Market Outlook
Fourth Quarter 2022

RETIREMENT PLAN ADVISORS

THE FUTURE IS BETTER THAN YOU THINK

MARKET SNAPSHOT

2022 proved to be one of the worst years for investors in decades, as both stocks and bonds saw double-digit losses driven by higher interest rates.

The Federal Reserve appears set to continue hiking interest rates, albeit at a slower pace than what we saw in 2022.

A number of leading economic indicators are triggering recessionary concerns, but a strong labor market, excess consumer savings, and China's re-opening may provide a buffer to any economic downturn.

Equities do not yet appear to have priced in a slowdown in growth and decline in earnings.

With the dramatic rise in interest rates, core bonds offer much more attractive yields and return potential than what we've seen in the past 10 years and should protect portfolios in a recessionary environment.

Market Recap

An extremely difficult year in the financial markets ended with a thud for U.S. stocks. After a 14% rally in October and November, the S&P 500 Index dropped 5.8% in December to close out the year with an 18.1% loss, its largest annual decline since 2008.

Foreign stock markets held up much better in the fourth quarter. Developed international stocks (MSCI EAFE Index) gained 17.3%—one of their best quarters ever—and emerging-market (EM) stocks (MSCI EM Index) were up 9.7%. For the full year, developed international stocks were down 14.5% in dollar terms (almost four percentage points better than the S&P 500), while EM stocks were down a bit more than the S&P 500 with a 20.1% drop. These annual returns were despite the U.S. dollar (DXY Index) appreciating 8.3% for the year, which reduces dollar-based foreign equity returns one-for-one. In the fourth quarter, however, the dollar dropped 7.7%, providing a tailwind to EM and international equity returns for U.S. investors.

Turning to the fixed-income markets, core investment-grade bonds (Bloomberg U.S. Aggregate Bond Index, aka the "Agg") had a solid fourth quarter, gaining 1.9%. But this was still the worst year for core bonds in at least 95 years, with the Agg dropping 13.0%. The key driver, of course, was the sharp rise in bond yields; the 10-year Treasury yield ended the year at 3.9%, up from just 1.5% a year prior. High-yield bonds (ICE BofA Merrill Lynch U.S. High Yield Index) had a strong fourth quarter, up 4.0%, but were down 11.2% for the year. Floating-rate loans (Morningstar LSTA Leveraged Loan index) were the best segment within the bond markets, down less than 1% for the year. Municipal bonds were down 8% (Morningstar National Muni Bond Category).

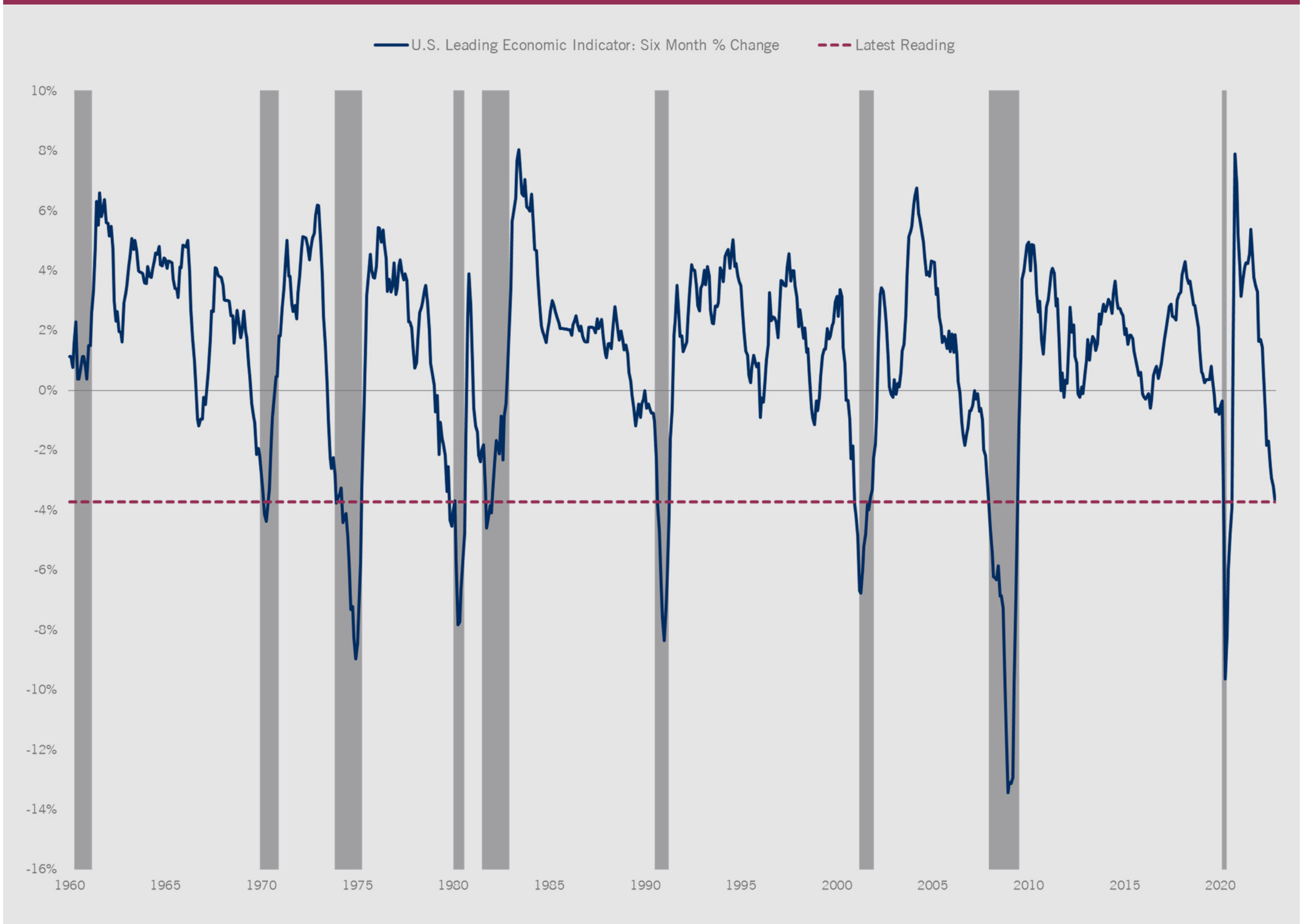
Investment Outlook and Portfolio Positioning

Inflation and monetary policy remain the financial markets' key macro focus. U.S. headline inflation data have improved, suggesting we've seen the peak in inflation for this cycle. Various measures of core inflation (i.e., excluding food and energy) have flattened, but remain at 5% or 6%, far above the Federal Reserve's 2% target. The Fed's message has been clear that it intends to maintain restrictive (tight) monetary policy throughout 2023. Indeed, at its December 14 meeting, the Fed raised the fed funds rate by 0.5% to a target range of 4.25% to 4.50%. It also forecasted 75 bps of additional rate hikes in 2023.

Inflation is not just a U.S. problem. Nearly all the other major global central banks (except Japan and China) are also continuing to hike interest rates in their countries. For example, both the European Central Bank (ECB) and the Bank of England hiked their policy rates another 0.5% in December. These synchronized global rate hikes will further depress global aggregate demand and economic growth over the shorter term. It's also typically a headwind for stocks.

On the economic growth front, key leading indicators deteriorated further in the fourth quarter. The Leading Economic Indicator (below), which has a long track record of "calling" recessions, has fallen for nine consecutive months (and likely will again in December). This has never happened without an ensuing recession.

The U.S. Leading Economic Indicator (LEI) Signaling Recession is Likely



LEI shown is six-month rate of change for the index. Dashed line represents latest reading. Shaded regions represent NBER-defined recessions.
 Source: Bloomberg LP. Data as of 8/31/2022.

While we weigh the evidence as leaning strongly towards recession, there are some positives supporting the economy that should mitigate the severity of a U.S. recession, if and when it happens. First and foremost, the labor market remains strong, enabling consumer income and spending growth; monthly job growth (nonfarm payrolls) has also remained solid, increasing by 263,000 in November; weekly new unemployment claims (a leading indicator for the labor market) remain low, though they are ticking higher.

Households also still have huge "excess savings" stemming from the pandemic—about $1.5 trillion (down from $2.3 trillion) that can support additional spending even as the Fed tightens. Business balance sheets are also generally in good shape, with many firms having refinanced their debt at low rates prior to this year's sharp rise. More broadly, there don't appear to be any major systemic economic/financial icebergs lurking under the surface, unlike in e.g. 2007-08 with the housing/mortgage derivatives market.

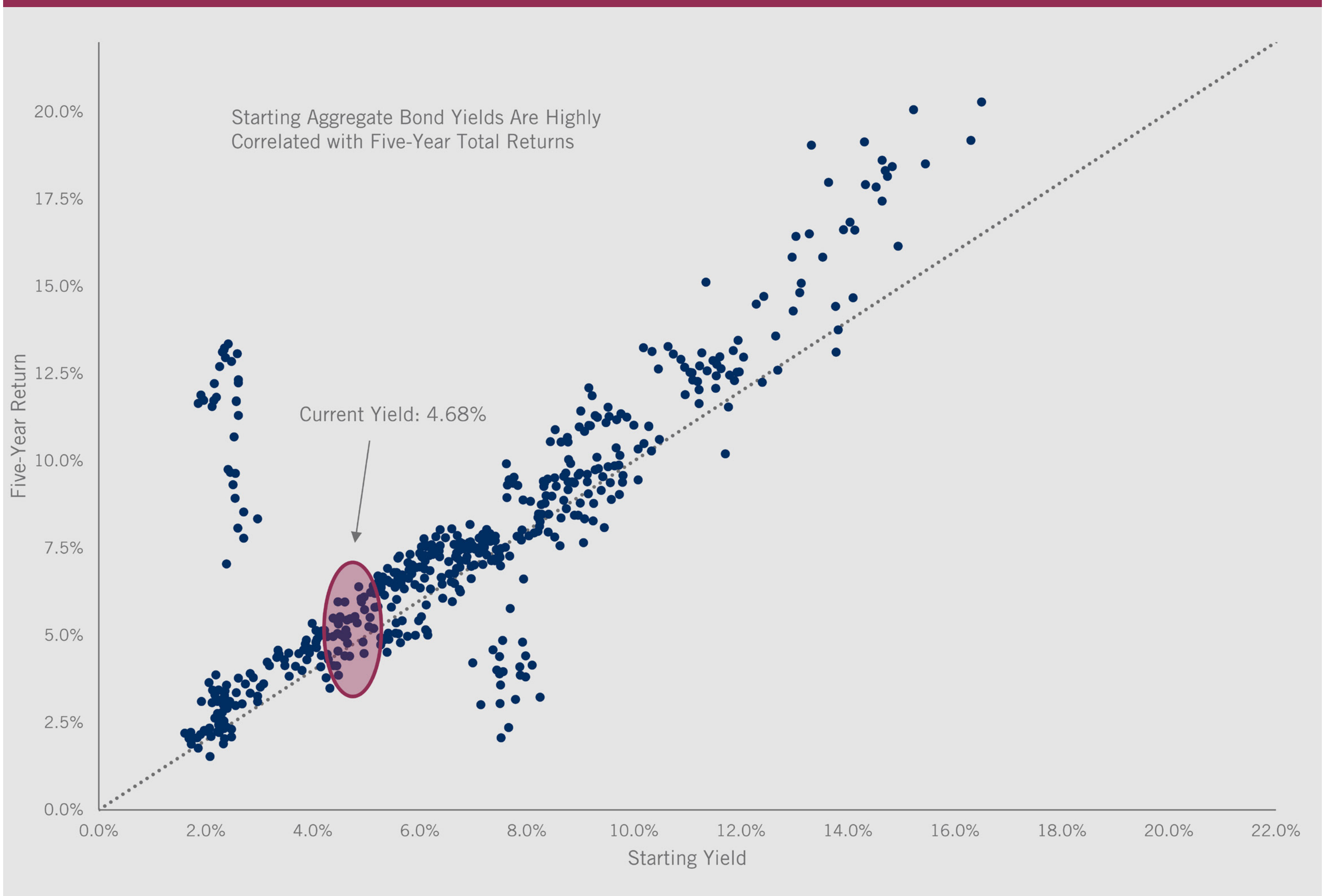
To the above list of macro positives, we'd add a significant new development in the fourth quarter: the unexpected and sudden abandonment of China's highly restrictive zero-COVID policy. Zero-COVID has been the key driver of China's economic slump the past two years. But now the most repressive measures—mandatory testing, quarantines, community lockdowns, and travel restrictions—are being revoked. The reopening of China's economy for domestic consumers should be a catalyst for a growth rebound in 2023.

The bottom line is that a U.S. recession in the next 12-18 months is not a certainty. But based on the evidence, it does appear likely and we are focused on managing that risk. On the positive side, it should be milder than the 2007-08 and 2000-01 recessions.

We reiterate that we take a long-term approach to managing our portfolios and do not believe in trying to time the market. However, at present we believe the current price of U.S. stocks (S&P 500 index) does not adequately discount the likelihood and severity of an economic and corporate earnings recession and are therefore not yet comfortable increasing exposure to stocks.

Turning to our outlook for fixed income, given the sharp rise in yields and steep sell-off over the past year, this asset class appears increasingly attractive. Historically speaking, the starting yield in core bonds (the Agg) is a good approximation of subsequent returns (see chart below). At year-end, the Agg was yielding 4.7%. Moreover, we expect core bonds to provide stability if a recession plays out, providing valuable downside protection while riskier assets such as stocks get hit. Beyond core bonds, there are other segments of the bond markets, including high-yield and floating-rate loans, that offer attractive risk/return potential which we access via our selected active managers.

Bloomberg U.S. Aggregate Bond Index: Starting Yields and Subsequent Five-Year Returns



Closing Thoughts

As 2022 has reminded investors, we should “expect the unexpected, and expect to be surprised.” This is expressed in our portfolio construction and investment management via balanced risk exposures, diversification, and forward-looking analysis that considers a wide range of potential scenarios and outcomes.

We believe 2023 will likely present us with some excellent long-term investment opportunities. Unfortunately, we also believe the probability of a recession is increasing, which could create additional stock market volatility.

While challenging, it is critical for long-term investors to stay the course through these rough periods. The shorter-term discomfort is the price one pays to earn the long-term “equity risk premium”—the additional return from owning riskier assets, such as stocks, that most investors need to build long-term wealth and achieve their financial objectives.

Outside of the U.S. stock market, we are starting to see attractive valuations from international and emerging markets stocks. (With a recession they will likely get more attractive.) A declining dollar, as we expect in the medium term, would further fuel non-U.S. equity returns.

Fixed-income assets and high-quality bonds are also now reasonably priced with the sharp rise in interest rates. Core bonds will also provide valuable portfolio ballast in the event of a 2023 recession.

As always, thank you for your continued confidence and trust.

Best regards,

Retirement Plan Advisors

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Market Indicators
Fourth Quarter 2022

RPA
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S&P Sectors

	QTR	YTD	1Y	5Y
S&P Technology Select Sector TR USD	5.14	-27.64	-27.64	15.75
S&P Financial Select Sector TR USD	13.61	-10.53	-10.53	6.42
S&P Consumer Disc Select Sector TR USD	-9.09	-36.23	-36.23	6.76
S&P Health Care Select Sector TR USD	12.80	-1.95	-1.95	12.53
S&P Industrial Select Sector TR USD	19.22	-5.48	-5.48	7.43
S&P Cons Staples Select Sector TR USD	12.63	-0.70	-0.70	8.59
S&P Energy Select Sector TR USD	22.86	64.56	64.56	9.26
S&P Utilities Select Sector TR USD	8.64	1.57	1.57	9.59
S&P Real Estate Select Sector TR USD	3.82	-26.13	-26.13	5.93
S&P Materials Select Sector TR USD	15.05	-12.27	-12.27	7.38
S&P Telecom Select Industry TR USD	6.24	-19.04	-19.04	4.94

Market Returns

	QTR	YTD	1Y	5Y	10Y
S&P 500	7.56	-18.11	-18.11	9.43	12.56
Russell Mid Cap	9.18	-17.32	-17.32	7.10	10.96
Russell 2000	6.23	-20.44	-20.44	4.13	9.01
MSCI EAFE	17.34	-14.45	-14.45	1.54	4.67
MSCI Emerging Markets	9.70	-20.09	-20.09	-1.40	1.44
BBgBarc U.S. Agg Bond	1.87	-13.01	-13.01	0.02	1.06
High Yield	4.17	-11.19	-11.19	2.31	4.03

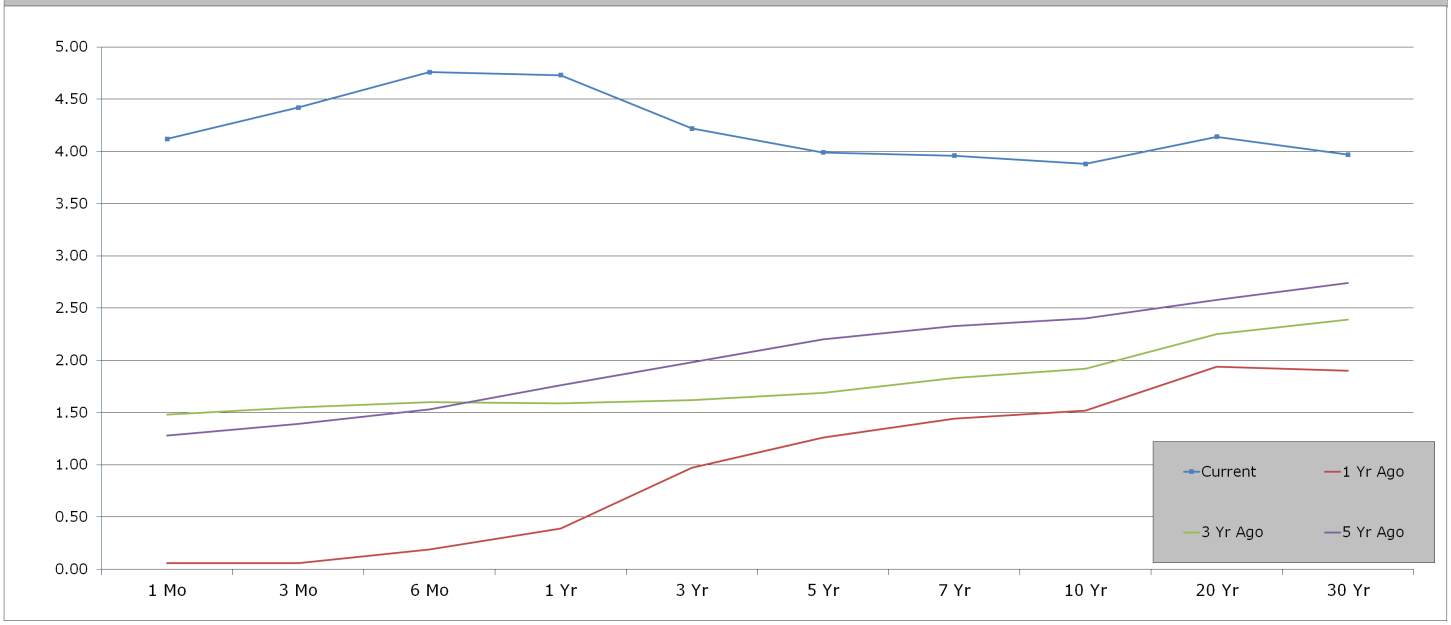
Value / Growth Returns

	YTD			Previous Calendar Year		
	Large	Mid	Small	Large	Mid	Small
Value	-5.22	-6.93	-12.73	-5.22	-6.93	-12.73
Growth	-29.41	-18.96	-21.08	-29.41	-18.96	-21.08

Index Characteristics

	LTM P/E	NTM P/E	Div Yld	Earn Yld
S&P 500	19.03	17.87	1.65	5.60%
Russell Mid Cap	16.08	15.89	1.59	6.29%
Russell 2000	10.80	12.56	1.48	7.96%
MSCI EAFE	12.65	12.24	2.68	8.17%
MSCI Emerging Markets	-	11.72	2.49	8.53%

Long-Term Outlook on Treasury Yield Curve



Source: Morningstar

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