



## *2023 INVESTMENT OUTLOOK*

**T**he year just ended was a challenging one for investors and marked a notable departure from the recent past. The broad based stock and bond markets peaked in January and spent the next twelve months in negative territory, despite periodic rallies that briefly offered investors some hope that the worst was behind them. As noted in the table below, while all the major equity indices fell in 2022, the more speculative areas of the stock market declined the most with the Nasdaq faring the worst last year, international and S&P 500 stocks next, and finally the Dow 30 performing the best on a relative basis.

A few dominant themes exerted their influence on the capital markets in 2022. None was more important than the return of inflation which reached a forty year high. Rather than being transitory, as many had predicted, high prices proved not only to be sticky, but also global in nature. While a robust job market and stimulative fiscal policies put money into consumers' pockets which helped offset the effects of inflation, there are signs that both of those tailwinds are easing which will impact the economic outlook in the new year.

High inflation led to a second trend last year which was considerably more restrictive monetary policies domestically and abroad. Dozens of central banks around the world raised interest rates in order to slow economic growth which is expected to lower inflation over time by reducing demand for goods and services. While there are some early signs that inflation may have peaked for this cycle, that outcome is not a forgone conclusion and monetary officials remain committed to further tightening to ensure that inflation is vanquished. As Federal Reserve Chair Jerome Powell has noted, price stability "serves as the bedrock of our economy. Without price stability, the economy does not work for anyone. In particular, without price stability, we will not achieve a sustained period of strong labor market conditions that benefit all."

Higher interest rates have imparted their intended effect on economies globally as growth has slowed nearly everywhere. The Fed, like many other central banks, is trying to balance its desire to bring inflation under control while creating as few disruptions as possible to the job market and minimizing dislocations in the capital markets. This has proved to be a difficult task as recessions are predicted across many economies in 2023. Should a recession hit the U.S. economy in the new year, rising joblessness and lower corporate earnings would likely follow. Stock markets can be expected to come under additional pressure under such a scenario.

International frictions are always a concern and 2022 was no exception. War in Europe and rising tensions with China topped the list last year and, with little resolution on either matter, both of these issues will impact the landscape in 2023. Given the rapidly rising interest rate environment, one potential new concern is the ability of foreign companies and countries to refinance dollar denominated debt that is coming due. This is of particular concern in those countries whose currencies have notably weakened versus the U.S. dollar.

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## *Equity Markets – 12/31/22*

	<u>Index Price Level</u>	<u>2022 Total Return</u>
Dow 30 Industrials	33,147	-6.9%
S&P 500	3,840	-18.1%
NASDAQ Composite	10,466	-32.5%
MSCI All Country World Index ex-USA	281	-15.6%

### *Outlook*

**A**s we turn our focus to the new year, economic activity appears to be slowing. S&P Global's purchasing managers index, which measures broad based business activity, has been in contraction territory for four consecutive months through December. Similarly, the Conference Board's survey of leading economic indicators, an index composed of ten components which historically have acted as a reliable predictor of the economic outlook, has been in decline for nine consecutive months. Going back to 1960, in every one of the nine previous times the six month change in this index has been at its current level, a recession has ensued. Anecdotal evidence supports this view including measures of consumer sentiment, CEO confidence and senior bank loan officer surveys which all point to significantly diminished optimism in the outlook. Broad based financial conditions have been tightening in recent months and are another sign suggesting that caution is warranted in the near term. Indeed, the Federal Reserve's forecast for economic growth for 2023 is only 0.5%, a rate consistent with recession expectations.

At the same time, evidence exists to suggest that a downturn is not imminent. Consumers remain in relatively good shape with abundant job prospects and ample savings. It is estimated that Americans in aggregate still have some \$1.2-\$1.8 trillion in excess savings which were accumulated in large part due to the federal government's largess during the pandemic and which can provide a buffer to consumer spending. However, it is likely that those funds are not distributed evenly but are clustered among upper income households. Rising indebtedness figures support this view. The Federal Reserve Bank of New York reports that total household debt grew by \$351 billion in the third quarter of 2022, the largest nominal increase since 2007. At the same time, credit card balances advanced 15%, the fastest quarterly growth in over twenty years. Meanwhile, the U.S. personal savings rate has declined to the second lowest monthly level on record with data going back to 1959. While loan delinquency rates remain low historically, they are rising across all income levels. Additional consumer headwinds exist. With the winter season now upon us, elevated heating bills will crowd out other spending for many Americans. Also, student loan repayment deferrals are set to end by mid-year 2023. This will create a financial hardship for many of those people who by that point will not have made a loan payment in over three years.

The job market remains a bright spot. According to the Federal Reserve Bank of St. Louis, there are still an estimated 1.7 jobs available for every unemployed person in this country. This implies that most people who want to work have an opportunity to do so. This has also led to increased bargaining power for workers in certain industries as evidenced by average hourly earnings which grew 5.1% in November, the latest figures available. Tempering this optimism is recent news of increased layoff announcements and bonus cuts, particularly in the technology and finance sectors. Additionally, the job market is a lagging indicator of economic performance so history suggests employment will weaken in the coming quarters.

Other parts of the world are facing similar growth challenges. The U.K. economy declined last quarter and will likely enter a recession soon. Europe is in a comparable situation, with the ongoing war in Ukraine exacerbating inflation problems even as economic growth remains weak. The Japanese economy shrank 1.2% in the latest quarter. Meanwhile, China, which had been struggling with strict COVID related lockdowns, is now facing a new wave of disease as those restrictions have been eased. Growth will be hampered in the coming quarters so that country will not be able to support overall global activity like it has historically.

Despite facing weak economies, global central banks are being forced to aggressively cut back on stimulus efforts. After years of inappropriately loose monetary policy, which encouraged profligate spending by governments and households alike, many parts of the world are experiencing intractable inflation. While high prices have been an afterthought in recent years, throughout history, periodic bouts of inflation have proven to be economically devastating and politically destabilizing which is why central bankers are so intent on defeating it now. While some have suggested that the war in Ukraine has been a key contributor to the global inflation problem, it is worth noting that the last consumer price inflation report in this country before Russia invaded showed that inflation was already 7.5%. At that same time, elevated price levels were being reported in many other nations, so it is clear that years of overly generous fiscal and monetary aid was the proximate cause for the inflation dilemma we currently face.

The Federal Reserve is wary of repeating the same mistake that was made in the early 1970s to the early 1980s when the Fed continuously shifted policy between raising rates to tame inflation and easing policy to restore growth and aid the labor market. The U.S. economy suffered from a series of recessions during that time. The underlying inflation problem was not solved until Fed Chairman Paul Volker helped bring an end to that inflationary regime by aggressively restricting credit which led to the double dip recession of the early 1980s. The current Fed would like to avoid another tumultuous period like that one. Multiple Fed governors have said on numerous occasions that they view the threat of sustained inflation as a far greater risk than the shorter term pain that a recession would have on the economy and job markets. Recent Fed minutes have noted that their actions will cause hardship for Americans but “these are the unfortunate costs of reducing inflation.” Meanwhile, Cleveland Fed president Loretta Mester opined that it is “important for Fed to anchor inflation expectations” and “real rates have to go into positive territory and remain there for a considerable period of time”, views shared by a majority of her colleagues at the Fed.

Global policymakers agree. The chief economist for the Organization for Economic Cooperation and Development recently said that “controlling inflation has to be the top priority otherwise we might end up with a wage-price spiral like we had in the 1970s, or we end up with a situation that inflation becomes so entrenched that the pain needed to control it will be even greater.” This is why, despite the growth challenges noted, dozens of global central banks continue to tighten policy.

Rising interest rates are impacting the U.S. housing market as expected. With the ratio of existing home prices to median household income now higher than at any point in the past twenty years and notably above the peak during the bubble that predated the 2008-2009 downturn, the housing market was ill prepared for the more than doubling of mortgage rates this year. Existing home sales have fallen for ten straight months through November according to the National Association of Realtors. Meanwhile, according to the S&P CoreLogic Case Shiller National Home Price Index, U.S. home prices have fallen for four straight months, a trend that is likely to continue as the market adjusts to tighter financial conditions.

Given all the economic headwinds noted above, it is no surprise that 2022 was a challenging year in the capital markets. The average stock and bond investor experienced disappointing results as the typical balanced portfolio offered little downside protection. Using the Lipper Balanced Index as a proxy, the average balanced fund returned -14.1% in 2022. Many of the mega-capitalization technology stocks that led the market higher in recent years suffered disproportionately last year. Meanwhile, lower quality and longer term bonds registered their worse return in several decades.

The reality of ongoing interest rate hikes into a weakening economy can be expected to hinder corporate performance in the new year. Supply chain reshuffling, reshoring of jobs and manufacturing, and an inability to hire needed workers are inflationary on the margin and will crimp profit margins in 2023. The consensus Wall Street forecast for S&P 500 earnings growth next year is 5.1%, a figure we deem to be too optimistic. At a time when both corporate earnings and stock market multiples remain above historical averages, caution is warranted on the near term outlook. With economic growth expected to notably slow down, it is likely that earnings, market multiples, and investor confidence will weaken in the coming months.

### *Investment Conclusion*

**D**espite the rising risk of recession at some point later this year, owning a diversified portfolio of high quality common stocks and bonds coupled with a long term investment horizon remains appropriate for most investors. Maintaining a suitable allocation to short term bonds and cash reserves to cover any known or unexpected needs which may arise is critical. This helps provide the necessary peace of mind to allow investors to take a more patient and disciplined approach with that portion of their portfolios that should remain invested for long term growth. Owning shares of appropriately priced, market leading companies, which represent ownership of real income producing assets, has been an effective hedge against inflation and a time tested way to protect and grow wealth. This has been the case for well over a century and it is likely to remain true in the decades to come.

Closely partnering with our clients to help them achieve the correct portfolio allocations based on their unique circumstances allows us to take a perspective that is different than most investors, who are often focused on shorter term time periods and therefore can get caught up in daily market gyrations which make them miss longer term trends. We also buy and hold a different basket of stocks and bonds than the typical investor. Historically, our approach has allowed our clients to outperform in market downturns as was the case in 2022. We focus on the key factors that are critical for a company's long term success, examples of which include the quality of the management team and board of directors, a history of innovation, financial strength, and the ability to grow earnings over a full market cycle. We couple this with a strict price discipline for new purchases which provides additional downside protection. This investment philosophy has allowed our clients to enjoy above average, risk-adjusted returns since our founding over thirty-three years ago.

One key upside to the recent capital market turmoil is that some first class companies, which for years have been overpriced, are now selling at more attractive prices for long term investment. Should a recession ensue in the coming quarters, earnings estimates would likely fall which has historically coincided with lower stock prices. Our clients remain well positioned for this outcome with ample stock buying reserves. Importantly, cash awaiting investment is earning money market fund and short term bond yields that are at their highest level in over fifteen years so clients can earn a respectable return while waiting for better long term investment opportunities.

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