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2023 Economic Forecast

Is a Fed-induced recession imminent?

Congressional gridlock, chaos and conflict

Preamble: 2022 was the year we'd like to forget. This 34th annual forecast is designed to inform readers of my assessments of the state of the domestic and global economies and forecasting the outlook for 2023. My findings are predicated upon employing demographic theory and analysis as they relate to the economy and the effect on the financial markets.

Is a Fed-induced recession imminent?

The direction of both the US and global economies and financial markets will be controlled by the Fed's response to our inflationary spiral, geopolitical concerns and how China's lifting of their Covid restrictions and stimulus policies play out. It is more probable the Fed will err on the side of caution. The Fed's monetary policy has already breached the prerequisite level of tightness necessary to trigger a Fed-induced recession. This recession probably will be mild based on historical standards and may occur within the next 6 to 12 months. In sum, the Fed has raised rates by too much and too quickly. Our financial markets have not priced in any recessionary expectation. As such, a future selloff could trigger a 15 to 20% correction. In this environment of rising interest rates, fixed income has been reborn as an alternative investment vehicle. Although rates have not peaked, investors should start rebalancing their portfolios in the first quarter of this year.

The inflationary crises of 2022 consisting of the post-pandemic supply-side shortages and the Ukrainian war have created an obscure long-term outlook for the global economies and financial markets. Economics 101 defines inflation as "too much money chasing too few goods". The seeds of our inflationary spiral were planted during the 2008 financial meltdown employing quantitative easing, the 2020 Covid pandemic stimulus and an extended period of easy money. So there is no misunderstanding, this spending was clearly necessary to avoid complete economic collapse. At issue was the excessive nature of the stimulus to the extent that unemployment benefits exceeded net pays so many chose not to work. In addition, the business PPP and ERC programs were entrenched with fraud. To add insult to injury, when you add in the Trump-era tax reform that benefited the rich, one can understand why our national debt is $31.4 trillion. The Fed's monetary tool to fight inflation is raising interest rates as they have done consistently during 2022 and will continue to do in 2023 until inflation falls to their 2% target rate. This becomes a vicious self-feeding cycle and makes it difficult for the government to handle the interest payments on our national debt. Our extremely tight labor market creates cost-push inflation that gets passed on to consumers. Employers are forced to pay higher wages for remedial-level jobs. This is evident not only in the US but the entire world which needs legal immigration to fulfill these labor demands. Domestically, we need almost 4 million jobs filled at this level. Although most of the post-pandemic supply-side shortages have abated, we can expect a resurgence against the backdrop of a severe disruption from China's death tolls resulting from lifting their Covid restrictions, the extended war in Ukraine, future reconstruction of the country and the possible major conflict with China over Taiwan. These will be inflationary by nature and ammunition for the Fed to continue raising rates and with it,

a Fed-induced recession. **From a long- term perspective, we face the headwinds of the demographics associated with the retirement of baby boomers, our enormous unrelenting national debt and planetary climate change costs.**

Recessions occur when the economy records two consecutive quarters of negative gross domestic production (GDP) caused by tight monetary policy and/or a severe shock to aggregate demand or supply. **US economic fundamentals imply we are not heading for a recession against the backdrop of stable corporate earnings, consumer spending that remains slightly below trend and governmental infrastructure spending that will accelerate.** The unemployment rate fell to 3.5% in December. Although the supply-side shortages have abated, the resulting reduction in inflation may only be enough to convince the Fed to ease its restrictive policy. The Fed's strategy is indeed working and at the end of the day, the Fed always wins.

Given our positive US economic fundamentals, it is possible a recession can be avoided if the Fed starts to cut rates before the onset of a recession. However, this scenario seems remote given the Fed's tendency to err on the side of caution. It is more likely they will reduce their pace of rate increases while inflation expectations subside during the first half of the year. When the unemployment rate hits 4% to 4 ½%, the Fed's policy will revert to easy money. **Either way, it seems the Fed's belief that the 2% inflation target rate remains the relevant basis for monetary policy decisions may very well be without merit in our current economic environment**. The equity markets may very well rally in the near-term while inflation subsides. However, on the downside, there may be a major sell-off in anticipation of a Fed-induced recession triggering a 15 to 20% correction. The recession will probably be mild absent any geopolitical or natural disasters.

State of The Economy

The US economy has produced sustainable below-trend growth in a fearfully deteriorating global economic environment where most central banks have inflicted extremely restrictive monetary policies in their war against inflation. US GDP rose to 2.9% in the fourth quarter. When all is tallied, our US GDP should come in at an anemic 1.3% at best with the world not doing much better producing a frail 1.6%. Our unmanageable national debt trajectory of $31.4 trillion reached our debt ceiling on January 19, 2023. The Republican-controlled House is refusing to extend it placing our US debt rating and the global economies and financial markets in jeopardy. **The Fed** has raised its rates multiple times reaching a 15- year high closing at 4.38%. Their restrictive policy will continue in 2023 with perhaps four more 25 bp monthly increases. We should suspect a mild Fed-induced recession by mid-year. **Inflation** closed the year at 6.5%**.** The rate should continue to fall within the first half of the year given the Fed's extreme response and a moderate contraction in spending. On the other hand, in the second half of the year inflation may rise along with China's recovery in aggregate demand and a rise in the price of oil. It is more probable that the inflation rate may drop to a low of 3.5% and close the year at 5%. **Labor**: The unemployment rate fell, rather than rose, closing the year at 3.5%. The rate is destined to rise but by how much in this tight labor market? Perhaps 4% by year-end. What we have needed for many years is immigration reform. Domestically, we are short four million remedial-level jobs. Filling these positions will reduce inflation. **Corporate America** has continued to surprise on the upside. In an inflationary environment of rising costs, profit margins are normally squeezed. However, the opposite has become a reality against the backdrop of raising prices in excess of the actual higher costs passed on to consumers. This corporate greed is a major contributor to our inflationary spiral. The only solution would be an excess profits tax. They are probably reluctant to lay off employees knowing the difficulty of replacing them in this complicated labor market. **Consumers'** balance sheets are in healthy order. They have secured low-interest-rate mortgages, so their debt service is clearly manageable. Although their credit card debt rose 15%, their balances are no more than their pre-pandemic levels. They have retained most of their excess savings accumulated during the pandemic. **Housing:** Notwithstanding values continued to climb/stabilize, residential home sales fell off 10% against mortgage rates having more than doubled closing the year at 6.7%. Expect values to contract by about 10% and home sales to decline between 15 to 20%. The pace of residential development will slow down and place additional pressure on our demographic needs for new homes.

State of The Global Economy

The entire world's central banks are synchronized in their assault against inflation employing restrictive monetary policies, like the US but to a lesser extent. The global inflation rate approached 10% in mid- 2022 and is destined to move towards 3.5% by mid-2023. When all is tallied, global GDP should be approximate 3% for 2022 and expect below-trend growth of 1.6% for 2023. Unlike the US, **Euroland** is confronted with tough headwinds primarily consisting of the geopolitical energy crisis. This has forced their replacement of Russian natural gas with more expensive liquefied natural gas, oil and coal. This has become not only a drag on corporate profits and employment growth but also a contraction in real wages and with it, consumption. **China once again has become the wildcard in determining the direction of the global economies**. In response to civil unrest, their authorities lifted their untenable zero Covid policies. This will place astronomic pressure on their healthcare sector which doesn't have the physical capacity to handle this crisis. The "Economist" has estimated 1.5 million will die within the first half of this year. This clearly implies further inflationary supply-side shortages for the same period. It should be noted that China has surpassed the US as the world's primary trading partner. Their authorities have eased monetary and fiscal policies with the intent to become more self-reliant rather than export intensive. The question becomes whether these policies are designed to stabilize or grow the economy. I project growth in the second half of the year, and if this occurs, the global economy will benefit and especially emerging countries. On the other hand, China's rising demand for materials and energy will be inflationary to the extent the price of oil could exceed $100 per barrel. China's population has been shrinking and will be replaced by India as the world's most populous nation in 2023. With their 2022 population at 1.4 billion, it is more probable they will become a self-reliant economy. Assuming their projected growth in the second half of the year, their GDP is expected to be about 4% for 2023. **Japan**, which has suffered protracted inflationary stagnation for decades. Its crippling demographics consisting of a shrinking labor force and the oldest population on the planet has benefited from its benign 3.8% inflation in 2022. They are the only country that maintained an accommodative monetary policy. China's projected growth will bode well for Japan's export and tourism sectors. They will probably avoid a recession and produce sustainable GDP growth of 1.8%. **Iranian** protesters lack leadership or any unifying goals. As such, the regime is not in danger of losing control. The US sanctions have devastated their economy to the extent inflation is running at 50%, unemployment is at 9.4% and their currency is at an all-time low versus the US dollar. Yet, the IMF projects their GDP at 4% for 2023. **Emerging countries are facing debt defaults. The UK is probably already in recession while Euroland will follow along with the rest of the world except for India and the Gulf nations. Absent any natural disasters the recession should be mild and occur mid-year.**

Geopolitical Risks in a World of Turmoil and Uncertainty

The pursuit for peace and democracy continues in a year filled with intensifying danger, crisis, conflict and extreme anxiety in a more unstable world. The Russian-Ukraine war remains the greatest elevated risk. Although Russia has been subject to US sanctions, most of the world has not participated. Euroland's reliance on Russian natural gas has been replaced by more expensive alternative energies. It appears China, Russia's largest energy consumer, seems to be keeping its distance from its ally. Ukraine's battlefield successes don't seem to match Russian attacks on their infrastructure and civilians. Expect this to be a long-protracted war with severe economic consequences. **This will be a waiting game measured by the West's willingness to finance Ukraine and Russia's ability to underwrite its war machine.** Putin will never voluntarily give up Crimea or the annexed territories. Any Russian cease-fire request would imply they're running out of funds for their war machines and troops. Although remote, Putin could cut oil production creating an energy crisis that would trigger a global recession. We need solutions before Ukraine becomes a concrete cemetery. To start, Turkey needs to overcome their objections to admitting Finland and Sweden into NATO. This entire invasion was based on lies. NATO recognizes that Putin is unstable. The only thing Putin understands is power. **No NATO member country wants boots on the ground but at some point, they need to consider allowing Ukraine to join NATO. China will take Taiwan** and control the South China Sea probably before Taiwan's elections in 2024. The US military has determined we would be unable to defend Taiwan under any war scenario. **China doesn't even have to fire one bullet to accomplish its goal. They can merely blockade the entire island.** Any US sanctions would barely work since China is the world's largest trading

partner. On the upside, **Global populism** is trending lower but democracy under populist rule remains in crisis. In 2022 we have witnessed the departure of Duterte in the Philippines, Bolsonaro's loss in Brazil and the majority of Trump endorsed mid- term candidates lose their elections. **Domestically,** with the Republicans taking control of the House, legislation will be paralyzed against the backdrop of a divided government. The Republicans' demand for spending cuts may have a negative impact on funding Ukraine. These disorders raise both the climate and environment for a future crisis, chaos and conflict. The cost of controlling these disorders depletes our global resources and impairs our living standards**. There is no prosperity without world peace.**

Political Roundup

President Biden's classified documents fiasco was a contribution to the GOP arsenal aimed at his possible impeachment. No matter what his successes have been, the White House's mishandling of this dilemma may force him to abort his plans for reelection. Although former VP Pence, who is considered a hero by many, has fallen victim to the same conduct, will probably be acquitted in the court of public opinion but not necessarily by the Justice Department. Although it sounds like a boxing match, it took Kevin McCarthy 15 rounds to become Speaker of the House after selling his soul and transferring control to the Freedom Caucus and MAGA Republicans. On the upside, Pres. Biden's immigration parole program requiring US sponsors and arrival in the US by airplane makes good sense and represents a good start. As promised, the GOP will open investigations into Pres. Biden, his administration, his family and the January 6 committee. They are in the process of producing their version of the January 6 report. We can expect bills to curtail our freedom to vote, criminalize abortion and cut Social Security and Medicare that will die in the Senate. To further enable their agenda, they approved a rules package that gutted the non-partisan Office of Congressional Ethics which is designed to police corruption, and they reintroduced a bill to defund the IRS. **Ethics by both parties do not exist.** The Republican majority refuses to demand the resignation of George Santos. This is all about power and retaining his seat no matter what the cost is. Under the new House rules, speaker McCarthy can be removed by only one member. It is more likely the GOP will not allow him to serve a full term. Just think if the dissenting member is George Santos. Democrats have never refused to raise the debt ceiling which is merely a procedural function of government given the enormous irreparable repercussions to the US credit rating and domestic and global financial stability. Both Democrats and Republicans voted multiple times to raise the debt ceiling during Trump's administration which added $7.8 trillion to our national debt. Notwithstanding Trump's campaign promise to reduce the national debt, this was the largest increase in our national debt by any President. During the Obama presidency, the Republicans were not in control of the government and held the debt ceiling procedure hostage to extort spending cuts so they can appear to be fiscally responsible. We all recognize that our $31 .4 trillion national debt is one of the greatest obstacles to our future prosperity. This needs to be addressed during the budget process and has nothing to do with raising the debt ceiling. The GOP's failure to demonstrate their ability to govern may cost them the White House in two years. Our clear and present danger today is ourselves. Our elected officials in both parties need to put their differences aside and need to address the issues affecting ordinary Americans which are the people who elected them. **On the downside, in this current political environment, we can only expect gridlock, chaos, conflict and multiple investigations.**

2023 Economic Forecast

The Bears devoured the Bulls. This was the year of investor indigestion where the markets frequently whipsawed Bear market territory hitting its lowest point in September. US stocks rebounded well in the fourth quarter with the Dow and S&P 500 closing the year at 33,147 and 3,840 generating unsettling adverse returns of 8.8% and 19.4% respectively. The NASDAQ closed at 10,466 suffering a depressing 33% collapse. On a positive note, by January 27, 2023 the US markets were the comeback kid producing gains of 2.5%, 6% and 11% for the Dow, S&P 500 and NASDAQ respectively. The Fed's excessive monetary tightening in response to the inflationary spiral created by post-pandemic supply-side shortages and the Ukrainian war energy crisis were the primary catalysts to the financial market's 2022 deterioration. On the upside, this

environment of rising interest rates has spawned the rebirth of fixed-income as an alternative investment. While interest rates may not have peaked, during this first quarter it makes good sense for investors to rebalance a part of their portfolios into fixed-income investments. Even though our economic fundamentals are in positive territory and inflation continues to abate the Fed is guaranteed to err on the side of caution and will not reverse their restrictive policies until inflation falls to their 2% target. **This 2% inflation standard needs to be adjusted upward in this current global economic climate.** Either way, the Fed always wins and will induce a mild recession probably by mid-year triggering a possible market correction between 10 to 15%. Investors should also consider placing stop-sale orders on their positions to protect them from the downside. After the selloff, the Fed's monetary policy will reverse to a more accommodative posture along with the global central banks as the economies of the world are destined to contract. At this point, equities will become a buying opportunity. This will motivate investors into reflation trade strategies, one that favors equities over bonds and therefore, taking on substantial risk in this world of unpredictability. At any rate, a lot can go wrong. **The direction of both the US and global economies and financial markets will be controlled by the Fed's ability to timely reverse their monetary stance, geopolitical concerns and China's rebirth.**

Equity will still outperform all other asset classes. Diversity is key to a well-balanced portfolio**. In terms of countries,** investors should overweight US equities without a global influence then reversed the position after the market correction. After the selloff, consider Euroland which has the most attractive valuations and Japan whose resilient fundamentals and potential currency gains is a good contrarian play. China, the global wildcard, makes sense only after there's clear and convincing evidence of its recovery by the second half of the year. To a lesser extent, emerging markets follow China's resurrection so long as they are able to overcome their potential debt defaults. **In terms of sectors**, overweight energy, financials, healthcare, utilities, aerospace, technology and consumer staples. Underweight real estate, consumer discretionary and tech hardware. In this environment, investors should favor growth stocks over value stocks**. Investor asset allocations always need to be adjusted based on your age and risk tolerance.** Given the anticipation of a Fed-induced recession, investors should consider a more conservative allocation consisting of 60% equities and 40% fixed income. It makes good sense to consider managed accounts and equities that have proven a consistent record of increasing dividends. **At the end of the day, investor's philosophy should favor capital preservation rather than asset appreciation. The US stock market may surprise on the upside and all exchanges may reach new highs.**

Forecast assumptions: Absent any geopolitical and or natural disasters, the forecast assumes the Fed will misjudge on the side of caution raising rates at least 25 BP four times in the first half of the year inciting a mild recession by mid-year. Inflation will continue to subside but not by enough for the Fed to reverse its monetary policy. On the other hand, inflation may rise against supply-side shortages from China's manufacturing disruptions due to Covid deaths in the first half of the year. US corporate profits will amaze on the upside, business and consumer spending will moderately retrench and unemployment will marginally rise. By the second half of the year, China's recovery is hopefully underway and gives a boost to global aggregate demand and with it, elevated oil prices. The Ukrainian war remains a stalemate and Russia does not cut oil production. **These assumptions give rise to a synchronized global economic expansion, all of which will benefit our financial markets.**

- **Equities:** Out of the Box the US Markets rallied in January recovering almost 1/3 of what was lost in 2022. Notwithstanding further Fed tightening, equities should continue to move forward against the backdrop of positive economic fundamentals. On or before mid-year, the markets may suffer a 10 to 15% correction against the recessionary fears. This will be a most challenging year and it remains possible to attain double-digit rates of return. The Dow may trade between a range of 30,000 and 37,500 closing the year at 36,500. The S&P 500 and NASDAQ may close the year at 4,000 and 12,500 respectively. This will be a trading year that will be one of extreme turbulence and volatility.

- **Bonds**: Fixed income as a viable alternative investment has been reborn in this environment of rising rates. There is a window of opportunity for investors to rebalance their portfolios into fixed income on a long-duration basis before the Fed starts to reverse their monetary policies against a recession scenario. Yield advances will be benign in the first half of the year and ultimately recede with the 10-year treasury closing at 3.5%, the 30-year fixed mortgage closing between 5.75 to 6% and the Fed rate ending the year at 3.75%. US high-yield bonds will outperform treasury in this climate.

- **Currencies:** The US dollar (USD) is a countercyclical currency meaning it rises during periods of economic contraction and falls during periods of economic expansion. The USD bull market has furthered to run and is up about 15% against a basket of foreign currency. The dollar should rise in the near-term while approaching a recession and ultimately retreat which would benefit oil.

- **Cryptocurrencies:** Bitcoin, the world's largest digital coin lost 65%. The entire industry got trashed against the backdrop of economic and regulatory uncertainty. Adding in the collapse of crypto exchange FTX and Terra Lab the market may have found a bottom. However, just like other risk assets they are sensitive to rising interest rates which implies they may have a further downside. These extremely speculative investments may start to rise once the Fed starts lowering its rates. Either way, investors should tread very carefully and limit their exposure only after investor confidence is restored. After all, there are many that believe this is the world's greatest Ponzi scheme.

- **Oil:** The price of oil may have the greatest impact on inflation and the direction of the global economy. As a result of the Ukrainian war, oil averaged $90 per barrel closing the year at $80. The price will rise in the near-term with the onset of winter and rising USD. As recessionary demand wanes, oil may trend lower closing the year at $85. On the other hand, demand will rise in the event of China's economic resurrection and oil may close the year above $100 per barrel.

- **Gold, Silver and Metals:** The standard belief that gold is an inflation hedge may have less merit today. Gold and silver closed the year at $1,820 and $24 per ounce respectively, basically the same position they started the year. The contributing factors of this phenomenon are the negative impact on price from rising US Treasuries along with the USD. These elements are destined to reverse enabling gold and silver to once again shine perhaps closing the year at $2,000 and $27 per ounce respectively. Copper may trend slightly higher given supply-side restraints while other commodities will not fare as well against the backdrop of limited global demand.

- **Commercial Real Estate:** This sector is facing the challenges of rising interest rates and retrenchment in lending. While the future of office space is cloudy at best and retail is at a turning point, on the bright side, industrial and warehousing remain in high demand. The shining star is multifamily which has performed the best given that demand for affordable/workforce housing surpasses supply.

- **Metaverse:** This sector, in its infancy stage, represents the technology in virtual and augmented reality with artificial intelligence enabling people to meet in the virtual world to work, play and more. Their values have dropped immensely from their 2021 extremes and still have a further downside. Investors should consider buying into these companies after the expected correction for the long-term. The major players are Google (GOOGL), and SNAP. Roblox (RR BLX), Nvidia (NVDA), and META.

In sum: **The direction of the global economic recovery is contingent upon the Fed's response to our inflationary dilemma, geopolitical conflicts and China's soft landing/economic rebound.** Given the positive economic fundamentals and if the Fed can timely start to reduce interest rates it becomes possible that a recession can be completely avoided. I give this scenario a 20% chance. Domestically, we face enormous challenges both in the near and long-term such as our

unmanageable national debt, climate change, demographics of retiring baby boomers, the costs of which will impair our prosperity and living standards. Politically, we have a divided government that has lost the ability to compromise which is the prerequisite to governing a democracy. Our society has somehow accepted lying and fake news as national standards. The solution to political obstructionists and liars is to vote them out of office. We had success during the mid-term elections. We can only pray that we have the same success in two years. **We are Americans and need to look at what unites us rather than what divides us and work together for our common good.**

All investment recommendations must be discussed with your own personal financial advisor/broker.

Disclaimer

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