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CIO MONTHLY PERSPECTIVE

FALSE PROPHETS

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Take 2023 forecasts with a grain of salt

2022 was one of those rare years where cash was king as most asset classes were in the red. More disappointingly, many deeply held beliefs and widely respected figures were discredited. Investors who have become addicted to the Fed's largess were shocked by Chair Powell's newfound hawkishness.

Big Tech perma-bulls learned that trees don't grow to the sky and valuations can actually contract. Some celebrated masters of the universe in the hedge fund world were revealed to be levered long speculators who had forgotten the art of hedging.

Crypto evangelists had to admit that they were at the mercy of the liquidity ebbs and flows of the Fed – the very institution that they claimed cryptocurrencies could prosper without. Mainstream media showed its true colors by collectively ignoring the shocking Twitter files released by Elon Musk to a few old-school liberal journalists regarding the long-suspected Orwellian censorship and collusion between the obscure deep state and Big Tech.

On the global stage, Putin, the supposed grandmaster in geopolitics, was exposed as an egomaniacal dictator who overestimated his corrupt military's ability and underestimated the West's resolve to stop Russia's aggression. The about-face in China's zero-COVID policy and the resulting long lines outside hospitals and crematoriums shattered the myth about the regime's technocratic competency.

Europe's much ballyhooed transition to green energy was far from being ready for prime time as their coal consumption hit record highs. In short, many emperors have lost their clothes, and the peons were left rudderless in uncharted waters.

While the new year marks a break in the calendar, these issues have yet to run their course. The market's focus will likely shift from inflation to calculating the odds, depth, and length of a widely anticipated recession, but reading the Fed's tea leaves, however flawed, may still temporarily trump fundamentals. Time will tell if equities are headed for new cycle lows, and if the private market can weather the economic downturn unscathed.

On the positive side, with the Fed funds rate approaching the cycle peak, treasuries and gold appear to be well-positioned. Patient investors may also be rewarded with buying opportunities associated with a climactic bottom if 2023 indeed marks the end of a historic boom-bust cycle triggered by a once-in-a-century pandemic.

THE ART OF PROPHESYING

Vangeliya Pandeva Dimitrova, better known as Baba Vanga, was an acclaimed psychic of the 20th century. Born in Northern Macedonia in 1911, she was an ordinary child until age 12, when a tornado lifted and threw her into a field, causing an injury to her eyes which led to a total loss of sight.

Still, she managed to learn Braille, play the piano, and complete household chores. Her psychic ability

developed slowly, initially with her helping her father locate a stolen sheep by describing the yard where the sheep was hidden.

She claimed that she could visualize the life of a person standing in front of her like watching a film from birth to death. During WWII, many people sought her help in locating lost relatives, dead or alive.

After marrying a Bulgarian soldier in 1942, she settled down in the town of Petrich in southwestern Bulgaria. As her fame grew, Bulgarian politicians, as well as dignitaries from various Soviet republics flocked to seek her soothsaying. It was alleged that even Leonid Brezhnev, the USSR's head of state from 1964 to 1982, had paid her a visit.

By 1966, Vanga was so sought after behind the Iron Curtain that the Bulgarian government added her to its payroll and provided her with two assistants as well as a panel of screeners to vet visitors. The state's Institute of Suggestology and Parapsychology commenced a study of her psychic abilities. Unfortunately, the semiliterate Vanga never published any works, so tales of her psychic readings and predictions were mostly secondhand.

One widely circulated story was about the encounter between Baba Vanga and Silvana Armenulić, a famous Bosnian singer-songwriter and actress. In August 1976, while on tour in Bulgaria, Armenulić paid a visit to Baba Vanga. The blind mystic reportedly sat in silence with her back to Armenulić. After a while, Vanga told her not to pay and come back in three months. As the disappointed Armenulić was walking out of the room, Vanga reportedly said, "Wait. In fact, you will not be able to come. Go, go. If you can come back in three months, do so." Two months later, Armenulić was killed in a car accident.

Vanga was credited with having foretold many major world events, including the 9/11 terrorist attacks. "Horror, Horror!" she had allegedly said in 1989, "The American brethren will fall after being attacked by the steel birds. The wolves will be howling in a bush, and innocent blood will be gushing."

THE ART OF PROPHESYING

In recent years, Vanga has become even more legendary as social media has been a powerful medium to spread her prophecies, real or fictional. Shortly after Vladimir Putin's invasion of Ukraine in early 2022, the Internet was abuzz with Vanga's alleged decades-old predictions of Russia's glory under Putin's leadership.

Although Putin was still a little-known, mid-level bureaucrat when Vanga died in August 1996, some have peddled stories of how she had sung his praises. It is alleged that Vanga had said to the late Russian writer Valentin Sidorov in 1979, "All will thaw, as if ice, only one remains untouched – Vladimir's glory, the glory of Russia."

She also purportedly added, "Too much is brought in a victim; nobody can stop Russia," and "All will be removed by her from the way and not only will be kept, but also becomes the lord of the world." Some have interpreted the last line to mean that Putin will become the "Lord of the world."

Despite these sensational claims about Putin and his motherland's glory, the Russian military's distinction as the second best army on Ukrainian soil should call into question the accuracy of Vanga's alleged prophecies, or the veracity of Sidorov's account of their interview.

Sidorov, a Russian nationalist and a proponent of an esotericism that preached the coming of a Russian messiah who would defeat dark forces and transform the world into a utopia, may have embellished or even made up the prophecies attributed to Vanga. Indeed, the archives of the aforementioned Bulgarian Institute of Suggestology and Parapsychology contain thousands of pages of notes recorded during Vanga's consultation sessions between 1967 and 1974. Researchers have found them to be mostly about personal issues rather than future geopolitical or world events. If any documents in the archive had presciently predicted world events, the institute would have actively publicized them. After all, the Bulgarian government has played an active role in commercializing the Baba Vanga phenomenon since the 1960s, as it has been a lucrative business.

Vanga's former home has been turned into a museum and there are movies and books about the "Nostradamus of the Balkans." A retired KGB officer has acknowledged that Vanga's assistants had collaborated with the KGB and Bulgaria's intelligence service as conversations between Vanga and her visiting dignitaries were a fertile ground for intelligence. I suppose that Vanga, blessed with her extrasensory perception, was keenly aware of the government's scheme and had probably played along by saying things that bigwigs from the Soviet Union wanted to hear. Imagine what would have happened to Vanga had she told the visiting communist officials, before the fall of the Berlin Wall, that they would someday be driven out of power. She probably would have been banished to a mental institution, or worse.

26 years after Vanga's passing, Putin launched the invasion of Ukraine under the guise of the glory of Russia. I wonder if Putin, surrounded by sycophants, was told of Vanga's alleged prophecies that lauded him as the "Lord of the world." Did these "prophecies" play a role in Putin's calculation, or miscalculation to be precise, in waging the war? It would be ironic if he had really bought into the alleged prophecy that "nobody can stop Russia."

FALSE PROPHETS

As we turn the calendar to 2023, it is customary for experts in various fields to make their forecasts for the new year, and this exercise is of particular interest to investors. Whether it's top ten surprises or mundane topics like year-end targets for the S&P 500 Index and U.S. Treasury yields, there is no shortage of professional soothsayers telling investors what they want to hear, similar to what Baba Vanga relayed to Soviet dignitaries.

For a typical year, the tricks of the trade on the sell-side are for equity strategists to forecast mid-to-high single digit growth in earnings and index levels; economists would usually peg inflation and real GDP growth at around 2% and set bond yields within 50 bps of the previous year's closing levels.

For the sake of career risk minimization, these talking heads usually refrain from making bearish calls – lower index levels and the dreaded "R" word (recession) – as they would not be well-received by investment bankers, advisors, and clients.

Today, with the benefit of hindsight, we know that most forecasts for 2022 have failed spectacularly as professional investors and Fed officials have all underestimated the inflation risk and the requisite policy response. Of course, it did not help that Putin had believed that "nobody can stop Russia" in launching his ill-advised invasion of Ukraine.

At the end of 2021, the Fed was guiding three 25-bps rate hikes in 2022 to bring the upper bound of the Fed funds rate to 1% by year-end 2022, and the policy rate was projected to peak at 2.25% by the end of 2024.

FALSE PROPHETS

While Chair Powell had pivoted away from the transitory inflation narrative, the Fed was still expecting inflation, the core PCE (personal consumption expenditure), to move steadily lower over time: to 2.7% by the end of 2022, and 2.1% exiting 2024.

Investors had an even more dovish expectation – the Fed funds futures market was pricing the upper bound of the Fed funds rate to rise to only 1.75% by the end of 2024. As for the economic outlook, the Fed and most economists were all expecting post-COVID pent-up demand to drive another year of strong growth, with the consensus real GDP expectation settling above the Fed's 4% growth projection.

This combination of lower-rates-for-longer and above-trend growth expectations buoyed sentiment for equities – many prominent sell-side strategists had set their year-end 2022 S&P 500 Index targets above 5,000 (a gain of more than 5%), and FactSet estimated that, by aggregating industry analysts' bottom-up price targets for all the companies in the index, the Street was forecasting a year-end 2022 index target of 5,225, a 9.6% price gain.

By the end of 2022, the upper bound of the Fed funds rate was raised to 4.5%, the latest core PCE reading was 5%, real GDP growth for the full year will likely be sub-1%, and the S&P 500 Index closed at 3,840, down 19.4% for the year.

The moral of the story is to take Wall Street forecasts with a grain of salt as there are simply too many variables and uncertainties for even experts to credibly come up with point estimates. It reminds me of the quote, "I believe that economists put decimal points in their forecasts to show they have a sense of humor."

Market Watch

Equity Market Indices[1]	11/30/22 Price	12/31/22 Price	MTD Changes	YTD Change
MSCI All Country World	631	605	-4.0%	-19.8%
S&P 500	4080	3840	-5.9%	-19.4%
MSCI EAFE	1944	1944	0.0%	-16.8%
Russell 2000®[2]	1887	1761	-6.6%	-21.6%
NASDAQ	11468	10466	-8.7%	-33.1%
TOPIX	1986	1892	-4.7%	-5.1%
KOSPI	2473	2236	-9.6%	-24.9%
Emerging Markets	972	956	-1.6%	-22.4%
Fixed Income				
2-Year U.S. Treasury Note	4.31%	4.43%	12	370
10-Year U.S. Treasury Note	3.61%	3.88%	27	237
BBG U.S. Agg Corp Spread	1.33%	1.30%	-3	38
BBG U.S. HY Corp Spread	4.48%	4.69%	21	186
Currencies				
Chinese Renminbi (CNY/$)	7.09	6.90	-2.7%	8.5%
Brazilian Real (Real)	5.19	5.28	1.7%	-5.3%
British Pound ($/GBP)	1.21	1.21	-0.2%	12.0%
Euro ($/Euro)	1.04	1.07	-2.8%	6.2%
Japanese Yen (Yen/$)	138.07	131.12	-5.0%	13.9%
Korean Won (KRW/$)	1318.40	1265.50	-4.0%	6.4%
U.S. Dollar Index (DXY)	105.95	103.52	-2.3%	8.2%
Commodities				
Gold	1769	1824	3.1%	-0.3%
Oil	80.6	80.3	-0.4%	4.2%
Natural Gas, Henry Hub	6.93	4.48	-35.4%	20%
Copper (cents/lb)	373	381	2.2%	-14.6%
CRB Index	280	278	-0.7%	19.5%
Baltic Dry Index	1355	1515	11.8%	-31.7%

Source: Bloomberg

SANGUINE CONSENSUS

While I may sound cynical of the Street's forecasts, I am sympathetic to most forecasters since investment is, by nature, a humbling business, and I have also made forecasts that I wish to forget. What I've learned is that, instead of focusing on price targets or specific numbers, one should try to get the big picture and major trends right. It helps to have a view on whether the macro-environment favors risk taking, staying neutral, or being defensive. One should also gauge what the market may have discounted.

Given the unusual developments in 2022 – the most aggressive tightening and the largest yield curve inversion in decades, a growing divergence between U.S. manufacturing and services activities, a hot war involving a nuclear power, etc. – investors have a wide range of views for 2023. However, after digesting various outlook reports, surveys, and market news, I would summarize the market consensus as the following:

EQUITIES OPTIMISM

The U.S. will either barely skirt a recession or experience a short and shallow downturn. However, with much potentially bad news already discounted, U.S. equities will likely generate solid returns.

FED PIVOT

Optimism for U.S. equities is driven by the expectation that the Fed will pivot to neutral in the first half of 2023 and start cutting rates in the second half. Fixed income is likely to do well in an environment of falling interest rates.

COMMODITIES REBOUND

A rebound in the commodity complex thanks to China's "reopening."

EM SHINES

A recession in Europe will be offset by a ceasefire in Ukraine and post-lockdown growth in China, which would favor emerging market equities, especially Chinese stocks.

GREENBACK WEAKENS

With the Fed's hiking cycle coming to an end, the U.S. dollar will weaken further, which will be favorable to international stocks and emerging market debt.

Interestingly, the common thread among these views is that regardless of the risk of recession here or abroad, stocks, bonds, and commodities are all expected to be up in 2023. This optimism seems to be built on the playbook from last decade when easy money trumped everything else; bad news would be spun as good news since the Fed would respond by turning on the liquidity spigot to drive asset prices higher. However, it is debatable how quickly we can return to the easy money regime of 2009 through 2021.

A SHALLOW OR DEEP RECESSION?

Regarding the outlook for the U.S. economy, the Bloomberg Economic Forecasts database, which collects projections from 55 contributors, currently pegs the median probability of a U.S. recession within a year at 70%, which is uncharacteristically cautious for sell-side research.

Notwithstanding this caution, a recent Bloomberg survey of 134 fund managers had 71% of them anticipating an up year with an average expected gain of 10% for U.S. equities.

Some of these experts urge investors to look past the potential economic weakness and start increasing equity exposure since much of the bad news – the most anticipated recession in decades – has supposedly been discounted in 2022's bear market.

While I wish the U.S. economy will fare at worst with a short and shallow recession, I would caution that Wall Street has habitually downplayed economic and market risks. In the mid-2000s, investors were told that the subprime crisis would be contained; one prominent economist even came up with the clever slogan "rust but not bust" to ease concerns about the housing market.

In early 2020, strategists collectively watched the coronavirus shut down the Chinese economy but did not make the logical call that it would soon affect the rest of the world. In 2021, most experts on Wall Street and at the Fed were busy confirming each other's biases in the "inflation is transitory" echo chamber. Well, you know the rest of the story.

The case for a short and shallow recession, or a mere economic slowdown, is built on the belief that American consumer finances and the U.S. banking system are in relatively good shape.

The tight labor market with depressed labor participation rate may also cap the rise of the unemployment rate. While these may be valid points, we are monitoring several disconcerting developments reminiscent of the early warning signs of deeper crises in the past.

One glaring risk is that the once red-hot U.S. housing market has weakened rapidly under the weight of surging mortgage rates. The year-on-year decline in existing single-family home sales is approaching the depth experienced during the mid-2000's housing bust.

One source of housing demand, the rapid rise in home purchases by investors, which accounted for nearly a quarter of U.S. single-family homes that sold in 2021, is now in reversal.

The recent gating of redemptions at several leading private REITs (real estate investment trusts) and credit funds are signs of potentially greater stress ahead. Indeed, while the U.S. banking system appears to be in solid shape to support the economy, the opaque shadow banking system may be the Achille's heel.

With shadow banking entities having taken much share from banks – in 2021, non-banks accounted for more than two-thirds of U.S. home purchase loans and 63% of the $3.1 trillion corporate lending market – disturbance in this segment of the market will reduce credit flow at the most inopportune time.

Furthermore, disruptions to the tech sector – sizeable declines in market caps, discontinuity in venture funding, rising job cuts, and inventory correction – are eerily similar to what had transpired after the dot-com implosion roughly two decades ago.

These issues individually may not pose much threat to the economy at this stage. However, their continued deterioration, along with falling real wages due to elevated inflation, portends higher risk than a garden variety recession.

CONTRADICTORY FORCES

One proven circuit breaker to prevent or cut short a recession is monetary easing by the Fed, which helps to rekindle animal spirits and ease financial conditions.

Over the last four decades, the Fed had consistently started easing before the onset of every recession. Unfortunately, the Fed is guiding a tighter-for-longer policy stance this time around – the FOMC's (Federal Open Market Committee) December Summary of Economic Projections pegs the year-end 2023 Fed funds rate at 5.125% despite forecasting the unemployment rate rising to 4.6%, which implies a recession with 1.5 million jobs lost.

Such a hawkish policy stance, if carried out, will exacerbate the economic downturn. This policy guidance also runs counter to the market consensus that the Fed funds rate would peak below the FOMC's 5.125% projection, followed by a couple of rate cuts in the back half of 2023. Indeed, some believe that the Fed is already done with rate hikes in the current cycle.

For the market's dovish monetary policy expectations to be proven correct, the upcoming recession would have to be worse than the short-and-shallow consensus to force the Fed's hand.

Other drivers of an earlier-than-planned Fed easing include political pressure in the face of a rapidly deteriorating fiscal picture in Washington, or major market dislocations in the equity or credit space.

Regarding Washington's fiscal picture, the combination of lower tax receipts (due to lower income and capital gains taxes) and higher interest expenses (because of higher interest rates) could raise alarms about Uncle Sam's fiscal sustainability.

Indeed, the Congressional Budget Office's (CBO) analysis in November 2022 has raised 2023's federal deficit estimate from the $1 trillion baseline in May to a range of $1.2 to $1.3 trillion – a sizeable increase of 20% to 30%!

In short, we are confronted with discordant views that will likely result in higher market volatility. There is the contradiction between the market's expectations of a mild economic downturn and monetary policy easing in 2023.

Chair Powell's recent attempts at sending hawkish messages were akin to spitting into the wind as investors were more focused on catching phrases that can be spun as expressions of his inner dovishness. These contradictory forces are reflective of our collective foibles, greed, and misperception:

• The Fed, having mishandled price stability in 2021 – perhaps the most egregious policy error in more than four decades – now seems willing to overtighten in order to avoid losing more of its inflation fighting credentials.

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• The market, conditioned by more than a decade of easy monetary policy, still expects the Fed to come to its rescue despite an unfriendly inflation backdrop. The fear of missing out (FOMO) is palpable judging by the repeated bear market rallies triggered by a persistent misreading of the Fed's resolve to fight inflation.

• The Fed's inability to convince investors of its policy roadmap has ironically loosened financial conditions, which could make it more difficult to tame the inflation beast.

If history is any guide, 2023 will wind up proving both the market consensus and the Fed wrong; as legendary speculator Jesse Livermore once said, "The stock market is never obvious. It is designed to fool most of the people, most of the time."

THE PAST IS PROLOGUE

Knowing how difficult it is to forecast the market, it may be helpful to look back at history for clues about the future. I believe the following statistics are relevant for 2023:

• Several tried and true indicators are flashing recession signal. For example, since the data series began in 1959, every time the Conference Board U.S. Leading Economic Index's 6-month annualized change fell below -4% (there were eight occasions), a recession followed within a year. This index has dropped to -7.3% by November 2022, signaling a countdown to the next recession.

• There were 12 U.S. recessions since the end of WWII. On average, a 0.4% rise in the unemployment rate from the cycle trough would usher in a recession; the median rise in the jobless rate at the onset of recession was also 0.4%. With the current business cycle having hit a 3.5% low in the unemployment rate, the U.S. economy will probably be in recession by the time the jobless rate rises to 4.0%.

THE PAST IS PROLOGUE

• Excluding the pandemic-induced recession in 2020, the other 11 recessions since WWII had the jobless rate rising from cycle lows to the peaks by an average of 3.1% and a median of 3.4%. Peak unemployment rates have never been below 6.1%, and the smallest rise in the jobless rate was 1.5%. Based on these numbers, the upcoming recession will likely see the unemployment rate reaching at least 5%, and more likely peaking above 6%.

• The U.S. has experienced 15 recessions since 1929. 13 of them had the S&P 500 Index hitting cycle lows during a recession, not before the start of a recession. In one instance, the 2001 recession, the market bottomed eleven months after the recession was over. The one time that the S&P 500 Index failed to hit a cycle low during a recession was in 1945, when the WWII victory trumped the downturn induced by reduced military spending. Based on this pattern, the S&P 500 has yet to hit its cycle lows if we wind up with a recession in 2023 or 2024.

• These recessions since WWII had the S&P 500 EPS (earnings per share) declining by an average of 27% and a median of 18%. The smallest EPS decline was 3.3% in the 1949 recession. Today, the consensus 2023 EPS growth expectation for the S&P 500 Index is roughly 4.5%.

• On the positive side, the average 12-month price return for the S&P 500 Index from the market closing lows in each of the 12 recessions after WWII was a whopping 44%, and the median was still impressive at 38%. That is, these recession-induced market lows tended to have V-shaped recoveries. However, how much the market will decline before the next bottom is reached remains to be seen.

Based on these precedents, my base case for 2023 includes a recession – which starts when the jobless rate hits roughly 4% – followed by an equity market bottom several months later. As for the depth of the economic downturn, I would assign a 45% probability each to the mild and deep recession scenarios, leaving a 10% chance for a softish landing.

Furthermore, the earlier the recession shows up, the greater the odds of a milder recession since the Fed will likely be forced into an earlier pivot. If the economy holds up into mid-year, the Fed will be emboldened to raise the Fed funds rate further, potentially compounding the eventual downturn with the long and variable lags of these additional hikes.

These recessionary scenarios are supportive of Treasury bonds as yields will likely head lower. There may be some upward pressure in yields in early 2023 if the Fed continues to hike rates, thereby pushing up shorter-term interest rates and potentially dragging yields across the curve higher. I would look to capitalize on these moves to extend the duration to position for the eventual recession-induced retreat in yields.

On the credit side, investors will need to be choosey in capitalizing on the tug of war between rising credit spreads and falling Treasury yields. Private credits, bank loans, and high yield funds could be roiled by aggressive leverage and weaker covenants that have become emblematic of the industry in recent years. However, distressed debt funds may finally get a decent opportunity to deploy fresh capital.

I am less sanguine on equities going into a potential recession as it is difficult to gauge where the market will bottom out. I have little confidence in the current consensus 2023 S&P 500 EPS estimate of $230 per share (I/B/E/S data from Refinitiv as of December 30, 2022), up 4.4% year-on-year.

Applying the 18% median EPS decline from past recessions to 2022's EPS estimate of $220 would yield $180 of EPS for 2023. A price-to-earnings (P/E) range of 15 to 20 times $180 of EPS pegs a S&P 500 target range of 2,700 to 3,600. If we assume a less punitive EPS decline of 10% as a result of inflation-fueled nominal growth, the roughly $200 per share of earnings for 2023 would yield an index price range of 3,000 to 4,000 based on P/Es of 15 to 20 times.

With sufficient economic and market hardship fueling disinflation pressure and driving up unemployment, the Fed will sooner or later relent and come to the market's rescue as it has done repeatedly over the last four decades. Similar to what had unfolded in early 2019, the Fed's eventual rate cuts and the cessation of quantitative tightening will likely kick off a new liquidity cycle to boost asset prices once again.

There is the irony that a deeper economic downturn could induce a stronger policy response from the Fed to rekindle the market's animal spirits. On the other hand, a softish landing or a very mild recession would likely keep the Fed on the sidelines and leave equities and bond yields in a trading range for an extended period.

Lastly, the worst-case scenario will be a stagflationary environment where inflation remains stubbornly above the Fed's desired range despite a deepening recession. I would view such a scenario as an outlier as a deep recession with surging unemployment and a collapsing housing market will likely unleash much deflationary force.

THE WILD CARDS

There are several wild cards outside the U.S. that will impact the macro environment and financial markets.

Two conspicuous issues are, of course, China's growth prospects in the face of its gross mismanagement of the COVID-19 pandemic, and Europe's ongoing energy crisis due to the war in Ukraine.

China's sudden shift from zero-COVID tolerance to a let-it-rip approach to force herd immunity upon its population has already inflicted much pain and created a bleak winter.

The silver lining is that by the spring of 2023, with expanded herd immunity, China will finally be in a position to enjoy a cyclical rebound.

This upturn will likely benefit Chinese and China-related equities, but investors should treat these opportunities as a trade rather than a secular trend.

This cyclical rebound will likely push up China's demand for commodities, resulting in the return of some inflationary pressure.

On the other hand, Chinese factories may unleash much deflationary force as they seek to repair damages done to the Made in China image during the lockdown phase.

Europe's challenges are a double-edged sword. With the flow of natural gas via the Nord Stream pipelines stopped, European countries will continue to pay up for energy, even though year-on-year inflation will soon come down materially with easier comparisons.

It remains to be seen how Europe will manage to restock its natural gas storage going into winter 2023, especially if it has to compete with the growing demand from China's rebound.

On the positive side, the energy crisis will force European companies to become more energy efficient, which should help their competitiveness in the long run despite the near-term pain.

As for the war in Ukraine, the pressure on President Zelensky to settle for a ceasefire will likely grow over time, but sanctions against Russia will likely remain in place even if the fighting stops.

In short, European equities should offer opportunities in energy and related investments even with the so-called Eurosclerosis remaining a structural challenge.

Another wild card is Iran, whose kleptocratic theocracy has been facing months-long popular protests. After spurning the West's nuclear deal, it's unclear how the oppressive ruling mullahs and the menacing Islamic Revolutionary Guard Corps (IRGC) will maneuver to remain in power in the face of rising domestic and external pressures.

With the hardline Benjamin Netanyahu making yet another comeback as Israel's Prime Minister, one cannot rule out potential military conflicts involving these two countries, which will not only disrupt the oil market and send prices sky high, but also realign the regional balance of power with unpredictable outcomes.

MORE HUMILITY LESS HUBRIS

In the final analysis, my 2023 outlook presupposed on historical patterns would be off the mark if this time turns out to be different. That said, I am mindful of Sir John Templeton's warning, "The four most dangerous words in investing are: this time it's different."

What I know for sure is that the new year will bring fresh surprises – some good and some nasty – and by definition these are things that we are not currently expecting. Indeed, three years into this decade, we have been living through one big surprise after another.

At the start of 2020, no one would have expected a SARS-like virus to concurrently lock down more than half of the world's population. The impact of the pandemic was so jarring that policymakers were deathly afraid of mass unemployment and deflationary forces.

However, thanks to Operation Warp Speed and the largest-ever stimulus packages, the U.S. economy and inflation wound up surprising on the upside.

At the start of 2021, no self-respecting economist, including the army of PhDs at the Fed, would forecast inflation to end the year at 7%. Policymakers who had worried about mass unemployment a year earlier were caught off guard by the "great resignation" wave even though labor participation rates were still below pre-pandemic levels for all age groups.

Then came the shocker in late February 2022 with Putin launching the invasion of Ukraine. Military experts had expected Ukraine to fall within days or weeks, but its conscripts wound up outfighting the much-feared Russian military, the Wagner Group mercenaries, and Chechen warlord Kadyrov's battle hardened fighters.

The list of surprises just kept on growing – the Fed's most aggressive tightening in four decades, China's sudden shift to let COVID-19 rip, and the Bank of Japan's abrupt tweaks to its controversial yield curve control policy just days before Christmas. It's fair to say that not even Baba Vanga could have predicted many of these surprises.

Speaking of Baba Vanga, some click-baiting articles on the Internet are featuring her alleged predictions for 2023, which include a nuclear power plant explosion. Whoever came up with this "prediction" was clearly thinking of Ukraine's Zaporizhzhia nuclear plant, which has been caught in the crossfire of Ukrainian and Russian shelling. It reflects the unpredictability of war and the surprises that a desperate Putin may spring up to preserve his grip on power.

In the face of still elevated macro and geopolitical uncertainties, I continue to advise patience, selectivity, and a defensive posture. I suspect the hangover from the most aggressive monetary and fiscal stimulus in our nation's history, coupled with the most aggressive Fed tightening in four decades have yet to run its course.

Judging by the range of potential outcomes, it's hard to justify much upside to equities, but the downside risk may be substantial. However, to end this report on an upbeat note, the classic V-shaped market bottom that has accompanied past recessions may make a return appearance in 2023.

It will be great for those with dry powder to capitalize on such an opportunity. Remember, the boom-bust cycle is a bumpy process that unfolds over time, and 2023 could mark the end of the pandemic-era boom-bust cycle that got started with the unprecedented monetary and fiscal stimulus in 2020. The climactic bottom will hopefully pave the way for more prosperous times ahead.

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