SK Market Insights

Market Insights - Issue 1/2023

2022 Recap and 2023 Outlook

▼ Summary

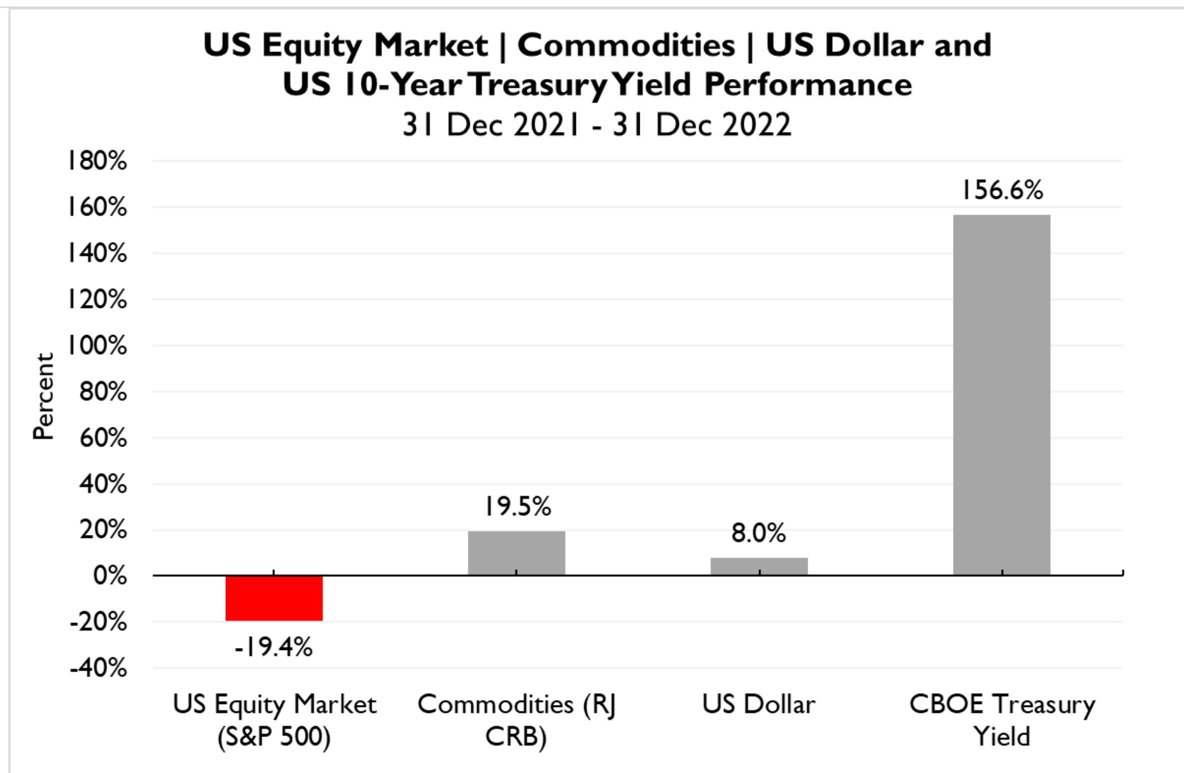
- **In 2022 markets were affected by a war in Ukraine, COVID issues in China, and US inflation outlook.**
- **Inflation in the US caused the US 10-year Treasury yield to reach 4.4% before receding.**
- **Equities (S&P500) experienced a 20% drawdown, while commodities, led by energy, gained 20%. The NASDAQ lost 33%, S&P500 20% and DJIA 9%.**
- **Energy and defensive sectors performed well while growth sectors performed poorly.**
- **The US Federal Reserve likely to struggle to reach its inflation target of 2% and may have to settle for 3%.**
- **This and the potential for a recession are expected to be major factors in market performance in 2023, along with the outcome of the war and a recovery from COVID.**

▼ The impact of War, COVID and Inflation on Markets in 2022

We survived a tumultuous year in 2022, enduring a war in Ukraine, COVID issues in China and an inflation outlook that went from “transitory” to “entrenched” in the language of the US Federal Reserve. All of these impacted markets differently and are summarized below.

Rampant inflation in the US drove the 10-year US Treasury yield to a peak of 4.4% before receding towards the end of last year. This was described in detail in last year’s Market Insights notes as well as the chart below Equities, as represented by the S&P500, had a drawdown of around 20% (Figure 1), a repricing triggered by higher interest rates. The commodities index gained 20% primarily due to gains led by the energy complex. The USD moved in concert with rising interest rates and chalked up a gain of about 8%.

Figure 1: The US Equity Market incurred a drawdown of around 20% last year

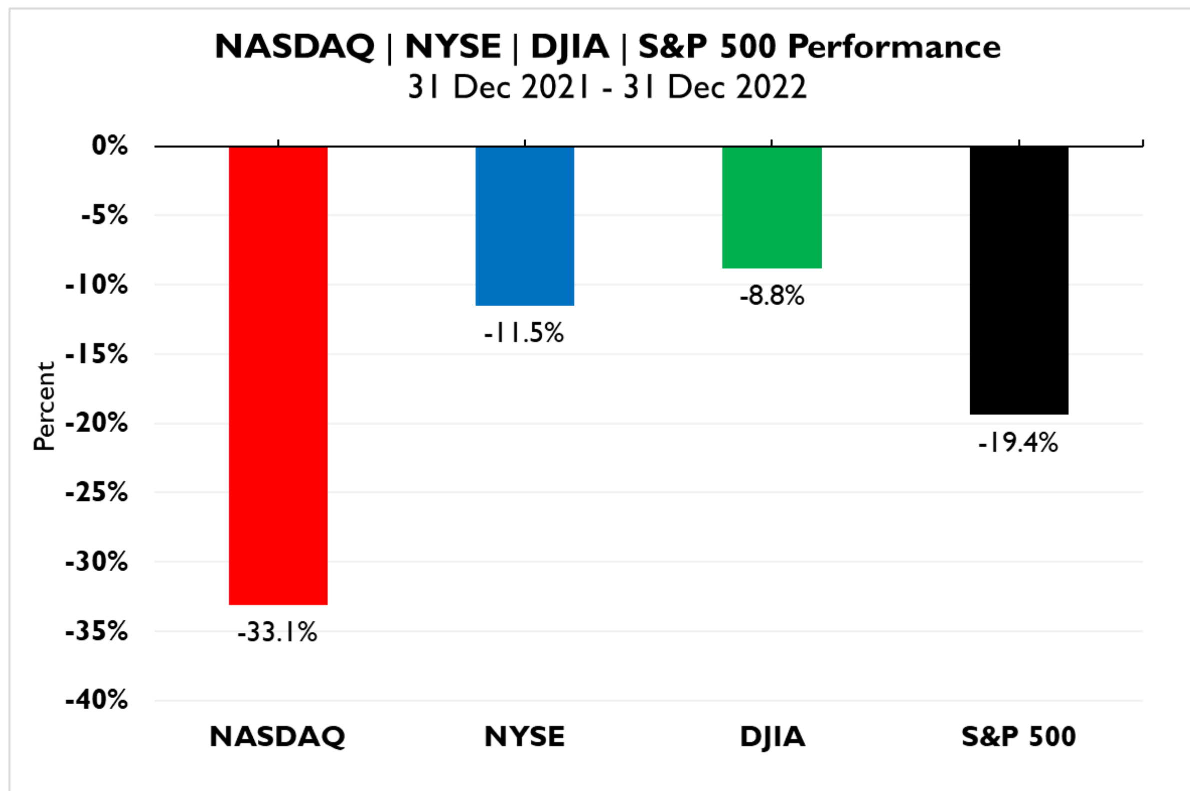


Source: SK Market Insights, StockCharts.com

▼ A Tough Year for Growth Stocks

Equity holders were in a for a tough year especially those holding high growth, low or zero dividend stocks with some lacking any reportable earnings. This is clear from the chart below (Figure 2) which shows the performance of the various US equity indices. NASDAQ lost around 33% vs. an S&P500 drawdown of 20% and the DJIA, in between, at around 9%. This is due to the DJIA being composed of a mix of growth and value stocks with proven performance, positive earnings and earnings growth and secure dividends. We went from a TINA (There is no alternative) environment to one where there now is an alternative in the form of bonds with positive yields. These yields may be below inflation for now and offer negative real returns, however, the safety of US Treasuries precludes the possibility of portfolio drawdowns.

Figure 2: Performance of various US Equity Markets in 2022

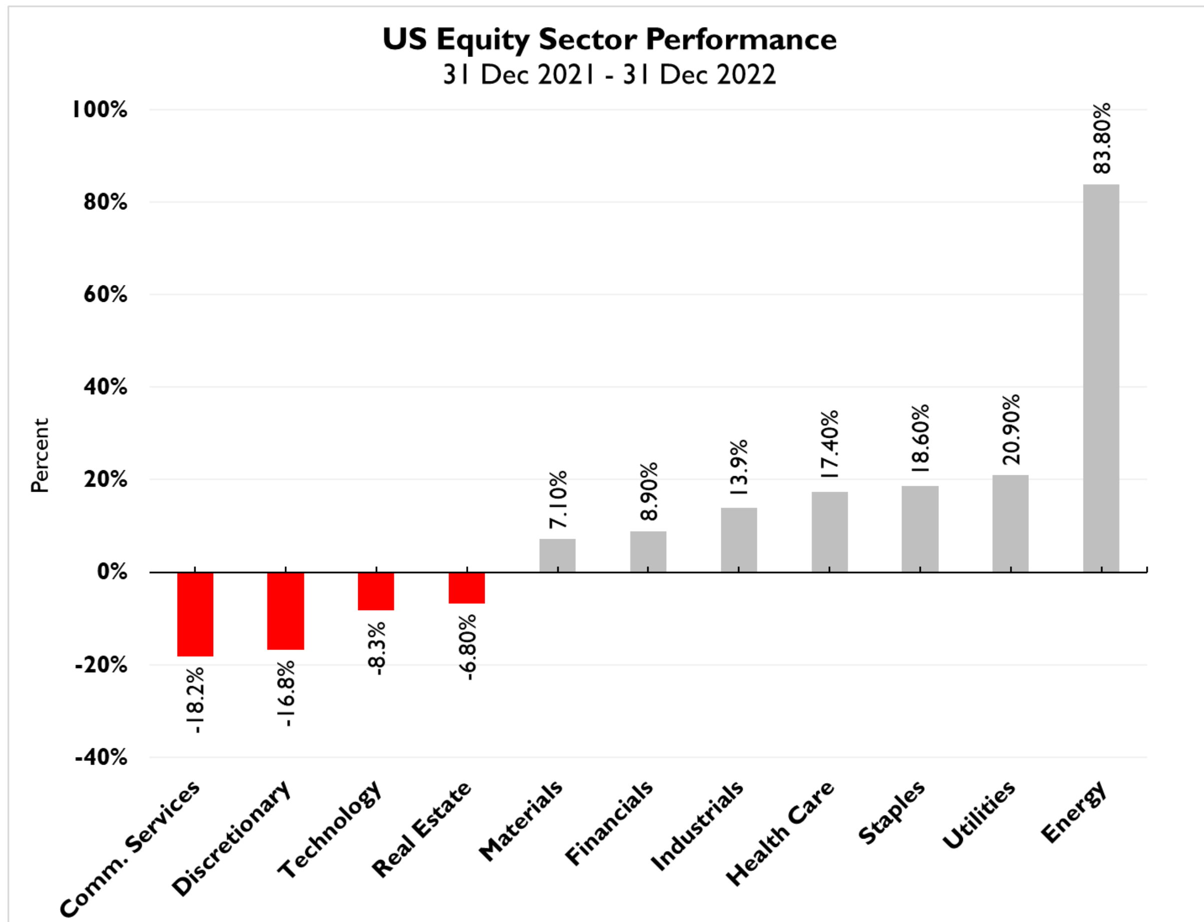


Source: SK Market Insights, StockCharts.com

▼ S&P500 Sector Performance in 2022

Drilling down further into the S&P500 sectors as shown below (Figure 3), losses in the frothy growth sectors of discretionary, comm. services and technology were offset by positive returns in energy and the defensive sectors of staples, health care and utilities and to a lesser extent industrials, materials and financials.

Figure 3: Cyclical sectors were hit the hardest and defensive sectors and energy gained the most last year

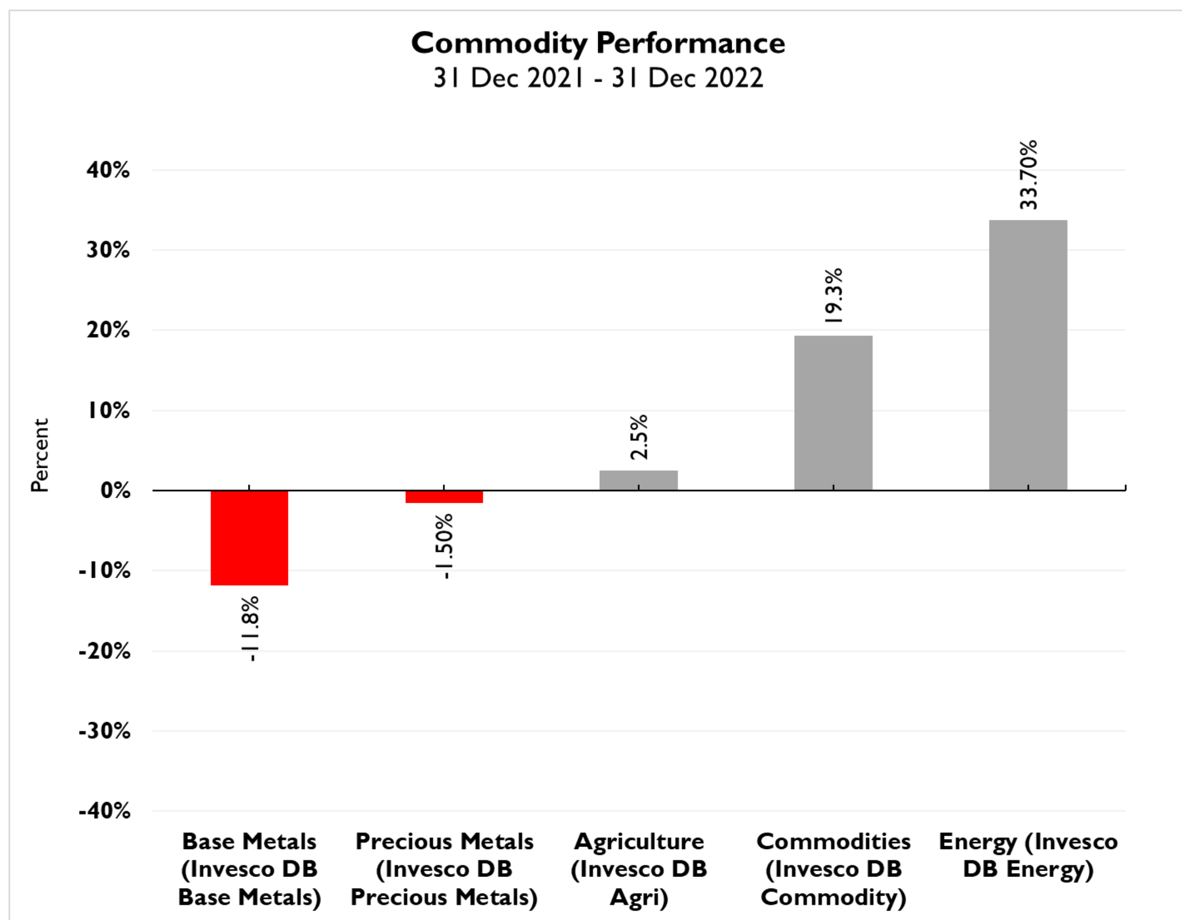


Source: SK Market Insights, StockCharts.com

▼ Energy Commodities were a star performer for the second year in a row

And what about commodities? The star performer for a second year in a row was energy (Figure 4) driven US govt. policies against hydrocarbons. Agricultural commodities corrected following the perception that getting grains out of Ukraine was no longer a global threat. Precious and base metals retreated due to a rising US dollar.

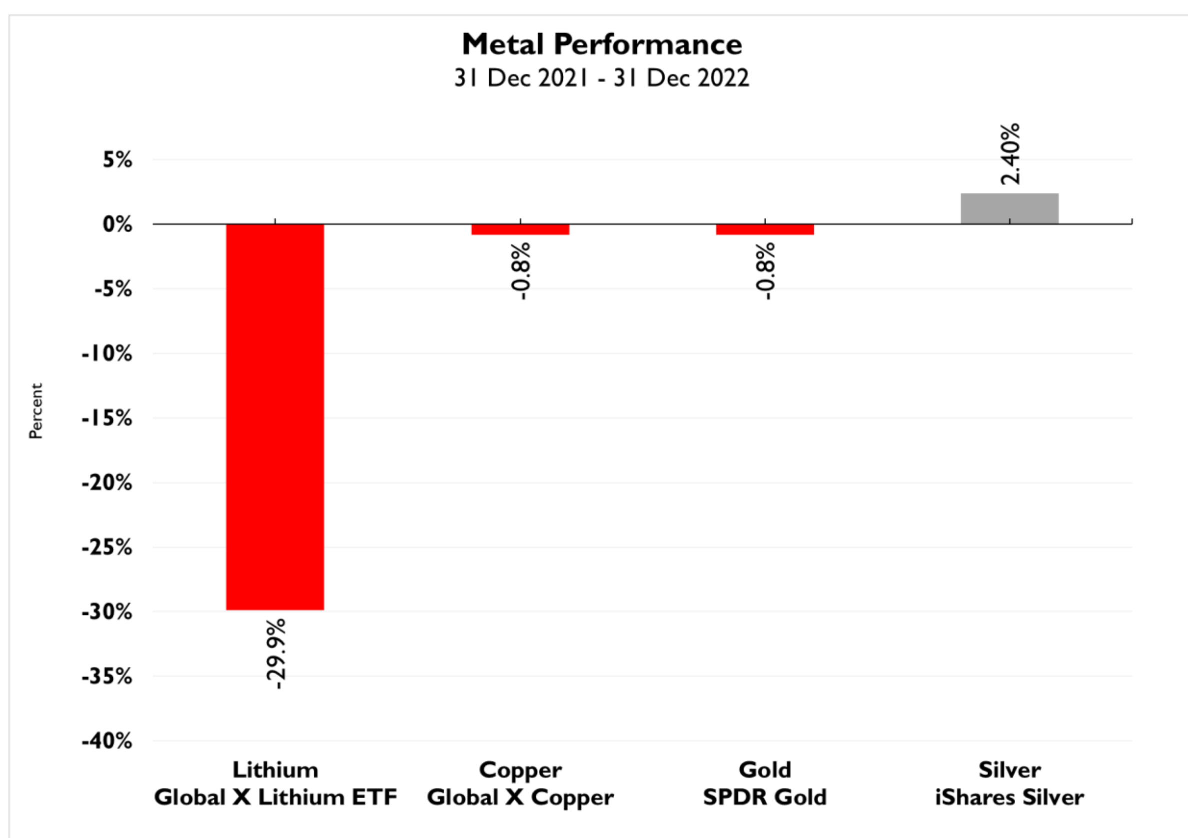
Figure 4: Commodities Market Recap last year - Energy Dominates, Agricultural Corrects, Metals Retreat



Source: SK Market Insights, StockCharts.com

A further drill down into the various metal sectors show, that with the exception of silver, other metals suffered a drawdown due to the US dollar. Lithium, a key commodity for EVs, had the highest drawdown (Figure 5).

Figure 5: Lithium a key commodity for EVs had the highest drawdown in 2022



Source: SK Market Insights, StockCharts.com

▼ Inflation Expectations and 10-Year Treasury Rates in 2022: An Uphill Battle for the Fed

Inflation expectations in the US reversed dramatically in November and December of 2022 as CPI prints showed signs of easing pricing pressure on goods. However, unemployment remains low at 3.6% vs a Fed target of 4.5%. The immediate upshot of all this is that the US Federal Reserve remains in an uphill battle to reach its longer-term inflation target of 2% and may have to settle for 3% as the 10 yr. Treasury yield chart below shows. Attempts to continue with rate increases to reach a target of 2% could bring about a recession according to economists.

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So where is the 10 yr. US Treasury rate headed in the near term? Checking the weekly chart, shown below, a target of 3% is in sight based on technical analysis using Elliot Wave Theory.

This chart shows that a five wave (1-2-3-4-5) sequence of rising rates being followed by a three-wave corrective pattern (A-B-C) with the "C" leg currently in progress (Figure 6). The completion of wave "C" at around 3% also coincides with a 38% Fibonacci retracement of the entire move from Aug 2020 to Oct 2022. Confluence of indicators generally raise the probability of targets being achieved.

Figure 6: The US 10-year treasury yield is currently in the "C" phase of the corrective A-B-C Elliott Wave pattern

Source: SK Market Insights, StockCharts.com

▼ The correction in the US 10-year treasury has had a knock-on effect on the USD

The knock on effect of lower 10 year US Treasury rates is a lower US Dollar. As one would expect, the USD as shown by the ETF "UUP" is in fact correcting since Oct 2022 (Figure 7). Having closed below the 50-day moving average on the weekly chart below, the next target could be the 200 day moving average at 26.

Figure 7: The correction in the US 10-year treasury rate has caused the USD ("UUP ETF") to correct

Source: SK Market Insights, StockCharts.com

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▼ Outlook for 2023

Having set the stage for lower 10-year US Treasury yields and consequently a lower US Dollar where can investors find returns in a lack lustre equities market? Obviously, the upcoming earnings recession in US equities will most likely cap any rallies for the near term. While companies with pricing power, low operating leverage, expense control and steady cash flow will remain attractive. Growth stocks remain in limbo, their fate having been decided by persistent inflation and higher interest rates. The unintended beneficiaries of a weaker dollar are clearly commodities and non US equities.

A review of the chart below (Figure 8), showing the performance of US bonds, Gold, Copper, Energy, Emerging markets and US defensives such as healthcare, staples, utilities and real estate during the past 60 days, confirms this trend. Energy is expected to remain firm as China returns from COVID. Bonds have now gained a place in portfolios as US interest rates have risen. US T-bills and notes of up to 6 months duration offer very attractive yields. The stellar returns of Gold and Copper as well as emerging markets are expected to continue driven largely by a weaker dollar. This trend is likely to persist through 1H23 as excesses in P/E valuations of growth stocks get resolved in the US equity market during this period. This repricing may offer attractive buying opportunities down the road and as the outlook for further rate increases by the US Fed becomes clearer.

Chinese internet stocks have rallied recently in part due to a more favorable stance taken by the Beijing administration. However, caution is in order as views may change at short notice.

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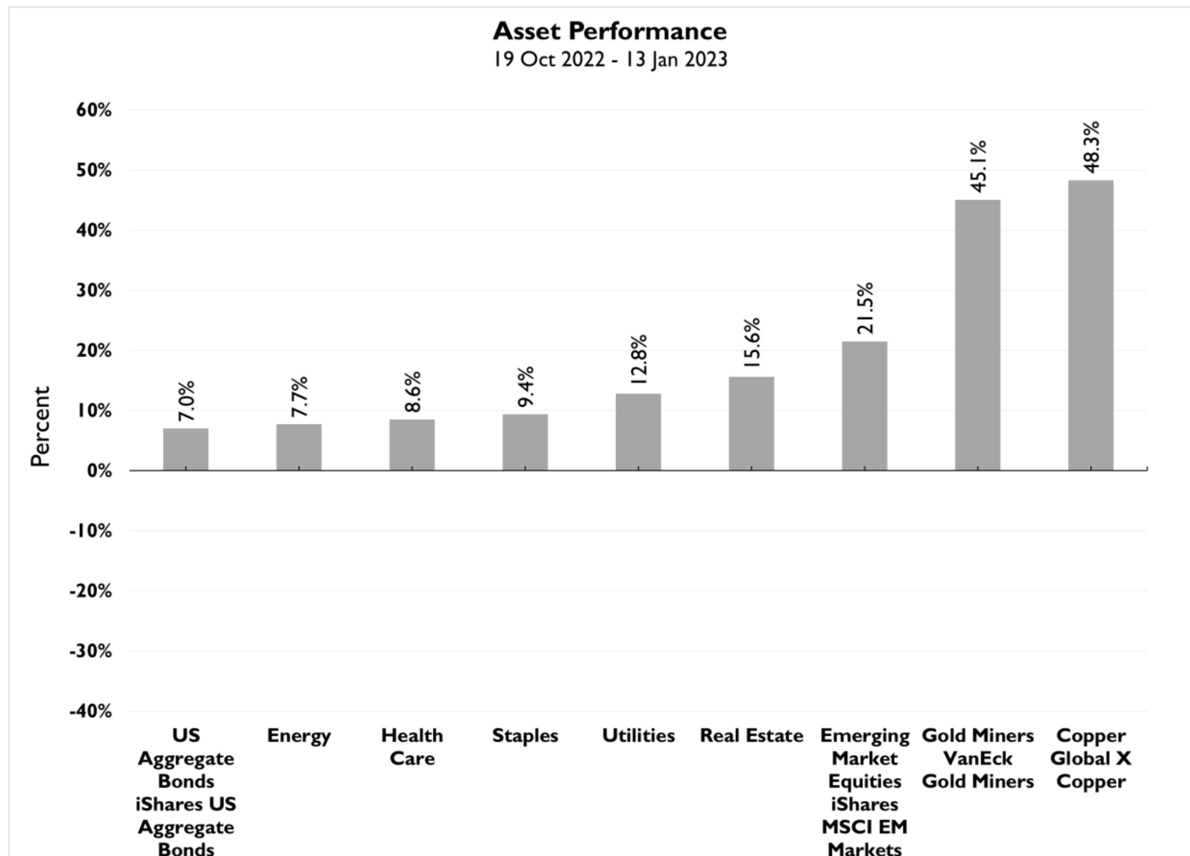
Figure 8: Asset performance over the last 60 days shows that commodities and non-US equities are the biggest beneficiaries of the fall in the US Dollar



Source: SK Market Insights

Please feel free to contact me for any further questions or clarification.

With Compliments,

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Sowmi is a Chartered Market Technician (CMT)and a member of the CMT Association, N.Y., U.S.A.; as well as an Associate Member of the Society for Technical Analysts, U.K. After completing a 35 year career with Mobil/ExxonMobil in a variety of roles in the across U. S. A., Asia Pacific and Europe, including an 8 year stint in a number of oil trading roles for Mobil in Asia Pacific, he has decided to embark on a new career in technical analysis, leveraging on his prior experience. In addition to his CMT, Sowmi has a Ph. D in Chemical Engineering and an M. B. A. in Finance. He is an avid sports enthusiast and has a keen interest in golf.

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