OCTAVIA
WEALTH ADVISORS

2023 Outlook: Navigating Uncertainty

January 2023

Building a Lifelong Partnership

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As we wrap up 2022, we acknowledge the whiplash that may be felt after ping-ponging between a brief but precipitous bear market in 2020, 18 months of substantial stock gains, and now a year of volatile markets and steep drawdowns. In our 2023 outlook, we say farewell to a decade of no investment alternatives to equities as we find ourselves on the other side of the market pendulum, looking forward to opportunities ahead, albeit amid considerable uncertainty. Our outlook remains tempered as we recognize the many possibilities of the future, but as market dynamics have changed, we are excited for the new opportunities presented in 2023 and beyond.

2023 Themes

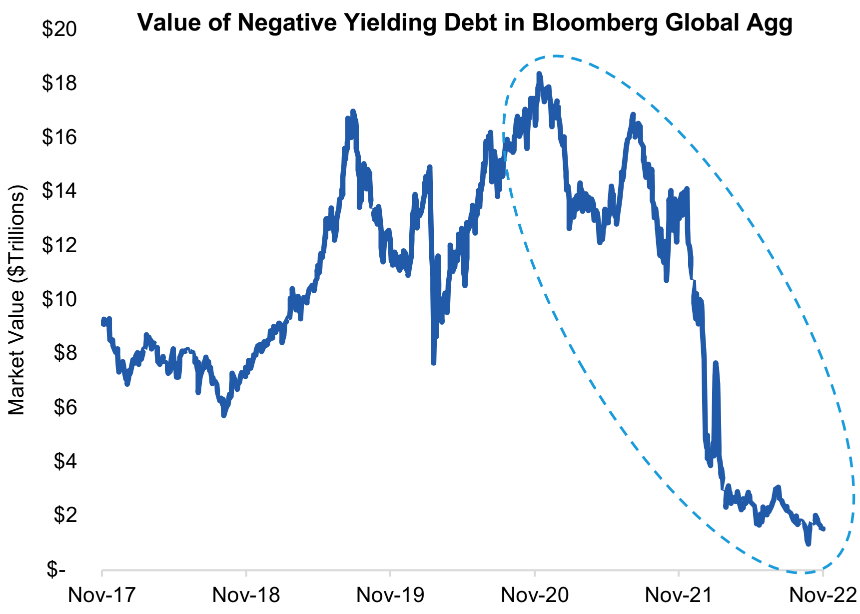
Rarely do market themes fit neatly into a single calendar year, and we expect 2023 to be no different as trends from 2022 spill over and events in the new year reverberate well beyond. Therefore, we present this year's views as if they were three acts of a play. The first act is one in which changes are just beginning and may have long-term implications that are not yet fully appreciated. The middle act is one in which change is obvious, but resolution remains unclear. In the final act, events take place whose culmination is expected in the near term.

Act 1: Persistent Volatility

In the first act of a play, facts and circumstances are revealed about a character which, in time, will shape his or her path, but careful attention must be paid to see how early clues may lead to varying outcomes. We view the reversal of zero-bound interest rates and unraveling globalization as pivotal moments that may lead to higher long-term volatility for financial assets.

The market environment since the end of the Global Financial Crisis has been unique compared to history, characterized by low interest rates, low inflation, and slow growth alongside maximum accommodation and liquidity. These conditions have bred abnormally low volatility and encouraged risk taking based on a decade where there seemed to be no alternative to investing in equities while fixed income yields were near zero. We believe that reversing some, but not all, of these conditions may produce higher structural volatility across asset classes. Additionally, these shifts may mean that investors expecting to replicate their investment strategy from the past decade may be disappointed by its efficacy in the decade to come.

THE GREAT UNWIND



Source: Fiducient Advisors. Data originally sourced from FactSet, as of November 30, 2022.

Quantitative easing, low rates, and low inflation sowed the seeds for low volatility and pushed investors out on the risk spectrum. The recent pivot from these conditions can be shown in the global reversal of negative yielding debt.

We believe a return to more normal conditions may produce greater volatility across assets, making risk management and asset allocation even more important than in recent years.

IMPACT ON YOUR PORTFOLIO

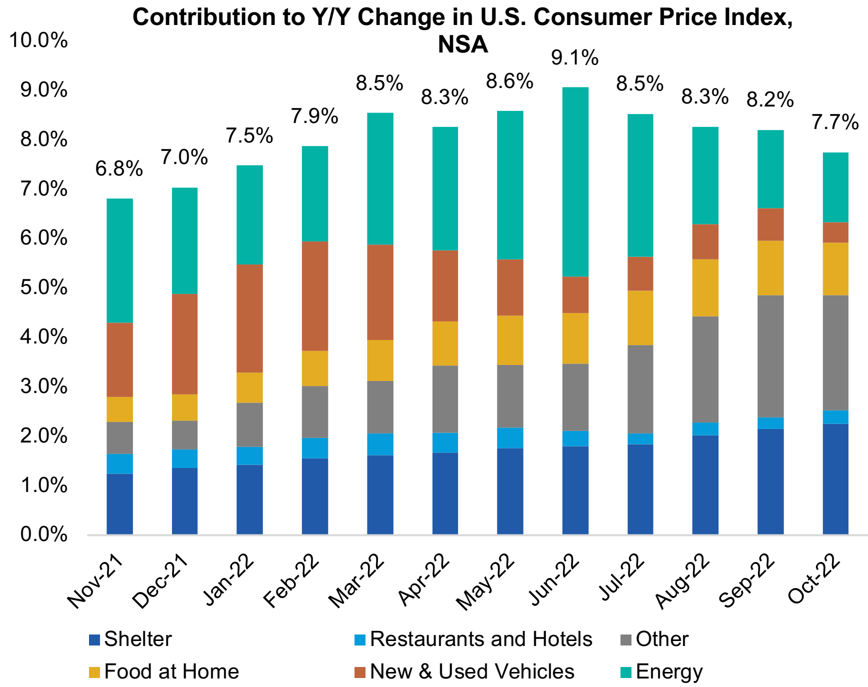
Resiliency, risk management, and humility may be keys to asset allocation in a higher volatility environment. As we look to the future, we are evaluating opportunities to increase our fixed income duration at higher yields as bonds finally appear poised to contribute positively to returns and, hopefully, retake their historical role of diversifying equity exposure.

Additionally, attractive valuations compelled us to increase our allocation to non-U.S. equities in 2022, and we maintain that conviction going forward. However, risk management encourages moderation, as recent geopolitical events have revealed greater potential for exogenous shocks to non-U.S. markets. As such, we remain moderately overweight U.S. equities compared to global stock benchmarks.

Act 2: Moderating Inflation

In the middle act of the play, conflict rises but a resolution is not yet apparent. Each inflection point in the conflict can leave the audience uneasy about the future. Inflation, and the Fed's role in moderating it, is in its middle act. In the year ahead, it is unlikely that inflation will fall straight to the Fed's target of 2%. However, we note that a straight decline is not necessary for the market to bottom or for the Fed to pause. We simply need the path to resolution to become clearer. So, while inflation may take several years to moderate, its pivotal moment in terms of market sentiment may be soon at hand.

SHIFTING INFLATION DYNAMICS



Source: Fiducient Advisors. As of Oct. 31, 2022. Based on U.S. Consumer Price Index, All Items, Not Seasonally Adjusted.

The impact of higher interest rates is just beginning to take hold, with goods inflation moderating but services picking up steam.

Owners' equivalent rent, the largest component of the CPI basket at 24%, has not seen the same repricing as housing prices. Shelter contributed ~30% to the most recent CPI print, compared to 18% a year ago. As monetary policy actions begin to affect prices, we may see inflation moderate further.

IMPACT ON YOUR PORTFOLIO

Our positive but tempered view on inflation moderating, but not immediately, highlights the need for resiliency. The path ahead is not likely to be smooth, but appears headed in the right direction. We increased our allocation to real assets in 2022 and maintain those positions in light of the potential for sustained above-target inflation. We also emphasize selecting quality stocks, defined as companies with consistently growing cash flows and pricing power. These companies may be more resilient in a period of sustained inflation.

Act 3: Bear Market Bottom

In our final act, we fully grasp the conflict and perhaps even see what is necessary for resolution, but are uncertain exactly how it will play out. We believe we are in a similar place with the eventual bottom of this year's bear market. First, some context: since 1950, the average pullback of 20% or more has lasted about 14 months before reaching its bottom. The longest of these was 31 months, from March 2000 to October 2002, while the shortest was just two months in 2020. While there is no such thing as a normal bear market, history would indicate that our 11-month-old bear market is likely closer to its end than its beginning.

How do bear markets typically unfold? The most common pattern is multiple contraction leading markets lower first, followed by a shift in Fed monetary policy, and, finally, a decline in earnings and expectations, creating a base from which to build new forecasts.

Stock index prices can be broken into two primary components: earnings per share (EPS) and earnings multiples. EPS is the economic value created by businesses, and the value of company ownership that investors seek. Multiples are how much an investor is willing to pay for future earnings. Multiples are often driven by sentiment and can change rapidly. Earnings, on the other hand, are backward-looking. Since the impacts of higher rates and/or slowing demand take time to appear in financial statements, bear markets often begin with multiple contraction as investors sour, then fall further as earnings decline.

This certainly has been the case in 2022. Multiple contraction has accounted for more than 100% of the pullback as earnings have made a modest positive contribution. The question that remains: what role will earnings play in the market bottoming this time around?

As shown in the table below, there is a meaningful difference in the earnings impact in recessionary bear markets compared to non-recessionary. Our expectation remains that if a recession does take place, it will be modest and cyclically-led, rather than one driven by structural imbalances (like the Global Financial Crisis) or an exogenous factor (like COVID-19).

Market Peak	Earnings Peak	Days' Difference	Market Trough	Earnings Trough	Days' Difference	Market Peak-to-Trough	EPS Peak-to-Trough
Recessionary Pullbacks							
3/24/00	8/7/00	136	10/9/02	12/17/01	-296	-49.1%	-17.5%
10/9/07	11/1/07	23	3/9/09	5/8/09	60	-56.8%	-39.3%
2/19/20	1/30/20	-20	3/23/20	5/15/20	53	-33.9%	-20.6%
Averages:		46			-61	-46.6%	-25.8%
Non-Recessionary Pullbacks							
7/17/98	9/29/98	74	8/31/98	1/4/99	126	-19.3%	-2.6%
5/21/14	10/7/14	139	8/25/15	2/6/15	-200	-7.2%	-5.5%
11/3/15	9/8/15	-56	2/1/16	3/1/16	29	-13.3%	-3.2%
9/20/18	12/6/18	77	12/24/18	2/1/19	39	-19.8%	-2.3%
Averages:		59			-2	-14.9%	-3.4%
Today							
1/3/22	7/12/22	190	9/20/22*	9/20/22*	?	-25.2%	-1.4%

*Dates may not represent actual trough since definitive market bottom is not yet known. September 20, 2022 used for comparative purposes.
Source: Fiducient Advisors. Originally sourced from Franklin Templeton, September 30, 2022.

With that in mind, some earnings are beginning to contract. Second quarter S&P 500 earnings growth was +6.2% year-over-year, but -4.0% when excluding the burgeoning energy sector. Third quarter earnings were +2.5% with energy, but -5.0% without it. These results compare unfavorably to expectations as high as +10.8% earlier this year. While earnings may have further to decline, this recalibration is another step toward a market bottom and, as noted previously, suggests that we are nearer the end than the beginning.

Finally, what role does the Federal Reserve play in all of this? We believe a quite important one, given the market's acute focus on the Fed this year. History has shown that markets tend to bottom only after the Fed is done raising interest rates, which makes intuitive sense, given that rate hikes are primarily intended to cool economic activity.

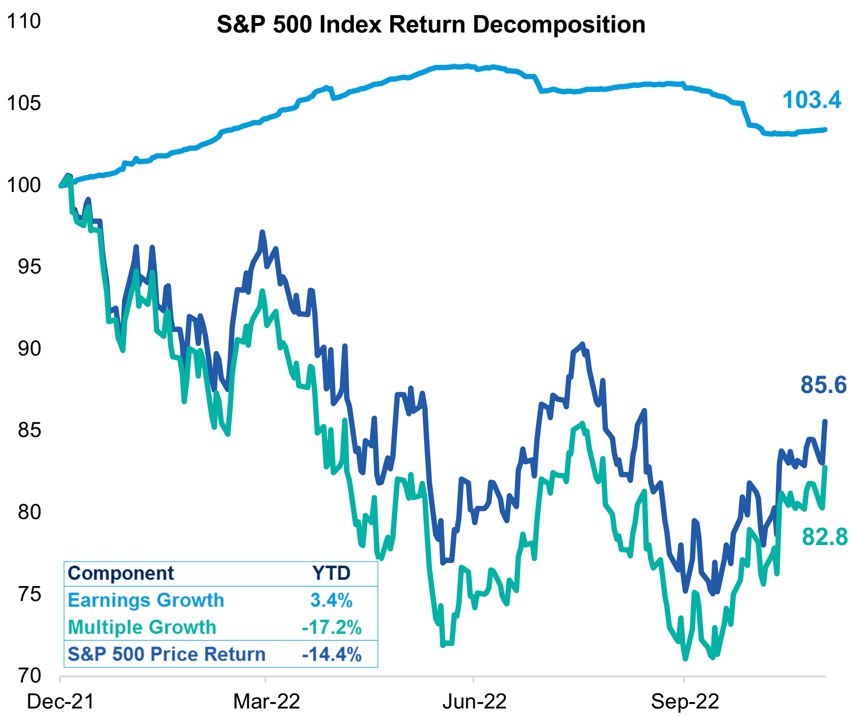
Trough	Duration of Drawdown	S&P 500 Drawdown	Recession?	Market Trough before/after Rate Increases Stopped?	Month(s) Before or After
Oct. 1974	21 months	-48.0%	Yes	After	13
Aug. 1982	21 mo.	-27.0%	Yes	After	51
Dec. 1987	4 mo.	-34.0%	No	After	8
Oct. 1990	3 mo.	-20.0%	Yes	N/A	N/A
Oct. 2002	31 mo.	-49.0%	Yes	After	74
Mar. 2009	17 mo.	-57.0%	Yes	N/A	N/A
Mar. 2020	1 mo.	-34.0%	Yes	N/A	N/A
Average Time					34

N/A indicates that the market decline did not coincide with Federal Reserve rate hikes.
Source: Fiducient Advisors. Originally sourced from Franklin Templeton, September 30, 2022.

Yet given the Fed's dual mandates of price stability and full employment, we note the importance of "cool" rather than "kill." We believe the Fed will be willing to pause rate hikes once they have seen modest success in slowing inflation. They took a step toward doing so on December 14th, raising rates by 0.50% rather than 0.75% after positive inflation readings.

However, the full effect of higher rates takes some time to work through the economy. Therefore, businesses are often in the midst of contraction when the Fed stops increasing rates. It is certainly possible that the market could bottom before the Fed stops its rate hikes, but continued hawkishness is likely to prevent significant rallies off the market bottom.

CORPORATE EARNINGS TO FOLLOW MULTIPLES?



Price multiple declines often lead earnings as bear markets unfold, as seen this year. Multiples have contracted while earnings are modestly positive. However, strength in the energy sector (over 100% earnings growth in 2022) is buoying the rest of the market.

Earnings across the rest of the market are beginning to show a pullback similar to those in previous bear markets not led by a recession. Repricing helps set the stage for a bear market bottom.

Source: Fiducient Advisors. Originally sourced from FactSet. As of November 30, 2022. On return index, December 31, 2021 = 100. You cannot invest directly in any index. Index performance is reported gross of fees and expenses. Past performance does not indicate future performance, and there is a possibility of loss.

IMPACT ON YOUR PORTFOLIO

We have no ability to precisely call the market bottom. However, as we look forward, we believe it is prudent to take advantage of a discounted market and prepare for a brighter path forward. Our forward-looking market assumptions have become more bullish on equities and high-yield bonds compared to this time last year.

We also note that a less hawkish Fed could cause the U.S. dollar to moderate against its peers after an extremely strong year for the greenback. This could be a tailwind for non-U.S. equities, playing into our decision to maintain a higher allocation overseas, as noted previously.

Final Thoughts for 2023

2022 was the reset button for many markets, as stocks declined broadly and bonds suffered one of their worst years on record. Moderating inflation, an exit from zero-bound interest rate policies, and repricing in global fixed income and equity markets have all helped sow the seeds for a brighter outlook for 2023 and beyond. While we anticipate volatility will persist in the years to come, leaning into newly created opportunities may prove to be the right decision over the long-term. Our Octavia team will be here to guide you through the uncertainty and capitalize on these opportunities every step of the way.

Past performance shown is not indicative of future results, which could differ substantially.

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