

Year-End Review and Outlook

2022: A Brutal Year for the Markets

As we said last year, we expected 2022 would bring increased volatility and muted returns as the highly elevated markets faced persistent inflation and rising interest rates. Then, as uncertainties increased following the global geopolitical turmoil and rate hikes accelerated, we revised our outlook to expect a down year for the markets.

2022 was the worst year for equities since 2008 and U.S. bonds had the most challenging time in over 40 years. For context, you'd have to go back to the 1800s to find a year where the total nominal returns of both asset classes were as low as in 2022. We don't think we're out of the woods just yet, but we believe that the markets have already "priced in" a lot of the negative news that will be coming out this year.

Last year started with many investments trading at record highs and enthusiasm for highly risky assets like meme stocks and crypto currencies. Prices for goods and services had been on the rise with post-Covid supply chain disruptions and continued business and consumer spending (which had been helped by low interest rates and government stimulus). To combat rising inflation, the Fed started tightening their monetary policy. Then the war in Ukraine broke out and energy prices soared, fueling inflation even more. In response, the Fed raised rates seven times last year, including four 0.75% hikes, going from 0% to a target range of 4.25% to 4.5% – the most rapid increase in interest rates since the 1980s.

Almost all investments were negatively impacted. Within equities, sectors that had been favored for more than a decade, namely technology stocks, declined sharply.

	2022	2021	<i>Previous 25 Years</i>
<i>U.S. large cap stocks (S&P 500 Index)</i>	-18.1%	28.7%	7.6%
<i>Tech heavy U.S. stocks (Nasdaq Composite)</i>	-32.5%	22.2%	8.7%
<i>Global stocks (MSCI ACWI IN Index)</i>	-18.4%	18.2%	6.2%
<i>Emerging markets stocks (MSCI EM Index)</i>	-19.8%	-0.3%	5.4%
<i>U.S. corporate bonds (FTSE U.S.BIG CORP. 3-7Y)</i>	-9.2%	-0.8%	4.8%

Source: Tamarac Inc.

2023: Slower Economic Growth but Better Markets

We believe economic data will continue to deteriorate as we move through 2023 and the U.S. economy will likely experience a recession. There will be more negative news associated with a slowing economy, in addition to how the government handles the debt ceiling. Market volatility will persist due to the many unknowns. However, as the markets start looking ahead to better macroeconomic conditions, we expect to see better returns this year for both equities and bonds than in 2022.

It's important to remember that the economy is not the same as the markets and they are rarely in sync. While the economy and economic data are backwards looking (reporting on what has already happened), the markets and investors are always looking forward (anticipating how companies are going to perform in the future). History has shown that it's possible to have a bear market (equity indexes down over 20%) without a recession. And the opposite has also been true – having an economic recession without experiencing a bear market. For extra credit, we've provided an illustration of this concept at the end of this Outlook.

We'll be closely watching the macroeconomic forces that influence the economy, while anticipating the effects of any policy changes: What happens with **inflation**? How will the **Fed policy** evolve in 2023? What's the current state of the **economy**?

- The Fed's job of combating inflation has been made more difficult by the resilient demand that comes with a strong job market and built-up household savings. Improvement in the supply will also be needed to cool inflation, and China's recent loosening of Covid policies should help. We'll also keep an eye on the developments in Ukraine, as this will continue to impact global food and energy prices.
- Until Inflation is under control, we believe that the Fed will continue to raise interest rates, albeit at a slower pace. On February 1, the Fed decided to raise rates by 0.25%. They project that rate increases will continue this year and begin to level off at around 5%. Interestingly, the market is pricing in interest rate *cuts* toward the end of 2023, even though the Fed hasn't yet indicated the possibility of reversing the course.
- So far, the U.S. economy has been resilient – as of January, the unemployment rate has returned to historical lows of 3.4% and wages have been strong. However, it takes months for interest rate increases to begin to impact the economy. We believe it's likely that the Fed will overtighten or be forced to keep rates higher for longer, tipping the economy into a recession.

Our View on the Major Asset Classes

- U.S. Equity
 - While we expect stocks to remain volatile in this environment, we also believe that we are closer to the end of the downturn than the beginning. Valuations have improved with the market decline last year. At the end of December 2022, the S&P 500 Index (which represents the U.S. large cap markets) was trading at 16.7x forward earnings – back near its historical average – vs. 21.4x at the all-time highs a year earlier.
- Foreign Equity
 - Although uncertainties persist in foreign markets as current geopolitical risks remain unresolved, our investment philosophy is based on valuations and diversification – and foreign equities shouldn't be ignored. When compared to U.S. equities, foreign equities have more attractive valuations and higher expected future returns.

- Fixed Income
 - Despite the worst year for bonds in decades, the short-term pain has provided higher expected yields (meaning higher income) and the return of the downside protection and diversification benefits. While we're already back to a more normal outlook for bond returns, we expect continued volatility as interest rates increase.
- Alternatives
 - We expect alternatives to continue to provide downside protection and diversification for portfolios. As a reminder, they help reduce the overall risk without sacrificing the portfolio's expected future return.

Keeping it All in Perspective

We know that periods of market declines can be unsettling and it's important to remember that your success is not dependent on the markets continually going up. There will always be market volatility and periods of decline, but with history as our guide, there have always been recoveries. The key is to have a well-diversified portfolio that gets you through these rough patches.

We have invested your portfolio in many different asset classes (stocks, bonds, alternatives, and cash) to help manage risk according to your specific needs. Income from dividends and bond interest is generated to provide a continued source of positive cash flow regardless of market movements. Having a plan in place that you're confident in, and sticking to that plan, is important to avoid chasing returns when markets are up or selling in reaction to the markets going down.

Our investment philosophy is to remain disciplined and focus on controlling the controllable:

- We continue to manage the risk in portfolios by trimming investments that have appreciated above strategic target allocations and by adding to asset classes with greater potential.
- We remain focused on tax efficiency and, when possible, look to take advantage of the market volatility by harvesting losses to minimize realized gains.
- As always, we carefully manage the cash, making sure to keep sufficient funds for your specific needs.

It was this time last year – with markets at all-time highs – that we ended the 2022 outlook on a cautious note. And although we expect continued volatility in the year to come, today we are more optimistic about the expected long-term returns for your portfolio. The news about the economy will likely continue to be negative, but we expect overall portfolio performance over the next 12 months to be better than it was in 2022.

If you have any questions or would like to discuss your portfolio, please let us know.

Extra Credit - On Recessions and Bear Markets

History shows that there can be recessions without bear markets, and bear markets without recessions. The chart below illustrates this concept along with the idea of the lag in economic data and recession announcements going back to the 1940s. And remember, recessions are a natural part of the economic cycle, just like bear markets are a natural part of investing.

It's the National Bureau of Economic Research (NBER) that officially declares the start of a recession, and its subsequent end. And NBER announcements come an average of 7 months *after* the recession actually began. And when the NBER announces the end of the recession, it's on average 15 months after the recession ended! In fact, in both 1991 and 2020, when NBER announced the start of those recessions, it turned out they were already over.



History reveals an important takeaway – the markets tend to bottom while the economic backdrop is still deteriorating. Remember, the economy and the markets are rarely in sync. Staying invested while sentiment is negative usually proves to be the winning strategy.