LAFFER | TENGLER
INVESTMENTS

What Could Go Right in 2023?
Sentiment will shift at some point; we want to be ahead of the pack.

Warren Buffett has said many clever things over the decades. But the following is one of my favorites: "In the business world, the rearview mirror is always clearer than the windshield." In other words, the past is crystal clear. The future? Not so much. That is why at turning points so many investors stay too long at bull market parties and bail out when bear market routs become too much to bear (pun not intended).

I know I will offend every technical, engineering-focused mind who reads this, but in my experience, investing is about being *mostly right*. (Yes, I know, I know, you can't build a bridge by being mostly right!) An important investing skill lies in sensing when to pivot. While it is nearly impossible to bottom tick the stock market—getting it mostly right can be a victory that pays off in subsequent years. If an investor buys a stock at $100 and it declines to $80 shortly thereafter but hits $300 a few years later, the best question to ask, perhaps, is why that investor didn't buy more. Not why did he buy the stock at all.

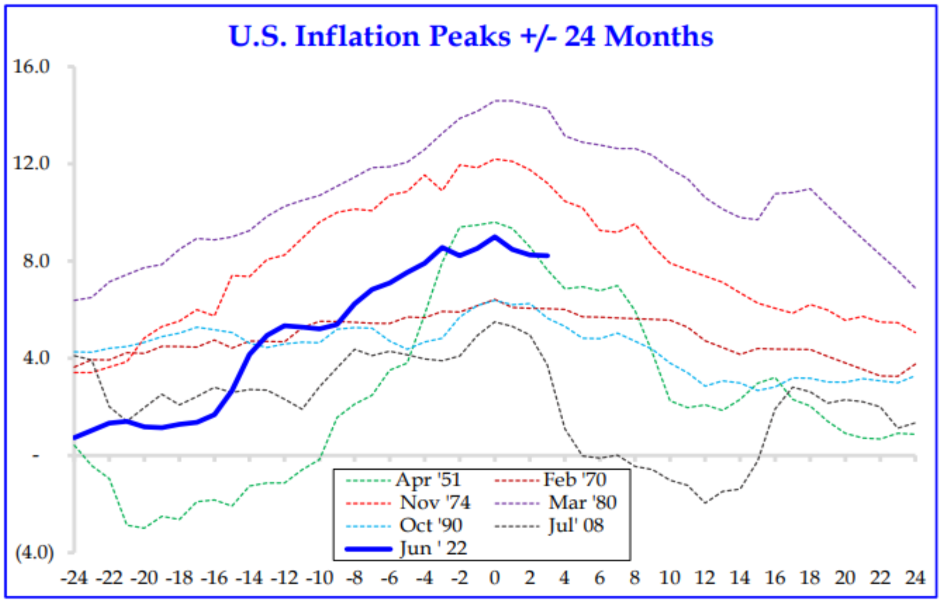
We think investors have become way too pessimistic given where we are in the rate hiking cycle. Since March the Fed has raised rates 4.25%--one of the fastest rate hiking regimes in history. And, because monetary policy has a lagged effect on the economy, we expect the economy to slow materially or enter recession at some point in 2023. To be sure a severe recession would be bearish for stocks, yet given the resilience of the U.S. economy and the tight labor market, we are expecting a slowdown or shallow and brief recession. That could allow stocks to rally in the second half of 2023 (after a volatile Q 1) as they look around the recession corner.

Here is what we are watching:

Inflation will continue to roll over. We believe inflation peaked in June. On November 2, 2022, I wrote a piece "How To Make Sense Of The Columbo Economy" Link here the following:

Peak inflation and timing of Fed pause. *It was our contention in the spring of 2021 that inflation would be more persistent and stickier than the Fed's transitory view. We take no comfort in being correct. We have written that we believe peak inflation in the headline CPI was reached in June of this year when it hit 9.1%. And we believe, as history shows, that the rise and fall of inflation is mostly symmetrical. It took 16 months to peak and now we expect it will take a like amount of time to get to a tolerable level (not necessarily 2.0%--the Fed's target).*

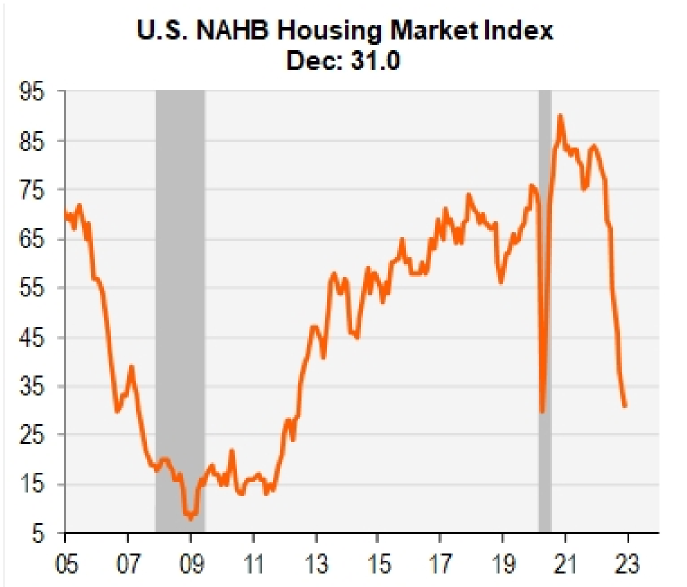
Dynamic US Inflation | Fourth Quarter 2022



Source: Strategas, October 19, 2022

We would emphasize that the trend is not necessarily linear as you can see in the chart above. But, inflation is, indeed, rolling over.

Housing is in freefall, manufacturing PMIs are in contraction, inventories are up, prices paid down, energy costs have come in, used car prices have declined materially as have airfares and hotels, wheat and corn are down, shipping costs have plummeted, copper, aluminum and palladium are well off their highs, and medical insurance costs are set to decline by –40% over the next 12 months. While we don't think the Fed's 2% inflation target is on the horizon, we do think inflation will surprise many to the downside.



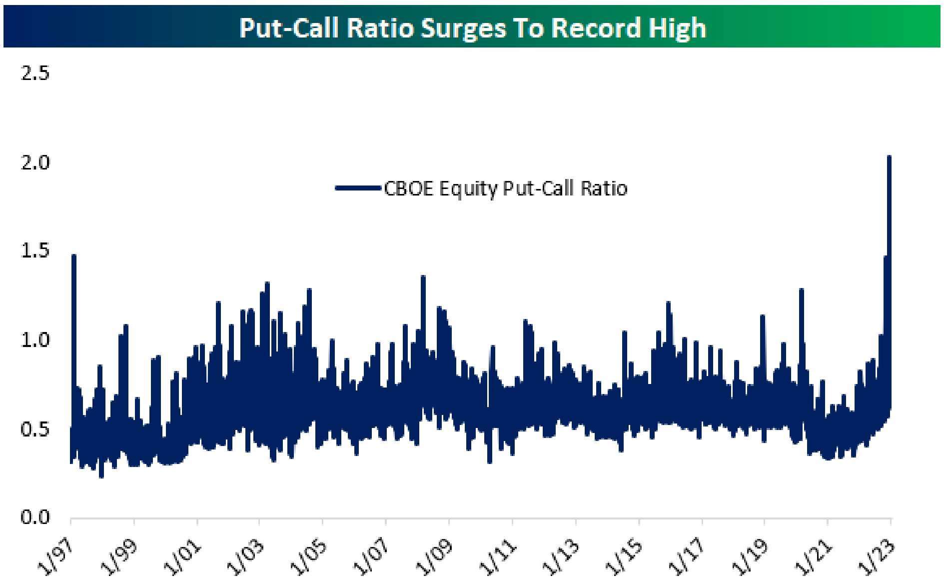
Source: Piper Sandler December 2022

Recession likely but not deep. The inversion of the yield curve and the steady decline in Leading Economic Indicators (chart below) almost ensure we see an official recession (versus 2022's slowdown) at some point in 2023. The question? How severe and long will the slowdown in economic growth end up being?

Source: Bloomberg, December 22, 2022

The consumer still has bandwidth and given the tight labor market we think spending will hold up better than the naysayers predict. Which is not to say it won't slow. But generally, we think the bears (never eager to leave the stage) are too pessimistic.

Sentiment is too negative (this is not the 1980s). Recent put volumes outnumbered call volumes by a factor of 2 on the CBOE—the highest level since the data has been measured. The move was driven by a surge in put options and a decline in call options. The put call ratio tends to be a contrary indicator spiking when investors are too pessimistic. Add to that institutional investors have remained on the sidelines with allocations to equities below levels held in 2008!



Source: Bespoke Investment Group, December 22, 2022

What are we worried about?

- The omnibus bill is likely to put upward pressure on inflation just as the Fed is making progress. Another day another $1.8 trillion in spending.
- The transition to onshoring/re-shoring could be a little messy but good news in the long-term. Hundreds of companies have announced their intention to move manufacturing back to the United States. Many are shifting from China to India and Vietnam.
- Geopolitical tension in the South China Sea.

The Bear Market of 2023, if over, would rank as one of the mildest of the 14-prior post—World War II bear markets at 282 days. Interestingly according to our friends at Bespoke Investment Group, this bear market has experienced seven 5% rallies, three of which extended to 10%. Those facts belie the way many feel about this bear market. I have been at this a long time and the only bear market that felt worse was the one that spanned 2001-2003. Investors are exhausted. Ultimately that will bode well for stocks in 2023. Q1 could be choppy (perhaps we will see the price exhaustion indicators marking a bottom then?) but we think the returns on stocks will be positive in 2023, though not necessarily spectacular.

Beware of unintended consequences. When government inserts itself into the free market unintended consequences abound. In 2022, due to high natural gas prices (wind and solar were unable to offset lower energy production from hydro and nuclear power) global coal usage hit an all-time high according to a report by the IEA.

Here's to a Happy and Prosperous New Year!

VB,
Nancy Tengler
CEO and Chief Investment Officer

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DYNAMIC US INFLATION COMMENTARY:
By Arthur B. Laffer Jr.
President

What's So Dynamic About the Laffer Tengler Dynamic US Inflation Strategy?

1. The inflation environment determines the overall inflation positioning of the strategy ranging from low inflation orientation is fixed income to high inflation.

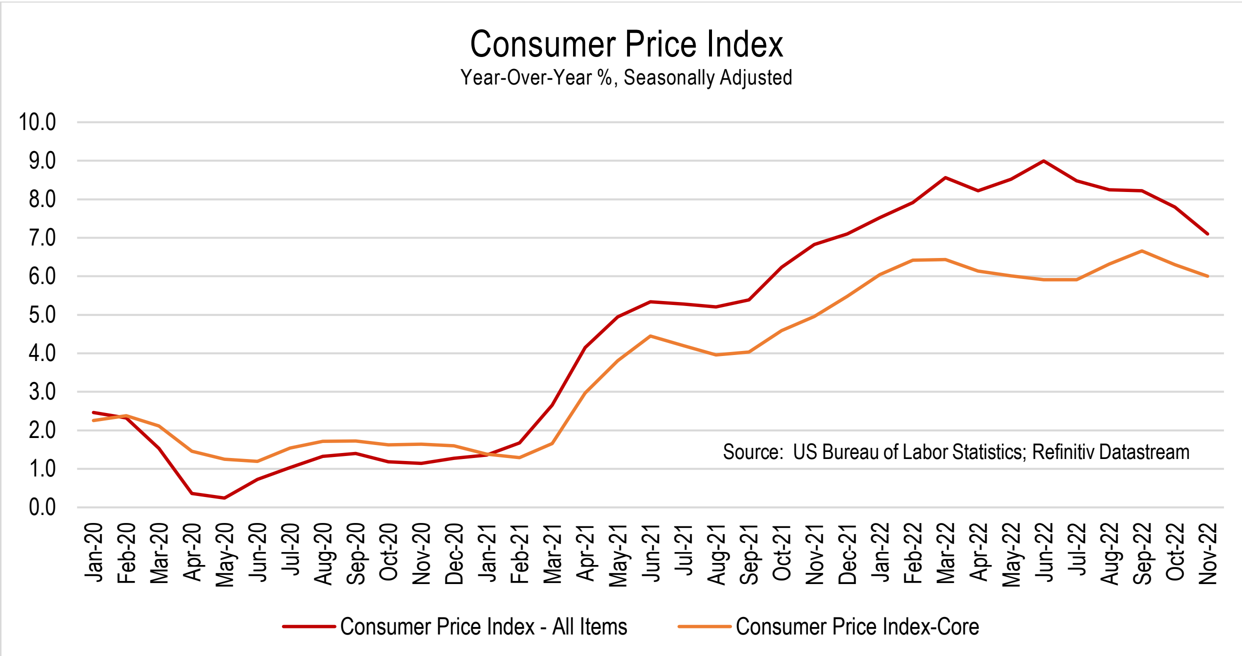
   The asset mix and investment opportunity parameters vary greatly based upon the inflation environment. The strategy is designed to change its allocations based upon the environment. In a low inflation environment, the strategy is designed to be a compliment for a fixed income allocation. In a high inflation environment, the strategy is designed to change into a portfolio that attempts to benefit, on a risk adjusted basis, from the inflation pressures. The strategy is designed to move back and forth dynamically between the two different environments so investors don't have to.
2. Within all inflation environments, the strategy dynamically changes its individual investment options based upon any opportunities specific to that environment.

   For example, in a low inflation environment the strategy would dynamically change its investments based upon interest rate expectations, fixed income credit quality, economic outlook, current income and other investment opportunities. In high inflation environments, the strategy could dynamically change its investments among, equities, real assets, energy, interest rated hedged fixed income, etc.

TURNING THE USS INFLATION - HOLD ON TO YOUR DRINK!
Prices Are Starting to Moderate are We in for Calmer Seas?

During the COVID lockdowns the Consumer Price Index ("CPI"), which is a broad measure of average domestic inflation, remained quite muted up until the end of the first quarter of 2021. March generally corresponds to the mass rollout of vaccinations and broad relaxing of pandemic work and travel related restrictions. Since March, CPI has been on a tear with numbers not seen since the 1970's and culminating with a year-over-year high in June 2022 of 9%! CPI has moderated over the past five months but still remains stubbornly high at 6.4% in December. Way too high for the Fed to think of lowering rates. To make matters worse, Core CPI (CPI excluding Food and Energy) hit a high in September of 6.7% bucking market expectations and has only come down to 5.7% so far as of December.

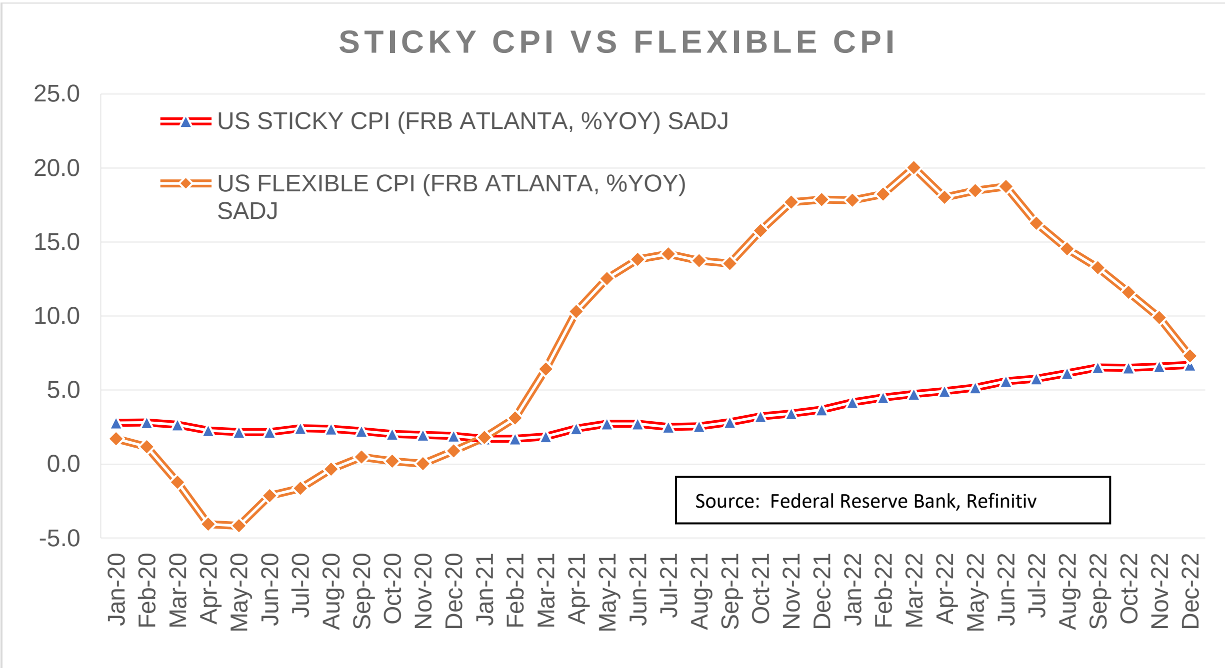
Dynamic US Inflation | Fourth Quarter 2022



Price Behavior is Not Always Homogenous – Sticky and Flexible CPI

Another interesting view of inflation is to look at the price behavior of two different subsets of CPI. In the chart below, we have displayed two seldom followed series of inflation data calculated by the Atlanta Federal Reserve Bank. The orange line displays the part of CPI that is more "flexible" ("US Flexible CPI") as it relates to how frequently its components historically change in price. An example of a CPI item with flexible price behavior would be the price of tomatoes. The price of tomatoes changes on average every 3-4 weeks. On the other hand, the blue line displays the components of CPI that are more price "sticky" ("US Sticky CPI") or the ones that change in price far more infrequently. An example of a sticky component of CPI would be laundromat prices. Coin operated laundry prices have historically changed on average every 6.5 years. That's a big difference! The sticky index looks fairly stable, but the December 2022 year-over-year index hit 6.7% which is the highest level since the 1980's and is the highest print in this cycle. You would expect the flexible series to be much more volatile than the sticky series and it is. But even with that being true, the series hit an all-time high in March of 2022 of 20% year-over-year! That includes the high inflation 1970's when the series hit its previous high of 16.7% in March of 1980. The good news is that Sticky CPI continues it sail downwards with December coming in at 7.3%. Good new and further confirmation that inflation is moderating but the Fed will continue to raise rates as inflation remains stubbornly well above their 2% target. Expect a 25 basis point rate hike at the next FOMC meeting.

Dynamic US Inflation | Fourth Quarter 2022



<u>4Q 2022 Strategy Changes</u>
N/A

<u>Top 3 Contributors</u>
Aberdeen Silver ETF
JP Morgan Equtiy Premium Income ETF
SPDR S&P Aerospace & Defense ETF

<u>Bottom 3 Contributors</u>
US 12 Month Natural Gas ETF
Teucrium Wheat Fund ETF
Innovators Inv Grd Preferred ETF

DISCLOSURE INFORMATION