Email Body 1/31/2023

**The Outlook For 2023**

Well, I hope the first month of 2023 has been a positive experience for you and that your New Years resolutions are still intact. The stock market continued its recovery from October lows well into January with the S&P 500 rising 5.29% month-to-date. There is an old saying in the investment community that “as January goes, so goes the rest of the year.” Empirical data generally supports that thought, but there have been exceptions, so no guarantees.

Everyone is putting out their annual economic and market outlooks for 2023. Commonwealth’s 2023 outlook is thirteen pages long. Most are “cautiously optimistic” about the economy ranging from predictions of mild recession to no recession. Also, most forecasters expect an “improved outlook” for the financial markets, but no one is predicting how strong that might be given that the Federal Reserve is expected to continue raising interest rates to fight inflation. So, I thought I would add my two cents.

Let’s get some historical context about the stock market. After very strong performances in 2020 and 2021, everyone expected a more “normal” year for U.S. equities in 2022. However, what we got was extreme with U.S. stocks down over 20% and bonds down over 15%. Historically, the *average* return in years following down years reflects the stock markets long-term average. However, the variation in returns is about 67% higher than the average year. In other words, years following down years tend to do very well or very bad, but rarely average. Fundamental conditions tend to explain these return tendencies. When a down year occurred due to an economic downturn or a mild interest rate hike cycle, the equity markets tend to come back quickly with strength. However, successive down years tend to result from extreme market valuations (i.e., the 1920’s, 1960’s and the 2000 tech bubble) or structurally high inflation (i.e., the 1970’s).

So, where are we at in 2023 and what are the chances the stock market has a double dip. After the past year’s performance stock market valuation levels are currently at or below long-term averages. Accordingly, I do not think this is an issue going forward. Unfortunately, high inflation is an issue and raises the risk we may experience a down year in 2023. The key factor is will inflation continue dropping enough to cause the Federal Reserve to pause or stop raising intertest rates. If so, then the equity markets will likely have a good year. If inflation levels remain high and the Federal Reserve continues raising interest rates higher than expected, we may experience another down year.

The good news is that the Federal Reserve Bank’s primary indicator of inflation, the personal consumption expenditures index (e.g., PCE), has begun trending down. Also, industrial production has peaked, the jobs market is beginning to slow, nonresidential investment is slowing, residential investment has dropped and for the first time in a few years, real disposable income in the aggregate dropped in 2022. All of this points to a general slowdown in the economy which could lead to inflation continuing to drop and a moderation of Federal Reserve Bank rate hikes.

The markets reflect an expectation that the Federal Reserve bank will raise interest rates another 0.50%- 0.75% so do not be alarmed by announcements of rate hikes in the next two to three months. If the Federal Reserve feels it must go beyond that, then all bets are off. Going forward all eyes are on inflation and the Federal Reserve Bank interest rate actions.

I continue to recommend for long-term oriented investments, that you maintain your current allocation strategies if your risk profiles and time horizons remain long-term (i.e., 4-5 years or more).

Make sure that funds you know you will need in the short-term are safe to relatively safe from volatility and that your long-term oriented investments are well diversified and subject to risk and volatility levels you are able to be comfortable with. If you have any questions or concerns about these things, please call me to discuss them further.

I have attached the executive summary of Commonwealth’s 2023 economic and market outlook by Brad McMillan, Commonwealth’s Chief Financial Officer. I encourage you to view it to get another perspective. If you want the whole thirteen pages, email me and I will send it to you.

I am always available to you via phone, zoom conference or in person. I look forward to talking with you over the next few weeks. If you have any questions or if we can be of any help, please do not hesitate to contact Linda or me.

*Certain sections of this commentary contain forward-looking statements that are based on our reasonable expectations, estimates, projections, and assumptions. Forward-looking statements are not guarantees of future performance and involve certain risks and uncertainties, which are difficult to predict. Past performance is not indicative of future results.*

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