

## Quarterly Market Outlook

January 2023

### 2022 Recap: Historic Tightening Drives Broad Sell-off

A year ago, inflation was at 7% and rising and short-term interest rates were at zero. After a late start, the Fed embarked on the most aggressive tightening in four decades to rein in inflation, selling assets and hiking rates past 4% by year end, with a couple further hikes expected this year. The result was the worst drawdown in asset classes broadly in 50+ years and among the worst years for the 60/40 portfolio on record, as assets repriced in the face of higher cash and discount rates.<sup>1</sup>

### Relief Rally in Q4 as Policy Expectations Continue to Drive Markets

For the past year, nearly all assets have moved together in line with Fed policy expectations. After declining in Q1 and Q2, assets rallied over the summer as Powell's tone softened, sold off again in late Q3 as tightening continued, and rebounded in Q4 as inflation fell on hopes the Fed would pivot. With policy now closer to neutral, we expect diversification to matter again in 2023, as changing conditions drive greater dispersion in performance across asset classes.<sup>2</sup>

### Where Are We Now?

After peaking at ~9% in the U.S. and ~11% in Europe, inflation is moderating but remains elevated, and growth has held up despite early signs of a slowdown. Much of the tightening has yet to flow through to the real economy. The key questions are (1) whether it will be enough to bring inflation back to target and (2) what the impact on growth will be.<sup>3</sup>

### Cyclical Inflation Pressures Mixed

Housing has turned, commodities have retreated, and supply-chain bottlenecks have largely resolved. This should ease upward pressure on CPI, particularly for goods, as policy curbs demand. At the same time, with unemployment back at its 3.5% low, the labor market remains historically tight, and wages are rising as much as 6-7% annually – money that will keep feeding inflation as it's spent, and as companies pass on higher costs to consumers.<sup>4</sup>

### A New Inflation Regime?

Markets expect a quick return to ~2% inflation as Covid's impact fades and higher rates slow the economy. But some argue the next decade will be a break with the past four. Since the early 80s, inflation and rates have trended lower, supported by a growing labor force, solid productivity gains and ever-cheaper production, as China came online and subsidized U.S. consumption. Those disinflationary trends are now reversing: globalization is giving way to deglobalization, productivity remains depressed, and labor-force growth is slowing as baby boomers retire while immigration continues to drop. Each of these factors may drive inflation higher longer-term. Meanwhile, with debt levels at records, governments have a strong incentive to print money to offset future contractions.

### Recession Ahead?

Calls for a pivot have fallen on deaf ears, and the Fed seems unlikely to ease until deteriorating conditions force its hand. Although pent-up consumer savings may last a few more months, economists now predict no real growth in the U.S. and Europe this year. And though China has ended Zero Covid, over-indebtedness continues to weigh on the Chinese economy. Corporate earnings typically decline ~20% in a recession. As demand weakens and margin pressures mount, analyst forecasts of positive earnings growth seem likely to disappoint. On the other hand, rising wages and the 8.7% COLA adjustment to Social Security benefits are likely to support spending this year. And given the relative strength of corporate and household balance sheets, the economy may prove more resilient this time compared to 2000 and 2008.<sup>5</sup>

### Irreconcilable Pricing?

Bond markets appear to be pricing a material recession. The yield curve is heavily inverted, reflecting expectations that the Fed will have to ease this year and that inflation will continue to plummet. At the same time, equity markets appear to expect a mild recession at worst, with substantial earnings growth in 2023 and beyond (despite a ~2% expected inflation rate). While an “immaculate disinflation” that avoids a serious recession is possible, history suggests it is unlikely. Conversely, if nominal growth stays strong, inflation is likely to stay higher for longer than markets are discounting.<sup>6</sup>

### Diverging Conditions Globally

Notwithstanding the challenging outlook overall, conditions, policies and risks look very different across the globe. The U.S. is nearing the end of its hiking cycle and may enter recession later this year. Europe’s recession seems imminent, but inflation remains higher than in the U.S., the risks of war continue to loom large, and Europe’s hiking cycle is just getting underway (the ECB policy rate has only hit 2% and was still 0% in September). Japan continues to maintain its yield curve control policy – the opposite of what other developed markets are doing. And China is reopening, with a wide range of outcomes depending on its policy response to the deleveraging. These differences may well lead to differences across economies and markets, which highlights why diversification still matters.<sup>7</sup>

### Diversifying to Different Outcomes

If inflation is slower to fall and/or if weaker demand hits earnings, conventional stock/bond portfolios may continue to be challenged. We recommend allocating to return streams that do not depend on the “soft landing” that markets are pricing to generate positive performance. We believe there are attractive opportunities in less correlated alternatives and private markets, where market dislocations can often lead to superior returns for top managers even if traditional investments disappoint.

## Notes

<sup>1</sup> Bloomberg (DOTS; FEDL01 Index; USGG2YR Index, CPI YOY Index); Bloomberg (SPXT Index, CRSPTMT Index, M1WD Index, MXWOU Index, M1EF Index, M1US000V Index, M1US000G Index, SPTRSMCP Index, MUNRT Index, LBUSTRUU Index, LUATTRUU Index, LUTLTRUU Index, LBUTTRUU Index, SPBDUFPT Index, LUACTRUU Index, LF98TRUU Index, LUMSTRUU Index, LMBITR Index, I00767US Index, BCOMTR Index, CL1 Comdty, XAU Curncy). 60/40 calculated as 60% MSCI ACWI, 40% Bloomberg Agg, rebalanced monthly.

<sup>2</sup> See, e.g., Bloomberg (USGG2YR Index) as a proxy for Fed tightening expectations vs. Bloomberg (LBUSTRUU Index, LBUTTRUU Index, M1WD Index, XAU Curncy).

<sup>3</sup> Bloomberg (CPI YOY Index, GDGCAJFP).

<sup>4</sup> <https://blinks.bloomberg.com/news/stories/RNJZ8UDWX2PT>; Bloomberg (BCOM Index; GSCPI Index, WGTROVER Index); <https://blinks.bloomberg.com/news/stories/RNYVRTDWLU68>; <https://www.bls.gov/news.release/pdf/empisit.pdf>.

<sup>5</sup> <https://www.bloomberg.com/graphics/2023-investment-outlooks/>; Bloomberg (ECGDUS Q123 Index, ECGDUS Q223 Index, ECGDUS Q323 Index, ECGDUS Q423 Index, ECGDEU Q123 Index, ECGDEU Q223 Index, ECGDEU Q323 Index, ECGDEU Q423 Index); <https://www.forbes.com/sites/jonathanponciano/2022/12/06/jpmorgan-billionaire-dimon-warns-americans-pent-up-savings-will-deteriorate-fueling-recession-next-year/?sh=5363f0b1706d>; <https://am.jpmorgan.com/us/en/asset-management/institutional/insights/market-insights/market-updates/on-the-minds-of-investors/what-will-an-earnings-recession-look-like/>.

<sup>6</sup> Bloomberg (USYC2Y10 Index; USGGBE10 Index); <https://www.spglobal.com/spdji/en/documents/additional-material/sp-500-eps-est.xlsx>; see also <https://www.yardeni.com/pub/yriearningsforecast.pdf>.

<sup>7</sup> <https://www.goldmansachs.com/insights/podcasts/episodes/12-06-22-mueller-glissmann.html>; [https://www.ecb.europa.eu/stats/policy\\_and\\_exchange\\_rates/key\\_ecb\\_interest\\_rates/html/index.en.html](https://www.ecb.europa.eu/stats/policy_and_exchange_rates/key_ecb_interest_rates/html/index.en.html).

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