January 20, 2023

MARKET SIGHT LINES

Outlook 2023 Spotlight No. 3: Scenarios and Signposts

By Michael O’Keeffe, *Chief Investment Officer*

Earlier this month, my team and I released our outlook report, Outlook 2023: *Finding Balance*. We have a base case view that is modestly positive, but as has been our practice, we’ve asked ourselves the question: What if we are wrong? We’ve modeled two additional scenarios – a more negative bear case and a more positive bull case. We’ve also identified eight signposts we’ll be watching for as we look to find balance and recovery in 2023. In this week’s Sight|Lines, we share a summary of these scenarios and signposts.

THE TAKEAWAY: 2023’S PATH WILL BE DEFINED BY INFLATION, FED POLICY, EARNINGS … AND SIGNPOSTS

Inflation, Federal Reserve (Fed) policy, and earnings will be key to which of our three scenarios unfolds: base, bear, or bull. And we’ve defined eight signposts to watch as we move through the year. In summary:

- In our base case view, we see inflation cooling, the Fed hiking rates another half percent then standing pat, and earnings growth that is modestly positive.
- If inflation remains elevated, the Fed will likely hike rates further, increasing the risks of an economic and earnings recession. In this bear case scenario, we see equity markets moving lower.
- In our bull case scenario, inflation cools more quickly than expected, the Fed softens its rhetoric and possibly eases, and earnings recover, sending stock markets higher.
- Our signposts: China reopens, Fed/market forecasts align, confidence troughs, shelter costs stabilize, wage growth slows, labor moves closer to equilibrium, earnings improve, and geopolitical hotspots cool.

IN-DEPTH: OUR BULL AND BEAR SCENARIOS HAVE “FAT TAILS” THIS YEAR, SO WATCHING FOR SIGNPOSTS WILL BE IMPORTANT.

In risk analysis, possible outcomes often look like a bell curve, meaning there are greater chances of “middle of the road” outcomes and much lower chances of tail events, positive or negative. But when these positive or negative scenarios are more likely, the bell’s tails are higher, called “fat tails.” We’ve assigned a 60% chance to our base case, 25% to our bear case, and 15% to our bull case. Fat tails. Going deeper:

- Our base case calls for cooler inflation, a Fed policy shift, and improved earnings:
  - Notably, the December Consumer Price Index (CPI) and Producer Price Index (PPI) inflation reports are out, and three measures – CPI, PPI, and core PPI – cooled in the fourth quarter to a level consistent with the Fed’s 2% target.

  - Core CPI remains elevated due to shelter cost increases, which are expected to fade later in 2023.
  - 2023 earnings are still forecasted to grow 4.6%, in line with our expected range of 0%-5%.
- Our bear case will unfold if inflation is sticky and the Fed stays aggressively hawkish, eroding earnings. Fed officials are still taking a hawkish tone:
  - In recent speeches, several Fed officials stuck to their hawkish tone despite more data points showing that inflation is cooling alongside fairly resilient economic data. Interestingly, St. Louis Fed President James Bullard said that the prospect of a soft landing has improved.
- Our bull base depends on better-than-expected inflation:
  - Fourth quarter 2022 inflation looks good, but the Fed wants a longer trend before declaring victory.
- We're watching eight signposts that can signal a greater sense of balance, perhaps toward mid-year. As these unfold, we'll have greater confidence in our base case unfolding:
  - *China Reopens*: In a Davos speech this week, China's Vice Premier, Liu He, a top economic advisor, said that officials will seek to boost demand now that pandemic restrictions are lifted with the goal of returning China's economic growth to pre-pandemic levels.
  - *Fed/Market Forecasts Align*: The Fed's December Summary of Economic Projections (SEP) reports a median forecast fed funds rate of 5.1% at the end of 2023, while fed futures imply a market forecast of 4.9%. The Fed publishes its next SEP on March 22.
  - *Confidence Troughs*: The preliminary University of Michigan Consumer Sentiment reading rose to 64.6 in January from 59.7 the previous month. Both current conditions and expectations improved.
  - *Shelter Costs Stabilize*: Shelter costs reflected in the CPI rose 0.8% in December, still elevated.
  - *Wage Growth*: The Bureau of Labor Statistics showed average hourly earnings on a yearly basis fell to 4.6% in December from 5.2% in August, but still elevated compared to pre-pandemic.
  - *Labor Moves Closer to Equilibrium*: The number of unemployed persons per job opening (the openings/unemployment gap) has fallen slightly to 1.8 from 2.0 in early 2022, still elevated.
  - *Earnings Improve*: We'll watch fourth quarter 2022 earnings results carefully. Current consensus estimates are for earnings to decline 3.9%.
  - *Geopolitical Hotspots Cool*: The Russia-Ukraine war continues. Warmer-than-expected weather in Europe has softened the blow of more limited energy supplies. Treasury Secretary Janet Yellen announced a trip to China, setting the stage for meaningful discussions on economic recovery, possibly reducing U.S.-China tensions.

CONCLUSION

At Stifel, we recently released our outlook report, Outlook 2023: *Finding Balance*. (See the full report, video summary, client webinar replay, or January's Investment Strategy Brief). We've assigned a 60% probability to our base case, which is modestly positive. We see a 25% chance of a bear case scenario unfolding and a 15% chance of a more positive bull case. Along the way, we'll be watching for eight signposts for finding balance.

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