Commentary

2023 Outlook

The top five trends to monitor in the year ahead

Dirk Hofschire, CFA
Senior Vice President
Asset Allocation Research

Cait Dourney, CFA, CBE
Research Analyst
Asset Allocation Research

Collin Crownover, PhD
Research Analyst
Asset Allocation Research

Jake Weinstein, CFA
Research Analyst
Asset Allocation Research

Lisa Emsbo-Mattingly, CBE
Managing Director of Research

Andrew Garvey
Research Analyst
Asset Allocation Research

OUR EXPECTATIONS FOR FIVE KEY TRENDS

- Inflation rates will decline markedly in 2023 but remain higher than the market anticipates.
- The Fed will slow its tightening cycle and eventually stop hiking rates during 2023, but its policy rate will remain higher for longer than expected.
- The U.S. economy will decelerate into a recession. Our base case is that it will be a relatively mild economic contraction, but we're actively monitoring downside risks.
- Through fits and starts, China's relaxation of COVID-19 restrictions may prompt a rebound in services activities and lead to a cyclical economic uptick.
- Interest rates—the yields on Treasury bills and bonds—are likely to remain volatile and trend lower.

INVESTMENT IMPLICATIONS

- The uncertainty around these trends is likely to persist well into 2023, implying high odds of continued market volatility and a heightened need for significant portfolio diversification.
- Broad-based declines in asset prices in 2022 imply much cheaper valuations to start the year in 2023, with long-term valuations of bonds and non-U.S. equities relatively attractive.
- Market volatility in 2023 could provide even greater valuation opportunities, as many recessionary periods historically coincided with high levels of investor pessimism and ended up providing solid entry points for new investments.

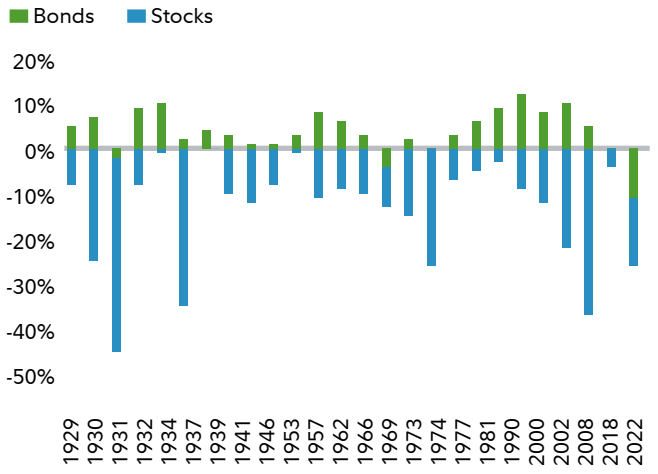
2022 Review

The prices of almost all asset categories dropped in 2022. Broad measures of the two largest U.S. asset classes—stocks and bonds—both posted double-digit losses for the first time in modern history (since 1926). This made portfolio diversification a major challenge. Historically, the bond market had posted either a gain or a smaller loss than stocks in the years that equity prices declined (Exhibit 1).

A handful of primary factors combined to create this challenging market backdrop over the past year. These include high inflation, tightening monetary policy and higher interest rates, slowing U.S. and global economic growth, and geopolitical turmoil. Looking ahead, how these factors evolve will be critical to the 2023 outlook.

Fidelity INVESTMENTS

EXHIBIT 1: Equity and Bond Returns When Equities Fell (1926–2002, annualized)



Past performance is no guarantee of future results. Diversification does not ensure a profit or guarantee against a loss. Fidelity Investments' proprietary analysis of historical asset class performance is not indicative of future performance. Source: Fidelity Investments and Haver Analytics, as of 12/31/22.

Top 5 things to watch in 2023

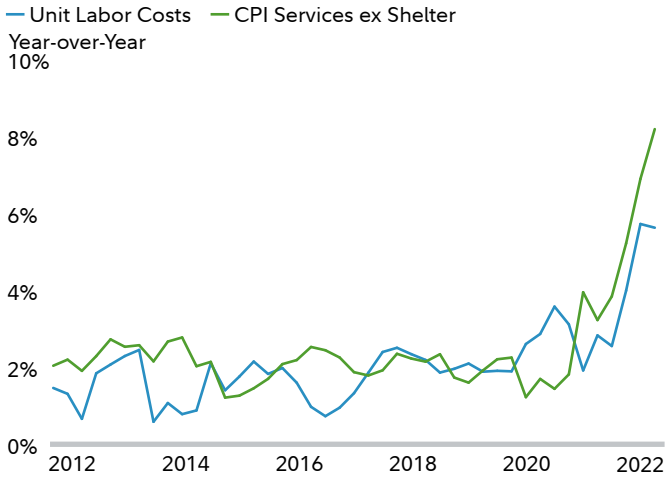
Inflation

- **Outlook:** We believe inflation rates will decline markedly in 2023 but remain higher than the market expects.
- **What to watch:** Housing and labor markets will be the two key indicators to assess the degree to which the inflation rate may slow in 2023.
- **Why it matters:** A definitive return to much lower inflation could provide a backdrop in which last year's big headwinds, including Fed interest-rate hikes and rising bond yields, can stop their uptrends.

U.S. consumer inflation peaked above 9% in 2022—the highest in four decades—and was a major catalyst for the monetary tightening and rise in bond yields that made 2022 so challenging for investors. The good news is inflation decelerated to about 7% year-over-year in the second half of 2022, and we believe it's headed toward a further significant slowing in 2023. Supply-chain disruptions have improved, energy prices have dropped off their recent highs, and prices for most goods disinflated late in 2022. The bad news is the financial markets have priced in a return to low and stable inflation quickly and relatively painlessly, which we believe is a tall order.[1]

The key to the outlook in 2023 is the degree to which disinflation occurs in services industries, where inflation tends to be more persistent and often requires greater demand softening. A weakening housing market could help slow rental inflation rates in 2023, which will be helpful, but official shelter inflation calculations typically adjust slowly to this dynamic. Therefore, housing-related disinflation may take a while. Our eyes will be focused on the labor markets, where employee costs typically have had a heavy influence on the price of services, as we can see from the historically tight relationship between unit labor costs and non-housing service prices (Exhibit 2).

EXHIBIT 2: Labor Costs and Services Inflation Still Elevated



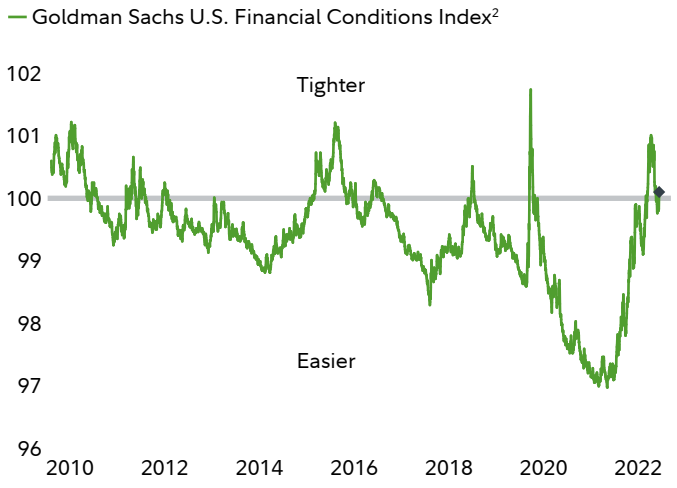
Source: Bureau of Labor Statistics, Bloomberg, Fidelity Investments (AART), as of 9/30/22.

Recently, we have seen early signs of softening demand for labor, but aging demographics and other structural issues may continue to restrain labor supply and keep wage growth above levels compatible with 2% core inflation. The potential for stickier wages to continue supporting elevated unit labor costs means inflation in services prices could be more persistent than commonly believed. For the market's low inflation forecast to be correct in 2023, we'd probably need to see much greater labor-market weakness and a significant increase in unemployment.

Monetary policy

- **Outlook:** We believe the Fed likely will slow its tightening cycle and eventually stop hiking rates during 2023, but its policy rate will remain higher for longer than the market expects.
- **What to watch:** Monitor financial conditions to gauge whether the Fed can maintain its singular focus on bringing down inflation, or whether an outbreak of financial stress causes it to change course.
- **Why it matters:** In general, monetary tightening is a headwind for asset prices and monetary easing a tailwind, so hopes for a "Fed pivot" will continue to be top of mind for many investors in 2023.

EXHIBIT 3: Roughly Neutral U.S. Financial Conditions



Source: Bloomberg Financial L.P., Goldman Sachs, Fidelity Investments (AART), as of 12/31/22.

The U.S. Federal Reserve chopped a lot of wood in 2022, raising its policy rate from near 0% to near 4.5% by the end of 2022. Also, the Fed began quantitative tightening (reducing its balance sheet), and many central banks around the world hiked rates throughout the year. As a result, and because inflation trends are now headed in the right direction, the Fed may be in the final innings of its tightening cycle. Current market pricing indicates a belief that the Fed could stop hiking at around 5% by mid-2023 and begin easing policy in the second half of the year. Partly because we don't expect inflation to come down as quickly as the market expects, we also don't think the U.S. central bank is likely to pivot so rapidly toward easing. The Fed appears willing to tolerate some economic pain in the form of higher unemployment to make sure that core inflation continues downward toward its 2% target.

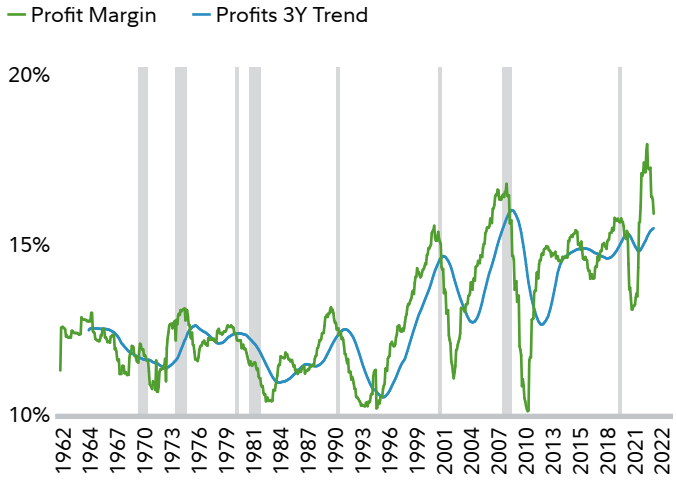
While the interplay between inflation falling and unemployment rising may be important, we'll monitor financial conditions closely to gauge whether the Fed can keep rates high or pivot to address financial stress. Global monetary tightening in 2022 served to reduce liquidity and asset valuations, including in some formerly high-flying markets like cryptocurrencies. But for the most part, the tightening in financial conditions has been orderly, and many measures of financial conditions fell back to a normal or neutral level by the end of 2022, as opposed to a particularly onerous one (Exhibit 3). If this changes in 2023 and something breaks and creates more stress, the Fed could be pushed away from its inflation-fighting focus and toward a more accommodative stance.

U.S. business cycle

- **Outlook:** We believe the U.S. economy will decelerate into a recession. Our base case is that it will be a relatively mild economic contraction, but we're actively monitoring downside risks.
- **What to watch:** How quickly and to what degree employment conditions deteriorate is a major factor, as tight labor markets have boosted a relatively healthy consumer and kept the U.S. expansion going (and the Fed hiking).
- **Why it matters:** The onset of recession typically implies a challenging time for riskier assets and outperformance of more-defensive categories, but recessions can also sow the seeds of greater investment opportunities once they are underway.

EXHIBIT 4: High But Falling Profit Margins

U.S. Corporate Profit Margins



Source: Haver Analytics and Fidelity Investments, as of 12/31/22.

The U.S. economy lost steam in 2022 but remained in a late-cycle expansion. Leading indicators suggest recession risks could continue to rise in the coming months. Credit conditions have deteriorated as banks have tightened standards for all types of loans. Also, Treasury-bond yield curves remain inverted as of the end of December. Inventories have risen relative to sales, and new orders for manufacturing goods have declined. Profit margins have fallen, which is typical of the final months of the late-cycle phase. At the end of December, margins appeared high relative to history but have fallen by about two percentage points and are nearing their cyclical trend, which often occurs at the start of a recession (Exhibit 4). According to consensus estimates, the market expects positive earnings growth of about 3% in 2023. It's possible earnings growth will hold up better than the average 18% decline during typical recessions, but we think there is downside risk relative to market expectations.

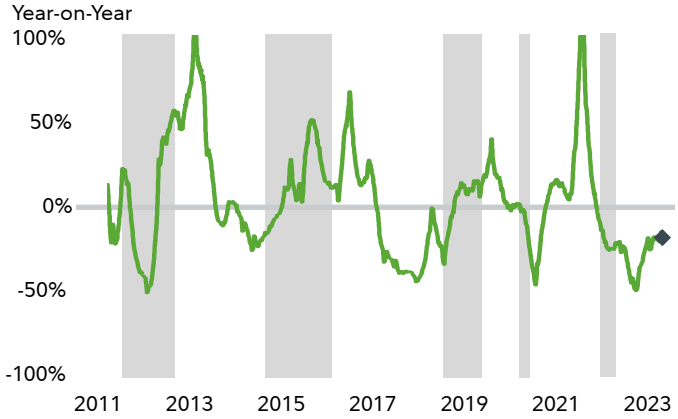
Due to the strength in labor markets and the resilience of the consumer sector in 2022, we're closely monitoring how employment markets evolve and affect consumer spending in 2023. On the downside, consumers' willingness to spend may be threatened by savings rates that have dropped to near all-time lows (about 2.3%), the apparent exhaustion of excess savings for low and some middle-income cohorts, and falling asset prices. On the upside, labor markets appear structurally tighter and more supportive of wage growth on a medium-term basis. As of the end of 2022, household balance sheets remain in good shape, the preponderance of fixed-rate mortgage debt implies a lack of financial stress, and falling inflation may boost real (inflation-adjusted) income growth. Of course, there are offsetting implications for good or bad economic news. For instance, stronger labor markets could keep the late-cycle expansion rolling but might also induce the Fed to keep monetary policy tighter for longer.

China's business cycle

- **Outlook:** We believe China's rapid relaxation of COVID restrictions will prompt a rebound in services activity and the potential for a cyclical uptick.
- **What to watch:** A sustained economic reopening in 2023 could boost Chinese consumption. Whether this translates into firm support for China's ailing housing market is a key factor.
- **Why it matters:** China is the world's second-largest economy, and its prolonged slump has weighed on global demand and emerging-market equities. Any cyclical improvement could be helpful for both in a year that may be challenging for the global economy and markets.

EXHIBIT 5: China's Struggling Property Sector

China Property Sales Transactions



Three-month moving average of property transactions for commercial and residential housing measured by 1,000 square meters of floor space sold. Gray bars represent growth recessions as defined by AART. Source: National Bureau of Statistics, People's Bank of China, Fidelity Investments (AART), as of 12/21/22.

After maintaining restrictive pandemic policies for far longer than the rest of the world, China dramatically eased its zero-COVID restrictions at the end of 2022. Early 2023 may involve high health costs, more potential supply-chain disruptions, and generalized uncertainty. But two years of pent-up consumer demand may ultimately imply a cyclical boost to the services sector, as reopening benefits restaurants, travel, and other consumer services. China's consumers do not enjoy the same high level of excess savings and tight labor markets that U.S. households did amid reopening, but a more normalized backdrop—along with a continued increase in fiscal and other policy stimulus—gives China a chance for a cyclical uptick that's been largely elusive in recent years.

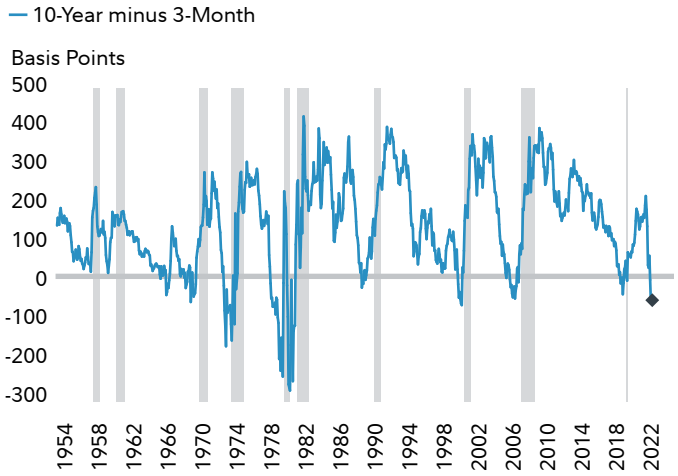
Unfortunately, lifting COVID restrictions would alleviate only one of the many challenges facing the Chinese economy. Serious structural problems—including aging demographics, an overleveraged commercial sector, and rising political and regulatory risk—appear likely to persist. At the center of it all is an inflated property market burdened by excess capacity. We're watching the property sector—for instance, whether property sales can stabilize—as the key swing factor in 2023 (Exhibit 5). After steep price declines and a rise in policy support, housing affordability has improved markedly; however, there's a real question as to whether homebuyer confidence will return to a sector dominated by headlines about struggling property-development companies and unfinished housing projects.

Interest rates

- **Outlook:** We believe interest rates—the yields on Treasury bills and bonds—are likely to remain volatile and trend lower.
- **What to watch:** The most important driver of bond yields is the U.S. business cycle; if the U.S. enters recession, we expect rates to move lower. Alternatively, an extended U.S. late-cycle expansion, cyclical improvement in China and the global economy, and unexpectedly high inflation could put upward pressure on interest rates.
- **Why it matters:** Bond yields move inversely to bond prices, so lower yields could provide some support for bond returns and create a very different environment from 2022. Lower bond yields may also support stock valuations, but whether equity prices benefit may depend on whether yields fall more because of disinflation (positive) or recession (negative).

High inflation and global monetary tightening propelled interest rates sharply upward during 2022. By the end of 2022, longer-term 10-year Treasury yields—largely determined by financial markets—dropped well below the shorter-term, 3-month Treasury bills that are more influenced by U.S. Federal Reserve policy (Exhibit 6). This steep inversion of the yield curve—with longer rates higher than shorter rates—is historically a leading indicator of recession and a sign that the financial markets believe at some point in the future the Fed will have to start cutting rates in reaction to economic weakness. We're watching our business-cycle indicators highlighted above to monitor whether a U.S. recession becomes the dominant story in 2023.

EXHIBIT 6: The Inverted U.S. Treasury Yield-Curve Spread



Shaded areas denote U.S. recession. Source: U.S. Federal Reserve Board, NBER, Haver Analytics, Fidelity Investments (AART), as of 12/31/22.

Investment Conclusions

There is great interdependence among the five factors discussed above, so the ultimate investment implications depend on the evolution of their interlocking paths.

- We believe that both inflation and policy rates could remain higher than current consensus investor expectations. The Fed's latest inflation and interest-rate projections indicate a similar sentiment, that the markets are overly sanguine about how quickly inflation will fall and monetary policy will begin to ease. (Exhibit 7).
- If our expectations come to fruition, a U.S. recession may be more supportive for the prices of bonds and more defensive assets.
- Alternatively, if market expectations prove more accurate and the Fed eases policy due to a relatively benign disinflationary backdrop, this scenario may be more supportive for equity prices (although bond yields might also fall and boost bond prices).
- The uncertainty around these trends is likely to persist well into 2023, implying high odds of continued market volatility and a heightened need for significant portfolio diversification.

Market volatility in 2023 could provide even greater valuation opportunities in some segments of the asset markets. Historically, many recessionary periods coincided with high levels of investor pessimism and ended up providing solid entry points for new investments.

- For instance, over the past 11 recessions since 1950, a diversified portfolio of stocks and bonds returned an average of 6% and 11% over the one- and two-year periods after the start of the recession.

EXHIBIT 7: U.S. Federal Reserve vs. Market 2023 Expectations

Fed values from December Summary of Economic Projections, Inflation: PCE. Market Policy and Inflation based on forward swaps. Employment: Contributor Composite view from Bloomberg Economic Forecasting. Source: Bloomberg Financial L.P., Federal Reserve Board, Fidelity Investments (AART), as of 12/31/22.

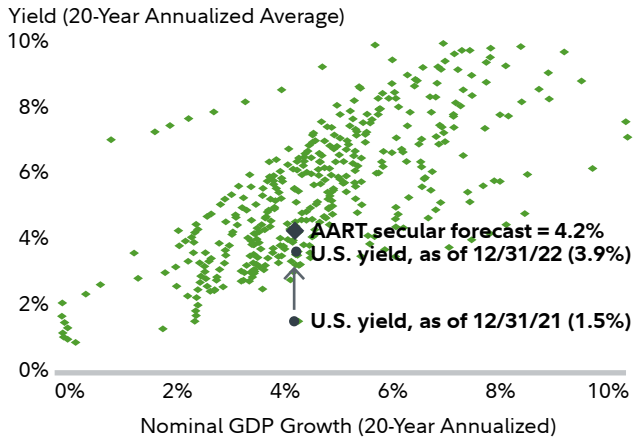
Perhaps the best news for investors is that the broad-based declines in asset prices in 2022 imply much cheaper valuations to start the year in 2023.

- Ten-year Treasury bond yields rose from near record-low levels (1.5%) at the beginning of 2022 and finished roughly near our long-term average projection at 3.6% (Exhibit 8).
- Cyclically adjusted price-to-earnings (CAPE) ratios dropped significantly for U.S. equities in 2022 from historically high valuation levels. While U.S. valuations are still elevated versus our long-term expectations, the CAPEs of non-U.S. equities fell to roughly fair valuation and appear relatively attractive (Exhibit 8).
- From these greatly improved valuation levels, we consider the odds of a repeat of 2022's performance—double-digit losses for both bonds and stocks—to be remote in 2023.

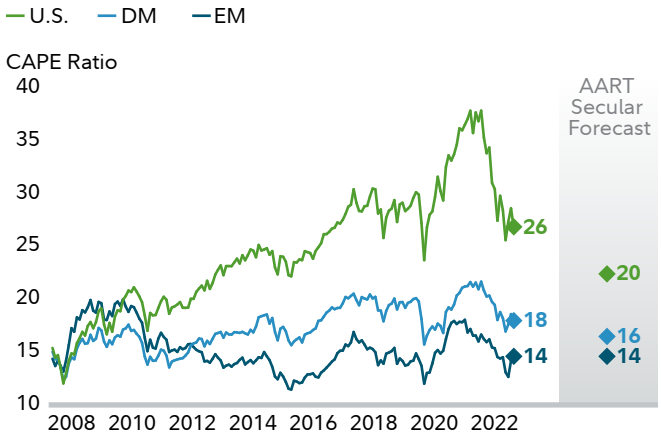
We believe valuations are perhaps the most important indicator of expected returns over the medium and long term, and 2023 is a more attractive starting point for valuations than at any time in the past decade.

EXHIBIT 8: Valuations Are Much Improved. Potential Opportunities Ahead?

10-Year Sovereign Bond Yields vs. GDP



Equity Valuations



Past performance is no guarantee of future results. It is not possible to invest directly in an index. All indexes are unmanaged. See Appendix for important index information. LEFT: Highlighted dots are U.S. 10-year Treasury bond yields. AART secular forecast refers to an estimate for U.S. nominal GDP (4.2%). Source: Official Country Estimates, Haver Analytics, Fidelity Investments (AART), as of 12/31/22. RIGHT: DM: Developed markets. EM: Emerging markets. Price-to-earnings (P/E) ratio (or multiple): Stock price divided by earnings per share, which indicates how much investors are paying for a company's earnings power. Cyclically adjusted earnings are 10-year averages adjusted for inflation. Source: FactSet, countries' statistical organizations, MSCI, Fidelity Investments (AART), as of 12/31/22.

Author

Dirk Hofschire, CFA
Senior Vice President
Asset Allocation Research

Cait Dourney, CFA, CBE
Research Analyst
Asset Allocation Research

Collin Crownover, PhD
Research Analyst
Asset Allocation Research

Jake Weinstein, CFA
Research Analyst
Asset Allocation Research

Lisa Emsbo-Mattingly, CBE
Managing Director of Research

Andrew Garvey
Research Analyst
Asset Allocation Research

The Asset Allocation Research Team (AART) conducts economic, fundamental, and quantitative research to develop asset allocation recommendations for Fidelity's portfolio managers and investment teams. AART is responsible for analyzing and synthesizing investment perspectives across Fidelity's Asset Management unit to generate insights on macroeconomic and financial market trends and their implications for asset allocation.

Fidelity Thought Leadership Vice President Michael Tarsala provided editorial direction for this article.

[1] As of 12/31/22, the breakeven rates on Treasury Inflation Protected Securities, or TIPS, implied inflation rates of between 2.1% and 2.3% over the next 1–10 years. Source: U.S. Federal Reserve Bank of St. Louis.

[2] The Goldman Sachs Financial Conditions Index broadly measures the tightening and easing of financial conditions using a weighted average of components including riskless interest rates and credit spreads, with weights that correspond to the direct impact of each variable on U.S. gross domestic product.

1067809.1.0 1.9908938.100