Wealth Management

QUARTERLY PERSPECTIVE
WINTER 2023

2022 Year in Review

Before writing each year's annual review, I usually like to start by going back to the previous year-end's numbers and the outlook projected at the time. I've been in this business long enough to be quite skeptical of any one person's predictions, or even the consensus view of short-term market and economic conditions. That skepticism proved warranted as last year played out much differently than most expected. First, the Federal Reserve (the Fed) finally got serious about fighting inflation after coming to the realization that it wasn't 'transitory' as previously hoped. The situation was worsened by factors such as China's zero-COVID policy which prolonged supply chain issues, and Russia's unexpected invasion of Ukraine in February, which led to a significant spike in oil, natural gas and other commodity prices.

Because the Fed waited so long to begin fighting inflation, they were forced to be far more aggressive with interest rate hikes than might otherwise have been necessary. This new stance shook markets that at the start of the year had only expected one or two rate increases. Both equities and bonds dropped significantly, with the S&P 500 Index in bear market territory by mid-year, and the Bloomberg Aggregate Bond Index down double digits, officially its worst year on record. This repricing based on higher rates was only made worse as the economy slowed more than expected, posting negative GDP growth for the first two quarters.

At this point it appears as though inflation may have peaked, with the Consumer Price Index down for three consecutive months, and future expectations continuing to drift lower. But we remain well above the Fed's 2% long-term target, and they're likely to raise rates 2-3 more times in early 2023, taking the target range to over 5%. With this, the concern turns to corporate earnings and GDP growth, and how much they'll slow, or even contract as we go through next year. Many economists spent 2022 worrying whether the Fed could engineer an economic soft landing, only to come to the realization that the Fed may have resigned itself to the need for a recession to break the back of inflation. In their minds, a mild to moderate economic slowdown—or even contraction—is the lesser of two evils, especially in an environment where we continue to be at or near historically low unemployment.

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Brian is a member of CNB Wealth Management's Investment Committee, where he is responsible for providing the research and analysis necessary to oversee the firm's investment portfolios. Additionally, Brian coordinates the firm's due diligence process, which monitors and evaluates all existing and prospective investment managers.

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Market Returns	4th Quarter 2022	2022
S&P 500	7.56%	-18.11%
Russell 1000 Growth	2.20%	-29.14%
Russell 1000 Value	12.42%	-7.54%
Russell 2000 Value	8.42%	-14.48%
Dow Jones US Real Estate	4.44%	-25.17%
MSCI EAFE (net)	17.34%	-14.45%
MSCI Emerging Markets (net)	9.70%	-20.09%
Bloomberg US Aggregate Bond	1.87%	-13.01%
Bloomberg Municipal Bond	4.10%	-8.53%
Bloomberg High Yield Bond	4.17%	-11.19%

Source: Morningstar

2022 Market Recap

After a great year in 2021, equities were priced well above their historical averages to start the year, but valuations seemed to be reasonably justified. Rates were expected to increase slightly, but remain exceptionally low, and GDP growth was forecast to moderate, but remain solidly positive through 2022. Those expectations, however, were short-lived, and both equity and fixed income markets had the rug pulled out from under them as investors realized that rates were going to move significantly higher throughout the year. Further uncertainty was added with Russia's invasion of Ukraine in February, leading to a consistent sell-off through the first half of the year. Despite some brief rallies in July and October, the S&P 500 ended the year down 18.1%.

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Growth stocks, especially in the technology sector, were down significantly on the rate hikes, which increased the discount rate used to value their earnings, which are typically further out in the future compared to most other stocks. By year-end the NASDAQ Index was down 32.5%.

International equities didn't fare much better, as the MSCI All County World ex. US Index declined 16.0%. Global inflation has foreign central banks increasing rates alongside the US Fed, with the picture complicated further by fears of a protracted war in Ukraine, and a strong US dollar.

The equity market declines were tough on investors, but most understand that this type of volatility is part of the game, and the reason they're compensated with higher returns over long time periods. But investors are not used to seeing their fixed income holdings drop in value like they did last year. Bond prices move in the opposite direction as yields, so when the Fed began aggressively raising rates, fixed income markets sold off dramatically.

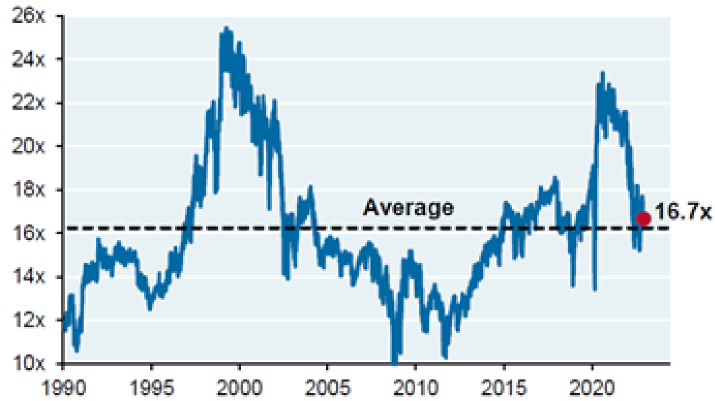
By mid-year the Bloomberg US Aggregate Bond Index was down over 10%, and eventually finished the year down 13.0%, its largest calendar year decline going back to its inception in the mid 1970's! If there's a silver lining, it's the fact that yields on short to intermediate term bonds have jumped significantly, and current investors are now generating income that they haven't seen in years.

Keys to 2023

The Fed is bent on taming inflation, and they've made it clear that they are willing to sacrifice economic growth, jobs and asset prices, at least in the near-term, to achieve that goal. The question now is how much economic damage has been done by the 4%+ in rate increases, and how much further will the Fed go. GDP growth has already slowed considerably, and they've acknowledged that will likely continue this year. But what about unemployment? Their hope is that before we see a large uptick in job losses, we'll first work off the 10 million plus job openings that currently exist. This could take pressure off the tight labor market without a dramatic increase in unemployment.

Finally, there are corporate earnings. Forecasts have continued to come down, but few believe that a full- blown recession is priced into today's valuations. Should one occur, we could likely retest last year's lows, and maybe even move lower. That said, the market is forward looking, and any bottom in equities generally takes place well before a recession is formally declared.

S&P 500 price to earnings ratio
Price / 12 month forward earnings



Source: Bloomberg, JPMAM. December 27, 2022.

So here are the positives. First, valuations are much more reasonable than they were at this time last year, and this is always a good sign for returns in coming years. Second, this applies not only to equities, but to bonds as well, where investors are now being more richly compensated for their fixed income holdings. Finally, commodity prices continue to fall, and many are well below their highs of last year, including energy. This should help to keep inflation moving lower and free up more discretionary spending for consumers.

Conclusion

This year starts with a great deal of uncertainty, and before markets can move meaningfully higher, we'll need more clarity around how much further the Fed must go in its fight against inflation. We'd expect continued volatility, especially through the first half of the year, as investors watch the trajectory of inflation, corporate earnings and GDP. Whether or not we have a recession, we do know that we're entering a period of economic weakness created by the Fed to break inflation, and the question for investors then becomes when does the market begin to look past this period to the eventual recovery. As always, patience is a hallmark of good investing, and while diversification provided little solace last year, it's proven itself over long periods, especially in combination with a well-designed financial plan.

As always, CNB Wealth Management is here to help you design, implement, and track your plan to ensure that it continues to meet your financial goals and objectives. Please contact your advisors if you have any questions or concerns, and we wish you and your family all the best in the New Year.

*Sources: *Morningstar, Bloomberg as of 12/31/2022.*