THE National Investor

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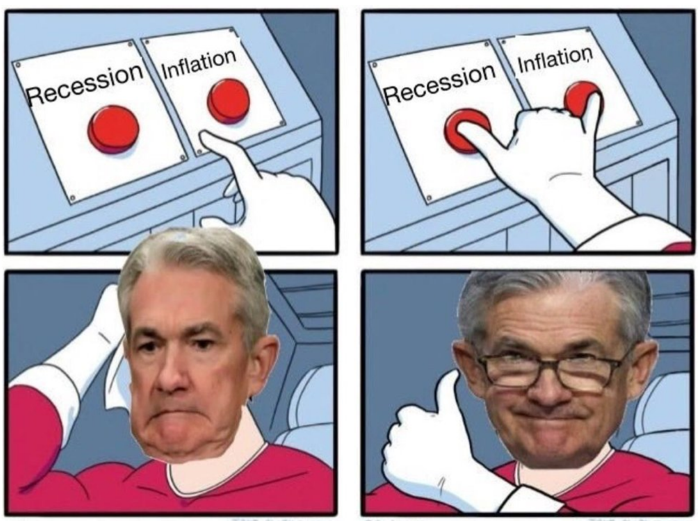
"THE GREAT STAGFLATION" WILL BE MORE "STAG" IN 2023



As 2022 is winding down to a close—and notwithstanding *somewhat* of a reckoning with reality following the latest Federal Reserve meeting—one still gets the impression that markets seem to be stuck in a bad dream. Any minute now, many seem to think, we'll be waking up to an *easing* Fed…inflation dead and buried again…no geopolitical fears…supply chains all working…everyone in the world getting along…etc.

Methinks 2023, as the year unfolds, will be stressing over and over again to us all that, no, this has *not* all been a bad dream. **What we have only begun to see this year, in many respects, is indeed but the first fruits of some *major, secular* changes to the global economy and markets which will be with us for as far ahead as one cares (or dares) to look.**

As Mike Fox and I discussed last week (see https://www.youtube.com/watch?v=llZ2c5if1ag&t=2s if you haven't already, *and listen*, for this lengthy 2023 forecast of sorts) **the Fed *clearly* intends to squeeze the economy and assets further**. How far they can still go remains to be seen. As discussed, few thought the Fed would be able to raise rates this much without blowing up *something*; but to date they have avoided that. Count me as one of those who is at least mildly surprised, notwithstanding my reminder in the above discussion of how Konni Harrison and I predicted an ultimate 4 – 5% peak in the 10-year Treasury back at our spring confab in Chicagoland.

Skeptics abound, of course, as to just how long this can go on. And as added in Friday's weekly podcast (at https://www.kitco.com/commentaries/2022-12-16/The-Metals-Money-and-Markets-Weekly-Dec-16-2022-Y-is-for-Yikes.html) Mickey and I discussed that ***somebody* here is *very* wrong**!

Though they have in the last few trading days corrected some of this unwarranted exuberance, **traders have behaved as if they still think 2023 will bring not only a pause *but a reversal* of the Fed's tightening.** For its part, the Fed has bluntly said "No way." Indeed, adding to the late December funk, Powell and Company upped the ante this last F.O.M.C. meeting, across the board predicting a higher threshold of rates *for the next three years* than had been expected. We'll still have a 5%-plus fed funds rate at the end of 2023…moving down to still north of 4% in 2024, if their predictions hold (OK, they probably *won't*, but…)

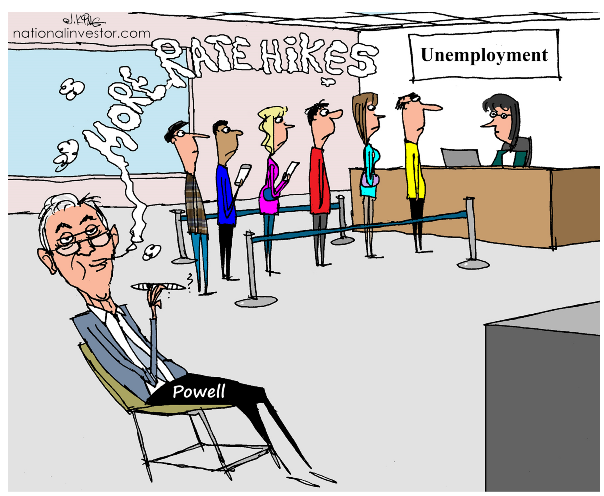
Can the Fed be as spectacularly wrong at year-end as they were year-end 2021, when the consensus was a 1% fed funds rate by now? Of course. But barring a deflationary/credit crisis event (China? Europe's banks? Ghana's new looming default spreading to other emerging markets?) there remains a lot of liquidity and inflation in the system. And the Fed is not about to turn tail and change unless *forced* to do so.

THE ECONOMY *STILL* PROVIDES THE FED SOME HAWKISH COVER

Just as I am buttoning up this issue, we got the final reading of Q3 GDP: an "unexpectedly strong" 3.2% annualized pace. This takes more of the strong from those two straight contractions in Q1 and Q2 (remember, though, the reasoning Yours truly and others gave at the time for Q1 being somewhat of a statistical "Mulligan.") As of now, Q4 is slated to be in the black as well, albeit less so.

Though millions' of folks Christmas travel plans are in the process of being disrupted by the weather, travel stats pretty much all year long have been back to *or above* pre-Plannedemic levels. That's the good news, showing that consumers are still able to spend some dough, albeit selectively. **But as I have commented many a time in recent months, that "selectively" is the operative word.** And as we get into 2023, even some of *that* strength RE: travel and the like will likely dissipate.

Fire Marshall Jay again at his most recent presser was uncharacteristically plain spoken, for a Fed Chairman. Having fully re-embraced the old Phillips Curve and otherwise believing again that the economy, consumers' balance sheets, etc. can be *too* good, **Powell is on a single-minded mission to "reduce demand."** Bolstered by the economy's continuing resilience—all else being equal *and* provided market/credit/systemic crises don't materialize in any big way—I *fully* expect the Fed to follow through on at least a couple more rate hikes to take the target fed funds rate a bit above 5%, as just telegraphed. And—all but saying outright that he will accept a recession as part of this quest—a broader slowdown in 2023 will not change this.



"Higher for Longer"

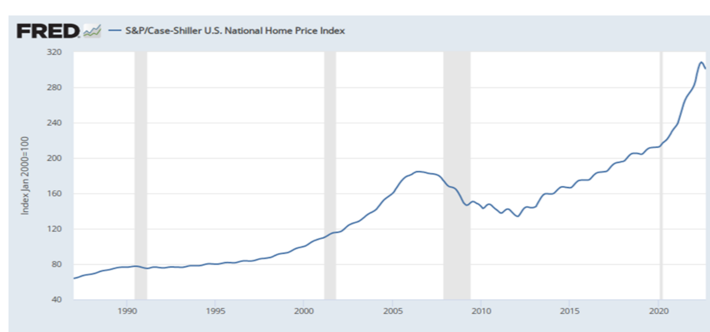
A MORE ABRUPT RECKONING IN THE COMING YEAR

***Not* seeing the damage this past year many of us had thought likely with what the Fed has done, the question now arises anew as to whether the Fed will manage to "break something" in 2023.** As Daniel Lacalle pointed out last week on *Mises Wire*, the much higher, chronic level of interest rates in the markets together with the ever-present dynamic of debt needing to be rolled over (and now at those far higher rates) is going to, at the least, throw a big monkey wrench into growth, corporate profits *and even the very solvency of many*. On that latter score, consider the more acute plight of Ghana lately; an insolvent debtor country that will be joined by many in 2023 needing new global handouts…or otherwise refusing/unable to make current debt payments.

This is where—as it does often—the Fed has forgotten that it is the de facto central bank of the world. As I opined on both those earlier links, I have no doubt that, as markets wake up to the fact that 2022 was not a bad dream and all the rest, **the dollar and Treasury yields alike will move back toward their October highs.** That will exacerbate the woes of the shakiest debtors and eventually lead to appoint where the Fed will have to relent somewhat (though my operative view of things as we go into the New Year is that this will still take some time.)

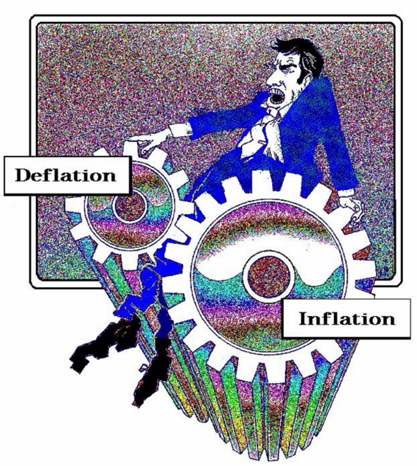
Until that point, the "more work" Powell says needs to be done includes whittling a fair bit more away from Americans' "wealth effect." In addition to otherwise throttling growth and wage increases, knocking *another* 20% or so off the S&P 500 will help in the cause of making Americans poorer. Then we'll spend less. Then inflation will come back down to the Fed's target. *Or so the story goes…*

In addition to the S&P 500 getting back down to the 2800-3000 area this coming year (a target we've discussed a few times of late in varying contexts) **the Fed also has its sights on real estate; *perhaps more so*, since it hasn't been dented all that much yet.** Here as well, the Fed no doubt believes it has considerable room to bring the white hot real estate market of the last



few years back down to earth. This last spike was not remotely as dependent on shaky mortgages and all as was the ill-fated housing boom and subsequent BIG bust/crisis 15 years ago. This one has been more so of simply too much money chasing too limited of inventories.

As I pointed out in the Mike Fox discussion, what I am seeing locally here in a better-than-average real estate market suggests we'll see the beginnings of a price pull back that took shape this year accelerate in 2023. *I do not necessarily see a "crash," though*. And as I have been commenting in relation to the stock market, there will be pockets of strength even as the majority of sectors/areas of the country see, likely, 20%-30% *average* price declines before this plays out.



The ongoing/accelerating decline in asset prices such as this will combine with still-high inflation for many basics to squeeze us all a LOT more in 2023. As I explain a bit below, we've likely seen the best we're going to of a relenting—somewhat—in energy prices. Many services, rents, etc. will stay high. (If all you need to do in the coming year is buy from amid the gluts in apparel and a coming, growing one in used cars, though, you'll be ok…)

This is especially a reckoning that Wall Street analysts need to deal with. By and large, far too rosy a picture is being painted by the average analyst who does NOT want to admit that the base case should be a 3000 or so level for the S&P 500 in "only" a mild recession, etc.

As my colleague Grant Noble said in his daily amalgamation of news and links on Monday, "The problem with current forward estimates is that several factors must exist to sustain historically high earnings growth:

* Economic growth must remain stronger than the average 20-year growth rate.

* Wage and labor growth must reverse to sustain historically elevated profit margins, and,

* Both interest rates and inflation must reverse to very low levels.

"While such is possible, the probabilities are low, as strong economic growth can not exist in a low inflation and interest-rate environment...In the NO-recession scenario, the assumption is that valuations will fall to 17x earnings over the next year. If such is the case, based on current estimates, then the S&P 500 should theoretically trade at roughly 3500. Given the market is trading at approximately 4000 (time of this writing), such would imply a 12.5% decline from current levels...However, should the economy slip into a "soft landing" or mild recession and valuations revert to the longer-term median of 15x earnings, such would imply a level of 3100…" If you *really* want to dig into myriad scenarios for 2023, check out https://realinvestmentadvice.com/valuation-math-suggests-difficult-markets-in-2023/ .

Bottom line: The Fed has every motivation and, until this changes, the conviction to continue squeezing the markets generally, real estate and the economy in 2023. The bear market will take on more earnestness, though there will still be LOTS of opportunities, as I will continue to discuss and bring you (for a corollary take, see https://fortune.com/2022/12/09/how-bad-economy-next-year-blackrock-2023-economic-outlook-new-regime-investment-playbook/.)

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