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The following contains a brief discussion of the equity markets from Chief Investment Officer and Senior Portfolio Manager, Ryan E. Crane.

2023 MARKET OUTLOOK

Hardly a day goes by without the spotlight on either inflation or employment. Both components of the Federal Reserve's dual mandate are the focus of nearly all investors. Let's start with the job market.

The Employment Puzzle

We keep getting reminded of the possibility of an impending recession and all the layoffs that are starting to happen. Is there a shortage of labor? Or a surplus? Figuring out this labor market puzzle has important implications for inflation and interest rates, and thus equity markets, too. If you rank jobs by the skill or technical expertise needed, there are shortages at either end, and about to be a surplus at the middle. At the high end, we simply have a skills mismatch. JOLTS data has been very resilient in the face of unprecedented rate hike and QT. There are still more open jobs than there are unemployed people. In many cases, the unemployed don't have the skills to fill these open positions. The problem at the low end is very different, and perhaps self-inflicted.

We highlighted during the pandemic when unemployment benefits were boosted and stimulus checks were sent out – there was a strong disincentive to work; some people had *more* disposable income by choosing not to work.

Today, the enhanced unemployment benefits are gone, as are the stimulus payments, but the safety-net programs are still in place, and the pandemic effectively trained a portion of the population how to access and maximize these government programs. For some individuals, these programs are equivalent or even superior to working a minimum wage job…without having to do the work. On top of that, the gig economy has become quite sizable, allowing many people to work when they want, supplement the government assistance, and avoid taxes. At today's wages, the government is crowding out these businesses. To solve this problem, the government would have to reduce these transfers, or wages will have to rise. Alternatively, in a recession, demand might fall enough to alleviate the shortage.

Meanwhile, the Fed is doing what they can to tame inflation, which means raising rates, ultimately killing jobs. It looks like it might be working, at least in the tech sector. Amazon, Meta, Salesforce, Twitter, Microsoft, and many others have announced layoffs, and in some cases have recently revised those intentions even higher. The economy suffers when restaurants and hotels can't adequately staff their operations to meet demand. The economy suffers when there aren't enough nurses. The job market is critically important in the fight against inflation and in monitoring the risk of a recession. During the pandemic, companies underestimated demand, and then had to play catchup by double ordering. There were shortages of nearly everything. Companies also double ordered employees, hence the tight labor market. Can the companies scale back on employees without wrecking the economy?

Some interesting data points lend credence to the idea that a soft landing is possible. Jobs creation surprised on the upside, unemployment fell, and the labor force participation rates ticked up. The best part was that average hourly earnings slowed. It's only one data point, but it's encouraging. It's still way too early to tell, and the odds are that a recession is coming. The point is that there are many structural issues and policy issues that contribute to inflation or employment – squarely in the Fed's domain, and yet the Fed has no say in the matter. They're limited to using the only tool they have. And *that* is likely to break something or cause a recession.

Nobody Knows Anything

The economic data has improved. Inflation has slowed, but that was expected. Some of the inflationary pressure was indeed transitory, because of COVID-induced supply problems combined with massive fiscal stimulus. The supply problems are mostly resolved or are at least improving, and the fiscal largesse is gone. Today, there are many signs that inflation is receding and some pundits seem ready to claim victory. However, some of the inflationary pressures are a result of structural changes in the global economy.

For the Fed, the risk profile is asymmetrical. If they overshoot and we end up with a recession, then they can chalk that up to the implicit cost of dealing with inflation – a painful, but necessary byproduct of saving the economy. However, if they undershoot, and inflation remains high or reaccelerates, then that is almost unforgivable, and might damage the long term credibility of the institution.

Given the massive moves the Fed made throughout 2022, we are not sure more are required. We still can't measure the impact of the multiple 75 basis point moves. It's well-accepted that impact of monetary policy won't fully impact the economy for 12 months or more. It was barely more than 9 months ago when rates were at zero and QE was still in place. We haven't even begun to feel the impact of the actions they've already taken. Why not pause for a bit and see what we've got before pressing on? Why? Because of the asymmetrical risk – they won't risk undershooting, which means they *will* risk overshooting.

Inflation is moderating, the direction is encouraging, but the absolute level is still high. The transitory component of inflation is receding, and maybe even reversing. However, the long term, structural components of inflation are still in place. We won't know the outcome for quite some time.

Growth Solves a Lot of Problems

From a historical standpoint, there have been moments of innovation and technological breakthroughs that have spurred significant economic growth. These moments of growth have been incredibly powerful in creating massive amounts of wealth and also raising the standard of living and quality of life around the globe. There's no doubt that personal computing, the Internet, mobile phones, and smart phones would fall into this category. Sometimes the impact is so strong that it overwhelms or masks other negative economic factors at play. As an investor, these things are fairly obvious in hindsight, but not as visible in the moment they begin – there are always naysayers.

When people today talk about the dot com bubble, they generally use it to convey negativity, disapproval, and even foolishness. After all, the "irrational exuberance" of the late 1990s, led to the painful losses investors faced when the market corrected in 2000. Implied is the notion that investors were wrong to be that optimistic about the internet. Take a look at the world's largest, most successful, most profitable companies today. Nearly every one of them was enabled and empowered by the internet: Apple, Google, Microsoft, Amazon, et alia. **The real lesson of the dot com bubble was that even the most bullish investors underestimated its potential**. I think any of us would be grateful to have been buying those stocks even at the height of the dotcom bubble. For investors, the trick was differentiating between the vast array of companies that failed along the way and the few winners that came to dominate the world. While investors had to deal with the complexity of figuring out who the winners were, the economy simply zoomed along with the new business creation and the massive productivity gains. A revolutionary innovation can completely change the economic path, which brings me to my point…

Have you used ChatGPT yet? If not, I implore you to go to https://chat.openai.com/chat. We are not experts on artificial intelligence, but we are trying to learn as much as we can. Those that have used GPT are blown away by its function. It can chat with you in essentially normal conversation and natural language, but it also knows a lot about a lot of things. It seems as though we have finally crossed the Rubicon with artificial intelligence. Version 4 (which should be available to the public in the first half of 2023) will be roughly 10x more powerful than the current version, and it will be “smarter” than most humans. It will be able to pass medical school exams, it will be able to pass the bar exam. It can quickly and efficiently generate software code. We saw that someone had fed it the press release from Netflix’s earnings announcement and past announcements, and then asked it to summarize any important developments or changes, and it did a pretty compelling job – on par with research you would read from any reputable sell-side firm.

It seems there is little doubt that it will completely upend education, coding and software development, the legal profession, internet search, and more. This is just the tip of the iceberg. We don’t know how to quantify the opportunity here, other than to say it’s very large. And combined with our overarching investment thesis – that because of behavioral biases, investors chronically underestimate the magnitude and duration of change – we are pretty excited about the disruption and growth this phenomenon could ignite.

There aren’t many ways to invest in this directly just yet. We don’t think this potential theme will have much impact on our portfolios in the short run. That being said, we are on high alert and re-examining this issue daily. Indirectly, AI will probably influence most companies. The firms that figure out how to best leverage this new tool will have an edge over their competition. In a general sense, the impact on economic growth and productivity could be profound. Could this AI revolution be the panacea our economy needs to bail us out of this unfortunate predicament? Will it get here in time? The race is on between tightening financial conditions and an impending recession, and a breakthrough in innovation that could catalyze huge gains in productivity and growth. The messy, noisy collision of these things could create opportunities that only come around once in a great while.

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