



# Wealthpin **Pro**

JANUARY 2023

# 2023 PREDICTIONS, BLACK SWAN INCOMING, AND WHY THE FED DOESN'T KNOW ANYTHING

Happy New Years!

2022 was one heck of a rollercoaster. And judging by the first few weeks of 2023, this year will be no less of a joy ride.

In this first edition of the new year, we're going to dive into a few predictions of ours.

We're also going to talk about a potential "Black Swan" event that could be about to hit the financial markets (that no one saw coming).

We'll discuss why the Federal Reserve is so incompetent.

And of course, we'll reveal our pick for this month.

Buckle up!

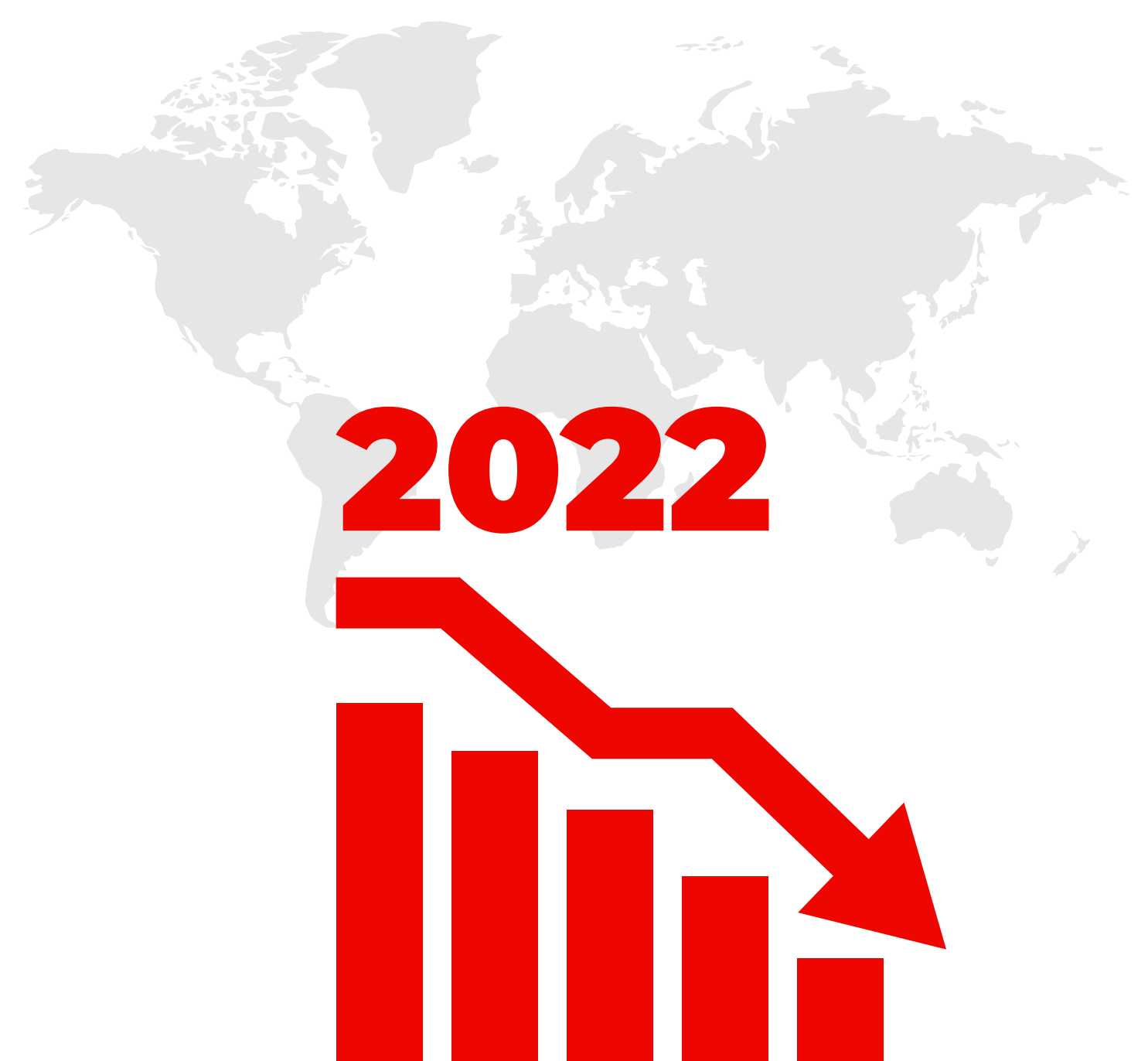


## PREDICTIONS ARE LIKE #%%-HOLES

Everyone has one, and they all stink. At least, that's how we'll hedge the predictions you're about to see.

Because the truth is, we're living through one of the craziest times in the stock market's history. I mean, truly historic. Unprecedented even. Which is why it's so hard to make any predictions.

For instance, 2022 was one of the four worst years in market history.





Take a look at this tweet from former Bridgewater insider Bob Elliott:



**Bob Elliott**   
 @BobEUnlimited

Any way you slice it, this was one of the worst years for financial assets in all of history.

The only other years where a diversified financial asset portfolio did this bad was the Volcker tightening, the depression, and the premature 37 tightening.

**Balanced Assets, Rolling 12m Return**



10:17 AM · Dec 30, 2022

38.4K Views
22 Retweets
3 Quote Tweets
183 Likes

This chart is measuring the performance of a traditional 60/40 portfolio (60% stocks and 40% bonds). Remember, when stocks go up, bonds usually go down. And vice versa.

A 60/40 portfolio is designed to give investors the perfect mix of growth and safety. If stocks go up, they get to capture those gains with the stock portion of their portfolio.

And if stocks go down, well, bond prices rise. So, investors are able to hedge their risk. In most cases, this 60/40 split works splendidly. Until it doesn't.

Like in 2022.



Bonds and stocks *both* fell. Which means there was nowhere to run. There's only been three other years in history that a 60/40 portfolio has done this poorly:

During the Volcker-era tightening of the early '80s, and during the Great Depression in 1932 and 1937.

The point is, few investors have any experience with the market conditions of the past year. And while many will look back five years from now and wonder, "How was it not obvious?"...

The truth is, it's hard to blame anyone for getting it wrong. (Except the Fed – you can always blame the Fed.)



And 2023 could very likely make fools of everyone again.

Despite that, we here at Wealthpin still think that predictions are valuable – they force you to think critically about the past, present, and future conditions.

Plus, they help you frame an investing thesis that, no matter if it's right or wrong, can at least give you a framework on which you can steer yourself.

So, let's wade in and make a few of our own predictions, shall we?





## PREDICTION #1:

# INFLATION HAS PEAKED

It may sound hard to believe, but many signs are indicating peak inflation has been reached.

The Fed measures inflation in two main ways:

Flexible CPI and Sticky CPI.

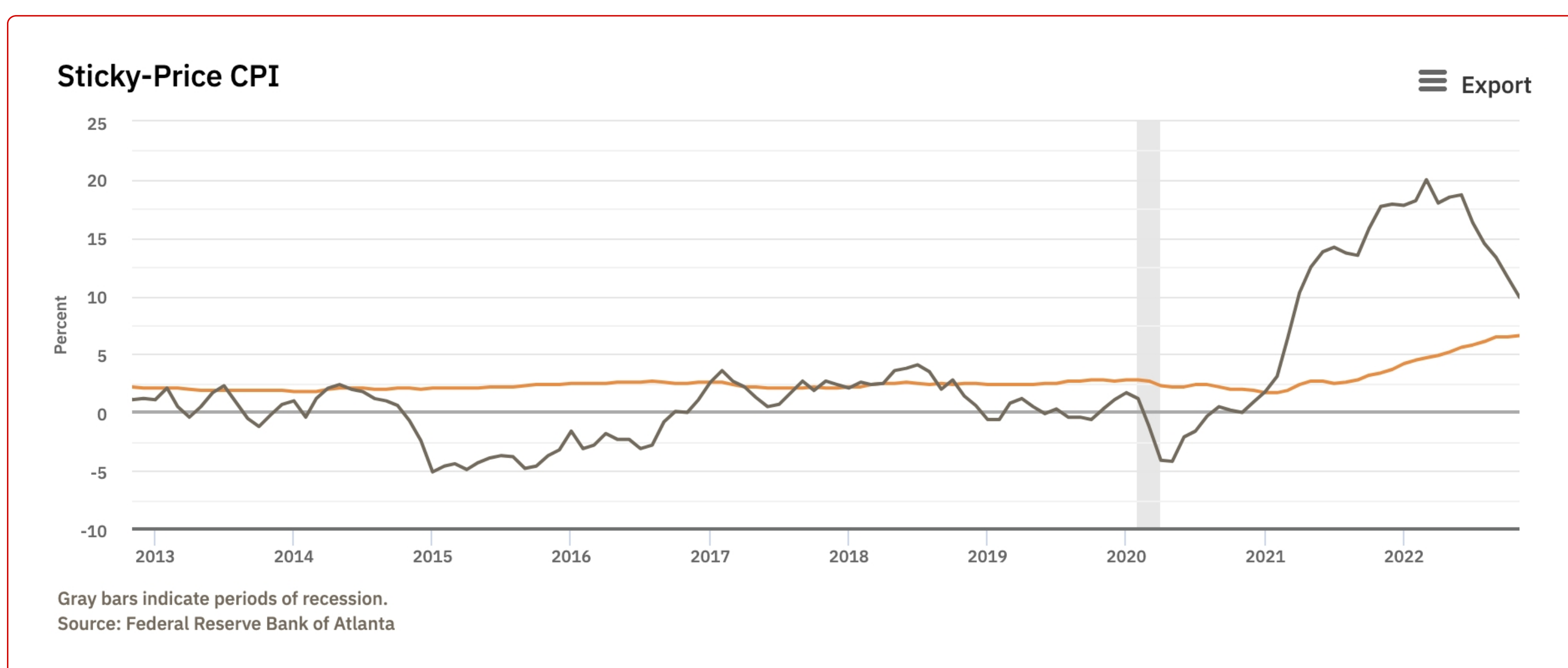
(CPI = Consumer Price Index).

**Flexible CPI** is calculated on goods that change price quickly – think gas, food, vehicles, etc..

**Sticky CPI** is slower to respond to price pressures, and encompasses things like medical services, education, and construction.

As you might guess, flexible CPI leads sticky CPI – usually by about 12 months. So, if flexible CPI starts to turn, you can expect sticky CPI to follow suit roughly a year later.

And would you look at this chart from the Atlanta Fed, which shows flexible CPI (grey line) peaking in March 2022.





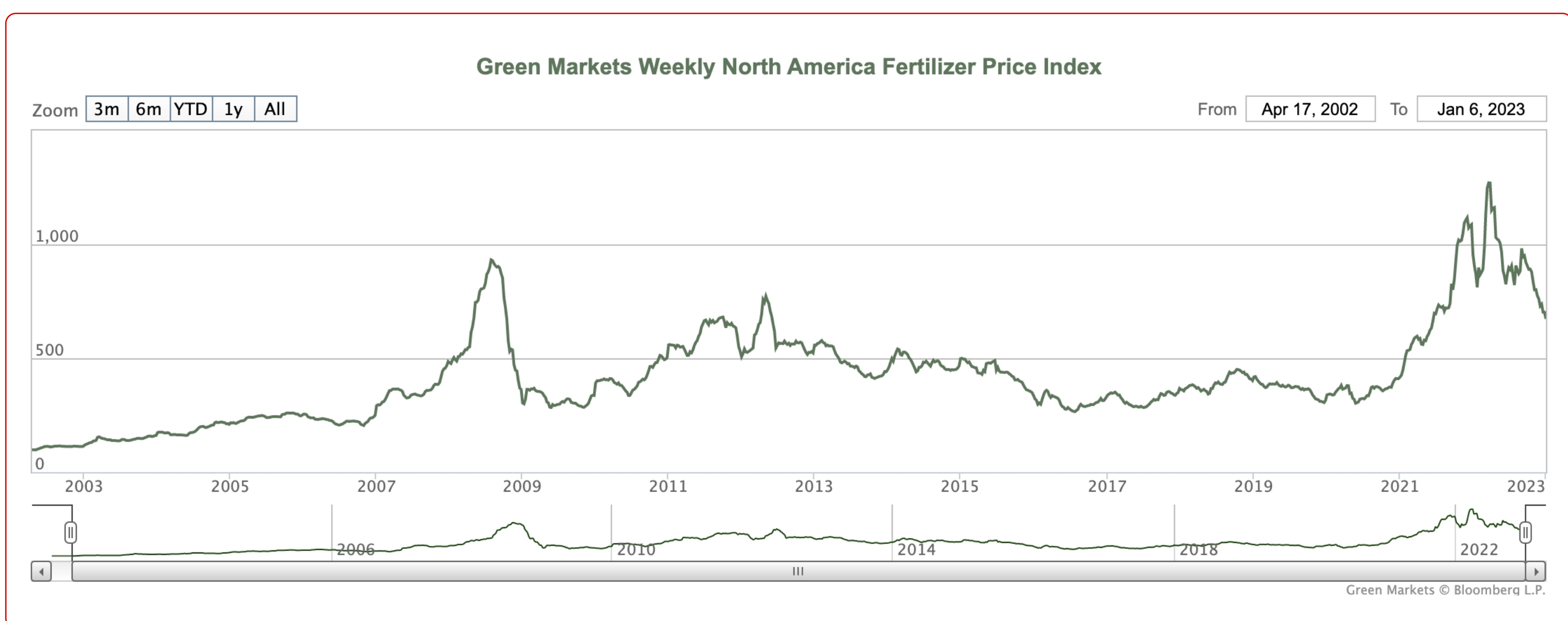
If historical averages hold true, that means we may have just about two more months until the sticky CPI begins to roll over as well.

This data is backed by recent European data.



Across the EU, inflation has started to roll over.

And North American fertilizer prices, which were one of the largest drivers of food inflation, have dropped precipitously as well:



Over the next 6 months, we predict that inflation will continue to fall. This will present more opportunities for high-growth stocks to outperform the market.



**There's just one catch:**

The Federal Reserve.

Which brings us to our second prediction.

## **PREDICTION #2:**

# **THE FED WILL MESS THINGS UP... AGAIN.**

The “headline” inflation rate is weighted at a 3:1 ratio sticky CPI to flexible CPI.

Can you see why this may be a problem?

**Let me explain:**

Both CPI types are reported on a lag.

Flexible CPI takes an average time to reprice of 2.6 months.

Sticky CPI – on the other hand – takes an average of 10.7 months to reprice.



In other words, any changes in sticky CPI won't be reported for nearly a whole year.

Yet, when the Fed is debating interest rates, they're mainly looking at sticky CPI.

Which means they're making policy based off the past, rather than the present.

As it stands now, the Fed is running a serious risk of overtightening, and sending the economy into a recession that isn't necessary.

Don't believe that the Fed could \$%#^ things up this bad?



Well, you shouldn't be surprised.

Don't forget that all throughout 2021 the Fed consistently said that inflation was transitory.

If they hadn't been in their ivory tower, the Fed policy makers could have easily seen that everything was getting more expensive and taken preemptive measures to stop inflation in its infancy.

Instead, they missed the signs, and then spent 2022 playing catchup.

Now, the Fed is self-conscious of its reputation. It has to play tough on interest rates in order to prove that it can stick to its guns.

People don't realize that much of the Fed's power rests on its reputation. If people think that the central bank is full of empty threats, well, then anything they say or do will be called by the markets, and the Fed will lose all ability to control the financial landscape.



As of the latest Fed meeting, it seems they have no inclination to back off raising interest rates. Here's a short excerpt from the meeting summary:

*"Participants generally observed that a restrictive policy stance would need to be maintained until the incoming data provided confidence that inflation was on a sustained downward path to 2 percent, which was likely to take some time...in view of the persistent and unacceptably high level of inflation, several participants commented that historical experience cautioned against prematurely loosening monetary policy."*



Following the meeting, no Fed officials expect any rate cuts in 2023. In fact, they expect the final 2023 rate to rise from its current 4.33% to 4.75%.

This is a shame, because with inflation turning over, it really does seem like the Fed is being far too aggressive.

And by overtightening, they threaten to derail what could be the start of a major market recovery. And this will have consequences. CNBC commentator Sven Henrich said it perfectly:



### **PREDICTION #3:**

## **THE FED WILL NOT MESS UP AND WE'LL GET A SOFT LANDING**

Ok, so I'm going to cheat a little bit with these predictions and call both sides.

Because at heart, I'm an optimist. I believe that things will work out in the end.

What if the Fed does act in a responsive way, and instead of overtightening, actually tightens just enough to cool the economy and tamp down inflation, without sending us into a recession or economic tailspin?



This would be called a *soft-landing*, and it's the best possible scenario.

The thing is, just like there's plenty of data supporting the thesis that the Fed will overtighten, there's also plenty of data to show that a soft-landing may indeed be possible.

Most notably, the payroll numbers released on January 6th. The data showed that job growth slowed for the fifth consecutive month and hourly wages grew less than expected.

Employers added 233,000 jobs in December, which was the smallest monthly gain in two years. Meanwhile, wages increased by 4.6% Year-over-year, which was the smallest increase since mid-2021.

At the same time, unemployment dropped to 3.5%, matching the fifty year low set under the Trump presidency.



This was truly the goldilocks of employment data. Slowed hiring and wage growth, coupled with a low unemployment rate...

You can't ask for anything better.

And this report, coupled with the turnover in CPI data means that the Fed could potentially back off the interest rate hikes, and allow the economy to glide itself to normalization.

At the very least, it could galvanize the Fed to slow down the rate ad height of rate increases. In an interview with the Wall Street Journal, Jim Bullard – the President of the St. Louis Fed chapter – said that

*"The probability of a soft landing has increased compared to where it was in the fall of 2022, where it was looking more questionable."*



So, at least the idea of a soft landing is on the radar of the Fed's top decision makers.

So, there you have it. Three Wealthpin predictions for 2023.

If a soft landing does indeed happen, we'll be looking towards the end of Q2 2023 to go full risk-on, and start gravitating towards higher growth opportunities.

In the meantime, we have to continue to look for low beta (i.e. low volatility) stocks that can provide stability during these uncertain times.

Which brings us to our investment idea for this month.

## **ARES CAPITAL CORPORATION (NYSE: ARCC)**



**PRICE AT PUBLICATION: \$\$18.50**

**MARKET CAP AT PUBLICATION: \$9.57 BILLION**

**SHARES OUTSTANDING: 517 MILLION**

**52-WEEK RANGE: \$16.53-\$23.00**



## THE ELEVATOR PITCH

Ares is a business development corporation (BDC). A BDC is a type of firm that invests in small to medium-sized businesses, or distressed companies in a poor financial situation. Many of the businesses a BDC invests in are private, but some can be very small public companies.

A BDC will issue loans to its portfolio companies via the money it raises from its public offering. So, you buy shares of a BDC, and the BDC then makes loans to private businesses.



It's sort of a roundabout way for regular investors to get exposure to the world of private equity, without being venture capitalists or PE firm themselves.

Then, as the portfolio companies rise in value and pay back those loans with interest, the BDC passes that money back towards shareholders in the form of a dividend.

With a 10.38% dividend and strong exposure to private companies in recession-resistant industries, Ares Capital is an excellent idea for investors who want to play it safe during this time of uncertainty, while at the same time cashing a nice dividend that will pay out more than current interest rates.



## THE THOUGHT PROCESS

Like last month, I'm not ready to go full risk-on just yet. These next two quarters will decide whether or not the country heads into a recession, or if we narrowly avoid one.

However, I also don't want to leave my cash parked on the sidelines.

That leaves two options:

- 1 Put it into bonds, or**
- 2 Find a way to beat the interest rates of bonds**

Why don't I want to put my money into bonds?

Because while bonds may have an attractive interest rate now, that can change tomorrow. Especially if we don't fall into a recession.

So, that leaves me with the one option:

Search for a higher yield opportunity that will still offer some safety from bearish forces threatening the markets.

Enter Ares Capital Management.



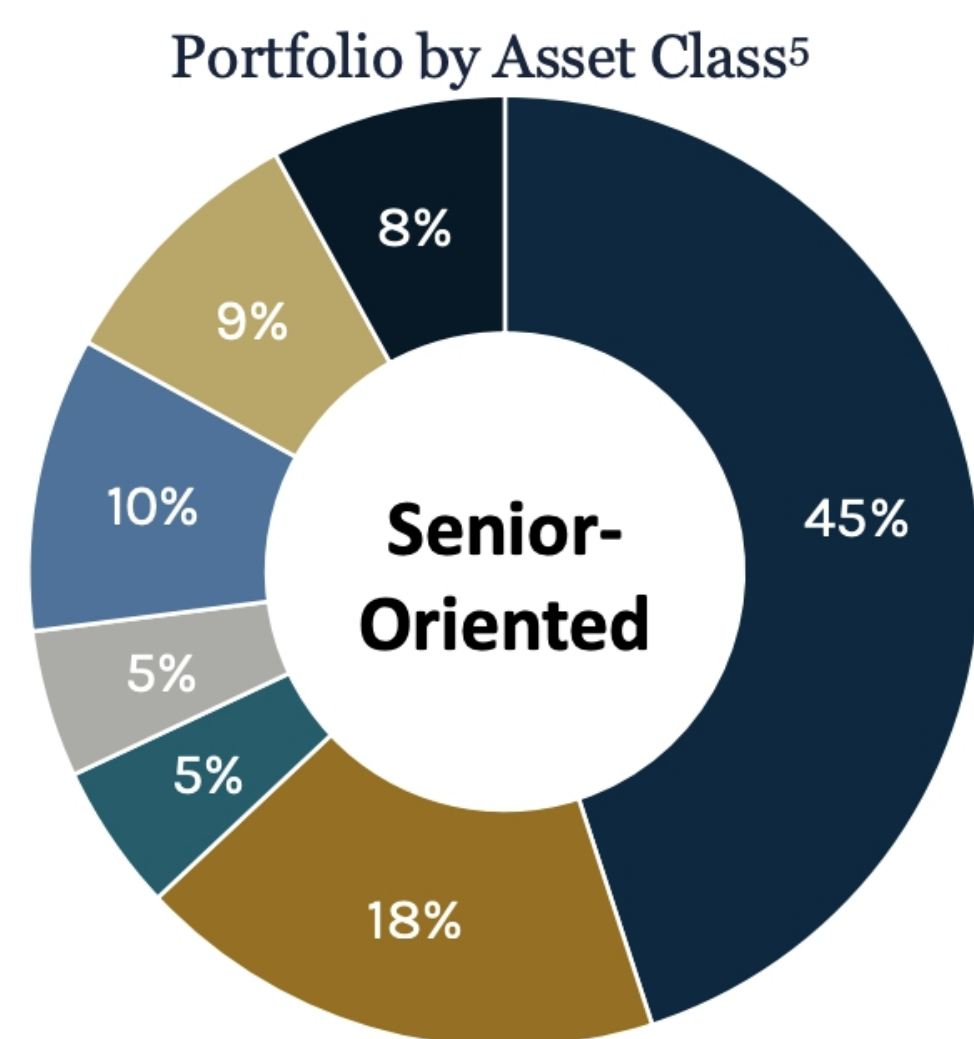


## THE BUSINESS MODEL

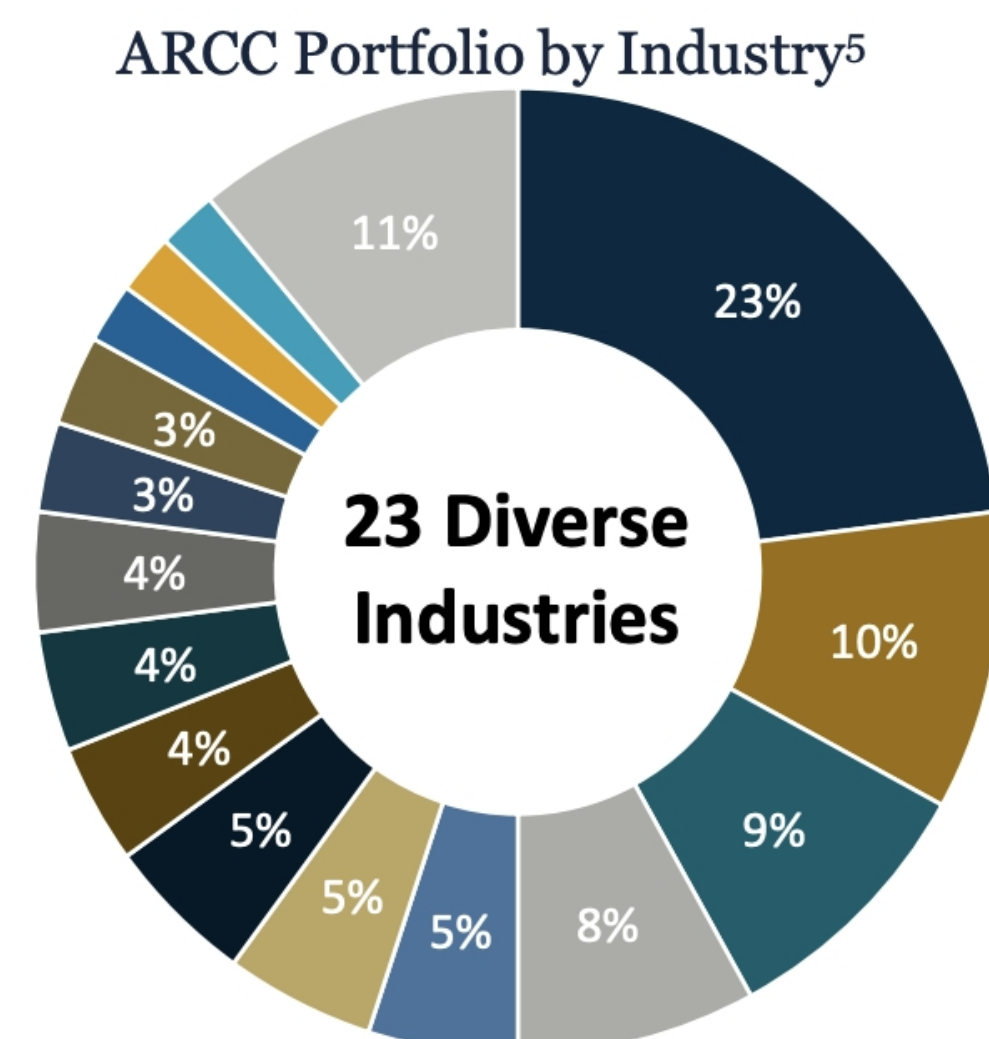
Ares mainly provides direct loans to “middle market” companies, which are companies with revenues between \$10 million to \$1 million.

The companies in Ares' loan portfolio cover a wide-range of non-cyclical, recession-resistant sectors, like insurance, utilities, and healthcare.

### Diverse Portfolio by Asset Class and Industry<sup>11</sup>



- First Lien Senior Secured Loans - 45%
- Second Lien Senior Secured Loans - 18%
- Senior Direct Lending Program, LLC - 5%<sup>12</sup>
- Senior Subordinated Loans - 5%
- Preferred Equity - 10%
- Ivy Hill Asset Management - 9%<sup>13</sup>
- Other Equity - 8%



- Software & Services - 23%
- Ivy Hill Asset Management - 9%<sup>13</sup>
- Insurance Services - 5%
- Power Generation - 5%
- Consumer Durables & Apparel - 4%
- Automobiles & Components - 3%
- Food & Beverage - 2%
- Media & Entertainment - 2%
- Health Care Services - 10%
- Commercial & Professional Services - 8%
- Senior Direct Lending Program - 5%<sup>12</sup>
- Capital Goods - 4%
- Consumer Services - 4%
- Diversified Financials - 3%
- Retailing & Distribution - 2%
- Other - 11%

Another important aspect of Ares' business is that a near majority (45%) of their loans are senior secured loans. This means that the loan is secured by collateral, and is first-in-line to be paid back in the event of bankruptcy.

In other words, this means that Ares' loan portfolio has been underwritten by hard assets that have significant intrinsic value. We're not investing in vaporware.





## **ARES CAPITAL = A WELL-DIVERSIFIED INDUSTRY TITAN**

Ares is the largest BDC by asset size, with a total of \$341 billion of assets under management. While the majority of its portfolio is in the United States, there is also exposure to Europe and Southeast Asia.

So, not only do investors get an anti-fragile spread across industries, they also get geographic risk dispersal.

What's more, every company that Ares' invests in is less than 2% of its total portfolio weight. So, even if a company fails, it shouldn't cause irreparable harm to Ares' business.

To add on top of all of this, Ares has been benefiting – and should continue to benefit – from higher interest rates. 73% of their loans are floating rate. Which means as interest rates clock higher and stay there, their yield on debt will continue to rise as well. Which means more money for shareholders.



## **GROWING REVENUES**

One of the unfortunate parts of the last two years is that many businesses have struggled. Of course, when businesses struggle, they need to take on loans...loans which BDC's like Ares provides.

Over the past year, the value of Ares' investments at fair value has risen 21% – from \$17.6 billion to \$21.3 billion. At the same time, core EPS was up 6% YoY. So, Ares was able to expand its portfolio while improving its financials. That's pretty good, if you ask me.



## THE DIVIDEND

Ares pays out 85% of its income to shareholders in the form of a dividend. As of the time of this writing, the dividend is 10.38%, or \$0.48 per share. With a Net income Per Share of \$0.57, the dividend is well-covered.

What's more, the dividend is far and above what you would get from treasury notes – the current interest rate on the 10YR is just 4.125%. But even if the federal funds rate was higher, Ares provides something that treasury notes simply can't offer:

### Growth.

With the mission-critical objective of investing in American small businesses, as the American economy grows, so too can Ares. To me, it seems like a win-win:

Either we miss a recession and the American economy continues to grow. Which will cause Ares' portfolio to grow in value. Or we do hit a recession.

In that case, there will be ample opportunity for Ares to extend loans and expand its portfolio. And once the recession ends, investors will be well-positioned to take advantage of the post-recession boom in American business.

Which is why we've made Ares Capital Corporation our trade idea for this month.

### Conclusion:

**We're adding Ares Capital Corporation to our model portfolio. The buy limit is \$19.10. The 12-month price target is \$24.10.**



To your wealth,  
**Alex Reid**  
Founder, Wealthpin Pro

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