Market Commentary
January 2023

English Version

Outlook 2023

A Tale of Two Halves

Quarterly Call Q1

Get guidance on investments, and the major structural factors behind your clients' portfolios.

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Transcribed from comments made during our Quarterly Call Q1 | 2023

January 9th, 2023.

A Look Back to 2022 and Implications

Last year will be remembered as one with heightened degrees of uncertainty and volatility, and one that most investors would quickly like to forget. In the recent past, a singular shock would roil markets, like the Global Financial Crisis of 2008 or the Covid pandemic of 2020. But in 2022, there were multiple surprises to the financial system, each with similarly deleterious effects. Investor confidence was first shattered by the rapid pace of global monetary policy tightening as surging inflation proved persistent and nefarious. This year liquidity was withdrawn from markets at a rate not seen since the 1970s and 80s in the developed world.

Ahmed Riesgo
Chief Investment Officer
Insigneo Financial Group

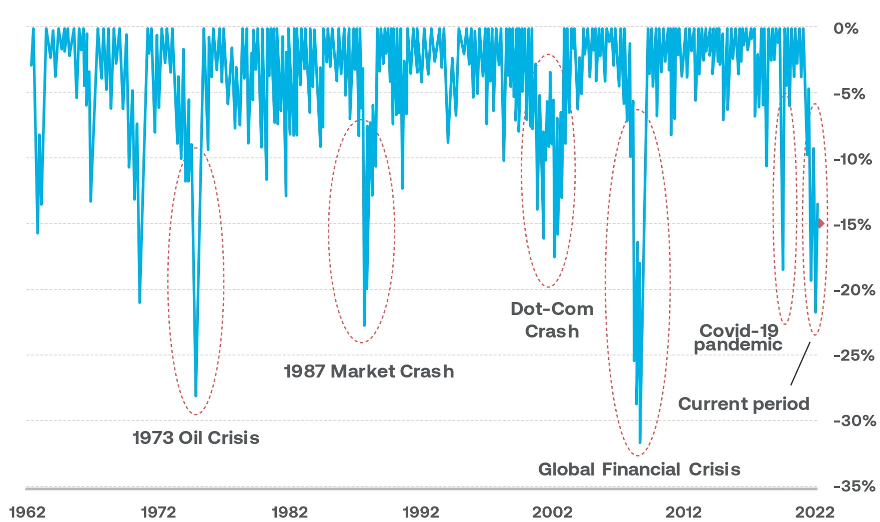
And the private sector's resiliency was equally unnerved by Russia's invasion of Ukraine, the first major land conflict on European soil since the Second World War, and China's tenacious "Zero-Tolerance" Covid policy, which resulted in several draconian lockdowns across the country reminiscent of the early stages of the pandemic.

There really has been no place for investors to weather the tempest. The poor performance of both stocks and bonds is exceedingly rare. We looked back a hundred years and found only two other instances when equities and rates declined comparably as they have this year – 1931 and 1969. A few of the more surprising takeaways were that it was the worst year ever for Investment Grade Corporate bond returns, and that the share of USD-denominated IG bonds trading below $80 reached its highest level on record. As Chart 1 shows, despite the equity pullback being a median fall (down -25% at the market trough), balanced traditional 60%/40% portfolios recorded one of their worst years on record. Clearly, fixed income failed to protect as it has over the past decade. In sum, 2022 was a difficult year for investors to navigate as relationships that many have come to rely on either broke down or, worse still, reversed.

As we enter the new year, it makes sense to pause and reflect: Why did we have these simultaneous bear markets in both equities and fixed income? **Our view is that this past year was the first instance that many of the long-term, structural shifts in the world became evident for most to see.** From globalization to deglobalization, from plenty to scarcity in energy and other commodities, from the "Washington consensus" to a 21st century version of the "Great Game", from population booms to bust, and from disinflation to inflation. Chart 2 shows us that the number of workers versus the number of consumers around the world peaked in the latter half of the previous decade and is now falling precipitously. Along with the greater frequency of conflict, this trend is probably the largest single driver of the new higher inflationary paradigm that could persist for the next few decades.

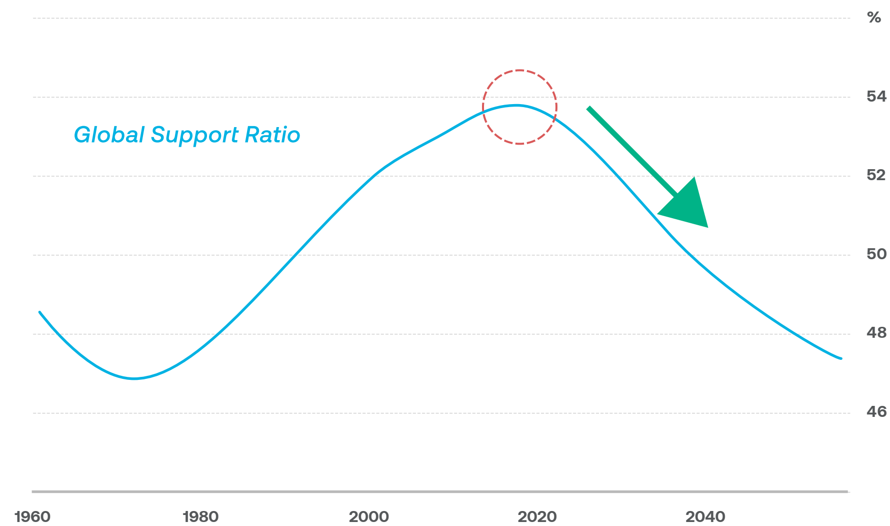
— "There really has been no place for investors to weather the tempest. The **poor performance** of both **stocks and bonds is exceedingly rare.**"

Tough Years for Balanced Portfolios Throughout History. 1-Year Drawdowns for 60/40 Portfolios.



Source: Haver Analytics, Datastream, Goldman Sachs GIR.

Global Demographic Trends are Inflationary: Number of Workers Relative to Number of Consumers is Falling



Source: BCA Research

Will this necessitate dramatic shifts in portfolio construction? I would call them "shifts" and "tweaks" and we have touched upon them frequently in our recent work like the heightened incorporation of real assets, commodities, infrastructure, gold, real estate, and private investments. It means more energy, materials, and value stocks than growth and tech companies in your sector allocations. **However, the 60/40% portfolio is not dead despite the many alarmist articles you may have read, and, in fact, 2023 might induce a resurgence as we anticipate a much better year for fixed income, particularly high-grade bonds, and sovereigns, due to a more benign rate environment than observed during this year's carnage.** According to our expectations, a 60/40 blended portfolio of US equities/bonds over the next decade should generate around 6.5% annualized returns, and a great chance of returning between 5.5% and 7.5% per annum.

— "From now on, it should be a series of higher highs and higher lows **until the new bond bear market is over**, and that could take many more years, perhaps decades."

Once we pass the short-term step-down in rates that we anticipate once we enter a recession, then the bear market in rates should reassert itself. Remember, rates should follow two steps up and one step down but a positively sloped trend. As we mentioned in the aftermath of the pandemic, the 40-year bond bull market ended that year when the US 10-year bond hit what we think will be its all time low of 0.32% on March 8, 2020. **From now on, it should be a series of higher highs and higher lows until the new bond bear market is over, and that could take many more years, perhaps decades.**

We hope you enjoy reading our annual outlook for 2023 as much as we delighted in putting it together for you. The future is unknowable, and it will surely bring surprises this year as it has in the past. But that does not mean that forecasting is a useless endeavor. It allows one to establish a framework and contingency plan around uncertainty that then may be updated

Economic Growth Below Potential Almost Everywhere

REGION	2022 ESTIMATE	2022 ACTUAL	2023 ESTIMATE
US	1.8%	1.9%	0.7%
China	1.9%	3.0%	4.8%
EU	1.7%	3.2%	0.1%
Japan	2.0%	1.4%	1.1%
World	3.1%	3.1%	1.6%

Source: Insigneo

as new information is made available to us. Have a wonderful, prosperous, and successful New Year.

Macroeconomic Forecasts

First, we will start with an assessment of the accuracy of last year's growth forecasts for the major economic blocks around the world. Overall, we correctly assessed the trajectory of the pandemic, and were right about the continued strength of labor markets around the world as the working-age population continued to normalize. In Chart 3, you will see our 2022 forecasts next to the actual growth numbers at the end of the year. Our US and World growth estimates were spot on, coming in at 1.9% and 3.1%, respectively, and attesting to the strength of our econometric models. For China and the Eurozone, we underestimated the resiliency of both regions to the war and lockdowns but were directionally prescient. In Japan, we overestimated the level of growth, but not by a materially significant margin. Overall, we are content with our economic forecasting record for the year.

Now, let us turn our attention to this year – 2023. You will see those figures popping up on the right-hand column of the same chart. There are a few key take-aways from these forecasts. **First, economic growth around the world should be significantly below potential, trend levels with one major exception – China.** We are projecting US Real GDP growth to be an anemic 0.7%, Japan at 1.1%, and the Eurozone basically flat at 0.1%. Our global real GDP estimate currently sits at 1.6%, the weakest figure in years and suggesting a mild global recessionary environment.

The Eurozone area is facing stronger short-term headwinds than other regions (in fact, it may already be in a recession), though the region may have the scope to grow faster beyond the next six-to-nine months. But for that to occur, we first need to see some stabilization in European energy markets and that requires a resolution to the war in Ukraine.

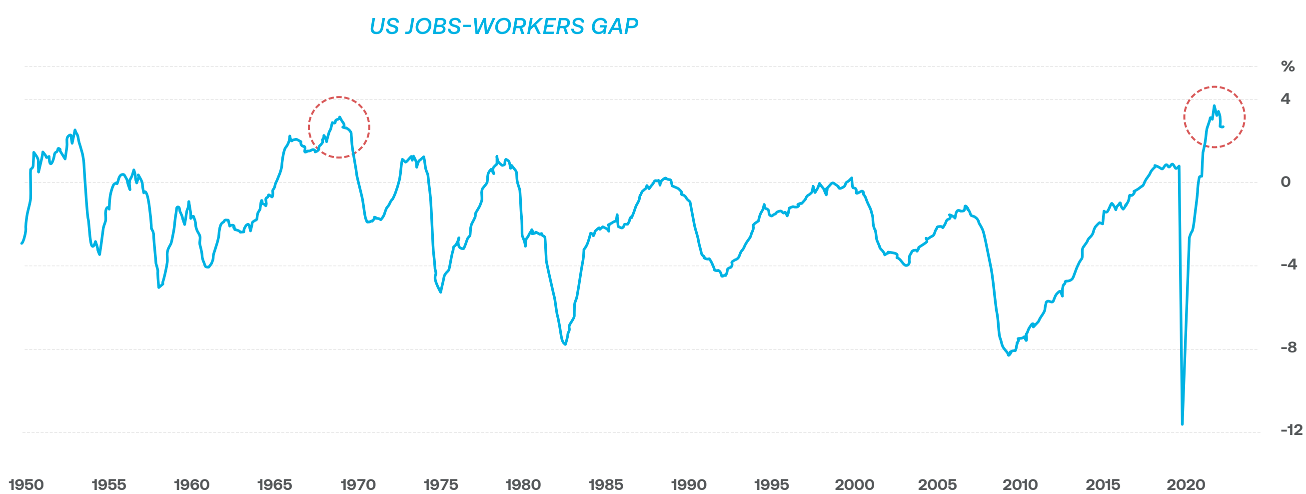
China is the one major region where we are forecasting growth to come in at or just above potential at 4.8%. We have revised this figure significantly upward in the last few weeks after the country's dramatic and abrupt shift to its Covid policy, which was largely forced on the government by the incredible pushback from the Chinese population. **In essence, China has become Sweden, allowing the virus to run its course through the country with minimal government interference** beyond vaccination campaigns. The Chinese government will rely on people rather than rules to self-regulate their behavior when cases are elevated. In addition, China is providing additional stimulus to its beleaguered property market, dampening its crackdown on Big Tech, softening its stance on the delisting issue with the US, and even looking to diffuse geopolitical tensions with the US and Europe. These are welcome developments, even if they are late arriving, and they pose upside risks to economic growth around the world and especially in the developing world. Unfortunately, it also poses upside risks to inflation in the developed world as China's unbridled reopening could place pressure on commodity prices next year.

Turning back to the United States, our proprietary Insigneo-Forefront Recessionary Indicator in has fallen dramatically over the past quarter from very elevated levels, largely due to the continued strength in the US labor market and consumer resiliency in the face of falling pent-up savings. Our model forecasts the probability of a US recession over the next 6 months at only 5% and over the next year at 37%. As we will show you in a few moments, our overall subjective probabilities for a US recession are much higher than our probit model suggests. Before we do that, however, it is worth highlighting the features of the US economy that are underpinning the model's low probabilities.

It starts with the US labor market. As Chart 6 demonstrates, there are still too many jobs available for US workers. The US Jobs-Workers gap is falling slightly but it still remains elevated. This measure is defined as the difference between the total number of jobs (i.e., employment plus job openings) and the number of workers (i.e., the labor force). It is still 3 to 1. That means that openings across the economy are down from the highs but still far exceed the number of unemployed Americans. In a recent survey, most laid off tech workers are finding jobs shortly after beginning their search, as employers continue to hire workers in a tight labor market. According to this ZipRecruiter survey, about 79% of workers recently hired after a tech-company layoff or termination landed their new job within three months of starting their search. That was just below the 83% share of all laid-off

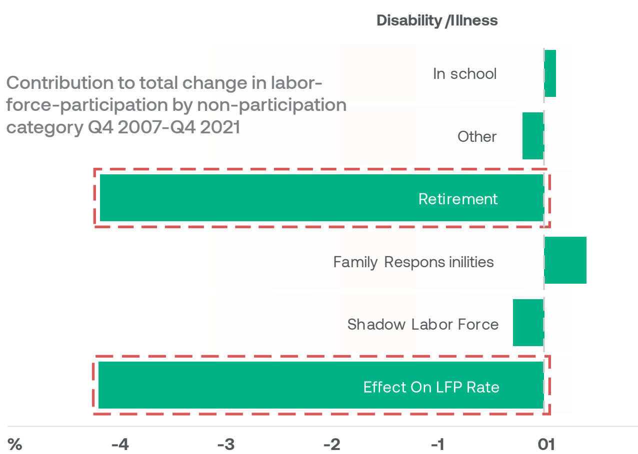
Jobs Aplenty: US Jobs-Workers Gap Falling But Still Elevated

Source: BCA Research



workers who were re-employed in the same time frame. And why is this the case? Simply, **US workers are a scarce commodity; the pandemic left a permanent scar.** As Chart 7 shows, retirements were the single largest contribution to the change in labor force participation. The permanent departure of older Americans from the workforce as a result of the pandemic is exacerbating the labor market imbalance and that is not reversing. We have read company management reports where they are reluctant to lay off workers, even if they otherwise would, due to how difficult it would be to rehire once economic activity picks up again. Furthermore, not only are layoffs likely to be lower than usual with a growth slowdown, but US consumers are

US Labor is Relatively Scarce, so Layoffs May be Smaller



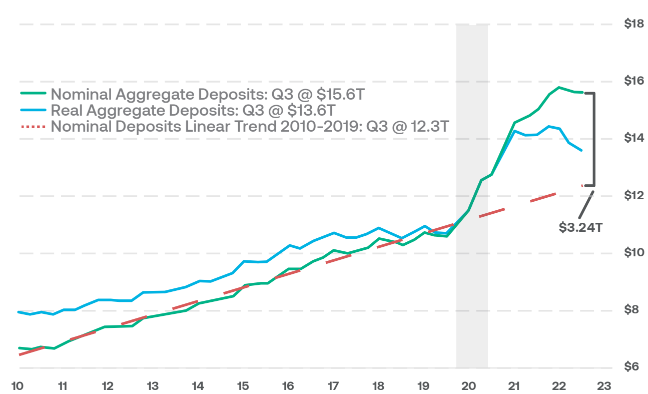
Source: Atlanta Fed Labor Force Participation Dynamics Dataset, BCA Research

still sitting on USD 3.24 trillion in excess savings (cash and deposits they would not have had in their bank accounts if not for the pandemic) as reflected in Chart 8. Yes, those are gone for the lowest income quintile of Americans, but not for the rest. Moreover, US consumer credit card balances are still at levels not seen since the mid-1990s. Chart 9 demonstrates that US credit card borrowing is at a level just over 6% of disposable income.

Now, we do not want to sound excessively optimistic here (and you will see that we are not once we show you our updated Bayesian probabilities). US monetary policy has already effectively reached restrictive levels and will certainly do so if the Fed gets to 5% on the Fed Funds Rate. In the past, that has typically triggered a recession within a year's time.

Certainly, US inflation is slowing, but the key question is whether it will fall fast enough for the Fed to achieve a soft landing? As Chart 10 shows, the shelter and core services ex-shelter component of CPI remain elevated, and they are sticky in the sense that they are resistant to quick changes despite shifts in the

US Cash Balances & Deposits Are Falling But Still Elevated (in trillions, shaded area denotes NBER designated recession)

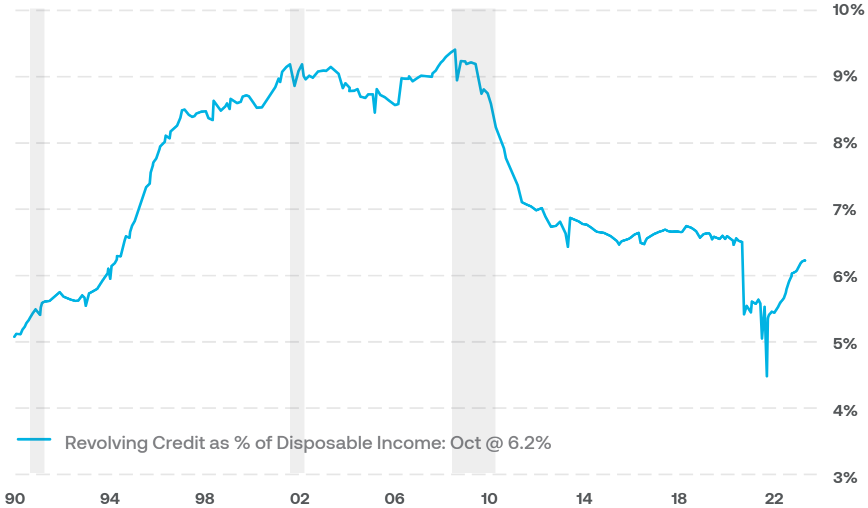


Source: Federal Reserve Board, Wells Fargo Economics

broad economy. For example, even though shelter inflation remains high in the official CPI data, more real-time high frequency indicators of rents show that these are already falling; it is simply a matter of time before it is reflected in the official government data. The Fed knows this phenomenon, but it has talked itself into a corner by saying that they need to observe CPI falling sharply before it can pivot, which is something that increases the likelihood of Fed

US Revolving Consumer Credit Still Low (expressed as a percentage of disposable income, shaded area denotes NBER designated recession)

Source: Federal Reserve Board, U.S. Department of Commerce and Wells Fargo Economics

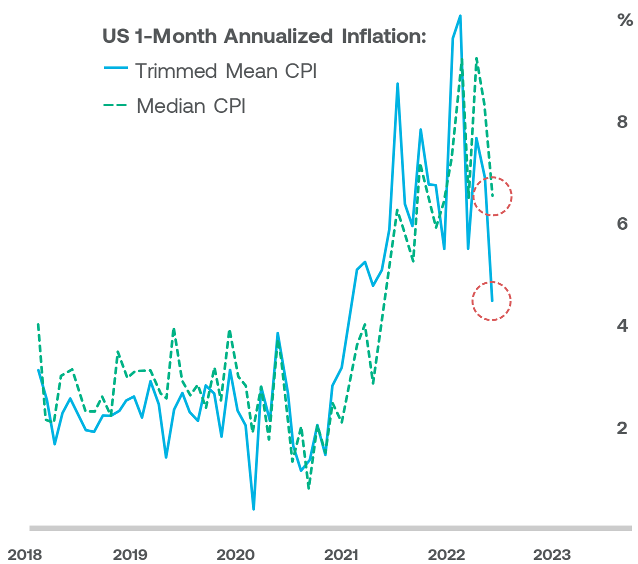


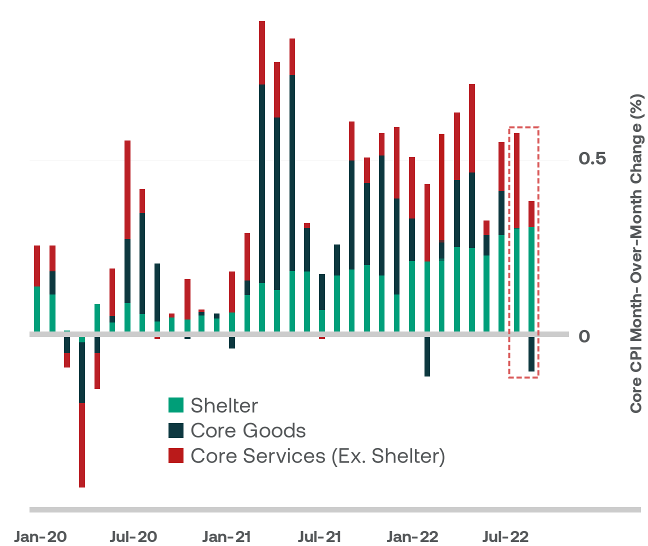
overtightening. In other words, it increases the risk of a policy mistake. In our view, the most plausible way that the US avoids a recession in 2023 is if the Fed cuts rates next year, which sacrifices some of its newfound hawkish credibility; this is something they may be reluctant to do.

Chart 11 displays Insigneo's subjective recessionary Bayesian probabilities for the United States over the next 2 quarters incorporating all factors, including our probit model and the monetary policy/Fed dynamics we just discussed. **From the previous quarterly call, our "mild recession" forecast is unchanged at 50%. The**

US Inflation is Certainly Slowing: But is it Slowing Quickly Enough for the Fed to Avoid a Recession?

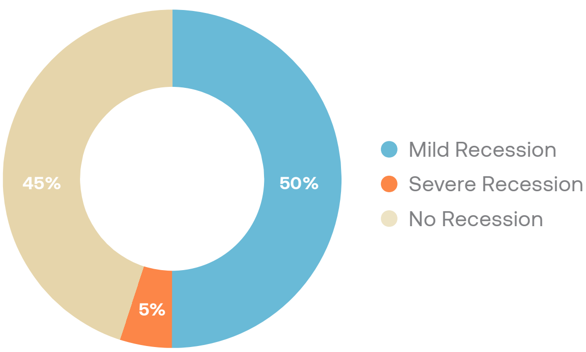
Source: Federal Reserve Bank of Cleveland, BCA Research





only change from last quarter is our view that the chance of "no recession" over the next 6 months has increased from 40% to 45%, at the expense of a "severe recession" which fell from 10% to 5%. Our view remains that the next US recession, whenever

Subjective Recessionary Probabilities Over 2 Quarters Incorporating All Factors



Source: Insigneo Research

it does occur, is likely to be a mild one, in contrast to the last two severe contractions. The US has no discernible private sector imbalances, excess savings remain elevated, and the ongoing scarcity of labor suggests businesses may be reluctant to shed as many jobs during a recession as they otherwise might be inclined to do. This should keep the unemployment rate from rising above 5%, our threshold for a "mild recession". In sum, we continue to expect the US and the world to enter into a mild recession sometime around the middle of 2023.

In the US, there is a possibility that it gets pushed out further into early 2024. In any event, it should be a relatively mild one, particularly given recent economic contractions. In Europe, the near-term environment is more challenging given the ongoing war and stress in their energy markets, but their economic rebound potential is greater than in the US in the medium term.

The outlook for China has brightened considerably given the government's dramatic pivot on Covid policy, the property market, tech regulation and interference, and their renewed emphasis on achieving their 5% growth target after a few years of discarding it altogether. With inflation receding all over the world and long-term inflation expectations well anchored, central banks around the world will be able to pivot if and when a recession ensues. **We think that, if anything, global growth risks may be slightly tilted to the upside relative to subdued expectations.**

Market Forecasts

The events of the past year have added significant uncertainty to the cyclical economic outlook as reflected in our own probabilistic projections which are basically a toss-up between a mild US recession at 50% and no recession at 45%. In any event, the era of low rates and easy money is over and both stocks and bonds merit higher risk premia relative to what prevailed before. Given our growth views and the path for monetary policy, we expect market volatility to persist, especially in the first half of the year. The direction and magnitude of rate moves, and ongoing geopolitical frictions should remain key market drivers. In our view, the most important market development for next year is that the correlation between stock prices and bond yields will likely turn positive again given that the Fed will be able to cut interest rates once a recession begins. **To that end, we have raised our fixed income allocations to neutral from underweight for the first time since the early days of the pandemic. Another key theme that we believe will begin to assert itself this year is the end of almost 14 years of US equity outperformance versus the rest of the world.**

Before we delve further into other important trends for the year, let us go over our scorecard on the market

side just as we did with our macroeconomic projections in the previous section.
With respect to market calls from last January, what did we get right in 2022? Three significant ones come to mind immediately. First, on the fixed income side, we correctly recommended that investors should maintain a short duration stance and were positioned for higher bond yields. This one is self-evident, as rates had their worst year in decades, and there is no need to expand this theme further. Second, we also correctly recommended overweighting Value factor equities over Growth factor equities. Finally, we favored investments in the broad commodity complex, and those have proved prescient as the sector as a whole has been flat to slightly up in a very negative year in other asset classes.

Now, perhaps the more interesting question: what did we get wrong? While our overall growth call was right our neutral positioning on risky assets was too optimistic and we should have clearly been underweight risk assets within multi-asset portfolios. That being said, we are glad that we reduced our bullish positioning from the previous year in anticipation of volatility given rich valuations across assets. Two developments contributed to the miss. First, we did not expect core inflation to remain as high as it did for so long, because we thought the supply-side and pandemic-related distortions would be unwound more quickly. But most importantly, we did not anticipate the Russian invasion of Ukraine which clearly exacerbated the inflationary trend. The war obviously raised energy prices for several months following the invasion, and global supply chain pressure indicators stopped falling and rose for a few months. For what it is worth, we did adjust our views once the war began and recommended that investors with low volatility tolerance maintain highly elevated of cash in their portfolios back in late February after the invasion. Chart 12 shows our two key market forecasts for the US for 2022 after the Russian invasion of Ukraine. We gave a target range of 3400 to 3700 on the S&P 500 and a range of 3.2% to 3.6% on the US 10-year bond. As of December 22nd, when we wrote this report, both values were at 3822 and 3.67%, just slightly above our target ranges. To the right, you will see our estimates for the end of next year. We have a projected range on the index between 4100 and 4300 and 3.4% to 3.65% on the 10-year rate. However, the far more interesting matter is the path that gets us there. If a mild recession begins in six months (50% chance in our view), then the index is likely to trade lower in the first half of the year and rebound in the second half of the year as the Fed cuts rates. If so, then we may see a retest of the lows we saw back in 2022 when the index traded down to approximately 3500. This downdraft would be preceded by a significant decline in corporate earnings, at a time of higher interest rates. If, however, the recession does not commence next year (perhaps in early 2024, remember 45% odds from our framework), then the market could gain some ground in the beginning of the year only to give some of it away in the latter half of the year. This is why we have titled this Quarterly Report, “A Tale of Two Halves”.

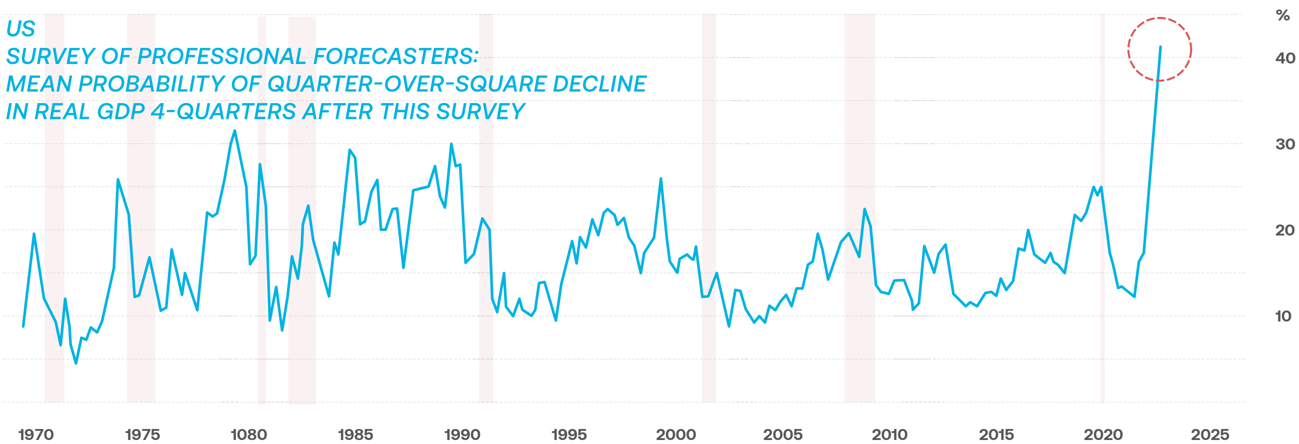
Key US Market Forecasts
(Assumes a mild recession beginning by Q2/Q3)

	2022 ESTIMATE	2022 ACTUAL (AS OF 12/22/22)	2023 ESTIMATE
S&P 500	3400 - 3700	3822	4100 - 4300
US 10-Year Treasury	3.2% to 3.6%	3.67%	3.4% to 3.65%

Source: Insigneo

Of course, **the plot twist would be which of those scenarios plays out: recession in 6 months or reces-**

Most Anticipated Recession in History (shaded area designates NBER recessions)



Source: Federal Reserve Bank of Philadelphia, Survey of Professional Forecasters, BCA Research

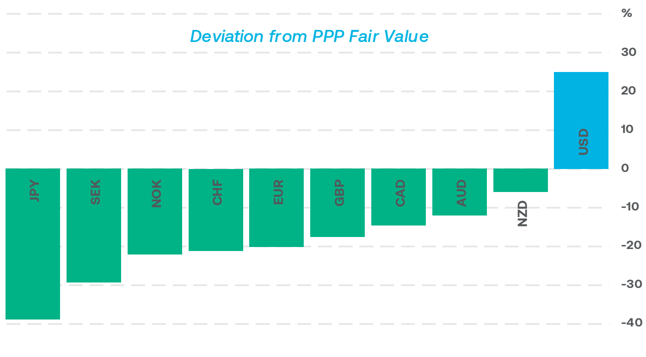
sion in a year. Under either scenario, we believe it is not prudent to de-risk further or shift into an underweight stance on risk assets as the odds we assign to a severe recession in the US are quite low (5%). Only in that worst-case situation do we see the index trading all the way down to 3000 to 3200. One of the reasons why we think that the time to de-risk has passed is that the recession, if it comes, will be the most anticipated one in history. Chart 13 shows you that this is the most anticipated recession in the history of this survey of professional economists and forecasters; this survey from the Philly Fed goes back all the way to the 1960s. That means that investors and other market participants are also anticipating one; that information is already likely reflected in the index.

Another reason is that investor positioning in risky assets is quite low as cash levels remain elevated inside their portfolios.

Now, it is worth discussing the US Dollar as it has been the one major asset class with above normal returns for the year as it is correlated to higher interest rates and tightening financial conditions. In the near-term, the path of the Greenback will most likely reflect the path of monetary policy; with the US central bank still tightening it is hard to envision the US Dollar exhibiting any sustained weakness. **But as soon as the Fed pivots, US Dollar weakness should closely follow.** Chart 14 demonstrates that the US Dollar is very expensive. In fact, it is overvalued by almost 25% from its implied fair value based on Purchasing Power Parity. That means that it is reasonable to expect the US Dollar to fall by roughly -4% per annum over the next decade.

Once the Dollar begins to fall, it will be a tailwind for equity bourses outside the US but especially the emerging markets. Table 15 presents the 12-month forward price-to-earnings ratio of global equities divided by region. It reflects that US stocks remain the most expensive equity market in the world and China the cheapest. **Despite the recent rally, we remain constructive on China as we mentioned earlier due to both favorable stimulus policy (China is the only major country now easing fiscal and monetary policy) and the country's Sweden-like abandonment of its Covid policy.** Sure, the country is now facing a massive wave of cases, which will likely peak around January-

The Dollar is Very Expensive: Valuation Suggests USD Will Fall -4% Annualized Over Next 10 Years



Source: BCA Research

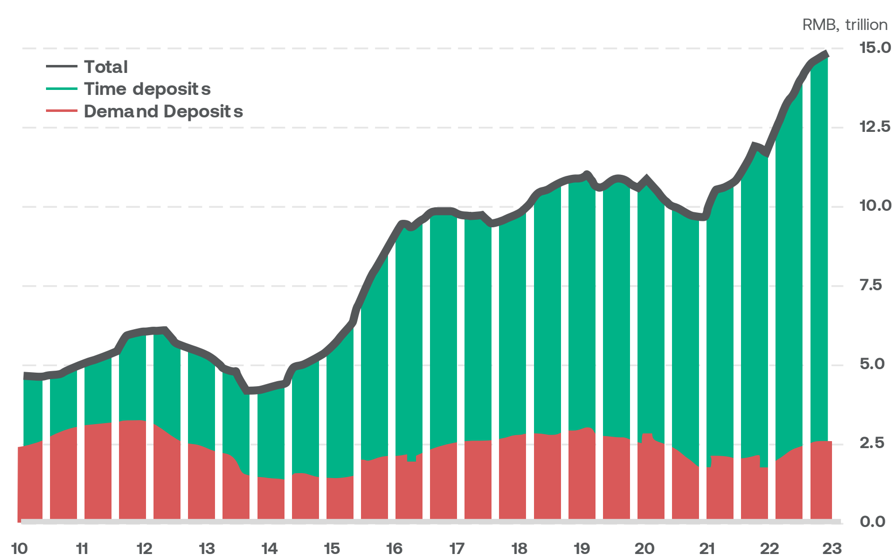
Global Equities Have Cheapened

	12 MONTH FORWARD P/E
US	17.7
GLOBAL	15.6
GLOBAL EX. US	12.1
EM EX. CHINA	11.9
EURO AREA	11.8
EURO AREA	11.6
CHINA	10.8

Source: BCA Research

February, but consumption is likely to begin a fundamental recovery as the drag on consumers Covid restrictions is finally lifted. Chinese households have amassed substantial savings during the past few years and should start to spend down those savings, just as their counterparts around the world did once the pandemic lockdowns ended. Chart 16 suggests that Chinese consumers are plush with cash they have accumulated since the pandemic, and consumer services should be a major beneficiary from reopening. We are already receiving data online retail sales are improving. **Overall, we expect both the Chinese economy and equity markets to be among the better performing ones in 2023.** As mentioned previously, European assets are also presenting a generational buying opportunity, but they remain at risk due to the

Chinese Consumers Are Plush With Cash



Source: Gavekal

ongoing war and accompanying energy crisis. The time will come to overweight European assets, but it is too early in our view. Only the most volatility-tolerant investors should overweight now.

Finally, the falling US Dollar will be a boon for commodities. O**ur long-held view is that we are in the early stages of a commodities super-cycle as the structural supply-demand imbalance around the world should persist for years.** Any pullback in prices due to a recession should be bought as it would only further delay the rebalancing that has to occur in those markets.

As previously mentioned, we upgraded fixed income to neutral from underweight for the first time since the early days of the pandemic. Chart 17 suggests that carry alone would be a sufficient condition to hold bonds this year when the Fed pauses or eases its rate hiking cycle. Some segments of the market that we find particularly attractive are long-dated taxable US municipal bonds. Chart 18 reflects that the spread of AA taxable Munis to AA corporates is the widest it has been in over 10 years, so they are currently at a very attractive entry point.

The following is a key summary of our market views and asset allocation guidance:

• We remain neutral on equities over a 12-month horizon but see the risks to stocks as tilted slightly to the upside over that same time period; for the S&P 500, our projected return for the index is between 5 and 10% given levels as of late December 2022

• However, gains could be backloaded in the second half of the year after some initial weakness.

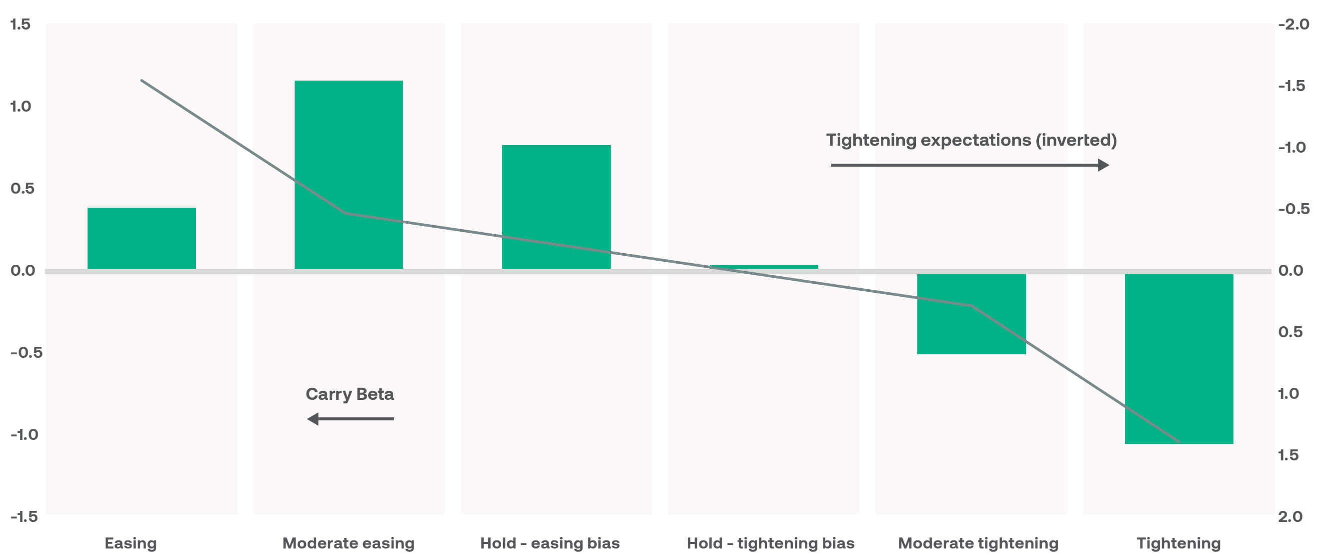
• Within equites, we would retain our bias to Value over Growth, but recognize that the latter may receive a respite from pausing or easing by central banks later in the year and would generally slightly outperform during a recession.

• We would also overweight emerging markets, especially China, relative to the US with an eye to increasing European exposure once there is more clarity on the war.

• After having been underweight rates since the early

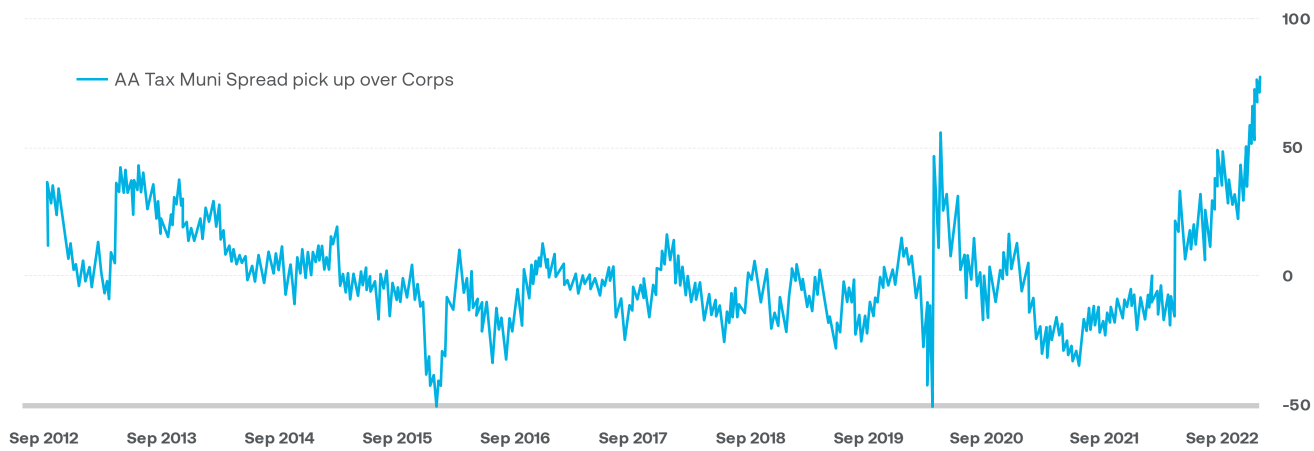
Fed Pause or Easing Will Be Tailwinds For Bonds

Source: JP Morgan



Long-Dated Taxable Munis are Very Cheap

Source: JP Morgan



days of the pandemic, we have increased our allocation to neutral expecting a tactical countercyclical rally within the ongoing bear market in bonds.

• The US Dollar will likely peak sometime in the first half of the year, and its subsequent fall should provide an impulse to emerging market equites and commodities over the next 12 months.

• The most prevalent sources of uncertainty are the timing of the onset of the US recession, and geopolitical events around the world.

So far, we have delved extensively into our macroeconomic and market outlook. Let us now turn our attention to our expectations on the geopolitical landscape.

Geopolitical Outlook

For some time, it has been one of our core views that geopolitical considerations will play a larger role in the economy and the broader world than they have in a generation. In our view, the fundamental reason for this is the relative power decline of the United States as other nations around the world ascend and reverse the anomalous unipolar world of the post-Cold War era. **The historical record indicates that multipolar political systems are inherently more volatile and conflict-laden than unipolar arrangements.** With this in mind, let us look forward to several ongoing conflicts and situations that should continue to be a source of instability in 2023 because these major issues are structural in nature, there is no evident diplomatic or internal solution, and the global economy should be weaker than it has been for some time.
First, let us start with the United States, the preponderant power in the international system but no longer the dominant one it once was. It is strikingly evenly divided between two political factions, largely preventing any policy continuity beyond the next election cycle. It suggests that **domestic policy should be paralyzed over the next two years, while foreign policy could be both vigorous and erratic.** Indeed, it should be a source of instability. **What adversary or negotiating partner will make a deal with the US, if it knows that deal would be easily torn asunder when the rival faction comes to power?**

President Biden's approval rating is low, the Democratic Party lost control of the House of Representatives, and the 2024 election outcome is very uncertain. According to the latest Gallup survey, President Biden's approval rating currently stands at 40% and his term average to date is only 45%. Keep in mind that his term so far mostly encompasses the beginning of his presidency when Presidential approval ratings are at their highest and they usually taper off with time in office. Biden's favorability may rise from these abysmal levels today, but it is likely to remain net negative. Of course, his ceiling is higher than Trump's, but he is not a charismatic president and questions about his age and ability will persist. **Our base case of a recession in the US next year, or early 2024 at the latest, would greatly increase the odds of a Republican victory in the 2024 elections.** Table 19 demonstrates that since World War II no incumbent President or political party has won an election in the case of a recession in the calendar year before the election or even if the recession ended just before the election. And if the recession begins in the calendar year of the election, the President's and political party's success rates are only 33% and 20%, respectively. Consequently, if our macroeconomic projections come to fruition, then Biden's and the Democratic Party's chances do not look promising for 2024. Indeed, if a recession materializes, Biden could quickly become a "lame duck" President and adopt a more aggressive foreign policy due to his lack of options domestically. But given that both the nation and Congress are so evenly divided, investors must worry that the US could face yet another contested election. The lack of certainty over the next few years will likely prevent foreign powers from making irrevocable pledges over the next two years and into the foreseeable future given US polarization.

We now turn our attention to the enduring Russian invasion of Ukraine. Against the current of all conventional thinking by policymakers and strategists over the past few years, Russia faces a potentially embarrassing strategic defeat in Ukraine. The first major land war in Europe in almost eighty years has escalated the threat of nuclear conflict to levels not seen since the most volatile moments of the Cold War. Alarmingly, many of the deterrent mechanisms in place during the

US Recession Next Year Bodes Ill for Democratic Chances in 2024

WIN RATES IN US ELECTIONAMID RECESSION

RECESSION IN CALENDAR YEAR OF ELECTION		POST-WWII
Incumbent President Win Rate	40%	33%
Incumbent Party Win Rate	36%	20%
RECESSION ENDS BEFORE ELECTION		
Incumbent President Win Rate	43%	0%
Incumbent Party Win Rate	43%	0%
RECESSION IN CALENDAR YEAR BEFORE ELECTION		
Incumbent President Win Rate	33%	0%
Incumbent Party Win Rate	25%	0%

Source: NBER, Dave LEIP's Atlas

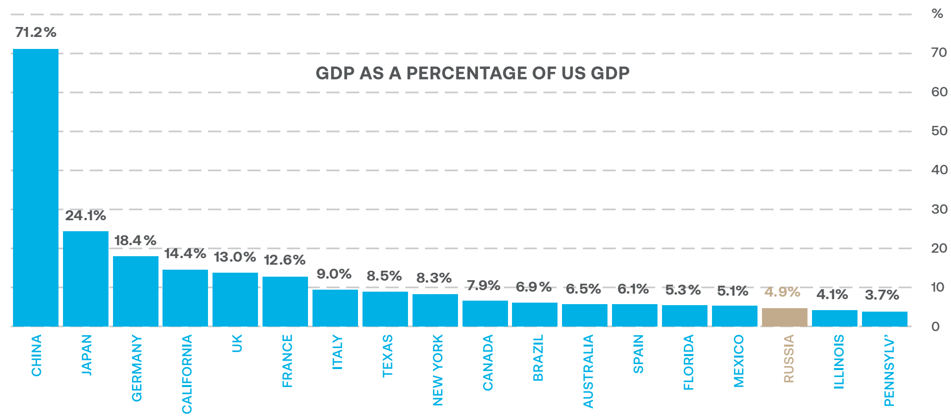
Soviet era have been dismantled or atrophied from disuse. Students of history may recognize many of the characters today as they played memorable parts in Cold War I, but their roles have slightly changed. In the Russia-China axis, the roles have reversed with Russia now the junior partner, subservient to China's rising economic heft and rapid militarization. Similarly, the NATO front features familiar players in new roles. **The US is still the global hegemon, but its persuasive powers are diminished. America's relative power decline is commensurate with the growing influence of China and parts of the Global South.**

To be clear, this war did not begin last year. It began in 2014 when Ukrainian rapprochement and flirtation with NATO became serious. Russia is a country that is shaped to a great degree by its geography. It is located at the heart of the Eurasian landmass, and its underbelly is an expansive plain with few natural impediments to invasions. Indeed, Russia's history is mired with foreign actors' attempts to strike deep in the geopolitical center of the country. Moreover, there are close historical ties between Russia and Ukraine. According to the latest census figures from 2001, almost a third of Ukrainians speak Russian as their primary language. In the eastern half of the country, especially the currently contested border regions like Crimea, Luhansk, and Donetsk, the percentages are approaching three quarters of the population. Indeed, Russian President Vladimir Putin published a lengthy essay, "On the Historical Unity of the Russians and Ukrainians", in which he argued for the historical intertwinement of the two peoples. Of course, his interpretation of history is self-serving and highly contentious, but it is a direct, unadulterated insight into the mind of Russia's dictator and, at least, into many other members of the Russian state as there is now considerable evidence that Putin has surrounded himself with sycophants.

Similar to Russia, Ukraine has historically straddled the boundary between the European Continent and the center of the Eurasian landmass. But this is not merely a geographical question, it is one of culture and civic society as well. **An increasingly anti-Western power, like Russia under Vladimir Putin, could not stand for an increasingly anti-Russian/pro-European Ukraine capable of hosting NATO troops and weaponry at its border.** Think of the American response when the Soviets tried to place nuclear missiles in Cuba in 1962. The US could not stand for it, and the world edged closer to global, nuclear conflict than it ever had before. Unequivocally, the Russian President overestimated his military capabilities and underappreciated Ukrainian resistance and Western resolve. He erroneously believed that he could blitzkrieg his way to Kyiv and that Russian troops would be welcomed as liberators. Some **NATO nations now too may mistakenly believe that they can outlast Russia's determination on a core security issue in its near abroad. Unless the adversaries can acknowledge the interests and constraints adherent to the conflict, the world risks the un/intentional nuclear escalation of the struggle.**
In terms of economic importance, Russia is no longer a great power. Chart 20 shows that in terms of its economic size, it ranks just above the American state of Illinois. So, Russian economic power is fading. But as Graph 21 clearly reveals, its nuclear arsenal remains the largest in the world. The Dutch historian Jolle Demmers said it best, "It is precisely the decline and contraction of Russian power, coupled with the possession of nuclear weapons and a tormented repressive president, that poses great risks." More-

> — "Unequivocally, the Russian President **overestimated his military capabilities and underappreciated Ukrainian resistance** and Western resolve."

Russian Economic Power is Fading... By 2020, Florida's Economy Was Already Bigger Than Russia's

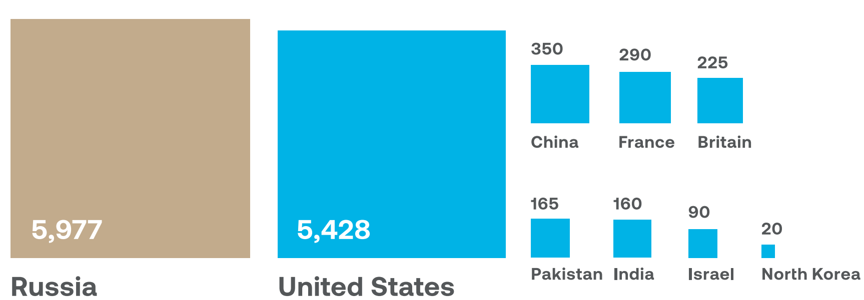


Source: IMF World Economic Outlook (October 2021), Bureau of Economic Analysis, & BCA Research

over, an empirical study of strategic geopolitical rivalries from 1816 to 1999 shows that state actors become more belligerent as their relative power declines versus when it rises.

Currently, Russia is losing terribly and unexpectedly. Its conventional forces have been beaten back by mid-level NATO weaponry, losing a portion of the territory gained during the initial assault. Their forces are suffering from insufficient supplies, poor strategy and coordination, low morale, and, as has been reported, some dissonance at home. At this rate of conventional military degradation, the one viable weapon that Russia will have at its disposal could be its nuclear arsenal. In terms of nuclear deterrence, NATO must be careful not to push Russia to the brink. Facing Russia's imminent defeat, Moscow would likely treat this as an existential threat for the current government. Things do not end well for Russian leaders with failed military adventures abroad; they usually turn up dead. Russia would likely escalate the war substantially, perhaps with tactical nuclear weapons, if its conventional forces were facing expulsion from Ukraine. Behavioral economics teaches us that the possibility effect causes utility curves to approach infinite steepness when faced with heightened odds of loss. In other words, actors are risk-seeking when faced with a really high probability of loss and small chances of gains. These notions are derived primarily from one of its foundational tenets – prospect theory. It shows that actors deviate most substantially from rational behavior at the extremes. It predicts that an actor's risk posture will vary depending on whether they perceive themselves to be situated on gains versus losses. During war games simulations, it is

...but Russian Nuclear Power is Not Estimated Inventories, 2022



Source: Federation of American Scientists generally difficult to get participants to cross the nuclear threshold, but once they do, a full-blown nuclear exchange typically follows. That said, **Russia is more likely to cut oil production and exports, triggering a global oil shock than to use nuclear weapons.** And it would not take either decision haphazardly since it must retain diplomatic partners and allies.

Ultimately, we still believe that the Russian invasion of Ukraine is likely to result in a stalemate or frozen conflict next year as neither side will gain a material advantage. Russia will not relinquish the annexed territories willingly, while Europe will not lift sanctions and allow Russia to rebuild its war machine. **We think that global financial markets will be satisfied with a stalemate, but we must be cognizant of some of the more disturbing scenarios we discussed above.**

Subjectively, we currently place the probability of a global nuclear war in the range of 5%. That is down a few percentage points from just a few months ago, after we learned recently that Russia and the US are discussing holding talks on strategic nuclear weapons for the first time since Putin launched the invasion. So, this is a very low-probability, high-impact risk in 2023.

What do we do with this forecast? On a personal level, it is deeply disturbing, perhaps terrifying. But from a purely financial perspective, one should ignore this risk altogether. It should not be a consideration for investment decisions. Most equities would plunge to zero, and most debtors, including governments, will either default or inflate away their obligations. In other words, the composition of your portfolio (or the cash under your bed) could be worthless.

Meanwhile, Iran and the US have not yet reached an agreement on what to do about the Islamic Republic's nuclear program. The most likely outcome is that those talks will fail. Unless domestic protests force Supreme Leader Khamenei to accept President Biden's offer, a new crisis could emerge in the Middle East. Currently, Iran could conceivably construct a deliverable nuclear device in as little as two years, setting a clock on a potential Israeli military strike. The current right-wing Netanyahu governing coalition makes a strike more likely, in our view, since the government has already demonstrated behavior that is less sensitive to traditional partners. To that end, Iran could sabotage energy infrastructure in the region to warn against potential Israeli unilateral action. If so, look for the Middle East to remain a source of uncertainty next year.

Finally, China is the only global power capable of rivaling the US over the long run, although we expect the country to remain a distant second to the US in terms of economic and hard power projection capabilities for the foreseeable future. Many of you have probably heard of the famous "Thucydides' Trap". This is a term used to describe an apparent tendency towards war when an emerging power threatens to displace an existing great power as a regional hegemon. The term comes from Thucydides' account of the Peloponnesian War between Athens and Sparta where he posited that conflict was inevitable because of Spartan fears of the growth of Athenian power. Recently, it has been wielded to describe a potential conflict between the United States and the People's Republic of China. Most of the discussions on the topic point toward a rising China confronting and attempting to undo the global hegemonic order established by the US after the Second World War, which reached its zenith after

> — "An increasingly **anti-Western power,** like Russia under Vladimir Putin, **could not stand for an increasingly anti-Russian/pro-European** Ukraine capable of hosting NATO troops and weaponry at its border."

— "we believe China is unlikely to launch a full-scale war against Taiwan this year. "

the collapse of the Soviet Union. It is an order based on free-flowing commercial trade, global cooperation through international organizations, laissez faire capitalism, liberal Democracy, and generally a rules-based system. But as mentioned earlier, **the United States (the declining power), rather than China (the rising one), is likely to be the source of rising geopolitical risk in this context according to historical evidence.** President Xi Jinping consolidated domestic political power at the Party Congress back in October, and the country is now providing ample stimulus across many different segments as they attempt to stabilize the economy. The country's diplomatic outreach, especially to the world outside of the US, is part of this renewed emphasis on economic growth. As long as China does not invade Taiwan, trade and capital flows should continue unabated. This need to keep itself tethered to the global system, coupled with the irreplaceability of almost two-thirds of the world's semiconductor foundries located on the island, are some of the reasons that **we believe China is unlikely to launch a full-scale war against Taiwan this year.** Russia's troubles in Ukraine similarly urge restraint. Instead, Beijing is more prone to impose punitive measures on Taiwan short of war, to undermine the ruling party ahead of Taiwan's 2024 elections. So far, the Biden administration has accelerated his predecessor's efforts to constrain China's military, technological, and economic growth, including through semiconductor export controls. If Biden starts to use secondary sanctions to insist that allies enforce these controls fully, then US-China conflict risk could increase abruptly. **In the long run, however, the risk of invasion is elevated in our estimation as Taiwanese reunification is a core, existential and security matter to the CCP in its near abroad and the Taiwanese are culturally and politically attempting to further distance themselves from the Mainland.** Alas, the harsh reality of geography will reassert itself.

The two major conclusions from this analysis have been that the conflicts that erupted in 2022 do not have definitive resolutions on the horizon, and that the United States is likely to be the largest source of geopolitical instability and uncertainty around the world as it remains highly polarized domestically and its relative power decline worsens. In a world with systemically higher geopolitical risk, investors must continue to tread carefully and add hedges like commodities and gold to their portfolios despite their macroeconomic or market expectations. ■

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House Views Matrix

	TACTICAL (UP TO 3 MONTHS)	CYCLICAL (UP TO 12 MONTHS)
US Equities[1]	NEUTRAL	UNDERWEIGHT
European Equities	UNDERWEIGHT	OVERWEIGHT
Japanese Equities	OVERWEIGHT	OVERWEIGHT
Emerging Market Equities	NEUTRAL	OVERWEIGHT
Chinese Equities	UNDERWEIGHT	NEUTRAL
US Treasuries[2]	NEUTRAL	NEUTRAL
Investment Grade Fixed Income	NEUTRAL	NEUTRAL
High Yield Fixed Income	NEUTRAL	NEUTRAL
Emerging Market Sovereign	NEUTRAL	NEUTRAL
US Dollar	NEUTRAL	UNDERWEIGHT
Energy[3]	OVERWEIGHT	OVERWEIGHT
Precious Metals	NEUTRAL	OVERWEIGHT
Cash	OVERWEIGHT	OVERWEIGHT

[1] *Relative to global equities in USD*
[2] *Relative to aggregate fixed income markets in USD*
[3] *Relative to an overall commodity allocation*

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