withum WEALTH MANAGEMENT

Winter, 2023

Investment Commentary

Review of 2022

We would like to wish you and your loved ones a Happy New Year and a healthy and prosperous 2023.

In 2022 there was almost a complete return to normalcy and acceptance that COVID is now a part of our lives. However, the end of the pandemic also meant the end of pandemic assistance and the market did not take kindly to tighter fiscal and monetary policy or the high inflation that was spawned by those highly accommodative policies.

The war in Ukraine rages on and continues to cause great humanitarian trouble across Europe. Oil prices have moderated, but high energy prices caused immense stress on the consumer through early 2022. In terms of the consumer, we saw spending habits shift from goods (new appliances, home renovations, pandemic related hobbies, etc.) to services (travel, restaurants, experiences, etc.). Entering 2023, the consumer remains strong but with dwindling savings. It has been estimated that the pandemic savings bump should be depleted by the summer.

The story of the year however was inflation – transitory, it was not. The good news is that 2022 may represent the peak of inflation for this cycle which means the Federal Reserve should be able to soon slow and eventually pause their tight policy stance in the months ahead. Extremely aggressive Federal Reserve policy caused immense market and economic implications that still worry investors today. The good news is that markets are forward looking and at some point will factor in easier monetary policy and better earnings in years to come; this can provide a tailwind for sentiment and market returns.

This past year was the worst year for the stock market since 2008. The S&P 500 dropped -18.11% on a total return basis and briefly dipped below -27.00% YTD, as measured on an intraday basis, in October. The Nasdaq fared far worse – the Nasdaq 100 was down -32.97% on a total return basis, closing near the lows of the year. Favoring "high quality" companies – those with strong balance sheets, positive cash flows in more predicable business lines with pricing power – led to relatively better returns.

2023 Outlook – Challenges Ahead

In 2023, some major concerns are facing markets and the economy.

- Will the Federal Reserve continue to raise rates in the face of slowing inflation and economic growth?
- Will geopolitical tensions in Eastern Europe and Taiwan worsen?
- Will the economy tip into a recession?

Each of these concerns could be enough to create more market stress in 2023, however much of this is likely already factored into current equity valuations.

At this point, most major Wall Street firms are forecasting a largely flat year for 2023, however it likely won't feel that way. Volatility should remain elevated but will hopefully calm towards year end.

> "Consensus thinking isn't necessarily wrong . . . it's just what's priced into the markets."
>
> *- Tom Lee, Wall Street Strategist*

The stock market interprets all the above potential issues and more while continuously assigning probabilities to those outcomes. Often in times of stress, people gravitate to worst case scenarios, lowering the expectations of what might be a favorable outcome. Should a soft landing occur, or the Fed's bark proves greater than its bite, equities could surprise to the upside.

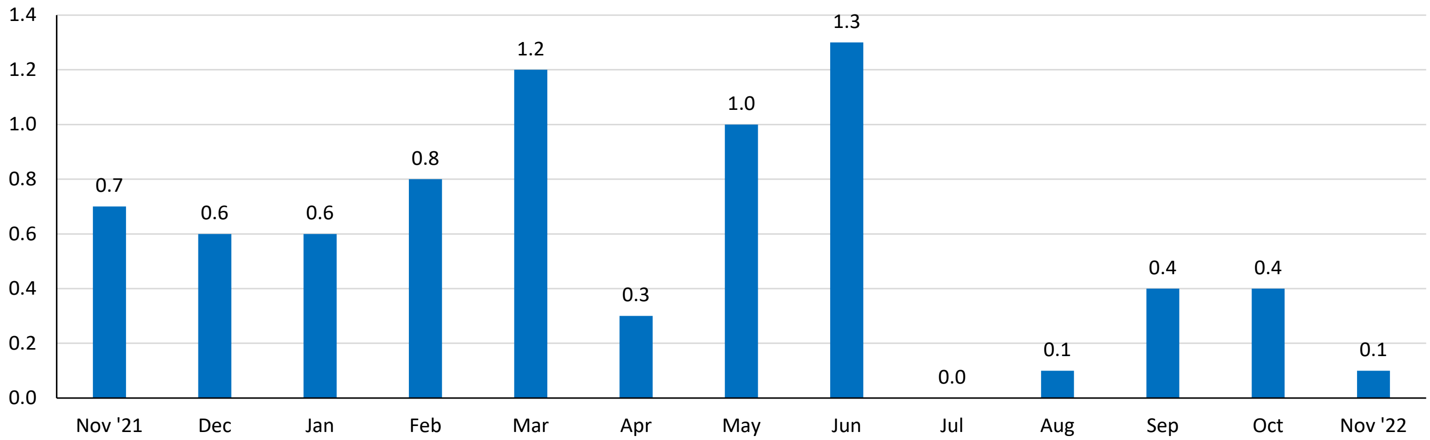
2023 Outlook - Reasons to be Optimistic

Inflation has likely peaked for this cycle. While headline inflation still sits at 7.1% for the twelve months ending in November, the more recent data is encouraging. Since July, inflation is annualizing a far more normal 2.5%. Looking forward and factoring in some of the more high-frequency data, the months ahead should continue to see inflation normalize towards the Fed's longer run target of 2-3%. If the trend of recent months continues, and the high month-over-month numbers from December, January, February & March fall out of the data set, it would not surprise us to see inflation below the Federal Funds rate at some point in late 2023/2024.

The Federal Reserve has done their job by raising interest rates to a restrictive level that is beginning to

One-month percent change in CPI for All Urban Consumers (CPI-U)

Seasonally adjusted, Nov. 2021 - Nov. 2022



Source: Bureau of Labor Statistics, U.S. Department of Labor

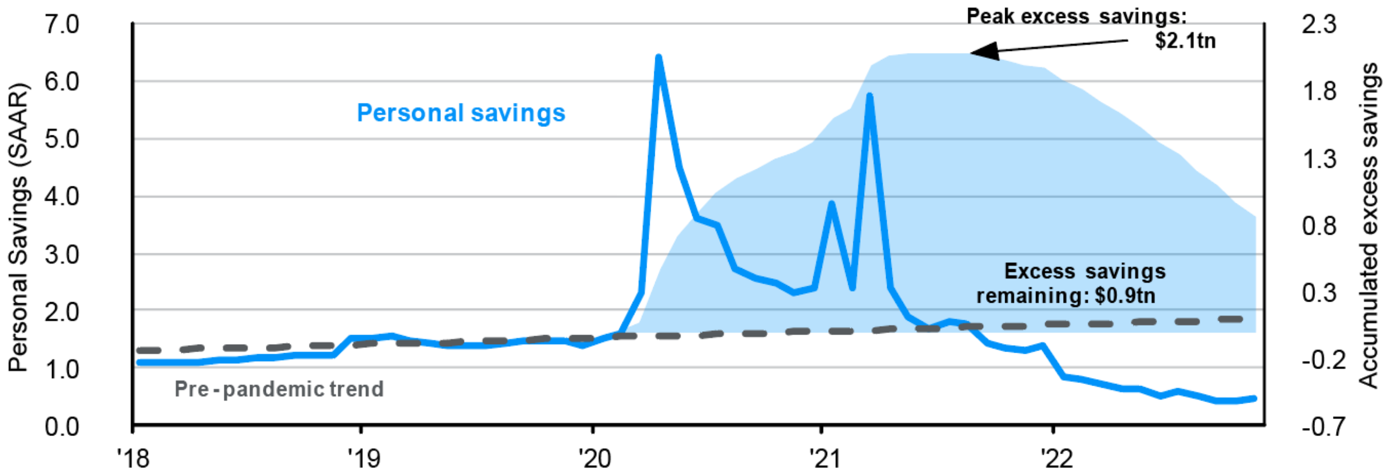
affect consumer demand for goods. Currently, the benchmark interest rate is between 4.25% and 4.50% and the Fed plans to hike rates another 0.25% in February. Interest rates could be thought of as "the cost of doing business" and the rapid rate rise last year is just now working its way into the economy. The next few moves might be crucial in determining whether we enter a recession in 2023. Prolonging tight fiscal policy in the face of slowing growth and earnings could be a big mistake. We have no reason to believe that the Fed will not stick to its word – they have been remarkably transparent of their moves so far—however, with inflation trending in the right direction, it's hard to believe the Fed will remain as restrictive as they are currently forecasting in the back half of the year. The bond market is signaling that they don't believe the Fed will meet their projections. A pivot in Fed policy could be a positive catalyst for stocks.

A major headwind in 2022 was the strength of the US Dollar. Currencies are valued relative to one another and since the US was the largest world economy to begin raising rates, our higher yielding debt became more attractive and made the Dollar stronger. Towards the end of the year, with foreign nations' yields catching up, the Dollar weakened, and created a tailwind for all stocks, but particularly foreign stocks. That pattern could continue in 2023.

The consumer also remains strong. Given the increased stimulus after COVID and lockdowns that prevented people from spending money, consumers saved upwards of $2 trillion above normal. This is currently being spent down due to pent up demand, but also because prices have risen faster than wages have grown. Some estimates are currently pointing towards this "excess" savings running dry sometime this summer. If wage growth can remain ahead of inflation by the time consumers deplete their excess savings – we could see a favorable situation for household wealth creation (wages growing faster than what we consume) and avoid an earnings slowdown that many are forecasting.

Another reason to be optimistic is potential multiple expansion. Just as now we're factoring in 2023 forecasted earnings, at some point next year, investors will begin looking to 2024 and 2025 earnings. If earnings are to dip this year, markets may begin to expect a return to earnings growth in 2024 and beyond. Markets are always forward looking and if we do enter a recession, the stage could be set for improving investor sentiment and market conditions. If the first half of the year is volatile, multiple expansion in the back half of 2023 could create another positive development as valuations become more attractive.

Household excess savings
Trillions of USD



Source: J.P. Morgan Asset Management - Guide to the Markets, December 31, 2022

While not a reason in and of itself, the market rarely experiences two negative years in a row – the last occurrence was in 2001/2002 as the already fragile economy coming down from the tech bubble was sent into a deep recession after of 9/11. Prior to that '73/'74 was the last two-year negative period and the only other instance since World War II. Barring any unforeseen crises, a mild recession that everyone seems to be expecting may not be enough to "mark down" an already discounted market for a second year in a row.

Back to the aforementioned Tom Lee quote - if consensus view calls for a recession and we do not see mass layoffs and continue to see strong consumer spending in the face of normal inflation numbers or an easier Fed, then these "surprises" could lead to positive stock market performance. On the other hand, a stubborn Fed could push the economy into a deeper than expected recession which would certainly lead to more volatility.

Closing Thoughts

In an effort to "expect the unexpected", we think employing discipline is paramount in 2023. There are many reasons for volatility to continue but remaining invested in high quality companies with more stable earnings has helped us weather the storm so far. While stocks are necessary for long-term wealth creation, fixed income now offers some of the highest level of yields in over a decade.

It would be nice if the market would tell us when the coast is clear, but it will not. Investing is always challenging, but it should not necessitate abrupt portfolio changes. We need to understand that down years like 2022 are normal and often we will not feel better until long after the bottom has passed. Until that time is clear, we are reminded that long-term success requires patience and discipline.

Thank you and cheers to prosperity and health in 2023!

Need More Information? Please do not hesitate to contact a member of the Withum Wealth Management team with any questions or concerns:

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