Inflation: A Sleeping Bear Awakens After Decades

2022 Year-End Review:

For the record books, 2022 goes down as the worst year for U.S. stocks since 2008 and the worst year ever recorded for bonds. The sharp spike in inflation along with aggressive rate hikes by the Federal Reserve and Russia's invasion of Ukraine in February hammered stocks and bonds with technology and growth stocks suffering the biggest casualties. The Dow Jones Industrial Average (DJIA) was the best performing U.S. equity index declining only -8.8%. Meanwhile the S&P 500 Index closed down -19.4% and the tech heavy Nasdaq 100 Index fell -33.4%. International equities fared only slightly better with the MSCI EAFE Index declining -16.8% for 2022. Japanese equities fell by only -9.4%, thanks largely to an accommodative rate stance by the Bank of Japan.

Signaling a change in market leadership that will likely continue in 2023 and beyond, value and defensive consumer staples stocks significantly out-performed their growth counterparts as the Russell 1000 Value Index fell -9.6% versus -21.6% for the Russell 1000 Growth Index. Thanks to rising oil prices, energy stocks were the lone standout in 2022 with the S&P 500 Energy sector gaining +59%.

As for fixed income, bonds typically provide a safe haven when stocks slump. Unfortunately bond prices also fell sharply in response to the Fed's aggressive rate hikes in 2022.

For 2022, the Bloomberg Aggregate Bond Index fell -12.8%. The yield on the 10-year Treasury note started the year at roughly 1.52%, peaked at 4.25% on Oct 24th and finally ended the year at 3.88%. On the shorter end of the yield curve, 2-year Treasury yields rose almost lock-step with Fed rate hikes, increasing from roughly 0.50% at the beginning of 2022 to 4.43% at the end of December. As noted in past reports, an inverted yield curve (i.e., short-term rates higher than long-term rates) historically has been an accurate indicator of an impending recession. In December, 30-year mortgages were priced close to 6.50% with the Prime Rate at 7.50%.

High inflation was a global theme and central banks around the world were forced to raise rates in an effort to contain consumer demand and price pressures. At the beginning of 2022, the Federal Reserve's short-term rate target was 0.00%-0.25%. In March, the Fed raised rates for the first time in three years by 0.25% and announced intentions for several more 0.25% rate hikes over the next two years. In May, the Fed accelerated their pace of tightening, raising rates by 0.50% and then by 0.75% each month in June, July, September and October. Finally in December, the Fed increased rates by 0.50% and signaled that future rate hikes would be data dependent.

The European Central Bank (ECB) increased rates three times over the year, finishing with benchmark rate of 2.5%. Meanwhile, the Bank of England raised eight times to 3.5%. The Bank of Japan was the last holdout and finally adjusted to a more hawkish stance by allowing their 10-year Japanese government bond to trade within 0.50% on either side of its 0.00% target from a previous trading band of 0.25%.

The U.S. dollar's standing as a safe haven currency in "risk-off" markets along with aggressive rate hikes by the Fed helped the U.S. dollar surge relative to other international currencies in 2022.

Despite experiencing a mild sell-off at the end of the year, the dollar remains significantly overvalued versus the euro, yen and British pound on a relative basis. We expect a reversion to the mean in 2023 with a weaker U.S. dollar and the likelihood of a pivot in Fed rate policy.

Meanwhile, the U.S. labor market remained surprisingly strong in 2022. Fed officials repeatedly indicated that they need to see loosening in the labor market to be assured their policy actions were working. However jobless claims remain near historic lows and non-farm payrolls keep increasing. In July, the unemployment rate hit a 50 year low of 3.5% and then rose to 3.7% in November. According to job postings, there are currently two jobs available for every unemployed American.

2023 Outlook:

Inflation is rolling over which should bring an end to the Fed's current tightening policy in 2023, however as long as unemployment remains near historic lows, expect the Fed to maintain their focus on keeping rates where they are in hopes of curbing inflation. We expect the Fed to announce another 50bps hike in February with a more measured approach of 25bps hikes at subsequent meetings depending on new data releases.

Meanwhile, with no rate relief from the Fed, recession worries will take center stage as equity markets anticipate a global economic slowdown in 2023. A key question is whether this slowdown ends in a "soft landing" with slower but still positive earnings growth or in a full-fledged recession.

We envision a more benign recession in 2023 similar to the period following the 2000 tech bubble. Any slowdown in the economy should be mitigated by a strong labor force and healthy balance sheets for companies and consumers.

Despite the recent spike in rates, overall debt levels remain well contained as 90% of U.S. mortgages are fixed at rates significantly below today's levels.

The consensus among many economists and strategists is a US recession starting in Q1 2023 with GDP falling 0.4% in 2023 and unemployment rising to 5.5% by early 2024. As of the end of November, forward earnings estimates forecast mid-single digit growth for the U.S. and Japan over the next 12 months and even slower growth in Europe and the emerging markets. Based on historical data, these estimates seem overly optimistic as past recessions resulted in an average peak-to-trough decline in earnings of 20% and a decline of 30% in the S&P 500. Given that markets have never bottomed ahead of a recession and the consensus view of a recession starting in 1Q23, we anticipate a new market bottom in 1st Half 2023.

Overall equity valuations have improved significantly following the sell-off in 2022, however U.S. equities still appear expensive on a relative basis. Signaling a change in market leadership, we believe that value stocks will continue to outperform growth in 2023 and beyond. On a valuation basis, value stocks still appear inexpensive relative to growth and, historically, value stocks outperform in high inflation periods.

U.S. small-cap stocks also could offer out-performance as long as the U.S. economy doesn't experience a sharp recession in 2023. Small-cap earnings generally recover quicker than large-caps in economic recoveries. U.S. small-cap valuations also appear cheap, both in historical terms and relative to large-caps.

Non-U.S. equities also present attractive opportunities. China is moving towards a re-opening and the Russia-Ukraine conflict might be closer to an end than we realize. Especially for U.S. dollar-based investors, a reversal in dollar strength would provide a boost for local currency returns in non-U.S. markets.

Widening corporate spreads linked to recessionary fears could pose a headwind for bonds, however we believe the worst of the interest rate adjustment is behind us.

There are now more attractive yield opportunities today than we have seen in years. We expect commodity prices to remain high over the next few years based on supply/demand imbalances across multiple precious metal and agricultural markets.

Finally, it's worth noting that the global economy is shifting from an extended period of declining interest rates to a new environment of persistent inflationary pressures and higher rates. This shift likely marks the end of cheap money, high valuations and outsized returns for certain asset classes. With this said, certain markets may have overreacted to some of those risks, creating attractive potential opportunities for investors. Equity markets are already clearly bearish which presents the potential for positive surprises if bearish scenarios fail to materialize.

Here's a recap of major market indexes for 2022:

Equity Indexes:	Q4 2022	2022
S&P 500	7.5%	-19.4%
Dow Jones Industrial Average	16.0%	-8.8%
Nasdaq Composite (Principal Return)	-0.8%	-33.0%
Russell 2000	6.2%	-21.5%
MSCI Emerging Markets	9.6%	-16.8%
Bond Indexes:		
Bloomberg Barclays U.S. Aggregate	1.9%	-12.8%
ICE BofA 7-12Yr Municipals	4.5%	-6.8%

Note: Returns are for the periods ended December 31, 2022. The returns include dividends and interest income based on data supplied by third-party provider RIMES and compiled by T. Rowe Price, except for the Nasdaq Composite Index, whose return is principal only.
Sources: Standard & Poor's, LSE Group, Bloomberg Barclays, MSCI, Credit Suisse, Dow Jones, and J.P. Morgan (see Additional Disclosures).

Sources: [1]Thomson Reuters. Past performance is no guarantee of future results. Yields may be lower or higher than quoted above. Yields fluctuate as market conditions change. An index is unmanaged and not available for direct investment. The indices are presented to provide you with an understanding of their historic long-term performance and are not presented to illustrate the performance of any security. Large Cap = S&P 500 Index (The S&P 500 index is weighted by market value, and its performance is thought to be representative of the stock market as a whole.), Mid-cap = Russell Midcap Index (The Russell Midcap Index measures performance of the 800 smallest companies (31% of total capitalization) in the Russell 1000 Index, with weighted average mark et capitalization of approximately $6.7 billion, median capitalization of $3.6 billion, and market capitalization of the largest company $13.7 billion.), Small-cap = Russell 2000 Index (The Russell 2000 Index is a small-cap stock market index of the bottom 2,000 stocks in the Russell 3000 Index.), DM Ex-U.S. = MSCI EAFE Index (The MSCI EAFE Index is a stock market index that is designed to measure the equity market performance of developed markets outside of the U.S. & Canada.), Emerging Markets = MSCI EM Index (The MSCI Emerging Markets Index is an index created by Morgan Stanley Capital International (MSCI) designed to measure equity market performance in global emerging markets.), Bloomberg Barclays U.S. Aggregate Bond Index (The Bloomberg Barclays US Aggregate Bond Index is a market capitalization-weighted index, meaning the securities in the index are weighted according to the market size of each bond type.), ICE U.S. Treasury 20+ Year Bond (The ICE U.S. Treasury 20+ Year Bond Index measures the performance of Treasury securities and is selected by a Market Value process.), Markit iBoxx USD Liquid High-Yield Bond Index (Consists of liquid USD high yield bonds, selected to provide a balanced representation of the broad USD high yield corporate bond universe. The index is used as a basis for tradable products, including ETFs.)

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