Key Takeaways

Financial markets ended with a thud for U.S. stocks to close out the year with an 18.1% loss, its largest annual decline since 2008.

What was unique about 2022 is the stock market declines were accentuated by large declines in bonds. 2022 was the worst performance experienced in a balanced 60%/40% stock/bond portfolio since 2008.

The silver lining for investors is uniquely discounted global valuations in both stocks and bonds, which sets the table for potentially compelling investment returns over the next 5 to 10 years.

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.

The Fed continues its hawkish stance, signaling possible rate hikes of another 75 bps 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.

Key leading economic indicators deteriorated further in the fourth quarter. The Leading Economic Indicator has a long track record of "calling" recessions and has fallen for nine consecutive months. This has never happened without an ensuing recession.

There are some positives supporting the economy that should mitigate the severity of a U.S. recession. The labor market remains strong, monthly job growth (nonfarm payrolls) has also remained solid, weekly new unemployment claims remain low.

China has abandoned its highly restrictive zero-COVID policy. Zero-COVID has been the key driver of China's economic slump the past two years. The reopening of China's economy for domestic consumers should be a catalyst for a growth rebound in 2023.

Between U.S. stocks, developed international stocks and EM stocks, I tactically favor EM stocks right now based on their relatively attractive valuations and growth prospects, particularly in-light of China's re-opening.

Bonds haven't been this attractively priced in over a decade. My 5-year expected return for core bonds is now in a range of 5% to 5.6%.

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 stocks (MSCI EM Index) were up 9.7 % for the quarter. 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).

Alternative strategies and nontraditional asset classes generally outperformed traditional stock and bond indexes. The standout was trend-following managed futures strategies, which gained roughly 27% (SG Trend Index) for the year. Flexible/nontraditional bond funds (Morningstar Nontraditional Bond category) declined 6.3%, roughly half as much as core bonds.

In short, what was unique about 2022 was that stock market losses were accentuated by bond market losses. A 60% stocks/40% bonds portfolio had its worst performance in 2022 since the 2008 financial crises and core bond returns were the worst they've been going back 95 years.

The silver lining for investors, though, is uniquely discounted global valuations in both stocks and bonds. It seems clear to me that the table has been set, for patient investors willing to stay the course, to earn compelling investment returns over the next 5 to 10 years.

Portfolio Performance and Key Performance Drivers

For 2022, Broadwing model portfolios had mixed performance relative to their benchmarks, with relative performance strongest in the Dividend Payers and more defensive BCA Flexible portfolios and weakest in the more equity-oriented BCA Flexible models due to greater higher exposure to US growth and emerging markets stocks, both of which struggled in 2022, whereas the Dividend Payers and defensive BCA Flexible models had very little exposure to these asset classes.

Positive contributors to performance included a large position in the Schwab U.S. Dividend Equity ETF (SCHD) and the JP Morgan Hedged Equity fund (JHQAX), which declined much less than other segments of the US stock market in 2022. My tactical allocation to gold, through the iShares Gold Trust (IAU), performed relatively well, losing just

0.67% for the year and providing the hedge I hoped for when I added it to all BCA Flexible models (except BCA Flexible 100/0).

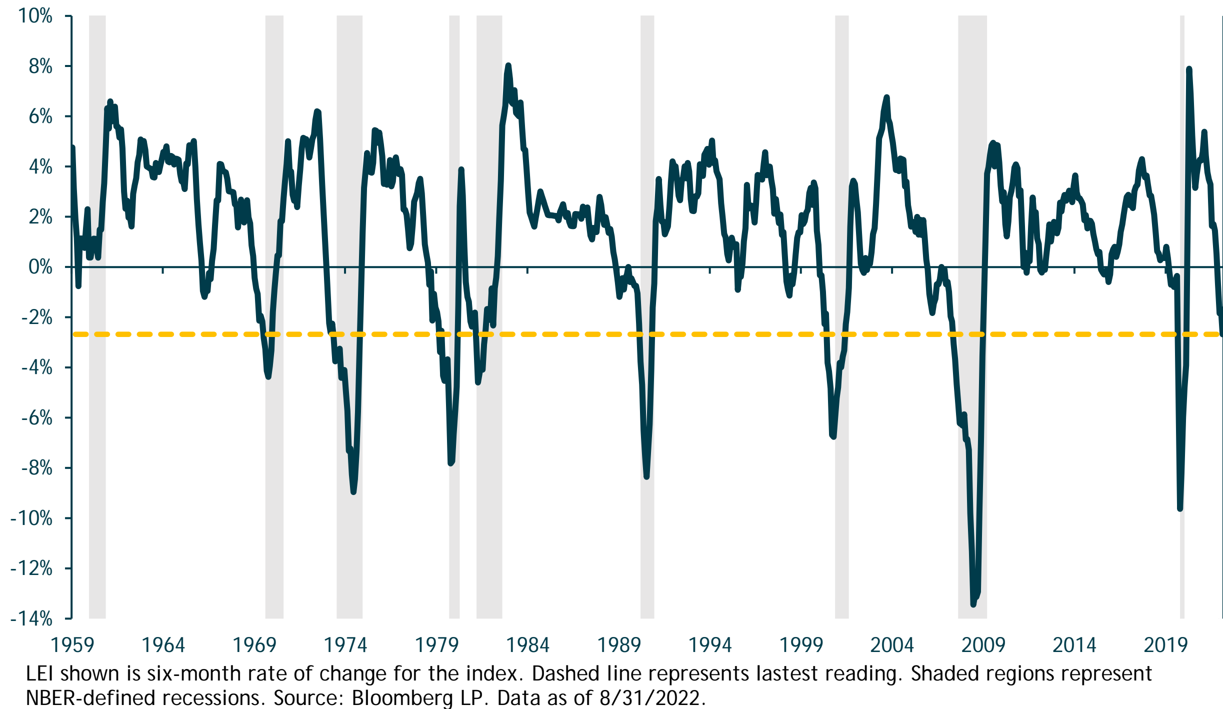
As for detractors from performance, a tactical position in treasury inflation-protected securities (TIPS) through the Schwab U.S. TIPS ETF (SCHP) oddly disappointed, losing 11.96% in a year when one would expect a fund that benefits from rising inflation to thrive. Not what I would have predicted. What seems to have occurred is the negative impact of rising interest rates on TIP bond prices more than offset the positive impact of inflation adjustments to the bond principal, leaving the fund firmly in the negative. But the biggest detractor was…(drum role here)..once again my allocation to the emerging markets through the PGIM Jennison Emerging Markets Equity Opportunity fund (PDEZX). While investments in emerging markets stocks generally struggled in 2022, the PGIM fund was a particular standout, losing a whopping 41.65% versus 20.2% for the benchmark, due primarily to significant exposure to Chinese stocks.

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 75bps 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.



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

While I 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, e.g., unlike in 2007-08 with the housing/mortgage derivatives market.

To the above list of macro positives, I’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 next year is not a certainty. But based on the evidence, I think it is highly likely. On the positive side, it should be milder than the 2007-08 and 2000-01 recessions.

At present and in the *short-term*, I believe the current price of U.S. Stocks (S&P 500 index) may not be adequately discounting the likelihood and severity of an economic and corporate earnings recession. This was my view one quarter ago, and since that time the S&P 500 has climbed a few percent while the economic data has worsened.

Analysis of past data on recessions, earnings declines and stock valuations suggests a real possibility of additional double-digit declines *in the short-term* for S&P 500 from current levels.

Foreign stock markets and earnings are also at-risk from a U.S. and global recession next year. However, unlike the S&P 500, my five-year base case expected return estimates for developed international and EM stocks are more attractive in absolute terms, ranging from the mid-single digits to the low-double digits, with EM the highest. (See the table below.) These returns are even more attractive relative to U.S. stocks and core bonds.

Between the three regions, I tactically favor EM stocks right now based on their higher expected returns, which are a function of what I expect will be faster sales growth and improving profit margins over the next several years. This comes after more than 10 years of stagnant EM earnings growth. Monetary policy is also likely to start loosening next year across many EMs as inflation comes down, which should be another support for EM equity markets.

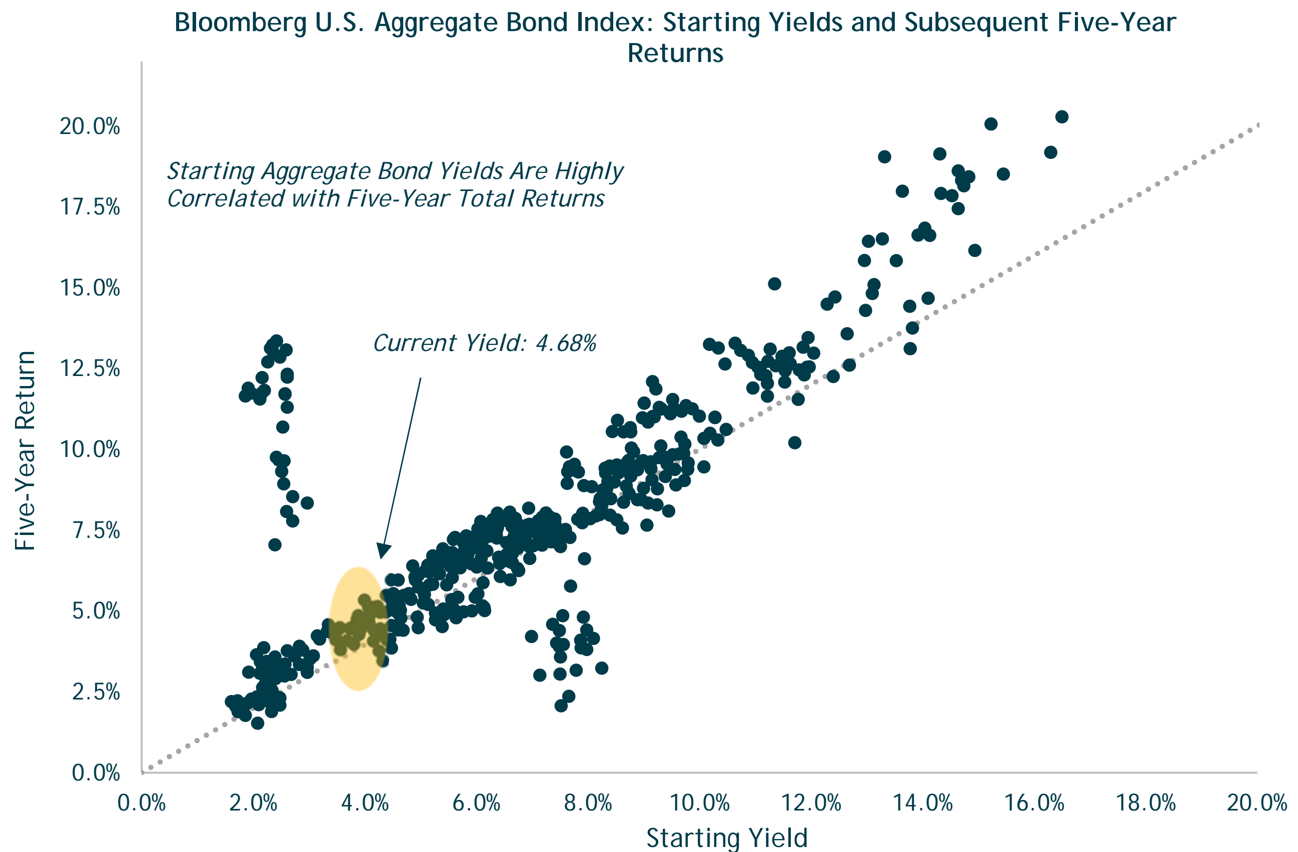
Five-Year Expected Returns for Equity

	Current Level	Downside/Bear	Base Case Lower	Base Case Upper	Upside/Bull
US Stocks	3,840 USD	-4.4%	3.1%	9.3%	14.1%
Europe Stocks	1,723 LCL	-3.2%	5.1%	12.4%	19.5%
Emerging-Markets Stocks	57,479 LCL	-1.3%	7.2%	14.0%	21.4%

US Stocks: S&P 500 Index, Europe Stocks: MSCI Europe Index, Emerging-Markets Stocks: MSCI EM. Europe and EM stocks return estimates in local currency—the US dollar will impact returns for dollar-based investors. Return estimates as of 12/31/2022.

This table shows my five-year, annualized asset class return estimates across several broad macroeconomic scenarios I believe are possible. Collectively, the scenarios encompass the range of outcomes I believe are reasonably possible and therefore worth considering in determining portfolio allocations. I make assumptions for various fundamental and valuation metrics I believe are consistent for each asset class within each macro scenario then incorporate current prices to generate an estimated return. The macroeconomic scenarios and estimated returns can change. When this happens, I will clearly note it and give guidance on new estimates. ***See "Estimated Returns Disclosure" at the end of this commentary for more information on macro scenarios and fundamental/valuation metrics used in the analysis.***

Turning to my outlook for fixed income, given the sharp rise in yields, bonds haven't been this attractive in over a decade. When estimating returns for core bonds (the Agg) over longer periods of time, the starting yield is a good approximation of subsequent returns (see chart below). At year-end, the Agg was yielding 4.7% and my 5-year expected return for core bonds is now in a range of 5% to 5.6%. Moreover, I expect core bonds to deliver a positive return if a recession plays out, providing valuable downside protection while riskier assets such as stocks get hit.



Data as of 12/31/2022. Source: Bloomberg LP.

Finally, I maintain core positions in trend-following managed futures and option-trading funds. Managed futures returns have been strongly positive in 2022 as traditional bond and stock funds have plunged. These alternative funds have different return and risk drivers, and I believe will continue to provide tactical and longer-term strategic benefits to balanced portfolios. Performance for these funds is much less dependent than traditional investments (long-only stocks and bonds) on which type of macroeconomic environment (e.g., deflation, stagflation, inflation, or growth) unfolds over the coming years. In this sense, they offer a different kind of diversification, one not dependent on what the economy does.

Closing Thoughts

As 2022 has reminded investors, we should “expect the unexpected, and expect to be surprised.”

I believe 2023 will likely present investors with some excellent *long-term* investment opportunities. Unfortunately, I also expect a recession and the potential for stock market volatility and further stock market losses *in the short-term*.

While challenging, it is critical for long-term investors to stay the course through these rough periods. The shorter-term discomfort is the price investors pay 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, I already see attractive medium-term expected returns from international and emerging markets stocks. (With a recession they will likely get more attractive.) A declining dollar, which I expect to unfold 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 mid-single digit or better expected returns. Core bonds will also provide valuable portfolio ballast in the event of a 2023 recession. My investments in alternative strategies and trend-following managed futures provide further resilience to Broadwing's portfolios no matter how the next year (and years) plays out.

I'd like to finish by wishing you all a happy and prosperous 2023. As always, I thank you for your trust and welcome any questions you may have.

Best,
Kelly D. Kane, ChFC, CFP

Estimated Returns Disclosure

Scenario Definitions:

Downside*: The economy falls into a deep recession for any of various reasons, such as deleveraging/deflation, unexpected systemic shock, geopolitical conflict, Fed or fiscal policy error, etc. At the end of my five-year tactical horizon, S&P 500 earnings are below their normalized trend and valuation multiples are below-average reflecting investor risk aversion. Inflation, 10-year Treasury nominal and real yields are below the Fed's long-term targets.*

Base*: Consistent with long-term economic and market history, reflecting economic and earnings growth cycles that are interspersed with recessions around an upward sloping normalized growth trendline. Inflation is moderately higher than the Fed's 2% target level (i.e., around 3%) and 10-year Treasury real yields are slightly positive. For equity markets, I bookend my Base Case with Lower-end and Upper-end estimates:*

- *In my Base Lower scenario, I assume nominal economic growth is higher than the average due to moderately higher inflation. I assume some additional profit margin compression and moderately lower valuations compared to the Base Upper scenario.*
- *In my Base Upper scenario, I assume nominal economic growth is higher than average due to both moderately higher inflation and strong real growth. As such, I assume S&P 500 profit margins remain elevated (although below their all-time highs) and valuation multiples are also elevated versus historical averages.*

Upside: This is the "Goldilocks" scenario for stocks. S&P 500 earnings end the period well above their Base Case trendline, driven by both higher sales growth and high profit margins. Valuation multiples are well above average and higher than the Base Upper assumption. Inflation is under control, around or slightly higher than the Fed's 2% long-term target. The fed funds rate is around the Fed's estimate of "neutral," the yield curve is positively sloped, and 10-year Treasury real yields are modestly positive.

What the Table Shows: My five-year, annualized asset class return estimates under several broad economic scenarios. Collectively, the scenarios I use encompass the range of outcomes I believe are reasonably possible and therefore worth considering in creating portfolio allocations.

Why I Use Scenarios: Considering how each asset class might react under a consistent set of scenarios allows me to calibrate my return expectations across asset classes. I believe this helps me make better asset allocation decisions.

These Scenarios Can Change: As the overall economic environment changes it will at some point necessitate changes to the scenarios I consider. Therefore, there could be times when I am reassessing scenarios and temporarily suspend providing updates for one or more scenarios. When this happens, I will clearly note it and give guidance on when I expect to complete this process.

Any projections provided regarding the likelihood of various investment outcomes are hypothetical in nature, do not reflect actual investment results and are not guarantees of future results. Investing involves risk, including the potential loss of principal, and investors should be guided accordingly.