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MARKET SIGHTLINES

Spotlight No. 2: Outlook 2023: Finding Balance

By Michael O'Keeffe, *Chief Investment Officer*

Last week my team and I released our outlook report, Outlook 2023: *Finding Balance*. While you can read the full report or watch the video summary or client webinar replay, in this week's Sight|Lines, we share a summary of our economic and market outlook for the coming year.

THE TAKEAWAY:
2023 UNFOLDS IN TWO PHASES, COMBINING INTO A MODESTLY POSITIVE YEAR

While our full report, Outlook 2023: *Finding Balance,* contains a number of articles, we share our views for the coming year in the article also titled *Outlook 2023: Finding Balance*. In summary:

- We expect the first part of the year to feel like a continuation of 2022, with heightened volatility and the prospect of weaker markets as we wait for cooler inflation and the Federal Reserve (Fed) to pause its rate hikes.
- We believe core Price Consumer Expenditure (PCE) inflation will fall to 3.50%–3.75% by the end of 2023, modestly above the Fed's latest projections and consensus estimates.
- After hiking another 50 basis points (0.50%) early this year, we see the Fed then pausing to await the full effects of cumulative tightening on the economy and inflation.
- As individuals, companies, and investors develop a greater sense of balance toward mid-year, optimism for the future grows, shifting us into the second, more positive phase of 2023.
- After some volatility in the first half, we see stocks ending the year higher, with earnings growth still modestly positive (0%-5%) and a total return on the S&P 500 of about 6%, translating to a corresponding index level of 4,000 at year end.
- After a challenging year in 2022, we see bonds well-behaved this year, with the 10-year Treasury yield range bound between 3.25%-3.75% and corporate spreads ending the year near where they started.

IN-DEPTH: OUR 2023 OUTLOOK IS ANCHORED ON COOLING INFLATION AND A FED PAUSE, WHICH WILL TAKE SOME TIME TO UNFOLD DURING THE YEAR

As happened in 2022, we consider inflation and Fed policy to have the greatest influence on the economy and markets in 2023. "Finding Balance" will take some time, translating to two distinct phases this year that combine to be mostly positive. Going a little deeper:

- We expect the first part of the year to feel like a continuation of 2022, with heightened volatility and the prospect of weaker markets as we wait for cooler inflation and the Fed to pause its rate hikes.

- Investors continue to parse Fed messaging, looking for signs of a policy shift. But so far in 2023, the Fed remains resolute in its restrictive stance and keenly focused on jobs and inflation.
- The S&P 500 is up 3.4% this year through January 12, but the daily returns have ranged from -1.15% to 2.29%, with volatility still elevated modestly.

- We believe core PCE inflation will fall to 3.50%-3.75% by the end of 2023, modestly above the Fed's latest projections and consensus estimates.
  - The December Consumer Price Index (CPI) report was published this week, showing that year-over-year CPI continues to decline. Headline CPI fell -0.1%, and core CPI rose 0.3%.
  - We expect shelter prices, a key inflation component, to continue rising early in the year, then stabilize. Shelter rose 0.8% in December and 7.5% in 2022.
- After hiking another 50 basis points (0.50%) early this year, we see the Fed then pausing to await the full effects of cumulative tightening on the economy and inflation.
  - The Fed next meets at the end of January, so we'll know the next policy move on February 1. Fed futures are indicating a 0.25% hike.
  - Fed futures are now also forecasting another hike in May and a possible peak of 4.75%-5.00% this year, in line with our views.
- Next week we will share eight signposts to watch as we develop a greater sense of balance toward mid-year, triggering a shift to a more positive phase this year.
- Despite some volatility, we see stocks ending the year higher, with earnings growth still modestly positive and a positive total return on the S&P 500.
  - The bottom-up consensus earnings growth forecast has been declining and is now at 4.8%. This reflects the Fed's continued policy shift and lagging effects to the economy. We see earnings growth in the 0%-5% range for 2023.
  - As unemployment moves higher and wage pressures slow, profit margins should stabilize. This, coupled with a modest price-earnings multiple expansion as investors see relief through "Finding Balance," leads to our 2023 S&P 500 total return forecast of roughly 6% and a related price target of 4,000 at year end.
- We see the 10-year Treasury yield range bound between 3.25%-3.75%, and spreads well-behaved.
  - We are forecasting the investment-grade spread to end the year between 1.0%-1.5% and the spread for high yield to fall between 4.5%-5% then.

CONCLUSION

Last week my team and I released our outlook report, Outlook 2023: *Finding Balance*. You can read the full report or watch the video summary or client webinar replay. Despite our view that volatility will continue early this year, our economic and market outlook is modestly positive for 2023.

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