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Gerry's Journal

January 20, 2023

Demystifying the Capital Markets

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As we begin 2023, there are a number of key factors and themes influencing the capital markets. Some of these themes are intertwined, while others stand on their own. The common denominator is that each of these themes has the ability to influence the direction of companies, nations, and investment portfolios in the new year.

What follows is a closer look at China, The Federal Reserve, Unemployment, Growth, Earnings, Deficit, Europe & Energy. In our view, these are the topics that are central to understanding the market movements that are yet to come. As always, we invite you to connect with your wealth advisor to discuss the concepts shared or your personalized wealth management strategy.

China

As we have noted in past journals, it is difficult to understate the impact of China from an economic and geopolitical perspective. At the moment, we can categorize developments into three basic categories: the good, the bad, and the ugly.

- **The Good**
  Throughout the COVID-19 pandemic, China has utilized a so-called "zero-COVID" policy. As the name implies, the policy imposed strict lockdowns and containment measures when infections spread. However, these measures have come at an economic cost, sharply reducing China's exports and retail sales, and putting significant financial strain on the Chinese people. Following months of rare public dissent within China, President Jinping is moving away from the strategy.[1] For global markets, this is an important development, since the move will re-open the Chinese economy.

  As it relates to inflation, there are host of implications. From a supply-chain perspective, this move may easy some of the disruptions which have contributed to higher consumer prices around the world. From a demand perspective, an accelerating Chinese economy would likely increase demand for various commodities, such as natural gas. Accordingly, this shift away from zero-Covid could spark inflationary pressures that may offset the supply-chain benefits referenced above.

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[1] Wall Street Journal, *Why Xi Jinping Reversed His Zero-Covid Policy in China* (link)

- **The Bad**
  Today, more than 90% of the Chinese population is vaccinated. However, the vast majority have received Chinese vaccines, which many consider to be less effective than the Pfizer or Moderna vaccines against the omicron variant.[2] This, combined with China's overburdened health care system, means that moving away from the zero-COVID policy is likely to bring about significant hardship for the Chinese people — with some estimates that 60% of the population will be infected during the next 6 months and that the death toll could reach 2.1 million.[3] The U.S. and other nations have shown that learning to "live with" Covid is a viable strategy, but China's transition from "zero-COVID" to "living with covid" is likely to be a very painful road for millions.

- **The Ugly**
  If there is one topic in Washington D.C. that has achieved bi-partisan agreement, it is that China's assertive posture in the South China Sea and its aggressive rhetoric toward Taiwan are significant geopolitical risks. If China were to attack Taiwan, graduating from geopolitical problem to full-blown pariah, what options would the U.S. and rest of the world have? While it is easy to compare this hypothetical situation to what we are seeing unfold in Ukraine, the reality is that it would be a very different conflict.

  For starters, China has a much larger economy and much more potent military than Russia. From this standpoint, the military conflict itself would likely be very one-sided, and, due to the geographic constraints of Taiwan being an island just 100 miles off the coast of China, the West would have very limited avenues to provide support to a resistance force. From an economic perspective, the differences go deeper. Today, China represents 32% of market capitalization within the emerging markets (as measured by the MSCI Emerging Markets index[4]). And one company in Taiwan, TSMC, produces roughly 55% of the world's contract chips[5], providing semiconductor chips to clients like Apple, Intel, and Nvidia[6]. If the flow of these chips were to be interrupted in a material way, we would see significant impingement on all dependent supply chains and a headwind for the global economy.

  So, while writing Russian investments down to zero and rising energy prices have been challenging, the economic pain from a Chinese invasion of Taiwan would have a much greater impact on the global economy.

Federal Reserve

Federal Reserve policy was one of the dominant drivers in 2022 and will continue to be so until we see a pivot or pause in the rate hike cycle. Last year the Federal Reserve raised rates seven times, moving the Federal Funds Rate from a range of 0.00% to 0.25% to 4.25% of 4.50%. The December rate hike of

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[2] NBC News, *For China, moving away from "zero-Covid" is easier said than done (link)*
[3] Wall Street Journal, *The Reckoning Ahead for China's Zero-Covid Policy (link)*
[4] MSCI, *MSCI Emerging Markets Index (USD) fact sheet (link)*
[5] Time, *The Chips That Make Taiwan the Center of the World (link)*
[6] Time, *Inside the Taiwan Firm That Makes the World's Tech Run (link)*

0.50% followed four straight 0.75% increases, and provided some indication that the rate hike cycle may be slowing.[7] The Fed also made headway on reducing its balance sheet in 2023, from $8.9 trillion in April of 2022 to $8.5 trillion today. This was the first meaningful reduction in the Fed's balance sheet since early 2019.[8]

Both of these measures (raising rates in tandem with a balance sheet reduction) are aimed at reducing the inflationary pressures that have challenged the Fed (and central banks around the world) for more than a year. In December, the U.S inflation rate was reported at 6.5% by the Bureau of Labor Statistics[9] and while this figure is down from the 9.1% inflation rate in June of 2022[10], it is nowhere near the long-term target of 2% set forth by the Federal Reserve. The question remains: how many rate hikes will we see in 2023 and how much additional liquidity will need to be drained from the system? We will continue to monitor inflation, Fed minutes, and the Fed's balance sheet in the coming weeks and months.

Unemployment

Intertwined within the discussion of central bank policy is the topic of unemployment. In December, nonfarm payrolls increased by 223,000 and the unemployment rate moved down 0.1% to a historically low 3.5%.[11] However, the tide appears to be shifting within the labor market, as evidenced this week by Microsoft announcing plans to reduce its workforce by 5% (10,000 jobs)[12] and Google parent company, Alphabet, cutting 6% of its workforce (12,000 jobs)[13]. These moves followed similar announcements from Amazon and Salesforce earlier this month.[14]

One of the dominant themes in 2022 was the Great Resignation, a shift which begin in 2021 and saw job postings greatly outstrip the number of unemployed individuals seeking work. The net effect of this historically tight labor market was upward pressure on wages which, in turn, contributed to higher inflation.[15] A softening of the labor market, as it appears we are beginning to see, would bring about downward pressure on wages and may ease some of the inflationary pressure within the economy. In this sense, a softer labor market is a double-edged sword for many Americans: something which would bring about economic pain from an employment perspective but has the potential to reduce the cost of consumer goods and services. The labor market is one of many factors that the Fed will be monitoring as it determines the path forward regarding interest rates.

Growth

A favorite pastime of those who cover the capital markets is to pontificate on whether we are going to have a recession, or are currently in a recession, or if we have just left a recession. And although we did see negative GDP output in Q1 and Q2 of 2022, the National Bureau of Economic Research (NBER) did

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7 Forbes Advisor, *Federal Funds Rate History 1990 to 2022 (link)*
8 The Board of Governors of the Federal Reserve System, *Recent Balance Sheet Trends (link)*
9 Bureau of Labor Statistics, *Consumer Price Index (link)*
10 Statista, *Monthly 12-month inflation rate in the United States from January 2020 to December 2022 (link)*
11 Bureau of Labor Statistics, *The Unemployment Situation — December 2022 (link)*
12 AP News, *Job cuts in tech sector spread, Microsoft lays off 10,000 (link)*
13 Wall Street Journal, *Google Parent Alphabet to Cut 12,000 Jobs Amid Wave of Tech Layoffs (link)*
14 AP News, *Amazon, Salesforce jettison jobs in latest tech worker purge (link)*
15 The Wall Street Journal, *U.S. Job Openings Rose in September in a Still-Tight Labor Market (link)*

not officially declare that the U.S. entered a recession in 2022. This may have been partly due to GDP growth resuming at a modest 3.2% growth rate in Q3 after two quarters of contraction.[16]

In Gerry's Journal from October 2022, we referenced two potential paths forward for the U.S. economy: a recession or a period of sustained inflation with stagnant growth.[17]

- **Path #1: The U.S. Enters a Recession**
  Under this scenario, the Fed aggressively raises rates and reduces its balance sheet, slowing inflation dramatically. Tighter credit conditions restrain consumer spending and business investment, tipping the U.S. into a recession that brings about a decline in corporate earnings.

- **Path #2: Sustained Inflation, Stagnant Economy**
  In scenario #2, the Fed fails to break the inflationary cycle, perhaps because it lacks the willpower to meaningfully raise rates or because a reduction in its balance sheet leads to a dislocation in the Treasury Repurchase market, as was seen in 2019.

There is certainly a degree of lag between Fed policy and the impact of that policy on the U.S. economy. If we believe that the economy has not yet fully absorbed the rate hikes that have happened to date, and that there will be some degree of follow through in the coming months, then a modest recession would be the baseline assumption. This would be path #1 outlined previously. However, risks to this assessment remain — most notably the pace of inflation moving forward and whether higher interest rates will have a meaningful and sustained impact on inflation. We will know more on February 14th when the Bureau of Labor Statistics releases their January CPI report.

Earnings

All of the factors previously mentioned will contribute to the earnings potential of companies and in turn, how the capital markets will value those companies in 2023. Earnings did slow in 2022 but did not drop to the degree that many observers expected: Q1, Q2, and Q3 saw aggregate year-over-year earnings across the S&P 500 grow by 9.4%, 5.8%, and 2.5%, respectively, while Q4 earnings are expected to contract by -2.8%. Drilling down to the sector level, relative strength was seen in energy, industrials, and real estate while weakness came from financials, communication services, and discretionary products.[18]

Just as we saw in 2022, in 2023 each sector within the market will be impacted differently by the issues discussed within this journal. One such example is central bank policy. If the Fed announces that it is pausing or pivoting away from its hawkish monetary policy, this would positively influence not just earnings but the price multiple at which investors are willing to pay for those earnings. This being the result of the inverse relationship between interest rates and stock valuations — when interest rates are higher, the present value of future earnings is lower, resulting in downward pressure on valuations.

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[16] NASDAQ, *U.S. GDP Growth Unexpectedly Upwardly Revised To 3.2% In Q3 (link)*

[17] We recognize that there are several potential outcomes that are possible, including: 1) modest economic expansion, 2) stagflation, 3) modest recession, and 4) deep recession. As alluded to above, modest recession is our baseline assumption.

[18] Factset, *S&P 500 CY 2022 Earnings Preview: Ex-Energy, S&P 500 Expected To Report Decline In Earnings (link)*

Deficit

On Thursday of this week, the U.S. deficit reached the current "debt ceiling" of $31.4 trillion. Secretary of the Treasury, Janet Yellen, has stated that the Treasury will begin taking "extraordinary measures" to avoid a default through June of this year.[19] Expect a food fight in Washington D.C. over the next six months regarding how much to raise the debt ceiling this time around and what spending cuts are needed. As with past debt ceiling debates, this will undoubtedly add a degree of volatility to capital markets.

From the 30,000-foot view: the U.S. public debt is currently 120% of GDP,[20] the highest level since World War II.[21] Now is a good time for the American public and policy makers to ask the question: *what is our long-term strategy for managing the deficit?* Clearly there is economic risk at hand with these levels of sovereign debt, but there are also geopolitical repercussions. Historically, the U.S. has been the only country in the world that can dictate the interest rate at which its debt is issued — giving us enormous flexibility to spend aggressively during difficult periods, such as World War II or in response to COVID-19. But this luxury cannot exist in perpetuity if debt levels are not reined in once the difficult moments have passed.

Accordingly, the stakes are high for Congress as they navigate this situation, and it is certainly not a time to play chicken with the full faith and credit of the U.S. Treasury. This is not the position that the U.S. should be in, but it is the situation that we are in. Hopefully, policymakers can work to resolve the near-term debt ceiling issue and develop a longer-term strategy to reduce the federal deficit.

Europe & Energy

The topics of Europe and energy are inextricably connected as a result of Russia's war with Ukraine. In the absence of Putin's sudden demise, the signaling from Russia has been that it is doubling down on its military efforts in Ukraine.[22] Over the past few months, we have seen changes to the Russian strategy including the bombing of civilian targets and energy infrastructure inside of Ukraine[23], ostensibly for the purposes of breaking the will of the Ukrainian people and the resolve of the West to back them.

The conflict has laid bare the naïveté and policy error that our European allies were guilty of in allowing themselves to become so dependent on Russia for its energy needs. This reliance, combined with efforts to rapidly transition from fossil fuels to sustainable energy resources, are continuing to cause pain for the people of Europe. Accordingly, this is another factor that the Fed will be analyzing closely when charting the path forward for interest rates.

Closing Thoughts

As we begin the new year, our focus remains on maintaining sufficient liquidity to cover short-term needs. This is because market volatility, while certainly uncomfortable, is only problematic when it forces

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[19] Reuters, *Yellen warns of U.S. default risk by early June, urges debt limit hike (link)*
[20] Federal Reserve Bank of St. Louis, *Federal Debt: Total Public Debt as Percent of Gross Domestic Product (link)*
[21] The Balance, *US National Debt by Year (link)*
[22] Wall Street Journal, *Moscow Details Plan to Boost Military as Ukraine Warns of Fresh Russian Offensive (link)*
[23] U.S. Department of Defense, *Russia Continues Attacks on Ukraine Civilian Targets (link)*

an investor to sell long-term assets to cover their short-term needs. We also remain opportunistic, with capital market valuations having contracted significantly during the last 12 months and many corners of the market showing more attractive valuations than in recent memory.

History has shown that the patient investor who remains committed to their long-term strategy will be rewarded. We remain committed to your strategy and your goals, and we invite you to connect with our team should you have any questions about the capital markets or your personalized plan of action.