

2022



GKV  
CAPITAL

FOURTH  
QUARTER

MARKET  
REVIEW  
AND OUTLOOK

# Being Contrarian

## 2022 DATA POINTS

DJIA	-8.9%
S&P 500	-19.4%
NASDAQ	-33.1%
US BOND	-13.0%
10-YEAR TREASURY YIELD	3.88%
S&P 500 LTM DIVIDEND YIELD	1.74%
S&P 500 EPS	\$220.16
S&P P/E	17.4x

# Opening Thoughts

The excitement around artificial intelligence is suddenly tremendous. While the promise of artificial intelligence has been a mainstay of science fiction since the beginning of the genre, recent advances in large language models and massive neural networks have progressed to the point where, if you read the press, reality may have caught up with imagination.

Neural networks, utilizing massive quantities of data, are able to generate human-like text, or computer code, or poetry, and even art. To be clear, these models, which include OpenAI's GPT-3, do not possess intelligence in the human sense. There is no cognition. The models are trained using large quantities of data, for example everything ever written on the outlook for the stock market. Using these examples, the model is able to write original content. Writing this update every quarter takes a lot work. We were eager to automate ourselves out of a job. We went to OpenAI and asked ChatGPT, "what is the U.S. stock market outlook for 2023".

ChatGPT proceeded to write the following:

As an AI language model, I don't have the ability to predict future events or market trends with certainty. The stock market is influenced by a wide range of factors including economic conditions, government policies, and investor sentiment, which can be difficult to predict.

That being said, the stock market can be influenced by the overall state of the economy, the stability of the financial system, and the performance of individual companies. If these factors remain positive, it is possible that the stock market will continue to perform well. On the other hand, if any of these factors were to deteriorate, it could lead to a downturn in the market.

It is important to keep in mind that past performance is not a guarantee of future results and that investing in the stock market always carries a degree of risk. It is also recommended to consult a financial advisor for personalized advice on investment strategy and risk tolerance.

Well, the result is grammatically correct and coherent. And while we can't argue with anything in the statements above, there isn't anything particularly insightful here. Which is what we should have assumed. If you feed a large quantity of typical stock market outlook double talk, the large language model will emulate that. In summary, if the economy does well the stock market should do well. But there is risk, and every investor's situation is unique and you should talk to an advisor. So there you go. We guess we will still have a job for the foreseeable future.

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# 2022 Review

Last year turned out to be very difficult for investors. The year began with optimism that we had finally moved past the economic impact of the COVID pandemic. Consumer demand was strong, unemployment low, and discretionary income data was positive. The highest inflation since 1981 derailed the positive outlook and sent nearly every asset class lower with the notable exception of energy and several commodities. While the arrival of a recession is debatable, earnings growth has slowed appreciably. Corporate earnings declined an estimated 4.4% in 2022. With the clarity of hindsight, it is apparent that the massive government stimulus, pent-up consumer demand, and supply chain disruptions combined to create a perfect storm for runaway

inflation. While broad U.S. economic data remained strong through 2022, rising rates and the Federal Reserve’s inflation fight took the air out of the markets.

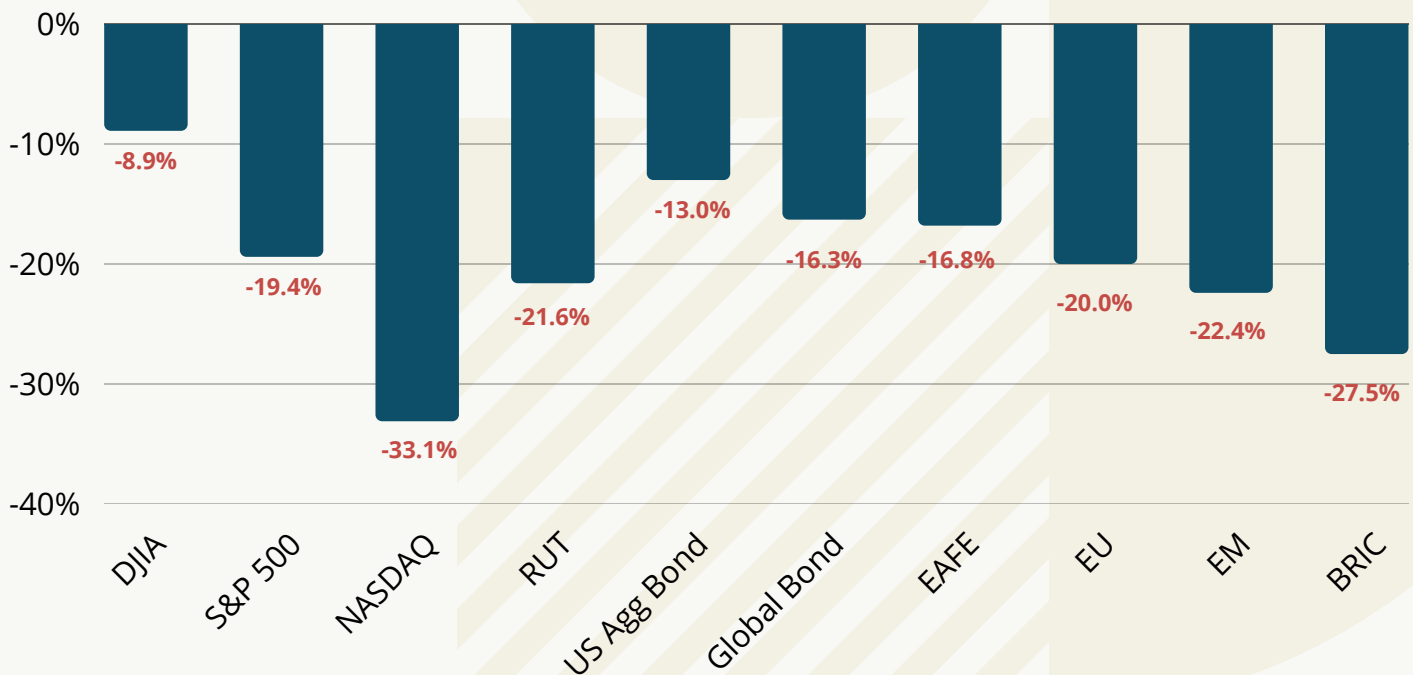
The year ended with the S&P 500 losing 19%, the Dow Jones Industrial Average finished 9% lower and the technology dominated NASDAQ Composite Index declined nearly a third, losing 33% for the year. The Russell 2000 Index, which tracks small companies, declined 22%. Most surprising was the extent of losses in the global bond markets. While we had anticipated risk to fixed income at the start of 2022 due to expectations of rising rates, the sudden decline was far worse than anticipated. The U.S. Aggregate Bond Index fell 13% in 2022.

Most of the damage in U.S. stock occurred in the first half of the year, although the S&P 500 hit its lowest level, a decline of 25% from the beginning of the year, in mid-October. With earnings somewhat

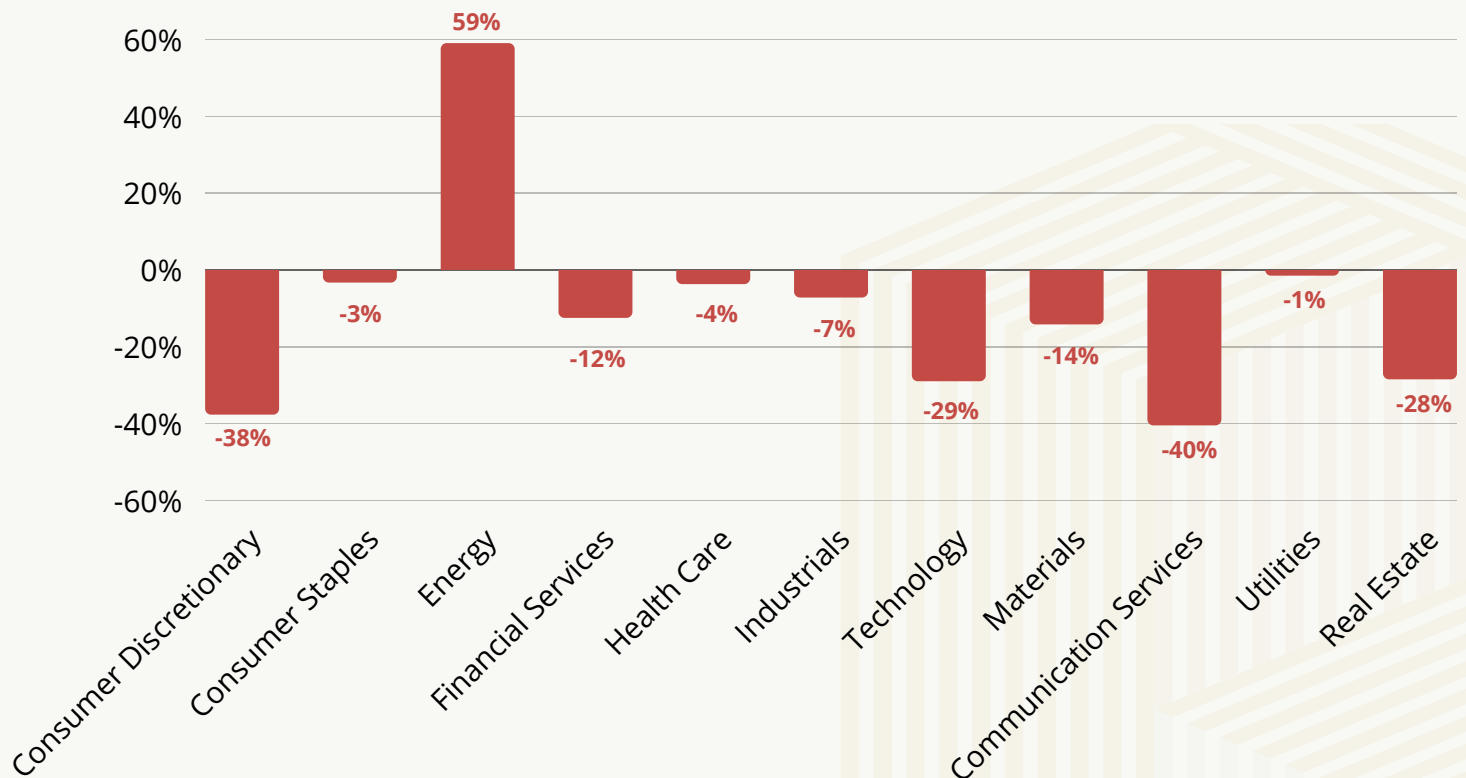
better than feared, stocks managed to recover slightly into the end of year.

The only bright spot in 2022 was the energy sector recording a spectacular 59% gain. Demand for all types of energy has bounced back to pre-pandemic levels while supplies have been constrained as energy producers struggle to get back to full output capacity. Add the disruption of the Ukrainian war and sanctions on Russian commodities and energy prices remain elevated. While there were a few subsectors that had positive returns in 2022, such as aerospace/defense and fertilizers and steel, all ten remaining sectors ended the year in the red with sectors that outperformed during the pandemic faring the worst. Technology and consumer discretionary sectors which are most affected by higher interest rates and recession fears declined 29% and 38%, respectively. Communication services, which includes Facebook parent Meta and social media in general, ended the year down 40%.

## 2022 MAJOR INDEX PERFORMANCE



## 2022 SECTOR PERFORMANCE



Globally, the performance in both equities and fixed income were uniformly weak in 2022. The MSCI EAFE (Europe, Australia, Far East) ended the year down 17%, Europe finished down 20%, and emerging markets ended 2022 down 22%. Elevated inflation has been a global phenomenon and central bankers around the globe have been forced to increase interest rates. One bright note for U.S. multinational companies is a stabilization of the dollar. In 2022, U.S. corporate earnings were negatively impacted by unusual strength in the dollar forcing higher prices for U.S. goods abroad. The dollar peaked last fall, up more than 18% against a basket of global currencies. The dollar ended 2022 up 8% after giving up nearly half of the gains.

Like the U.S., global growth has slowed. The expected 4.4% growth

in 2022 was reduced to 3.2% and even that seems somewhat optimistic. Growth is expected to weaken even further in 2023 and 2024, although these forecasts are highly unreliable and appear overly pessimistic.

In the U.S., the macroeconomic data particularly related to the health of the consumer continues to be positive. The unemployment rate hit a new low of 3.4% in January. Retail sales for January were up 3.9% from a year ago. U.S. disposable income also increased in January, up 2.7% from last year. Somewhat more troubling is accelerating growth in household debt which increased 8.5% in December over the year prior.

In the fight to rein in inflation, the U.S. Federal Reserve has few tools. The most effective is to sharply

raise interest rates making the cost of debt considerably more expensive resulting in a forced reduction in demand. If car loans and mortgages cost more, consumers will spend less. The same is true for companies. A higher cost of capital results in less investment in everything from buildings to equipment to information technology. Clearly growth slowed in 2022. At the start of the year, analysts anticipated \$220 in earnings per share in 2022 for all the companies in the S&P 500 combined. After most companies have reported year-end results, earnings for 2022 will come in about \$196 per share. Instead of the anticipated 7.4% earnings growth, earnings declined 4.4% over 2021. Understandably the estimates for 2023 have also been reduced. Analysts currently forecast \$220 per share in 2023,

down 11% from an expected \$246 per share estimate made this time last year.

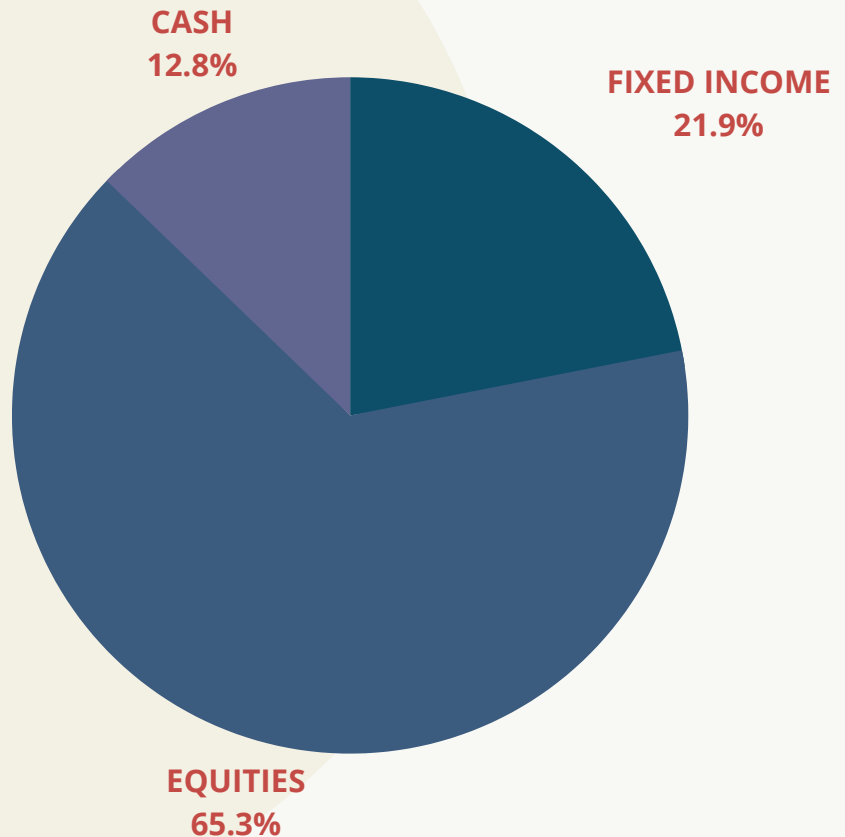
While the earnings forecasts have been revised downward with lower growth expectations, they are still relatively positive despite a generally negative view of the economy by the general public. If the \$220 earnings per share estimate in 2023 is attainable, that would represent 12% growth over the disappointing 2022 results. The 10-year treasury yield hit 3.88% on December 31st, up dramatically from 1.5% at the beginning of the year. The U.S. Federal Reserve increased the Federal Funds Rate to 4.75% from 0.25% at the start of 2022. We anticipate continued interest rate increases to further rein in inflation although at a much slower rate of increase. We expect the Fed Funds Rate to end 2023 around 5.25%.

The rapid increase in interest rates had a historic impact on bond prices resulting in a 13% decline for the U.S. aggregate bond index in 2022. To put the selloff in bonds in context, prior to 2022, the largest single year decline in bonds since 1976 was a 3% decline in 1994. 2022 was a disaster for fixed income portfolios. Although each of our client portfolios are individually managed and are therefore unique, as a firm, only 22% of client assets were in fixed income at the start of 2022. With the rise in interest rates, bond yields have become attractive relative to stocks, and we expect to continue to allocate more assets to fixed income in 2023. Firmwide, we ended 2022 conservatively positioned with 13% of assets on the sidelines in cash, 22% of assets in fixed income and 65% in equities. At the beginning of the year we began increasing both our exposure to equities and fixed income.

**WE MANAGE SEPARATE ACCOUNTS FOR EACH OF OUR CLIENTS. NONE OF OUR CLIENT PORTFOLIOS LOOK THE SAME.**

GKV FIRMWIDE

# Asset Allocation



# Being Contrarian

Many sectors of the financial markets peaked in the fourth quarter of 2021. With rapidly rising inflation in early 2022 the Federal Reserve embarked on a shift in monetary policy from ease to restraint. The goal of its present policy is to cool consumer spending and business activity to restore price stability and bring inflation back to the arbitrary objective of 2% annual growth. The consequence of a prolonged tightening of monetary policy will be weak to negative economic growth in 2023 similar to, or less than, the growth of 2022. The dominant economic story for 2023 is the probability of a recession. It was heralded for 2022, but the missed forecast is now being even more broadly proclaimed for 2023. Economies have a cyclical rhythm of expansion, contraction, recovery and expansion. It is an immutable cycle. The difficulty for an investor is determining the degree of contraction and expansion and the duration of both.

Each complete economic cycle lays the seeds for long term change in various components of an economy. For example, globalization has been sharply curtailed and reoriented. The law of comparative advantage is being unwound in the face of geopolitical realities. Globalization had a very positive effect on reducing inflation for the last three decades. Because of the absence of comparative advantage, inflation may not get down to the Fed's goal of 2% but it will decline to manageable levels. Labor shortages and rising wages will reinforce the existing trend toward automation and artificial intelligence to increase long-term productivity. Corporate America will be more reluctant to terminate workers due to the difficulty of finding people to fill vacancies. Supply chain models are being revamped to lessen the exposure of the economic cycle to political instability. In the recovery phase of the current economic cycle, industrial investment in U.S. based facilities from high technology to basic industries is laying the foundation for reorienting and strengthening U.S. industrial policy. These changes being implemented throughout the country should reinforce historically low unemployment levels and a lengthening of the next expansionary phase of the economic cycle. Barring existential negative variables such as global warfare, we do not see any reason to assume the normal economic cycle of expansion-contraction-expansion has changed. In each phase of the economic cycle the indeterminant is its length and severity. Our expectations are for a mild economic recession in 2023 coupled with a mild recession in corporate profits this year. We do not forecast a collapse in corporate profits for most sectors of the economy. Some will continue to do well throughout 2023.

**"THE ONLY FUNCTION OF ECONOMIC  
FORECASTING IS TO MAKE ASTROLOGY LOOK  
RESPECTABLE."**

**-JOHN KENNETH GALBRAITH (1908-2006)**





## Where do we go from here?

As we have mentioned repeatedly over the years in our commentaries, it is the long-term growth in corporate earnings which determines the direction and rate of growth in stock prices. Earnings as measured by the S&P 500 Index declined modestly in 2022. Earnings would have been worse but for the sizeable growth in the energy sector of the economy. This year energy-related companies will have a considerably harder time showing strong growth over last year's stellar results. Earnings growth was modest and irregular for the other 10 industry groupings comprising the S&P 500 Index. In 2023 we expect earnings growth to be below average and perhaps flat with 2022. However, earnings performance will not evolve evenly throughout the year. The weakest results should occur in the first two quarters of 2023 with the last two quarters of the year reflecting the start of a recovery in earnings which should continue throughout 2024.

The potential for "black swan" events (potentially unforeseen catastrophic events) always exists, but other than an expanding European war, we do not see any financial insolvencies or system collapses which should turn a mild economic slowdown into a severe protracted one which will cause an enormous, painful decline in asset values. Some investors fear an inability by Congress to raise the debt ceiling and reach a budget compromise will cause a crash in the financial markets. In a divisive, polarized political environment anything is possible, but we place a low probability on such a self-destructive event.

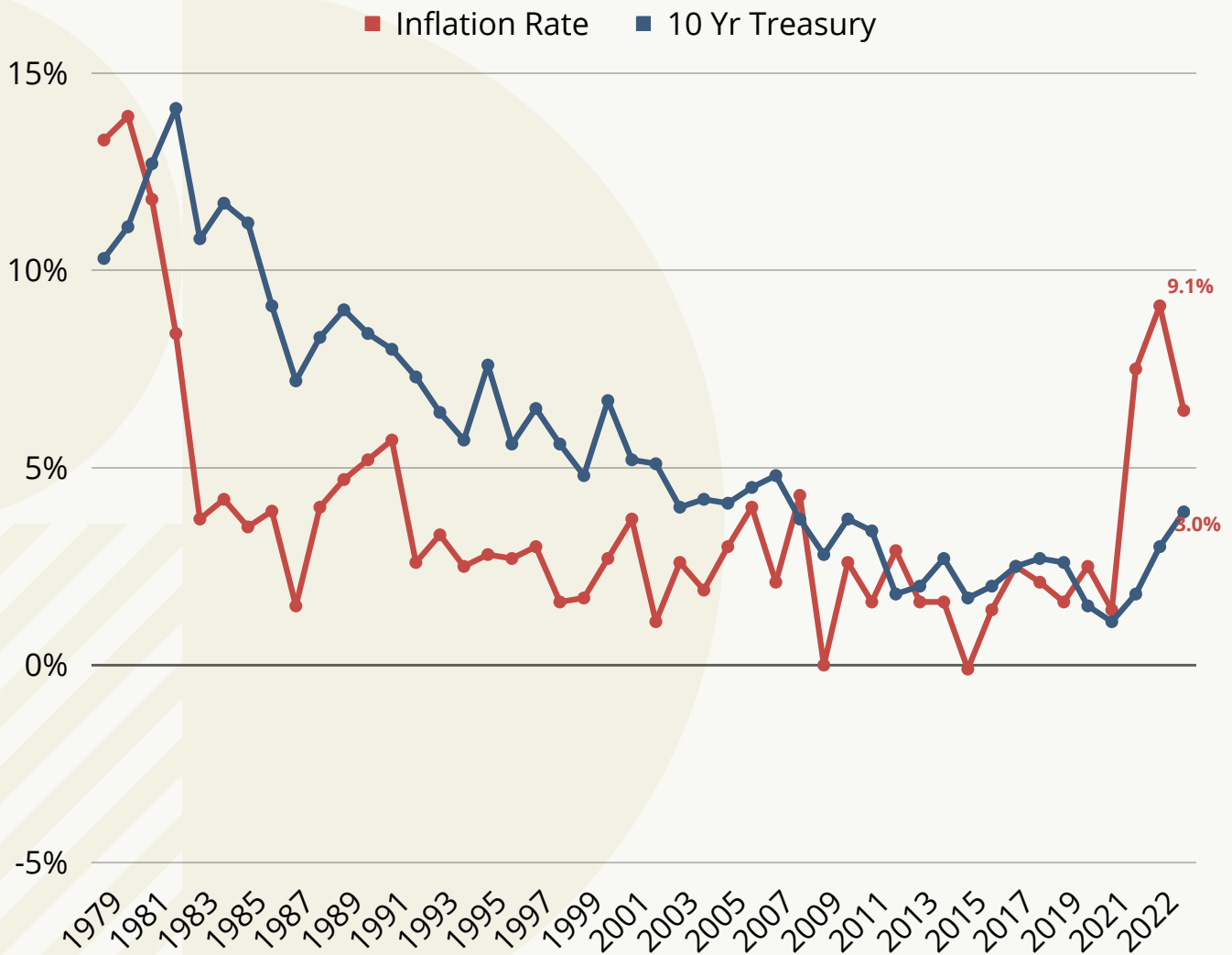
### **A PIVOT IN FEDERAL RESERVE POLICY TOWARD LOWER RATES IS UNLIKELY TO OCCUR THIS YEAR.**

The stock and bond market declines in 2022 were about rising interest rates, a contracting monetary policy and its effect on future earnings growth in 2023. Today we are beginning to see the effect of monetary tightness and the increasing cost of money on corporate earnings. The unknown is the magnitude of the adverse impact on earnings.

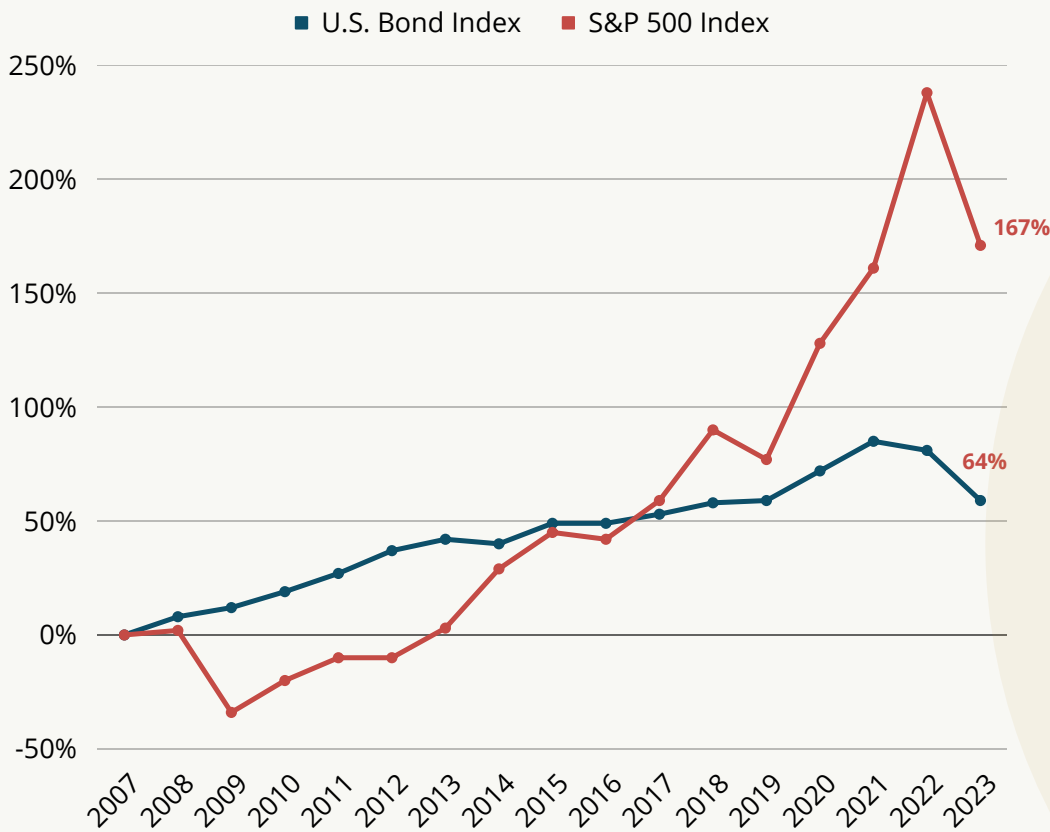
The stock market at its present valuation reflects the uncertainties of 2023 and the headwinds confronting the investor. In making forecasts we place a lot of emphasis on rational expectations. We believe the Federal Reserve is close to an inflection point regarding interest rates. Last year showed an unprecedented acceleration in rates from about zero percent in January 2022 to about 4.5% by yearend. We believe the necessary rate to produce a continuing moderation in inflationary expectations is at hand. Rates could reach 5% in the first quarter, but they will probably stay flat for the rest of the year. A pivot in Federal Reserve policy toward lower rates is unlikely to occur this year.

Financial markets overreact on the upside and downside. The pendulum always swings from too much enthusiasm to excessive nervousness. The decline in stock and bond valuations reflects the expectation of a recessionary environment in 2023. Zero interest rates prior to 2022 led to an overly enthusiastic reaction in the outlook for secular growth. Interest rates at 4.5% to 5% have destroyed this excessive extrapolation of future growth, caused revisionist analysis of growth and precipitated last year's broad decline in values. These values now reflect the no-growth to-slow growth environment we see for this year.

## 10 YEAR TREASURY YIELD & INFLATION RATE







## » STOCK VS BOND LONG-TERM PERFORMANCE

We have presented the case that the stock market in 2023 should produce a positive return as investors realize the negative trends in 2022 have ended and could begin to reverse by late 2023. Despite our expected improvement in investment performance for the stock market in 2023, it will probably be below the average return for the last 40 years. Looking at long term stock market statistical analysis of the last 50 years, the most accurate long-term stock market indicators imply that future returns on average for the broad stock market for the rest of this decade should be positive but may be below average. This possibility is not because of any long-term economic malaise but because valuations at the end of 2021 were very high as a result of the Pandemic and historically excessive Federal Reserve monetary policy.

But with a peak in interest rates soon and continuing declines in inflation, the environment for earnings expansion later this year and in 2024 becomes much more favorable. With the prospect of a better 2024, we anticipate that stock prices by year end will be higher than at the end of 2022. This will reflect a more rational pricing of assets in a more normalized setting. It is possible that in 2024 investor focus will be on how low interest rates and inflation will go to assess how high the rally in stock prices should be.

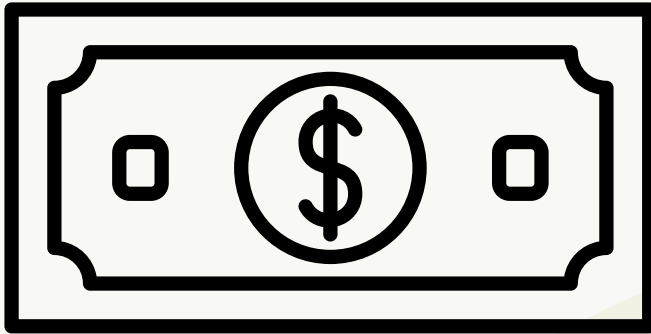
The magnitude of the decline in 2022 in stock and bond prices was significant. While interest rates last year reached their highest level since 2007, the decline in stocks in 2022, excluding the losses in bonds and cryptocurrencies, erased more

than \$12 trillion dollars of market value, the largest fall since the dot-com bust in 2001. In other words, much of the recessionary scenario is already reflected in current prices. Using the pendulum analogy, it may have a little more to go before reaching the end of its arc to the negative side, but it is not far from the end before beginning its pivot and recovery. Volatility will remain high and will continue to provide “angst” for many investors who will question any deviation from an improving trend line in inflation, rates and the economy. Investors have gone from trying to justify the high valuations at the end of 2021 to now trying to justify further declines in asset values.

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## FOLLOWING THE HERD IS NOT A GOOD INVESTMENT PHILOSOPHY

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Conditions change over time and factors which influence stock prices for one decade may be less relevant in the next decade. These long-term stock market performance indicators are only a possible indication of long-term over or under valuation at any given point in time. They are not a useful predictor of stock market performance for a shorter one- or two-year horizon. What the long-term indicators signal, if accurate, is that stock selection and timing of investments will be the key to generating superior investment performance for the rest of this decade. Active investment management will be more necessary than usual to achieve above average portfolio results. Just as timing has a lot to do with the outcome of a rain dance, recognizing that below average annual gains in investment performance may be the most probable long-term forecast at the moment is important to achieve above average growth.

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## POTENTIAL FOR "BLACK SWAN" EVENTS

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The timing of stock market purchases, and timing of changes in asset allocation among investment asset groups will become the avenue to superior average annual investment growth. We expect passive investing to yield below average results similar to the first decade of this century.

Being a contrarian in market timing is usually a rewarding endeavor within the context of a 5-year time horizon. Presently there is an abundance of pessimism. Uncertainty is plentiful. There is instability throughout the world. Confidence is declining. In the context of this environment investors' concerns are understandable. Based on previous recessionary bear markets it is possible that there is room for further downside to prices. However, it is fallacious to compare one bear market to another when trying to determine the final phase of investors' psychological despair. Each bear market during the last 60 years had its own characteristics which precipitated the decline in stock prices. Once they were known and their negative effect on prices recorded, capitulation occurred and a foundation for recovery was in place.

In other words, the good news is that much of the bad news is known and discounted in prices. Themes of a bear market are that everything goes bad at once, e.g., higher interest rates, a contracting money supply, higher inflation, uncertain corporate profits, and a decimated bond market. By illustration, 10-year U.S. Treasury bonds recorded their worst performance in 234 years last year. Problems in an economy when they occur, come in bunches, not singular. This is what feeds uncertainty and apocalyptic forecasts. Today a large majority of the country, from Wall Street gurus to the common citizen on Main Street expect a recession this year because of the well published litany of woes. In market timing when the vast majority anticipate an event, it is already discounted in prices. It is good to remember that good judgement comes from experience and most of that comes from bad judgement. Emotional panic superseding rational judgement has occurred in every recession. Following the herd is not a good investment philosophy. It is informative to review the bad judgement expounded at every market bottom. These moments of misplaced emotional conclusions provide the experience to realize that bear markets provide investment opportunities to achieve above average longer term investment performance. Wall Street is too focused on the short-term. It is too fixated on hourly, daily, and weekly price movements. The assets underlying stock prices do not change in this short time period. They are not even fractionally as volatile.

Trying to time a market top or bottom is a fool's mission but recognizing that pessimism has already been substantially priced into a market provides an excellent opportunity to make money. There are many positives in our current economic picture which belie a severe economic recession in 2023. A moderate downturn has been priced into the stock market. The strength of the financial system, corporations and individuals along with very low unemployment and solid wage growth will prevent a mild downturn in economic growth from becoming a severe recession. The current ghosts of economic demise will dissipate, and growth will continue and slowly be confronted with a new set of problems.



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**EMOTIONAL PANIC SUPERSEDING  
RATIONAL JUDGEMENT HAS OCCURRED  
IN EVERY RECESSION.**

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# To Fund Your Passions

GKV Capital Management is an independent investment advisory firm registered with the Securities and Exchange Commission since 1975. We provide portfolio management services for our clients which include individuals, families, charitable trusts, corporations and retirement plans. We are an independent, fee-only advisor. We do not receive commissions and we do not sell any financial products. We have a fiduciary responsibility to put our clients' interest first.

Client accounts are separately managed and tailored to meet the specific needs, including risk tolerance, investment objectives, and tax consequences of each client. Client assets are held at an unaffiliated brokerage firm.

With extensive expertise in security analysis, we make direct investments on behalf of our clients buying individual securities. This eliminates costly mutual fund fees and increases the flexibility to manage volatility. We actively allocate capital to take advantage of investment opportunities altering exposure to individual companies, industry sectors, and asset classes in anticipation of the changing investment and economic environment.

We are transparent in all facets of our asset management practice and believe it is important for our clients to know what they own, why, what their performance is, and what they are paying in fees. We build comprehensive portfolios for our clients with a goal of reducing volatility and producing prudent growth. We protect and build wealth at GKV Capital.



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