Stark Financial Advisers, Inc.

A Registered Investment Adviser

1st Quarter 2023 Commentary

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Special points of interest:

- 2023, Concerns and Strategies
- Fast Food and Drone Deliveries
- Does the Federal Reserve Lack Credibility?
- Fuel Prices to Rise in 2023
- New Rules for Chinese Disclosure
- Three Reasons to Cheer

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2023 Investment Thoughts

In 2022, the market's fixation on inflation, and the Fed's interest rate moves, appear to be slowing, at least for now. We're moving onto real concerns, such as an economic recession and, for investors, a corporate earnings and growth decline as a result of a recession. We are not going to predict where the S&P 500 will end next year. Predictions are mostly meaningless. Nobody knows. As investors and money managers, during 2023, we will need to navigate through a series of known unknows. How bad is the recession? When will interest rates plateau? Then, what about geopolitics and war escalation? Will there be a pandemic? How does all this impact the economy and markets? Despite everything, not all is lost. Investors should just be prepared to adapt. First, remain defensive. Asset allocation remains important, despite 2022's disappointing performance when just about all asset classes fell. Historical correlations were stressed, as bonds failed to temper equity losses. It is also a good time to remain focused on defensive companies, versus cyclical and growth entities. Defensive stocks generally refer to industries that are less economically sensitive, such as household products, grocery stores, healthcare, and utilities. After an atypical year, where both bonds and equities fell, many experts predict bonds will show a good return in 2023. Again, that is a prediction. However, the risk/reward tradeoff for bonds has significantly improved. Corporate bonds are trading at compelling entry points. Even if interest rates continue to rise, the impact on bonds is likely to be less than stocks. Similarly, foreign bonds have gained in attractiveness. Despite the overall defensive positioning, it's still wise to place a few secular, thematic bets. One theme is deglobalization and onshoring. This is caused by rising labor costs in emerging markets, but also due to geopolitics, as China and Russia continue to isolate themselves. Setting up new production capabilities requires a significant source of raw materials, commodities, and energy. Think of miners, such as BHP Group, chemical companies, such as Albemarle Corp., and energy firms, such as ExxonMobil. Another shift is the world's aging demographics. Demand for medical services, affordable drugs, etc., is growing. There may also be opportunities in real estate investment trusts (REITs) that own senior housing, dialysis and care centers, and medical offices. War preparation and defense is another secular trend. The ongoing conflict in Ukraine has highlighted, to many countries, the importance of investing in self-defense and defending allies. Germany and the EU are increasing their budgets, as is Japan. China's belligerent stance against Taiwan is another wake-up call. Aside from these new risks, many countries' military equipment is in desperate need of upgrade. Defense and aerospace firms, such as Lockheed Martin and Martin Marietta, are some of those that could benefit. These are long-term trends, not just for 2023. But as the country tips into a recession, market valuations this year can offer a good entry point for a long-term investment.

Drones Pros and Cons

Google's drone deliveries may have more down than upside. In early November, the Commonwealth Department of Infrastructure invited public comment on proposed Australia-wide "drone delivery guidelines" it has been quietly developing with industry stakeholders. A slick new website – drones.gov.au – boasts of the supposed benefits of delivery drones. It claims they will create jobs, provide cost-efficiency, and be environmentally sustainable. The draft guidelines focus on minimal technical considerations concerning land-use planning, safety, and noise issues. Then, there's the question of whether the purported benefits stand up to scrutiny. A team at the University of Western Australia's Minderoo Tech & Policy Lab has stress-tested the claims made in the department's guidelines. Drones hold a lot of promise in being able to substitute humans in dangerous or otherwise difficult (but important) work, such as emergency relief. Commercial delivery drones, however, are an entirely different proposition. Concerns have ranged from noise and safety complaints, to impacts on wildlife, pets, and privacy. In some cases, operations have had to cease after extensive protest from residents. The guidelines emphasize the economic and eco-promise of a drone-filled future. A projected A$14.5 billion added to Australia's GDP, and 10,000 jobs over the next 20 years are undeniably attractive. However, the estimates aggregate multiple markets for drone use, well beyond just delivery. The segment of the drone market for military and industrial applications is estimated to grow to more than $5.5 billion, while the food delivery market, at $0.26 billion, is, at best, 20 times smaller. Also, the 2020 report caveats if its predictions of market expansion change, so too will its economic analysis. Australia's highest inflation rate in more than 30 years, coupled with a global economic slowdown, and worsening business confidence, suggest predictions are, perhaps, on shaky grounds. The fragility of the economic promise is matched by equally shallow claims of environmental sustainability. There is a shrewd focus on "last-mile delivery emissions" to demonstrate drones' green credentials. But this ignores the emissions generated along the entire logistics chain of this complex, technology-heavy system. The guidelines state drones deliver "on-demand supplies." This raises the question: demanded by whom? "On-demand supplies" is a loaded description that conflates necessity with desire – blurring essential medication with donuts. This descriptive sleight of hand casts drones as an all-or-nothing offering, which, of course, is untrue. Do you want to tolerate repeated junk-food deliveries whizzing by on the way to neighbors down the street? Drones demand an open and expansive discussion about the vital, living habitat above our heads. We must resist empty promises and indulgence and center on the much broader needs of all living things before globally exporting drones. Australians have a chance to turn this plan on its head. We'll see what happens.

The Fed Vs. the Markets

With its latest half-point increase, the Federal Reserve has raised interest rates 4 1/4 percentage points in 2022, putting the benchmark federal funds rate in the 4.25% to 4.50% range. The rates ordinary borrowers pay have risen in tandem. Everyone wants to know how high rates will go and how long they'll stay high. The Fed has an unwelcome answer for them. Financial markets have a more optimistic one. The Fed's rate setters are projecting a 5%-to-5.5% range for the end of 2023. They don't see rates beginning to come down until 2024. Recently, Fed chair Jerome Powell stressed that the Fed won't stop raising rates until it's convinced inflation is on a sustained path to 2%. Indeed, Powell said the Fed's outlook is for "slower progress on inflation, tighter policy, probably higher rates, probably held for longer." Tighter, longer is not how equity investors had been seeing things. Investors seem convinced that inflation will continue to fall, nearing the Fed's 2% inflation target by the end of this year. The Fed's rate-setting Federal Open Market Committee sees inflation falling far less – to 3.5% by the end of next year. You could say this means the Fed has a credibility problem, and it does. Having been dovish on inflation in 2021, Fed officials may feel they need to sound twice as hawkish now to be taken seriously. The market may well think the Fed is talking tough now because it needs to reestablish its credibility. In the Fed's forecasts, next year will end with unemployment at 4.6% and annual GDP growth at 0.5%, along with inflation at 3.5%. That's not how the markets see the situation. Some investors think there will be a recession, some don't; either way, they believe inflation will have come down significantly faster than the Fed is predicting. From individual consumers to business owners, borrowers hope the markets are right.

Energy Outlook Remains Strong

2022 was a painful year, unlike 2020 and 2021. As the Fed became increasingly dominant in 2022, most financial sectors retreated. One sector that outperformed was energy. In 2023, we continue to see oil prices rising, driving share prices higher. Within the sector, there has been minimal spending on exploration, while global demand has continued to rebound and grow. Energy did reasonably well in 2022. It could have done better but for the unexpected purge of Strategic Petroleum Reserve inventory, along with China going offline due to Covid. These two trends seem destined to reverse during 2023. Meanwhile, Russian oil production is permanently impaired and likely in free-fall. As the outlook for demand improves, look for a substantial swing in daily demand. Some see a swing as large as 5 million bbl./day. That is highly unlikely; a swing of that magnitude would surely stifle demand. However, demand will only suffer at triple digit oil prices. Of the energy sectors, Oil and Gas Field Services has been a market stalwart. We expect this outperformance to continue in 2023. Here are a few of our favorite names: Valaris Limited/VAL, ~$67, located in the United Kingdom, this company provides offshore contract drilling services in southeast Asia and the Gulf of Mexico. The next three companies are all located in Houston, TX: Halliburton/HAL, ~$39, provides reservoir completion and drilling services and products worldwide to the upstream oil and gas industry. Tidewater Inc./TDW, ~$34, provides offshore support vessels and marine support services to the offshore energy industry; finally, Schlumberger Ltd./SLB, ~$53, provides technology services, project management and information solutions to the petroleum industry.

New Chinese Disclosure Rules

The days of a double standard for China are ending. Chinese companies will no longer be able to skirt Securities and Exchange Commission (SEC) audit rules and take advantage of American investors. They have been able to violate U.S. law, until now. U.S. companies must comply with the Sarbanes-Oxley Act which imposes rigid record keeping requirements and strict rules regarding the types of accounting firms and auditors that companies can use. The Sarbanes-Oxley Act gave rise to the Public Company Accounting Oversight Board (PCAOB), which serves as a watchdog for the work of auditors of publicly traded companies. Companies that fail to comply can be delisted. Historically, the China Securities Regulatory Commission has maintained that, under Chinese law, the books of Chinese firms could not be made available to foreign regulators - thus avoiding investor protections. Now, the SEC and the U.S. government have decided that the rules apply to everyone. A separate piece of legislation, the Holding Foreign Companies Accountable Act of 2020, requires listed companies to disclose whether they are owned or controlled by a foreign government, or an entity controlled by a foreign government. The danger for U.S. shareholders is that state-owned and state-controlled companies may make decisions for political, rather than financial, reasons. The ownership structure of many listed Chinese companies has gone undisclosed; however, this structure is one piece of information that would be revealed during an audit. Chinese stocks sold in the United States are fraught with irregularities and risks for U.S. investors, such as "pump and dump" schemes, and variable interest entity (VIE) structures. For example, U.S. investors believe they are purchasing shares of Alibaba, when they are buying shares of a Cayman Island corporation that has a contractual agreement to pass through the profits of Alibaba to the shareholders in the United States. While VIE's are not illegal in the U.S., there is poor disclosure and limited information upon which to make investment decisions. Now, Chinese firms must grant access to the PCAOB or risk delisting. Audit reviews have begun in Hong Kong. In mid-November, after a seven-week inspection, the PCAOB reported they could obtain sufficient access to review the audits of New York-listed Chinese firms. PCAOB expected that would happen by the end of the year. Now they will be able to provide at least a preliminary report on the results of the audits. Firms that fail their audits may either be delisted or given a grace period to correct the problems and meet transparency requirements.

About Stark Financial Advisers

Stark Financial Advisers is an investment adviser registered with the State of Florida. SFA seeks to achieve positive returns over a long-term investment horizon by creating and maintaining the optimum portfolio for each investor. We view the optimum portfolio as one having the highest potential return consistent with the risk tolerance and investment horizon of the owner.

We also understand the relationship between risk and return and seek to reduce risk through targeted asset allocation among numerous asset classes. Each asset class has separate and distinct characteristics, including returns and risk that can be measured over time. While all classes are cyclical, they often trend in different directions. Two portfolios, each having similar return prospects, may have substantially different short-term risk characteristics. Clearly, the lower risk portfolio would be the choice of most investors.

Of course, all investments contain risk and there is no guaranty of positive returns; losses can occur. For additional information, please visit www.starkadvisers.com.

Pursuant to Rule 204-3 of the Investment Advisers Act of 1940, we are required by the Securities and Exchange Commission to offer each client a copy of Form ADV Part II that describes our firm and methods of operation. To receive a copy, please call 863-697-8024.

Stark Financial Advisers, Inc.

730 S Federal Highway
Lake Worth Beach, FL 33460

16950 U.S. Highway 441 N
Okeechobee, FL 34972

561-243-3815
863-697-8024

gstark@starkadvisers.com

"Helping Clients Balance Risk and Return"

WE ARE ON THE WEB

STARKADVISERS.COM

Gary L. Stark, President

Ellen R. P. Adler, Senior Vice President

Stacey Stark, Vice President

Account Managers

Bryan R Stark

Sean Kilmartin

James Scharff

Reasons To Be Thankful

2022 had its challenges. We experienced the first major European war since the 1990s, unprecedented sanctions, energy-price mayhem, bail-outs, global interest rates rising at their fastest pace in four decades, a faltering Chinese economy, an overheating American one, housing markets looking peaky across the rich world, and a crypto blow-up for the ages. Most of it has been miserable. But there were three reasons for cheer. Begin with the avoidance of mass starvation. When Vladimir Putin launched his invasion of Ukraine in February, there was reason to worry casualties would spread far beyond the battlefield and include many of the world's poor. Before the war, Russia and Ukraine exported more than a quarter of globally traded wheat and barley. After the invasion, prices soared. Unexpectedly, however, they returned to earth in the summer. Today, they sit at pre-war levels. Diplomacy, in the form of a grain deal and lucky bumper harvests, saved the day. The second reason for cheer is that financial blow-ups prompted by rising interest rates have, so far, been contained. In October, Britain's fiscal fiasco, fueled by Liz Truss - who was prime minister for just six weeks - hurt the country's finances. The episode upset global markets but did not send them into a downward spiral. FTX's bankruptcy is painful for depositors and embarrassing for investors. However, it has hardly made a dent in the real economy. The third reason for cheer is that autocratic regimes have struggled economically, too. Democracies have certainly had their troubles; in America, the labor market is red hot, hindering the Federal Reserve's fight against inflation. Europe is feeling the pain from sky-high energy prices. But in Russia, sanctions have put the country on a permanently lower growth path. Even as they try to exit zero-Covid, China's autocrats face a worsening long-run economic trajectory, courtesy of their clamp-down on the private sector and geopolitical decoupling. Few of these issues are settled. We will have plenty to talk about this year too.

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As always, the professional staff at Stark Financial Advisers thanks you for your confidence and business