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2022 Review & 2023 Outlook: Where do we go from here?

Webster Private Bank wishes clients, colleagues, and friends a happy and prosperous 2023!

2022 was a year both stock and bond investors would like to forget, as both stock and bond markets repriced in response to stubbornly high levels of inflation and the Federal Reserve's actions to reign it in. As a result, this was the first year in decades to see both stocks and bonds post negative returns for the full year. While client portfolios managed by Webster saw losses in 2022, they were moderated by prudent investment allocations made throughout the year. Webster strategies in aggregate have seen positive results over the long-term with strong returns seen over the past three, five, seven and ten-year periods. Successful long-term performance highlights the importance of adhering to a disciplined and systematic approach to investment management that is predicated upon both acceptable risk/volatility levels and portfolio return objectives over a client's time horizon. Webster Private Bank's investment team has and continues to advocate investing in this manner.

Capital Markets Review

The fourth quarter showed recovery across the board, as global equities rebounded off October lows. U.S. large cap stocks returned 7.6% on the quarter yet remain near bear market levels on the year, down -18.1%. Small cap stocks returned 6.2% for the quarter, while down -20.4% on the year. Developed international equities rebounded sharply in Q4, surging 17.3% on a more positive outlook for the Russia – Ukraine conflict and easing COVID restrictions in China. Emerging markets rose 9.7%, finishing the year down -20.1%.

Fixed income markets recovered modestly in Q4 while experiencing one of the worst years in history, with the aggregate bond market down -13.0%. Alternative investments cushioned the blow in diversified portfolios, returning -4.4% on the year.

Asset Class Returns

	Asset Class	Index	December 2022	Q4 2022	YTD
Equity	U.S. Large Cap	S&P 500	-5.8	7.6	-18.1
	U.S. Small Cap	Russell 2000	-6.5	6.2	-20.4
	International Developed	MSCI EAFE	0.1	17.3	-14.5
	Emerging Markets	MSCI EM	-1.4	9.7	-20.1
Fixed Income	U.S. Investment Grade	Barclays U.S. Aggregate Bond	-0.5	1.9	-13.0
	U.S. Inflation-Indexed	Barclays U.S. TIPS	-1.0	2.0	-11.8
	U.S. High Yield	BBgBarc U.S. Corp High Yield	-0.6	4.2	-11.2
	EM U.S. $ Debt	JPM EMBI Global	0.3	8.1	-17.8
Alternative	Absolute Return	HFRX Global Hedge Fund	-.06	.16	-4.41

Source: Morningstar

Sector Review

Taking a closer look at U.S. sectors, energy rose 22.8% in Q4, resulting in a 65.7% return for the full year, despite crude oil declining from $122 per barrel in June to $80 at the end of December. With the exception of Utilities, which were up 1.6% for the year, every other sector posted negative returns in 2022, despite generally strong performance in Q4.

Sector Returns: Q4 and 2022

Sector	Index	December 2022	Q4 2022	YTD
Energy	S&P 500 Sec/Energy	-2.9	22.8	65.7
Utilities	S&P 500 Sec/Utilities	-0.5	8.6	1.6
Consumer Staples	S&P 500 Sec/Cons Staples	-2.8	12.7	-0.6
Health Care	S&P 500 Sec/Health Care	-1.9	12.8	-2.0
Industrials	S&P 500 Sec/Industrials	-3.0	19.2	-5.5
Financials	S&P 500 Sec/Financials	-5.2	13.6	-10.5
Materials	S&P 500 Sec/Materials	-5.6	15.0	-12.3
Real Estate	S&P 500 Sec/Real Estate	-4.8	3.8	-26.1
Technology	S&P 500 Sec/Information Technology	-8.4	4.7	-28.2
Consumer Discretionary	S&P 500 Sec/Cons Disc	-11.3	-10.2	-37.0
Communication Services	S&P 500 Sec/Commun Services	-7.8	-1.4	-39.9

Source: Morningstar

Inflation and recession remain primary drivers of market volatility

As we look forward into 2023, the themes we've focused on in recent Market Insights newsletters continue to dominate the headlines. Inflation and recession remain the primary drivers of market volatility as market participants attempt to reach conclusions based on uneven monthly data points.

While short-term forecasting is difficult, we must read the tea leaves in an attempt to navigate volatile markets. Going into 2023 the investment team is focused on the following items:

- Central bank actions regarding interest rates and its impact on economic growth in 2023.
- The best places to allocate capital in equity and bond markets given the uncertain environment.
- The improved long-term outlook for investors and the resurgence of the balanced portfolio in 2023.

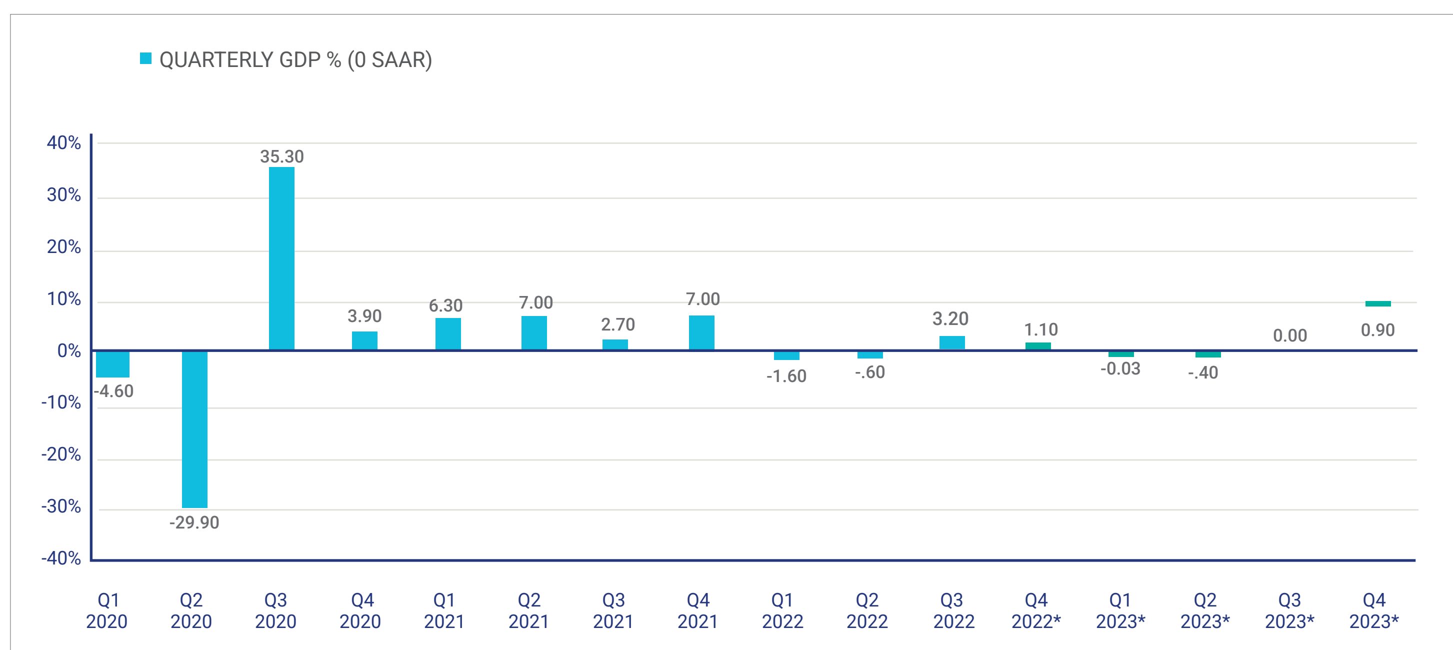
Let's take a look at each:

Central bank actions regarding interest rates and its impact on economic growth in 2023

The Federal Reserve has dual mandates of price stability and full employment. In 2022, the Fed fulfilled only one of its mandates: full employment. As of December 2022, the unemployment rate was at 3.5% well below the 50-year average of 6.2%. Furthermore, demand for labor continued to trend at levels not seen in decades with the ratio of job openings per job seeker coming in at 1.72 as of the most recent JOLTS survey.

While the labor market was a positive in 2022, its impact on inflation was negative as it pushed wage growth well above its long-term trend of 4%. Coupling wage pressures with the war in Ukraine, continued supply chain issues, and strong consumer demand spurred by pandemic induced stimulus, year-over-year headline inflation peaked at 9.0%, its highest rate since 1982. This resulted in the Fed embarking upon its most aggressive policy tightening campaign since the 1980s, bringing the Federal Funds overnight lending rate from 0.0-0.25% at the beginning of the year to 4.25-4.50% at year-end. The campaign has resulted in both stock and bond markets exhibiting extreme levels of volatility as markets began to price in the chances of slow or contracting economic growth in 2023.

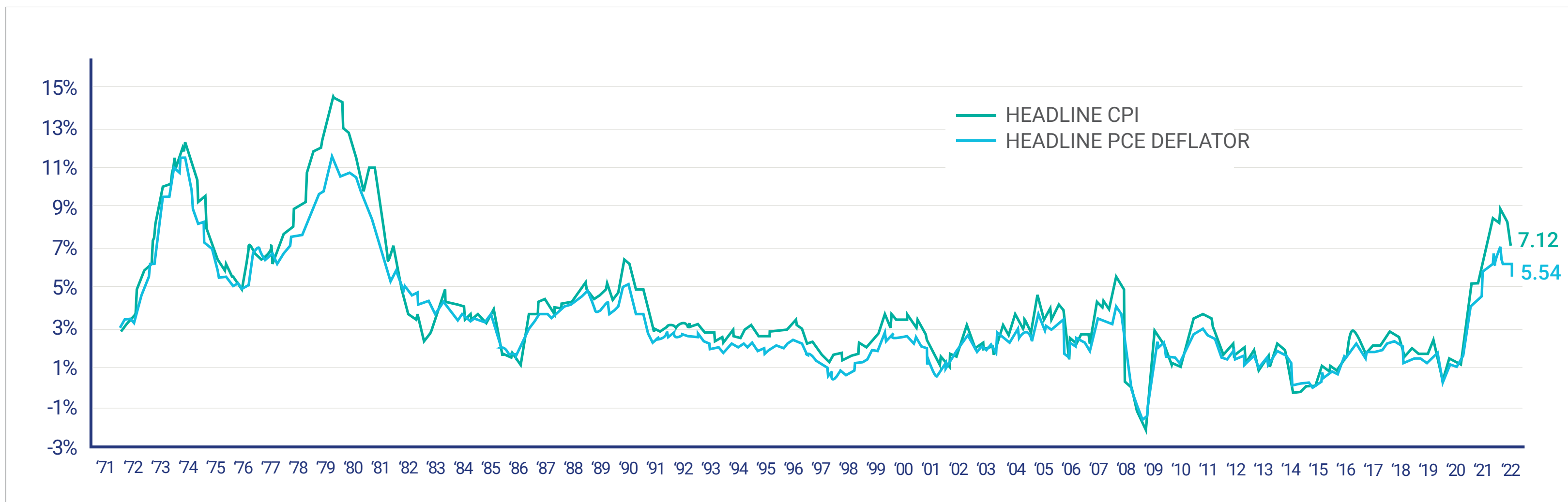
Quarterly U.S. Real GDP Growth Including 2023 Forward Estimates Forward Estimates



Source: FactSet
*Estimates as of 1/5/2023

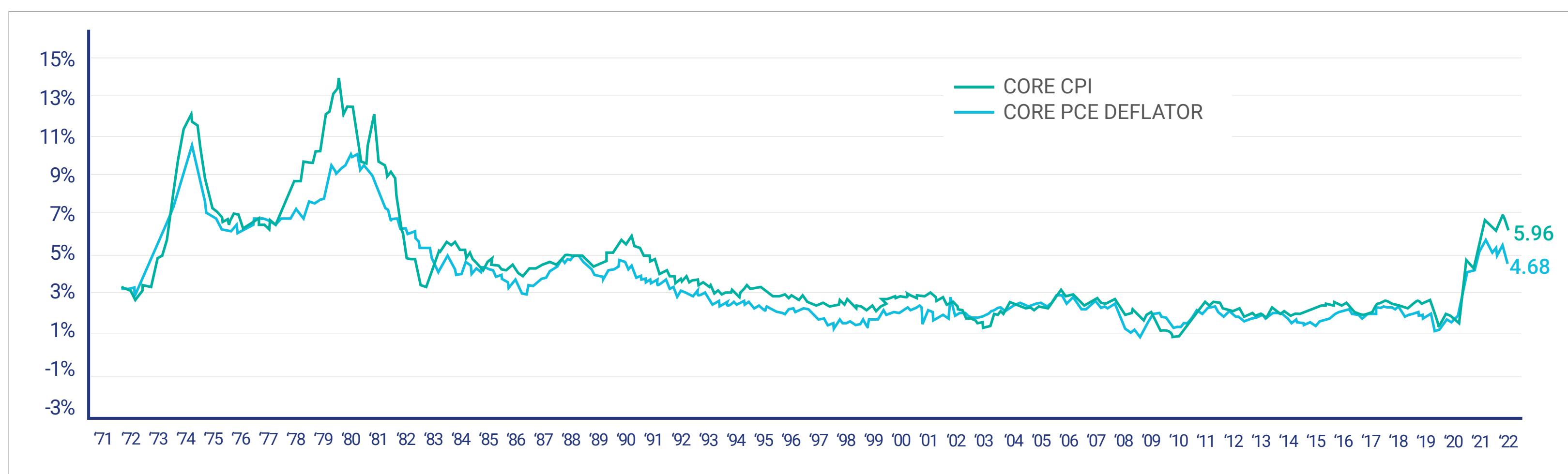
As mentioned, the Federal Funds overnight lending rate currently stands at a target of 4.25%-4.50%. The Fed has indicated that they plan to continue hiking the target rate until it is above 5% to achieve price stability (i.e., lower inflation) in the U.S. economy. As shown in the charts below, inflation appears to have peaked. Both headline and core (ex-food and energy) CPI and PCE suggest that the Fed's actions are having the desired effect.

CPI and Headline PCE Inflation



Source: FactSet, FRED Economic Data, St. Louis FED
Data as of 11/30/2022

Core CPI and Core PCE Inflation

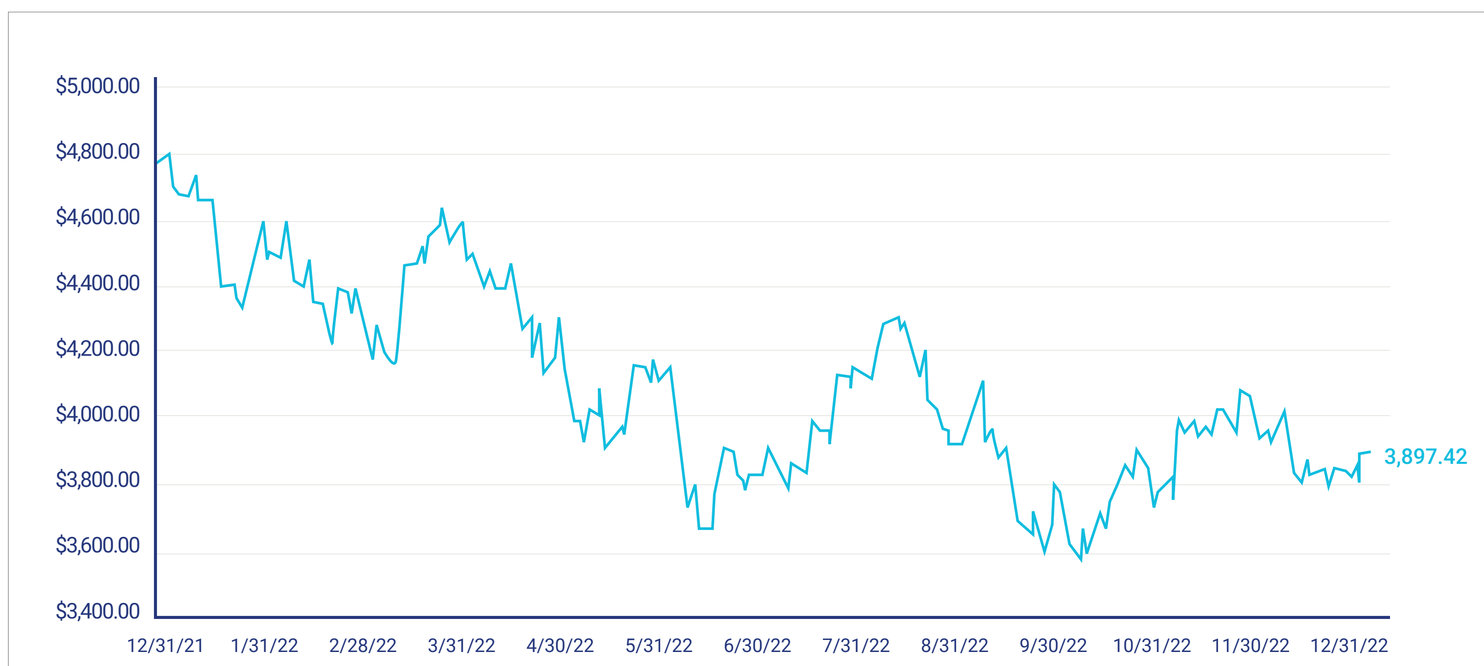


As the Fed has moved aggressively to combat inflation, concern has grown that the Fed will over-tighten, tipping the economy into recession. Market volatility is likely to remain high as data points either support or contradict Fed policy. Due to this uncertainty, we believe extreme prudence in investment decisions is of utmost importance in the year ahead. We discuss below how we are positioning into 2023 to protect client assets and continue them on a growth trajectory long into the future

How does our team currently think about allocating capital in such an uncertain environment?

First and foremost, we continue to believe that long-term investors need to stay invested and ride out any additional volatility. Attempts to time markets in 2023 are likely to be met with disappointment as market trends continue to sharply reverse in response to mixed data points. While episodes like what was experienced in 2022 are certainly painful, trying to time the market and missing the ensuing recovery can make it much worse.

S&P 500 - Daily Price



Source: FactSet
12/31/2021 - 1/9/2023

The economy is not the stock market

Despite the challenging backdrop we are faced with as the calendar turns to 2023, we are reminded that the "economy is not the stock market" and vice versa. Main Street and Wall Street do not move in synch. In other words, just because 2023 is likely to be a more difficult year for our economy does not necessarily mean it has to be another "down" year for the stock market. 2020 was a good example of this divergence, as real GDP was down -3.5% while the S&P 500 index was up 18.4%. (Source: FactSet).

Companies with strong financials are likely to outperform

On the equity side, 2022 saw nearly all sectors lower (except for the energy and utility sectors). However, on a relative basis "Value" sectors outperformed "Growth" sectors by the largest margin since 2001 (Source: Blackrock's "Student of the Market" December 2022). While it is possible this could continue in 2023 as the Fed continues its tightening regime, we prefer not to make a huge bet either way on the growth/value debate. Instead, we think a more balanced/nuanced approach across sectors is important in this environment. We look for companies with specific characteristics to outperform: Strong Balance Sheets, Pricing Power, and ability to benefit from cyclicality regardless of sector. Rather than placing all our chips in the "Growth" or "Value" bucket, we want to hedge a bit in such an uncertain environment. It is entirely possible that "defense" may be prudent in equity allocations for the first half of 2023 before playing a bit more "offense" becomes appropriate in the second half.

Relative Annual Performance of Growth versus Value: 2002-2022

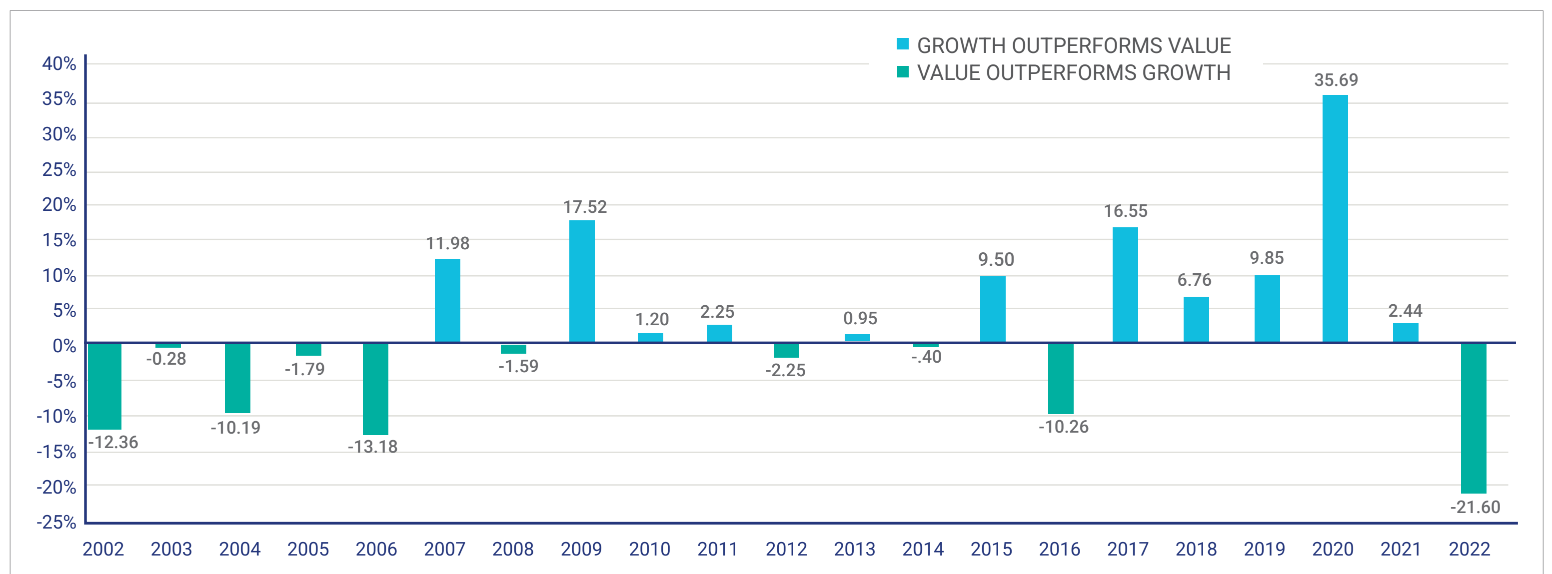


Chart represents Russell 1000 Growth annual performance minus Russell 1000 Value annual performance.
Source: Morningstar

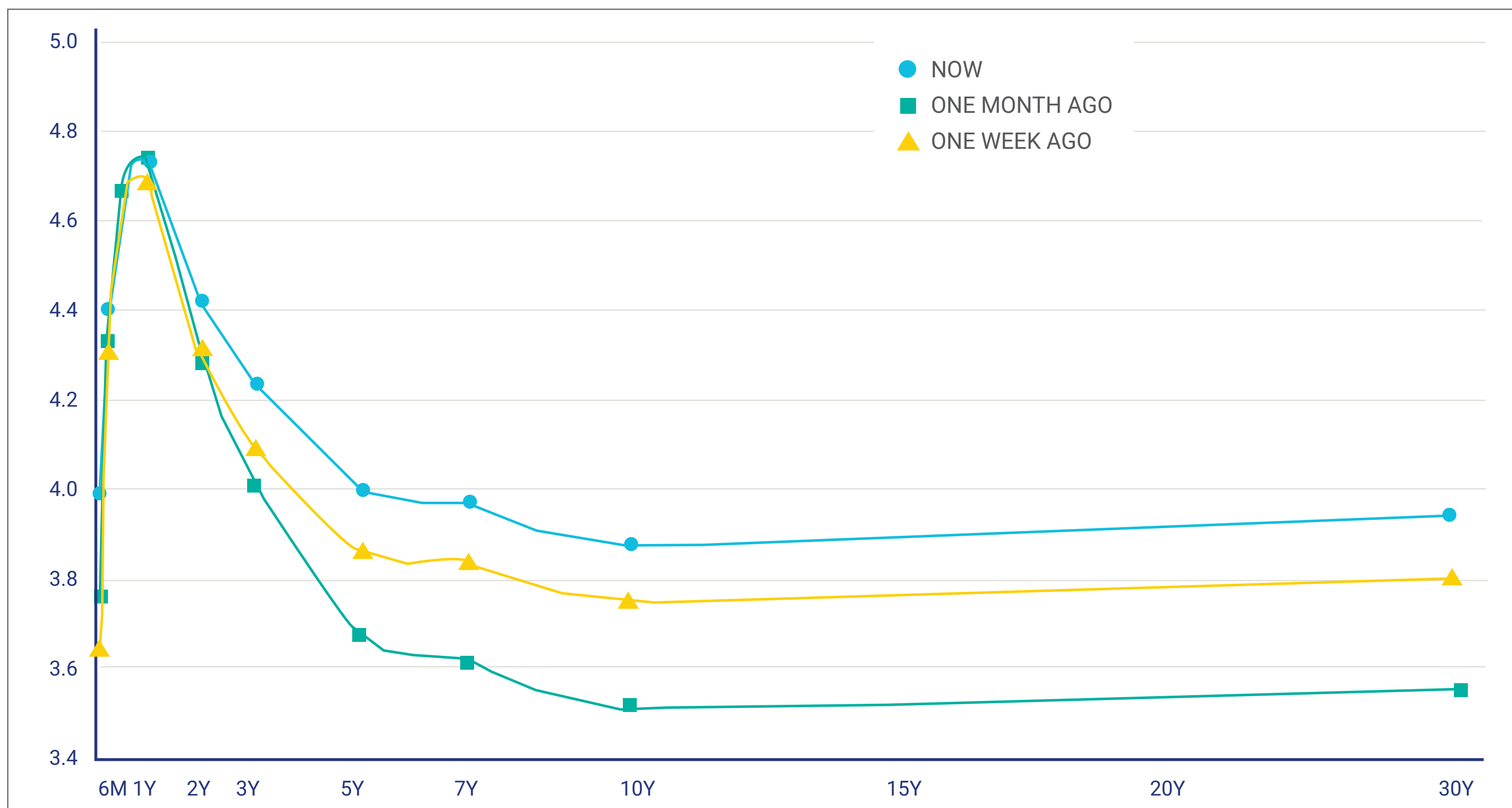
Patience still required for non-U.S. markets

While recognizing the value of global diversification, we continue to maintain a pro-U.S. bias as we enter the new year. Many of the characteristics we find most appealing in companies (strong balance sheets, pricing power, etc.) are found more often in the U.S. at the moment. Europe, in particular, may have a deeper recession to dig out of than the U.S. as a result of their energy dependence on Russia. It is unclear how/when that conflict might end and we certainly won't speculate on it here. While encouraging from an economic perspective that China has abandoned its "Zero-Covid" policy and is finally reopening, there is much uncertainty and chaos ahead with that process before we fully embrace adding to emerging market allocations. While some will point to more attractive valuations in non-U.S. markets (a fair point), to us, there is still significant risk involved and patience is key.

The improved long-term outlook for investors and the resurgence of the balanced portfolio in 2023.

After one of the most painful years in history, there is finally one positive thing to say about bond investing: the "Income" has returned to fixed income. At the time of this writing the 1-year U.S. Treasury bond is paying 4.75%. This yield would have been unfathomable just a year ago, when 4.75% is roughly what High Yield (aka, "Non-Investment Grade Bonds") were paying. So, there is finally some reward to be had in fixed income with some attention to detail. The chart below shows the current yield curve inversion that has resulted from the Fed's forecasted interest rate hikes. This inversion is the steepest in over 40-years (Source: Bloomberg.com), with the 6-month T-Bill currently yielding 4.83% and the 10-year Treasury bond yielding 3.53% (Source: FactSet, January 9, 2023). As a result, longer bonds make little sense at this point.

U.S. Treasury Yield Curve



Source: FactSet
As of 12/30/2022

Given the current yield curve inversion, we continue to favor shorter duration bonds (as we did in all of 2022) and are beginning to embrace the balanced 60/40 portfolio for clients interested in generating an income stream from their bond holdings. While we believe that this inversion is not sustainable, it is difficult to predict exactly how the inversion unwinds itself. As a result, we remain more comfortable taking credit risk rather than duration risk, keeping maturities very short. Corporate balance sheets are healthy, and the United States banking system is in solid shape. While recession is absolutely a possibility (as discussed in detail earlier in this piece), any comparison to the 2008 Global Financial Crisis looks misguided in our view.

Keeping a watchful eye on markets in 2023 and beyond

For the first half of 2023, we see an environment where equity markets remain vulnerable to elevated levels of volatility as the inflation/recession dynamics work through the economy. A recession is a distinct possibility in 2023, but we believe it will be moderate. We anticipate that the second half of the year will be marked by a recovery in financial markets in advance of healthy economic growth in 2024 and beyond. At present we continue to favor U.S. companies whose underlying businesses have strong balance sheets and recurring cash flow. Shorter bond maturities will continue to complement our equity positioning while the yield curve remains inverted. Alternative assets, which helped protect portfolios against downside risk in 2022, continue to be an important component in client portfolios. Lastly, we will continue to watch markets closely and stand ready to adjust to unfolding developments in the economy and markets.

As always, please don't hesitate to reach out to your contacts at Webster Private Bank if you have any questions. It is a pleasure to serve you during these difficult times and we appreciate the trust you have placed in us.

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