With 2022 now having drawn to a close, one would be hard-pressed to find many feeling nostalgic for the year past. The S&P 500 finished down 19.4%, while the aggregate fixed income market registered an equally stomach-churning negative 13% return; since 1928, only six years produced a worse return for stocks and 2022 was the singular worst year for bonds in history. A maelstrom, a perfect storm, a 100-year flood… whatever ominous nautical analogy one can prescribe to the year would be apt and suffice to say that we look forward to 2023 with some optimism that the winds may be shifting.

The old mantra of "don't fight the Fed" certainly reigned last year, as Jerome Powell relentlessly raised interest rates to combat inflation and reverse the excesses of easy monetary policy from the past 12 years. Heading into 2023, the Fed has remained unwavering in their hawkish messaging, telling anyone and everyone that they intend to hold rates elevated for longer. However, an interesting divergence has begun to appear, with the market predicting a Fed pause and pivot much sooner than Powell has suggested.

Peak inflation seems almost assuredly behind us, as the cyclical component of inflation i.e., goods prices, has already started to roll over and show consistent month-over-month declines. The structural side of the ledger (services and wages) has remained sticky, and the labor market continues to exhibit impressive resilience. If the Fed is waiting to see evidence of a softening in labor, then perhaps the market is overpricing the equation. However, another path may emerge, neither a hard nor soft landing, just a 'landing,' where the labor market and growth remain resilient, and inflation slowly declines to the 3-5% range. This scenario might not necessarily be a boon for risk assets, per se, but on the flipside, it would hardly be the type of apocalyptic event that some have forecast.

There has been an unending stream of bearish sentiment from some, predicting a hard landing scenario where a deep recession occurs due to Fed policy. Historically, severe recessions occur because of extreme imbalances and excesses in the system; the overleverage in the financial system as a whole and more specifically in the housing market in 2008, as an example. Oftentimes, markets and businesses are surprised, caught flat-footed and over-extended. Today, this seems highly unlikely, as any recession that we end up in may be the most anticipated and foretold ever; it is hard to envision that corporations and investors are unprepared for, or blind to, the possibility.

Given these factors, it is extremely hard to forecast, with any certainty, the outlook for 2023. Earnings estimates for S&P 500 companies have been steadily revised lower, from an overly optimistic $240/share to a current level of $230. From a valuation perspective, this puts the forward P/E ratio at 17.3, below the 5-year average of 18.5 and just above the 10-year average of 17.2. At this level, the equity market seems fairly valued, given the macroeconomic uncertainty. It seems likely that the market will range trade from here, perhaps +/- 10%, until some clarity on the economy is achieved.

As we have written since Q2 of last year, the silver lining to the repricing of rates has been the opportunity to finally achieve attractive risk-adjusted returns in fixed income. We have succeeded in allocating a portion of the portfolio back into corporate bonds at yields of 5-7% and seek to further this strategy. Given the uncertainty in equities, 2023 may be a year where we rely on the total return of our fixed income portfolio to do more of the heavy lifting. With returns at 5+% percent, we are happy to clip the coupons.

We hope that everyone had a restful and happy holiday and look forward to meeting with you in the New Year! As always please do not hesitate to check in with us if you have questions or would like to schedule a review.