

# January 2023 Market Commentary

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Back to the Soft Landing



## Key Benchmarks: Performance and Characteristics as of 1/31/2023

Equities	MTD	QTD	YTD	1-Yr Fwd P/E: Current vs 10-Yr Range		
S&P 500	6.3%	6.3%	6.3%	18.2x	13.3x	22.9x
MSCI EAFE	8.1%	8.1%	8.1%	13.2x	11.2x	18.2x
MSCI Emerging	7.9%	7.9%	7.9%	11.5x	8.4x	14.1x

Fixed Income	MTD	QTD	YTD	Real Assets	MTD	QTD	YTD
Bloomberg Barc U.S. Aggregate	3.1%	3.1%	3.1%	US REITs	10.1%	10.1%	10.1%
Bloomberg Barc US High Yield	3.8%	3.8%	3.8%	GSCI Commodities	-0.1%	-0.1%	-0.1%
Bloomberg Barc Global Agg ex U.S.	3.5%	3.5%	3.5%	GSCI Prec Metals	5.4%	5.4%	5.4%

Data Source: Bloomberg

## January 2023 Highlights:

- January saw a surge in risk appetite as global equities rallied from the year-end sell-off over signs of disinflationary slowdown that could prompt the end of central bank tightening. Favorable winter and net energy demand reductions also helped European stocks despite an economic slowdown/recession. 4th quarter earnings from beaten-up growth stocks helped drive this month's high beta rally within the U.S. market as did the classic January effect that tends to see stocks subject to tax-loss harvesting the prior year rebound sharply in January. In January, the MSCI All-Country World Index (ACWI) returned 7.8%.

- Across major regions, International Developed and Emerging Markets outperformed the U.S. although Emerging Markets saw a month-end sell-off across China and India, giving up some of its earlier leadership. In January, MSCI Europe and MSCI Pacific ex-Japan led major regions, returning 8.7% and 8.6%, respectively, followed by MSCI Emerging Markets (+7.9%). MSCI Japan (+6.2%) and the S&P 500 (+6.3%) lagged major regional performance. The U.S. dollar weakened further from last quarter's depreciation over prospects of an end to Fed tightening while the rest of the world is viewed as catching up to the U.S. with respect to policy tightening.
- Within the U.S., small caps benefited from the high beta rally outperforming large caps, while value stocks surprisingly outperformed growth stocks despite the strong performance of speculative growth stocks. The S&P 600 Index returned 9.5% versus 6.3% for the S&P 500. S&P Pure Value outperformed Pure Growth, returning 11.6% versus 3.7%, respectively.
- Across sectors, beaten-up large cap growth stocks that comprise the majority of sector weightings contributed to the outperformance of Communications and Consumer Discretionary sectors as well as Technology and Real Estate (both 2022 year-end laggards) while defensive sectors such as Consumer Staples, Healthcare and Utilities lagged as did traditional cyclicals such as Industrials and Energy.
- January was a challenging month for Risk Factor performance as all major risk factors underperformed the broader market. Among Risk Factors, High Quality and Value outperformed High Dividend, Minimum Volatility and Momentum, as the latter three lagged due to the lower risk profile of the underlying holdings. Long/short low volatility and momentum were negative for the month while long/short multi-factor also struggled even though long/short value and quality were positive.
- The Bloomberg U.S. Aggregate Bond Index rose 3.1% for the month while the Global ex-U.S Aggregate returned 3.5%. The 10-Year U.S. Treasury yield ended the month at 3.5%, down from 3.8% at the beginning of the year, while the 2-10 Year Term structure remains deeply inverted even though inflation expectations implied by breakeven rates between TIPS vs Nominal Treasury yields remain elevated.
- Non-U.S. bonds and emerging market local currency bonds outperformed, helped by U.S. dollar depreciation over prospects that the U.S. Fed is close to the end on rate hikes while the rest of the world remains behind the U.S. on the inflation front. U.S. high yield benefited from the U.S. equity rally and a drop in interest rates as credit spreads narrowed. The Bloomberg US High Yield Index returned 3.8%, while Bloomberg/Barclays Emerging Market Debt LC returned 4.4%.
- Within equity alternatives, Real Estate rose sharply recovering from the prior quarter's sell-off. Precious Metals also rallied over prospects that the Fed was close to ending interest rate hikes. It was a mixed month for commodities as industrial metals rose in conjunction with China reopening from COVID lockdowns, while oil prices were unchanged (even though natural gas saw a sharp sell-off). The S&P GSCI Commodities Index returned -0.1% for the month while the Dow Jones REIT Index rose 10.1%. The S&P GSCI Precious Metals Index rose 5.4% for the month.

### Back to the Soft Landing



Source: istockphoto.com (not the actual DeLorean used in Back to the Future)

*“Unfortunately, purchasing stocks in this environment also requires a hefty dose of denial (or blindness) about the outlook for profits and, in particular, about the outlook for the total dollar value of goods and services produced by the economy. Such denial can be dangerous. Persistent denial of the implications of weaker growth is a necessary condition for a mild recession to become a serious recession.”*

*– John H. Makin, AEI, “Don’t Count on a V-shaped Recovery,” 11/2/2001*

*“Since when can weathermen predict the weather, let alone the future?”*

*– Marty McFly, “Back to the Future”*

Risk-based assets (both equity beta and fixed income duration) had a phenomenal start to 2023 as global equity valuations rose despite earnings pressure as operating costs are rising faster than revenue growth while interest dropped in anticipation of a global economic slowdown to be met with a reversal in central bank tightening. And unlike prior counter risk-on rallies such as early August 2022, there was little pushback by central bank officials to the renewal of the animal spirits that drove double-digit gains across many of 2022’s most beaten down sectors such as stocks with the highest short interest, most unprofitable stocks, “meme” stocks, and Chinese technology stocks (**Figure 1**).

Indeed, the 6.3% January return of the S&P 500 was overshadowed by the 11% return of the tech-heavy Nasdaq 100 and 18-25% returns in the most speculative segments of the equity markets that arguably benefited (and whose money-losing business models could only be sustained by) a zero-interest-rate environment. It seems with an economic slowdown on the horizon, inflation on the wane, profit margins about to collapse, and central banks on the brink of lowering rates after sharply raising rates throughout 2022, it’s Back to the Go-Go Growth Future where growth becomes scarce to the benefit of [“disruption” companies](#) seeking to maximize total addressable market (TAM), regardless of the cost and capital burn.

Figure 1 – It's Back to the Post-Pandemic Speculative Growth Future



Source: Bloomberg

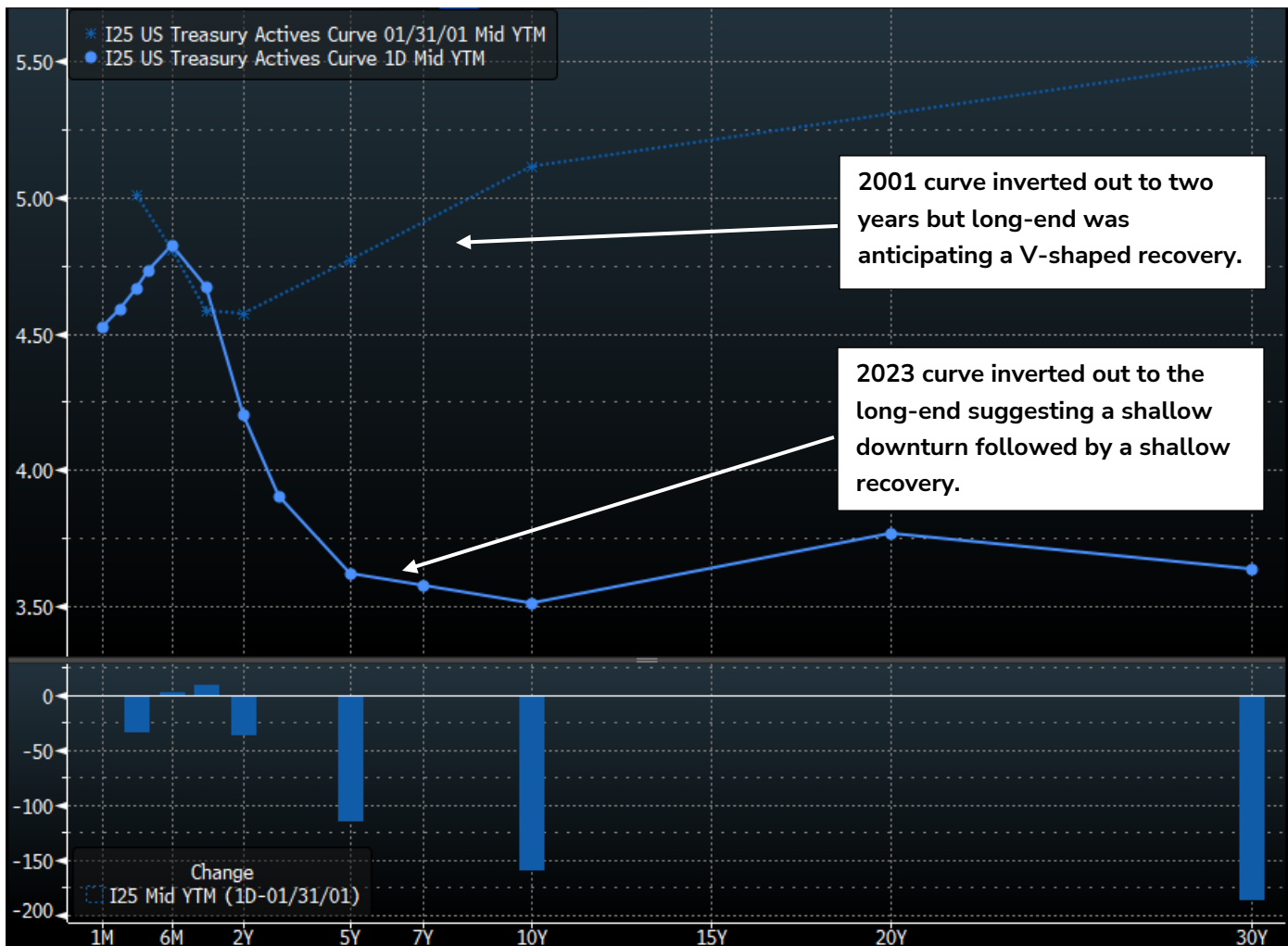
Some pundits are drawing comparisons of January 2023 versus January 2001 that saw a similar sharp recovery in the prior year's worst performers (back then the Internet and Tech/Telecom stocks that characterized the 1999 Internet Bubble). 2023 is starting to feel eerily similar to the market dynamics that shaped 2001. According to the Bear Traps Report, the worst performing stocks of 2022 (growth stocks, meme stocks, 'innovation' stocks) which were down 37% were January's best performers, collectively up 15% - similar to the 15% January 2001 recovery of dotcom growth stocks that had collectively dropped 31% the year before.

It seems that V-shaped recovery is also a connecting theme between 2001 and 2023. Both periods were facing a downturn following a boomtime period of speculative investing and both periods also had their geopolitical disruptions (9/11 in 2001 and Russia/Ukraine/China COVID lockdowns in 2022). In 2023, where earnings estimates are already being revised down (now flat for 2023 from 5% prior to 4Q2022 earnings releases), equity investors are trying to look past the earnings and economic downturn anticipating a V-shaped recovery in 2024 where earnings are projected to grow 10+% and the Fed will have cut rates by 1.5-2%. The implied hope in the 'V' is a short, shallow recession that may lead to an uptick in unemployment but not a severe contraction (think growth slowdown rather than cliff-drop) - maybe not barn-busting reflationary economic growth in 2024 but enough oomph for corporate profitability to recover. So, it would seem 2023 is shaping up to be Back to 2001 and the sought-after Soft Landing of slowing, but not inflationary, economic growth.

However, there are some notable differences between today's market narrative versus 2001. Headline inflation was running just north of 3% in 2001 versus 6-7% today, so there was more scope for a rate policy pivot unlike today where

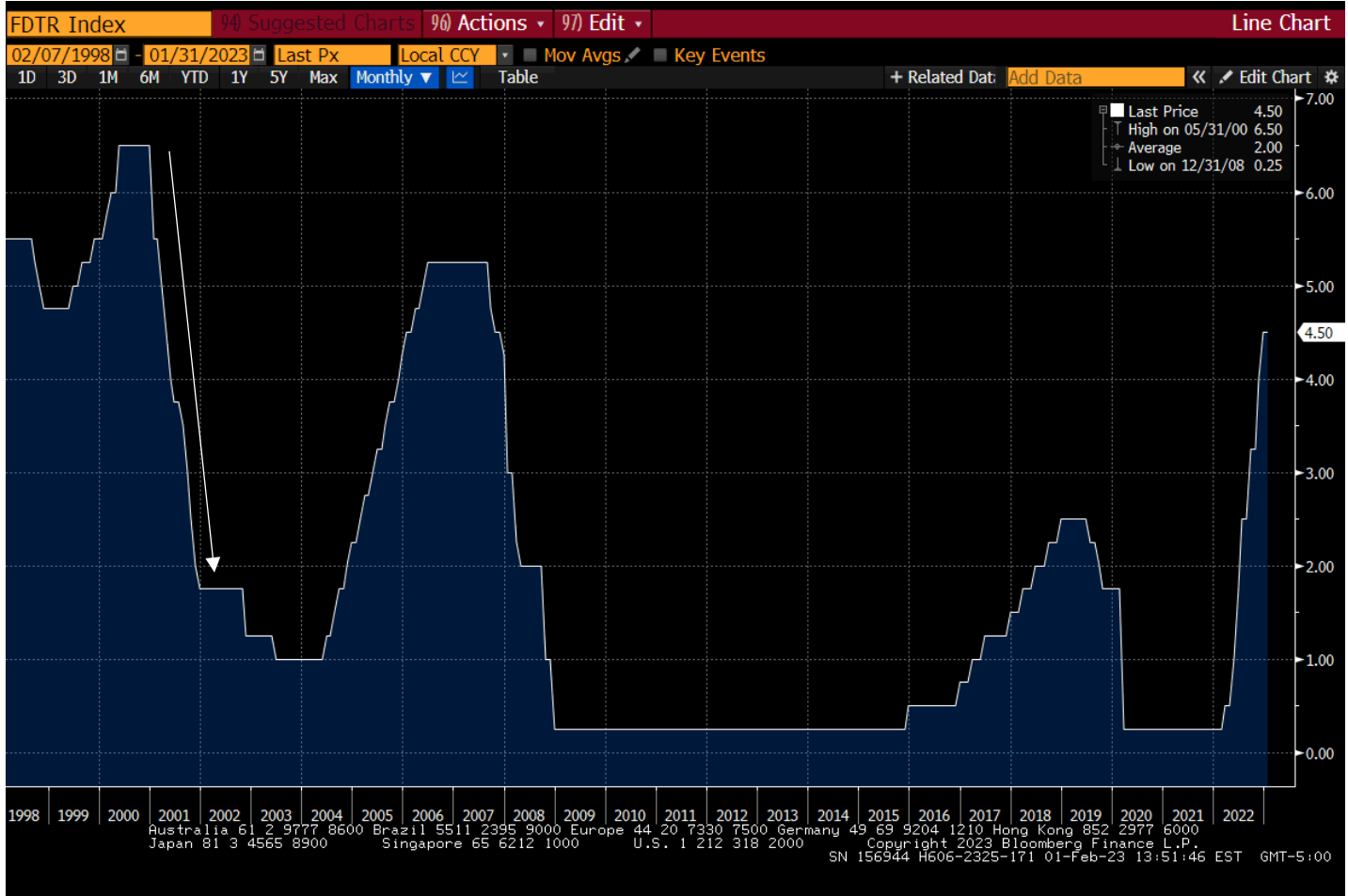
the Fed is somewhat hamstrung by higher inflation to respond to economic weakness. The short-end of the U.S. Treasury yield curve is inverted in both periods (**Figure 2**) as the market anticipated a disinflationary slowdown that would eventually see a drop in the Fed Funds Rate; however, the Fed had already been cutting rates in 2001 by the tune of 4% (**Figure 3**) after having reached peak terminal rates in late 1999 as the long-end of the curve was anticipating a reflationary V-shaped recovery. The 2001 rate cuts did not stop the credit markets from eventually imploding as the pullback in business investing eventually caught up with overleveraged corporate borrowers (notably Calpine, Enron, Worldcom), who later, as it turned out, had also been engaged in creative accounting. As the above-referenced AEI article argued at the time of publishing in November 2001, investors who purposely ignore the implications of a slowdown in economic activity and profitability underestimate the extent of an economic downturn as the V-shaped recovery didn't materialize but rather the U.S. economy succumbed to a deeper recession. In contrast, the 2023 curve is implying a flatter V-shaped recovery with a shallow downturn to be succeeded by a shallower upturn.

**Figure 2 – Short-Term Interest Rates in 2001 and 2023 Were/Are Anticipating Lower Fed Funds Rate in the Face of Economic Weakness, but Steepness in 2001 Curve Implied a Reflationary V-Shaped Recovery**



Source: Bloomberg

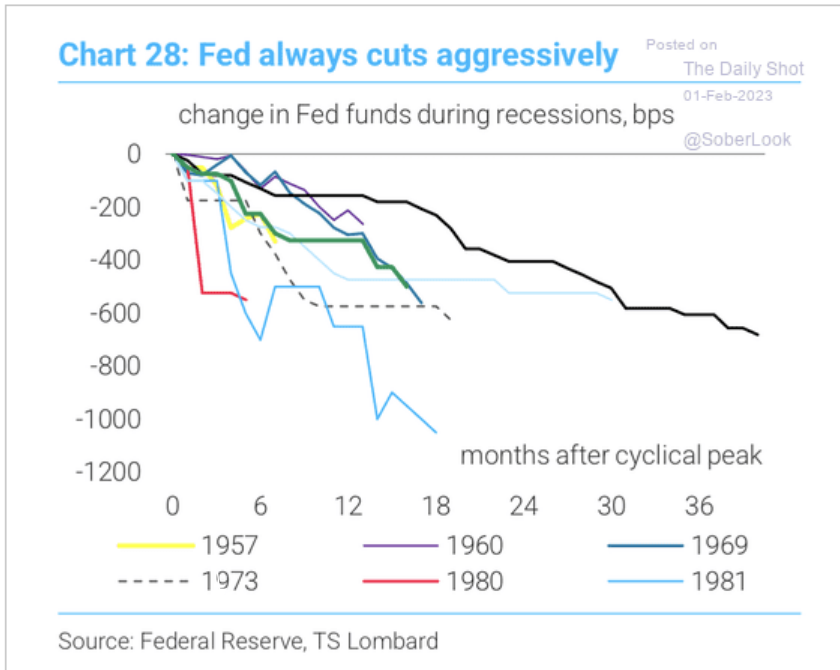
Figure 3 – Historical Fed Funds Rate. In 2001 the Fed Had Drastically Cut Rates Following the Initial Dotcom Implosion (Not to Mention 9/11). The Fed is Expected to Cut Rates in Late 2023.



Source: Bloomberg

The timing over Fed rate cuts is not a matter of “if” but “when” should the U.S. economy succumb to inflation based on prior Fed rate cycles (**Figure 4**). Nor is the magnitude in question as the Fed is expected to cut rates aggressively in the face of an economic downturn. Where the real or inflation-adjusted interest rate (assuming inflation drops to the Fed’s long-term average target of 2%) settles remains to be seen. Even with Fed rate cuts priced into the yield curve, rates remain positive on an inflation-adjusted basis, which constitutes relatively tight levels. This is why some economists are anticipating a short shallow recession conducive to positive real rates as opposed to a deeper deflationary downturn.

**Figure 4 – The Fed Is Expected to Respond Aggressively to Economic Recession Based on Prior Fed Rate Cut Cycles**



As of month-end, Fed Funds futures anticipate a peak terminal Fed Funds rate of 5% to be followed by 0.50% rate cuts later this year (Figure 5).

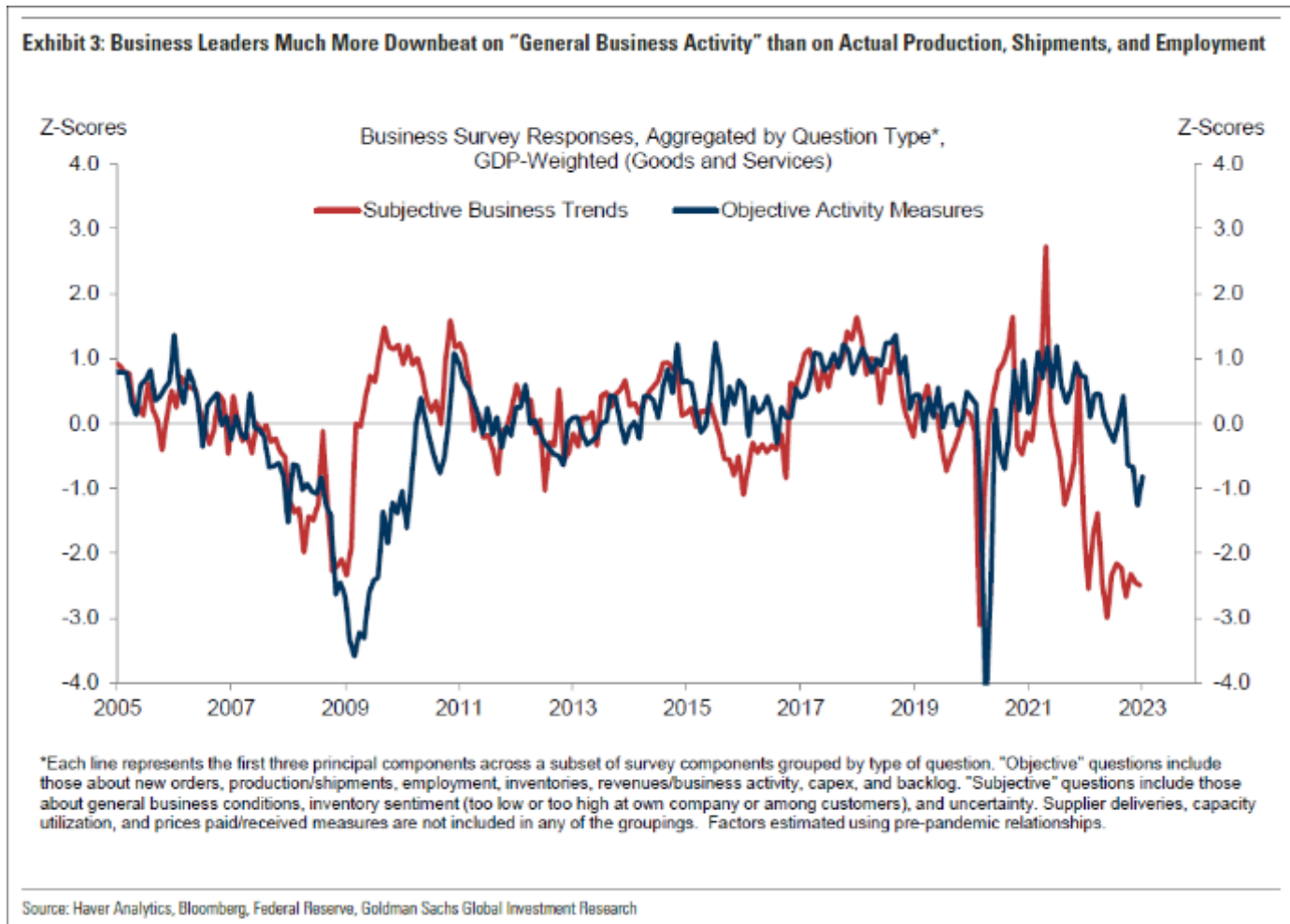
**Figure 5 – Despite the Drop in Long-Term Interest Rates, Fed Funds Futures Still Anticipate a Terminal Rate of 5% by May to be Followed by 0.50% in Rate Cuts Later This Year**

Region: United States »		Instrument: Fed Funds Futures »			
Target Rate	4.50	Pricing Date	01/31/2023		
Effective Rate	4.33	Cur. Imp. O/N Rate	4.331		
Meeting	#Hikes/Cuts	%Hike/Cut	Imp. Rate Δ	Implied Rate	A.R.M.
02/01/2023	+1.034	+103.4%	+0.259	4.590	0.250
03/22/2023	+1.845	+81.1%	+0.461	4.793	0.250
05/03/2023	+2.266	+42.1%	+0.566	4.898	0.250
06/14/2023	+2.339	+7.4%	+0.585	4.916	0.250
07/26/2023	+2.125	-21.4%	+0.531	4.863	0.250
09/20/2023	+1.770	-35.5%	+0.443	4.774	0.250
11/01/2023	+1.268	-50.2%	+0.317	4.648	0.250
12/13/2023	+0.578	-69.0%	+0.145	4.476	0.250
01/31/2024	-0.245	-82.3%	-0.061	4.270	0.250

Source: Bloomberg World Interest Rate Probability (WIRP)

The outlook for the anticipated slowdown and recovery is somewhat clouded by an increasing divergence between “soft data” (business surveys, consumer sentiment) and “hard data” (actual production, labor conditions, consumer purchases) as seen in **Figure 6**. The drop in business sentiment as expressed through surveys could be a function of residual pandemic shutdown effects such as demand surges, supply chain bottlenecks and higher input costs, as businesses try to work through work backlogs and excess inventory.

**Figure 6 – “Hard” Economic Data Not as Downbeat as “Soft” Data**



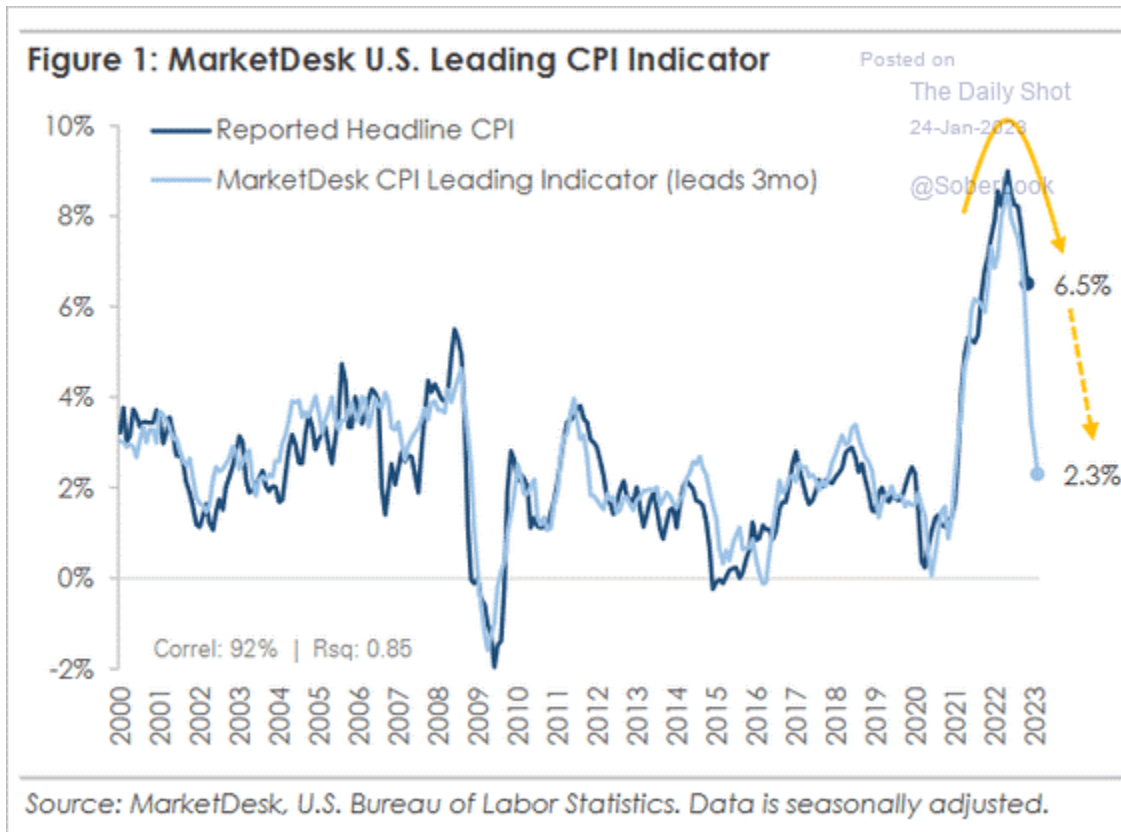
The labor market remains relatively healthy based on jobless claims remaining at cycle lows even if hiring and wage growth are slowing down (albeit from post-pandemic feverish pace). Headlines have been focused on announced layoffs from technology and financial companies that, in hindsight, over-hired based on extrapolated growth from post-pandemic trends. However, the labor market is experiencing more of a rotation as layoffs in some sectors are offset in other sectors across traditional industrial and service sectors (**Figure 7**).

Figure 7 – Layoffs Across Headline Sectors (Technology, Financials) Offset by Hirings Across More Traditional Sectors (Industrials, Health Care)



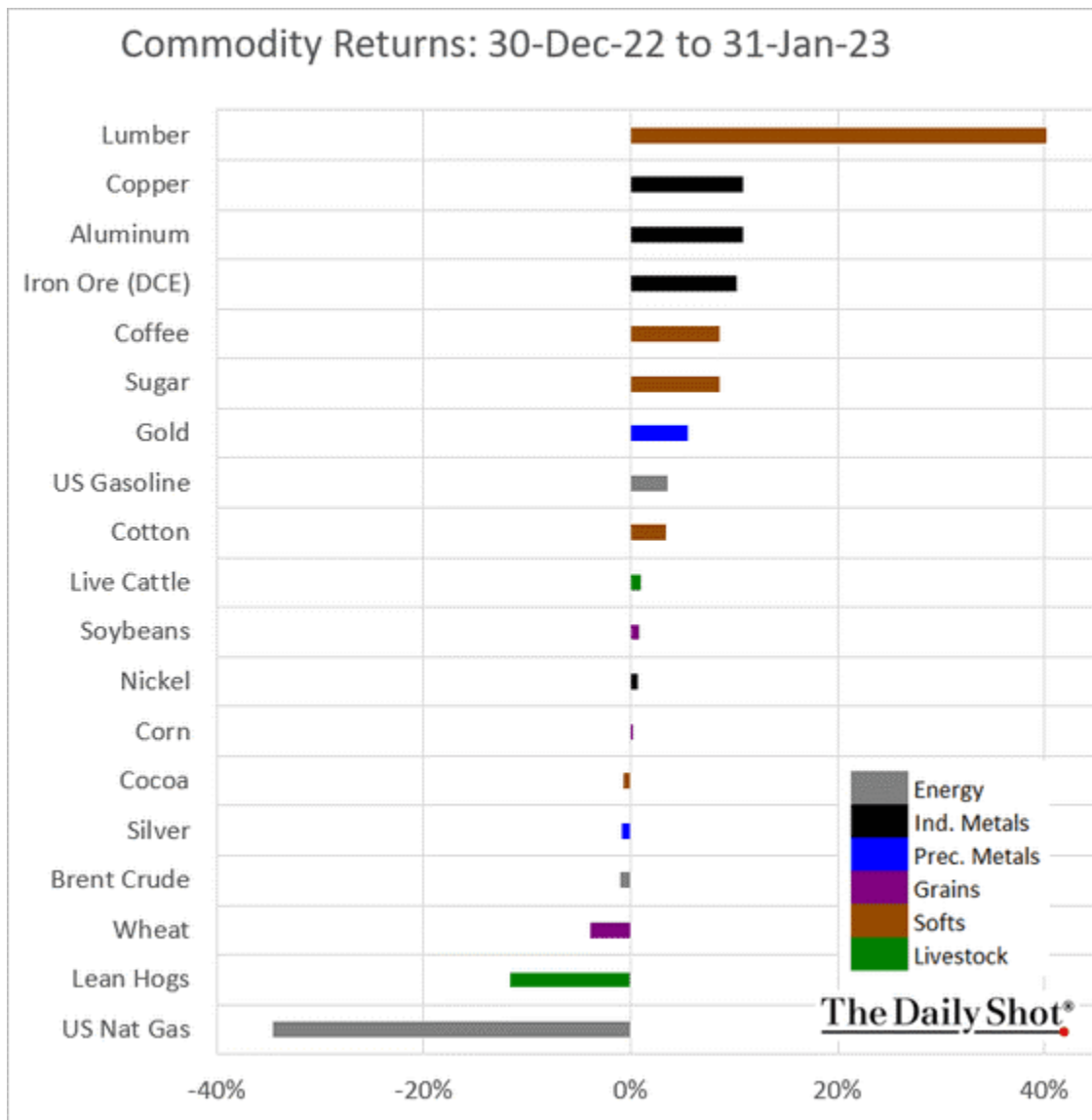
Headline inflation is expected to drop towards the Fed’s long-term target of 2%, mainly driven by lower energy and core consumer goods with shelter costs expected to decline based on various rental/leasing surveys (Figure 8).

Figure 8 – Headline Inflation Expected to Turn Much Lower Throughout 2023



However, near-term inflation may start to get a second wind with gasoline prices and food prices increasing as well as a momentary stop in the decline in used car prices per the latest Manheim survey. The key to inflation likely remains in labor costs relative to productivity as well as continued deceleration in shelter costs, assuming lower home prices bring down rental rates. Whether a [surge in demand from China's post-COVID reopening](#) produces a new wave of inflation also remains a potential upside risk, as is evident in the rise of industrial metals (**Figure 9**).

Figure 9 – Commodities-ex Energy Make a Strong Comeback in January

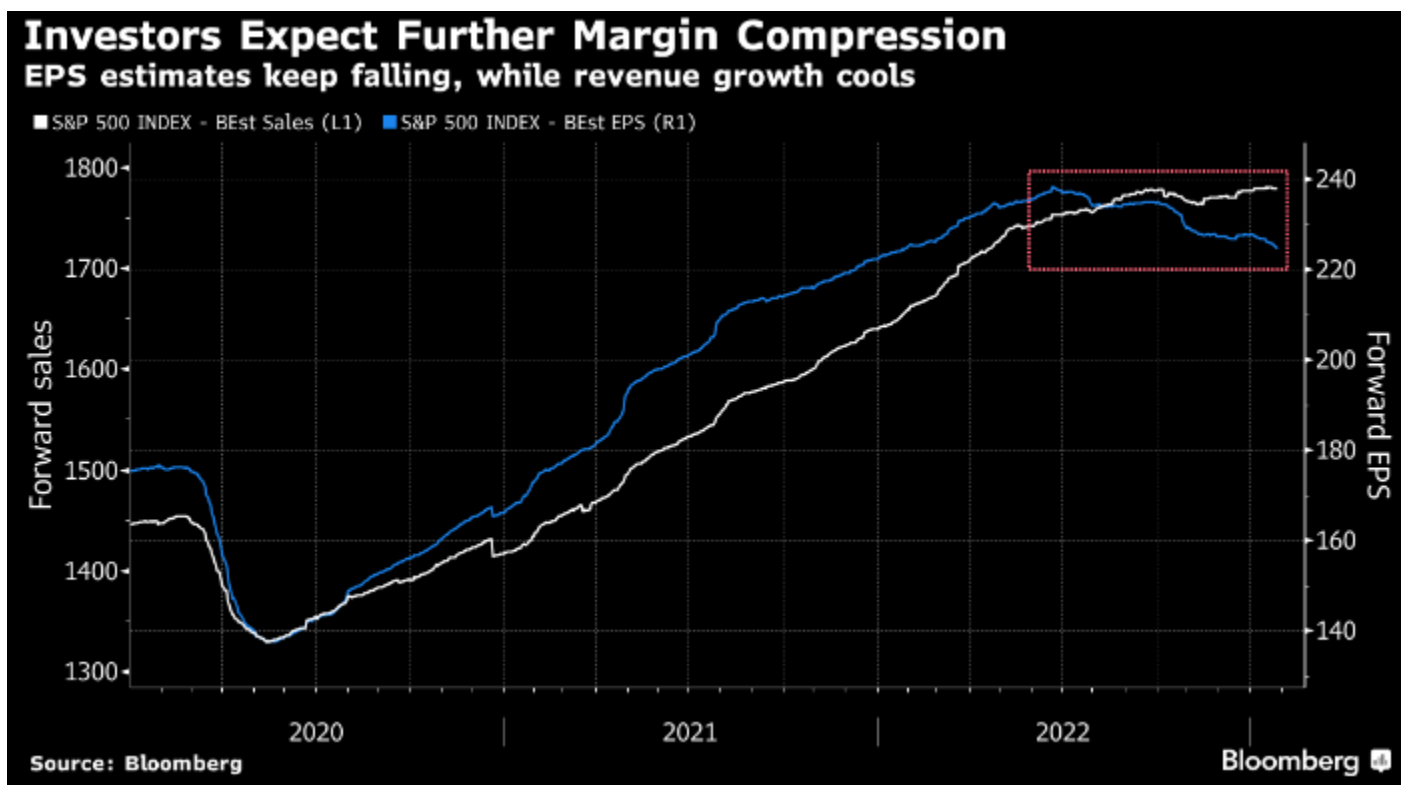


In 2001, the V-shaped recovery didn't materialize until 2003 (following the Iraq invasion) as stocks (particularly growth stocks) made new lows. Will history repeat itself throughout 2023 with new market lows being tested, or will markets continue to their animal-spirit driven rally this year? Economic prognostication is challenging (much more so than predicting the weather). It's challenging to predict the future even if the consensus seems confident in their forecasts for a disinflationary slowdown that won't wreck financial assets or employment. Marty McFly should have pursued a career in weather forecasting as the accuracy in those models increased substantially from the 1950s.

### Markets Looking Past 4<sup>th</sup> Quarter Earnings Decline

Fourth quarter earnings are presenting a mixed bag for S&P 500 companies. With 29% reporting as of 1/27/2023 (per [Factset Earnings Insight](#)), the blended earnings decline is -5.0% (driven by Financials, Energy and Industrials) vs. an anticipated decline of -3.2% prior to the 4Q reporting season. Some of the weakness stems from 2022 issues related to higher operating costs (materials, labor) and slower global activity (Russia/China, Europe energy crisis, China COVID lockdowns) as companies with greater global exposure had reported relatively weaker financial results (-7.5% blended earnings growth rate for companies with > 50% sales outside the U.S. versus -3.5% for those with >50% sales within the U.S.). More disconcerting is a decline in profitability in the face of slowing revenue growth (**Figure 10**). Sell-side consensus expects a weak first half for S&P earnings to be followed by a recovery in the second half with projected earnings growth of 3.4% on revenue growth of 2.6%. This is down from 5% growth expected prior to reporting season, but analysts still don't project an outright decline even in the face of an economic recession.

**Figure 10 – US Profitability Under Pressure as Earnings Decline in the Face of Slowing Revenue**



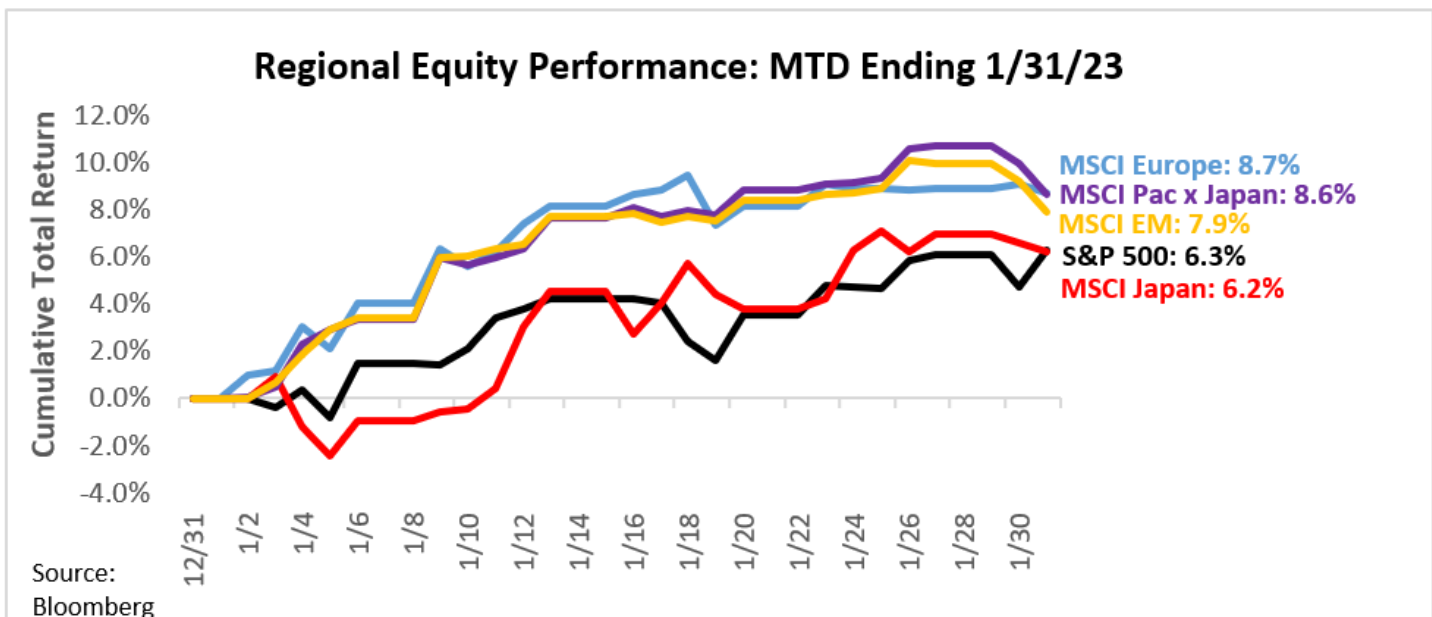
U.S. stock valuations are expanding (see valuation table at the beginning of the commentary) as investors anticipate an earnings recovery and lower interest rates. How much further earnings multiples can expand without confirmation that margins will hold and that U.S. companies won't succumb to an earnings recession remains to be seen, but the margin for error is being reduced.

## January 2023 Market Review

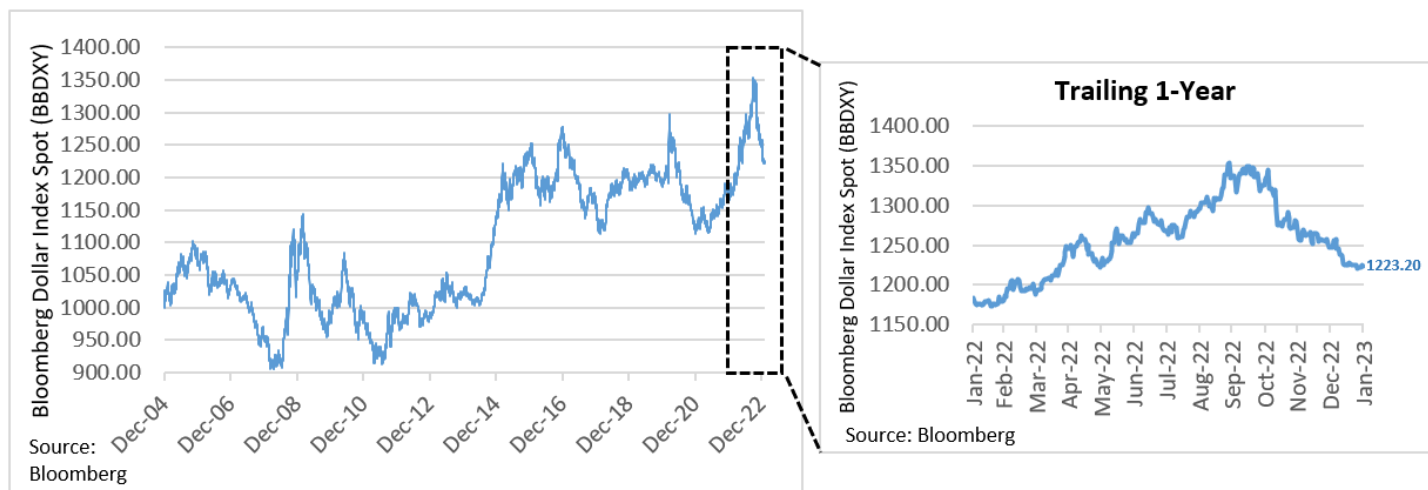
January saw a surge in risk appetite as global equities rallied from the year-end sell-off over signs of disinflationary slowdown that could prompt the end of central bank tightening. Favorable winter and net energy demand reductions also helped European stocks despite an economic slowdown/recession. Fourth quarter earnings from beaten-up growth stocks helped drive this month's high beta rally within the U.S. market as did the classic January effect that tends to see stocks subject to tax-loss harvesting the prior year rebound sharply in January. In January, the MSCI All-Country World Index (ACWI) returned 7.8%.

Across major regions (**Figure 11**), International Developed and Emerging Markets outperformed the U.S. although Emerging Markets saw a month-end sell-off across China and India, giving up some of its earlier leadership. In January, MSCI Europe and MSCI Pacific ex-Japan led major regions, returning 8.7% and 8.6%, respectively, followed by MSCI Emerging Markets (+7.9%). MSCI Japan (+6.3%) and the S&P 500 (+6.3%) lagged major regional performance. The U.S. dollar weakened further from last quarter's depreciation (**Figure 12**) over prospects of an end to Fed tightening while the rest of the world is viewed as catching up to the U.S. with respect to policy tightening.

**Figure 11 – Ex-U.S. Developed and Emerging Markets Outperform the U.S.**

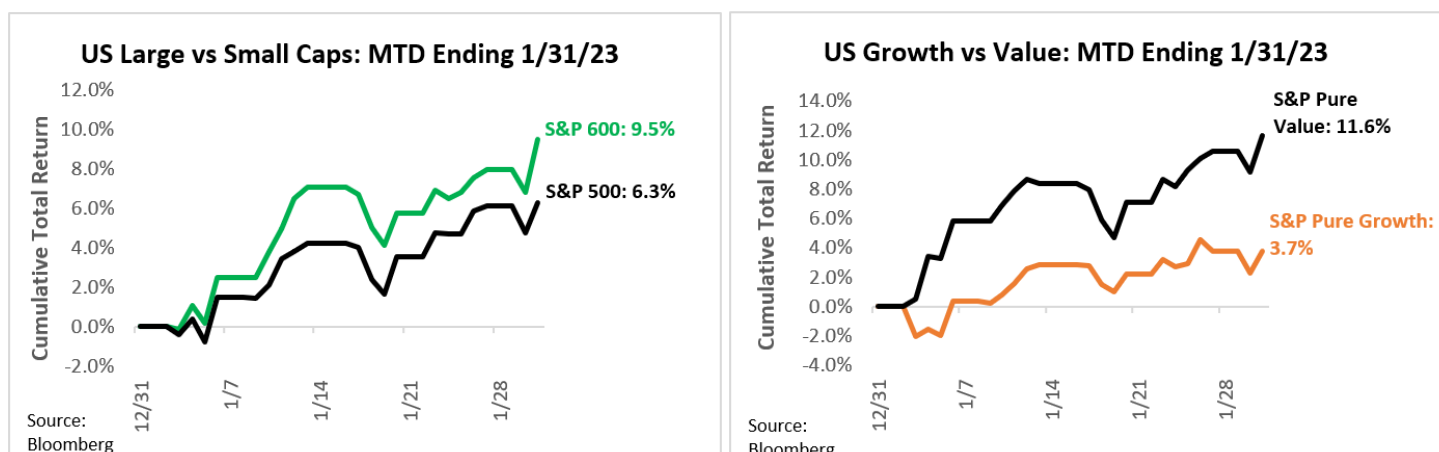


**Figure 12 – The U.S. Dollar Continues to Weaken from Peak “Wrecking Ball” Fears Over Expectations that the Fed is Close to Pivoting On Rate Hikes**



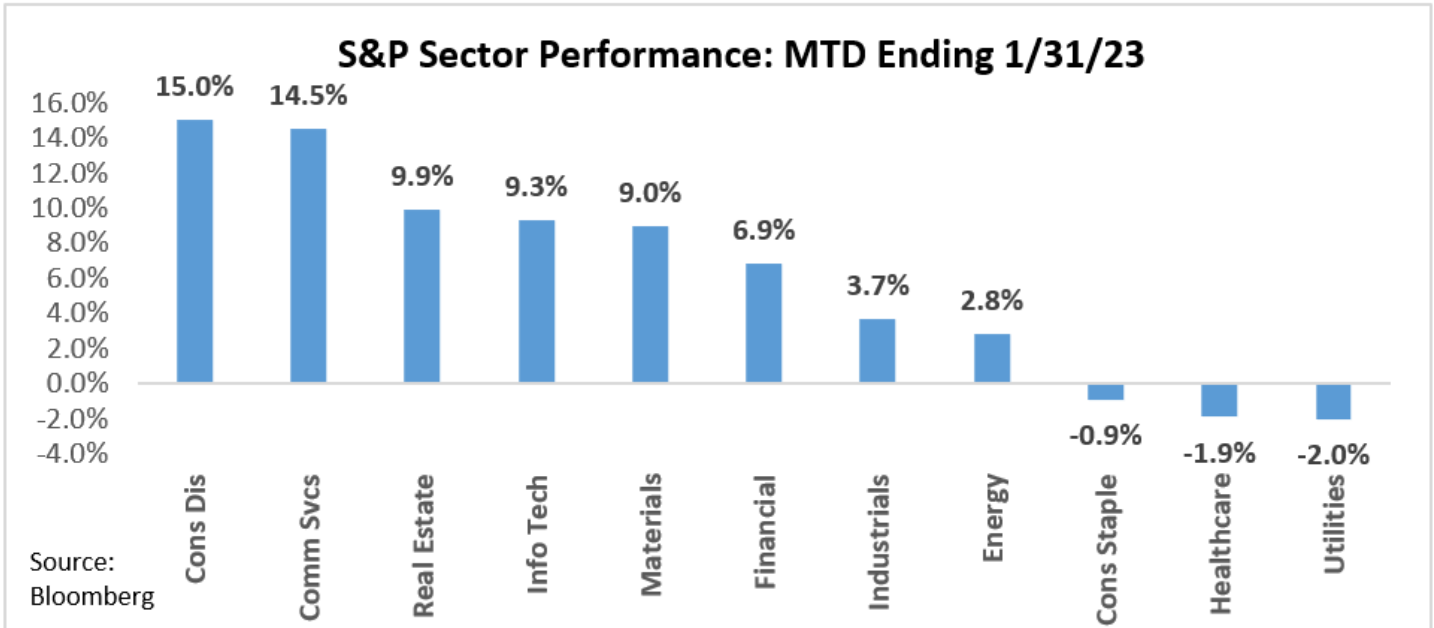
Within the U.S., small caps benefited from the high beta rally outperforming large caps, while value stocks surprisingly outperformed growth stocks, despite the strong performance of speculative growth stocks (see Figure 1 above). The S&P 600 Index returned 9.5% versus 6.3% for the S&P 500. S&P Pure Value outperformed Pure Growth, returning 11.6% versus 3.7%, respectively (Figure 13).

**Figure 13 – Small Caps Outperformed Large Caps While Value Outperformed Growth**



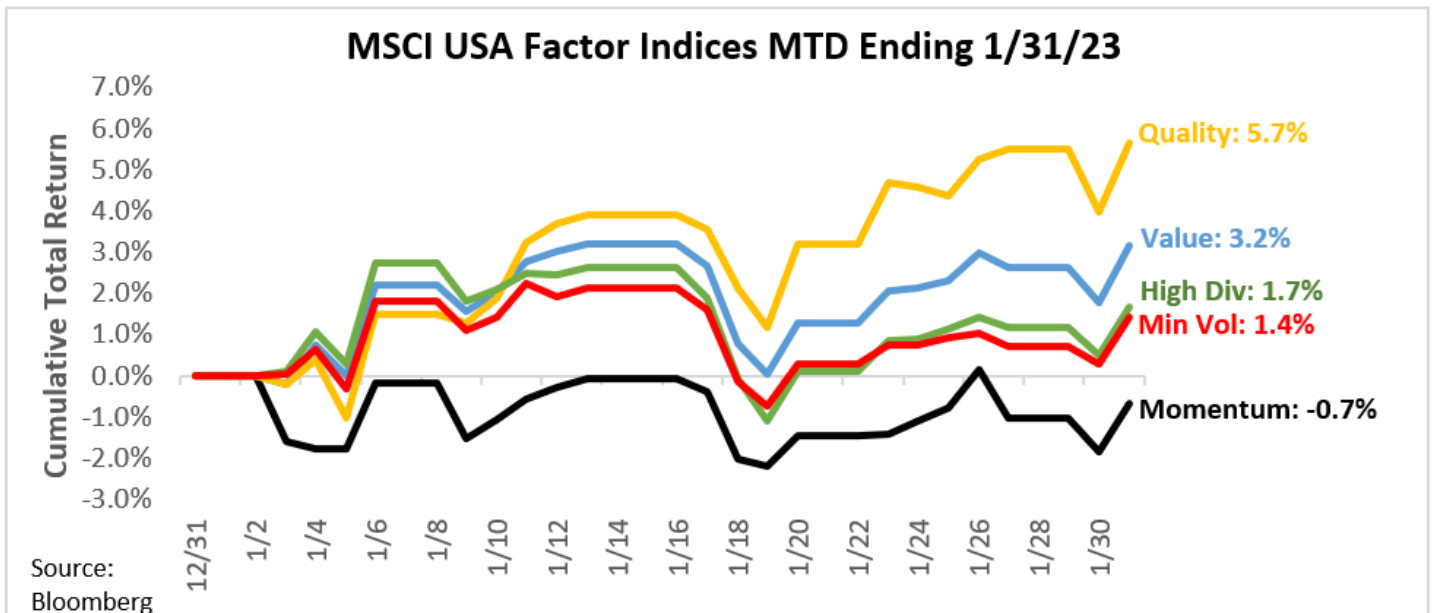
Across sectors (Figure 14), 2022’s beaten-up large cap growth stocks that comprise the majority of sector weightings contributed to the outperformance of Communications and Consumer Discretionary sectors as well as Technology and Real Estate (both 2022 year-end laggards) while defensive sectors such as Consumer Staples, Healthcare and Utilities lagged as did traditional cyclicals such as Industrials and Energy.

**Figure 14 – Growth Sectors (Consumer Discretionary, Comm Services, Technology) and Real Estate Outperformed Traditional Cyclical (Industrials, Energy) and Defensives (Staples, Healthcare, Utilities)**



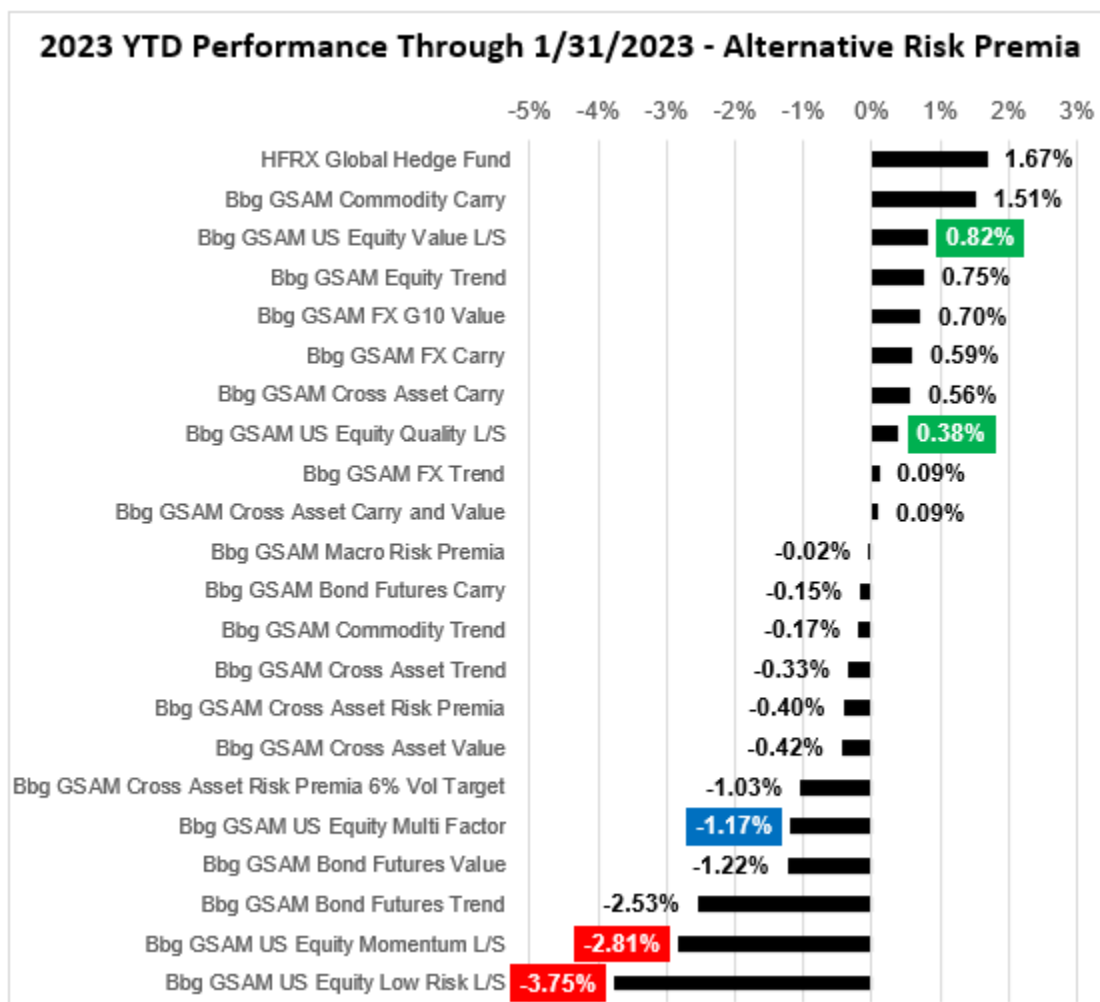
January was a challenging month for Risk Factor performance as all major risk factors underperformed the broader market (Figure 15). Among Risk Factors, High Quality and Value outperformed High Dividend, Minimum Volatility and Momentum, as the latter three lagged due to the lower risk profile of the underlying holdings.

**Figure 15 – All Major Risk Factors Underperformed the Broader Market in January**



The underperformance of low-risk or low-beta stocks can be seen in **Figure 16** which displays the performance of alternative risk premia. Long/short low volatility and momentum were negative for the month while long/short multi-factor also struggled even though long/short value and quality were positive.

**Figure 16 – Long/Short Equity Momentum and Low Volatility Struggled in January**



The Bloomberg U.S. Aggregate Bond Index rose 3.1% for the month (**Figure 17**) while the Global ex-U.S. Aggregate returned 3.5%. The 10-Year U.S. Treasury yield ended the month at 3.5% (**Figure 18**), down from 3.8% at the beginning of the year, while the 2-10 Year Term structure (**Figure 19**) remains deeply inverted even though inflation expectations implied by breakeven rates between TIPS vs Nominal Treasury yields remain elevated. Non-U.S. bonds and emerging market local currency bonds outperformed, helped by U.S. dollar depreciation over prospects that the U.S. Fed is close to the end on rate hikes while the rest of the world remains behind the U.S. on the inflation front. U.S. high yield benefited from the U.S. equity rally and a drop in interest rates as credit spreads narrowed (**Figure 20**). The Bloomberg US High Yield Index returned 3.8%, while Bloomberg/Barclays Emerging Market Debt LC returned 4.4%.

Figure 17 – Fixed Income Benefited from a Drop in Interest Rates and Narrowing Risk Premiums Across Investment Grade Sectors (MBS, Corporate) and High Yield

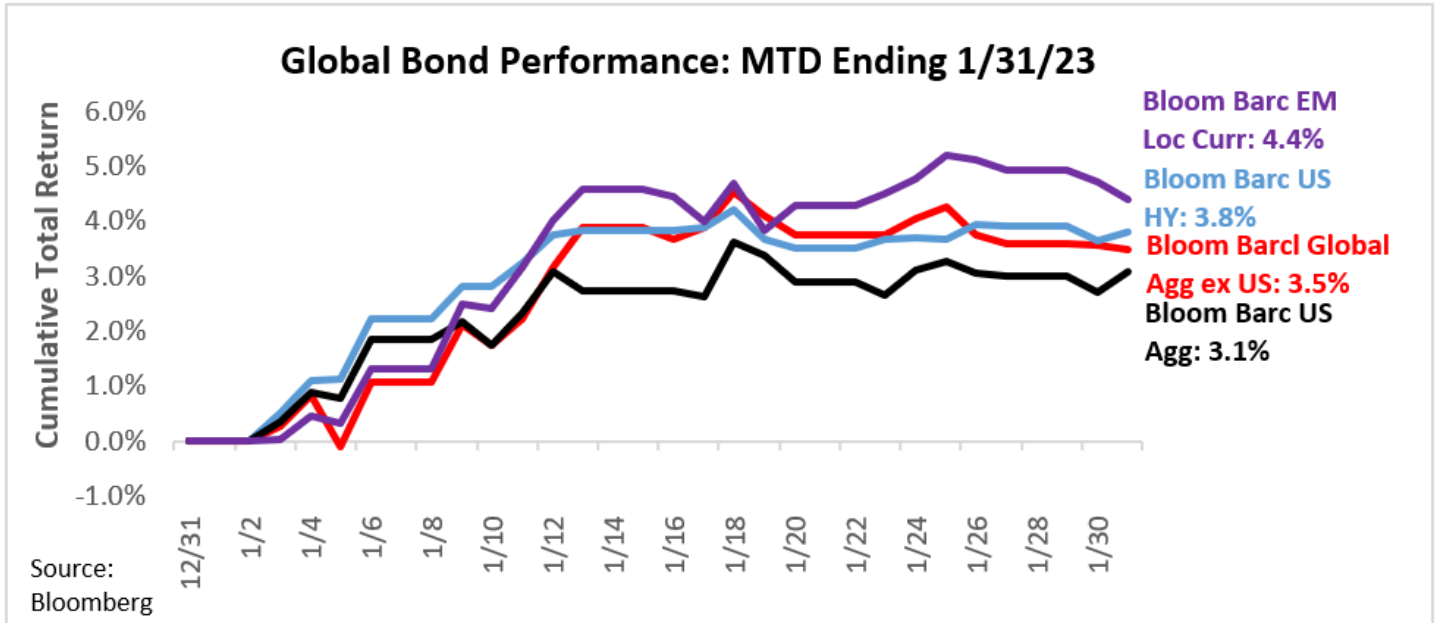
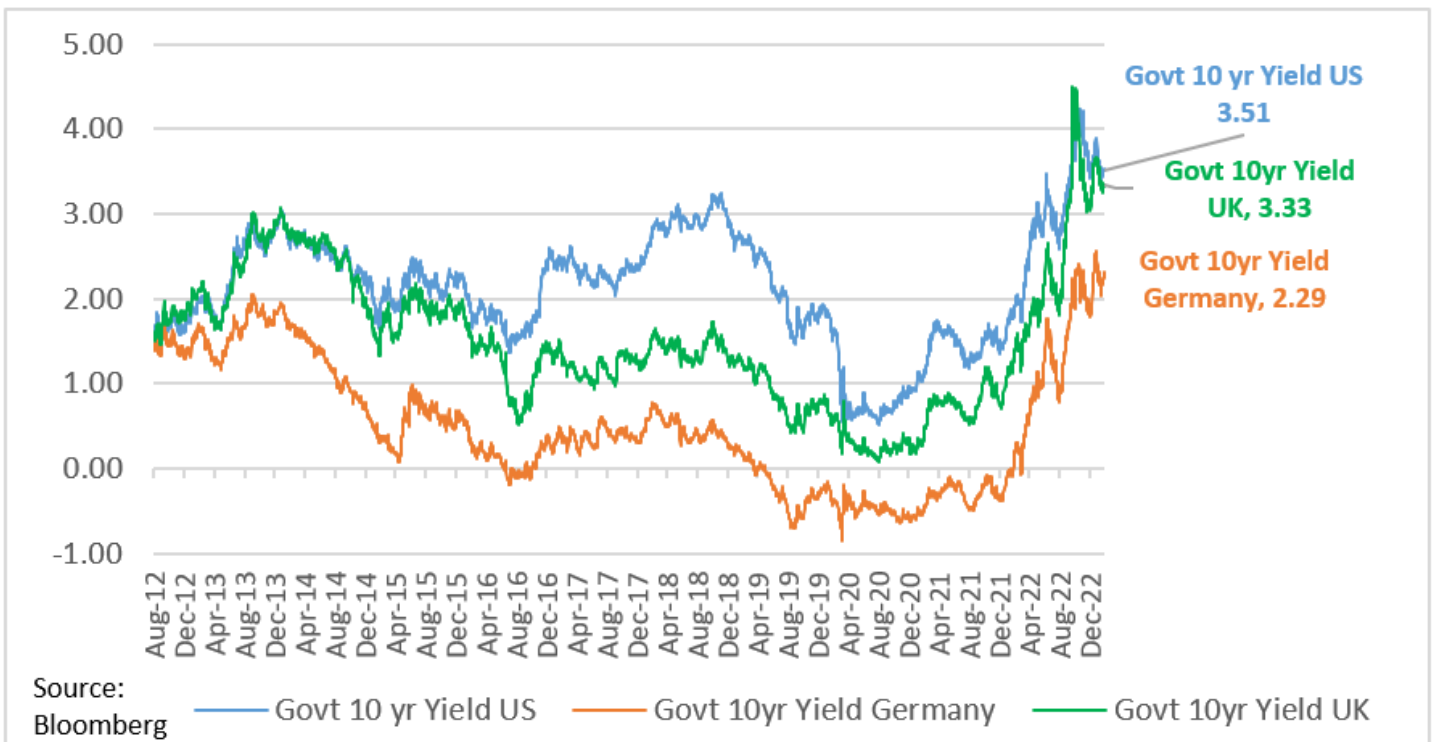
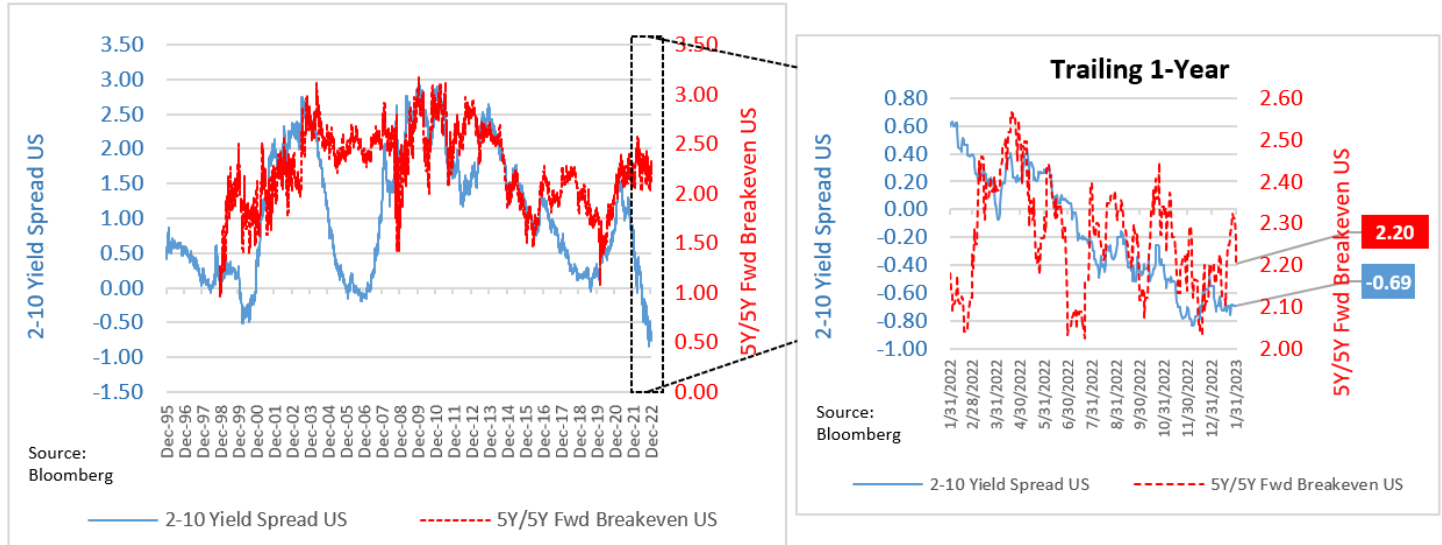


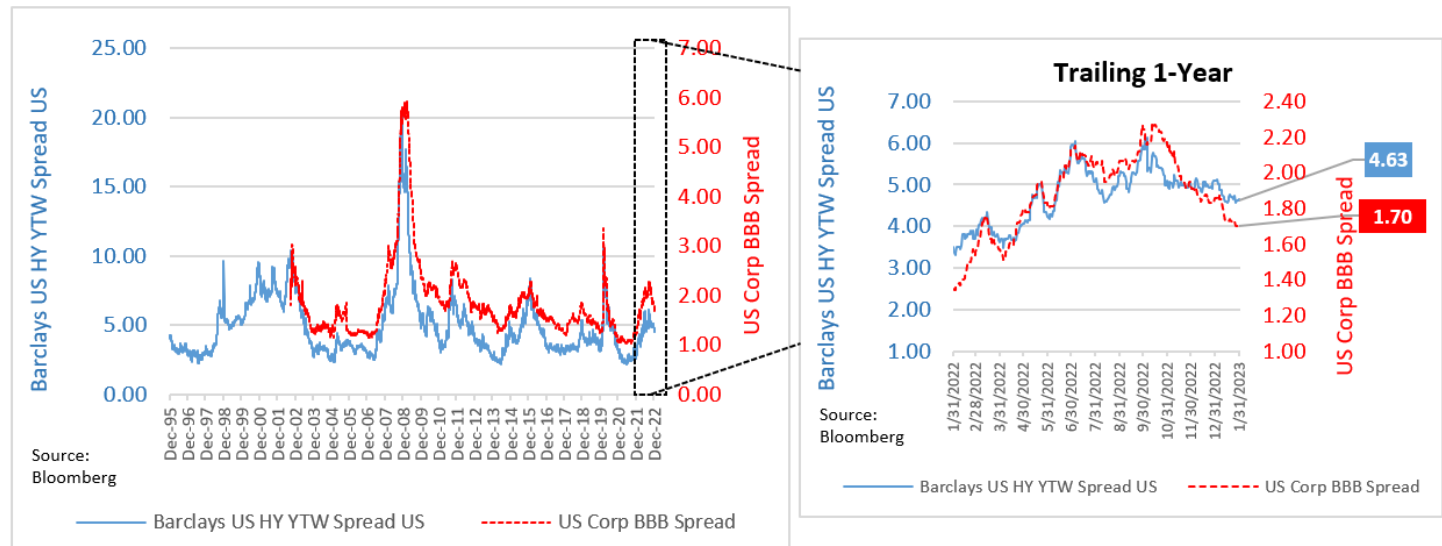
Figure 18 – Sovereign Bond Yields Dropped in January



**Figure 19 – 2-10 Year Term Structure Remains Deeply Inverted by Inflation Expectations (Breakeven Rates Between TIPS vs Nominal Treasuries) Remain Elevated**



**Figure 20 – Corporate Credit Spreads Narrow in January Alongside Equity Rally**



Within equity alternatives (**Figure 21**), Real Estate rose sharply recovering from the prior quarter's sell-off. Precious Metals also rallied over prospects that the Fed was close ending its rate hikes. It was a mixed month for commodities (**Figure 22**) as industrial metals rose in conjunction with China reopening from COVID lockdowns, while oil prices were unchanged (even though natural gas saw a sharp sell-off). The S&P GSCI Commodities Index returned -1.7% for the month while Dow Jones REIT Index rose 10.1%. The S&P GSCI Precious Metals Index rose 5.4% for the month.

Figure 21 – REITs Outperformed the Broader Market Benefiting from Lower Interest Rates and Precious Metals Rallied But Commodities Lagged

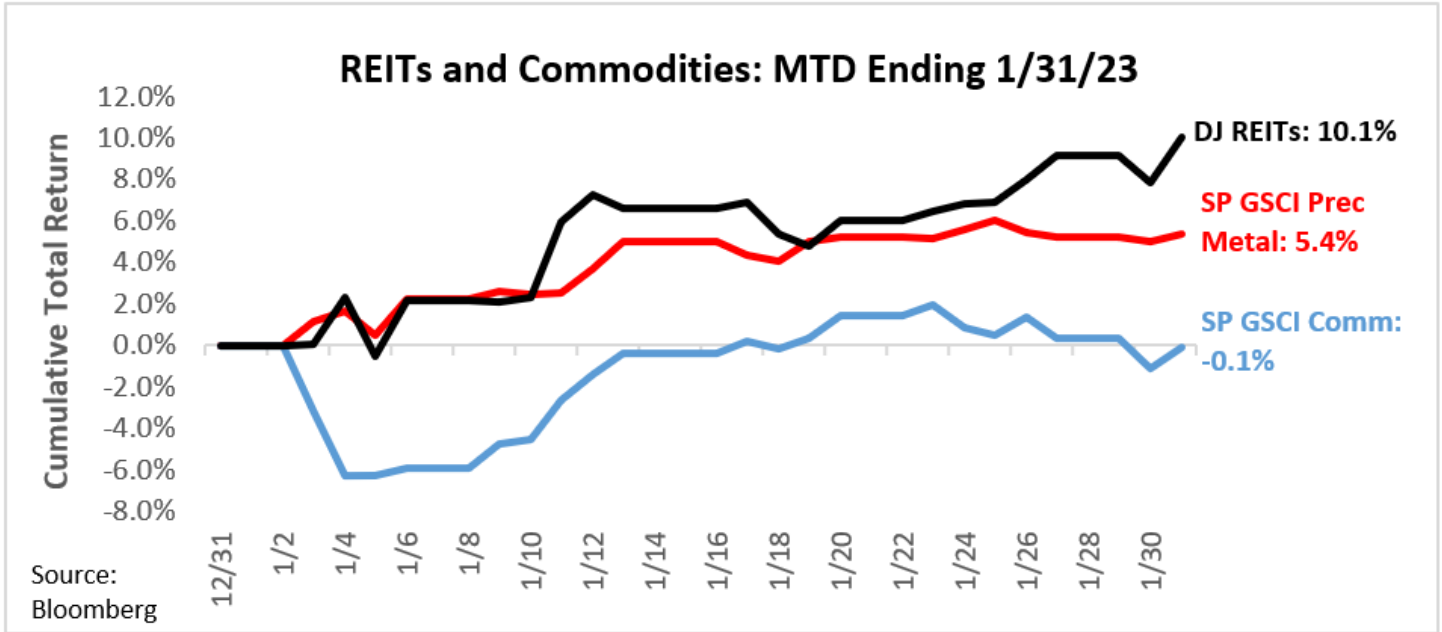
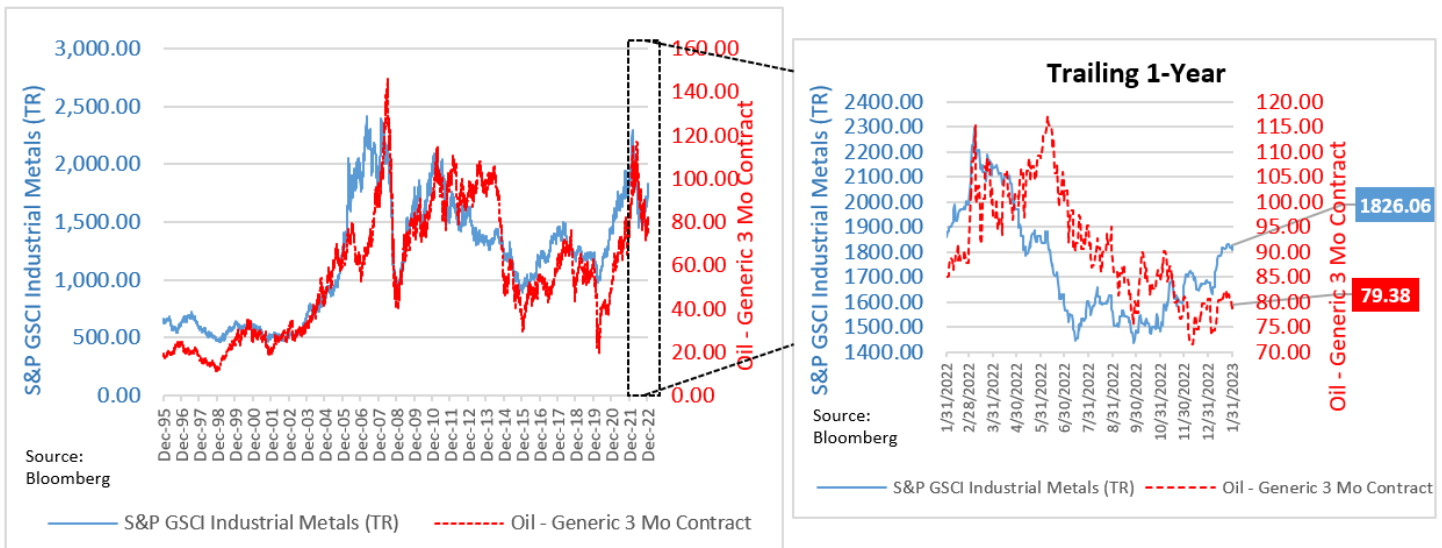


Figure 22 – Industrial Metals Rally Over China Re-Opening from COVID Lockdowns While Oil Remains Range-Bound





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Disclosure:

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