TC Wealth Partners
Trust Company
of Illinois

# MATTERS OF TRUST

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FROM THE DESKS OF

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## ANYTHING BUT ORDINARY, EXPECTING THE UNEXPECTED IN 2023

2022 proved to be the most challenging year for investors in more than a decade as multiple headwinds hit the economy and the markets. Four-decade-high inflation, aggressive central bank tightening, a war in Ukraine and lockdowns in China, all contributed to a rapid adjustment in interest rates, valuations, and sentiment. As a result, most major equity indexes peaked on the first trading day of the year and have been on a downtrend since, with the S&P 500 navigating its longest bear market since 2008. Also vulnerable to the inflation surge and the withdrawal of monetary stimulus, bonds experienced their largest sell-off since records started in 1926.

As we look ahead, we think that inflation and central bank actions will remain in the driver's seat in 2023, but conditions could slowly start to shift in a more favorable way for the markets. With investors ready to turn the page on the calendar, we review some of the milestones that defined the markets over the past 12 months and offer some perspective on how these factors could evolve.

## Economy

The U.S. economy contracted in the first half of the year with GDP declining in the first and second quarters, stoking worries of recession. Consumer spending – which accounts for 70% of GDP – stayed healthy, despite rising prices and interest rates. The largely undeterred consumer, together with the historic low unemployment rate, helped to prevent a 2022 recession.

### OUR VIEW

We think that the economy will soon be tested when the full impact of the Fed's restrictive policies has filtered its way through the system. Financial markets bared the brunt of the rise in borrowing costs in 2022, but the real economy could be next as consumers and business pull back on spending. A recession is not a foregone conclusion, and if it happens, we think it will be a shallow or a mild one compared to history. Household finances are in decent shape compared to prior downturns, the banks are in a strong financial position, and the expected rise in unemployment could prove modest.

## Employment

The labor market was the brightest spot in the slowing economy. After averaging about 390,000 job gains a month in 2022, total employment returned to where it stood before the pandemic, while the unemployment rate declined back to 3.5%, a 53-year low. Strong employment continues to support incomes, but when viewed through the lens of inflation it is a cause for concern for central banks. With all roads leading back to the Fed, and upcoming Fed actions being dictated by inflation expectations, the trend in wages is perhaps the most important element of the labor market for now. To this end, wage growth moderated markedly in December, dropping back to 4.6%, the lowest reading in 16 months.

### OUR VIEW

We doubt the labor market will remain unscathed in 2023, but the historically high amount of job openings will probably provide some cushion against a sharp spike in unemployment. We think that the unemployment rate will rise but stay below 5%. Over the last 50 years, in the six months leading up to a recession, monthly job growth averaged 99,000. In the last six months of 2022, job growth has averaged 307,000. To us, this does not suggest that we'll completely skirt a recession this year, but it does tell us that we're entering a slowdown from a much healthier employment position, which we think will produce a milder downturn.

## Inflation

Inflation remained the number one driver for the markets throughout the year, with every successive upside surprise resulting in investors adjusting their interest-rate expectations higher and pressuring valuations. The headline consumer price index (CPI) hit a peak of 9.1% in June, a 41-year high, before starting to slowly ease over the past few months. The spike in inflation was first driven by a surge in oil and grain prices sparked by the unexpected war in Ukraine, but then price pressures broadened to the service industry.

### OUR VIEW

One of the potential surprises in 2023 could be how fast inflation subsides. We expect price pressures to ease meaningfully throughout the year, providing some relief to consumers and central banks. We see CPI falling below 4% by summer, and likely approaching 3% by the end of the year. This moderation will likely be driven by slowing consumer demand, easing supply shortages and a cooling housing market. We believe that the path of disinflation is unlikely to be a straight line and will require some downward pressure on wage growth as the labor market becomes less tight.

## Federal Reserve

The persistence and breadth of inflation led the Fed to embark on its most aggressive tightening campaign in decades. In response, short- and long-term yields shot up, with the 10-year yield almost tripling from 1.5% to 4.3% before pulling back recently. The Fed's aim is to raise borrowing costs enough to slow growth and tame inflation, but not so much as to push the economy into recession. However, the farther policy rates move into restrictive territory, the narrower the path for a soft landing.

### OUR VIEW

While it has been a long and painful road as interest-rate expectations kept adjusting higher throughout 2022, there now seems to be some light at the end of the Fed's tightening tunnel, and market expectations for the peak fed funds rate have stabilized around 5%. With economic growth weakening and inflation falling, we think the Fed will be able to conclude its rate hikes, probably in the first half of 2023, and that will likely start to relieve the upward pressure on bond yields and equity valuations. We expect markets to remain volatile as the effects of the Fed's actions over the past year begin to show up in a slower economy. But we believe (and history shows) that less restrictive policy from the Fed will be a positive catalyst for both stocks and bonds as we move through 2023.

## Equities

2022 was the most difficult year for investors from a return and volatility standpoint since the Global Financial Crisis. Multi-decade highs in inflation combined with historically aggressive Fed rate hikes and growing concerns about a recession pressured stocks and bonds. The S&P 500 posted its worst performance since 2008, while major benchmarks for both stocks and bonds declined together for the first time since the 1960s. Investors who were in a traditional 60/40 equity-fixed income portfolio suffered the fourth-worst return since 1926, punctuating just how disappointing the year was for investors. On a full-year basis, all three major indices posted negative returns, with the Dow Jones Industrial Average down -6.86%, the S&P 500 down -18.11% and the Nasdaq down -32.38%. Internationally, foreign developed markets represented by the MSCI EAFE registered solidly negative returns of -14.01%, as did emerging markets represented by MSCI EM which returned -19.74%.

### OUR VIEW

While the economy could possibly enter a mild recession in 2023 as the lagging impact of higher interest rates feeds through the economy, in our view this outcome is well-anticipated, and stocks can start looking past the downturn. It will likely be a bumpy ride early in the year as economic data possibly underwhelms. Yet we think equities can navigate a U-shaped recovery, with the right side of the U emerging in the second half of the year. Corporate earnings could be a key focus for investors in 2023, but also a potential instigator of volatility. As the economy slows, we believe that earnings will likely come under pressure. Assuming the recession is not deep or prolonged, corporate profits should hold up better than during past downturns. We believe that once inflation starts to moderate and the Fed pauses, equity valuations could stabilize and possibly expand, supporting positive and potentially above-average equity returns for the year.

## Fixed Income

Switching to fixed income markets, the leading benchmark for bonds (Bloomberg Barclays U.S. Aggregate Bond Index) realized a positive return for the fourth quarter but declined by -13% for the full year of 2022, as more aggressive than expected Fed rate hikes combined with decades-high inflation

pressured most bond classes. This was the first time ever that the Bloomberg Barclays U.S. Aggregate Bond Index recorded back-to-back annual losses (-1.5% in 2021 and -13% in 2022).

### OUR VIEW

2022 was unprecedented for investors in that both equities and bonds fell into bear market territory by the second half of the year, as the rapid rise in interest rates put downward pressure on both markets. This was particularly painful for investors who had hoped their bond portfolios would provide a buffer during equity market volatility. However, there is likely good news ahead for bond investors because we believe that bonds could play their more traditional diversification role in 2023, and perhaps offer outsized returns as well. The Fed is likely nearing the end of its rate-hiking cycle. With a more gradual pace of hikes ahead, yields and income opportunities are higher than in recent history, and there is potential for price appreciation if bond yields peak and start to trend lower.

## CONCLUSION

As always, all of us at TC Wealth Partners/Trust Company of Illinois are so appreciative to serve you through these turbulent times. Please rest assured that we remain dedicated to helping you successfully navigate this market environment. Every day we analyze our investment selections and strategize how to invest our clients' hard-earned assets, while remaining vigilant towards risks to the economy and your portfolios.

Please do not hesitate to contact us with any questions, comments, or to schedule a portfolio/financial plan review. Thank you for your ongoing confidence and trust.

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