Economic & Market Outlook

2023 Year Forecast

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A Cloudy Outlook With A Silver Lining

2022 is a year investors hope will not repeat anytime soon. The turmoil of 2022 followed 2021's economic reopening and easy money—with big gains for stock investors. By contrast, 2022 was a year of inflation, rising interest rates, war, and big losses for both stock and bond investors. **[Figure 1]**

We don't think that 2023 will be a repeat of 2022, but it won't be easy street either. A cloudy outlook for growth and inflation will likely keep volatility high, but there is a silver lining as we expect the outlook to be much clearer by the end of the year. And financial markets like clarity.

Looking ahead, we expect economic growth to slowly grind lower through at least mid-year as the economy normalizes after the pandemic reopening boom and the lagged effects of higher interest rates make themselves felt by weighing down demand. We expect inflation to ease as the year progresses and we may even see the Federal Reserve cut rates by the end of the year.

An environment of slow growth and perhaps recession combined with slowing inflation tends to be good for bonds as interest rates typically decline, pushing bond prices higher. Declining interest rates are often good for stock valuations as well. However, if earnings estimates prove to be too optimistic due to recession, stocks may struggle to record gains.

While the near-term outlook is cloudy, the long-term outlook has improved significantly over the past year. Compared to a year ago, long-term expected returns are notably higher for both stocks and bonds. The punchline is that the 10 to 15-year expected annual return for a balanced portfolio is about 8% compared to 5% a year ago, which provides long-term investors with reason to remain patient as near-term issues resolve.

Long-Term Capital Market Returns

- The rapid increase in interest rates weighed on asset valuations in 2022, creating a rare circumstance in which stocks and bonds declined in the same year.
- The valuation reset creates a better return outlook from current levels. Compared to a year ago, investors in a 60% stock, 40% bond portfolio can expect average annual returns of about 8%—up from 5% a year ago.
- Fixed income returns are expected to average about 4%-5% annually and equity returns about 8-10% annually over the next 10-15 years.

Figure 1

Annual Return by Asset Type

as of December 31, 2022

FIXED INCOME	LAST 3 YEARS	CY 2022	QTD
Bloomberg U.S. Aggregate Intermediate	-1.9%	-9.5%	1.7%
Bank of America Merrill Lynch Municipals 1-12 Yr	-0.2%	-4.9%	3.1%
U.S. EQUITY			
S&P 500	7.7%	-18.1%	7.6%
Russell 1000 Growth	7.8%	-29.1%	2.2%
Russell 1000 Value	6.0%	-7.5%	12.4%
Russell 2000 (small-cap)	3.1%	-20.4%	6.2%
INTERNATIONAL EQUITY			
MSCI ACWI Ex U.S. (international)	0.1%	-16.0%	14.3%
MSCI EAFE (developed)	0.9%	-14.5%	17.3%
MSCI EM (emerging markets)	-2.7%	-20.1%	9.7%
COMMODITY			
Bloomberg Commodity	12.7%	16.1%	2.2%
U.S. Dollar Index	2.4%	7.9%	-7.7%

Source: Morningstar Direct

Fixed-Income

- Large interest rate increases in 2022 pushed bond prices down by double-digits at the low point before finding some relief during the fourth quarter. The declines were the worst in 45 years.
- As interest rates climbed during the year, we extended the average maturity of our bond portfolios to lock in the higher level of rates.
- In a similar manner, we upgraded quality and reduced credit exposure during the year due to elevated recession risk that we do not believe is adequately compensated in credit spreads.

Equities

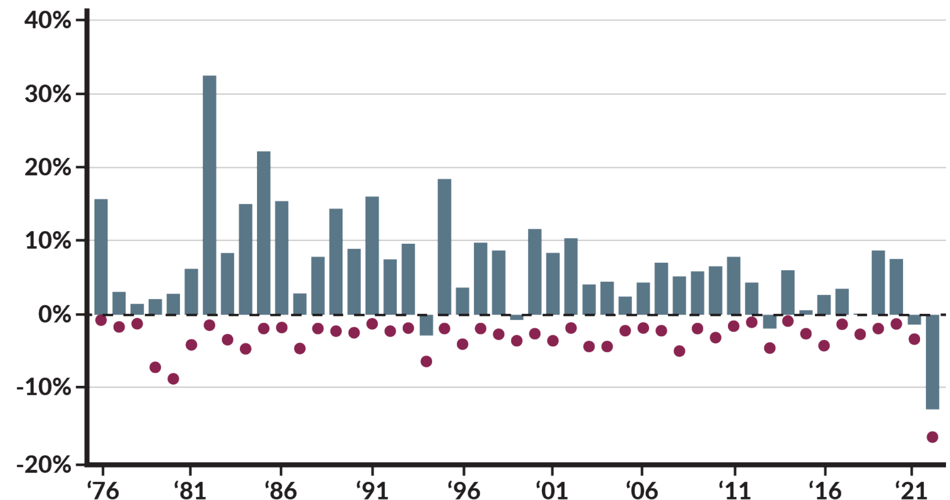
- The increase in interest rates impacted equity prices through a decline in valuations. The price/earnings ratio for the S&P 500 declined about 20% in 2022 to 17x expected earnings over the next 12 months.
- While interest rates drove equity prices for most of 2022, the coming year is likely to be driven by earnings. Earnings are expected to increase 6% in 2023, which will likely be revised lower in the event of recession.
- For this environment, we have positioned portfolios to focus on less economically sensitive large-cap stocks, while deemphasizing smaller companies, cyclical value, and high-valuation growth styles.

Complements

- While not all complements investments posted positive returns in 2022, most did hold up better than their equity and fixed income counterparts, demonstrating their diversification benefit.
- Although somewhat less compelling than stocks and bonds, long-term returns for our complements sleeve remain attractive in the mid-single digit range.
- In recent months, portfolios have been rebalanced to bring our complements allocation back to long-term targets.

Figure 2

Bloomberg U.S. Aggregate Intra-year Declines vs Calendar Year Returns



Source: Bloomberg, J.P. Morgan Asset Management

2022: A Year To Forget

Bonds declined across the maturity and credit spectrum in 2022, leaving fixed income investors bruised **[Figure 2]**.

The Fed raised interest rates at the fastest pace in modern history, causing bond prices to fall as yields rose. The Fed Funds rate ended the year at a target range of 4.25%-4.50%, up over 4% in less than 12 months. The Treasury yield curve ended the year deeply inverted, signaling an increase in recession risk.

Despite recession risks, credit spreads remained largely contained throughout the year, with most of the spread widening contained to leveraged loans and emerging market bonds. Loans outperformed most fixed-rate bonds despite the spread-widening thanks to their floating-rate coupons, which reset higher throughout the year. Emerging market

bonds were battered in the first half of the year due to the combination of a strong dollar and the war in Ukraine but rallied smartly in the fourth quarter and represent value at current yields in our view.

Cash was king in a year with unrelenting upward pressure on bond yields. Money market yields near 4% are compelling now, but investors should consider their investment horizon and reinvestment risk if the Fed pivots to an easing stance in 2023.

Stocks declined in 2022 with the S&P 500 Index down about 18%. For context, **Figure 3** shows this is just the third down year for stocks since the 2007-2008 Great Financial Crisis, demonstrating how resilient the last bull market was.

While not an exhaustive list, stocks have faced numerous headwinds in 2022. While uncertainty remains high, we expect improvement in each of these areas in 2023.

- Higher interest rates
- High inflation
- Supply chain issues
- Geopolitical risks: Russa-Ukraine war, U.S.-China tensions and China's zero-Covid policy
- Normalization of demand after the 2021 pandemic reopening boom (2021 S&P 500 earnings were up over 50%!)
- Tighter policy conditions (Fed rate hikes and reduced fiscal stimulus)

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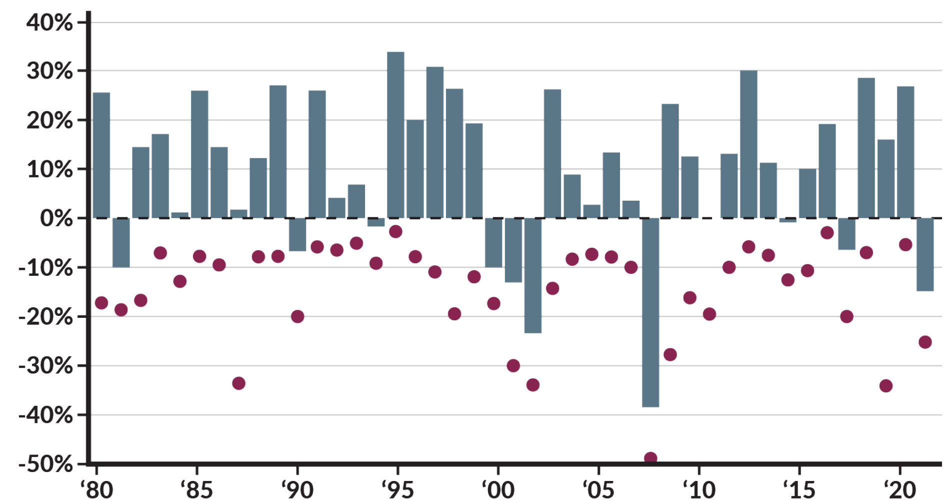
Figure 3

S&P 500 Intra-year Declines vs Calendar Year Returns



Source: FactSet, Standard & Poor's, J.P. Morgan Asset Management

While these headwinds were significant, corporate profits remained resilient through mid-year before facing modest deterioration. The resulting price decline was therefore primarily due to the rapid increase in interest rates. To understand how interest rates impact stock prices, you can think of a stock's price being related to the future expected profits for the company. Higher interest rates have the effect of reducing the value of those future profits.

Looking at the impact of higher interest rates from another angle, consider that if interest rates are higher on bonds, stock prices must adjust lower to offer a higher expected future return to compensate investors for taking the risk of owning stocks versus bonds. As an example, if investors can buy a bond that will pay them 4%, they will demand an expected return of at least 7% to take on the additional risk of owning the stock.

Looking at market returns at the sector level, in a year characterized by inflation, it is no wonder that the Energy sector ended up as the top-performing sector with a return of over 50%. Sectors with less economically sensitive earnings in the Utilities and Consumer

Staples sectors also held up well, with small positive to low-single digit declines. The Communication Services, Technology, and Consumer Discretionary sectors faced declines in the 30-40% range. The primary reason for the large declines is that these sectors have exposure to companies most impacted by the valuation adjustment from higher rates and the normalization of demand after the pandemic.

From a style perspective, value outperformed growth primarily due to sector composition. While facing an 8% average headwind from a stronger U.S. dollar, international stocks performed remarkably well despite the Russia-Ukraine war due to lower starting valuations than their U.S. counterparts, less aggressive monetary policy tightening and greater exposure to value-oriented sectors.

The Future Looks Brighter

The last twelve months have certainly been a challenging period in the financial markets. Inflation has been a driving force in economic policy for the first time in nearly 40 years following the turmoil of the pandemic. Stocks tumbled due to higher interest rates and the anticipation of an economic slowdown and ended the year in negative territory for only the third time since 2008.

In addition, bonds experienced the most significant annual losses in 45 years as the Fed has been aggressively raising rates to subdue inflation, as reflected by the Bloomberg U.S. Aggregate Bond Index. The result was a disappointing year for the traditional "60/40" portfolio, which did not experience the traditional benefits of stock/bond diversification during equity bear markets.

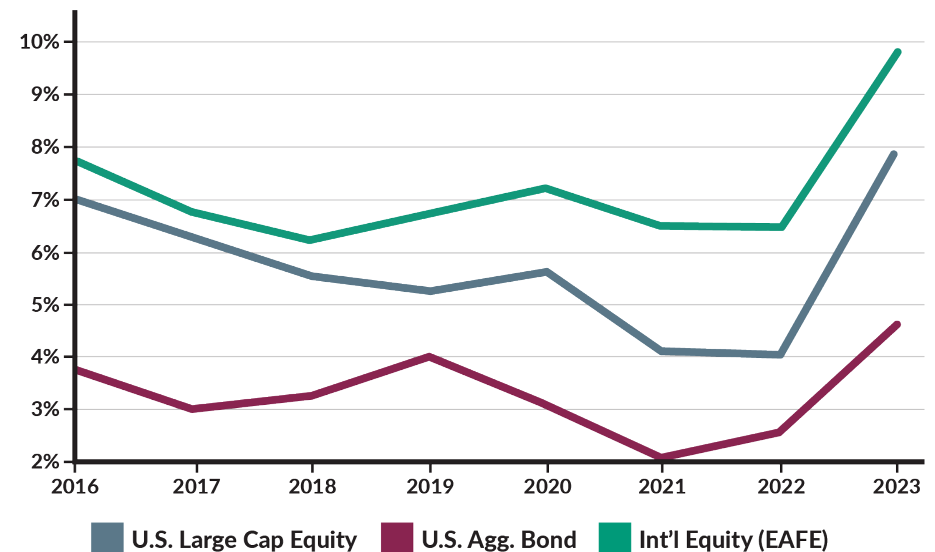
While it's natural to focus on market returns for a particular calendar year, the turn of the calendar can also be a helpful time to refocus on long-term expectations for investment returns. At this point last year, equity markets were experiencing significant gains and trading at ambitious valuations. In fixed income, expectations were muted as the historically low levels of interest rates continued for more than a decade. A lot has changed!

As we look forward, the market reset of 2022 has had a material impact on return expectations for the next 10-15 years. The outlook for equities has increased significantly as we expect average returns over the next decade to be in the 8-10% range. The primary driver for the more optimistic view is starting valuations. Equity valuations have historically been a poor short-term indicator for returns, but much more reliable when looking out over a longer period. Current valuations are now closer to historical norms, which leads to return expectations closer to long-term historical averages. The fixed-income outlook has also improved as rate increases over the past year position bonds for improved returns, which we expect to be in the 4%-5% range over the next 10-15 years. **[Figure 4]**

Figure 4

2023 Long-term Capital Market Assumptions

Traditional Asset Classes



Source: J.P. Morgan Asset Management

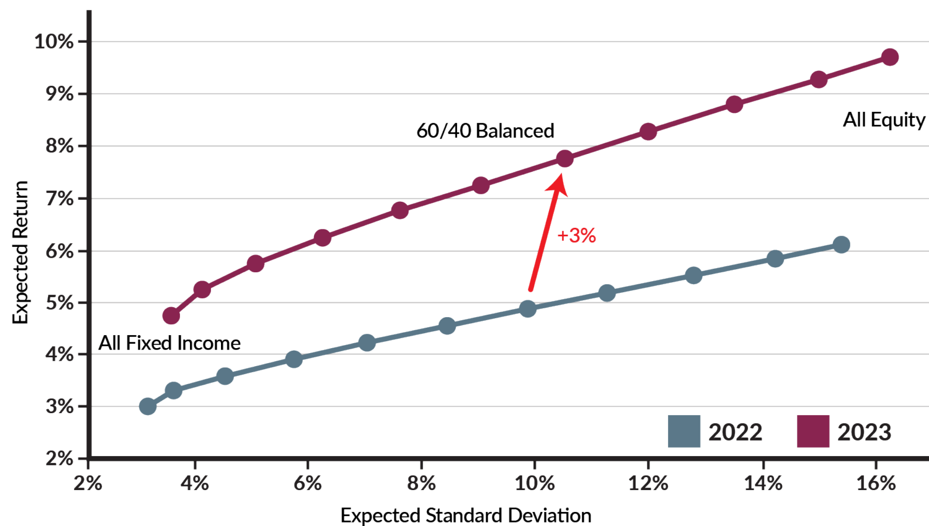
As shown in **Figure 5**, combining the equity outlook with the fixed-income outlook provides a 60/40 balanced portfolio with a 10 to 15-year return outlook of about 8%, which is about 3% higher than year-ago levels. While 2022 was certainly a difficult year for the 60/40 portfolio, we believe there is reason to be more optimistic as we look forward to the next decade.

2023 Outlook: Uncertainty Resolved

We expect economic growth to slowly grind lower as the economy normalizes after the pandemic reopening boom. A strong labor market and the remaining stimulus-driven momentum are currently offsetting the headwinds of interest rates, energy prices and the strong U.S. dollar, but the probability of recession in 2023 continues to climb as the headwinds mount.

Figure 5

Equity vs Fixed Income Returns



Source: J.P. Morgan Asset Management

While 2022 was certainly a difficult year for the 60/40 portfolio, we believe there is reason to be more optimistic as we look forward to the next decade.

We believe inflation has peaked and will decline through 2023. Although wages, housing and services pricing will slow with a lag, inflation is already coming down for most commodities and durable goods (homes, cars, furniture, etc). It is unlikely that inflation will slow all the way to the Fed's 2% target level in 2023, but we are reasonably confident that inflation will slow.

We believe the Federal Reserve is near the end of its rate hiking campaign. The Fed expects to increase the Fed Funds rate to approximately 5% and keep it there through the end of 2023. Futures markets, on the other hand, predict rate cuts could start as early as the second half of 2023. Intermediate and long-term interest rates have fallen off their peaks as recession probabilities have increased, resulting in a deeply inverted Treasury yield curve, with three-month yields exceeding 10-year yields.

The Bloomberg Barclays Intermediate Aggregate Index currently yields about 4.5%, providing a base case for expected returns in 2023. Intermediate rates would need to rise an additional 1% to offset one year of income, while a further decline in intermediate rates would result in higher than 4.5% annual returns.

We started 2022 with shorter-than-benchmark average maturities, which benefitted fixed-income portfolios as interest rates rose. We gradually extended the average maturity of bond portfolios to lock in higher rates as they approached the top of their

range over the last decade **[Figure 6]**. We are currently positioned with average maturities in line with portfolio benchmarks. We have adjusted credit exposure within portfolios to align with our outlook for the economy. As recession risk increased mid-year, we took steps to increase quality and reduce the credit risk in the portfolio as we do not believe the current level of spreads compensates us for the risk.

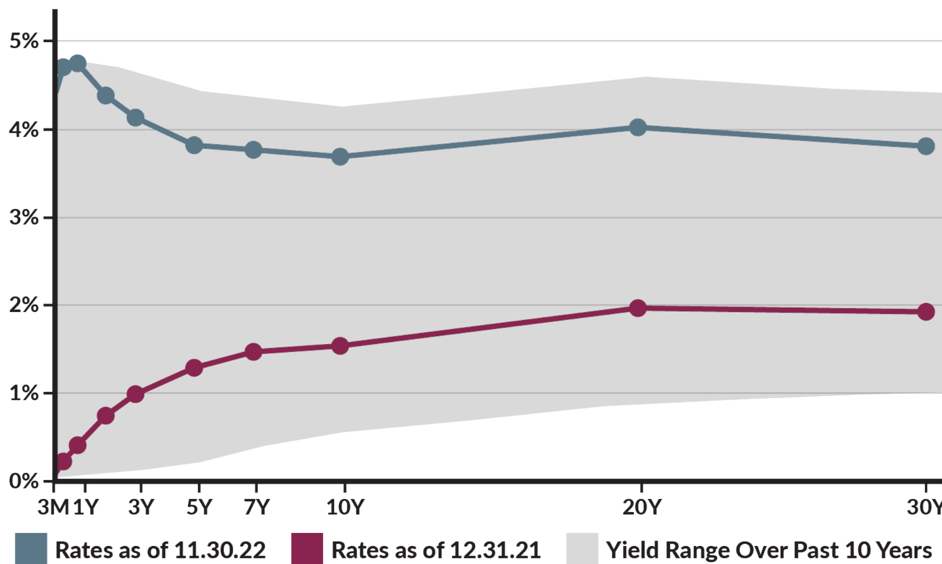
Perhaps the biggest question for investors in 2023 is whether the Fed will pause or pivot. For now, the Fed has maintained a hawkish tone in an attempt to control inflation expectations and get core inflation closer to its 2% long-run target (Core CPI is currently running at 6%).

We believe a further tightening in financial conditions, including possibly lower stock prices, and a weaker labor market will be necessary to force the Fed to pivot to easing, although the lagged effects of this year's hikes may lead to a pause in rate hikes in the first half of 2023.

Figure 6

Interest Rates At More Attractive Levels

10 Year Yield to 3.9% from 1.5%



Source: FactSet, Federal Reserve, J.P. Morgan Asset Management

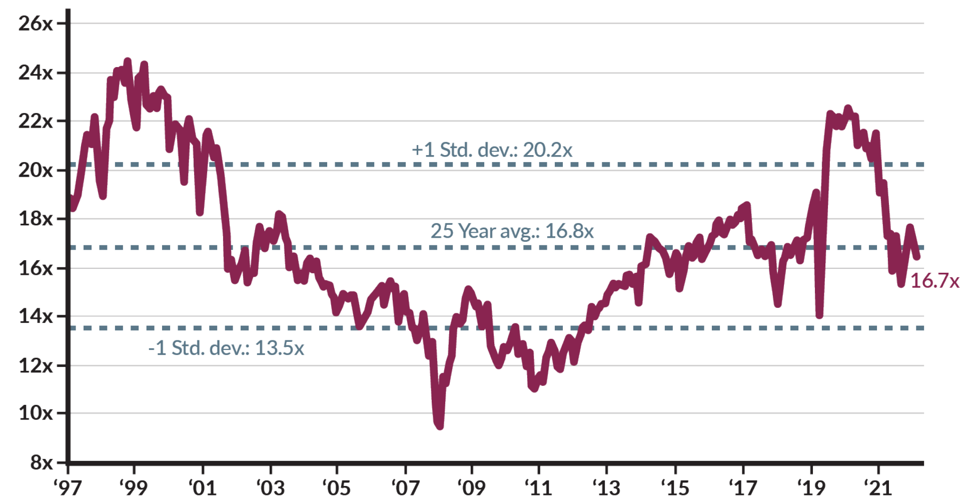
History tells us that tighter monetary policy typically leads to wider credit spreads. We look forward to opportunities to add to credit exposures—and thereby attain higher yields—opportunistically throughout the year.

The outlook for stocks is largely a function of the level of corporate profits and the valuation investors are willing to pay for those earnings. In 2022, earnings are on pace to increase about 6%, but the surge in interest rates pushed valuations lower, from 21x next-12-months expected earnings to 17x, leading to the 18% decline in the S&P 500 Index in 2022 **[Figure 7]**.

2023 is unlikely to face the same valuation challenge, assuming that interest rates don't shoot up another 3%. However, the earnings outlook is far from certain given the potential for recession. Earnings typically decline during a recession, whereas market observers' consensus is still a 6% increase for 2023. As a result, we believe the outlook for economic growth will replace inflation as the top concern for equity investors in 2023. We will be watching leading economic indicators like the housing market and manufacturing new orders for clues about the health of the economy and the outlook for earnings.

Figure 7

S&P 500 Index: Forward P/E Ratio



Source: FactSet, Standard & Poor's, Thomson Reuters, J.P. Morgan Asset Management

ASSET ALLOCATION

ECONOMY

Growth	○ ● ○ ○ ○
Inflation	○ ○ ● ○ ○

ASSET ALLOCATION

Equities	○ ○ ○ ● ○
Fixed Income	○ ● ○ ○ ○
Complements	○ ○ ● ○ ○
Cash	○ ● ○ ○ ○

CAPITAL ALLOCATION

EQUITIES

International	○ ○ ● ○ ○
Small/Mid Cap	○ ● ○ ○ ○
Value Style	○ ○ ● ○ ○

FIXED INCOME

International	○ ○ ○ ● ○
Duration	○ ○ ● ○ ○
Credit	○ ● ○ ○ ○

Although we anticipate volatility to remain high for at least the first half of 2023, long-term investors can take some comfort in these historical facts about equities:

- Equities typically bottom before the economy. A second-half recession would likely be priced into markets three to six months beforehand (i.e., soon).
- Stocks are higher in about 70% of years, and back-to-back calendar year declines are rare. Since 1945, stocks recorded consecutive declines in only two periods: 1973-1974 and 2000-2002.
- The biggest declines and gains occur near market bottoms, demonstrating the risk of market timing.
- Stocks are a long-term investment, and long-term returns look promising relative to a year ago, even if returns remain below-average in 2023.

Perspective & Patience

The historical perspective we've shared this quarter may not ease the pain of a very difficult 2022 for financial markets. It does, however, provide reason for optimism for the path ahead.

Though we expect slowing growth—and possibly recession—we also see strong reason for confidence in more attractive long-term annual return expectations, such as 8% over 10-15 years for a balanced portfolio versus 5% a year ago.

As always, we will closely monitor markets, economic indicators, and the performance of the third-party managers we engage on your behalf. We thank you for your confidence and warmly welcome further discussion as we move into what we all hope will be a brighter year ahead.

Let's Start a Conversation

Your Johnson Financial Group team is here to help you understand this complex and ever-changing economic landscape. We aim to position your portfolio with the flexibility to navigate this volatility while also meeting your financial goals. We understand these times can be very stressful but hope you take comfort in having an experienced and dedicated financial team working specifically for you. **Thank you for your partnership and trust in Johnson Financial Group.**

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