CAPITAL CREEK PARTNERS REPORT – FEBRUARY 2023

Preparing to Lean In – 2023 Markert Outlook

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About Scott

Partner, Chief Strategist

Scott is a partner of the firm and the Chief Strategist. Before joining Capital Creek, Scott was the Head of Asset Allocation at UTIMCO, where he served on the firm's Management, Investment, and Risk Management Committees. Scott has 35 years of investment experience as a strategist and portfolio manager. Scott spent most of his career in New York, working at Kidder, Peabody, Morgan Stanley, and Tudor Investments. Scott studied at the University of Texas at Austin, where he received a BBA in finance in 1988. Scott is also a Chartered Financial Analyst, CFA.

About Capital Creek Partners

A Private Investment Firm, Founded by Families.

We are an investment partner organized to serve the needs of family offices, foundations, endowments, and private investment companies. Established in 2018, Capital Creek Partners was founded as a boutique multi-family office to serve a small number of prominent families. Our firm's culture is rooted in *Integrity, Humility, and Excellence*.

CAPITAL CREEK PARTNERS

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"Fortitude is the marshal of thought, the armor of will, and the fort of reason."

Sir Frances Bacon

Executive Summary

The year 2022 was one of the most painful in market history as bonds and equities became positively correlated and fell hard in tandem. The highest inflation in forty years prompted the Fed to raise interest rates by 425 basis points in only 9 months. This was far higher and faster than markets were anticipating at the beginning of the year. Higher policy rates combined with quantitative tightening (QT) drained the financial system of liquidity which put downward pressure on the prices of all assets. Fears of impending recession were pervasive all year long. There was nowhere to hide, and diversification did not work for most capital allocations. This is especially true for the traditional 60% stocks / 40% bonds portfolio (see Exhibit 2).

Exhibit 1: Total Returns by Asset Class as of February 21, 2023

Source: Capital Creek Research, Bloomberg

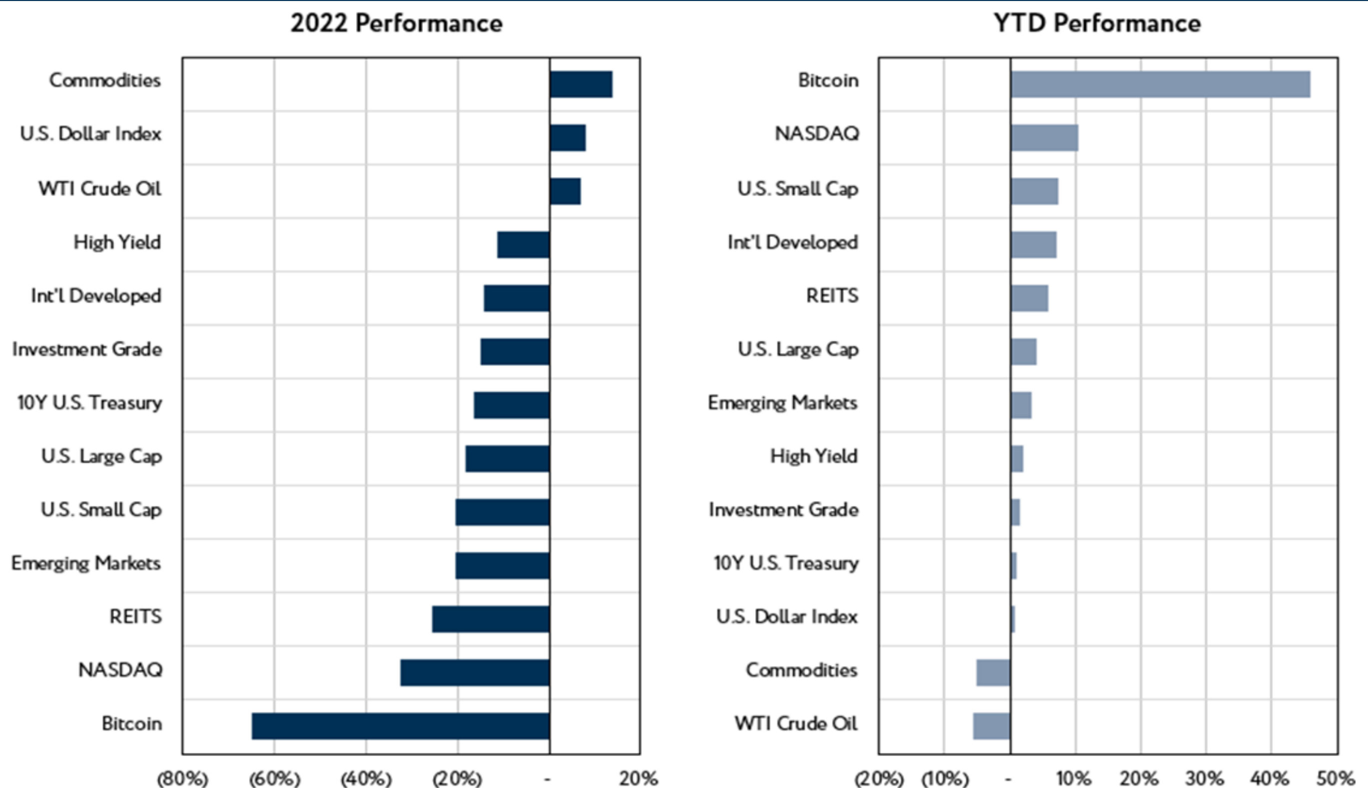
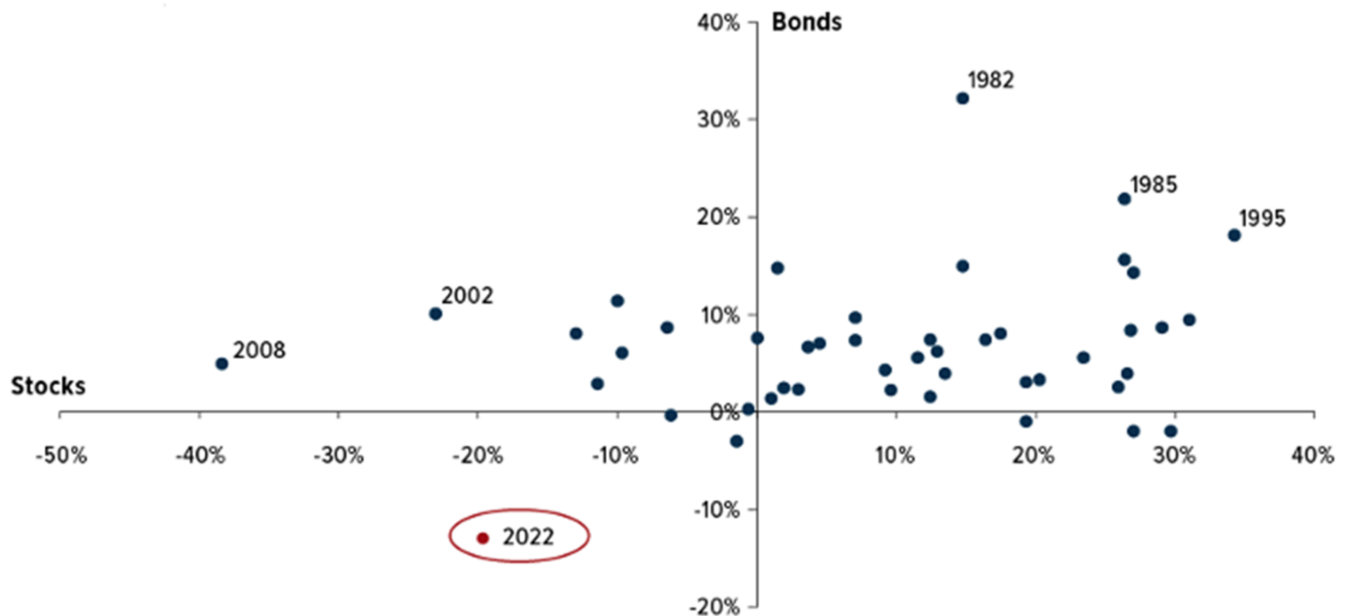


Exhibit 2: 2022 was an outlier year for a balanced stock & bond portfolio

60/40 Stock/Bond Portfolio Total Returns (1977-2022)

Source: Capital Creek Research, Bloomberg



Perhaps the most important thing we learned in 2022 was the clear recognition of a very different geopolitical and monetary/fiscal landscape powerful enough to catalyze an investment regime change. The period of peaceful cooperation, globalization, low interest rates, and high returns on capital that characterized the 1990-2020 period is probably over. We have moved from an era when profit triumphed over politics to a new phase where political and national security concerns take precedence over growth and profits. Visible examples from 2022 were Putin's war on Ukraine, the Biden Administration's Chips and Science Act, and Xi Jingping's Zero Covid Policy.

We are more constructive on risk assets in 2023. Persistently declining rates of inflation and slowing growth will likely keep the Fed from raising rates beyond 5.5% vs 4.75% today. The US and global economy appear surprisingly resilient and the prospects for a "soft landing" are rising. We expect the labor market and services-based inflation to cool in the second half of 2023, allowing the Fed to pause. China's dramatic policy flip from Zero Covid and austerity to "going for growth" is supportive of global growth and bullish for risk assets. We expect 10-year Treasury yields to stabilize and for the S&P 500 to rise approximately 10%-to-15% by year-end. After a decade plus of lagging, non-US equity markets are poised to outperform. The US dollar has topped out at extreme valuation levels, setting the stage for commodities and gold to resume their super cycle bull markets.

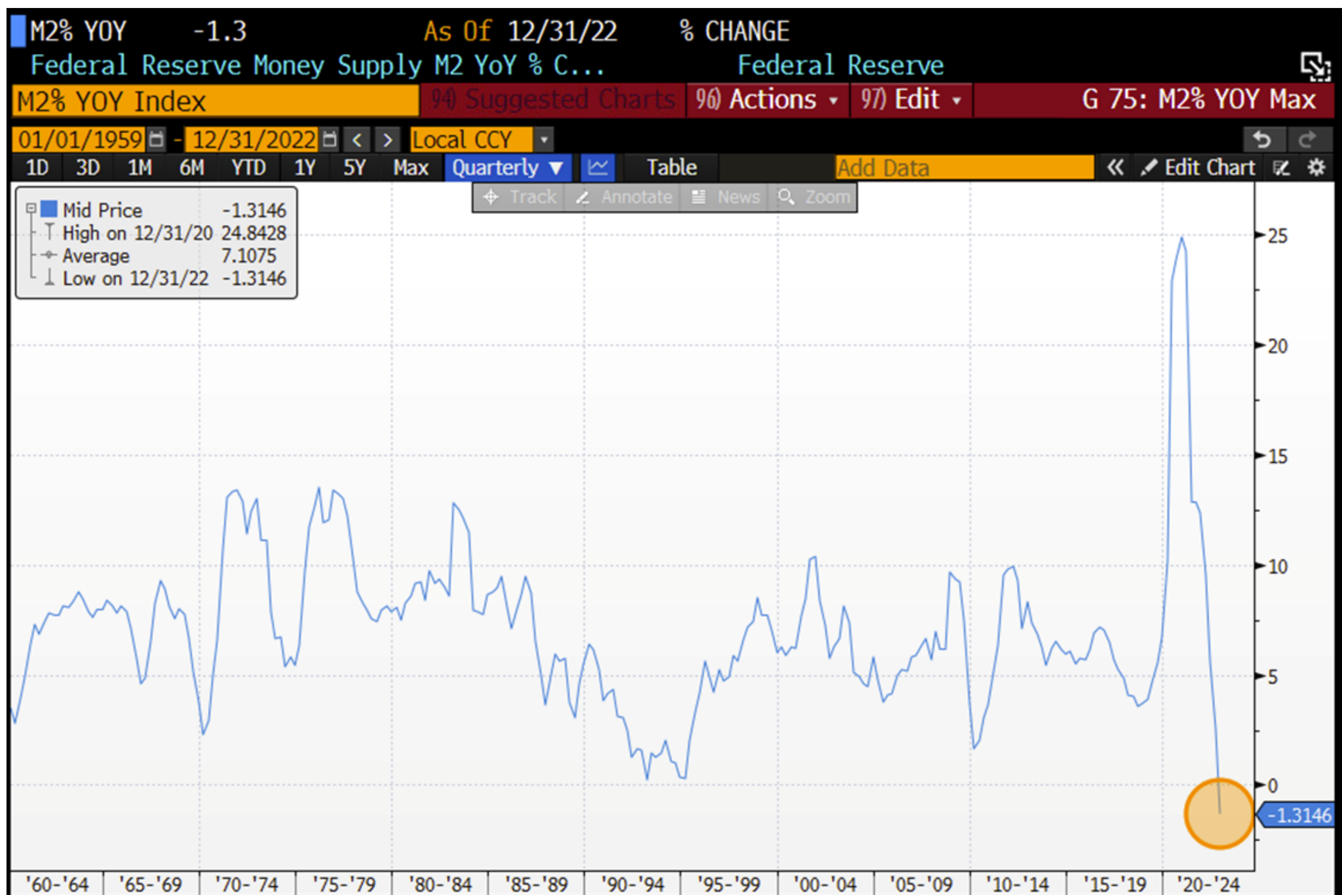
2022 in Review

The year 2022 was a devastating year for investors that left even well diversified portfolios with some of the deepest losses in the last 100 years. There was almost nowhere to hide, with every single major asset outside of cash and commodities ending significantly lower on the year. The fundamental hallmark of '22 was the persistency of high inflation, which forced the Fed to raise policy interest rates much higher and

faster than investors anticipated. Higher interest rates decimated low yielding, long duration Treasury bonds. Higher rates pushed up discount rates for future earnings and cashflow on equities, which led to large declines in valuations. In a nutshell, the Fed slammed on the breaks causing liquidity to plunge (see Exhibit 3), which took elevated asset prices down hard. This negative chain reaction was made more painful due to historically high bond and equity valuations to begin the year.

Exhibit 3: Declining Money Supply Kept Pressure on Asset Prices Throughout 2022

Source: Capital Creek Research, Bloomberg



The very strong US dollar performance was another key feature of 2022. At its high-water mark for the year in late September, the Bloomberg Dollar Index was up a staggering 15.63%. The rapid Fed policy tightening increased the rate differential between the dollar and other G-10 currencies, which helped drive the dollar's strong performance. Fears of global recession also drove foreign investors into dollar assets as a safe haven. Based upon Real Effective Exchange Rate (REER) valuation measures, the dollar became very expensive relative to its history.

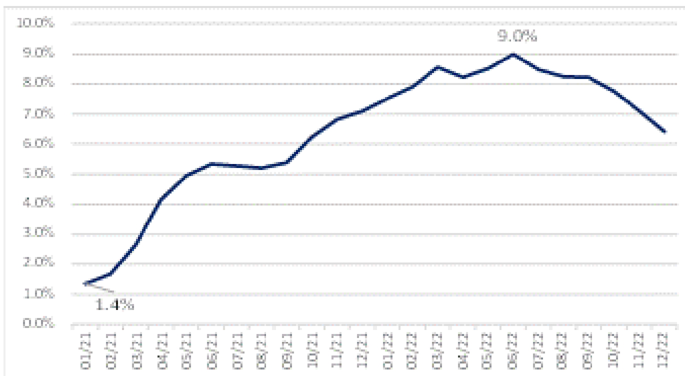
The extremely positive performance of Energy equities stood out last year. The S&P 500 Energy Index (S5ENRS) finished the year up 45.86%. No other sector even came close. The combination of high oil and gas prices, strong earnings, attractive valuations, high dividend yields, strong buybacks, and inflation protection was exactly what equity investors desired in a tumultuous year. In this context, investors that

shunned fossil fuels were hurt, while investors who maintained long-term asset allocation discipline had some positive performance to reduce overall portfolio losses.

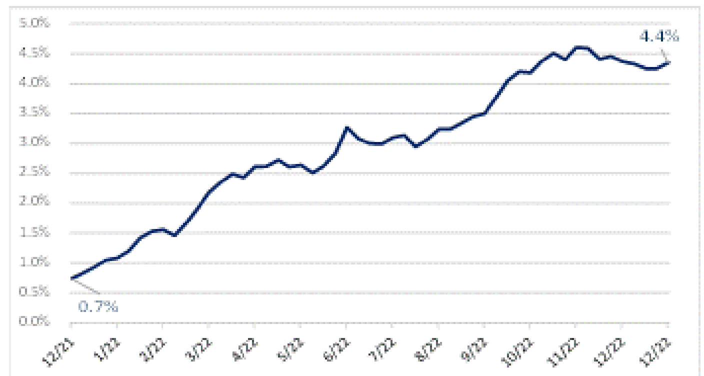
Exhibit 4: The Four Big Charts of 2022

Source: Capital Creek Research, Bloomberg

CPI % YoY (2022)



2-Year Note Yield (2022)



Dollar Index (DXY) (2022)

S&P Energy Index (S5ERNS) (2022)

What We Learned in an Exceptionally Difficult Year

In the investment business you are always learning because the game is constantly changing. Staying humble and flexible are critical to allocating capital successfully. There were some very important lessons to glean from such a challenging year. Perhaps the most important lesson from 2022 was the value of protecting client portfolios on the downside. CCP clients came into 2022 with relatively high cash balances, low public equity and fixed income allocations and excellent risk adjusted private market strategies. This anticipatory asset allocation mix allowed us to defend clients in a down year. According to JPMorgan, even a well-diversified portfolio was down approximately -14%. The classic 60% equity/40% bond portfolio returned -17%.

Another key lesson from last year is the primacy of monetary and fiscal policy in the modern finance-based economy. The principle of "Don't fight the Fed" was reinforced repeatedly throughout 2022. The Fed never wavered from its hawkish stance last year. Chair Powell made it crystal clear that the Fed was singularly focused on fighting inflation. Whenever bonds and stocks rallied, the Fed was there to smack them back down to tighten financial conditions and keep the downward pressure on inflation.

The Outlook for 2023

As we begin 2023, we admit to being torn about the future direction of the economy and risk assets. The macro and policy backdrops are extremely complex. Our best models and leading indicators are cautious towards the S&P 500 and the US economy. However, we recognize inflation is falling persistently and that the US economy is proving far more resilient to interest rate increases than we expected several months ago. We believe the odds of a mythical "soft landing" have been steadily rising to around 50% or greater.

We begin calendar 2023 more positive on risk assets. The single most important macro factor in the year ahead will be the persistent decline in the rate of inflation. Eventually, the Fed will acknowledge lower inflation in its policy trajectory. While we remain skeptical of rate cuts in the second half of this year, just the Fed going on hold should be enough to lift animal spirits and reflate earnings multiples. Currently, the six-month rate of change on the headline CPI Index is +0.164% or close to zero. The CPI is now down slightly over the last three months. This is a major constructive change from the first half of 2022. The 1975 playbook could be the appropriate analogue for 2023. In '75, inflation plunged from atrociously high levels of 12.3% in December 1974 to 6.9% in December 1975. The S&P 500 Index responded by rallying non-stop to finish the year higher by 31.55%. The fly in the ointment of this analogue is that a recession could still be ahead of us instead of behind as it proved to be in '75. A glass half full view is that we already had two consecutive quarters of negative GDP growth (recession) in 1Q and 2Q of 2022. A 2023 recession is highly anticipated and is the consensus view from economic forecasters. We believe a recession is at least partly discounted in the prices for stocks and bonds.

Exhibit 5: Inflation is Running Below 1% on a 3 and 6-Month Rate of Change Basis

Source: Capital Creek Research, Bloomberg

Exhibit 6: The 1975 Falling Inflation Analogue is Exceptionally Bullish for Stock

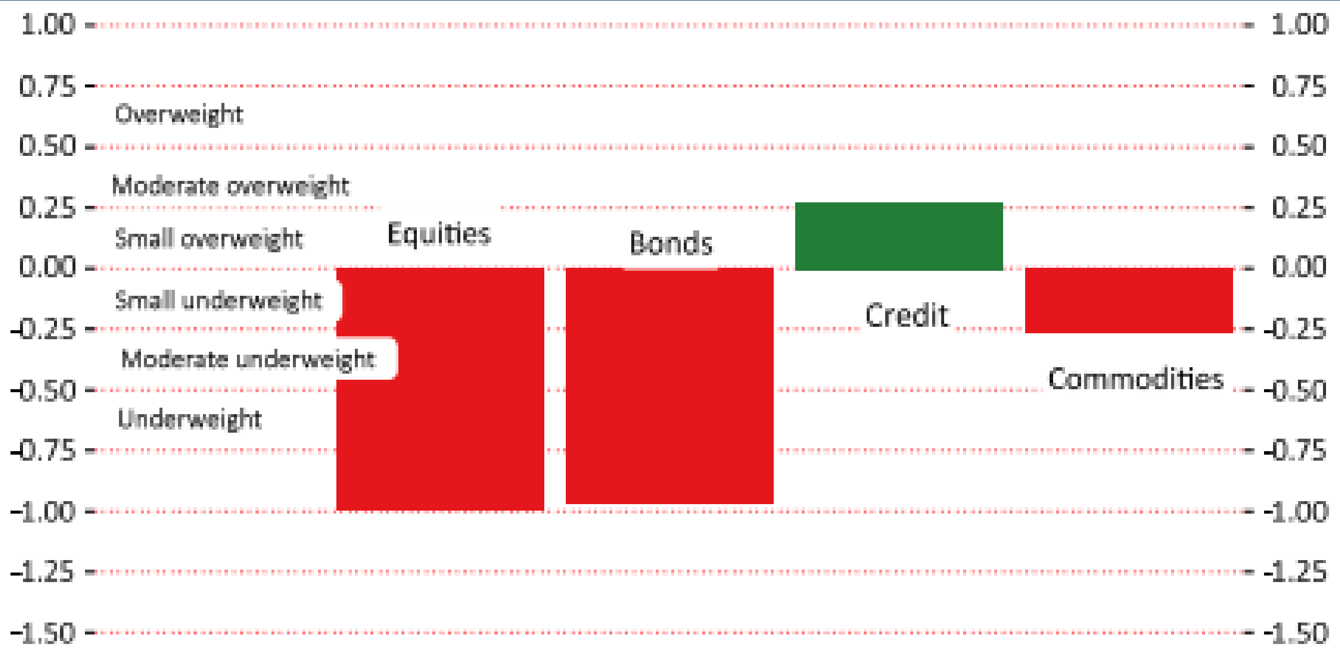
Source: Capital Creek Research, Bloomberg

CCP Allocation Models

We start to think about the path forward by turning to two of our most trusted models. The Capital Creek/AGMR Tactical Asset Allocation Model remains heavily underweight both equities and bonds. The model indicates a very modest overweight to the credit asset class along with an underweight to commodities. This model is being driven by a lower ISM Manufacturing Index forecast, a forecast for higher unemployment, and ultimately an economic recession set to begin sometime in 2023.

Exhibit 7: The CCP / AGMR Tactical Asset Allocation Model Remains Cautious on Risk Assets

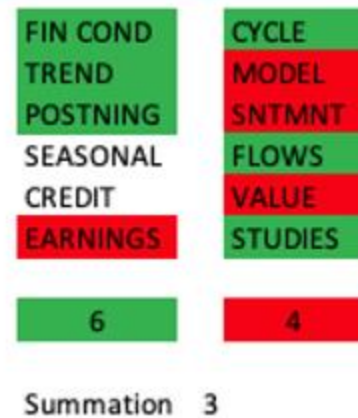
Source: AGMR, Capital Creek Partners Research; Note: The Reflects Standard Deviation Return Forecasts Compared to Long Run Averages as of February 2023.



The Capital Creek Tactical Equity System Model (TES) indicates a bullish to neutral outlook for the S&P 500 Index over the coming six months. In this factor model, we grade out the 12 key factors that typically impact the direction of the US equity market. The bullish factors now outweigh the bearish factors by a count of 6 to 4. The model's 60 indicator summation index is neutral at +3. This is a major improvement from 2022 when the model was extremely bearish through October. To get a buy signal on TES, we would need to see 7 of 12 factors turn positive without additional negative factors. If equities consolidate the recent rally and allow sentiment to correct from excessive short-term optimism, we could see TES confirm a new bull market.

Exhibit 8: Tactical Equity System (TES) as of February 6, 2023

Source: Capital Creek Partners Research



Early in 2023, the Fed remains a headwind to equity and bond performance by continuing its hawkish stance on monetary policy despite what is becoming a persistent flow of indicators pointing to meaningfully lower inflation. The Fed has been clear and unequivocal in indicating that policy rates will continue to be raised in early 2023 and will then likely be on hold in restrictive territory for the remainder of the year. Quantitative tightening or QT is the mechanical reduction in the size of the Fed's balance sheet. QT is running in the background and is reducing the size of the Fed's balance sheet by a significant $95 billion per month. Nobody, including the Fed really knows the ultimate implications of this large amount of balance sheet shrinkage. We do know QT is not positive for monetary growth or economic

growth and is likely depressive for asset prices. The Fed's current cocktail of raising policy rates combined with QT is reducing liquidity and will likely be a challenge to higher asset prices.

Another factor that we weigh heavily in our analysis of the year ahead is the overall trend in asset prices. We don't like to fight the Fed, fiscal policy, or trend. For the first time in many months, price trends are no longer bearish and appear to be in the process of changing. The trend in the S&P 500 and the trend for 10 US Treasury yields are at key inflection points. In our view, a persistent and faster than expected decline in inflation is what is needed to put the Fed on hold and spark sustainable rallies for risk assets in 2023. We are increasingly open to this possibility.

Our most trusted Leading Economic Indicators, including the ECRI Long Leading Index and the AGMR Leading Indicator are both signaling a high probability of a US recession in 2023. In addition, the message from the US Treasury yield curve is unequivocal. The yield curve is inverted at virtually every tenor and is the most inverted it has been since the early 1980s. An inverted yield curve has a strong track record of forecasting US recessions. We understand that markets are dynamic and constantly evolving. We will be watching our indicators carefully and monitoring for new signals and trend changes. Maintaining flexibility will be paramount in 2023 and we will shift our strategic positions accordingly as the facts and circumstances change.

Exhibit 9: The uptrend in US 10 Year Treasury bond yields remains in force

Source: Capital Creek Partners Research, Bloomberg

Exhibit 10: The downtrend in the S&P 500 Index (SPX) appears to be broken.

Source: Capital Creek Partners Research, Bloomberg

Exhibit 11: A deeply inverted US 2-30s US yield curve is signaling economic recession in 2023 or 2024. Our view is that if a recession occurs at all it will be postponed into 2024.

Source: Capital Creek Partners Research, Bloomberg

Exhibit 12: U.S. 10-Year Treasury Yields

Nothing symbolizes our regime change theme more than this very long-term chart of US 10-Year Treasury yields. The forty-year era of low inflation, easy money, and extremely low interest rates is probably over. This chart has tremendous implications for future returns in 2023 and beyond.

Source: Capital Creek Partners Research, Bloomberg

Exhibit 13: Back-to-back annual declines for SPX have only happened four times in the last 100 years

Source: Yardeni Research, Standard and Poor's, Haver Analytics

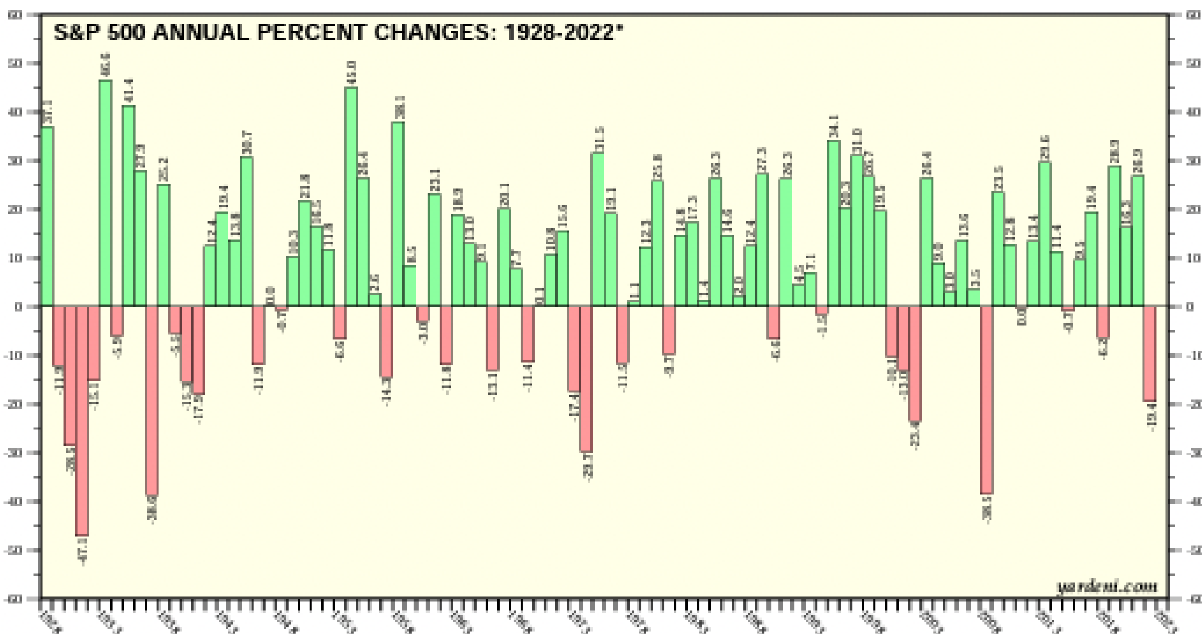
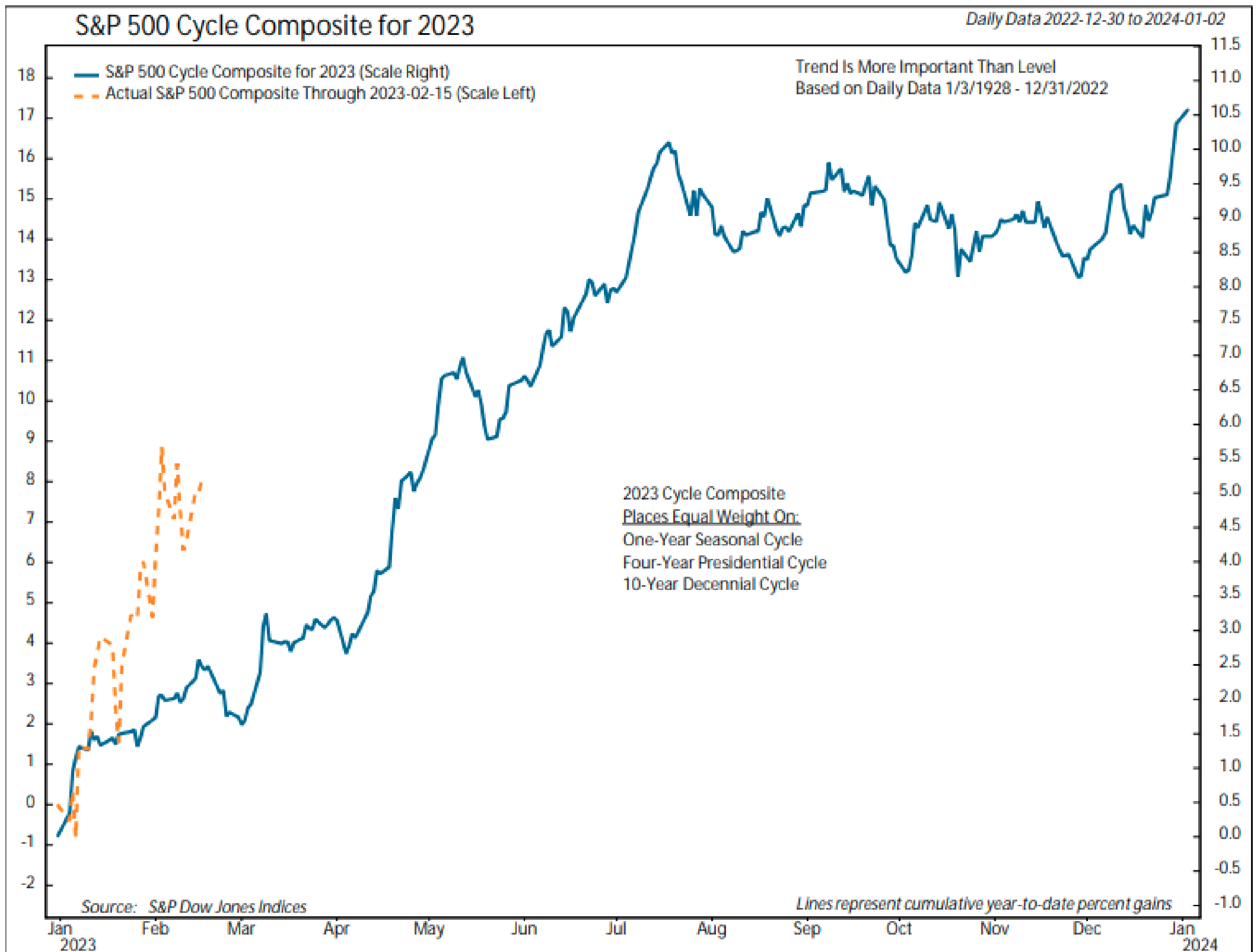


Exhibit 14: The NDR cycle composite points to a strong year in 2023

Source: Ned Davis Research



SPX Scenario Analysis

Base Case (50% probability): The SPX charges out of the gates and has a strong first half of 2023. Inflation continues to decline, and the US economy slows but avoids a classic NBER recession. Corporate earnings fall modestly as margins come under pressure from higher labor costs and reduced corporate pricing power. A high-quality buying opportunity develops in the third quarter and SPX rallies to finish the year in a range of 4,200-to-4,500. This is a decidedly more constructive outlook than the consensus which expects flat to down equity prices in 2023.

Bull Case (25% probability): Inflation falls faster than the markets are currently discounting. The US and global economies avoid recession. The Fed responds to much lower inflation by holding rates steady for most of the year and then cuts rates twice in 4Q23. The reversal of China's Zero Covid Policy and renewed stimulus efforts are much more successful than expected and help to underwrite a faster growth rate in emerging and developed markets. A new equity bull market proves to be underway since last October. The

index finishes the year back above 4,500 and perhaps near the old highs of 4,800. New all-time highs are not out of the question in 2023.

Bear Case (25% probability): Inflation remains stubborn and even reverses back higher as the US labor market remains surprisingly strong. The Fed responds by taking policy rates deeper into restrictive territory above 6%. The labor market cracks hard in the second half of the year and a recession takes hold in the US. Earnings come under heavy pressure and decline 10%-to-20%. SPX bottoms in 3Q23 around 3,000 on a traditional bear market multiple of around 15x forward earnings of $200.00. The Fed responds to the recession and begins to cut interest rates. The market rallies sharply off depressed levels to finish the year around 3,500 or down around -10% for the year.

The weighted average of these three scenarios yields a year-end SPX target of 4200, up approximately 10% for calendar 2023. Key to our thinking is that the high to low price range could be unusually wide this year (3,500 to 4,500 or 30%), which could present excellent tactical asset allocation opportunities as the year progresses.

Exhibit 15: SPX Forward P/E Ratio back to 25-year average at year-end 2022

Source: JPMorgan

Valuation measure	Description	Latest	25-year avg.*	Std. dev. Over-/under-Valued
P/E	Forward P/E	16.65x	16.82x	-0.05
CAPE	Shiller's P/E	27.96x	27.93x	0.01
Div. Yield	Dividend yield	1.81%	1.99%	0.53
P/B	Price to book	3.42x	3.10x	0.40
P/CF	Price to cash flow	12.42x	11.19x	0.56
EY Spread	EY minus Baa yield	0.17%	0.27%	0.05

The Case for Cash

Cash is no longer trash. With three-month US Treasury bills yielding 4.75% and one-year Treasury paper at 4.95%, savers are now getting paid reasonably well to save and protect capital. Of course, at current

rates of headline inflation running north of 6%, savers are still losing purchasing power in real terms. However, if the Fed raises policy rates above 5% as expected and inflation continues to fall, modest real returns should become available on short-term risk-free paper later in 2023.

Three-month bill rates have been at or near zero in 9 of the last 15 years. Investors have been starved for yields during this period of financial repression. With equities arguably still somewhat expensive, it makes sense to have several percentage points of capital in cash. Cash does not just guarantee a positive nominal rate of return, it provides investors optionality in the form of available capital to deploy into market dislocations. Most investors substantially undervalue this cash option in our view. Returns on cash are now competitive with equities. Over the last hundred years, US equities have produced total returns of around 8%. You can now get almost 60% of that long-term return in cash while taking little risk.

As we move deeper into a period of investment Regime Change, we think it makes great sense to allocate anywhere from 2% to 5% of a median risk portfolio to a laddered portfolio of 3-month Treasury bills, 6-month bills, and 1 & 2-year Treasury notes. If inflation remains more persistent and the Fed continues to hike, the shorter maturities can be reinvested at higher yields. Conversely, if recession strikes and yields fall, some solid yields are locked in for up to two years. This cash strategy adds ballast, diversification, yield, and optionality to a well-constructed portfolio.

Exhibit 16: Cash is suddenly competition for stocks and bonds

Source: Capital Creek Partners Research, Bloomberg

Commodities

Our view is that a commodity "super cycle" was born back in the depths of the pandemic in 2020. The asset class had just gone through a twelve-year cycle of underinvestment and horrendous returns for investors. Businesspeople, investors, investment banks, and hedge funds cleared out of the asset class leaving it for dead. 2022 was a corrective year for commodities as the rallies of 2020 and 2021 were consolidated. See Exhibit 17.

The commodity asset class fits very well with our view of a regime change or new era of investing. The commodity super cycle story begins with underinvestment in supply which occurred from 2008 through 2021. Underinvestment was caused by low returns on investment resulting from depressed commodity prices from 2008 through 2020. Investment was also retarded by investors discouraging capital spending in favor of dividends and buybacks. Many institutional investors such as pensions and endowments had Boards pushing in favor of ESG investment principles which steered capital away from dirty investments like fossil fuels, metals, and agriculture.

In recent years political winds have shifted in favor of labor over capital. We see this very clearly in the policies favored by the Biden administration. Trillions of dollars were printed and transferred into the hands of middle- and lower-income groups who were ready to spend it. Much like the late 1960s Great Society programs, these populist fiscal policies have proven to be inflationary. Commodity markets historically thrive during periods of rising inflation, especially when supply curves are constrained. The increasingly tight knit relationship between Putin and Xi Jingping is another piece of the super cycle puzzle. Russia is now almost a vassal state supplier of commodities to an aggressive and hungry China. These supplies that were once put on the free market are making their way to China and to a lesser extent, India at reduced prices. A bellicose Russia has learned how to weaponize its natural resources to punish the west through higher inflation. Resource nationalism is probably here to stay.

The massive energy transition will require copious amounts of commodities to bridge the future from fossil fuels to cleaner sources of energy. We are just starting this 30-year journey and it will require tremendous amounts of uranium, copper, cobalt, lithium, rhodium, aluminum, oil, and natural gas. Projections from Goldman Sachs among others indicate that the world may face critical shortages of these key strategic commodities in coming years. China and Russia would like to engineer these shortages to undermine western democracies.

The trends described above are longer-term in nature and will likely result in higher-than-expected commodity prices in the years ahead. We believe investors should understand the bullish backdrop for commodities and add them to their asset mix for at least the next five years. This exposure could add to returns, reduce portfolio volatility through diversification, and protect investors from structurally higher inflation in the years ahead. The commodities we favor the most are oil, copper, aluminum, nickel, zinc, silver, gold, corn, and soybeans.

Exhibit 17: Commodities consolidating in a super cycle bull market

Source: Capital Creek Partners Research, Bloomberg

Role of Private Market Investments

Since the founding of our firm, we have stressed the importance of private market assets in portfolio construction and the benefits of diversification and improved risk adjusted returns. We were quite negative on public equity and bond markets coming into 2022 after the incredible rise in all asset prices post the massive amount of stimulus provided to fight the negative economic impacts of Covid. Valuations for bonds and equities were quite stretched especially bonds with the long tail of zero interest rate policy adopted by the Fed in 2020. Additionally, we favor allocating capital to skilled investors in the private markets that stick to a disciplined investment approach and understand the benefit of dollar cost averaging across vintage years. We will continue to work with each of our clients to determine the right amount of liquidity in their portfolios and help customize their private market allocations to reach their respective goals and objectives.

Client Portfolio Implications

If we are correct about a new investment regime, it will require some changes to client portfolios at the margin to protect and grow wealth. Importantly, both equities and fixed income securities reset in

valuation terms in 2022. Unfortunately, despite a bear market for stocks and a devastatingly bad year for bonds, neither asset looks statistically cheap on traditional valuation metrics. Nevertheless, forward returns for both core assets are significantly higher than at the start of last year. Since 1990, when the last regime began, there have been precious few opportunities to buy stocks or bonds at historically attractive valuations. If we are right that we are in a new investment era post 2020, great buying opportunities may happen more often. This is supportive of our call for clients to have higher levels of cash on hand to take advantage of potential dislocations in risk assets.

Our game plan for 2023 is to add to stocks, bonds, credit, and commodities opportunistically on declines. If our view on 2023 is correct, we should get our opportunities to enter risk assets at favorable levels.

Rebalancing

- Our game plan is to rebalance client portfolios closer to their target levels on an annual basis. This is good investment discipline and keeps portfolios from becoming too concentrated in expensive assets. In addition, annual rebalancing allows clients to buy low and sell high after a full year of price action.

Getting to Target Allocations

- After appropriately keeping client portfolios heavily weighted toward cash in 2022, we see 2023 as the year to get client allocations much closer to longer-term target levels. If we are correct in expecting high volatility again this year, the timing could be very advantageous.
- We are firm believers in the positive long-term outlook for capitalism, innovation, and growth in the US economy and corporate profits. We have set our targets with this in mind and plan to move opportunistically to invest capital when the timing is favorable.

Concluding Thoughts

The year 2022, was one of the worst years in investment history for traditional portfolios consisting of 60% equities and 40% bonds. A negative confluence of events from high inflation, plunging liquidity, energy crisis, high valuation, extreme Fed tightening, a major war in Europe, and an ill-advised Zero Covid Policy in China all combined to punish portfolios. There was literally nowhere to hide outside of commodities and energy. Our analysis of the year ahead tells us to expect some positive change to these dynamics in 2023. Consequently, we will be patiently looking for opportunities to invest your wealth across a broad range of diversified investments at what we deem to be attractive prices. The future is likely to be brighter than the very dark recent past. We will be investing your assets accordingly to preserve and grow your wealth and purchasing power for current and future generations. We deeply appreciate your partnership with our firm, and we look forward to earning your trust again in 2023.

Appendix: China, The US Dollar, and Key Investment Themes for 2023

The Path for China in 2023

The coronation for Xi Jingping was completed in 4Q22 at the 20th Party Congress. Xi is arguably the most powerful person in the world with practical control of over 1.5 billion humans. Xi has proven to be an enigmatic leader and his path to ever greater power has not resulted in strong domestic growth and it certainly has not rewarded shareholders. Xi has embarked China on a confrontational path with the US that shows no signs of changing. However, now that he is secure in his quest for a third term and perhaps a life term, he has dramatically shifted China from the failing Zero Covid Policy (ZCP) to a more pro-growth set of policies. Starting in late November of 2022, China began a 180-degree shift from ZCP to a "let it burn" policy of ignoring Covid and gunning for faster economic growth. This shift was in response to the ineffectiveness of ZCP combined with mounting protests over continued lockdowns, falling property prices, high youth unemployment, and the slowest growth in forty years.

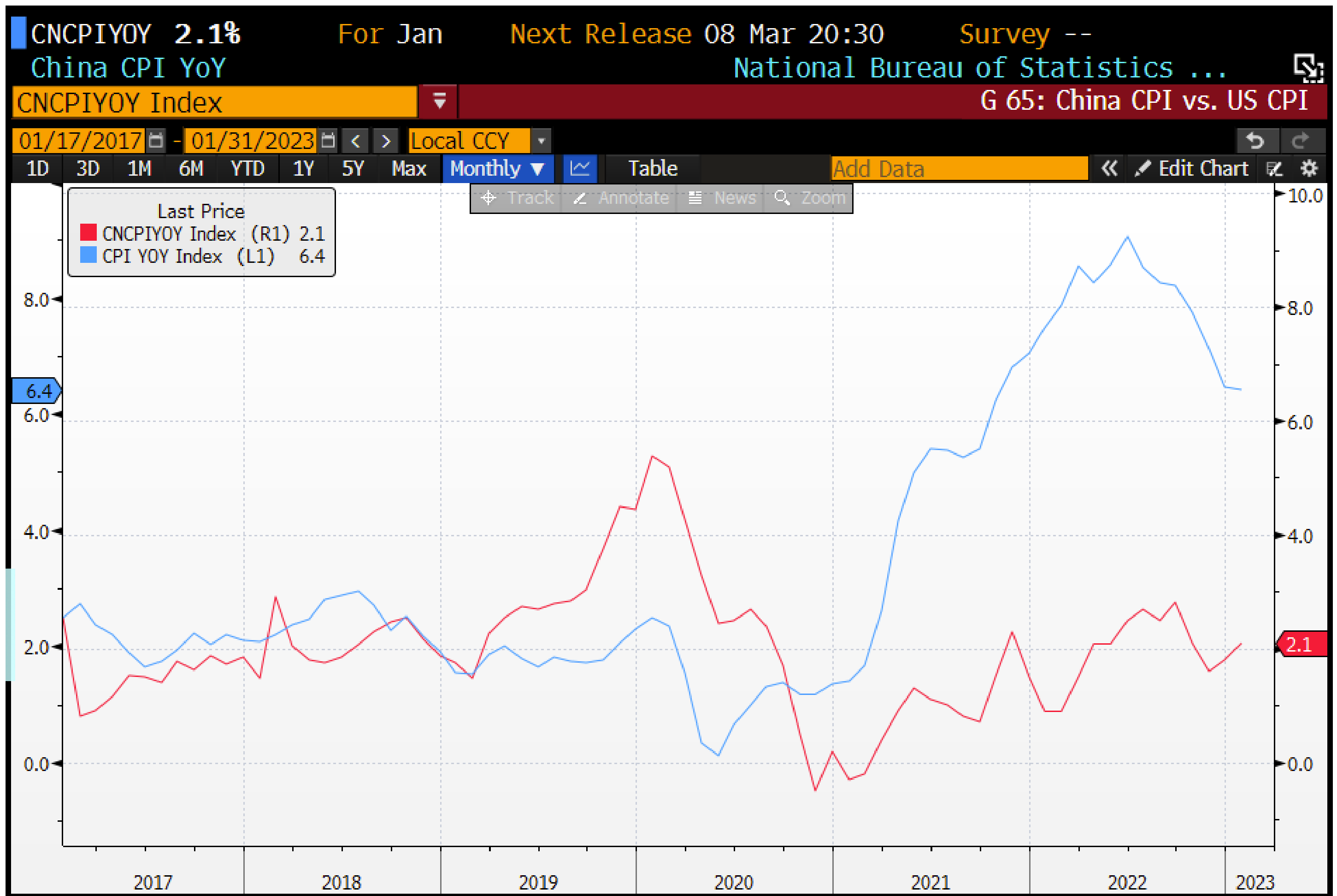
We believe this major policy shift could have profound implications for global growth and risk appetite in 2023. Not only has Xi dumped ZCP, but he has also shifted the focus to backstopping the property market by pushing banks to extend financing to failing property developers (extend and pretend) who took on too much debt and built too many offices, retail malls, and especially apartments. The real estate downturn in China is going into its third year and combined with ZCP is responsible for much of the slowdown that has pushed Chinese growth down into the low single digits. In 2022, Chinese growth finally hit weak enough levels to trigger high youth unemployment and widespread protests. That was enough to move Xi to flip from austerity to growth. The question is how aggressive the growth campaign will be in 2023. Our answer is that it will be a significant change, but it will not resemble the opening of the floodgates approach that characterized the massive stimulus efforts of 2008-2009 when China and the Fed helped pull the global economy out of the Global Financial Crisis (GFC).

The global macro backdrop is now somewhat more complicated by the world's two largest economies moving in different cyclical rhythms. The Fed is trying to slow the US economy to take pressure off the labor market. At the same time the Chinese government is trying to stoke growth and strengthen the labor market. The Fed is constrained by high inflation, while the Chinese government has the benefit of low inflation. The planet's two largest economies are in completely different cycles now. China has the luxury of policy flexibility while the Fed should remain constrained for most if not all of 2023. The global economy has one foot on the gas (China) and one foot on the brake (USA). A more pro-growth set of policies out of China could take a global recession off the table in 2023.

A stronger Chinese growth trajectory combined with more government sponsored liquidity should be bullish for Chinese equities, emerging market equities, commodities, oil, gold, and the CNY currency. Conversely, Chinese government bonds (CGBs), the US dollar, and even US Treasury bonds could suffer from stronger Chinese growth.

Exhibit 18: Chinese inflation is way below that of the USA—providing PBOC policy space to ease.

Source: Capital Creek Partners Research, Bloomberg; Note: red line is China and blue line is US



US Dollar View

We enter 2023 with a bearish view on the US dollar. Following a decade long rally that took the dollar from statistically cheap to more than 2 standard deviations rich, we think the dollar has significant downside ahead. The main driver of dollar upside last year was the Fed's ferocious tightening campaign and the resulting rate differential in favor of the buck. That trade is over now that the Fed is nearing the end of its tightening campaign. Once again, lower inflation is a key ingredient in this call. Last year, money piled into US assets as a safe haven. If we are correct about 2023 being a better year for risk assets, then it makes sense that money will flow back to non-dollar assets which are much cheaper and offer more yield.

Many have forgotten that the US has several structural issues that could make for a long bear market in the dollar. These include the gradual loss of dollar hegemony, massive budget, trade, and current account deficits. Throw in the fact that China and Russia are working hard to undermine the US reserve currency status and you have a potentially very bearish cocktail. We could also see China's Central Bank Digital Currency (DCEP) launch this year which could spook dollar holders and create flows into the digital Yuan as an alternative.

The Biden administration has mishandled the relationship with Saudi Arabia and has unwhittingly pushed the Saudis closer to China and Russia. Saudi is currently negotiating to sell many more barrels of oil to China denominated in Yuan. If this comes to fruition, the dollar could lose one of its critical reserve currency supports that has held for over fifty years.
Technically, the dollar uptrend has been decisively broken in recent months leading us to believe a new important downtrend is underway.

As a result of our bullish view on commodities and our bearish view on the dollar, we are very bullish on gold for 2023. Extremely hawkish Fed policy along with a correspondingly strong dollar have kept gold prices pinned down for the last 18 months. We see this backdrop fundamentally changing to a much more gold friendly one. Retail investors have stopped selling gold ETFs and Central Bank purchases have reached the highest levels in many years. China, Russia, and India have been very strong buyers as they perfer to avoid US dollar investments over the long-term. Our year end target for gold is $2,200 or up over 15% from current levels.

Exhibit 19: The US dollar appears early in a bear market

Source: Capital Creek Partners Research, Bloomberg

Exhibit 20: The Citi Broad Real Effective Exchange Rate (REER)—Got over two standard deviations above mean in 4Q2022. In our view, the dollar has peaked for the cycle.

Source: Capital Creek Partners Research, Bloomberg

Investment Themes for 2023

1. **From Benign Globalization to Great Power Competition.** We believe this is the defining theme of the 2020s. The US and China have divorced and will be working actively against each other's interests for the foreseeable future. The implications are higher inflation, greater defense spending (arms race), the struggle for energy/food independence, greater need for cyber security, greater cap-ex spending for reshoring/friend shoring, lower unemployment plus higher wages for US employees, and more inventory building for goods and commodities. Asset allocation impact: long commodities; long US defense primes; caution toward long duration US Treasury bonds. Chinese equities are tradeable (we are bullish), but fundamentally uninvestable for US based clients over the long term.

2. **Energy Transition.** Estimates are that the globe will spend approximately $130 trillion on energy transition over the next 30 years. This is the biggest spending bonanza of our investing lifetimes. It will require a massive amount of hydrocarbon energy and commodities to bridge the world to a

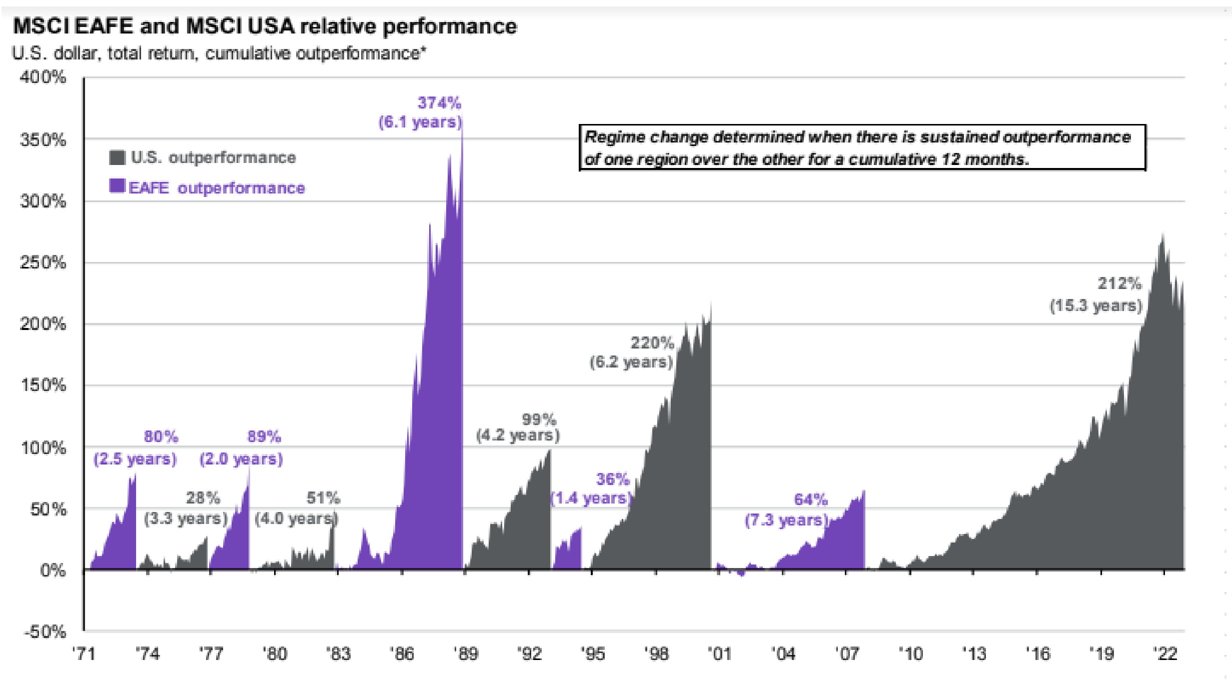
greener future. Asset allocation impact: long oil, natural gas, copper, aluminum, nickel, and uranium. Long energy equities (XLE), oil service equities (OIH), global metals and mining equities (PICK), clean energy equities (ICLN), global carbon credits (KRBN), and uranium miners (URNM). The energy transition theme promises to be inflationary due to massive amounts of spending, much of which will likely be "printed" by governments, due to slower growth and tax revenue shortfalls. Once again, long duration US Treasury bonds should be viewed cautiously in most portfolios.

3. **Higher Global Interest Rates.** The long and durable trend of falling interest rates in G-10 countries is over. In the US, inflation is likely to settle into the 3%-to-4% range due to numerous tailwinds including themes #1 and #2. Given the higher resting heart rate for inflation, investors are likely to demand a much higher term premium for longer duration bonds. US 30-year bond yields are headed into a range of 4% to 6% in coming years. The bear market for bonds is just getting started. Asset allocation impact: avoid long duration Treasury bonds; avoid large capitalization technology stocks that have benefited from future cash flows being discounted at artificially low interest rates.

4. **Head East.** The best equity values are to be found outside the USA. The US S&P 500 has massively outperformed non-US markets since the onset of the Global Financial Crisis in 2007. Non-US markets are early in an outperformance regime that started in the second half of 2022. Valuation, higher dividend yields, a weaker US dollar, and mean reversion all favor non-US markets in 2023. Asset allocation impact: overweight ACWI ex-USA; overweight Emerging Markets; overweight Japan equity in local currency (EWJ); overweight small cap value equities in the USA (VBR); underweight large cap US technology stocks (QQQ).

Exhibit 21: Outperformance by USA is the longest and strongest on record. It's probably over.

Source: JPMorgan



5. **Physical Assets over Digital Assets.** In 2023, we want to keep client assets focused on physical assets. These include real assets or companies that make tangible things that are necessary to live in the physical world. Think oil, metals and mining, housing, industrials, and capital goods. Ownership of these old economy physical goods makers should come at the expense of owning large cap technology stocks, metaverse/Web3, or crypto currencies. Digital assets became overinflated during the Fed's QE mistake and now they need to spend time in the penalty box and work down their valuations. Higher interest rates will weigh on long duration assets that have most of their cash flows in the distant future. Terminal values will be further compressed by higher discount rates. Tech has proven to be more cyclical than most investors expected with earnings and employment being cut as advertising spending slows. Greater regulation appears to be on the way for tech which will be an overhang. The focus for 2023 will be on reasonably valued free cash flow generators that can pay dividend yields closer to the rate of inflation. Asset allocation: overweight XLE, OIH, PICK, GDX, and DBC; underweight IYW, SMH, NDX, and Bitcoin.

6. **Peaking Inflation.** Inflation across the world exploded over the last two years as the Fed and other Central Banks made a monetary policy mistake at the same time fiscal authorities overspent money they did not have. These policy mistakes are in the past, at least for monetary policy as global central banks are fighting inflation with all their might. Inflation is likely to decline consistently in 2023. Inflation in the US should average around 3%-4% in 2023. Asset allocation implications: own international equities (ACWX), (EEM). Own small and mid-cap equities in the USA (VBR), (IJR), and (MDY).

7. **Japanese Equities are Best Contrarian Equity Investment in the World Today.** Japanese equities are cheap at 2.2% yield, 14x earnings, 1.5x book value, 1x sales. Japan is heavily underweighted in portfolios. The NKY Index is full of old economy companies that make physical goods. Companies like Toyota, Sony, and Shin-Etsu Chemical. Japanese equity indexes have very little technology exposure. High inflation is bearish for equity markets except for Japan, which has been battling to exit deflation for 30 years! Inflation in Japan is now running a still moderate 2.8%. With inflation up and fixed income securities yielding a paltry 5 to 48 basis points, investors will be exiting fixed income for equity. The weak JPY is also a thing of the past, now that yield curve control is normalizing. We believe USD/JPY could fall from 133 down to 115, which would be a huge bonus for US investors. Japan is likely to have the developed world's best performing equity market in 2023. Asset Allocation impact: long EWJ.

8. **Maintain Value Over Growth Bias.** If 2023 proves to be another difficult year for investors with a significant drawdown for risk assets, then value-oriented equities should decline less than their more expensive growth brethren. What was surprising about 2022 was that "growth" equities, namely technology companies proved to be far less defensive and much more cyclical than expected. Investors had to learn once again that business models built on advertising spending can

come under severe pressure. Google (GOOG) and Meta (META) are examples of businesses that came under pressure from lower advertising as the global economy began to slow. Value oriented companies including Industrials, Energy, Metals & Mining, and Financials are likely to hold up much better than growth stocks if recession strikes later in 2023. Value companies are under owned, have lower valuations, higher dividend yields, and in most cases are supported by greater share repurchase programs. Well established technical trends also support value over growth. Full mean reversion in the value/growth relationship looks to be in the middle innings after a decade plus of massive deviation from the mean.

9. **The Return of Deficit Politics.** The recent battle for the Speaker of the House of Representatives is a foreshadowing of things to come in Washington DC. The Freedom Caucus has outsized power to cause chaos over budgeting issues. It will be increasingly difficult to pass spending legislation through Congress. Investors should prepare for a return of brinksmanship over the debt ceiling. It could also become much more difficult to pass further deficit spending to aid Ukraine in the war against Russia. A technical default by the US government is a low probability, high impact event that should not be underestimated. A bear market in equities could be turbocharged on the downside by just such an event. Treasury term premiums could also rise because of a potential technical default scenario. Asset allocation impact: Keep cash on hand to deploy into fiscal chaos.

10. **Resource Nationalism and Weaponization.** Natural resources have become a matter of national security. Increasingly, we envision key commodities such as uranium, oil, natural gas, copper, nickel, lithium, and rare earth minerals will be hoarded by countries that once sold them freely into the marketplace. These strategic commodities are being weaponized by Russia, and the rest of the world is paying attention. We are back to an environment like the early 1970s when OPEC used oil as a geopolitical weapon against the US and Israel. In our view, this is another positive factor in the commodity super cycle story that gives us a greater appetite to add client assets to this still under owned asset class. Asset allocation impact: Add exposure to a passive commodity ETF such as DBC.