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Quarterly Outlook

Q1
2023

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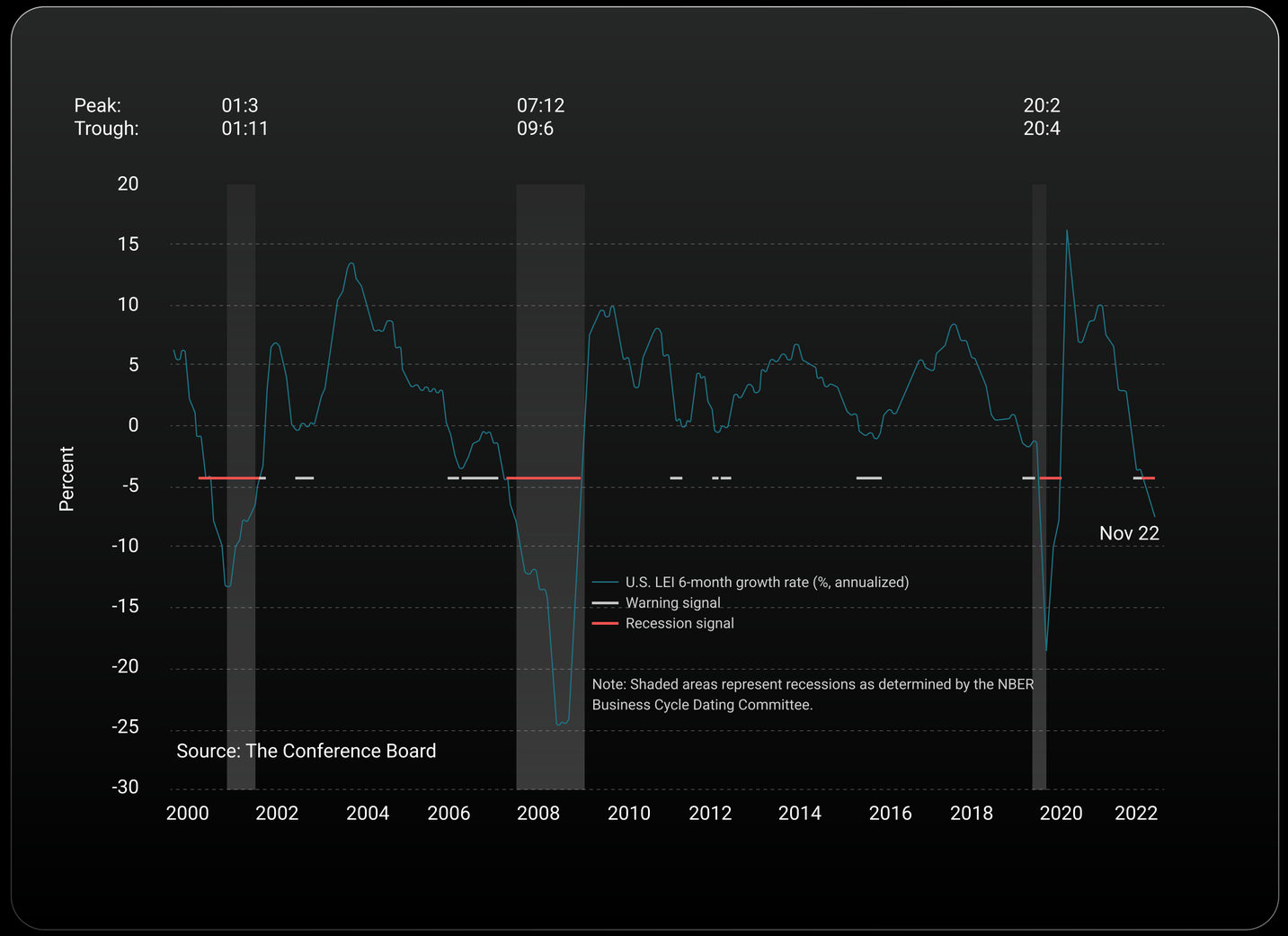
Overview

The year 2022 was tough for the investment world with rising inflation and interest rates plus shrinking equity and crypto markets. Risk appetite across the board diminished substantially as the notion of an upcoming recession is being pushed in the media.

Many financial institutions have issued warnings about the continuation of the bear market in 2023. Opinions vary from heavily bearish, such as the prediction of a “hard landing” from Fidelity Investments, to moderately optimistic from BlackRock, which aims to return to risk assets “at some point in 2023”.

The variation of opinions represents the ambiguity of recent economic data. Some data is relatively strong, such as job openings and payroll employment in the US. The NFP number for December 2022 was higher than expected (263K instead of the 200K forecasted).



Some data displays weaknesses, such as US PMI, which is below 50, and, most importantly, the US conference board economic index, which is currently underwater. This index combines various fundamental indicators and is known as a historically reliable forecasting tool.

Another benchmark that points to a recession is the spread between 10-year and 3-month Treasury bonds: it is deeply in the negative territory, which represents a high level of conviction of investors in the bond market about a potential economic slowdown.

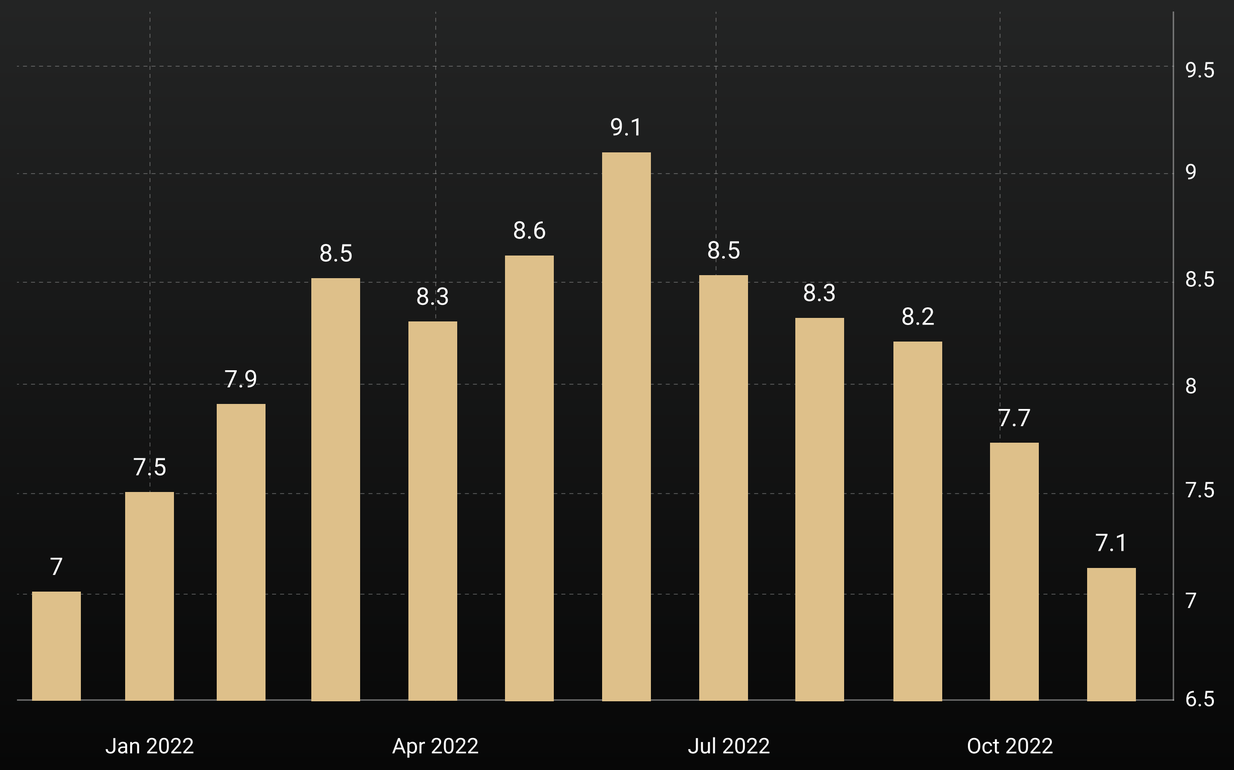
Is there such a thing as a planned recession? The previous two recessions in the US were triggered by shocking events: the recent one was triggered by Covid-19 (it was short and lasted for only two months), and the preceding one was launched by the housing crisis in 2007-2008.

The media narrative about the upcoming “recession” has been called a “necessary economic slowdown” instead by the Fed, while participants in markets have tended not to be so optimistic.

Nonetheless, the “planned” character of the upcoming recession points to potentially slow and choppy action in markets rather than a quick crash with a rise of volatility.

Inflation

Inflation moved down in the second half of 2022, which was the result of rising interest rates, recession fears, and, partially, the world going back to normal after the Covid-19 pandemic. Most countries reopened for travel, and China has finally given up on the “zero-Covid policy”. Recently this resulted in a new variant of the virus in that region, but the narrative in China is focused on reopening with economic recovery.



US annual non-core inflation. Source: Trading Economics/BLS

Current trends

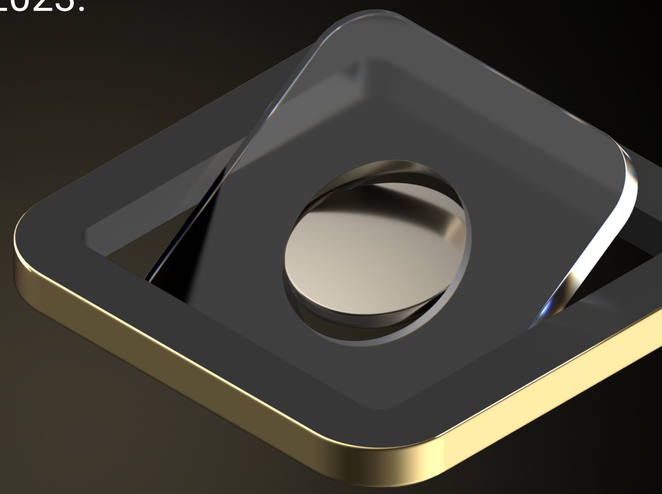
Money in the financial markets is now moving more into the debt market than stock or crypto markets. Europe is facing a potentially tough situation with higher bond yields. For the United States, yields of long-term Treasury bonds could be about to stabilize as the interest rate is expected to reach a plateau of around 5% in the first half of 2023.

In 2020 and, partially, 2021, the “cash is trash” narrative was the main driving force. Today, the narrative is turning upside down; “cash is king” seems more popular. Negative interest rates are gone: money is no longer cheap or free.

In the stock market, the quality of businesses and cash flow they can generate have become priorities among investors. Value stocks outperformed most growth stocks in 2022 and this trend has a chance to continue in 2023. Some “Covid stocks” have plummeted by more than 90% since their peaks in 2021.

Crypto markets might become more regulated after a series of large bankruptcies of crypto projects in 2022, not to crypto winter most investment banks have excluded analysis of cryptocurrencies from outlooks for 2023.

Most trading and investment activity might happen in currency markets as investment yields of different currencies might change and rotate in 2023.



Stock markets

The current observable trend in the stock market is “migration to value”, which puts dividend and value stocks in the focus of investors and traders. If we take a look at the relative performance of QQQ (Nasdaq ETF), SPY (S&P 500 ETF), and VLUE (an ETF of value stocks from VanEck), we see that VLUE has outperformed even SPY and left QQQ far behind.

This is a representation of a new regime: growth stocks are extremely fragile, while value stocks dominate the action.

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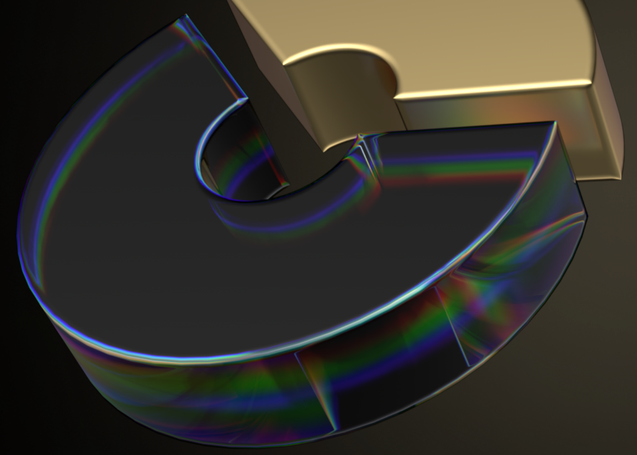
Sectors

We observe similar dynamics across different sectors except for the energy sector, which has held high as disruption of supply and demand for energies remains.



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Possible scenarios

Let’s not forget that, according to fundamentals, the market is still bearish, which means a potential escalation of the downturn this year. However, the bear market still might generate substantial pullbacks, which might drive prices higher aggressively.

Thus, shorting stocks immediately might be not the best idea as a “short-coverage rally” might be around the corner.

This doesn’t mean that picking bottoms would be a good idea either.

What one might expect is rotation between the performance of different sectors of the stock market early in 2023, and maybe already in the first quarter.

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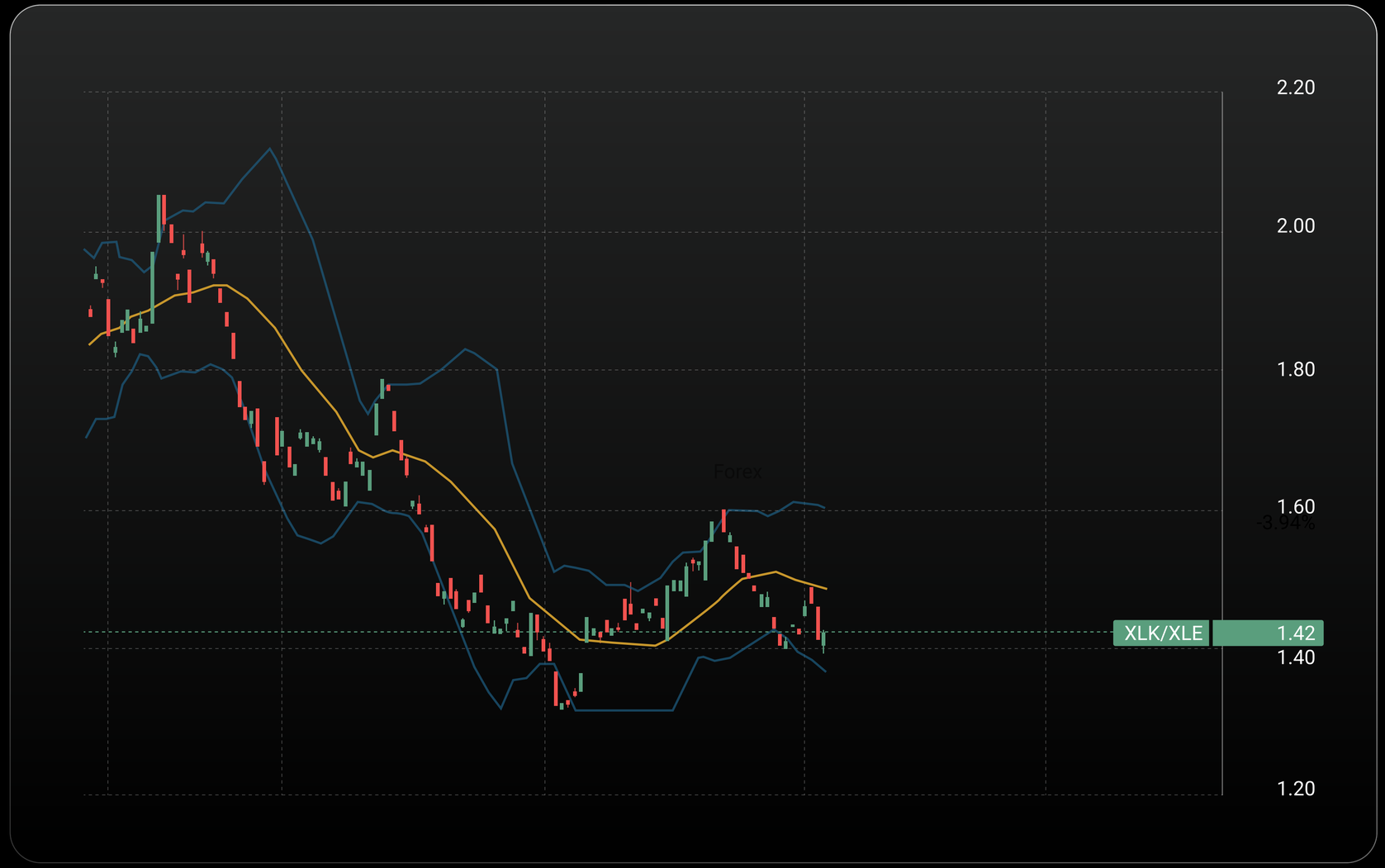
Rotation between tech and energies

Below you see a chart of the spread between the tech and energy sectors from the US stock market, and we observe that tech has been underperforming. If we put a simple Bollinger Bands indicator here, we see that the chart of the spread is close to the bottom of the indicator, which might potentially give fuel for rotation.

Thus, one might carefully select some technological stocks which might pull back in the first quarter, with the disclaimer that the market is still bearish.

Picking buys in a declining trend is quite difficult.



TSLA

The first stock with high potential is TSLA. This is volatile, so it's not suitable for everyone, but it was probably oversold, displaying a parabolic move down as shown on the chart below. If the rotation between tech and energy stocks happens, TSLA might benefit from that and initiate an aggressive short-coverage rally. Of course, one has to wait for confirmation – for example, the price holding a level above the current trendline.

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TSM

Taiwan Semiconductor has performed relatively well in comparison to its competitors from the USA, NVDA and AMD. The semiconductor industry is sensitive to early changes in economic conditions and might rebound sharply if there's a rotation between sectors in the stock market.

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TSM is building a massive “cup-and-handle” formation with a neckline around $78. If the neckline is broken, it’d be possible to observe a further breakout to $100 or higher.

China-related stocks

The reopening of China gave new hope for recovery despite the new outbreak of Covid-19. Considering this and a potential rotation of tech stocks, it's possible to see tech stocks from China at the front of the possibly upcoming pullback.

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BABA

BABA is already showing decent momentum, and if it comes closer to the recent trendline, it might try to break it as shown on the chart.

Bitcoin

Current conditions

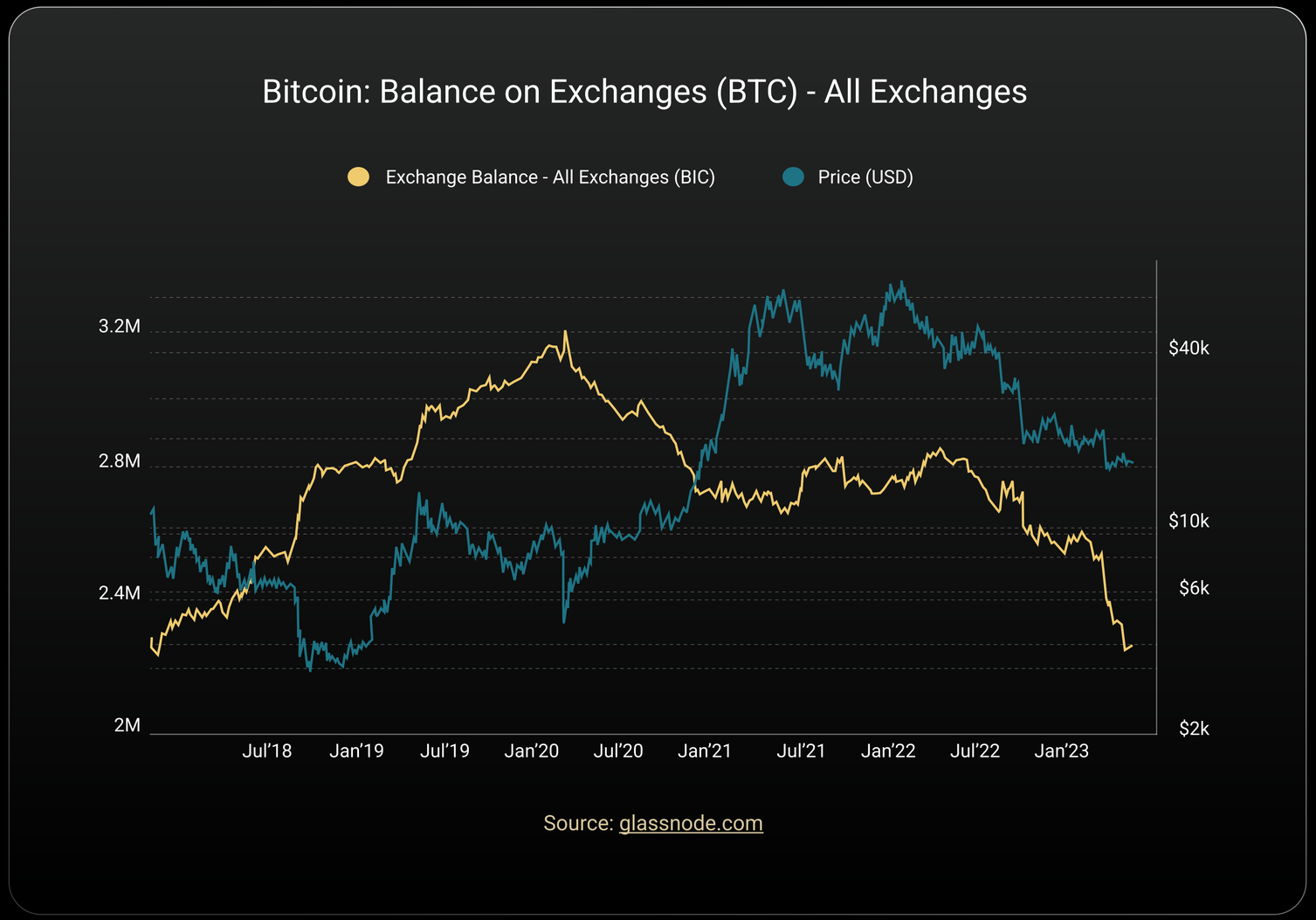
In the third quarter of 2022, the crypto market was down with some coins even hitting 30% of their all-time highs. This drop was based on various factors but one that clearly affected sentiment in the crypto world was the failure of FTX, one of the biggest if not the biggest scandal for cryptocurrency exchanges.

The acceleration of rate hikes by the Fed was also a factor, with triple hikes in late September and early November then ending the year with a double hike in December. The aggressive pace by the Fed pushed investors to more “safe” instruments away from cryptos.

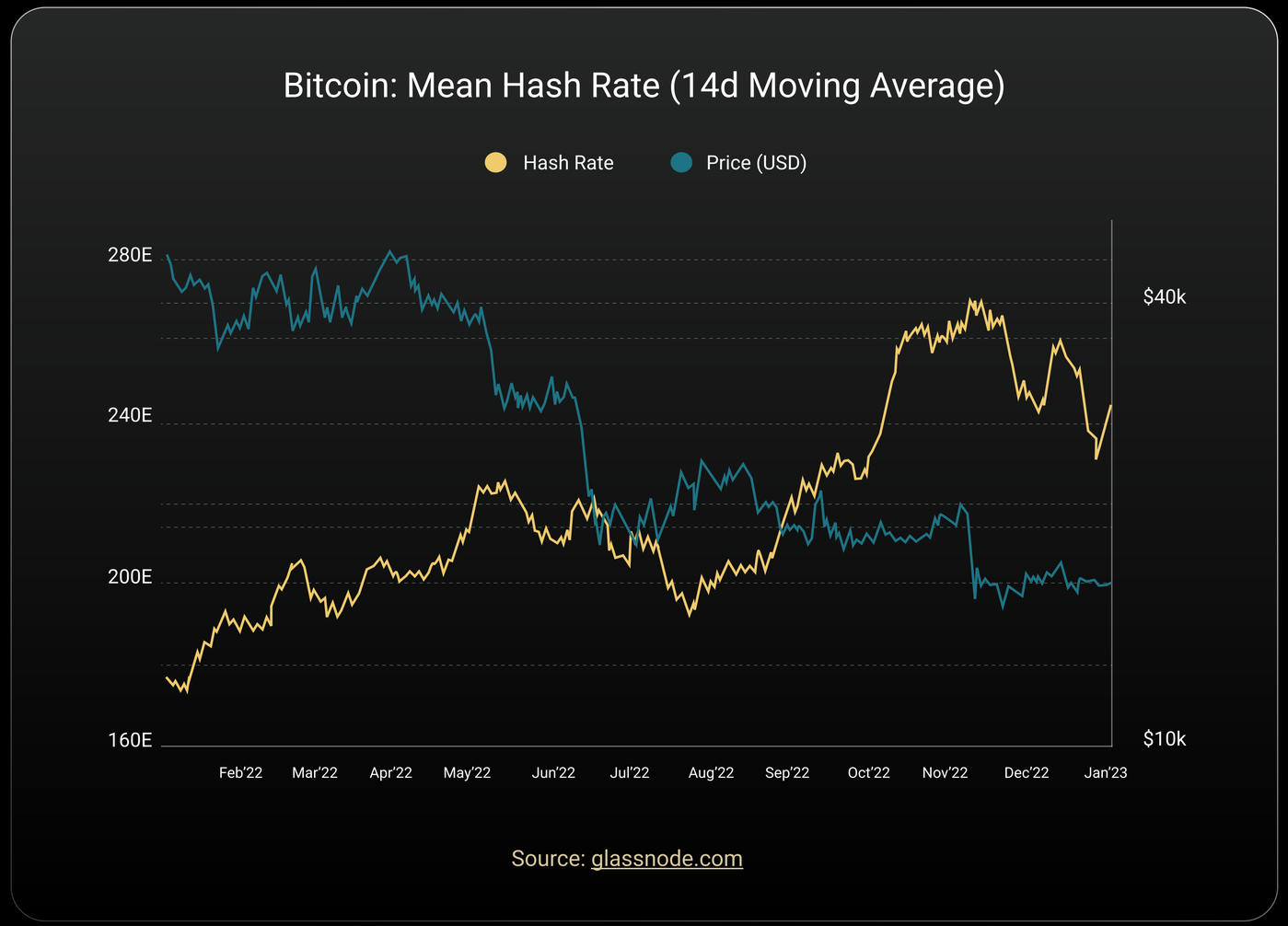
Supply and demand

The Bitcoin reserve on exchanges globally kept dropping since its highest point in 2022 in January. The number of balances picked up very slightly in the last week of that year, possibly after investors kept hoping for a Christmas rally. The lower number of Bitcoins on exchanges might drive a supply shortage and make the price vulnerable to be moved by market makers. The data presented below shows that the number has kept dropping since its all-time high in January 2022.

Following the bankruptcy of FTX and recent articles about Binance failing to disclose key financial information about its operations, withdrawals from multiple exchanges have grown to unprecedented levels. The amount held on exchanges dropped significantly, even at its lowest level since March 2018. The drop could mean that holders want to keep off exchanges and avoid the risk of another exchange going bust, preferring to keep their coins in cold storage.

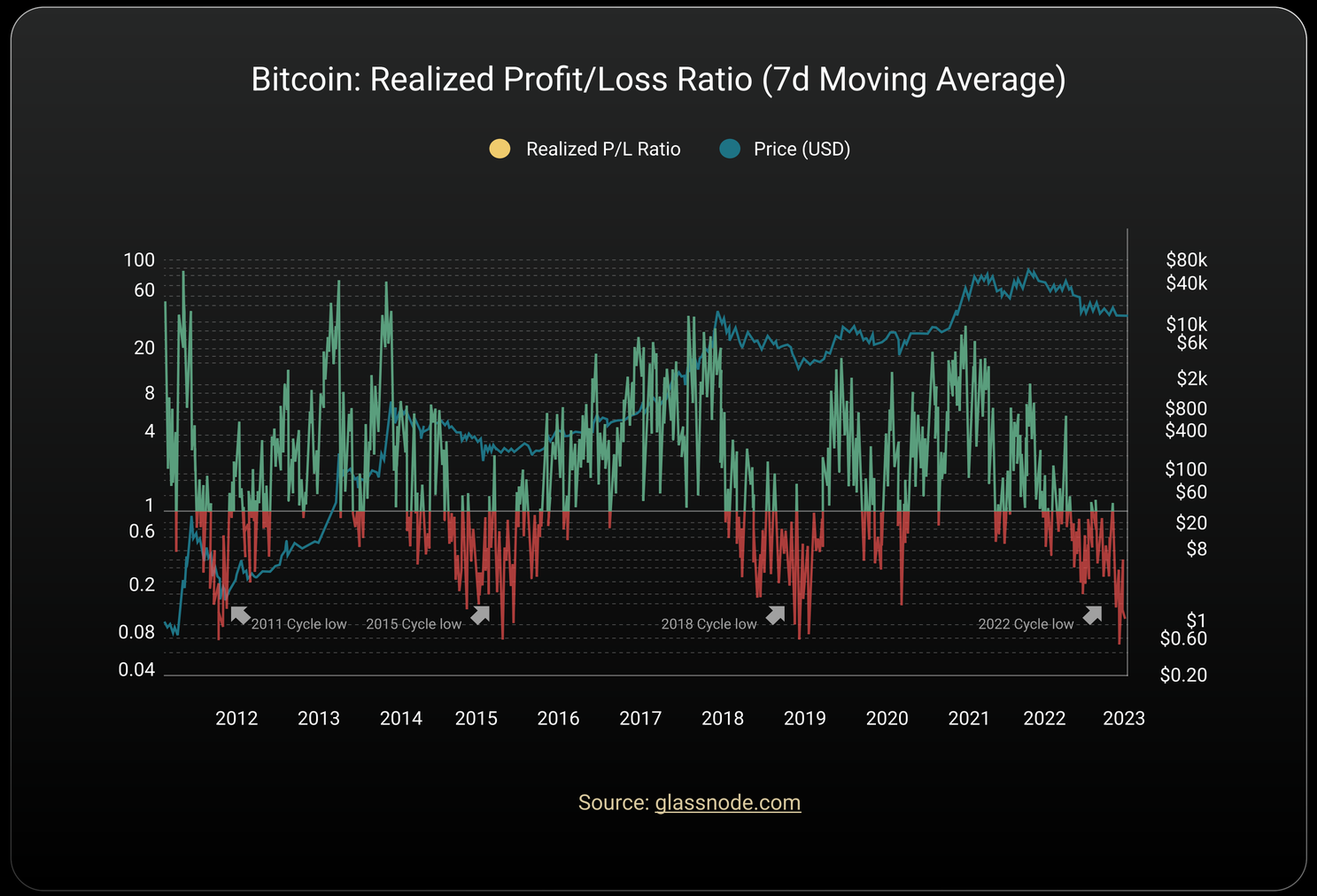


The hashrate took some hits in December, but it managed to increase in the last days of the year and remained higher than in October even though the price fell below $17,000 at the same time. This shows that there are more mining rigs running to secure the network, making Bitcoin more appealing to potential institutional investors.



Advancements in mining hardware and the use of alternative energy sources make Bitcoin mining a better “investment” for smaller miners compared to the norm in recent years; it’s easier now for many miners to generate returns compared to 2021 or early 2022.

Despite the incredible pain crypto investors faced in 2022, there is a pattern in historical data with cycle lows. The indicator's extremes coincide perfectly with the price's lows.



Technical view: bitcoin

From a technical perspective, the price has been moving in a range for the last two months after losing almost 25% in a single week in early November following FTX's collapse. The price managed to cover some losses in mid December only to resume the bearish movement.

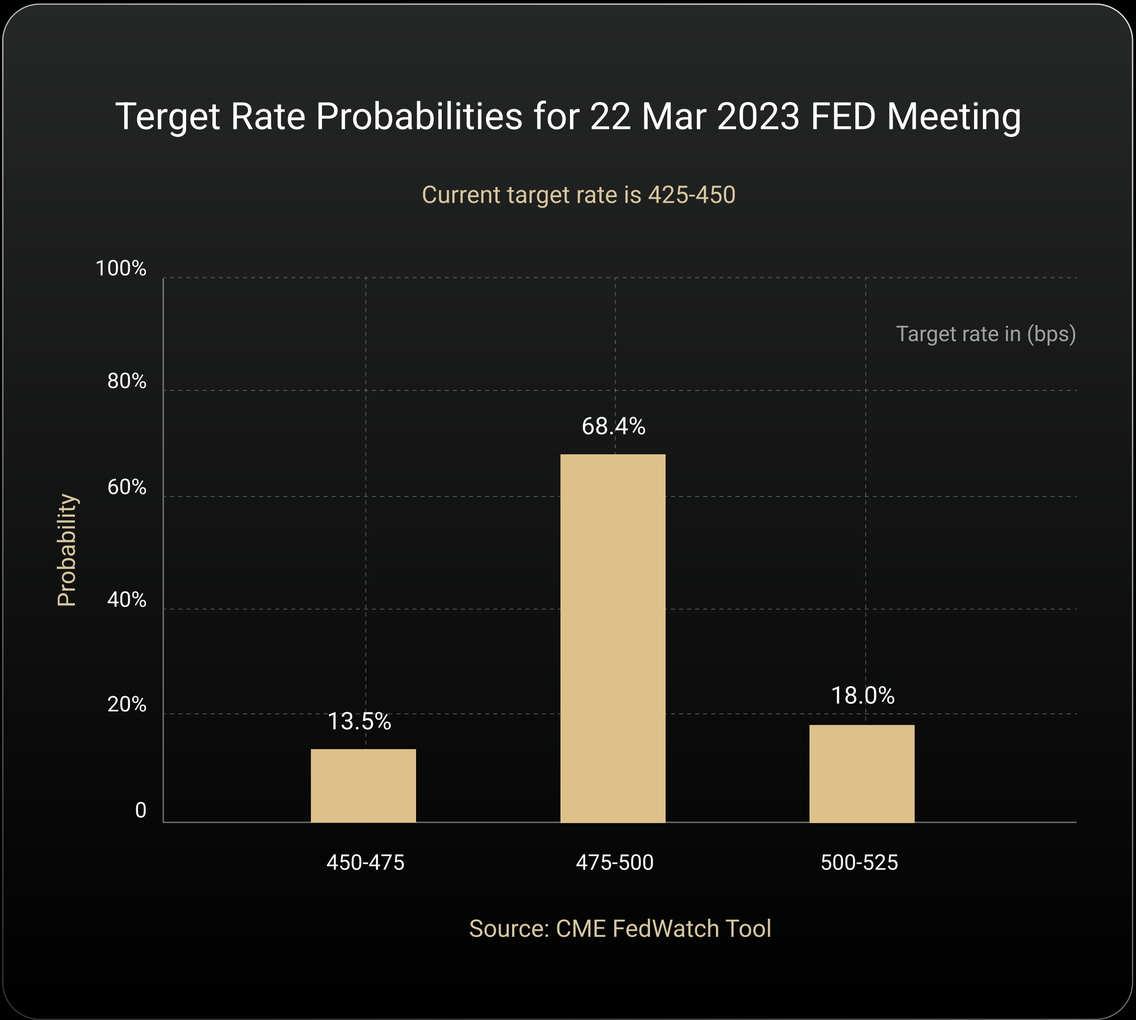
Bollinger Bands have contracted, indicating that volatility has significantly declined without any major movements in the last months of the year. Currently the price is trading below the 23.6% Fibonacci retracement and below the 20- and 50-day moving averages.

The stochastic is not showing any overbought or oversold, possibly indicating that the range is going to continue in early 2023.

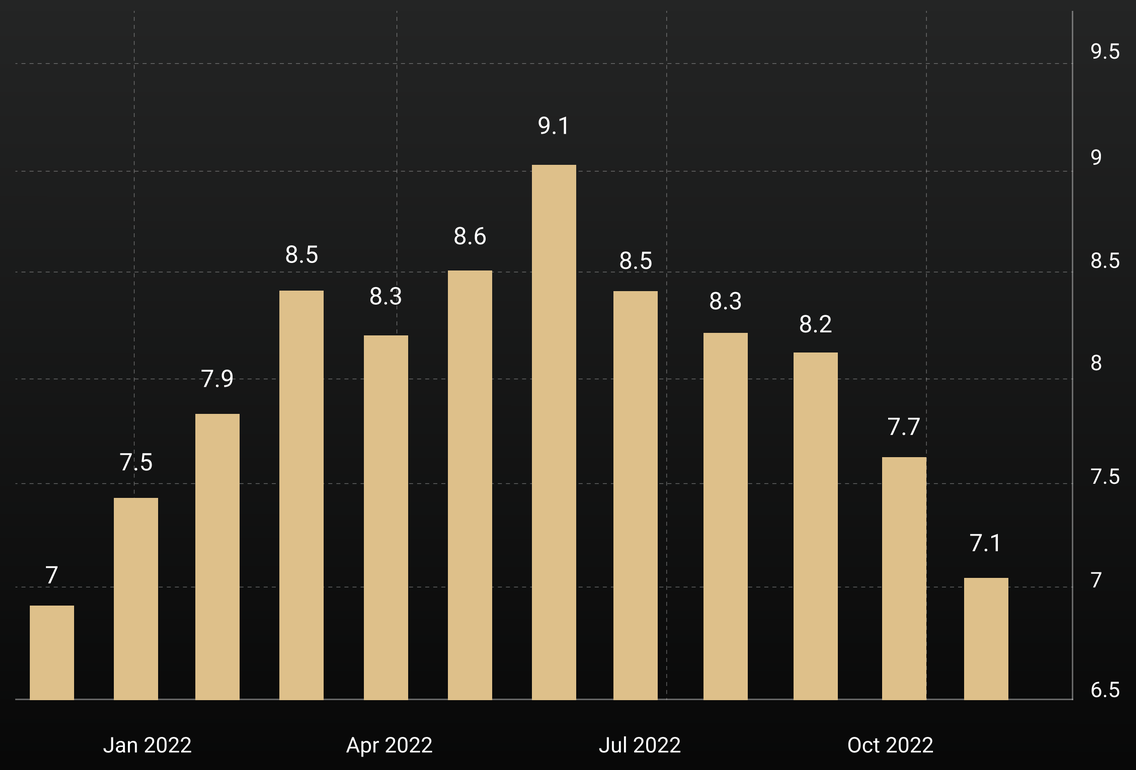
Gold

After two quarters of fairly consistent and large losses, gold's performance in the fourth quarter of 2022 was positive. The pace of the Fed's tightening last quarter slowed and participants in markets started to expect less aggression from the world's most important central bank while questioning how long rates can remain around 5% in the USA.

At the time of writing in early January, the likelihood of the funds rate reaching 5.25-5.5% this quarter is nil. As noted in the overview, there has been some progress on inflation, which is a result of a lower price for oil and less positive economic conditions in many countries as well as the Fed's rapid hiking last year.



Since the peak of US annual non-core inflation in June 2022 at 9.1%, the figure has declined by an average of around 0.4% per month. If that average held, inflation would return to the traditional target of 2% by around this time next year. However, a consistent decline in inflation isn't clear yet, partially because the Fed has started to slow the pace of hiking but also because China's reopening could drive the price of oil back up (see the section on oil below). Certainly the rate of decline in inflation is extremely unlikely to be consistent.



Tradingeconomics.com | U.S. Bureau of Labor Statistics

The main reason the Fed seems to be wary of hiking rates too high or keeping them there too long is not the possible damage this could cause to the economy. On the contrary and as noted in the overview, the FOMC seems to be eager for a weaker economy because that would likely help to curb inflation.

Instead, one of the main issues with high rates is record levels of debt in the USA, both national and private. The latest figure for American national debt in December 2022 was nearly $31.42 trillion, the highest ever recorded.

A rapidly rising funds rate last year makes it significantly more difficult for the government to service this huge amount of debt.

Meanwhile central banks around the world are buying gold at the fastest rate in more than 50 years. Amid ongoing de-dollarisation in some countries and with a high likelihood of inflation remaining significantly above rates in every advanced economy this year, the situation looks good for gold.

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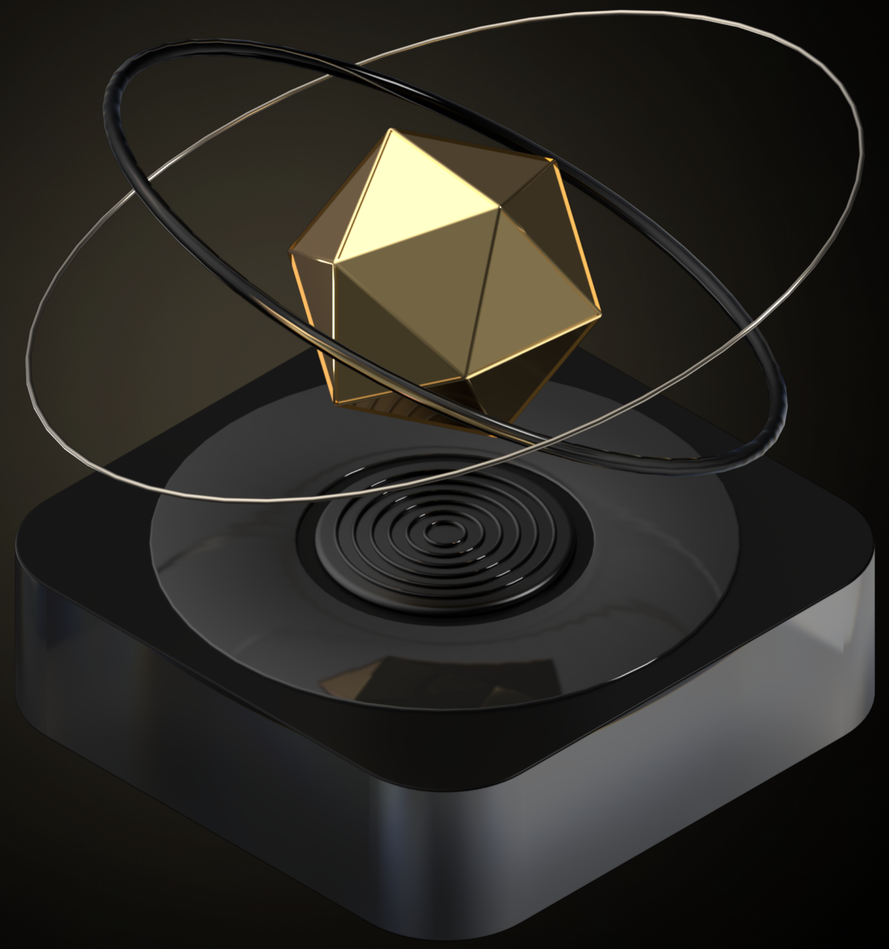
Technical view

The technical picture for gold is also generally positive. After the triple bottom early in the fourth quarter of last year, the price has made generally consistent gains and recently tested seven-month highs. However, there are clear overbought signals from Bollinger Bands and the slow stochastic, so longer term traders looking for a buy would traditionally prefer to wait for an entry lower.

The main areas of resistance in focus for now are the 61.8% and 78.6% weekly Fibonacci retracements. It would probably be difficult for the price to break through $2,000, a key psychological area, so a retest of 2020's all-time closing high around $2,070 looks unlikely, at least for this quarter.

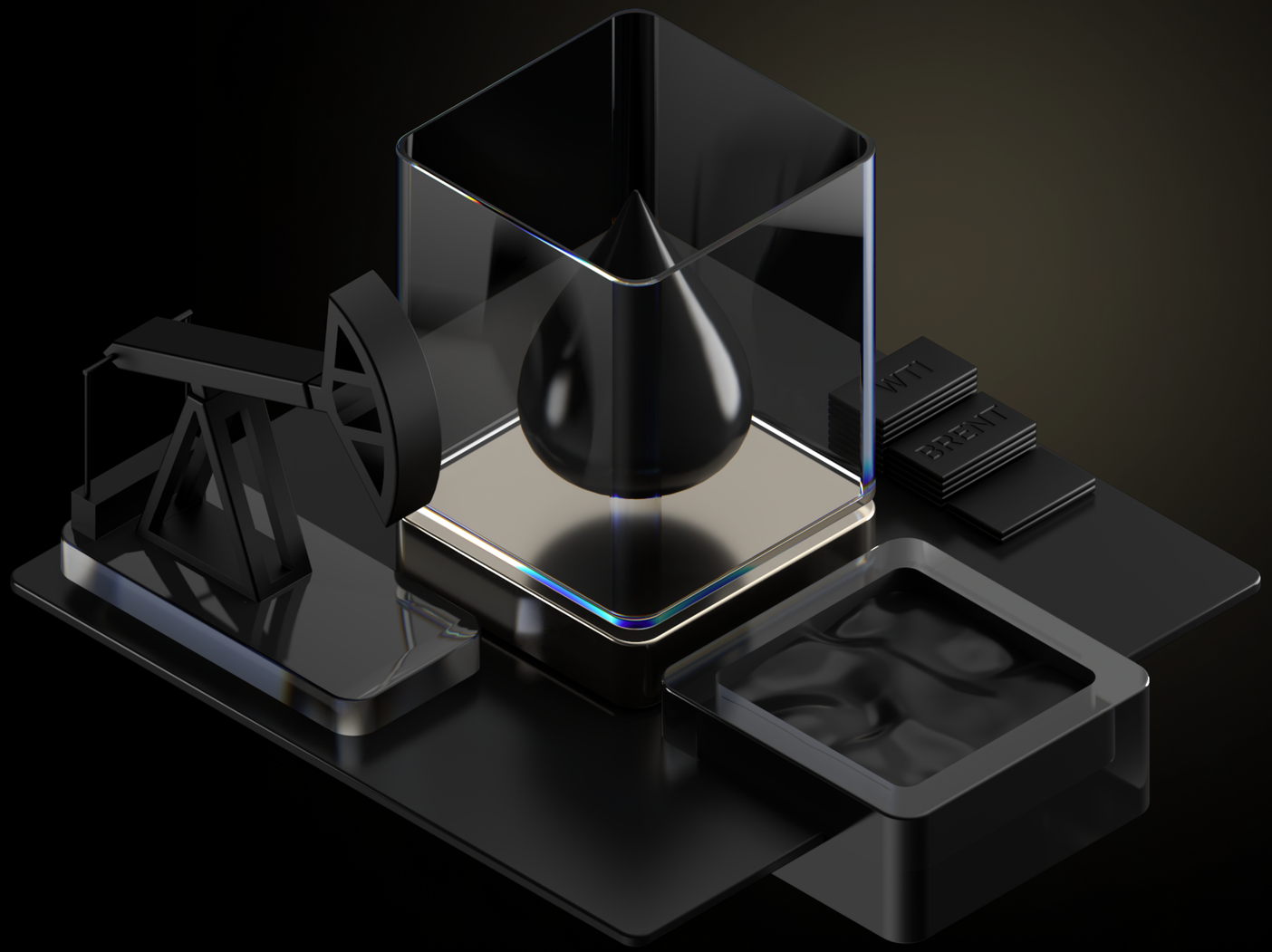
Conversely, a move back below $1,700 doesn't seem favourable either for the moment given the situation on the chart and from fundamentals. However, traders should be prepared for surprises: expectations for the funds rate can change very quickly. Markets have also tended to overreact to individual surprises from monthly inflation over the last few quarters.

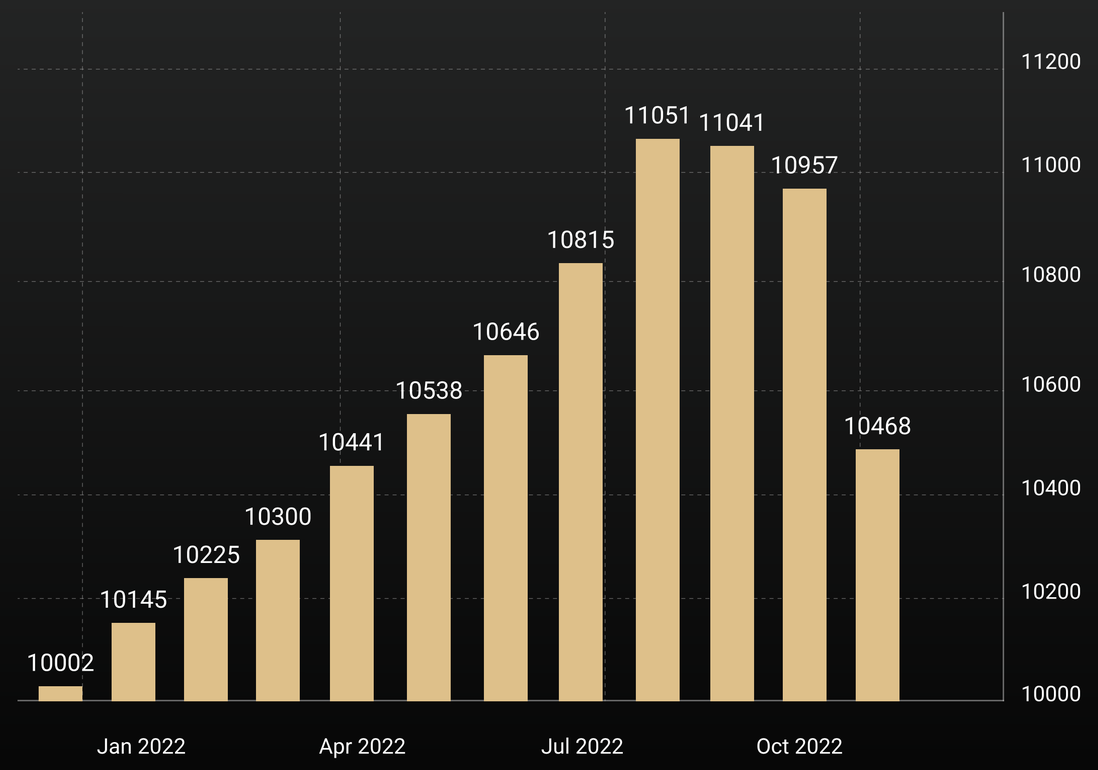


Oil

Supply

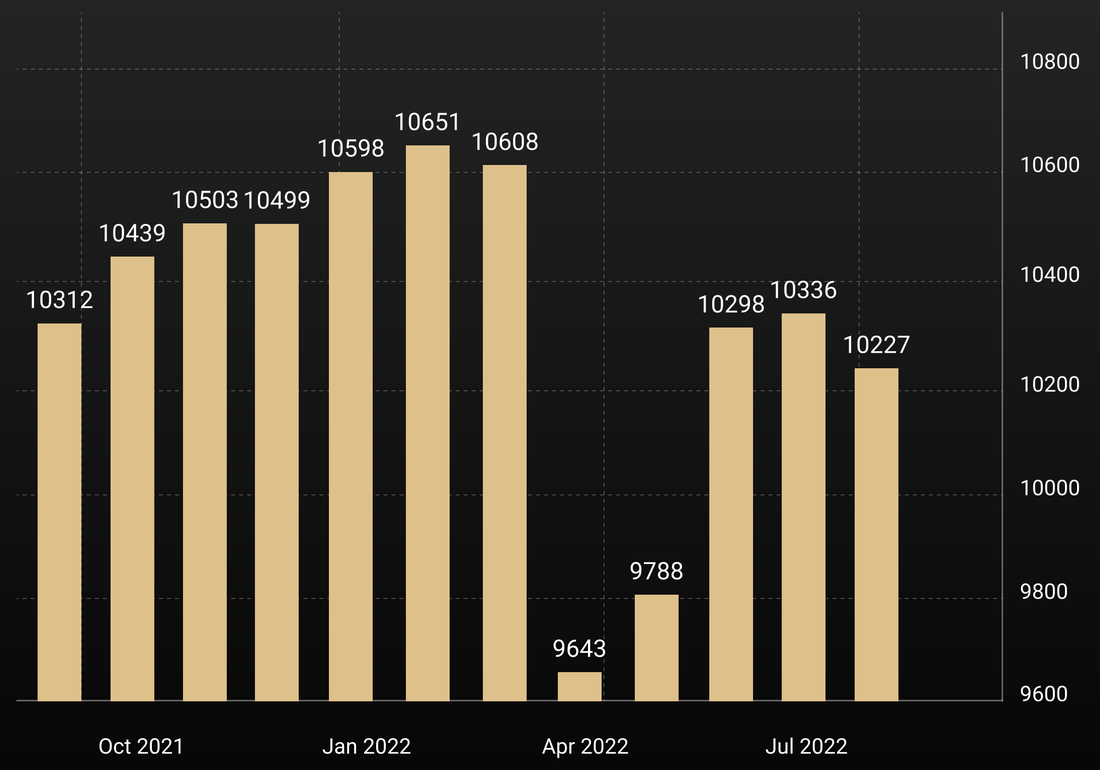
Following OPEC+’s meeting on the 5th of October with its announcement of a supply cut of two million barrels per day taking effect in November, we can observe a reduction in Saudi Arabia’s production by almost half a million barrels daily in November after a slight decrease in October.





Saudi production of crude oil, average thousands of daily barrels.
Source: Trading Economics/OPEC

The Saudi minister of energy replied recently to rumors about supply increases, denying these as false information and announcing that the country will stick to the original statement of OPEC+ about supply cuts and stating that it is more possible to proceed with further deductions in production rather than an increase in output.

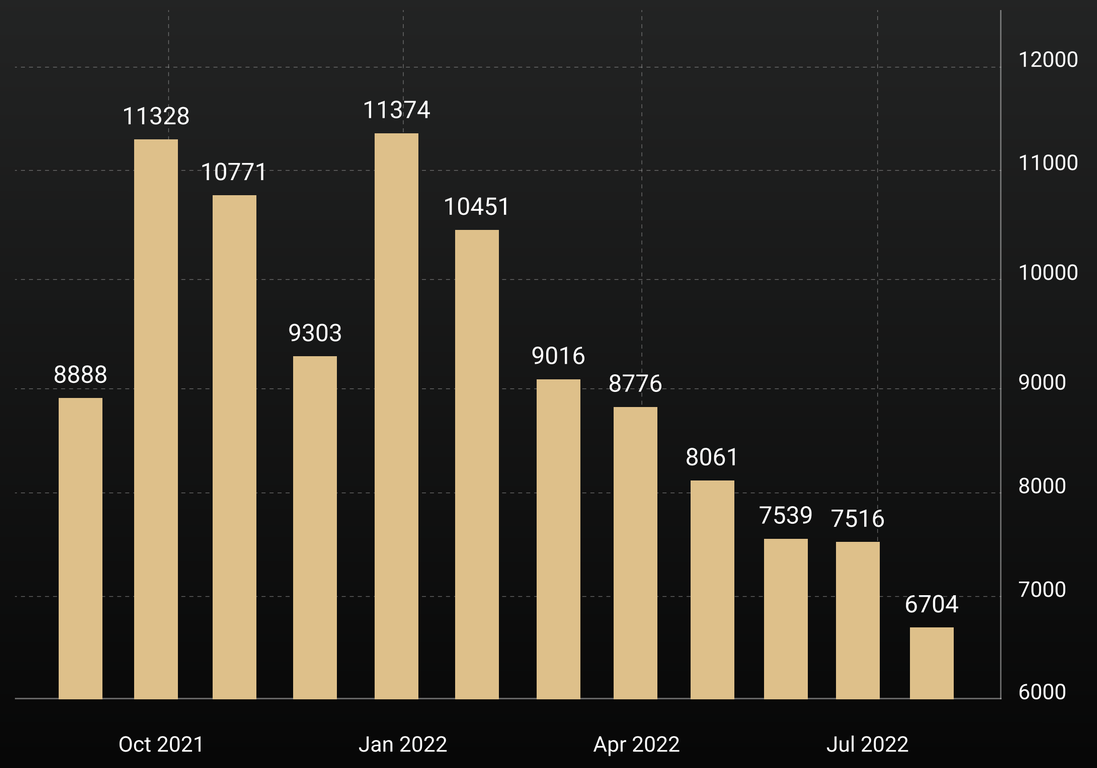


Russian production of crude oil, average thousands of daily barrels.
Source: Trading Economics/OPEC

As the war between Ukraine and Russia continues, the supply of crude oil by Russia is seen to have decreased also (being an ally of OPEC) by more than 100,000 barrels per day in August. The supply pipelines play a critical role in the outcome of this war that affects the whole world with minor attempts to damage them in an effort to slow down the Russian war machine.

This is also the quarter when European sanctions on Russian oil start to bite:

Data for EU imports of crude oil lag heavily, but from the chart above one can conclude that sanctions on Russia because of the war have definitely taken their toll on Russian exports to Europe. While Russia has already replaced their oil clients from the EU and shifted to Asian countries like China, Turkey and India, the EU is seeking alternatives by increasing supplies from the Middle East, West Africa, Norway, Brazil and Guyana, the IEA has said. The United States and Kazakhstan could also be potential replacements for approximately 1.1 million bpd of Russian oil that will be lost after December.



Total EU imports of crude oil from Russia, thousands of tonnes monthly.
Source: Trading Economics/Eurostat

Fears of a recession have increased sharply in the last quarters of the year after aggressive rate hikes by the Fed, increasing inflation around the world and the war on Ukraine still ongoing without any indications of ending. There's no undeniable evidence that a general recession is here yet, but many analysts are arguing about negative effects on economic growth and how they could possibly be carried forward into 2023.

In the last quarter of 2022 the US government announced that they would start buying back oil to replenish their SPR (strategic petroleum reserve).

The initial amount is set to be three million barrels, which is yet to be confirmed, with contracts set to be actioned in early 2023. This increase in demand for the black gold would possibly boost the price of the commodity in the short term.

Restrictions against Covid in China are loosening significantly. The economy basically restarting for one of the top importers of oil is likely to create major movements on charts. The likely increase in demand from China would most likely push the price, creating possibly large bullish momentum for investors, but it's unclear to what extent this is priced in.

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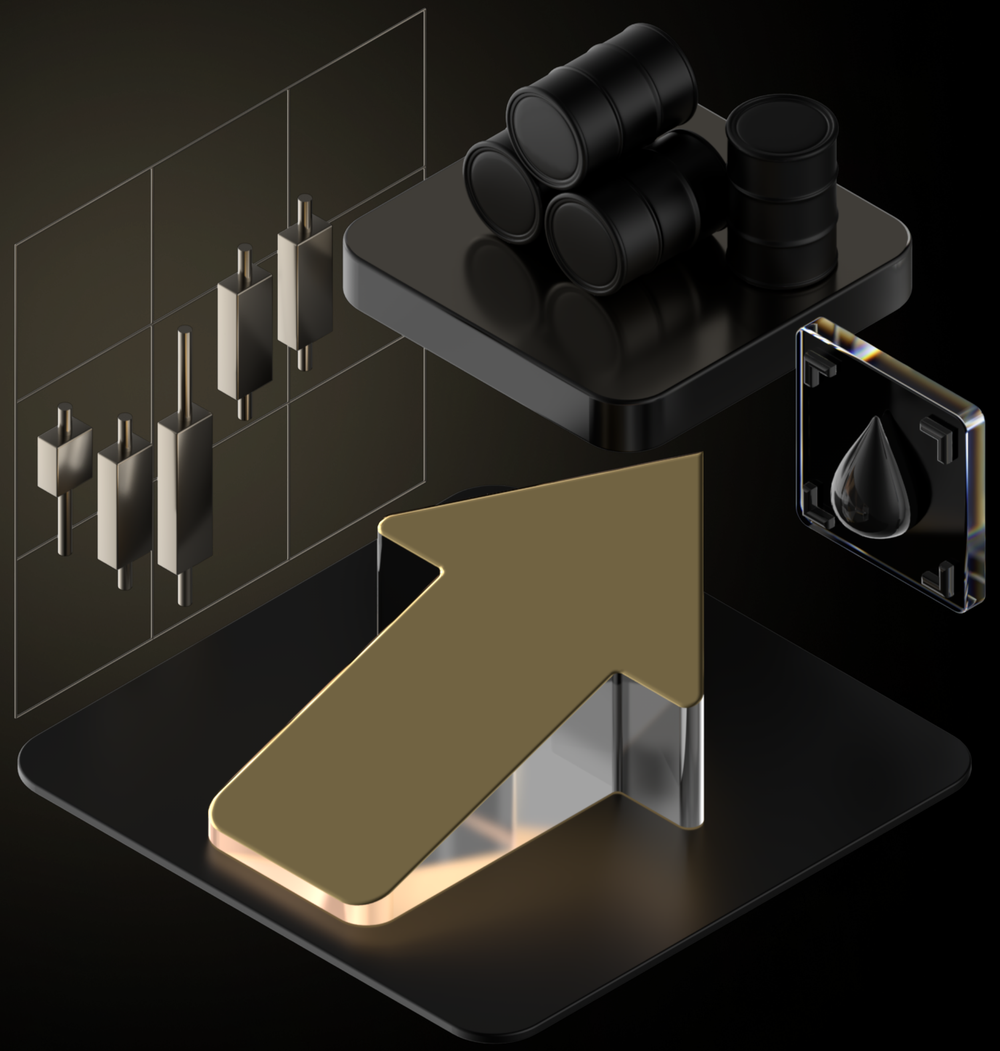
Technical view

From a technical point of view, the price of oil has been moving with relatively steady bearish momentum, losing around 6% of value last quarter. In the sessions immediately before the time of writing we see a bearish engulfing pattern forming. However, a reversal/correction to the downside might not develop since this is a strong technical support consisting of the 23.6% daily Fibonacci retracement and the 20-day moving average.

With the factors affecting demand mentioned above, there might be a resumption of upward movement with a major point of resistance at $80+. This is formed by the 50% Fibonacci retracement, the upper band of Bollinger Bands, the 100-day moving average and the daily downward trendline.

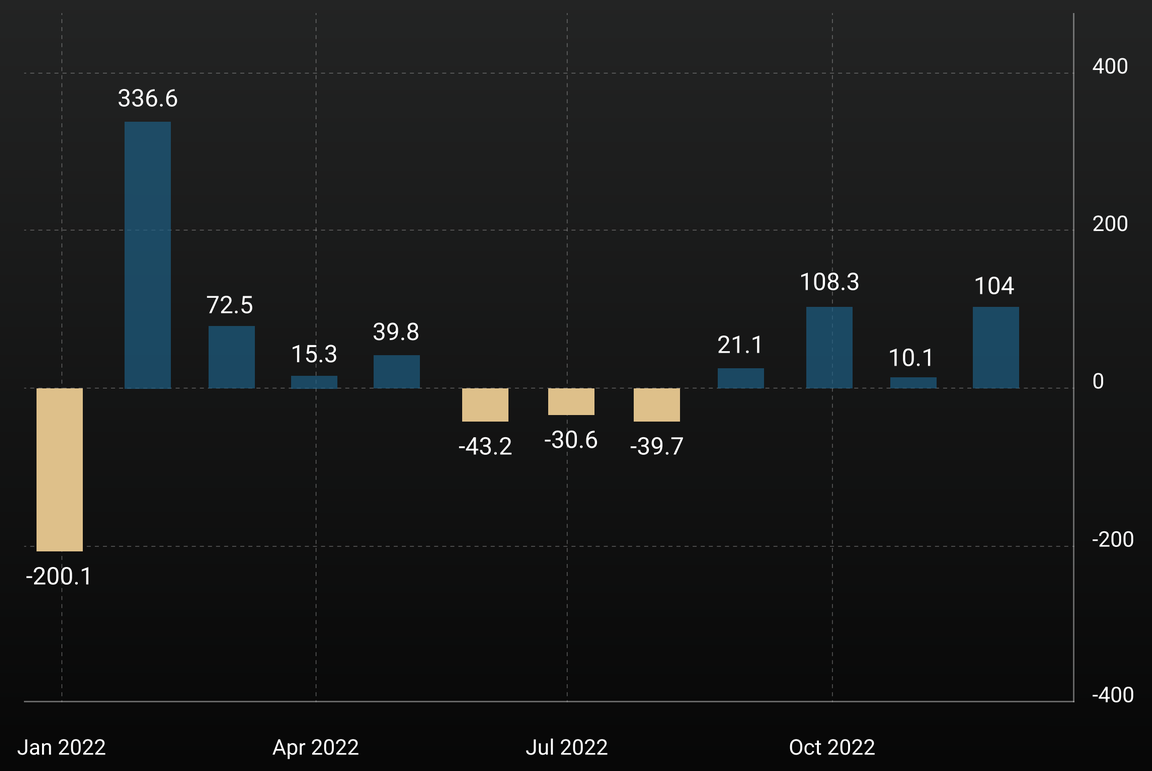


Forex

As discussed in previous sections, activity in forex markets is likely to increase this quarter as the Fed slows the pace of hiking at least to some degree while most other major central banks continue to tighten policy decisively. However, economic conditions in general seem to be worse in the EU compared to the USA and significantly worse in the UK than the USA.

This impression combined with the fact that clear long-term trends for forex majors are generally rare makes it more of a challenge now to pick trades over the long term. Nevertheless, the overall likelihood of a weaker US dollar and (probably limited) recovery by most other hard currencies seems to be holding for now.

One of the better options based on data appears to be the Canadian dollar. The Bank of Canada's target overnight rate at 4.25% is in the same range as the Fed's funds rate while the situation with inflation seems to be similar in Canada to the USA. The major difference is that the Canadian job market is much stronger than the USA's according to recent data:



Canadian monthly employment.
Source: Trading Economics/Statistics Canada

Canadian employment change in December came in at 104,000 on 6 January, more than 12 times the consensus. Unemployment in Canada has also declined to 5%, close to the record low. This exceptionally strong job market considering the circumstances suggests that the Bank of Canada will need to continue hiking aggressively to try to tame inflation and possibly trigger its own ‘necessary economic slowdown’, but the result in the next few months is likely to be gains for the loonie.

Although dollar-loonie looks like a poor candidate for a short-term sell at the time of writing in the second week of January, there seems to be significant potential for it to move lower in the further future. The price is near the upper end of its range on the weekly chart and remains within five cents of October 2022's high just below $1.40 while 2021's bottom around $1.20 is quite far below.

The idea to sell here based on fundamentals seems to be supported by the chart, with the price having pushed below the 50 and 100 SMAs.

However, an immediate move downward seems unlikely given the oversold signal from the slow stochastic, so a longer-term sell limit or simply waiting for a better entry would traditionally make sense.

The obvious caveats with this possibility and other similar ones to sell the dollar against other majors are the same as for gold above: what markets expect the Fed to do can change very quickly and participants have repeatedly overreacted to individual 'blips' in inflation data since last year.

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