2023 Economic and Market Outlook

A Soft Landing Ahead?

Commonwealth

Executive Summary

As we prepare for 2023, we need to reckon with what happened in 2022. Both stock and bond markets were down around the world. Still, the U.S. and global economies showed impressive resilience despite multiple disruptions. The worldwide challenges included pandemic shutdowns in China, the war in Ukraine, and inflation, which hit a 40-year high. Given this environment, what can we anticipate for the economy in the year ahead?

First, we'll see the same disruptors as we did in 2022. Supply chains have largely recovered from the pandemic shutdowns. But manufacturing will continue to be held hostage as China struggles to stay open despite medical and geopolitical complications. The war in Ukraine will continue to disrupt global food and energy markets. The divided nature of the U.S. government following the midterm elections is likely to ratchet up the political conflict. The Federal Reserve (Fed) will keep tightening monetary policy until inflation drops significantly.

But there's good news, too. Just as 2022 had a surprisingly positive economic outcome, 2023 is likely to fare better than the headlines would have us believe. Job growth should continue to show strength. Healthy levels of employment and wage growth will support consumer confidence and spending. The labor shortage will keep businesses investing, paid for by consumer spending. For the private economy, the signs suggest healthy growth.

What weaknesses could affect that outlook? The housing and manufacturing sectors are slowing down, which will hurt business investment across the board. The Fed's actions to reduce inflation will continue to dampen the economy. Depending on how hard higher rates bite, we could see a recession in 2023. But if we do, we don't believe it will be the deep recession the headlines are screaming about.

A shallow recession much like the one we saw in the first and second quarters of 2022 is more likely. Labor market fundamentals are expected to remain sound, and inflation is likely to roll over. So, the damage should be limited in severity and duration. The stage will be set for the Fed to declare victory over inflation and stop tightening monetary policy. And that should enable future growth.

For the markets, we can expect continued volatility in the short term, but our outlook for the coming year is cautiously positive. Economic growth is likely to resume, and interest rates should stabilize. With market valuations at the lower end of the recent range, these factors should provide considerable cushion to limit further short-term declines and support gains by year-end.

There are no guarantees, of course. But 2023 may bring a soft landing for the economy and an improved outlook for the markets.

Let's dive deeper into the opportunities and risks at play.

What We're Watching

Inflation

Surged to the highest level in **4 decades**

Fed Funds Rate

Up **4.25%** since March 2022

GDP

Year-over-year growth = **1.8%**

Equities & Fixed Income

S&P 500: forward P/E **17.6x**

10-year Treasury: **3.5%–4%**

Sources: Federal Reserve, The Conference Board, FactSet, Bloomberg

Will the Economy Avoid Recession?

 **Brad McMillan**, CFA®, CAIA, MAI  **Sam Millette**

We believe inflation is set to fall meaningfully throughout the coming year as the economy slows due to the Fed's aggressive interest rate hikes. We've already seen positive signs that drivers of inflation in key economic sectors have improved or rolled over. If that continues, without kicking off a recession, the Fed just may achieve its elusive soft landing.

Here's what we'll be watching for.

Factors in the Battle Against Inflation

Goods, food, and energy. Supply chain constraints were largely resolved in 2022, allowing retailers to increase inventory at the fastest pace in decades. By year-end, however, excess product prompted businesses to cut prices to attract demand. According to the Bureau of Labor Statistics, annual inflation on major appliances dropped into negative territory in 2022, after reaching a high of 17.2 percent in 2020.

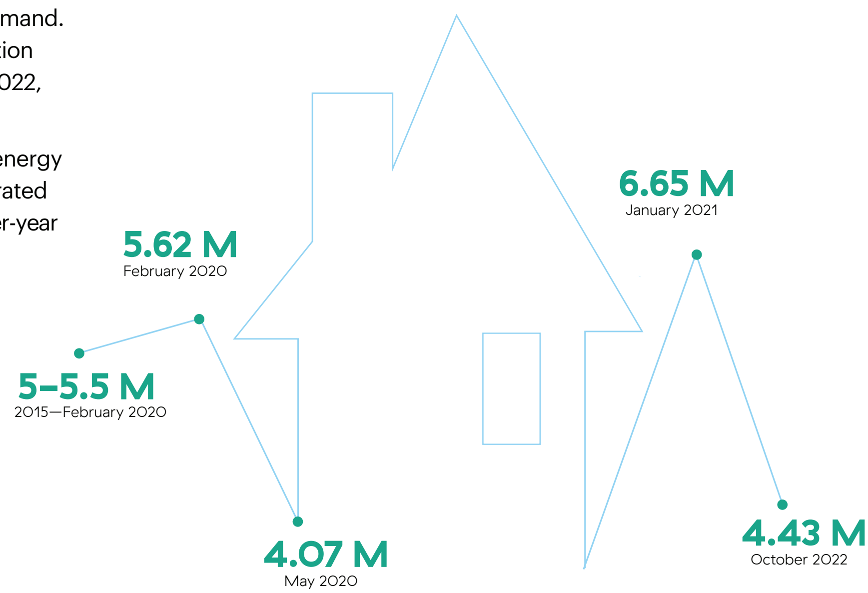
We're also seeing less inflationary pressure in food and energy prices. They spiked in early to mid-2022 and then moderated toward year-end. While they remain elevated on a year-over-year basis, the slowdown is encouraging.

Housing. This sector, a major driver of inflation in 2022, is set to reverse trend in 2023. Over the past year, the housing market slowed notably, as higher mortgage rates and home prices deterred buyers. According to Zillow, the average 30-year fixed-rate mortgage was up more than 3 percent through the first 11 months of 2022. The pace of existing home sales fell notably as a result, closing out the year well below pre-pandemic levels (see Figure 1).

And, while home price growth has remained high on a year-over-year basis, we have seen a slowdown. This indicator of the Fed's progress in combating inflation will likely lead to further price declines in 2023.

FIGURE 1

Existing Home Sales
February 2015–October 2022



Sources: Bureau of Labor Statistics, Haver Analytics

With inflation starting to slow, will the Fed keep raising interest rates at 2022's fast pace? The answer remains to be seen, but there are signs a pullback is being considered. We believe that investor expectations for more rate hikes are already baked into the market. That means even a pause in the Fed's tightening cycle should be seen as a positive development.

The Effects of Fed Policy on Economic Growth

In 2023, we'll be closely watching how the Fed's policy announcements affect the four primary economic drivers: consumers, business, government, and international trade.

1 Consumer Jobs and Spending

Inflation will likely slow job growth and consumer spending in the year ahead, but these key indicators should remain at healthy levels.

> As consumer spending is the largest part of the economy, strength here will mean a severe recession is unlikely.

Jobs. Following two years of strong hiring, the expected slowdown in job growth should help contain inflation in 2023. That said, the high number of job openings, combined with the low unemployment rate, indicates that excess hiring capacity remains. With the unemployment rate well below its peak at the start of the pandemic (see Figure 2), there's some room for an increase in that figure as the Fed focuses on reducing inflation.

Spending. Consumer spending held up admirably throughout 2022. It was supported by job growth even when inflation caused consumer confidence to fall. These trends are expected to continue in 2023, albeit at a slower pace if the economic backdrop slows. As consumer spending is the largest part of the economy, strength here will mean a severe recession is unlikely.

2 Business Investment

As with consumer spending, business investment stayed strong in 2022 despite inflationary pressure and a drop in business confidence. High consumer demand should continue to serve as a tailwind for business growth in 2023.

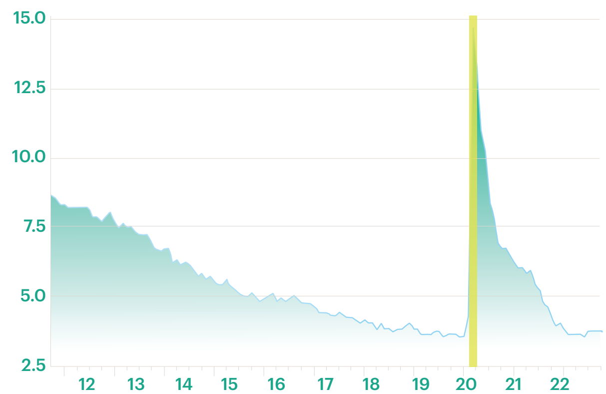
Transportation. Despite the overall strength of investment, business transportation spending was muted in 2022. This trend may prove a boon for 2023. As supply chains continue to ease, businesses are expected to increase transportation investments.

Housing. We expect slower and possibly negative growth in housing investment, particularly if we get a recession. Slower residential investment may become evident in the first half of 2023. But a recession led by this sector is typically less damaging to individual workers. It's also quicker to reverse as interest rates stabilize. A housing slowdown bears watching, but it's not a major risk.

FIGURE 2

Unemployment

2012–Present

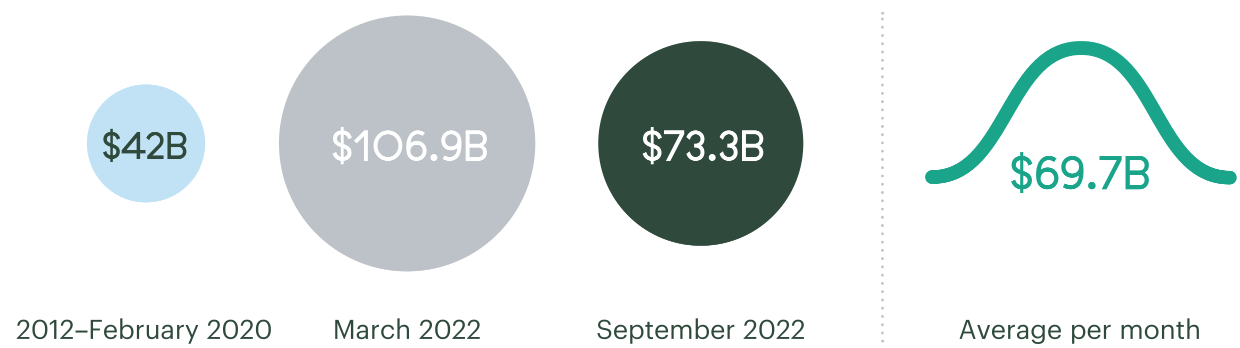


Sources: Bureau of Labor Statistics, Haver Analytics

FIGURE 3

The monthly trade deficit averaged roughly $42 billion per month between 2012 and February 2020. Since then, it's averaged $69.7 billion per month, with the largest monthly deficit on record coming in at $106.9 billion in March 2022. As of September 2022, we're at $73.3 billion.

Trade Deficit Average



Sources: Census Bureau, Haver Analytics

3 Government Policy

The federal budget deficit declined notably throughout 2022. In the coming year, we expect the deficit to widen modestly. The plan to forgive certain student loan debt will contribute meaningfully to this increase. This program's estimated costs will be booked in 2023.

Expectations. Our expectations for this sector are flat. Given divisions in the federal government following the mid-term elections, gridlock in Washington should continue. Thus, the chances for major spending bills to be passed in 2023 may be lower. But government spending should not drop as significantly as it did in 2022 when Covid-19 support bills expired.

4 International Trade

Both imports and exports are expected to decline in 2023, due to lowered demand in the U.S. and abroad. Exports are likely to be especially hard hit by the strong dollar and the weakness of many U.S. trading partners. Imports slowed toward the end of 2022, as U.S. businesses bought fewer foreign goods after rebuilding their inventories. As a result, the monthly trade deficit narrowed notably in the second half of this year, though it remained large historically (see Figure 3). Looking ahead, the disappointing year sets up a tailwind for growth.

What Could Go Wrong—or Right?

With consumers working and spending, and businesses investing, the economy should continue to grow through 2023. This trend may slow, or be reversed for a quarter or two, by the expected headwinds. Other risks could be ahead, such as persistent inflation and tighter Fed policy. We'll also face political risks, both domestic (Congress and the debt ceiling) and foreign (the Ukraine war and China). We enter 2023 with a laundry list of things that could go wrong.

> A strong labor market should keep economic growth humming in 2023.

Ultimately, however, a strong labor market should keep economic growth humming in 2023. And a growing economy, underpinned by low valuations to start the year, offers the likelihood of renewed market gains.

Equities: What Opportunities Lie Ahead?

Chris Fasciano

There were few places to hide from U.S. market declines in 2022. Every asset class came under pressure. Growth? Down. Value? Down. Large-, mid-, and small-cap equities? All down. The story was much the same in global markets (see our "Spotlight" section to learn more). The duration of the declines wore on investors' emotions, leading to fear and uncertainty.

But how bad was the year, really? A look at past events can help put the current situation into perspective.

Viewing Returns Through a Historical Lens

In 2020, the pandemic lockdowns led to a 34 percent decline in the S&P 500 over six weeks. During The Great Financial Crisis of 2008–2009, the index recorded a 57 percent drop in a year and five months, with most of the losses occurring in the six months after Lehman Brothers declared bankruptcy. When the dot-com bubble burst in 2001, the S&P 500 sank 49 percent within two and a half years.

In contrast, on October 13, 2022, the S&P 500 reached its year-to-date low, a decline of slightly more than 27 percent. This drop put the index near its 25-year average on most standard valuation measures (see Figure 1).

Price-to-earnings (P/E) and price-to-book (P/B) ratios, as well as dividend yield, are common measures used to show whether a stock is over- or undervalued.

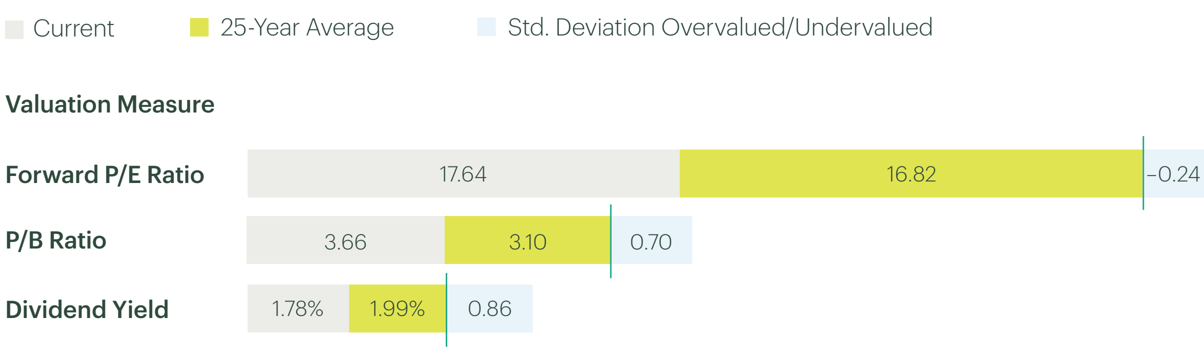
- The forward P/E ratio divides the current share price of the index by its estimated future earnings.
- The P/B ratio is the current market price of the index divided by its book value.
- The dividend yield is calculated by dividing the price of the index by the amount of total dividends earned in a year.

We believe this data shows that much of investors' uncertainty has already been priced into the markets. The year-to-date correction for the S&P 500 doesn't necessarily make equities cheap, and they could get cheaper. Still, nearing the close of 2022, many equities are more attractively valued than they were a year ago.

Keep in mind also that from 1980 to the present, annual returns for the S&P 500 were positive in 32 of 42 years despite intra-year declines averaging 14 percent, according to J.P. Morgan Asset Management. While past performance is no guarantee of future results, investors with a longer time horizon may be wise to look beyond the short-term pressures the market is facing.

FIGURE 1

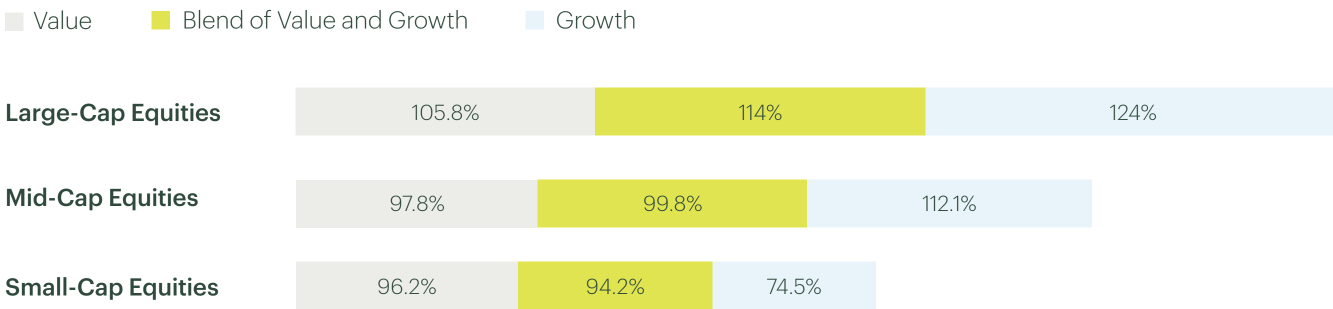
S&P 500 Valuation Measures



Sources: FactSet, FRB, Refinitiv Datastream, Robert Shiller, Standard & Poor's, Thomson Reuters, J.P. Morgan Asset Management, as of November 30, 2022

FIGURE 2

Current P/E as % of 20-Year Avg. P/E



Source: J.P. Morgan Asset Management, as of November 30, 2022

Identifying Opportunities: Growth Vs. Value

According to FactSet, industry analysts currently expect S&P 500 earnings growth to be in the mid-single digits by the end of the year, with 2023 growth in the 5 percent range. We believe these expectations are reasonable, especially if the labor market and consumer spending remain healthy and inflation weakens. With this as our backdrop, how do we identify investment opportunities that may lie ahead?

From 2007 to 2021, growth outperformed value by a wide margin. Then, in 2022, growth came under pressure as higher interest rates weighed on long-term valuations. Other fundamental weaknesses in high-flying growth stocks stemmed from reduced demand and lower earnings growth. As of November 30, 2022, the Russell 3000 Growth Index was down 23.14 percent, while the Russell 3000 Value Index was down just 3.96 percent, according to FactSet.

Valuations. In the U.S., valuations tell only part of an investment's story. As seen in Figure 2, small-cap growth appears to be the most attractive asset class based on its lower P/E ratio of 74.5 percent. At the same time, large-cap value (105.8 percent) looks more attractive than large-cap growth (124 percent). This juxtaposition creates an interesting question in a market that thinks in black and white with no tolerance for gray. Which investment is truly more attractive: growth or value?

Infrastructure spending. The truth is, a good investment today needs elements of both growth *and* value.

Old-economy companies, such as those formed during the Industrial Revolution, can benefit from growth in emerging technologies going forward. Companies in the latter category include Tesla and the FANMAGs: Facebook, Amazon, Netflix, Microsoft, Apple, and Google (trading as Alphabet). They are selling products and services into new-economy markets driven by differentiated services and technology. To get their goods and services into their customers' hands, they require production, manufacturing, warehousing, and office facilities—think Amazon's mega distribution centers, Tesla's Gigafactory, and expanded facilities in the semiconductor industry.

To support these needs, we're likely to see a wave of infrastructure spending coming from the private sector that could approach a trillion dollars in the years ahead. The construction, equipment, and global delivery services old-economy companies provide will help fuel secular growth. It's impossible to build and run the new economy without the old one.

The Path Ahead

So, is growth or value a better investment? There's no clear-cut winner. Instead, it's likely the sounder investments will be found somewhere in the middle.

We continue to believe the best way to successfully navigate a market with this much uncertainty is to cultivate a mix of styles, market caps, and geographies within a portfolio. Owning a little of this and a little of that will help provide balance as we wait for some clarity from the economy, inflation, and the Fed.

Fixed Income: Let the Bond Party Commence?

Peter Essele, CFA®, CAIA, CFP®

The last year was one of the most volatile periods for fixed income in four decades. After starting 2022 at 1.63 percent, the 10-year Treasury rate rose more than 2.5 percent in a matter of months. Bond prices (which move inversely to yield) collapsed across the board as investors reacted to inflationary pressures and an uncertain economic outlook. In response, the Fed implemented an aggressive series of interest rate hikes.

As a result of the 2022 sell-off, fixed income asset classes may now offer some of the most attractive valuations we've seen in decades. The Fed has been very vocal about its goal of bringing inflation under control. If it meets its objective, which appears likely, interest rates should stabilize, which could support a number of segments in the fixed income universe.

U.S. Treasuries

If inflation reverts to its long-term average of 2.2 percent over the next decade, owning a low-risk 10-year Treasury bond at 4.2 percent is an attractive prospect. At 2.1 percent as of November 30, 2022, the differential between the 10-year Treasury yield and the S&P 500 dividend yield is the largest it's been since November 2007. While the consensus seems to be favoring short-term Treasuries in this environment, there may be opportunities further out on the Treasury curve for longer-term investors.

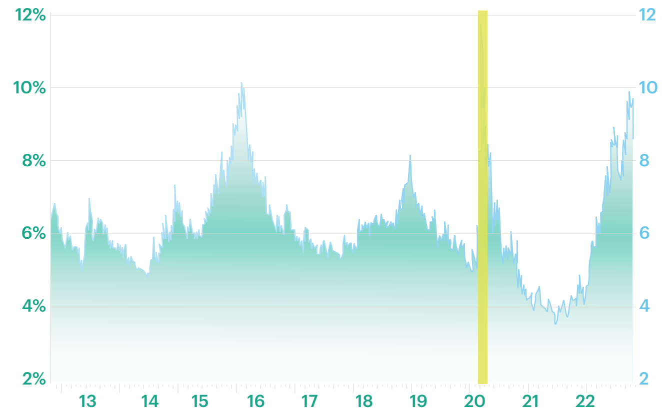
High-Yield Bonds

The sector succumbed to a considerable amount of selling pressure in 2022. As of November 30, 2022, the yield-to-worst (i.e., the lowest yield an investor can receive) on the Bloomberg U.S. Corporate High Yield Index is 8.76 percent (see Figure 1). This level has been reached only three times in the past decade.

The price of bonds in the index is averaging a market value of $86.80 (against the par, or face, value of $100). This price isn't too far off from where things ended up in the 2020 downturn. Effectively, investors are being paid to wait for bonds to reach their maturity value. As investors consider their fixed income outlook and allocations, this is one area that deserves some attention.

FIGURE 1

Bloomberg U.S. Corporate High Yield: Yield-to-Worst



Sources: Bloomberg, Haver Analytics

Municipal Bonds

Municipal bonds also experienced selling pressure in 2022. The yield-to-worst on the BBB-rated Bank of America Merrill Lynch Municipal Bond Index stood at 4.5 percent as of November 30, 2022 (see Figure 2). This rate equates to a 6.43 percent taxable-equivalent yield for someone in the 30 percent tax bracket.

In the lower-credit-quality, high-yield municipal space, yields look attractive as well, with the Bloomberg Municipal Custom High Yield Composite Index yielding 4.61 percent (the taxable equivalent of 6.6 percent) as of November 30, 2022.

Corporate Bonds

Another investment-grade sector that is presenting attractive value as of late is the corporate space, specifically A-rated securities. As of November 30, 2022, the yield-to-worst on the Bank of America Merill Lynch Corporate Bond A-Rated Index was just shy of 5.27 percent (see Figure 3). This level was last seen in early 2009. In tax-free and tax-deferred accounts, we believe the current yield can be an attractive prospect for investors willing to accept some level of volatility.

Emerging Markets

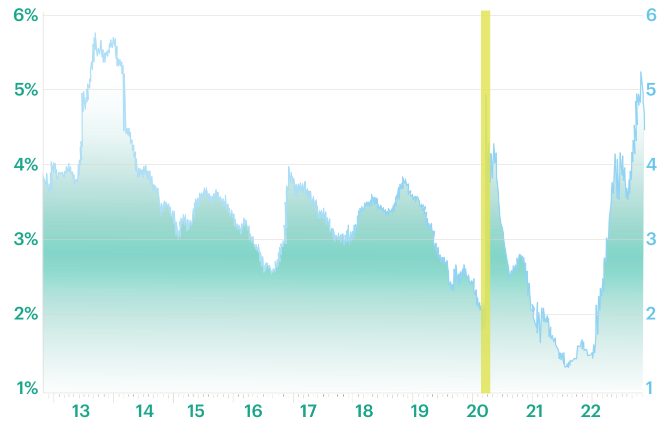
For investors with a high risk tolerance, emerging market debt offers some of the most attractive yields in the fixed income space. As of November 30, 2022, the average yield-to-maturity, as measured by the J.P. Morgan EMBI Global Core Index, was 7.01 percent. Emerging markets saw many securities experience double-digit losses in 2022, however. So, investors should allocate prudently. (See our "Spotlight" section for a closer look at our expectations for this space.)

An Optimistic Outlook?

After years of exceptionally low yields, it may be time to take another look at bonds. From high-quality, low-risk Treasuries to lower-quality, tax-free municipals, bonds seem to be presenting incredible value once again.

FIGURE 2

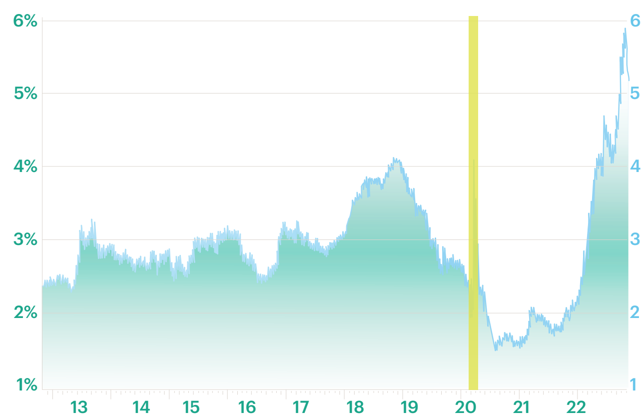
Bank of America Merrill Lynch Municipals: BBB-Rated Yield-to-Worst



Sources: ICE, Bank of America Merrill Lynch, Haver Analytics

FIGURE 3

Bank of America Merrill Lynch Corporate Bonds: A-Rated Yield-to-Worst



Sources: ICE, Bank of America Merrill Lynch, Haver Analytics

November 2022 Yield-to-Worst

8.76%	4.5%	4.61%	~ 5.27%
High-yield bonds	BBB-rated municipal bonds	High-yield municipal bonds	A-rated corporate bonds

Spotlight on Foreign Equities: Bull Vs. Bear

Brian Price, CFA®

Throughout 2022, developed international and emerging markets faced increasing challenges. Several catalysts—including the war in Ukraine, China's struggles with Covid-19, and the political theater in the United Kingdom—contributed to the underperformance of foreign equities.

As we look forward to 2023, does the outlook remain much the same, or could a bullish case for foreign equities be made? Let's take a closer look.

Will Strong U.S. Dollar Remain a Headwind?

The greatest headwind for investors with allocations to foreign stocks has been the unrelenting strength of the U.S. dollar.

Over the past 12 months, the Fed has launched an aggressive campaign against inflation through an unprecedented series of interest rate hikes. This has caused a spike in the real effective exchange rate for the U.S. dollar, which was 134.27 as of October 2022, according to Bloomberg and J.P. Morgan Asset Management (see Figure 1 on the next page). And when the dollar is strong, returns on foreign assets translate into less money when exchanged back into U.S. currency.

Going forward, it's reasonable to believe the U.S. dollar will remain strong. But an equally compelling argument could be made that its current strength will not be sustained throughout 2023.

If the Fed cools down inflation and curbs interest rate increases, investors could see the U.S. dollar stabilize—or possibly weaken—against other currencies. Several wild cards need to be considered, including the ongoing war in Ukraine, elevated oil prices, and above-average inflationary readings for a prolonged period. Still, our current expectation is that the greenback will not cause as many headwinds for international equity allocations as it did in 2022.

A Bullish Case for Foreign Equities?

In 2023, there are other factors (beyond a weaker U.S. dollar) that could support a modestly bullish case for foreign equities.

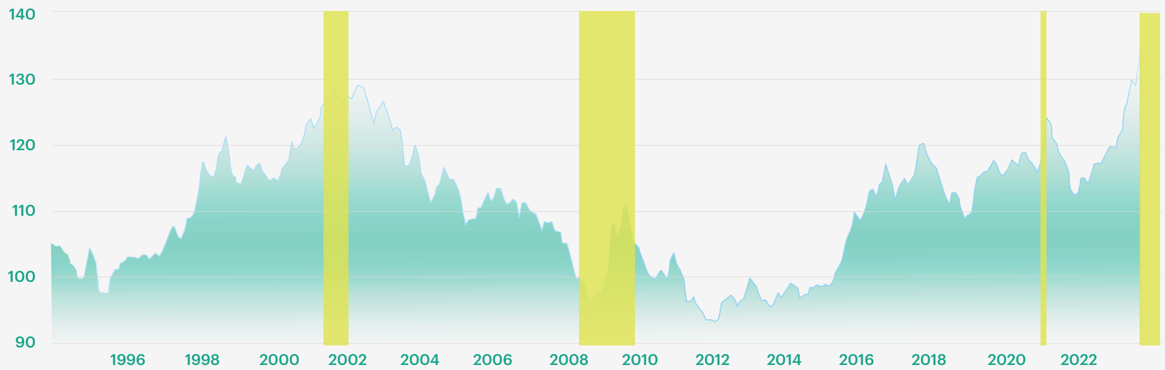
P/E ratios. First, if earnings per share estimates prove accurate, it's reasonable to conclude that international equities will be relatively inexpensive. As of November 30, 2022, the MSCI ACWI ex USA Index was trading at 12.2x P/E, which is near all-time lows for the past 20+ years (see Figure 2 on the next page).

Investor sentiment. The lackluster performance of many international markets over the past several years has given investors a bleak outlook.

FIGURE 1

U.S. Dollar Real Effective Exchange Rate

as of October 2022



Source: Bank for International Settlements

But could this sentiment change as we move into 2023? The answer seems to be yes.

Asset classes can participate and perform well moving forward even when pessimism is at extreme levels—it's what we've seen with international equities as of late. And, according to the U.S. AAII Sentiment Survey, forward returns for U.S. equities have generally been strong when investor enthusiasm has been quite the opposite.

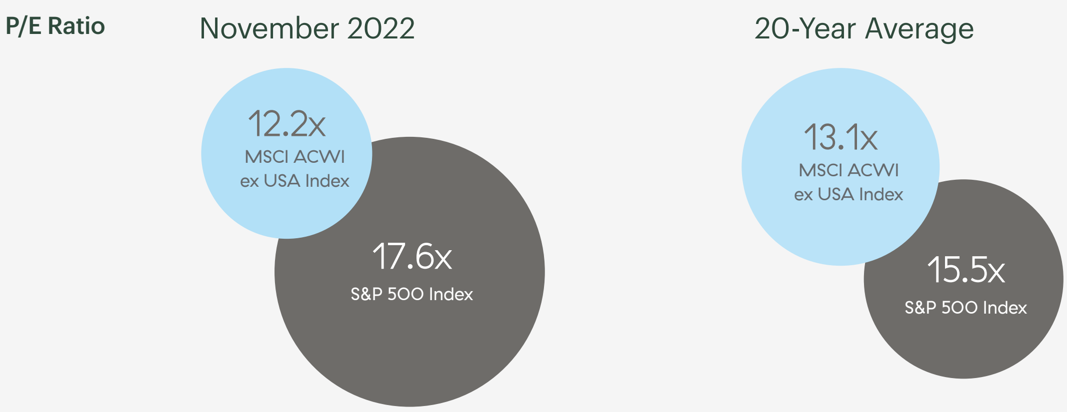
Beware the Bear?

While both valuations and investor sentiment support a favorable outlook for foreign equities, we must also acknowledge the bearish case as we head into 2023. The geopolitical landscape is always a risk factor that investors must consider, especially during the current period of elevated global tensions.

War in Ukraine. The economic consequences of the war in Ukraine were in full force through much of 2022, sending shockwaves throughout the globe. Entering the winter months, the price for European natural gas remains

FIGURE 2

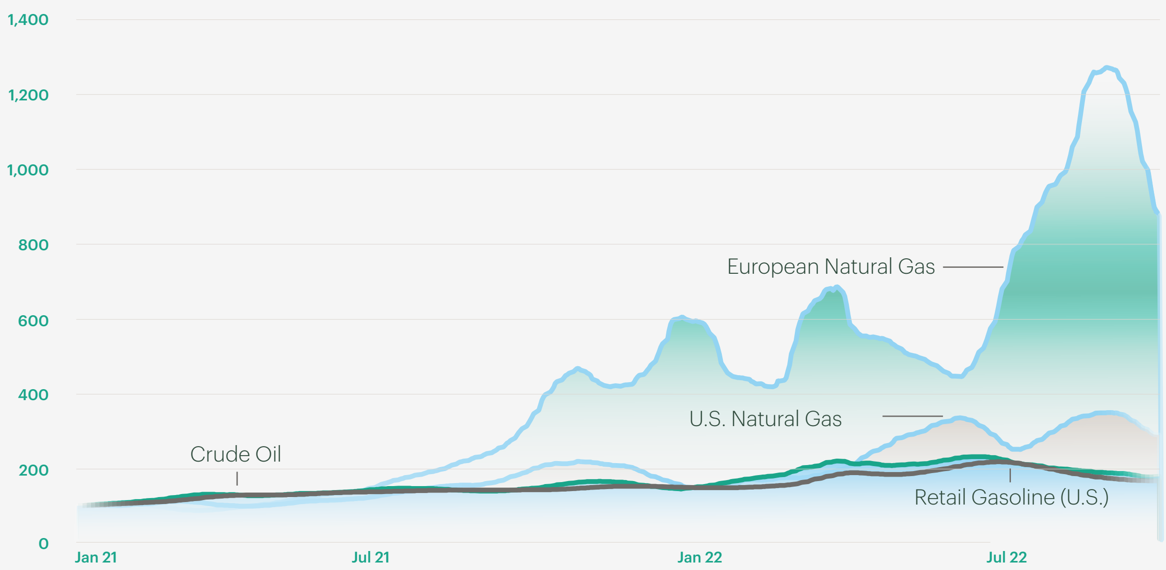
International P/E Discount Vs. U.S. P/E



Sources: FactSet, MSCI, Standard & Poor's, J.P. Morgan Asset Management, as of November 30, 2022

FIGURE 3

Monthly Average Energy Prices Disproportionately Hitting Europe



Sources: Refinitiv, AB, as of September 30, 2022

significantly elevated (see Figure 3), and supply constraints could further exacerbate the situation in Europe. The ongoing war in Ukraine will undoubtedly keep investors on edge while adversely affecting the outlook for international economic growth.

Covid-19. The world's ongoing battle with Covid-19 represents another significant risk factor. Since the onset of the pandemic nearly three years ago, the world continues to face an unknown path forward for this virus. Investors should be mindful of the possibility of future lockdowns and their potential impact on the economy. This threat is particularly acute in China, where Covid-19 surges have continued to result in localized shutdowns. Further, factories and businesses across the globe could face renewed closures as the fight against Covid-19 continues.

Proceed with Caution

In balancing these risks and potential rewards, our outlook for international developed and emerging markets remains cautious. We believe foreign equities will eventually have their moment in the limelight, but our near-term outlook is weighted toward the ongoing risks and relatively underwhelming fundamentals.

At the same time, we should avoid being too pessimistic about foreign equities. Yesterday's headwinds (i.e., the strong U.S. dollar) could very easily become tomorrow's tailwinds as we move into 2023.

It Depends on the Fed

Our outlook for 2023 remains uncertain and will hinge on whether the Fed is able to rein in inflation while keeping us out of recession. But because the labor market continues to show strength, lending support to the consumer sector—the largest part of the economy—we are cautiously optimistic that the economy and markets will move in a positive direction in the new year, though there may be some bumps along the way.

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