

At a recent industry conference, the CEO of United Airlines said, "If I didn't watch CNBC every morning the word 'recession' wouldn't even be in my vocabulary. You just can't see it in our data." Meanwhile, a WSJ headlines reads, "Amazon to increase layoff count". Two major companies in two different industries, yet two different perspectives. Which brings me to my one word to describe markets in 2022 – **inconsistent**. Parts of the economy have been hot, parts have been cold, and most of it has been both. I don't think the state of uncertainty will change just because the calendar turns, but I do think we'll end 2023 with a lot more clarity on the economy than we'll have when it begins.

Traditionally, year-end notes are divided into "last year's review" and "next year's outlook." However, this year, the review of 2022 and the outlook for 2023 are based on the same concept. Last December, it was expected that the post-COVID economy would experience a smooth and orderly return to trend, with higher rates, some changes in spending patterns, and a decline in pandemic-related inflation. However, the actual return to trend has been chaotic, with rates rising higher and faster than expected, spending shifts occurring in a series of starts and stops, and inflation remaining stubborn. This disruption has affected financial markets, leading to the worst year since the Great Recession, and breaking historical correlations as no assets consistently acted defensively throughout the year.

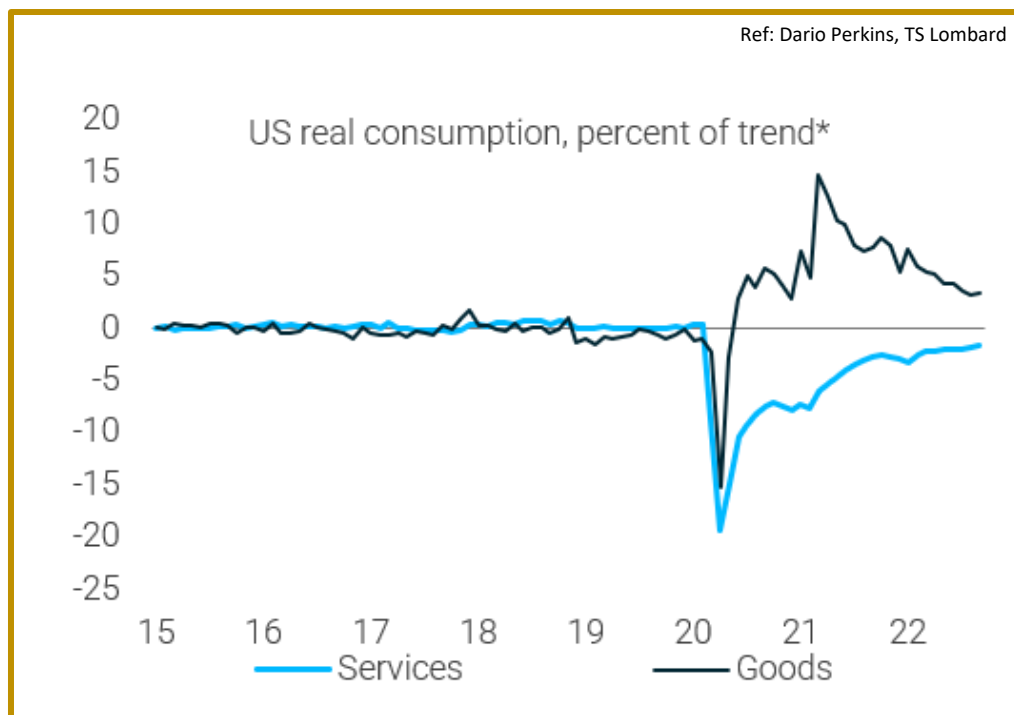
The Federal Reserve [publishes anecdotes](#) from companies they talk to over the year, and this recent excerpt from a manufacturing firm in the Dallas area seemed to nail the current environment well:

"We're a manufacturing business making packaging. I believe we are a very good indicator of economic trends. Having said that, order volumes are down versus prior quarters. There is less panic buying going on. Inventories are beginning to go down. Lead times we are able to give to our customers are beginning to decrease as input of new orders slows. The slowdown is consistent with normal seasonal factors but way below last year's very high fourth-quarter order level. We are beginning to see the end of the dislocations caused by the pandemic."

The body of what this company said is in essence, our summary of 2022: *[Most of]* **The economy is slowing down and unwinding from the 2021 boom**. But the last sentence of their quote is essentially our outlook for 2023: **"We are beginning to see the end of the dislocations caused by the pandemic."**

**If 2020 was the initial shock,
then 2021 was the boom out of it,
then 2022 was overcorrecting back down,
then 2023 will be the year that gets us back to the middle?**

This is the only chart you need to understand what's going on in the economy right now, brilliantly made by our friends at research firm, TS Lombard. It shows US consumption of goods and services, as a % of total trend –



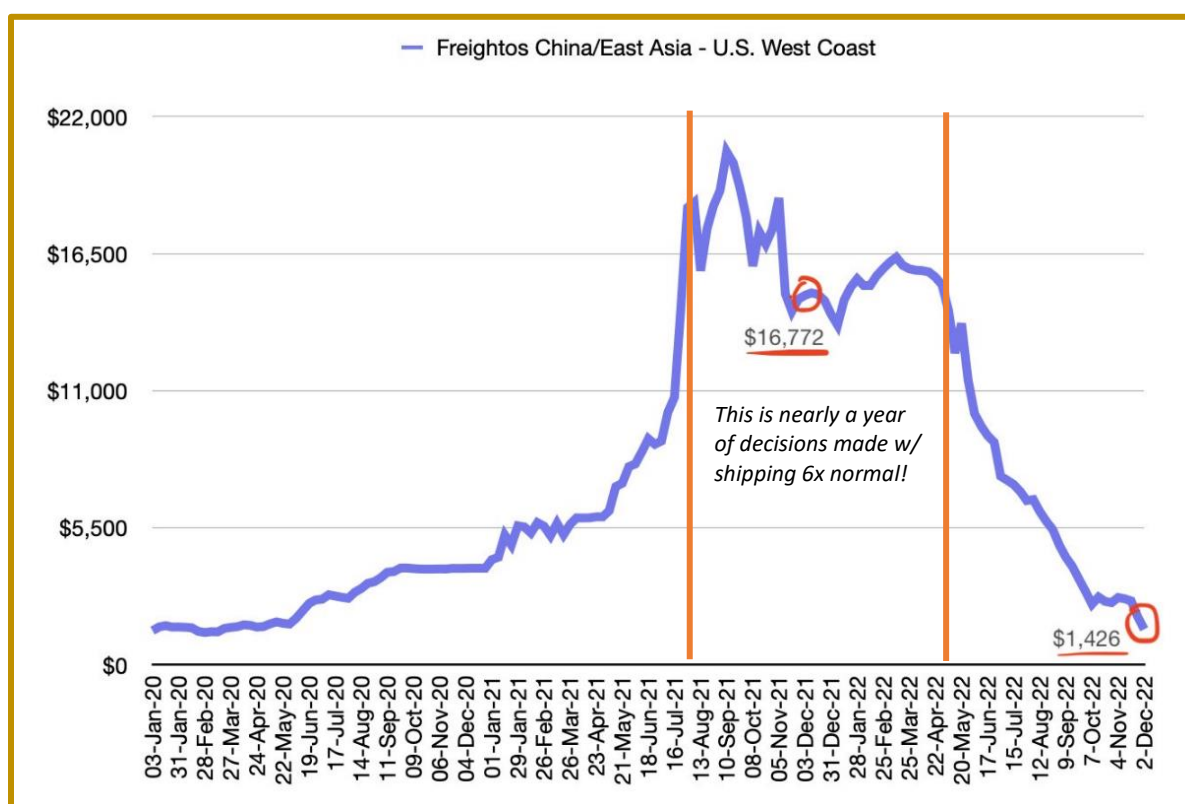
Notice how **massive** the deviation was off of normal post-Covid compared to the five previous years. Putting numbers to it, in 2021 the goods portion of our economy was roughly **\$2.2 trillion bigger** than it should have been. The services economy was almost **\$1 trillion smaller** than it should have been. Importantly – when I say “should have been”, I’m referring to the normal trend of consumption growth. And that matters because managers at Target or Delta or your local salon will make decisions about their future based on their past. **Which is why this very large gap between goods and services in 2021 affected us all in 2022:**

- Coming off of a year where demand and shortages were unrelenting, managers at Target ordered enough inventory to fill their best forecast of demand. This kept inflation high. Then they realized they ordered too much. Now Target is discounting and clearing their excess inventories (deflationary).
- Delta did the opposite, being very cautious as travel came back quick on some routes, slow on others. Then the flood gates opened this summer, and Delta didn’t have enough pilots, routes, or planes. When there is a shortage of something prices go up (inflationary). Good news is going forward you’ll see more planes, more routes, and more TSA agents (disinflationary).

I’m going to paint with a very broad brush here, and it’s not going to sound like a deep analysis, but it really seems to describe how the economy has involved since the Covid recession:

Millions of business leaders, big and small, each make decisions that affect their businesses tomorrow, using the data and trends of yesterday – staffing, new inventories, machinery, etc. The multi-trillion-dollar 24+ month mismatch of resources (*i.e. the chart above*) has really broken that process and hindered our (*the business community*) ability to properly forecast. This 1) created the [bullwhip economy](#), and 2) takes a long time to resolve! **Our economy is big!**

Think as if you were a purchasing manager forecasting your shipping costs for the next quarter. At what point over the past year would you have penciled in shipping costs being back below pre-pandemic prices? \$16k down to \$2k per container is a really big difference! Plus, you have contract lock-ins, price pass throughs, etc. – and that’s just one company’s decisions in an economy of thousands. You can see how all those decisions add up to collectively impact the economy in a big way. And there are tons of charts that look like this one!



The investing world often mistakes macro trends for structural changes, which can be difficult to distinguish in the moment. An easy example was the summer of Covid (2020). Every week there was a new article about how travel would be changed forever. I think it’s fair to say two years later our travel habits are exactly how they used to be.

Another example comes from the early 2010’s. The widely accepted narrative about the millennial generation was how they would never buy cars or live in the suburbs. Now with the power of hindsight, we can say the car buying did happen, just later in life and more electric (*structural change*). And the biggest home buying cohort for the last number of years has been

millennials! They aren't necessarily going to the suburbs of Chicago, but rather just moving to Denver (*second tier cities, a structural change*).

There could pages written about this topic, but the point here is that it's very hard to see a passing trend and a structural one in the moment - and both can exist at the same time! Businesses like Amazon also have to navigate these distinctions in real-time as they make strategic decisions. In 2021, they saw a significant increase in e-commerce demand during the pandemic and invested heavily in capacity to meet it. However, it later became apparent that some of the increase in demand was temporary and not indicative of a long-term shift in consumer behavior. As a result, the company now has to right-size its operations to match the new reality of the market.

Our 2020 pandemic habits weren't structural, the 2021 reopening boom wasn't structural, and the 6%+ inflation of 2022 wasn't structural. So for us, 2023 is about the beginning of the end of these dislocations and a return back to economic normal.

2023 Outlook

The buzz word around 2023 across Wall Street is "recession" as its the consensus in nearly every forecast. I won't really push back against it – two quarters of negative y/y growth that is. But to us, it's what causes a recession (*or a slowdown*) that matters more. We [wrote about this 2 years ago](#). As for next year, think about the Amazon situation I described above: "*...now they have to right-size themselves.*" A bunch of companies correcting from their post-Covid spending equals a slowdown – no doubt about it. The good news is that slowdowns are normal and we can't see any fundamental issues in the economy, in fact it's quite strong as [we've been saying all year](#). The bad news surrounds the reaction to the side effect from the 2021 boom: **inflation**.

Note that I said the reaction to inflation, **not** inflation itself. I'm deliberate in saying that because we see inflation as a passing trend, not a structural change – for a lot of the reasons outlined previously (*the bullwhip economy!*). However, it isn't going down as fast as the Federal Reserve wants, so they have tightened policy (*i.e. raised interest rates*) at the fastest pace in history. This reaction to inflation can make a mild slowdown into a bigger one, making it the biggest risk to our outlook. Investing rarely presents black & white situations, but 2023 is as close to one as I can remember. The faster inflation goes down, the better off markets & the economy will be – and vice versa. Therefore, we'll keep the focus on inflation.

Our base case for 2023 is that the Fed will recognize a slowing economy + falling inflation means their job is complete. This equates to a normalizing post-Covid economy that's sluggish in the first half as businesses continue to readjust, then picks up steam in the second half.

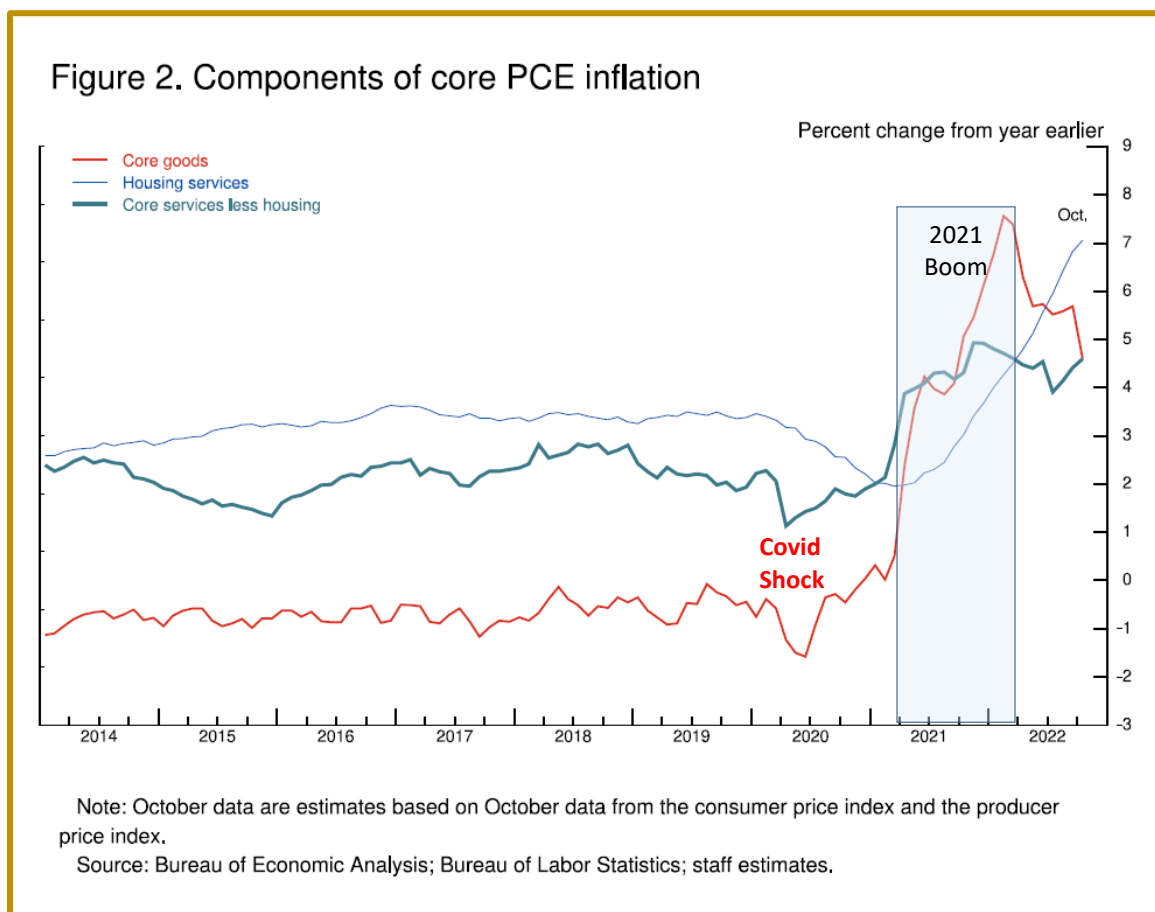
The downside risk? The Fed gets too aggressive into the slowdown because inflation isn't falling fast enough, which makes the slowdown worse (recession?). The economy stays in this readjustment period for longer.

It is important to understand that when the Federal Reserve and economists discuss inflation, they typically focus on "core" inflation, which excludes the prices of gas and food. These prices are excluded because they can fluctuate significantly and are not easily influenced by policy. Inflation measurements are complex and involve data from over 1,000 sources, and can include nuances that can cause significant fluctuations. For instance, airfare prices are typically measured monthly by taking the percentage change in the median price of popular routes on both coasts. This demonstrates how inflation measurements can be imperfect and subject to significant swings, and it is important to understand the underlying factors that contribute to these fluctuations.

Why we see inflation decelerating in 2023

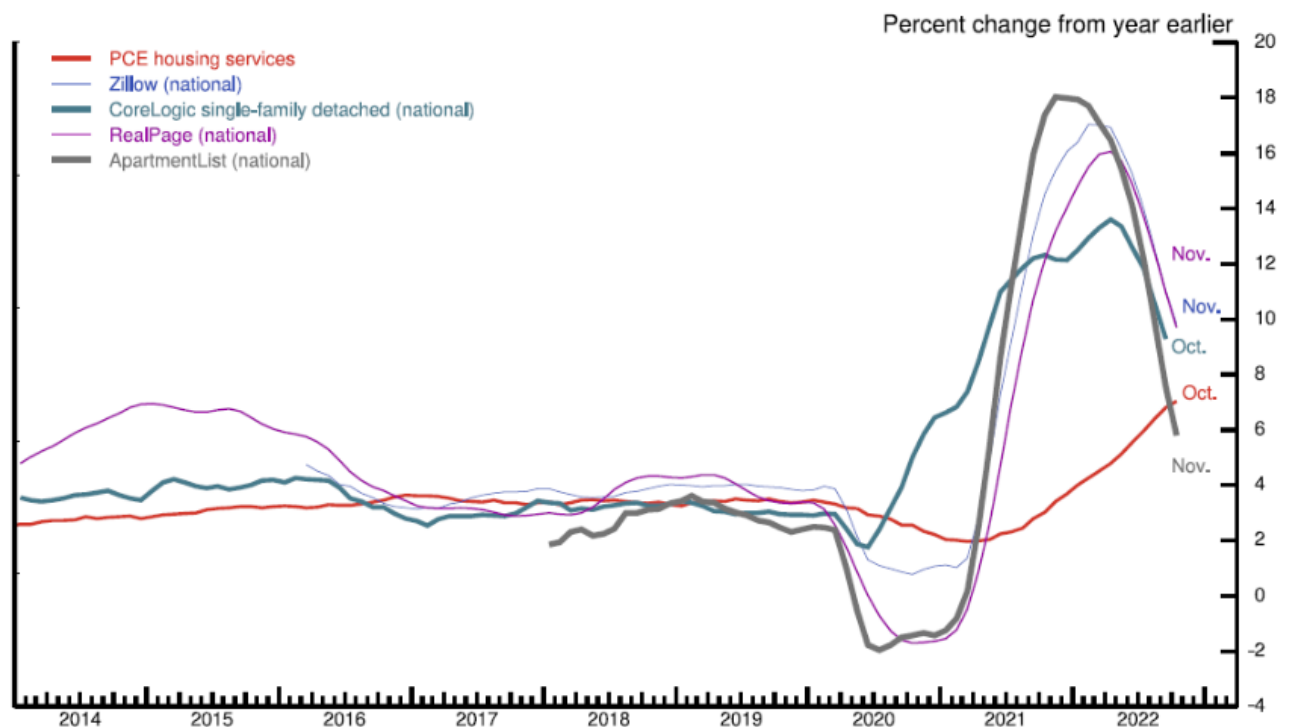
I'm going to use two charts from the Fed Chair's recent presentation at The Brookings Institute ([source](#)) to break this down.

Inflation is measured in 3 distinct parts: goods prices, housing prices, and services prices. These categories are weighted, with housing comprising the largest weight at 40%, and combined to produce the overall inflation rate. The most discussed and understood is goods inflation (red line). That's where all our supply chain problems, high used car prices, and out-of-stock appliances reside. The freight chart from page 3 is a good micro-example of what's going on here: a huge ramp up, now a huge ramp down. This is the epicenter of the bullwhip effect, where inventories need to be drawn down (*more discounts!*) and supply chains are getting fixed (*cars & chips*). So this red line should continue to fall through 2023.



While, declining goods inflation is a positive development, it isn't sufficient to bring down overall inflation on its own. The largest contributor to overall inflation is housing inflation, represented by the thin blue line. Currently, housing inflation is at the highest level of the three categories, contributing significantly to the elevated overall inflation rate. The measurement of housing inflation can be somewhat wonky, as it's based on changes in rent prices and something called "owners' equivalent rent," which involves asking homeowners what they could hypothetically rent their homes for. Skipping the technical details here, what's important is this: the series historically lags by 9-12 months and private sector measures are more up-to-date but also more volatile.

Figure 3. Market rents and PCE housing services inflation

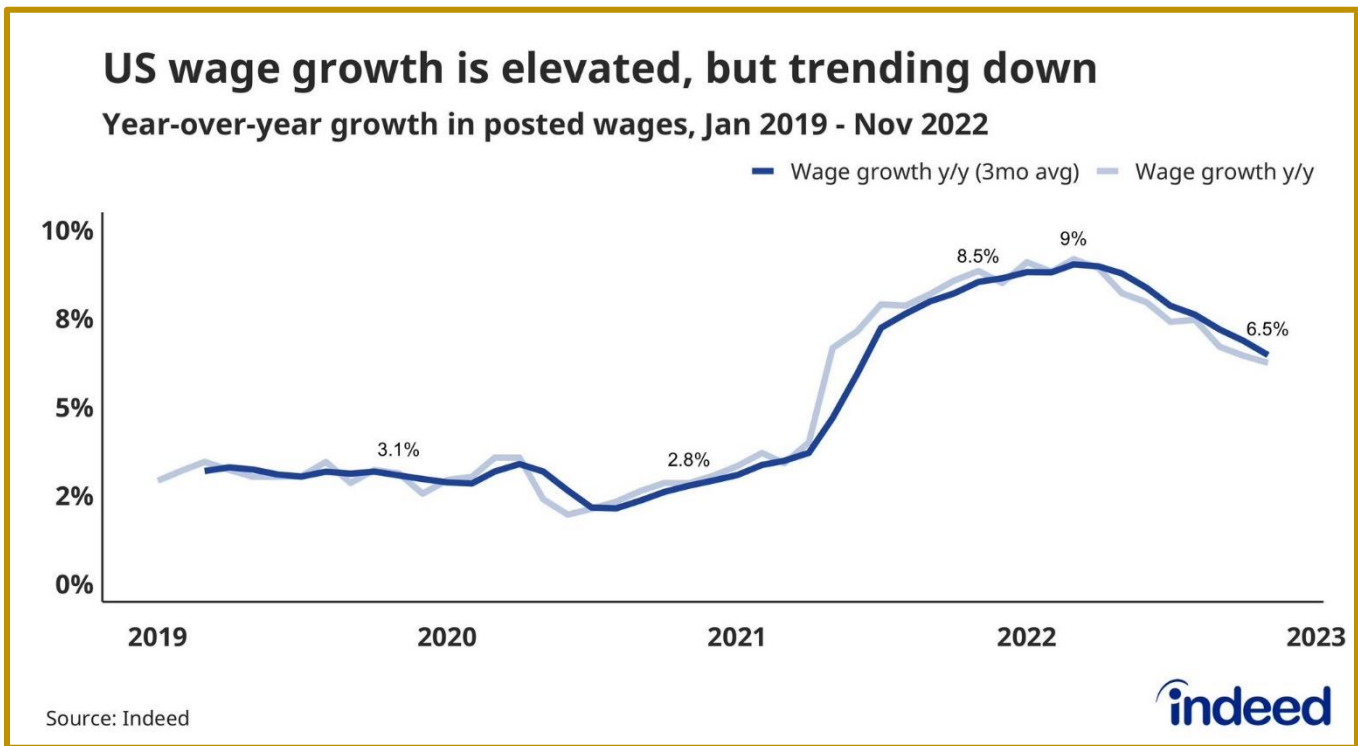


Note: ApartmentList, CoreLogic, RealPage, and Zillow measure market rate rents — that is, rents for a new lease by a new tenant. October PCE (personal consumption expenditures) data are estimates based on October data from the consumer price index. The Zillow data start in March 2016, and the ApartmentList data start in January 2018.

Source: ApartmentList; Bureau of Economic Analysis; Bureau of Labor Statistics; CoreLogic; RealPage; Zillow; staff estimates.

Above is a brilliant chart from the Fed on this exact topic. The red line here is the same housing series as in figure 2 with the other lines being measures from more real-time sources. The conclusion here is pretty simple: rents have peaked and are coming down fast. Applying the lag rule, this should show up mid-year in the official data and will provide another disinflationary tailwind.

Two down, one to go – services inflation. This is where you'll find dining out, travel, haircuts, transportation, etc. The general rule of thumb here is that while there is a correlation to goods, it's generally less volatile and harder to bring down because the biggest input is labor (wages). So let's look at a chart from [Indeed](#), a good real-time data source on wages and jobs across US firms. Again, we can see a clear deceleration here that tells us there is a low probability of services inflation spiraling out of control. Where this ultimately settles out will be very telling and something to watch, but for now this decline should be enough to keep inflation readings on the cooler side.



The aftershocks of the COVID-19 pandemic are still being worked through in the economy, and as a result, economic growth is expected to be slow in the early part of the year as we return to normal trends. The prices of stocks and bonds already reflect this expectation, so the real question for 2023 is more about inflation data and how quickly it decreases, as well as the Federal Reserve's response to it. In times of market uncertainty, it's important to remember the wisdom of investor Bill Miller: "It's time, not timing, that builds wealth in investing."

Lastly, I want to answer the same question I get after every note we send out:

Q: "Ok, so what does this mean for a portfolio?"

A: Remember, asset prices are all about expectations and don't change because things are good or bad, but rather if things are better or worse. Also, positioning for just one base outcome I've written about isn't that smart because things can happen fast – that's why we diversify!

At Doxa, I write these notes to keep our readers informed about what's happening in the economy and our thoughts on how scenarios may unfold. But our real work is done on the planning side, where we focus on crafting financial plans that can help families achieve their goals no matter what challenges they, or the economy, may face. We create portfolios that are diversified and sound, with companies that have long-term advantages and can be held through all stages of the economic cycle. While the big picture is still important and can influence some decisions on the margin, time and quality remain at our foundation. Another quote from another legend, "The more worry that goes into short-term price fluctuations, the less focus can go into whether or not the future will be successful."¹

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¹ Of course that's a Howard Marks special!

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