



Sanctuary Corner

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Executive Summary

We push into the new year having survived a brutal year where both stocks and bonds fell sharply into bear territory. For the year, the S&P 500 was down 19.4% (more than 20% below its record high), the Russell 2000 was down 21.56%, and the tech-heavy Nasdaq was down 33.1%. Of the major indexes, the Dow fared the best, down only about 8.8%, having less tech and a more value-based list of stocks. The equity market did rally in the early part of the fourth quarter and the S&P, Russell, and Dow were all up for the fourth quarter. Will the momentum continue into 2023? Likely. Will it become a full-fledged Bull? It has the potential. But it's a question of When? How do we prepare? The answer will always be: Patiently.

As for the bond market, the Federal Reserve raised interest rates the most aggressively in history causing a sharp decline in bonds and putting them also in a Bear market. The 30-year Treasury bond was down sharply at 33%, investment-grade corporate bonds were down 15% and munis were down 5%. It was a rare time in history when bonds did not provide downside protection. Recently interest rates have begun to fall as some favorable inflation data suggested a peak in inflation. The bond market is pricing in both an economic slowdown and a peak in inflation, so we are questioning if rates have peaked. But all members of the Federal Reserve are not forecasting a cut in rates this year. Most Fed Governors are forecasting a terminal rate above 5%. So will a Bull arrive in bonds this year? We think yes. But it will be choppy until the Fed signals a pivot to peak rates. We believe bonds can end the year as one of the best-performing asset classes with a double-digit return. But again, the answer will be Patience.

The Best Strategy for 2023
will be Dollar Cost Averaging

Positioning

We will continue to beat the drum for Quality as long as the Fed is raising interest rates. As noted above, this is the time to shift to areas in Value while reducing exposure to Growth. Like the Dogs of the Dow strategy (see page 5), there's going to be increased demand for Dividends as well as short-term U.S. Treasuries and, yes, cash. Continue to diversify into bonds staying in the 3–5-year range, but prepare for longer duration assets once the Fed gets closer to its peak terminal rate near 5%.

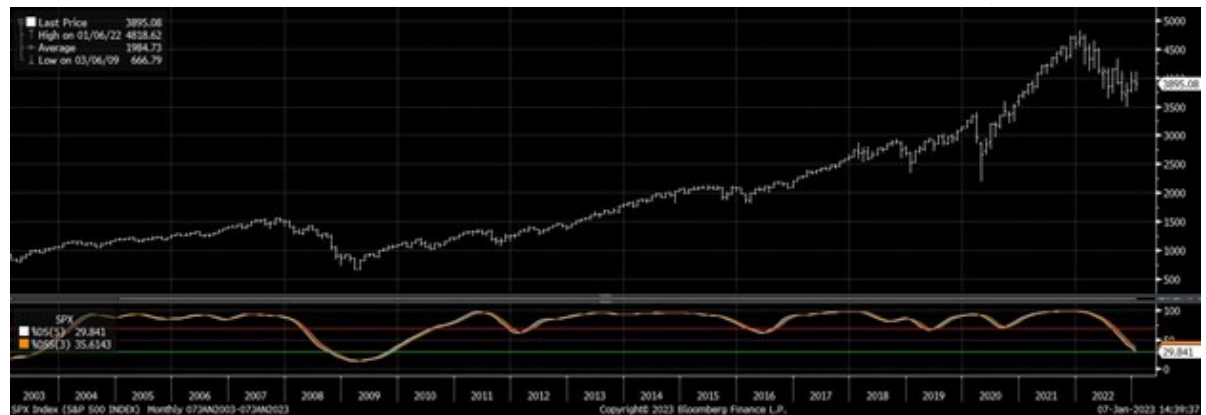
Where We Stand Today on Equity Markets

The equity markets are very oversold and can have a tactical rally to resistance near 4000 on the S&P 500. But we are still in a bear market with the lows of October expected to be tested near 3500. Should this level not hold, the next area to test is 3200. At the risk of sounding like a broken record: As long as the Federal Reserve is raising interest rates, the equity market will remain volatile. We think the biggest risk is to Growth stocks. Value stocks have already begun their Bull market, in our view. We believe despite the market being in a Bear market, you can dollar cost average into these names. These will be the leaders in the next Bull run, which is likely to last several years. So despite some of these stocks being near or at all-time highs, we would still be buyers as we see prices going much higher.

Best Buying Opportunity in a Decade?

We can expect more interest rate hikes in the first quarter (25 bps in February), but the end of the Fed's anti-inflation strategy is within sight. We also see that corporate balance sheets are clean with low debt levels. Meanwhile, the mighty consumer – who accounts for the majority of the GDP – also has a healthy balance sheet. There's definitely potential for the planets to line up in 2023 and create one of the best buying opportunities in a decade. Why? Because the market is approaching the most oversold monthly stochastic price momentum reading since 2008–2009. Investors are going to start paying attention to this soon.

S&P 500 Index and Monthly Price Momentum Stochastic



Source: Bloomberg 1/7/2023

The World Goes Round in Cycles

Let's talk about cycles. This is why we're in the midst of a secular Bull. The equity market has long cycles that can last up to 20 years. (See the chart of the Dow Jones Industrial Average (DJIA) over the last 100 years.) The greatest secular Bull lasted from 1982 until its peak in 2007. The new Bull returned in 2013, and we believe this cycle can last until 2030. And yes, we think it can run even in a higher interest rate environment as rates are normalized from the zero-bound policy, similar to what we saw in the 1950s.

Dow Jones Industrial Average

For further support of the current secular uptrend, we can look at the Wilshire 5000 Total Market Index. This index represents the full market capitalization of the US market, and back in 2013, it experienced a significant breakout. With evidence that secular bulls can last up to 20 years, it goes to show that the current uptrend could extend to at least 2030. (Don't get confused: there can be Bear-like corrections during secular up-trends as Bulls and Bears are often disguised – at first glance.)

Looking at the Wilshire 5000 chart, you'll see its stair-step pattern, indicated by the green lines in the chart below. This pattern is created whenever a temporary pullback stays above the prior low, and the next peak reaches above the prior high. When this pattern repeats, it's bullish. But as the Fed continues to raise interest rates to the expected peak terminal rate in the 5% range, markets can still have periods of episodic volatility. Once the Bull digs in, the extreme volatility should ebb and markets will eventually rally to all-time highs.



Wilshire 5000 Total Market Index



Don't Catch a Falling Knife

When the Bull runs in 2023, it will not be led by the stocks that drove the last Bull market. In fact, those now mega-cap growth stocks with high P/E multiples, particularly in Technology, will continue their 2022 plummet, in our view. You can make a long-term case for the Technology sector, but don't try to catch a falling knife – these stocks are deadly right now as their valuations reset back to more reasonable levels. All the fiscal and monetary stimulus that flooded into Tech drove up valuations and created a concentration of supercharged stocks – let's call it the Nifty FAANG, which has dominated the S&P 500 and NASDAQ indexes. These stocks today make up 11% of the S&P 500 with Apple the largest at 6% and, for NASDAQ 100, these stocks make up nearly 30% of the index with Apple at 11.6% (Microsoft is the largest at 11.7%). Technology is one of the most expensive sectors (23.6x forward earnings) – and the largest, at around 26% of the S&P 500. With high market caps and expensive prices, this sector is driving the final decline in the Bear market.

What happens when a market shifts from the Bear to the Bull? New leaders emerge and ford a new path. In fact, they begin to outperform before the Bear is over. That's exactly what we've been seeing. The leadership void created by the falling Growth names is being filled by Value stocks. It's just that their market capitalization is so much lower than the Growth stocks, causing the market averages to go down despite pockets of Value near or at record all-time highs.

Leadership has shifted from Tech to Energy, Industrials Materials, and Healthcare. The Energy sector has been trading at a forward P/E multiple of 9.8x – the only S&P 500 sector at a single-digit multiple. Keep in mind that Energy is only 5% of the S&P 500 while Apple alone is 6%. The Energy sector also posted the strongest earnings growth last year. It is also one of the most under-owned sectors in the market – there's plenty of room for investors to buy. Energy stocks such as ExxonMobil and Chevron hit record all-time highs during 2022. Industrials are also showing leadership, with Defense stocks such as Lockheed and Northrop Grumman hitting record all-time highs last year and Caterpillar at record highs, and Deere near record all-time highs.

Favoring Value Over Growth

With interest rates still rising, the risk is Growth stocks continue to go down and the sectors most impacted are Technology and Consumer Discretionary. Real Estate is the most at-risk sector with rates up, permits down, mortgages demand down and challenges in the Private Equity market in real estate. It is also the most expensive sector in the market. So, with the most expensive sectors in Growth, the cheapest sectors are in Value and that's where the opportunity lies.

S&P 500 GICS Sectors for 1/10/2023	2023 Forward Price-Earnings Ratio
Energy	9.8x
Financials	12.7x
Materials	14.2x
Communication Services	14.6x
Healthcare	18.8x
Industrials	20.1x
Utilities	20.8x
Consumer Staples	22.3x
Technology	23.5x
Consumer Discretionary	24.3x
Real Estate	31.2x

Source: Bloomberg and Sanctuary Wealth 1/10/23

Growth Versus Value

After two years, the Covid silver lining that the Growth sector has enjoyed is over. That bubble has popped. Growth is likely to continue to deflate as its forward P/E multiple remains high at 23.7x as interest rates are still projected to rise another 50 basis points approaching 5%. The FAANG stocks still represent 11% of the S&P 500 with an average P/E of 35.2x with Apple and Amazon dominating this group. High P/Es just don't work well in a rising rate environment. Conversely, we have Value trading at a forward P/E multiple of only 14.7x, making this the most attractive area of the market that is under-owned by investors. This gives it some running room.

iShares Russell 1000 Growth Versus iShares Russell 1000 Value

Let's flip that chart upside down and look at Value versus Growth. It's a pretty clear picture that Value is well-positioned to outperform Growth this year.



Source: StockCharts.com 1/10/23



Source: StockCharts.com 1/10/23

Dogs of the Dow Should be a 2023 Winner

The Dogs of the Dow is an annual strategy of buying equally the 10 highest-yielding stocks in the Dow Jones Industrial Average (DJIA). In periods of market declines and volatility, this strategy has done well. Last year, the Dogs of the Dow was up 1.5% on a total return basis and an absolute basis was down only 1.0%, clearly beating all the market averages in 2022. Since 2000, the Dogs of the Dow have outperformed the DJIA. The list of stocks this year are all high-quality companies with an average yield of 4.5%. The basket is not biased toward Growth but towards Value with a forward P/E of 11.8x – which aligns with our thesis that Value is the new leader within the market. We believe this basket of stocks should again beat the market on a total return basis in 2023.

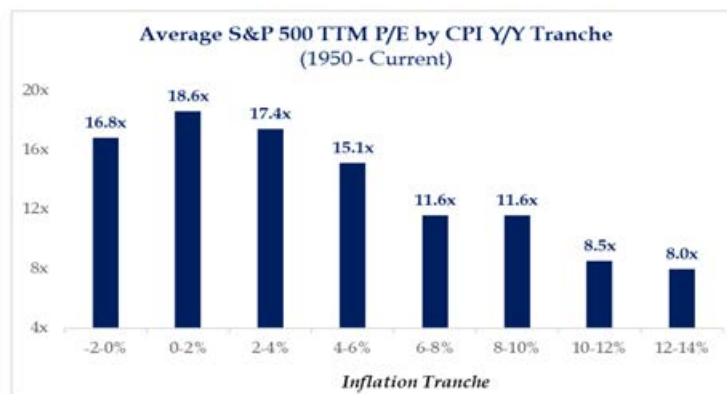
Dogs of the Dow	Ticker	Forward P/E	Dividend Yield 12-30-22
Verizon Communications	VZ	8.1x	6.62%
Dow	DOW	8.7x	5.56%
Intel	INTC	15.0	5.52%
Walgreens Boots Alliance	WBA	8.1x	5.14%
3M	MMM	12.5x	4.97%
International Business Machines	IBM	15.9x	4.68%
Amgen	AMGN	15.4x	3.24%
Cisco Systems	CSCO	13.8x	3.19%
Chevron	CVX	9.1x	3.16%
JP Morgan Chase	JPM	11.9x	2.98%
Average		11.8x	4.5%

Source: Dogsofthedow.com; Bloomberg 1/9/23

Inflation vs. Price - Earnings Multiples

Fundamentals drive stock prices, but inflation influences the price-earnings multiple that investors will put on the equity market. The chart below examines the S&P 500 price-earnings multiples versus ranges of inflation. The lower inflation the higher P/E; conversely, higher inflation leads to lower earnings multiples. We believe the market is likely to trade to a 16.5x-15x multiple (against an inflation range of 4%-6%). Using \$213 for consensus earnings points to a range for the S&P 500 of 3500-3200, which also aligns with the important technical levels for the market.

HIGHER INFLATION HISTORICALLY LEADS TO LOWER EQUITY MARKET MULTIPLES



Source: Strategas, January 2023

In the New Bull, Energy is the Value Leader

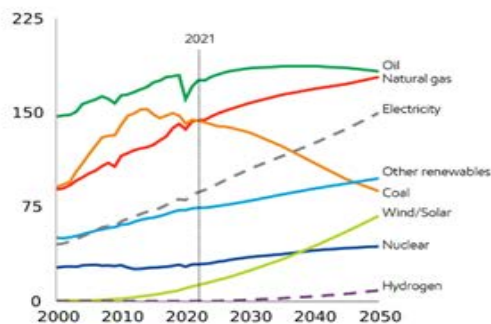
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We anticipate the S&P 500 Energy sector to reach a record all-time high in 2023. Energy is the most inexpensive sector trading at 9.8x forward earnings, represents only a 5% weight in S&P 500 index, and is under-owned by investors.

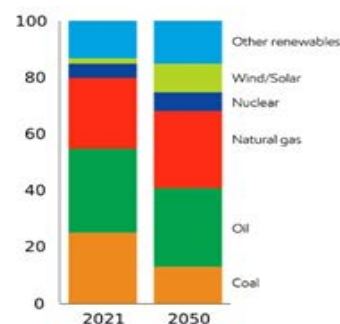
The sector has been scorched by ESG but the Big Oil companies are spending aggressively on alternative/green energy as corporate pay is now linked to the E in ESG (Environmental). This should allow them to clear some of the hurdles under the ESG investing rails. Confirming to us that the sector is the new bull leader is the attractiveness of most of the subgroups: Integrated, Equipment & Services, Exploration & Production, Drilling, Refining & Marketing and Storage are all performing well, so this is a broad-based move.

Global energy mix shifts to lower-carbon fuels

Primary energy – Quadrillion Btu



Percent of primary energy



Source: ExxonMobil Outlook for Energy report October 5, 2022

S&P 500 Energy Sector with Relative to the S&P 500



Source: StockCharts.com 1/10/23

Equities Will Heat Up

Throughout 2022, equities were sold off and are not currently held at extreme levels. With the Bull returning this year in earnest, a return to stocks is expected. But most pundits and investors are biding their time, expecting a bad first half and better second half. However, we contrarians like to point out: if we bottom in early 2023 and it's rally-time, then the chances of a double-digit return for equities by year-end are high.

Back to the Future?

We've been considering the thesis that – while 2022's inflation build-up was evocative of the 1970s – our current environment is more reminiscent of the 1950s. During that decade, the Consumer Price Index (CPI) revealed inflation spiking near 10%, then falling over a few years, before moving modestly back up. We could see that pattern repeat today.

So, if CPI falls this year in the range of 3%-4%, and if we experience the 1950s pattern, then CPI should eventually fall back to the Fed's target of 2%.

CPI Year on Year

During the 1950s, 10-Year Treasury yields rose gradually as inflation picked up, and this translated into a secular Bull market for equities. This leads us to believe that, even as the Fed continues its hikes, higher interest rates are not a death sentence for a secular Bull market trend. A strong economy with a modest level of interest rates results in corporate profits, and profits lead to higher stock prices.



Source: Bloomberg 1/10/23

Back to a 60/40 Future

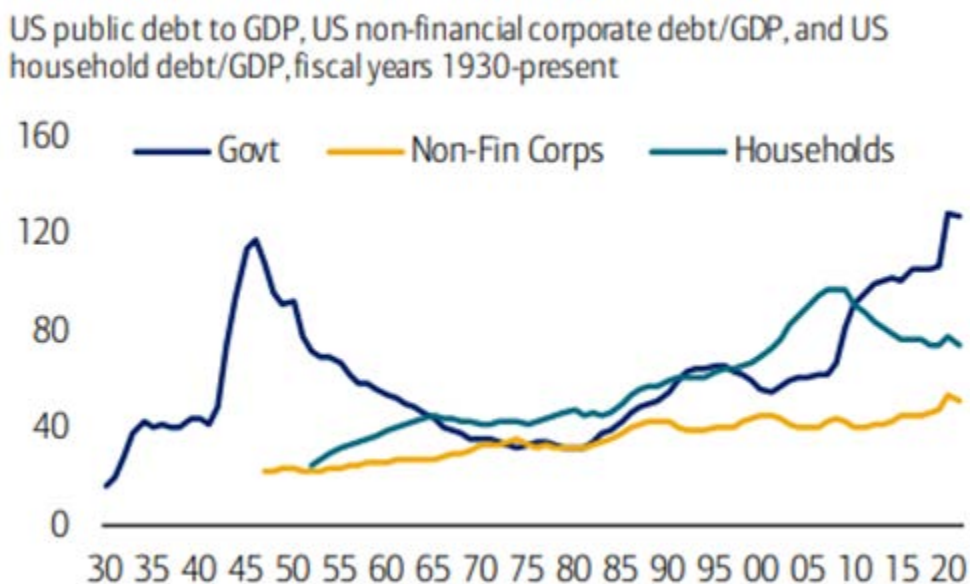
In 2023, we see bonds and cash becoming attractive again which should reverse last year's rampant underweighting in bonds and herald the return to a 60/40 asset allocation. A move to short-duration fixed income assets began before 2022 closed out. And since long-term Treasury yields tend to peak well before the rate hiking cycle ends, investors would be smart long-duration bonds as rates peak, because bonds could post double-digit returns this year.

Can Government Debt Get in Our Way?


The U.S. Government has the largest balance sheet in history. While consumers have significantly paid down their debt along with corporates, the government has been a big spender. But government spending should begin to slow this year, given the political gridlock that will freeze up Washington's ambitions.

The Government Holds Most of the Debt

At this point, the balance sheets of Corporate America and John Q. Public seem ready to carry the day – and the Bull.



Source: Bank of America Global Research; Strategy Year Ahead 11/22/2022



Put a Bow on It

With so many variables in play – from inflation and recession, to war and geopolitics – will the markets in 2023 prove to offer the best buying opportunities in a decade? Here's what you have to keep in mind:

1. Maintain high-quality positions until the Bull market is confirmed.
2. Leadership has shifted to Value, particularly in the commodity-sensitive sectors, along with Small Caps, and Dividends.
3. Expect long-duration assets to perform well both in stocks and bonds by year-end. Given the volatile environment, we recommend dollar cost averaging into the markets.
4. Prepare for the return of 60/40 and don't forget cash.
5. Appreciate that China's full re-opening will be another bullish element and will alleviate some of the economic pressures surrounding trade and the global supply chain.

Lastly, the key data to keep an eye on remains the employment story. It's what keeps the Fed up at night. But we believe the rate hikes will get the job done and inflation will be tamed this year.

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