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## KEY POINTS

- Despite stock and bond markets steadying in the fourth quarter, both finished down materially last year. Looking ahead, we discuss why a sustained stock market recovery could occur in 2023, and why bond market volatility is likely to subside.
- Across the globe, central banks responded to surging inflation with coordinated interest rate policy increases that have outpaced anything seen for several decades. The result was a weakening in economic activity across many regions last year. We discuss where risks of recession are highest and why Asia could experience a growth rebound in 2023.
- Investors experienced one of the most challenging years in 2022, even those with balanced and diversified portfolios containing a mix of stocks and bonds. Looking ahead, we discuss why investor outcomes are likely going to improve in 2023 and beyond.
- Lastly, we discuss how our near-term and longer-term outlook informs how we recommend positioning portfolios going forward.

## MARKET REVIEW

### SHARPLY RISING INTEREST RATES AND EXPECATIONS OF A FORTHCOMING SLOWDOWN TOOK A SIGNIFICANT TOLL ON STOCK VALUES IN 2022

Global stock markets declined materially in 2022, experiencing their first down year since 2018 and their worst year since 2008.[2] After three consecutive years of strong positive returns, global stock markets reversed course in 2022 as major central banks (led by the U.S. Federal Reserve) swiftly began raising interest rates to combat high inflation. As a result, stocks struggled throughout the year primarily due to higher rates compressing valuations and a weakening outlook for corporate earnings amid recession fears.

### SIMILARLY, BOND MARKETS DECLINED MATERIALLY AMID THE PRESSURE OF HIGHER INTEREST RATES

The bond market fell considerably in 2022, experiencing its worst calendar year on record in the U.S.[3] This historic decline in bonds occurred because of the surprising speed and magnitude that the Federal Reserve (the Fed) raised interest rates throughout 2022. In addition, because interest rates were nearly zero at the start of the year, there was minimal yield cushion to help offset the uncharacteristically large bond price declines. Despite the Fed holding steady with its hawkish policy stance, bond markets stabilized in the last quarter of the year.

### STOCK & BOND MARKET RETURNS

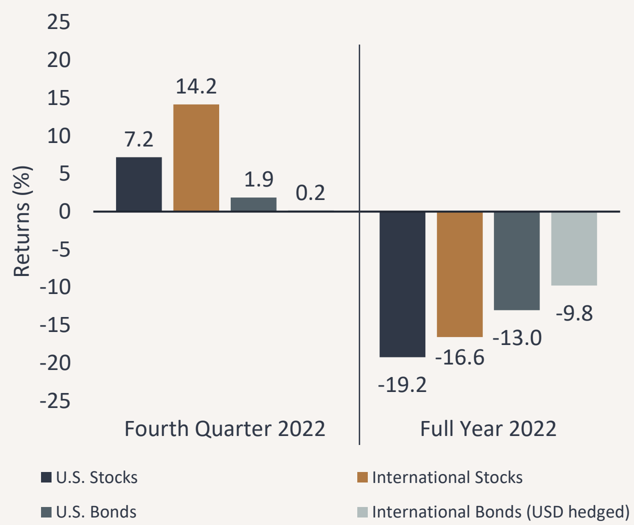


**FIGURE 1.** Despite stock and bond markets steadying in the fourth quarter, both finished down materially last year.

Even though the U.S. dollar appreciated significantly, international stocks outperformed U.S. stocks for the first time since 2017. The international stock outperformance resulted from relatively less exposure to technology and other growth sectors that suffered the most significant declines last year.

Although bond markets declined materially in 2022, they outperformed stocks by falling less. In addition, international bonds (dollar-hedged) outperformed U.S. bonds because most foreign central banks did not raise rates as aggressively as the Fed.

SOURCE: MORNINGSTAR, RUSSELL, MSCI, BLOOMBERG. DATA AS OF 12/31/2022. SEE ENDNOTE 1 FOR ADDITIONAL DISCLOSURES.

# MARKET OUTLOOK

### STOCK MARKET VOLATILITY IS LIKELY TO REMAIN, BUT A RECOVERY COULD START IN 2023

Stock markets will likely remain turbulent throughout the first half of 2023 amid the current state of uncertainty. We expect that stocks will likely remain highly volatile. They may fall if worse-than-expected economic and earnings metrics are released. Or they may rise should positive news, about inflation moderating and indications of a milder-than-expected economic slowdown, be reported. Stock markets could ultimately stay rangebound until there is more clarity around economic growth, inflation, and subsequent central bank interest rate policy.

However, as the year progresses, stock markets could stabilize as the economy slows, inflation subsides, and the Fed becomes less hawkish by stopping interest rate hikes. The prospects for an easier monetary policy in the second half of 2023 could allow stock markets to begin a sustainable rally. Because stock markets are forward-looking, historically bull markets typically start *amid* economic slowdowns or recessions, as markets eventually look past the current weakness and shift towards reasons for future optimism and the resumption of growth.

### BOND MARKET VOLATILITY IS LIKELY TO SUBSIDE, AND HIGHER YIELDS WILL BOOST FUTURE BOND RETURNS

Even after the extraordinary bond market volatility of 2022, the outlook for bonds is brighter than it's been in many years. The severe bond market volatility investors experienced last year is likely to subside because the Fed will probably stop hiking rates in 2023, removing a key source of uncertainty for bond investors. (See **Figure 2**.) Although policy rates will likely increase some more throughout the first few months of the year, the bond market has already discounted for this.

Moreover, the good news for bond returns going forward is that yields on bonds are now at levels that have not been reached in over a decade. Yields are much higher now in nearly every sector of the bond market. Those increased income payments will serve as a buffer against potential future rate increases that are not already anticipated by the market today. Further, higher yields have historically provided a much better starting point for total returns in the future. As such, expected bond returns going forward are materially higher than they've been amid ultra-low interest rates over the past several years.

THE BOND MARKET IS EXPECTING A PEAK POLICY INTEREST RATE OF ABOUT 5%, AND A DECLINE IN LATE 2023

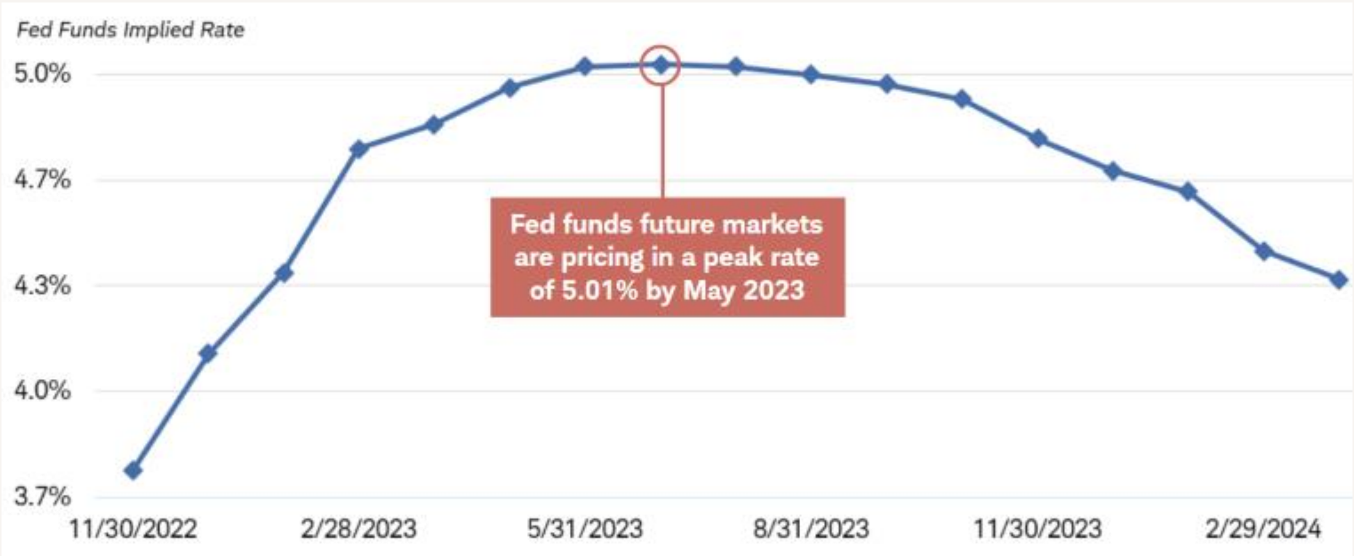


**FIGURE 2.** At some point in 2023, the Fed is likely to pause its rate hikes and let the economic dynamics play out given that it may take anywhere between 12 and 24 months for the impact of higher interest rates to be fully realized by the economy. Should the economy slow materially or enter a recession, policy rates would likely start declining again and bond prices would rise.

SOURCES: BLOOMBERG, CHARLES SCHWAB. DATA AS OF 11/30/2022. MARKET ESTIMATE OF FED FUNDS POLICY RATE USING FED FUNDS FUTURES IMPLIED RATE. .

# ECONOMIC REVIEW

## THE U.S. ECONOMY GREW, BUT AT A MUCH SLOWER PACE IN 2022

The U.S. economy contracted in the first half of 2022, expanded in the third quarter, and is projected to have grown in the fourth quarter. So, for the full year 2022, the U.S. economy likely eked out a small positive gain (probably in the 0.25% to 0.50% range); however, economic growth will have slowed down materially compared to growth of 5.7% in 2021.[4]

Inflation, led by rising oil prices, surged throughout the first half of 2022, peaking at 9.1% in June.[5] Elevated inflation led to a dramatic rise in interest rates that began to dampen economic activity, particularly in more interest-rate-sensitive sectors like technology and housing. Moreover, while the U.S. job market remained healthy overall, it started to show signs of softening. (See **Figure 3**.)

### THE U.S. JOB MARKET STARTED TO MODERATE FROM AN EXCEPTIONALLY STRONG LEVEL

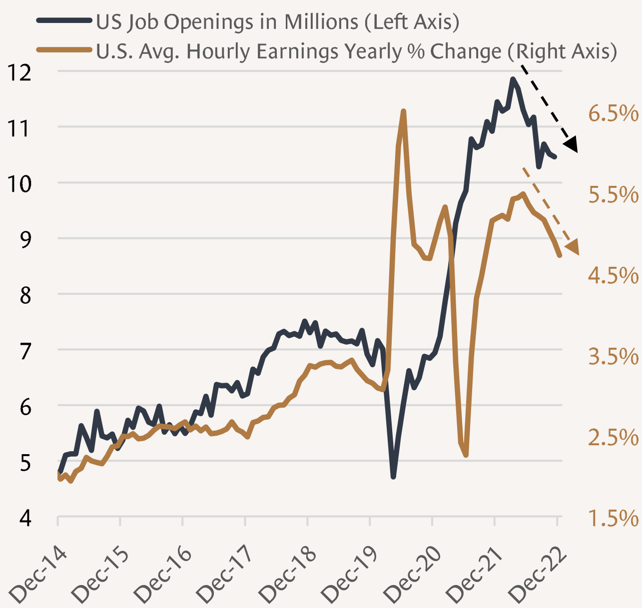


**FIGURE 3.** Labor demand, as measured by job openings, started to decline last March, resulting in decelerating wage growth. Although the U.S. job market is still very strong with "excess demand" for labor, these declines are early signs that the Federal Reserve's interest rates hikes may be starting to take hold. Investors are focusing on labor market statistics (especially wages) to gain conviction that inflation will continue cooling.

SOURCE: YCHARTS, BUREAU OF LABOR STATISTICS. AVERAGE HOURLY EARNINGS DATA ARE RERESENTED BY A 3-MONTH MOVING AVERAGE AS OF DECEMBER 31, 2022. JOB OPENINGS DATA AS OF 11/30/2022.

## INTERNATIONAL ECONOMIES BROADLY EXPERIENCED A MATERIAL GROWTH SLOWDOWN IN 2022

Across the globe, central banks responded to surging inflation with coordinated interest rate policy increases that have outpaced anything seen for several decades. The result was a weakening in economic activity across many regions.

The war in Ukraine added to European economic uncertainty and inflation pressures in 2022. Sharply higher natural gas prices contributed to the tighter financial conditions and depressed sentiment that may have pushed the Europe region into recession in the fourth quarter. However, as in the U.S., inflation in Europe started to moderate toward the end of the year.

Meanwhile, China's zero-COVID lockdown policy and a contraction in the real estate sector were significant drags on its economic growth in 2022. In the third quarter, China announced major economic stimulus measures focused on infrastructure spending, and in the fourth quarter announced plans to ease COVID-19 restrictions. However, given the late-in-the-year timing, the benefits of these efforts were not meaningfully realized in 2022. As a result, China's economy likely grew around 3% for the full year in 2022, well below the historical average and its official 5.5% target.

Emerging market economies broadly (outside of China) faced significant headwinds in 2022, including higher developed market interest rates and the simultaneous growth slowdown in the United States, Europe, and China.

## ECONOMIC OUTLOOK

### THE U.S. ECONOMY WILL CONTINUE SLOWING, HOWEVER A RECESSION WOULD LIKELY BE MILD

The Federal Reserve will remain committed to slowing economic activity to ease demand-side inflation pressures in the U.S. With that said, we believe that the Fed is near the end of its hiking cycle given how much it will have raised its policy rate (likely over 5%) and how long it's been since the Fed started raising rates (March 2022).

As a result, the economy will more fully realize the effects of higher rates throughout 2023. Although the U.S. economy will continue slowing down, a recession--should the U.S. officially enter one--would likely not be severe. This is due to the current strength of the economy's labor market, consumer finances, and corporate balance sheets. Moreover, unless the recession is deeper or longer than expected, interest rate cuts are unlikely until 2024 to ensure inflation returns to a near-2% normal level.

### THE EUROPEAN ECONOMY IS LIKELY TO REMAIN CHALLENGED, WHILE ASIA COULD EXPERIENCE A GROWTH REBOUND

The economic environment in Europe is likely to remain challenging. High energy and food prices will continue to weigh on real household disposable incomes, while uncertainty about the war in Ukraine will impact consumer confidence. As a result, consumer demand suppression combined with higher policy interest rates in Europe may well cause the region to enter a recession (if it hasn't already) ahead of other regions of the world. However, relatively low unemployment across Europe and government fiscal policies to counter the current energy crisis could help avoid, if not, moderate the recession's impact and ultimately help Europe quickly recover.

Meanwhile, China's economy is expected to rebound from an unusually weak year in 2022. After China's 20th National Communist Party Congress in October, policymakers announced a sooner-than-anticipated relaxation of COVID-19 restrictions. Easing restrictions combined with recent policy measures to support its ailing property sector are likely to increase consumption in the country and support economic growth throughout Asia. Although higher growth from China could result in rising commodity prices, China's reopening would improve broader global growth and trade.

## ON THE MINDS OF INVESTORS

### AFTER A DOWN YEAR – WHAT SHOULD INVESTORS EXPECT AHEAD IN 2023?

In 2022, the combination of rising interest rates, geopolitical shocks, and slowing economic growth led to a stubborn global sell-off that spanned most asset classes. Investors experienced one of the most challenging years in 2022, even those with balanced and diversified portfolios containing a mix of stocks and bonds. Typically, high-quality (investment-grade) bonds rise when stocks fall; however, this was not the case in 2022. The tandem decline for stocks and bonds was relatively rare. (See **Figure 4**.)

Interest rates directly impact how assets like stocks and bonds are valued. The unexpected sharp increase in rates in 2022 put severe pressure on both stocks and bonds simultaneously. However, this dynamic could change in 2023.

Inflation appears to have peaked and is subsiding, as evidenced by normalizing commodity prices and supply chains, and waning demand for goods amid the economic slowdown. The current situation should allow central banks to end their rate hiking cycles in the coming months, limiting the further rise in interest rates in 2023. Furthermore, recessionary conditions would eventually push rates back down, boosting bond prices at a time when stocks might struggle. In other words, the portfolio diversification benefit of bonds is likely to resume.

### LIKELIHOOD OF BETTER LONG-TERM RETURNS AHEAD

The dismal market performance and asset valuation reset in 2022 could set up a diversified portfolio for better returns in 2023 and the years ahead.

Last year was the worst year since 2008, but 2009 boasted positive returns for both stocks and bonds, and a 60/40 portfolio was up 18%. In 1974, both stocks and bonds were down, but both rebounded in 1975 for a 28% return on a 60/40 portfolio. Of course, challenges remained in both 1975 and 2009, but markets typically begin to recover *before* economic growth resumes and corporate earnings bottom.

BOTH STOCKS AND BONDS DECLINED IN 2022, FOR THE FIRST TIME SINCE THE MID-1970'S

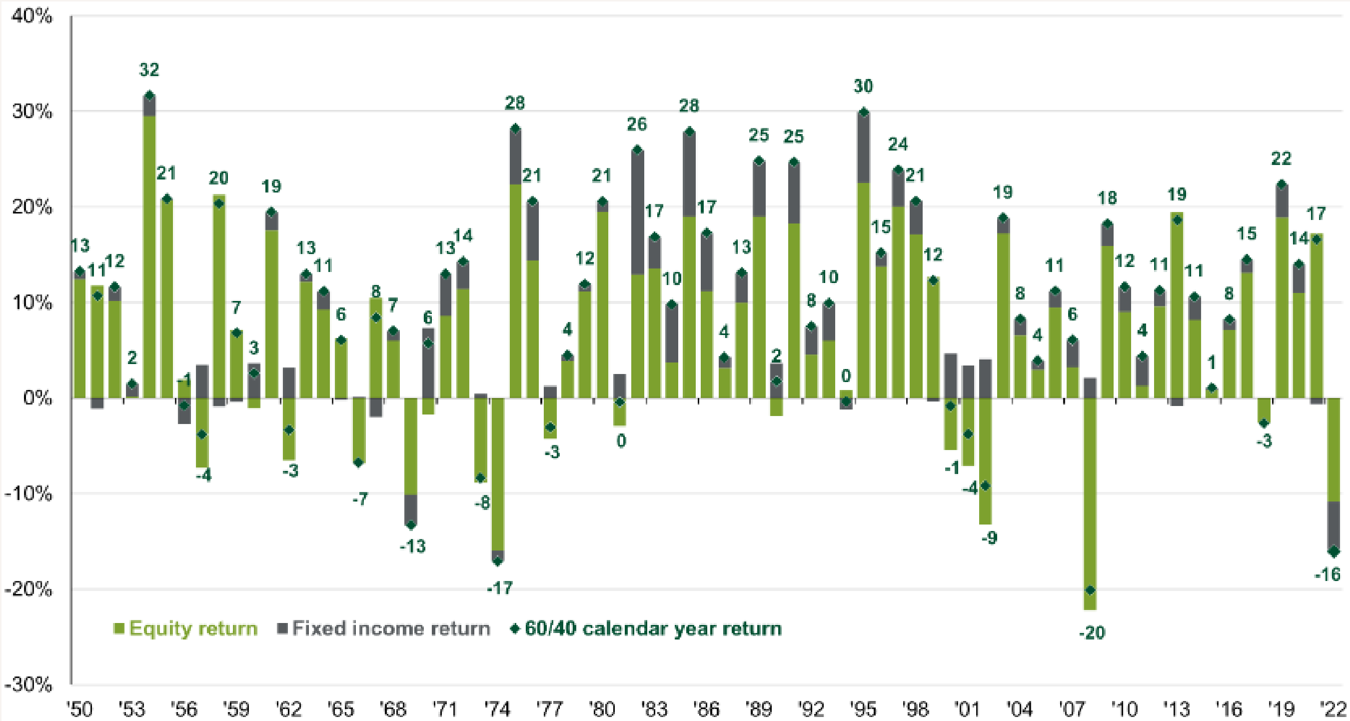


**FIGURE 4.** Diversification faced a challenging year in 2022. This chart illustrates the historical calendar-year performance of a hypothetical 60% stock and 40% bond portfolio which was down -16% in 2022. Not only was it the worst performance since 2008, but also it was the first year since 1974 in which both stocks and bonds declined.

SOURCES: FACTSET, STANDARD & POOR'S, ROBERT SHILLER, YALE UNIVERSITY, BLOOMBERG, IBBOTSON/STRATEGAS, J.P. MORGAN ASSET MANAGEMENT. DATA ARE FROM JANUARY 1, 1950, TO DECEMBER 31, 2022. SEE ENDNOTE 6 FOR ADDITIONAL DISCLOSURES.

The material decline in stock and bond valuations in 2022 has created a more attractive investment starting point for investors going forward.

Stocks and bonds are no longer expensive like they were at the start of 2022. The 2022 valuation reset across most asset classes points to potentially higher returns over the coming decade. Of course, it can be hard to imagine an upturn when prices have fallen materially or when there is worry about the economy's direction. But history shows that investors get rewarded in the long term for exhibiting discipline and patience, particularly following a significant and broad-based market sell-off.

## PORTFOLIO MANAGEMENT

The near-term outlook for continued market volatility, elevated inflation, and interest rates, combined with a longer-term perspective for an eventual sustained recovery in markets, informs how we recommend positioning portfolios going forward.

### POSITIONING FOR CONTINUED MARKET VOLATILITY

Investors need to continue being somewhat cautious in this environment. In our view, this means taking a defensive approach by diversifying and investing in high-quality assets. In other words, maintain a balanced portfolio of growth and defensive assets, and avoid concentrated positions in speculative areas of the market that tend to decline the most amid slower growth or recessionary environments.

Within stock allocations, we recommend emphasizing value sector stocks and relatively more profitable companies with stronger balance sheets. These types of companies can better weather more challenging economic environments. Additionally, within bond allocations, we recommend investing mainly in “investment-grade” rated bonds, which have a much lower probability of default. These types of bonds now pay much higher yields and will likely resume providing portfolio protection, particularly if we enter a recession.

## POSITIONING FOR ELEVATED INFLATION

Although inflation has been moderating and should continue to do so amid improving global supply chains and moderating growth, inflation is still expected to remain materially above the pre-pandemic (2%) average for some time.

Given a sustained high inflation environment, we continue to keep portfolio cash levels down to a minimum and recommend that clients invest excess cash beyond what they need for near-term liability needs. Moreover, investing extra cash is particularly opportune now, given the current relative discount in valuations across stock and bond markets.

Within stock allocations, we think portfolios should include diversified allocations across various sectors, including energy, materials, industrials, and utilities. These sectors tend to do particularly well in an above-trend inflationary environment because of their ability to pass on price increases to consumers and businesses.

Additionally, we will continue to recommend allocating toward "real assets" like real estate and infrastructure equities, which tend to provide increased inflation protection to portfolios via rising rents and contracted cash flows that are often automatically adjusted with inflation

## POSITIONING FOR AN EVENTUAL SUSTAINED MARKET RECOVERY

Investors should stay disciplined amid market volatility. We highly recommend staying invested, given the potential for a sustained market recovery, which would likely occur well before we see improvements in economic data.

We are going through a cyclical slowdown after years of positive, above-trend economic growth. The good news is that economic slowdowns (or recessions) are typically short-lived and are followed by much more extended periods of economic acceleration. As such, we believe it is more important for investors to be strategically positioned for long-term recoveries rather than to tactically position for potential short-term declines.

The economy is slowing, but it will not crash. Inflation will remain elevated for some time, but it will come down. Interest rates have increased dramatically (from zero) but are not likely to move much higher. Stock and bond markets have been volatile but currently present great valuation opportunities for long-term investors. Markets will eventually recover, and investment discipline will be rewarded.

# SOURCES & ENDNOTES

[1] U.S. stock returns are represented by the Russell 3000 Index. International stock returns are represented by the MSCI ACWI Ex USA IMI. U.S. bond returns are represented by the Bloomberg Aggregate Bond Index. International bond returns are represented by the Bloomberg Global Aggregate Ex USA Hedged Index.

[2] Sources: Morningstar Direct, MSCI. Global stocks represented by the MSCI All-Country-World Investible Market Index NR USD, declined -18.40% in 2022, declined -10.08% in 2018, and declined -42.34% in 2008.

[3] Source: Morningstar Direct, MSCI. The U.S. bond market represented by the Bloomberg U.S. Aggregate Bond Index declined -13.01% in 2022, the largest calendar year decline in its history dating back to 1976.

[4] Source: Bureau of Labor Statistics. Year over year % change in the Consumer Price Index as of June 2022.

[5] Source: Bureau of Economic Analysis. Year over year % change in Real Gross Domestic Product as of December 2021.

[6] The 60/40 portfolio is 60% invested in S&P 500 Total Return Index and 40% invested in Bloomberg U.S. Aggregate Total Return Index. S&P 500 returns from 1950 – 1970 are estimated using the Shiller S&P Composite. U.S. fixed income total returns from 1950 – 1975 are estimated using data from Strategas/Ibbotson. The portfolio is rebalanced annually.

Past performance does not guarantee future results. Indices are not available for direct investment; therefore, their performance does not reflect the expenses associated with the management of an actual portfolio.

## IMPORTANT DISCLOSURE INFORMATION



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