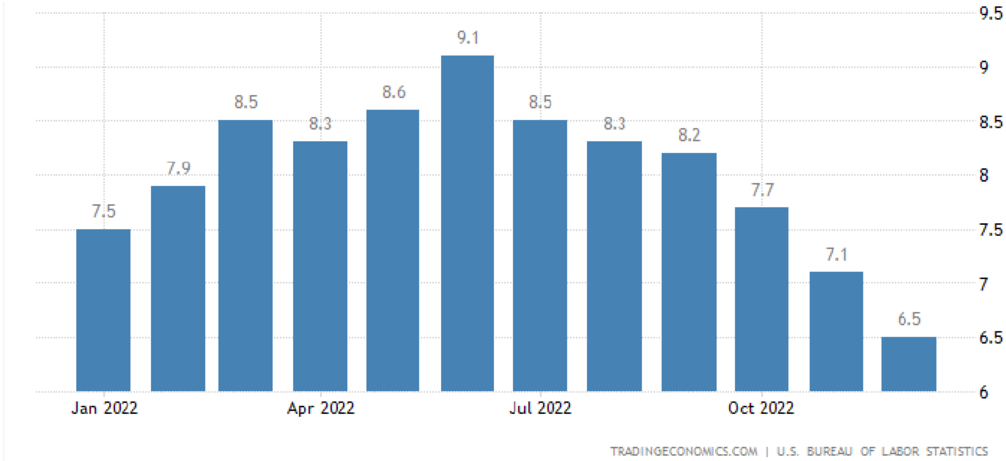
Navigating Changing Tides, Investment and Economic Outlook 2023

Executive Summary:

1. Inflation proved to be far from transitory, but has indicated peaking in June of last year.
2. The rate hike cycle which started in earnest to combat inflation, together with the Ukraine crisis and high commodity prices, especially energy, were huge headwinds for both stocks and bonds in 2022, stocks had their worst year since 2008.
3. The standard and poor's 500 stock market index (S & P 500) declined by 18% and the US aggregate bond Index by 13% bringing the traditional 60% stock 40% bond portfolio (balanced) down by 16% the fourth worst year of balanced portfolio returns dating back to 1792! 2022 was the only time in history when stocks and bonds each fell by more than 10%.
4. While bonds did not prove to be the traditional ballast against market volatility last year, with yields up, the federal reserve's interest rate cycle nearing completion, and inflation abetting, 2023 will likely be an extremely strong year for fixed income.
5. Whether there is a 2023 recession is unknown; however, if there is one, the likelihood of a mild one is fairly high, according to the consensus of many economists.
6. Back to back years of negative returns in the stock mardet are extremely rare, the expectations are for a modest year gains in 2023.
7. There are always some risks to any forecast. The big onew appear to be a federal reserve policy error (Raising rates to much), a larger than anticipated recession, corporate earnings surprises to the downside, a frugal consumer with spending tightening significantly, geopolitics (Russia/Ukraine, China/Taiwan, China Covid Policies) and a US debt crisis. These are only the ones that we have identified as major ones. It is always the unknowns that cause deeper problems. There could also be "unknowns" that will be very positive for the economy and markets.

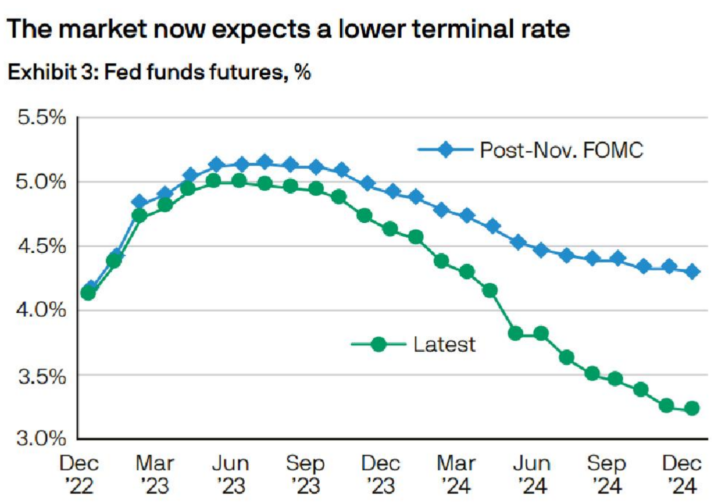
Domestic Equity		2022
	S&P 500	-18.13%
	Russell 1000	-19.14%
	Russell 2000	-20.46%
	Russell 3000	-19.22%
	Russell 1000 Value	-7.56%
	Russell 1000 Growth	-29.14%
International Equity		
	MSCI Emerging Market	-20.09%
	MSCI All Country World (ex US)	-16.00%
Fixed Income		
	BBgBarc U.S. Aggregate Bond	-13.01%
	BBgBarc U.S. Treasury	-12.46%
	BBgBarc U.S. Corporate	-15.76%
	BBgBarc U.S. Corporate High Yield	-11.19%
	BBgBarc Municipal	-8.53%

Inflation



Supply chain disruptions, labor shortage, high commodity prices, the reopening of the economy, consumers with money to spend, the unintended consequences of over stimulating the economy by the Fed- all of these together led to a perfect storm of an inflationary cycle. In early 2022, many believed, Columbus Advisors included, that inflation would abate. We can attempt to place blame on the war in Ukraine, which was largely unexpected to escalate the way that it did, and the immediate effects on energy prices, but it is fair to admit that we were wrong, although we were in the company of many who thought similarly. In retrospect, it is logical to understand that the enormous amount of stimulus created by the government in order to avoid a Depression-era environment caused by the Covid 19 pandemic just left too much money floating around the economy. The other factors, such as the supply chain disruption and the ability of companies to take advantage of the situation to put in place long-awaited price increase only exacerbated the problem. We have used the World War II analogy for some time to compare how the government needed to spend an enormous amount of money to beat the enemy, in this case, Covid 19. After World War II, there also was significant inflation. The difference now is that economists understand much better how to tame inflation. As the chart above shows, December was the sixth consecutive month to see a decline in annual inflation rate. We believe this trend will continue. However, the 2% target inflation rate of the Federal Reserve will take a while to be achieved. We do not believe we will get to an inflation rate that low this year.

Rate Hike Cycle



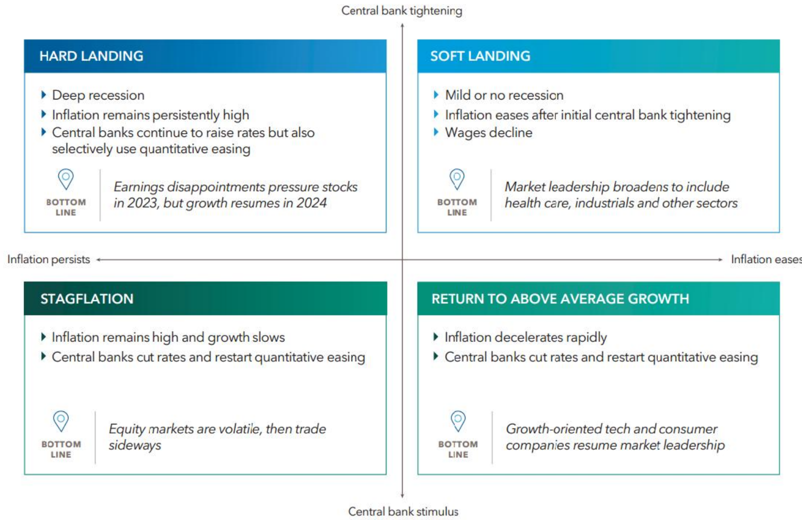
The Federal Reserve has likely almost completed a rate hike cycle that started in early 2022. Many blame the Fed for starting the cycle later than it should have. We do not fall into that camp for two reasons. First, many, including the Fed, believed that inflation was transitory. Second, we have never, ever gone through the events of the last three years before: closing the entire world economy, suffering a major worldwide health crisis, going into a deep, though short-lived recession, and opening up economies around the world only to shut some of them down again for short periods. The Federal Reserve had no "playbook" to deal with unwinding the massive stimulus bills that poured trillions into our economy. Cut too soon and the economy starts to gasp for air again .Jerome Powell has made it known that like samurai warriors, they will slash inflation. But will it need to be slashed to below 2%, their ultimate target, or will inflation be allowed to run slightly higher at 3-4% while the effects of the rate hikes and the slowing economy take hold? The risk is always raising rates too much and for too long. We believe that the end of the rate cycle is near and that the Federal Reserve will be prudent and patient enough to watch inflation continue to subside and the growth of the economy to slow. We have already seen new and existing home fall, real estate prices subside, construction jobs decline, and consumer spending weaken. Let us wait and see.

<u>Effects on the Stock and Bond Markets</u>

The S & P 500 started 2022 with an all-time high of 4796 on January 3, 2022. It sits at about 4000 today, so it will take an almost 20% return to get back to its high water mark. It seems unlikely that that will happen this year, although oftentimes markets have returned greater than 20% in any one given year. More likely, the markets have a modest return, held back by a slowing economy and contracting corporate earnings this year, with more robust returns and a growing economy in 2024. As we have said previously, companies adjust to inflation by increasing prices. It takes several quarters to absorb higher costs within pricing, but ultimately, price go higher as do profits. With a slowing economy the absorption of the effects of the positive effects of inflation (higher pricing) is likely to take longer and thus affect corporate earning negatively in the short term. Fixed income is a much different story.

Bonds have gotten massacred over the past twenty-four months. Bonds, unlike stocks, cannot fall to the floor, unless the issuer of those bonds (a government, municipality, or corporation) fails to pay back its loan, which is what a bond essentially is. Bond pricing is convoluted to understand for many. Think of it this way- The Federal Government borrows $10,000 from you two years ago in the form of a ten year bond and agrees to pay you 2% per year. This bond is publicly traded and you decide today to sell this promise to receive 2% per year for another eight years and $10,000 returned then. New investors can loan the government at 4% today, so the bond that you hold has gone down in value because it only receives 2% per year, even though it will still receive the same $10,000 in eight years. In order for there to be parity, when you go to sell this bond, the new investor will buy it at a price such that they will receive 4% for the next eight years, so they will get a discount on the price of that bond. Essentially, this is what has happened- interest rates have gone up; thus, bond prices have gone down. Since interest rates were basically at zero when interest rates started to rise, the percentage of change has been very high and bonds have gotten clobbered. Now, interest rates are at a more attractive level and are not likely to rise significantly from here. Bonds have become very attractive again. This year, investors can expect yields (or interest on bonds) of anywhere from 4-8%, depending upon whether it is a government, municipal, investment-grade corporate or high yield bond. There is a strong likelihood that interest rates decline later in the year, which would cause price appreciation in bonds (the opposite of what was described above). For these two reasons (yield and potential price appreciation), we believe that now is likely the best entry point for new fixed income investors or additional investments into bonds from current investors. The majority of Columbus Advisor clients have a significant portion of their portfolios in bonds and will likely be rewarded for their patience these past two years.

Recession possibilities



Recessions are a normal part of the business cycle. Three general possibilities exist for a 2023 recession: no recession, a shallow one, or a deep one. The consensus seems to be that the US experiences a mild, short (shallow) one, likely the second half of the year. Although the possibility exists that one is averted, there appears to be a set-up for a short and mild one: the Fed's efforts to tame inflation with a continued rate hike cycle, possibly increasing too much, consumers' pocketbooks stimulus money largely spent, white collar job layoffs, the housing sector and real estate prices contracting, and corporate earnings falling to name a few. Higher inflation and commodity prices coupled with an even tighter monetary policy (Quantitative Tightening increased as well as continued rate hikes throughout the year) point to the possibility of a deeper one. Sometimes, stock market declines cause consumers to tighten their wallets as they see their 401k and other financial assets (Wealth Effect) fall. With housing prices already on the decline, a skittish consumer would also cause a recession to be more severe. While we would like to be optimistic and hope that a recession does not materialize at all, we are realistic about its possibilities. The good news for investors is that markets price in these possibilities before they occur, usually on average by about six months. The stock market may stay in a trading range for the next several months (up a little, down a little, then back up) in the short term in anticipation of a recession in the second half of the year. We would guess, and that is exactly what it is a guess, though an educated one, that if the market continues its upward trend for the first half of the year, there is a strong likelihood that a recession is avoided. Stay tuned.

Staying invested for the years ahead

There are many unknowns in the coming year. Some are negative and can cause further harm to the markets, such as a prolonged Russia/Ukraine conflict, a longer-term inflationary environment, especially wage inflation, or a continued labor shortage. Positive trends are already emerging that have long term effects on growth and profitability for companies as well as a higher standard of living for individuals ultimately. Automation, AI (artificial intelligence), quantum computing, bioengineering are all in very early stages of what is now referred to as the Fourth Industrial Revolution. Advances in health sciences and health care may lead the next bull market much like digital technology led to the huge bull market of the last twenty years and the advances we daily enjoy, including Amazon deliveries, and the I-Phone. Higher interest rates bode well for fixed income. This past year has been challenging. However, Columbus Advisors stands prepared to continue accompanying our clients for the long-term: monitoring investments, checking clients' budgets, income needs and financial plans, and adjusting portfolios as needed. Feel free to reach out to us at any time and know that we will continue to check in with you regularly. Know how much we value your trust and your business. Let's make 2023 a healthy, happy, and productive year ahead.

DISCLOSURE

Discover a new way

Frank Lavin CLU, ChFc, CFP®
415-796-2693 / Frank.Lavin@securitiesamerica.com

Frank Lavin II CFP®, MSFP
415-335-4431 / Frank.Lavin2@securitiesamerica.com