Email Body 12/19/2022

**What Is Happening and Where Are We At? – Final Report 2022**

It has been a disappointing year for the financial markets, however, there are many reasons to be happy and confident about what the future will bring. We all will celebrate Christmas in our own unique ways and hopefully, enjoy time with family and friends as we close out this year. Merry Christmas and Happy New Year from myself and Linda here at Financial Life Concepts.

Unfortunately, unless something changes in the next two weeks, it looks like the stock and bond markets will close the year with double-digit losses in the mid to upper teens. This is primarily the result of the Federal Reserve hiking short-term interest rates from near zero to about 4.50%. Increasing short-term interest rates is one of two tools the Federal Reserve has to fight inflation. The objective is to reduce overall demand and business activity by increasing the cost of financing business operations and end-user purchases. The other tool is open market purchases/sales of bonds in the bond market. The Federal Reserve continues to reduce its portfolio of bonds through normal maturation or sales at the rate of $95 billion a month. The impact of this action is to remove liquidity from the bond market and raise long-term interest rates.

So where are we now? The Federal Reserve Board of Governors met last week and raised the Federal Funds target rate by 0.50% to between 4.25% and 4.5%. Federal Reserve Chairman Powel further iterated that he was prepared to keep raising interest rates to push inflation back to 2.00% or less for as long as it takes. Given recent declines for the past two months in both the consumer price index (CPI) and core inflation (i.e., CPI without food and energy), most economists and analysts expected a less hawkish stance.

At this point, most economists and analysts that I watch believe the Federal Reserve is near a tipping point. Expectations are that we will likely see a total increase of between 0.50%-0.75% in the Federal Funds target rate over the next two to three Board of Governors meetings in the first six months of 2023. Assuming inflation measures continue to move in the right direction, the Federal Reserve may pause raising interest rates for a period of time. The financial markets would likely view this positively and react accordingly. However, if inflation does not continue to decline, more rate hikes would likely be the course of action. It all depends on what is happening with the overall economy.

Currently, the housing market is being crushed by higher interest rates and soaring building costs. The manufacturing sector is already in contraction, and we are beginning to see layoffs in certain sectors of the economy. The services sector, however, continues to reflect increased demand and higher spending resulting in capacity constraints and higher wages. Unemployment is still below 4.00% as of November which from the Federal Reserves view, means higher wages and upward pressure on inflation. Ultimately, the Federal Reserve would like to see the unemployment rate increase to between 5.00% and 6.00% to attach an anchor to inflation.

Going forward I believe a mild recession is more likely than not. The good news is that the stock market appears to have already priced that in, if not for a more significant economic downturn which I believe is unlikely. Corporate earnings are still strong, debt levels are low, and valuations are now below long-term averages. For me, this means downside risks are lessened and upside potential is higher than it was six months ago. Volatility will still be significant as the markets react to economic news and Federal Reserve interest rate decisions. Hopefully, inflation will continue to moderate, and the Federal Reserve will pause raising interest rates and give the markets a breather.

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 a commentary by Brad McMillan prepared on December 16th. In it he discusses his view of market performance and his economic outlook. I encourage you to read it to get another perspective.

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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