Market Outlook 2023

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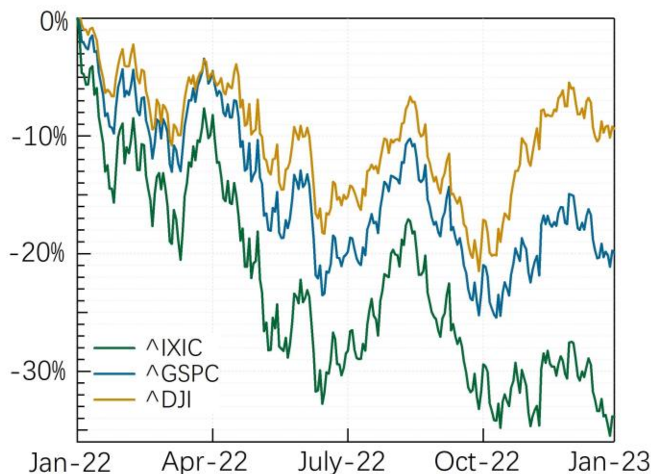
The performance of the stock market in 2022 has been unsatisfactory. Nasdaq led the S&P 500, and Dow Jones closed at -33.9%, -19.5%, and -9.4%, respectively. Now is the time to put 2022 behind, as the market may look quite different this year.

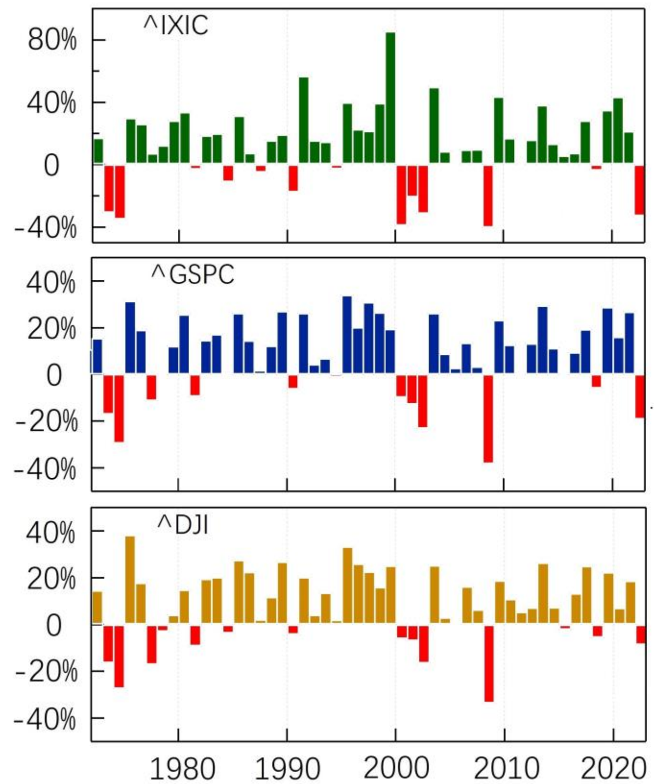
Exhibit 1: Selected Major Indexes One-Year Return



Source: Yahoo Finance

Over the past 50 years, it has been unusual to observe price declines for two consecutive years in a row [Exhibit 2]. More importantly, the market often rebounded the following year after a disappointing return, with the median increase being 17%. It appears that 2023 will be a good year for investors. On the other side, the declining trend shown in Exhibit 1 persists; the Federal Reserve has gradually raised interest rates, and inflation is still stubbornly high. A recession is on the horizon.

Exhibit 2: Annual Return of Selected Indexes



Source: MarketTrends.net

There is no doubt that inflation was the major concern last year. While a slow economy can be advantageous to keep inflation at bay, the situation has now completely changed. The protracted slowdown is exacerbating investors' fears of a recession. Since last November, the steep decline in Consumer Price Index (CPI-All Items) has been primarily caused by poor economic activity. Worries about a recession have gradually replaced concerns about inflation.

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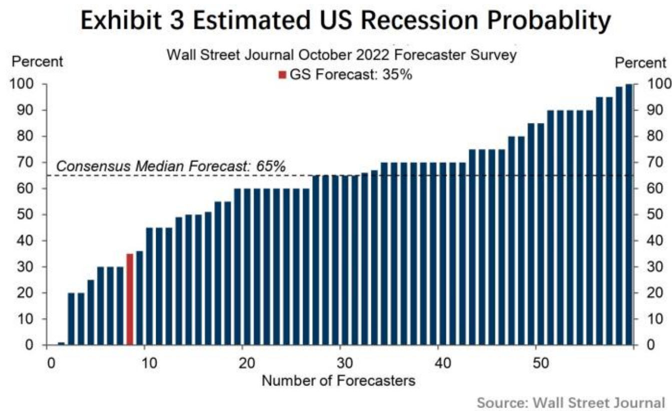
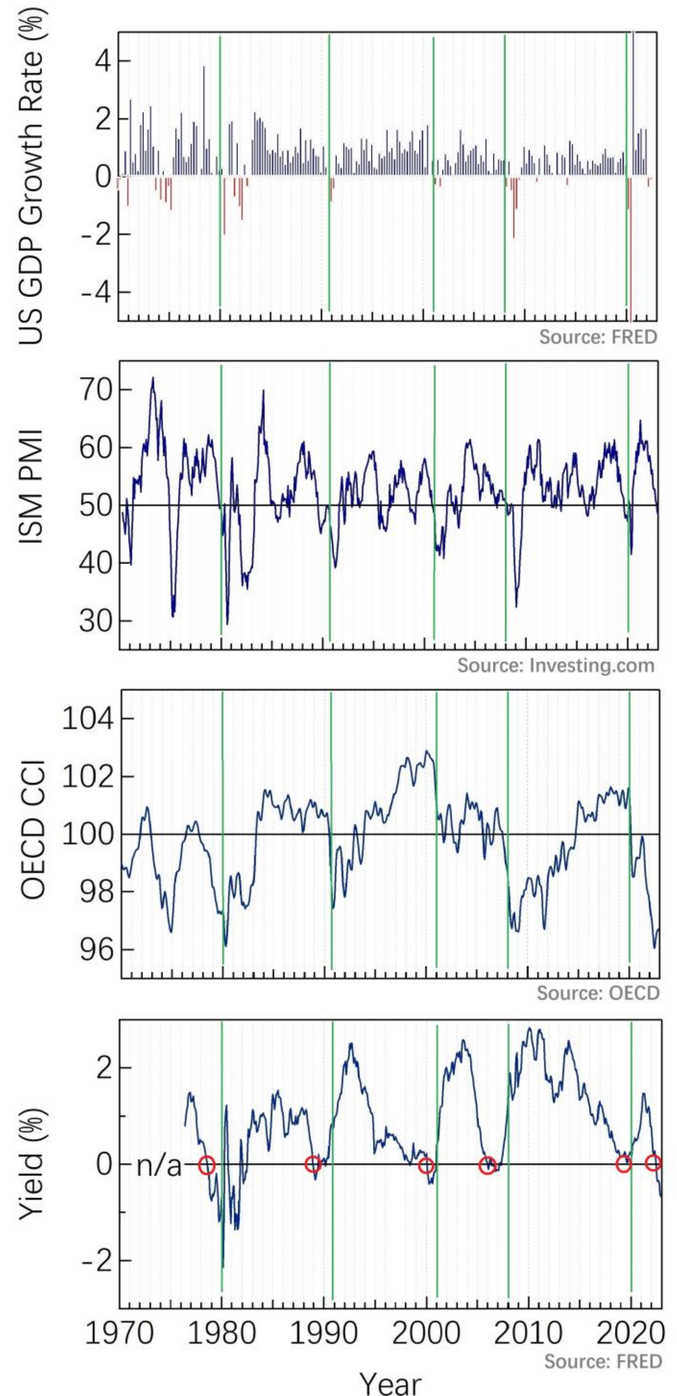
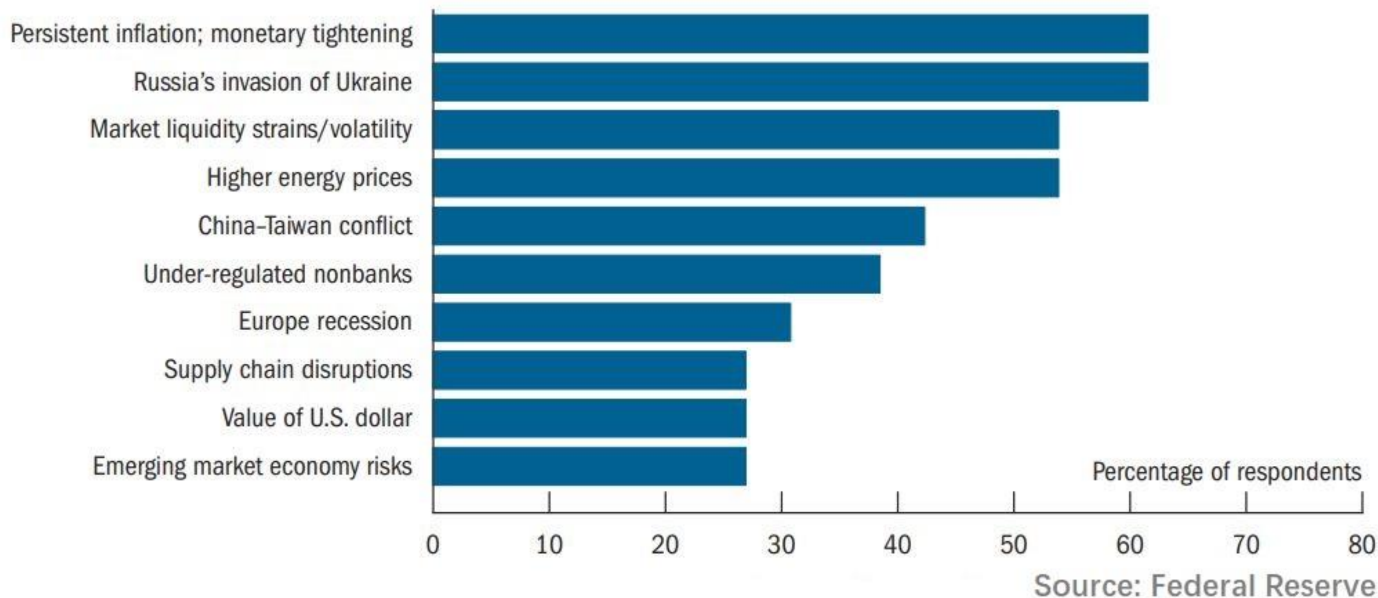
According to a survey by Wall Street Journal, there is no consensus on whether a recession might occur. Exhibit 3 below depicts the forecasts from 60 investment banks for the upcoming year 2023. The median probability was found to be 65%. However, the other 35% of institutions believe that the likelihood of the US economy entering a recession is less than 50%. Due to such various expectations, market uncertainty is at an all-time high.



We here in SZC believe that a recession is inevitable as almost all leading economic indicators are pointing toward one. For instance, the ISM Purchasing Managers Index (ISM PMI), which measures business activity, has fallen below the 50-point mark. The continuing negative slope is a pronoun recession indicator. The Consumer Confidence Index (OECD CCI), another leading indicator, has reached an all-time low, lower even than that of 2008. Note that consumers contribute to 80% of the US GDP. Given the low level of attitudes, it is difficult to argue the US economy is not heading toward a downturn. Furthermore, financial market indicators are also confirming this point. The Treasury Bond Yield (T10Y2Y) curve has remained inverted for more than a half-year, a signal that never missed predicting a recession in the past.

Exhibit 4: Indicators of Recession





The inverted yield curve can also provide timing cues. Every single zero-crossing event (red circles in Exhibit 4) since 1970 are followed by a recession within two calendar years. The most recent inversion was triggered in March 2022. Based on the precedent, a recession can be anticipated to occur between Q2 of 2023 and Q1 of 2024.

What's more important is how server the recession will be. The current market decline is obviously insufficient if the economy is in a bad slump. To find out the likelihood of a significant downturn, one might as well look at the history.

The server recessions in history, as well as the worst stock market crashes, were either caused by or accompanied by problems in the financial system. That is to say, for the US economy to enter a deep dive, systematic problems are a necessary condition. Following the 2008 financial crisis, banks have reshaped their own balance sheets, and more strict regulations have been implemented. The US financial system has never been in better shape than it is now. A survey by Federal Reserve shown in Exhibit 5 also validates the absence of hidden systematic threats. The upcoming recession can be referred to as the most man-made, and most foreseen one.

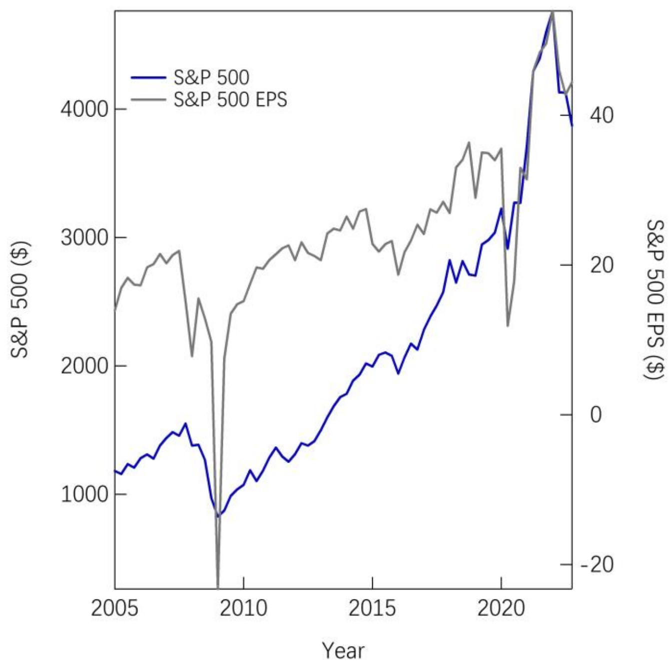
It is worth emphasizing that paying attention to leading indicators should be at the forefront. In the mean time, we also suggest that the corporate earnings, and decisions of Federal Reserve will be the two critical factors that drive the market movement.

Earnings will eventually decrease as economic growth slows. The decline stems from a shrink in demand and the cost side of businesses facing significant pressure (commodity prices remain high, and labour costs continue to rise). When combined with the high cost of financing, it will be even more difficult for businesses to remain profitable. Wall Street analysts suggested that earnings will increase in 2023, but such a forecast may be overly optimistic.

There is a good chance that noteworthy earnings revisions will occur within the next few months, which will be a risk factor that triggers market decline.

One should not confuse a drop in earnings with a fall in the stock price. Instead, the market often starts to rally in the midst of earnings decline. Exhibit 6 below shows a comparison of the stock market and earnings per share (EPS) for S&P 500. The stock price bottomed out ahead of earnings during the two recessions in 2008 and 2020.

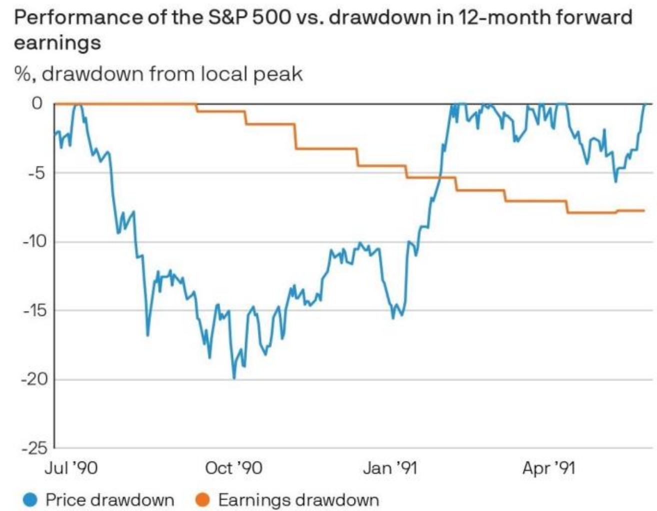
Exhibit 6: S&P 500 Recovers before EPS



Source: Yahoo Finance

A similar behavior can also be found during mild recessions; Exhibit 7 depicts one during the 1990s. The stock price recovered after hitting a low point as earnings continued to plummet.

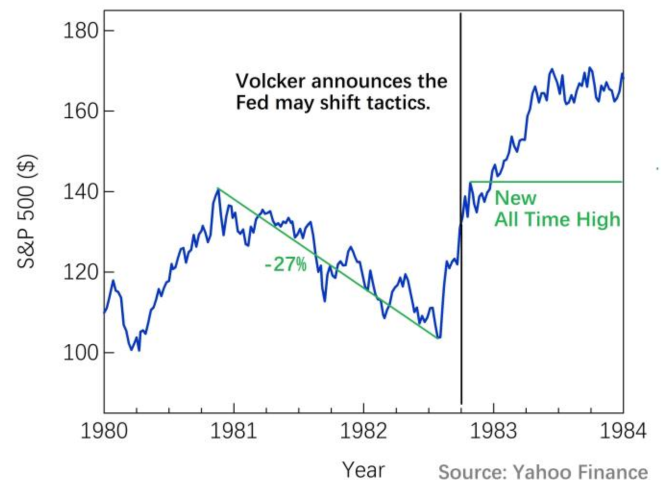
Exhibit 7: Stocks Rallied on Declining Earnings



Source: JP Morgan

Another critical factor influencing the market this year is the Federal Reserve's policy shift. Once the recession hits, the Fed's policy is likely to alter soon, not promptly implementing a lower interest rate; instead, it is a change in attitude that will push the market for a rebound.

Exhibit 8: Market Reached New All Time High after Fed Shifted Tactics



Source: Yahoo Finance

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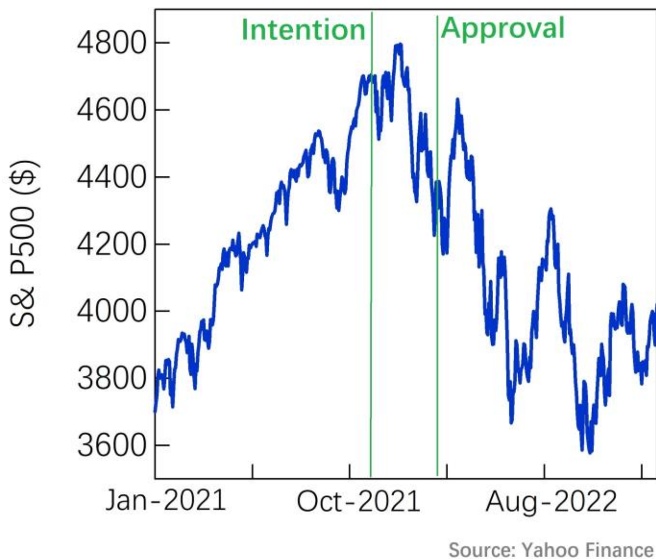
During the early 1980s, for example, the stock market fell by nearly 27% in a year due to inflation [Exhibit 8]. But two months prior to Volcker's announcement, the price has already begun to recover. The rebound was extremely rapid, with the previous loss being overturned in just more than a quarter.

Exhibit 9: Market Reversal During Early 2020s



The opposite is also true [Exhibit 9]. Back in November 2021, the Federal Reserve stated its intention to raise interest rates earlier than anticipated. Since then, the market has been going downhill. However, the official approval came five months later, in March 2022 (benchmark rate increased from 0.25% to 0.50%).

After all, when the recession hits, the Fed's stance is crucial to the market movement as the reversal usually occurs before the policy approval.

Key Points

1. A mild recession is expected between the second quarter of 2023 and the first quarter of 2024.
2. Apart from leading economic indicators, earnings decline and Fed's stance are the other two market reversal signals.
3. Stock price will recover before the earnings.

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