2022 YEAR END COMMENTARY

4th Quarter Market Recap

While the year 2022 ended much like it started with some stock market weakness in December, the fourth quarter in its entirety provided a bit of relief to investors with the S&P 500 finishing up north of 7% for the quarter. Let's begin with a review the performance of some of the key barometers of the financial markets for 2022.

	QTR	YTD	1 Year	3 Year	5 Year
Equities					
US Large Cap	7.56%	-18.11%	-18.11%	7.66%	9.41%
US Mid Cap	10.78%	-13.06%	-13.06%	7.23%	6.70%
US Small Cap	9.19%	-16.10%	-16.10%	5.80%	5.87%
International Developed	17.34%	-14.45%	-14.45%	0.87%	1.54%
International Emerging	9.70%	-20.09%	-20.09%	-2.69%	-1.39%
Bonds					
US Aggregate	1.87%	-13.01%	-13.01%	-2.71%	0.02%
Short Term Bond	1.20%	-5.49%	-5.49%	-0.67%	0.85%
Treasuries	0.72%	-12.46%	-12.46%	-2.62%	-0.10%
High Yield	4.17%	-11.19%	-11.19%	0.05%	2.31%
Specialty					
Real Estate (REITs)	4.22%	-25.01%	-25.01%	0.27%	4.47%
Gold	8.49%	0.44%	0.44%	6.19%	7.03%
Bitcoin	-14.67%	-63.83%	-63.83%	32.40%	3.01%

In 2022, the financial markets performance and news flow were dominated by the following headlines: 1) Inflation surging to multi-year high; 2) The policy response by the Federal Reserve to combat inflation; and 3) The rapid increase in interest rates and corresponding impact on bond prices and balanced portfolios.

Throughout 2022, we have discussed inflation and the policy response to it. But now, it is time to turn our attention to the next chapter and identify both the opportunities and challenges ahead in 2023. Below is a summary of our thoughts as we embark on the new year.

- We expect 2023 to be a year of transition, with gradual fading of inflation pressures, allowing policymakers and market participants to take a more balanced approach to assess the impacts on economic growth, the labor market, and corporate earnings.
- The timing of that transition, however, remains unclear and is likely to be defined by the amount of damage done to the economy by this tightening cycle.
- Behind the scenes, US and global money supply is falling at unprecedented rates as liquidity is being drained from the financial system.
- The combined and cumulative effect of rate hikes and reduced financial system liquidity should be sufficient to bring inflation down and quell economic growth, but there remains uncertainty with how fast inflation will subside and how much the economy will slow.

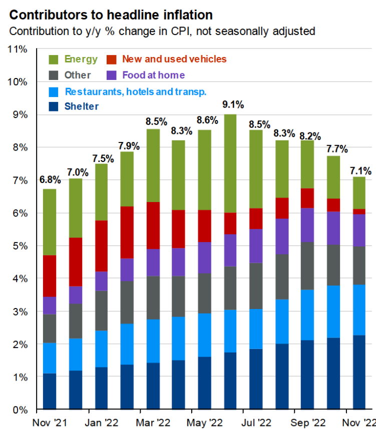
- The FED Chair reiterated the focus on taming inflation with no change to the target fed funds rate of 5% by early 2023.
- Balanced, diversified portfolios experienced a tough year as the bond market suffered one of its worst years in 50 years and did not provide the usual offset or counterbalance to stocks.
- Non-US equities modestly outperformed US stocks in 2022. After several years of significant underperformance versus US stocks, both non-US developed and emerging markets represent good relative value and may be poised to outperform in the years ahead.

Transition from Focus on the FED to the Economy

With the bulk of the work of the FED behind us and only a couple of rate hikes ahead, the financial markets will now transition to assessing the impact or results of higher rates on inflation, the economy, unemployment, and corporate earnings. While the inflation rate has been coming down from its peak, the "job" of fighting inflation is not complete, and current indications are that the FED will stay the course to ensure that the rate of inflation continues to fall.

While the cumulative impact of rate hikes and tighter monetary policy (which is draining liquidity form the financial system) should be sufficient to bring inflation down, it remains unclear how much and how fast inflation will decline and is likely to be defined by how much the economy slows. The labor market remains tight, creating wage pressures, but it is always the most lagging of indicators. Layoffs from large major corporations are happening as we speak and should accelerate over the coming months.

Inflation has rolled over, but continued declines will be dependent upon those areas that remain the most sticky, like Food and Shelter.



Source: Bureau of Labor Statistics, FactSet, Federal Reserve Bank of Philadelphia, University of Michigan, J.P. Morgan Asset Management. Contributions mirror the BLS methodology on Table 7 of the CPI report. Values may not sum to headline CPI figures due to rounding and underlying calculations. "Shelter" includes owner's equivalent rent and rent of primary residence. "Other" primarily reflects household furnishings, apparel, education and communication services, medical care services and other personal services. *Reflects the latest daily 5yr/5yr breakevens, preliminary or final Consumer Sentiment survey, and the quarterly Survey of Professional Forecasters interpolated to a monthly series. The Survey of Professional Forecasters reflects the median estimate by professional forecasters of average CPI inflation over the next 5 years. The series has been adjusted by J.P. Morgan Asset Management to exclude realized inflation readings within the forecast window.
Guide to the Markets – U.S. Data are as of December 31, 2022.

Housing inflation significantly lags the developments in real-time house prices, such that it can take roughly 12-15 months for price reductions to pass through to inflation. Since housing prices appear to have peaked in Aprile 2022, it may not be until mid-year that housing-related inflation falls materially.

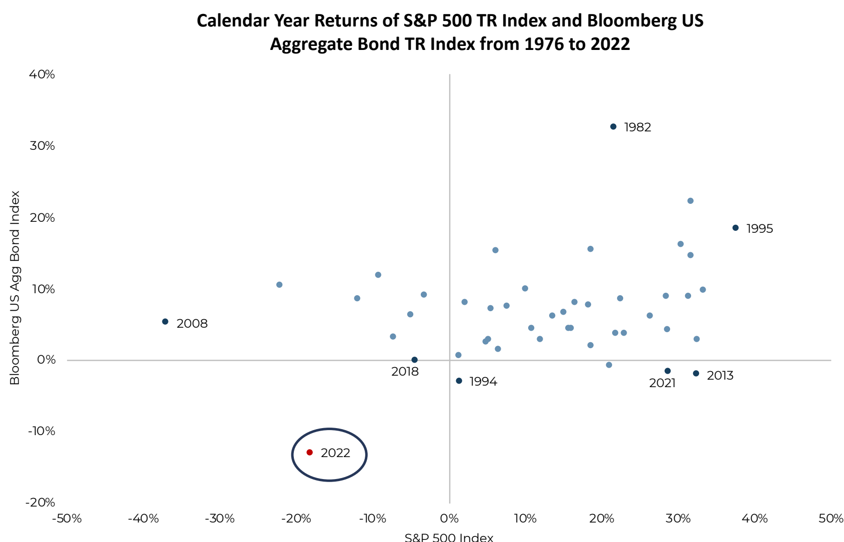
The primary driver of non-housing services inflation is the labor market. Tight labor markets mean rising wages, which are being passed to consumers, pushing services inflation higher. While the FED is likely to stop raising rates in early 2023, they are also likely to leave them at restrictive levels until the labor market weakens meaningfully, which we expect to become more evident as the year progresses.

The Death of the Balanced Portfolio Has Been Greatly Exaggerated

Following one of the worst years for bonds in the last 50 years, some investors are calling into question the benefits of a diversified, balanced portfolio with bonds. Investors own bonds to generate income and to provide complementary ballast to a portfolio of equities. Since bonds historically tend to perform well when stocks do poorly, bonds have typically provided support to balanced portfolios during those difficult years.

Given the fact that bond performance and the high correlation of bonds to equities in 2022 was an anomaly based on historical data, we believe that the death of the balanced portfolio has been greatly exaggerated. To the contrary, this year may have created a very good opportunity for fixed-income investors and that, on a go forward basis, bonds will play their usual role in the balanced portfolio.

Clearly, 2022 was an outlier for bonds. In all prior years of negative performance for stocks, bond returns were positive.

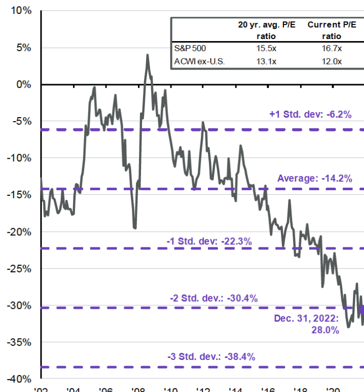


Source: Bison Wealth LLC, Bloomberg.

Non-US Equities Looking More Attractive

Following an extended period of outperformance by US Equities over the last 10 – 12 years, non-US equities appear attractively valued relative to US stocks. This could offer balanced and diversified portfolios a boost to performance in the years ahead. 2022 could have possibly been a turning point with non-US stocks modestly ahead in the past year.

International stock valuations appear attractive compared to US stocks, looking at a lower relative price-to-earnings ratio and higher relative dividend yields.



Source: FactSet, MSCI, Standard & Poor's, J.P. Morgan Asset Management. *Guide to the Markets – U.S.* Data are as of December 31, 2022.

The Bottom-Line

Inflation remains elevated and is likely to come down gradually in the first part of 2023, now that supply chain disruptions have eased, energy prices (both oil and natural gas) have fallen, and housing prices may be set to pull back. The labor market will be the last to roll over but the Fed's aggressive tightening of monetary policy should have its desired effect of slowing economic growth and dampening labor demand, which should result in a moderation of wage growth.

We expect additional rate hikes in the near term to be followed by a sustained period of stable monetary policy. Rate cuts are possible in late 2023, but we are not nearly so confident in that outcome as financial markets appear to be. Meanwhile, sticky inflation remains the predominant risk. If inflation doesn't fall, the Fed will have little choice but to keep tightening even at the risk of causing a more negative economic outcome. While we don't foresee the variables in place for a spiraling downturn, financial-sector instability or bursting asset bubbles remain a possibility as growth slows.

The growth outlook for the US and global economy is gloomy, to be sure, but in contrast with 2022, we expect the FED and global monetary policymakers to acknowledge the economic slowdown as the year progresses, resulting in a more stable monetary policy. This should reduce interest-rate volatility and asset price volatility as we head toward the 2nd half of 2023. While it is likely that the ride will remain bumpy at least for the first few months of the year, the overall outlook for markets has improved in the last few months, a trend that should hold for the back half of 2023.

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Index definitions: “U.S. Large Cap” represented by the S&P 500 Index. “U.S. Small Cap” represented by the S&P 600 Index. “International” represented by the MSCI Europe, Australasia, Far East (EAFE) Net Return Index. “Emerging” represented by the MSCI Emerging Markets Net Return Index. “U.S. Aggregate” represented by the Bloomberg U.S. Aggregate Bond Index. “Treasuries” represented by the Bloomberg U.S. Treasury Bond Index. “Short Term Bond” represented by the Bloomberg 1-5 year gov/credit Index. “U.S. High Yield” represented by the Bloomberg U.S. Corporate High Yield Index. “Real Estate” represented by the Dow Jones REIT Index. “Gold” represented by the LBMA Gold Price Index. “Bitcoin” represented by the Bitcoin Galaxy Index