INVESTMENT INSIGHTS

Market Outlook

January 2023

Today's Forecast will bring…

With 2022 finally behind us, it is reasonable to ask what 2023 will bring. After all, we crave certainty. This time of year, there is no shortage of market pundits offering their predictions of what is to come. Every major financial publication and every large financial firm is offering their 2023 outlook.

> 14 Major investment firms were all off the mark with their short-term year end 2022 prediction for the S&P 500.

The reality is that these predictions can offer a false sense of certainty. They are based on all the available data at the time they were written. Jonathan Ferro, a Bloomberg TV and radio anchor, demonstrated how hard market predictions really are. He provided the 2022 year end forecast for the S&P 500 from 14 major investment firms including Goldman Sachs, JP Morgan, Barclays and Morgan Stanley. The predictions ranged from a low of 4400 to a high of 5330. The S&P 500 closed at 3839. How could these firms, with their vast resources and data, miss by so much?

They, like everyone else, were unable to forecast war, inflation, rising interest rates, and recessionary fears. If you recall, we wrote about this perfect storm last October. As much as you may want us to tell you what will occur in the markets over the next twelve months, this would not provide any useful strategy. As Ben Carlson recently wrote, "the planning process should include setting realistic expectations, playing the probabilities and making course corrections along the way. Planning should not include making short-term predictions about what's going to happen in the stock market." Perhaps the best place to begin is with what we know, followed by a discussion on strategy, with the obvious understanding that market uncertainty may require course corrections.

> The planning process includes realistic expectations, probabilities of outcomes and making course corrections throughout the process.

2022 was a roller coaster for investors with Russia's invasion of Ukraine challenging global energy supply, central banks raising rates aggressively to combat high inflation, along with fading, yet still widespread effects of a global pandemic impacting consumers, businesses, and supply chains. In summary, 2022 was a volatile year.

> US stock market investors had to weather the largest broad market decline since the Global Financial Crisis in 2007-2009.

U.S. stock market investors saw 2022 deliver the biggest broad market losses since the Global Financial Crisis. The S&P 500 finished the year 20% lower, small caps (represented by the Russell 2000) finished lower by nearly 22%, and the Nasdaq 100 lost nearly 33% of its value. While 2022 was a difficult one for investors, 2023 does not bring any additional clarity.

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What are the Bears saying about stock markets in 2023?

- The Federal Reserve continues to raise short-term interest rates, although the pace of the increases has begun to slow, there is still no clear end point.
- Higher interest rates make stocks less attractive because it pressures corporate earnings and makes other investments with less risk seem as or more attractive.
- The average bear market decline for the S&P 500 is more than 30%. The index is currently only down about 20% from its all-time high.
- The Price/Earnings multiple for the S&P 500 remains relatively high in comparison to history and corporate earnings estimates remain high, if recession is on the horizon.
- The Federal Reserve will overshoot their target and cause a recession.
- Technical Analysis suggests pressure will remain to the downside.

Bear View: Average bear market decline is more than 30%, markets at year-end were down about 20%.

What are the Bulls saying about stock markets in 2023?

- Consecutive years of negative performance is extremely rare. The last time markets recorded back to back years of negative returns was 2000-2002, in the aftermath of the Dotcom crash.
- Inflation will moderate, providing stronger than expected GDP growth, while also allowing the Federal Reserve to loosen policy.
- The Federal Reserve attains the elusive “Soft Landing” and a recession is averted.
- Markets will 'climb a wall of worry' as they often do, despite grim fundamentals.
- Geopolitical tensions will subside, allowing global economies to recover.
- Corporate earnings will be assisted, more than investors think, by interest earned on large cash balances.

Bull View: Back –to- back down years in Stock Markets are rare, last time was 2000-2002.

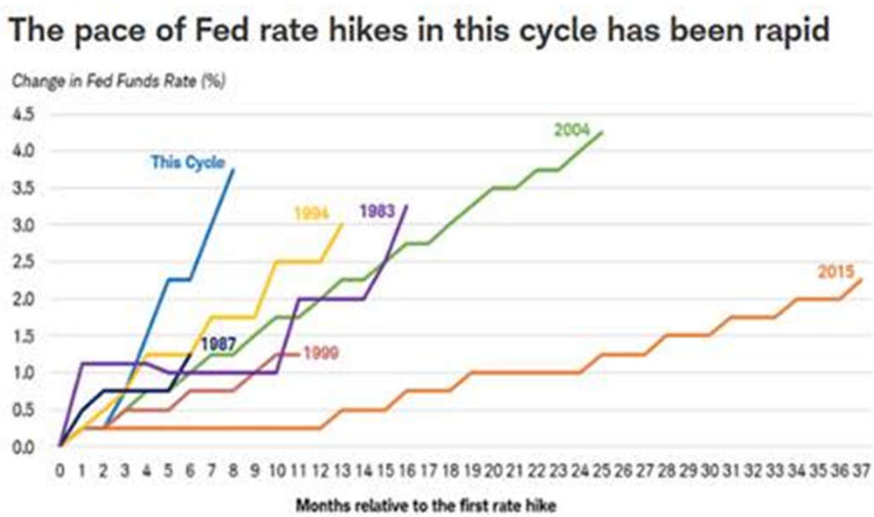
What about fixed income? This market hardly moved over the last decade, but recent events have turned it upside down. Since about 2013, and after the end of the financial crisis, bond yields remained low and inflation was static at about 1.5%, below the Federal Reserve’s 2% target. There was very little that moved the needle until the March 2020 pandemic when all markets fell off the charts for about three weeks. In May 2020, inflation hit a 7-year low of 0.01% but then rocketed over the next two years to 7.9% by March 2022, when the Fed finally made its first rate increase of 25 basis points.

Fixed Income markets were quite steady over the last 10 years, 2022 has turned the market upside down.

Rate increases tighten or slow the market as borrowing money becomes more expensive, but consumer demand remained very strong post pandemic and supply was hindered by laborers not returning to work. The continued shutdown in China kept any goods from being produced and government stimulus kept the population flush with cash without a need to return to their former employment. By the time of this first rate increase, prices had already increased to the point where inflation had a firm grip on economies across the globe, and the Federal Reserve was forced to react with much stronger vengeance than a 25bp rate increase.

Strong post-pandemic demand, limited supply and government stimulus all worked together , increasing inflation quickly.

The Fed's rate increases were quite radical in both size and quantity. A 25 basis point (bp) move is historically considered the norm: in 2022 the Fed pushed through four 75bp increases, two of 50bps and only one (the first) of 25bps. This 425 basis point move caused bond prices to not just drop, but plummet.



Inflation had a firm grip on economies, causing the Federal Reserve to be very aggressive with rate increases.

In fact, 2022 was the worst year for fixed income over the last several decades, but the major difference in fixed income this year was not necessarily that bond prices fell by so much, but rather that they declined along with stocks. In the ideal world, stocks and bonds are negatively correlated, meaning, fixed income offers diversification and portfolio protection as a buffer against falling equity markets. For most of the last two decades, this negative relationship provided a good defense in managing portfolio risk during equity downturns. During 2022, however, the relationship between stocks and bonds has shifted towards a more positive correlation.

In the ideal world, when stocks decline, bonds offer a cushion of protection, this was not the case in 2022.

This year the S&P500 was down about 20% at the same time that the Aggregate bond index declined 13%, in line with other bond index declines. This is a rare occurrence: historically, the S&P500 and Aggregate index have both reported annual negative returns just five times in the last 50 years. While the simultaneous double-digit decline in bonds and stocks in 2022 is disconcerting, it is anticipated that we will see these markets, and their relation to one another, return to normal over the next year or so.

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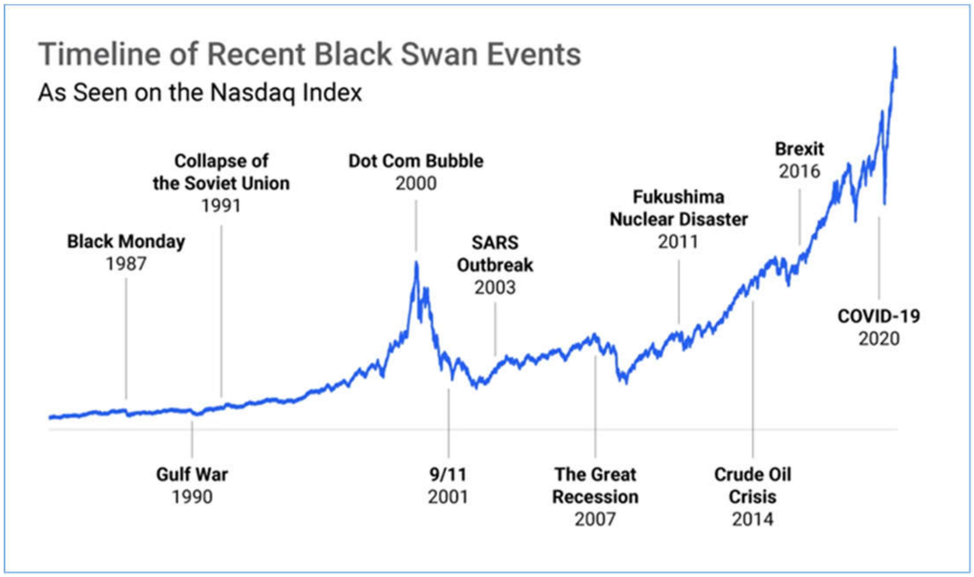

> The biggest threat facing a portfolio is not yet known.

Rarely can we determine the direction, let alone the magnitude, of all markets over shorter-term cycles. In fact, the biggest threat facing a portfolio is not yet known. Forecasting markets is quite difficult and the reality ends up somewhere in the middle. That is why they say that God made Weathermen -- so Investment Strategists would look good.

> Wealth is built over many economic and market cycles, not in 6-12 months.

However, there are steps we can take to position the portfolio appropriately. We can remain nimble, ready to make course corrections as the economic and market data evolves. We can review asset allocation to ensure that it aligns with our time horizon, risk tolerance and goals. Warren Buffett is credited with saying, “We don’t have to be smarter than the rest. We have to be more disciplined than the rest.” We know wealth is built not over the course of 6 to 12 months, but rather over the course of many economic and market cycles.


Robert Magan, CFA
SENIOR VICE PRESIDENT
INVESTMENT OFFICER
603.527.4219
Magan@banknh.com


Dona Murray
SENIOR VICE PRESIDENT
INVESTMENT OFFICER
603.527.3936
Murray@banknh.com


Michael St. Onge, CIMA
SENIOR VICE PRESIDENT
INVESTMENT OFFICER
603.527.3234
Stonge@banknh.com

Bank of New Hampshire
WEALTH MANAGEMENT

3 Eagle Square
Concord, New Hampshire 03301
603.527.3371 | www.banknh.com