WestStar Wealth Management | Wealth Watch

For Managed Portfolios

2022 Q4 Review & 2023 Outlook

It was 1923 when a particular visionary young man moved from Kansas City to Hollywood. Though he was only 21 years old, his ambition, drive and determination to pursue his dreams led to him founding his new animation company. A few years later he released the world's first sound cartoon, the starring character Mortimer Mouse renamed "Mickey" at the urging of his wife. Soon thereafter he became convinced that a feature-length animated film was needed. Hollywood insiders' pessimistic predictions of imminent bankruptcy were proven wrong as the revolutionary Snow White and the Seven Dwarves became the first full color, full sound animated feature, was the highest-grossing film of all time to that point, introduced new film techniques and technologies, and kicked off the "Golden Age of Animation."

"A Whole New World"

Being the 100th anniversary of the Walt Disney Company, it seems fitting that this edition of the Wealth Watch pay homage to that visionary young man and his mouse. "A Whole New World" is the signature song of Disney's *Aladdin* but the phrase also accurately describes both the impact Walt Disney's innovations inspired and the state of the capital markets following the unprecedented events of 2022. In the pages that follow we will explore the ways the world has changed for investors as we enter 2023.

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What You Need To Know:

- 2022 was the first time in history both stocks and bonds were down double-digits
- Markets did see a rebound in the fourth quarter of 2022, however
- The rapid rise in interest rates to curtail inflation resulted in short-term bond market pain but provided future yield opportunity
- Current environment for bonds better than any time in the last decade
- Inflation has peaked and the Fed has begun to slow pace of hikes; may pause or halt in 2023
- Stocks likely to rise in 2023 whether or not recession occurs
- Remain focused on your long-term strategy even amid volatility

Asset Class Index Performance* 2022

Commodities
16.09%

Money Market (Cash)
1.49%

Alternative Investments
-5.62%

High Yield Bonds
-11.19%

US Investment-Grade Bonds
-13.01%

International Developed Market Stocks
-14.45%

US Large Cap Stocks
-18.11%

International Bonds
-18.70%

International Emerging Market Stocks
-20.09%

US Small Cap Stocks
-20.44%

Real Estate
-24.41%

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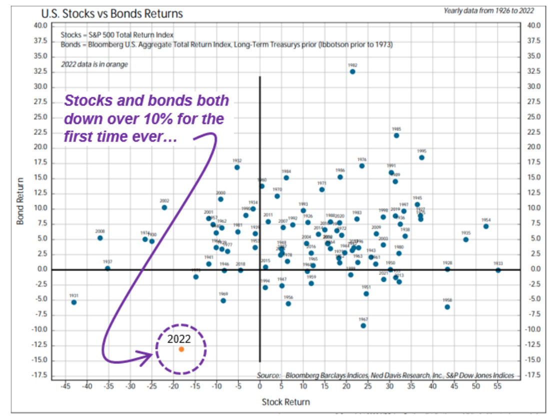
2022 Market Performance: *"Un Poco Loco"*

One of the most memorable songs among many in Disney's *Coco* also accurately describes market behavior in 2022, as it was a bit crazy. The chart below illustrates this fact, being only the sixth time since 1926 that both stocks and bonds declined together and the only time in history they both fell by more than 10%! It was for that reason and the resultant worst-since-2008 decline of a 60/40 stock/bond portfolio that erroneous assertions of the death of diversification resurfaced. Volatility overall was unusually high, with the S&P having eight 5% corrections and three 10% corrections during the year and the bond market at or near the most volatile on record. That said, and in the spirit of another wonderful *Coco* song, "Remember Me," we were correct in the Q2 Wealth Watch cautioning that bonds were not riskless and in last quarter's edition when we suggested a fourth quarter rebound may be in store. All major asset categories were up in the final three months of 2022, with the S&P 500 up +7.6%, the Bloomberg Aggregate Bond Index up +1.9%, and leading the pack was International Stocks, with the MSCI All Country World ex-US Index up +14.3%.



Source: Ned Davis Research

Tactical Strategy: *"Be Prepared"*

Because stocks and bonds comprise the lion's share of any diversified asset allocation strategy and, as previously mentioned, both were down double digits for the first time ever in 2022, diversification was less effective. As such, though we presciently prepared our clients' portfolios as memorialized in the song "Be Prepared" in Disney's *The Lion King*, a surface-level survey of performance conceals this aspect. We reduced exposure to stocks in the first quarter and, through August, maintained a max-underweight to bonds and an overweight to inflation-defense and volatility-defense strategies. While our tactical shifts and timing thereof were spot-on, the concurrent decline of all major asset classes for the year superseded said maneuvers. That said, the unprecedented rapid happenings and ensuing short-term pain of the bond market downturn—initially expected to transpire over the next decade—has given rise to a monumental reset and future opportunity. As sung in *The Lion King,* "a shining new era is tiptoeing nearer."

Fixed Income Reset: *"For the First Time in Forever"*

The catchy and earworm-inducing "For the First Time in Forever" from the movie *Frozen* is an accurate characterization of the current state of the bond markets. Interest rates were kept so low for so long that it has been over a decade since we've seen the 10-year Treasury yield 3.5%. In response, investors sought income opportunities elsewhere, looking to dividend-paying stocks and Real Estate Investment Trusts (REITs), for example. Both asset categories are worthy of investment but they are not bonds and have entirely different volatility profiles. While it is true that bonds did not act as a ballast to stock market volatility in 2022, for the first time in over a decade, there are yield opportunities in bonds themselves.

*Large Cap: S&P 500 Index; Small Cap: Russell 2000 Index; Int'l Devel: MSCI EAFE Index; Int'l Emerg: MSCI Emerging Markets Index; Core Bond: Bloomberg Aggregate Index; Int'l Bond: Bloomberg Global Aggregate ex-USD Index; High Yield: Bloomberg US Corporate High Yield Index; Cash: BofA Merrill Lynch 3-Month US Treasury Index; Real Estate: FTSE EPRA/NAREIT Developed Index; Commodity: Bloomberg Commodity Index; Alternatives: Wilshire Liquid Alternatives Index

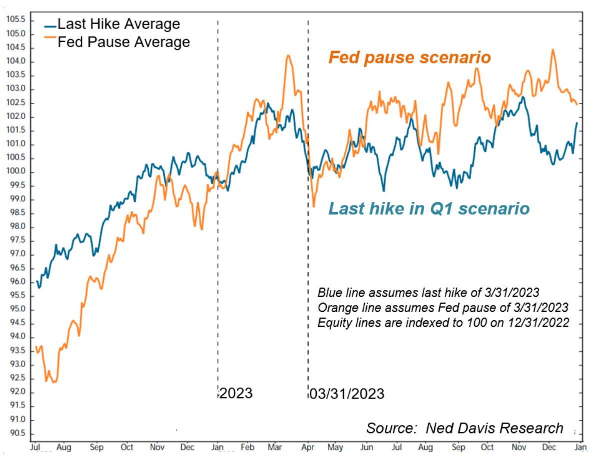
Income investors were naturally attracted to dividend-paying stocks and REITs amid effectively non-existent yields in bonds, but the heightened volatility was undeniable. A review of the current state of bond yields as shown on the table at right, however, indicates investors can once again attain the income they seek in the generally less volatile fixed income category. Indeed, with the 100th yield percentile being the most attractive, various bond categories are presently offering the most attractive yields they have in over a decade!

Index	Yield to Worst *(1/17/2023)*	Yield Percentile *(Last 10 Years)*
Bloomberg US Aggregate Bond Index	4.33%	97th
Bloomberg US Treasury Index	3.87%	97th
Bloomberg Municipal Bond Index	3.17%	94th
Bloomberg US Corporate Index	5.03%	97th
Bloomberg US Corporate High Yield Index	8.11%	91st

The fundamental changes in fixed income and the interest rate environment as a whole have been so remarkable that revisions to the long-term projections for the asset class are warranted. In pursuit of optimal investment strategies that seek to maximize returns and minimize volatility, we are increasing our strategic allocation target to fixed income in many cases. Across the spectrum, long-term returns are projected to be higher than was the case in January 2022 and long-term volatility is projected to be lower. In the near term, however, several wild cards remain including Fed hikes and the possibility of recession.

Rates and Recession: *"Beauty and the Beast"*

S&P 500 Index Post-War Fed Last Hike vs Pause Scenarios

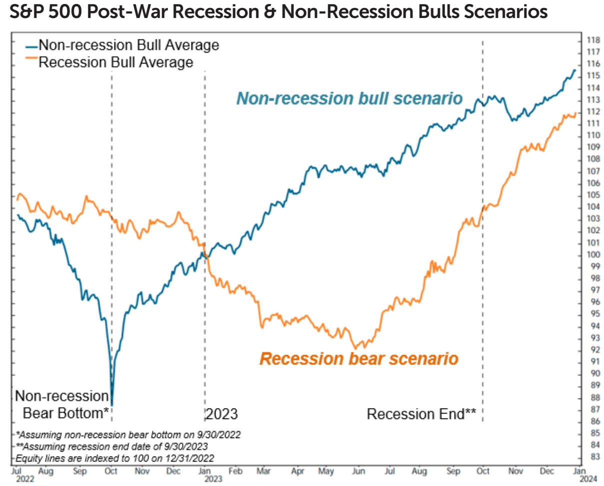


Source: Ned Davis Research

The dramatic circumstances surrounding the bond market were, of course, driven by the aggressive Fed and their mission to curtail inflation in short order. It would seem their efforts have borne fruit as we have indeed witnessed a rapid deceleration in inflation—so much so that the Fed has begun to slow its pace of hikes. Among its seven hikes of 2022, its most recent of 0.50% in December was lower than the previous four of 0.75%. The Fed recognizes the improvement in inflation, the slowing economy, and supply chain pressures abating. In keeping with the theme, these signs of improvement would be the "beauty" aspect and should allow the Fed to pause its hikes entirely at some point in the first half of 2023. That said, the chart at left differentiates projected market performance following a temporary pause of rate hikes (orange line) vs. a final hike in March (blue line). It suggests a pause would mean less volatility to be expected but a similar end result. But what of the "beast" aspect—that being the possibility of recession?

While we find that historically the market tends to bottom about 4 months *after* the final rate hike, it tends to lead the economy out of recession, bottoming an average of 4 months *before* recession-end. The chart at right shows what might happen in the stock market in recession vs. non-recession scenarios based on post-WWII historical average data. The chart suggests that if the Fed is unable to achieve a soft landing and a recession results, a stock market decline may occur in the first half of 2023 with a second-half rebound expected (orange line). However, if the Fed does indeed adjust its policy to the evident improvement in inflation and recession is either mild or avoided entirely, a rally might be expected (blue line). In either scenario, by historic average standards 2023 should see a positive year in the stock market.

S&P 500 Post-War Recession & Non-Recession Bulls Scenarios



Source: Ned Davis Research

Investment Outlook: *"When You Wish Upon a Star"*

Originally from the movie *Pinocchio* and what has become the de facto theme song of Disney itself, "When You Wish Upon a Star" inspires hope for young and old alike. As inflation abates and the Fed mellows, there is certainly hope for 2023. Bonds are once again in a position to offer investors income with lower volatility and stocks are primed to rebound whether or not an even mild recession arises. Following the rapid and rocky reset of 2022, a return to normalcy is seemingly on the horizon. We remember Jiminy Cricket's immortal words, "Like a bolt out of the blue, fate steps in and sees you through," as we adjust investment strategies to help our clients achieve their long term goals accordingly.

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Our team of wealth management professionals has the valuable depth of expertise you need to navigate life's events.

From retirement planning and investment management to trust services and estate settlement, we can help you devise the most effective plan to meet your financial goals.

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