery in the face of

Summary

The first half of 2023 may be a final chapter to the post-pandemic hangover. There are many signs of a pending recession, including the inverted Treasury yield curve, the slump in the real estate markets and weak retail sales. The downside risks of inflation are numerous but include consumers with declining purchasing power, profit margin squeezes, declining corporate earnings and falling PE multiples.

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deadly aggression, catapulted Ukrainian President Volodymyr Zelensky to the cover of TIME MAGAZINE as the 2022 Person of the Year.

The year also marked the end of an era for Great Britain when Queen Elizabeth II, after 70 years on the throne, died at age 96 on September 8. Simultaneously, the UK was experiencing a revolving door in political leadership and had three prime ministers in a seven-week period between September 6 and October 25. These were in order: Boris Johnson, Liz Truss (50 days as prime minister), and Rishi Sunak.

Domestically, the US Department of Energy announced a major breakthrough in nuclear fusion after researchers successfully produced more energy from fusion than the laser energy spent to drive it. Politically, New York FBI agents stormed Donald Trump's Florida Mar-a-Lago home in August removing 20 boxes of materials, while in Washington DC, the Democratic House select committee probed the January 6 attack on the US Capitol. On December 22 the committee released its final report recommending that Trump should be barred from ever holding office again and on December 30, the House Ways and Means Committee released Donald Trump's tax records. In the November mid-term elections, the control of the House of Representatives shifted to the GOP.

We expect S&P 500 earnings will fall 10% to $180 in 2023. Unfortunately, applying an average PE multiple of 16.4 times earnings to $180 produces a low in the S&P 500 of 2952 in the next twelve months.

Plus, 2022 was a year of numerous natural disasters. These included a northeastern winter storm leaving 100,000 Americans without power in January, a series of wildfires in southern Europe, floods in South Africa, Nigeria, Brazil, India, Afghanistan, and Pakistan (where major flooding submerged a third of the country), earthquakes in Indonesia killing 334 people, in Afghanistan killing 1,036 people and in California killing two, droughts in East Africa, and back-to-back hurricanes in Florida. Mother Nature was unforgiving in 2022.

OUR 2023 FORECASTS

Nonetheless, the global Covid pandemic had a major impact on fiscal and monetary policies around the world and its aftershocks will continue in 2023. Most developed countries employed historic amounts of stimulus to counter the economic shutdowns mandated in March 2020 to prevent the spread of the virus. Continuous stimulus packages led to booming stock markets and escalating inflation in 2020 and 2021 which were the upside of easy money. However, in May 2022 the Federal Reserve began to fight inflation by ending quantitative easing and increasing interest rates. This shift in monetary policy was late, but it was a predictable consequence of stimulus, and it had a debilitating impact on the equity market and PE multiples. In the first half of 2023 we believe there may be a final chapter to the post-pandemic hangover and Fed tightening, i.e., a recession. There are many signs of a pending recession, including the inverted Treasury yield curve, the slump in the real estate markets and weak retail sales. The downside of inflation is numerous, including a consumer with declining purchasing power, a profit margin squeeze, and declining corporate earnings.

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With this backdrop we are forecasting GDP will grow 0.3% YOY, including negative growth in the first half of the year and a modest recovery in the second half. Much of this is based upon the fact that we expect the Fed to raise rates to at least 5% to 5.25% in the first quarter, and keep rates at that level for most, if not all, of the year. As a result, we forecast S&P 500 earnings will fall 10% to $180 in 2023. Unfortunately, applying an average PE multiple of 16.4 times earnings to $180 produces a low in the S&P 500 of 2952. In sum, we believe the S&P 500 will fall below the magic 3000 level in the first half of the year as the Fed fights to get inflation under control.

Recession Proofing

Given our forecasts, we believe a better buying opportunity will appear in the next six to eight months. Therefore, it would be advantageous to have above-average cash levels in portfolios. In our opinion, the US could be experiencing a series of rolling recessions, beginning with the two consecutive quarters of negative GDP recorded in the first half of 2022 and ending with a mild recession in 2023. The good news is that the balance sheets of households, corporations and banks are healthy, and this should temper the weakness expected in the economy. However, a recession will have a debilitating impact on earnings and stock prices. Therefore, we remain defensive and would protect portfolios as much as possible early in 2023. This means emphasizing areas of the stock market with recession-proof revenue growth and earnings such as energy, staples, utilities, aerospace, defense, and select areas in healthcare, such as health insurance.

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