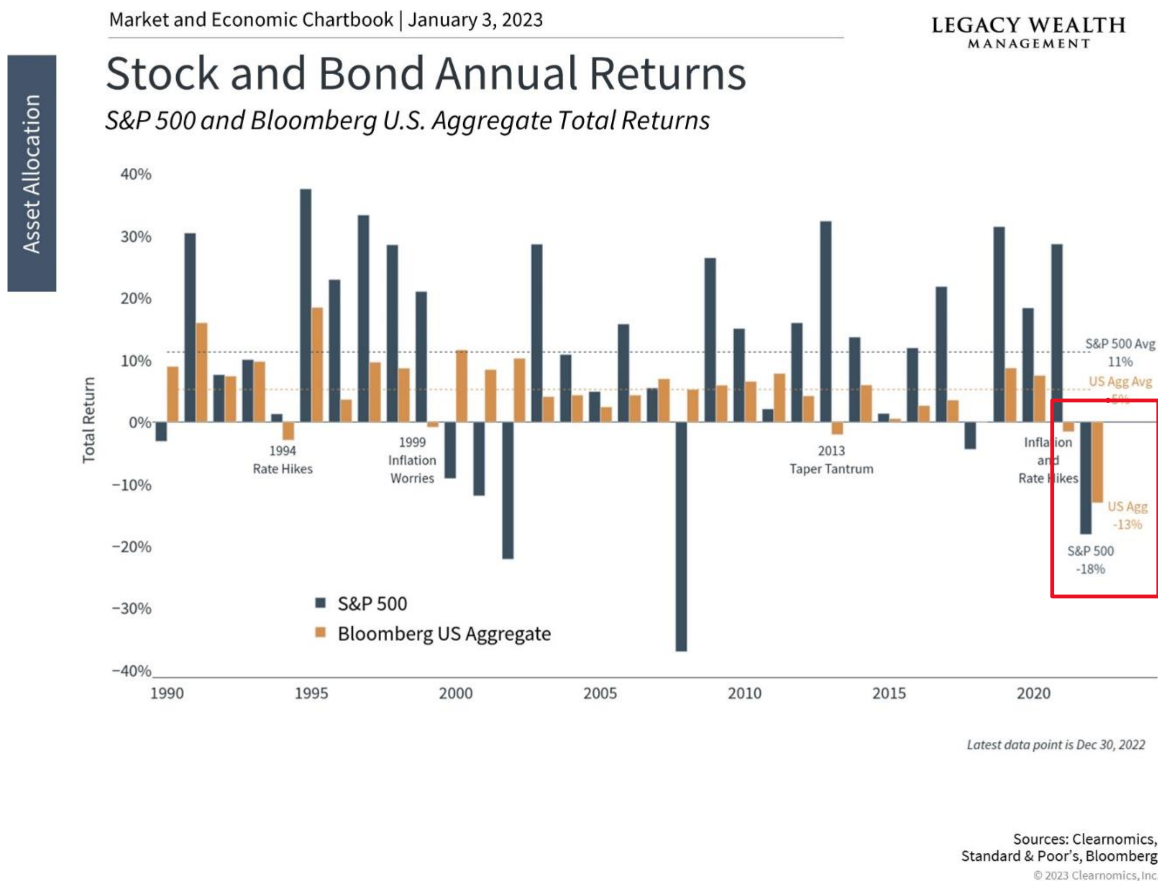
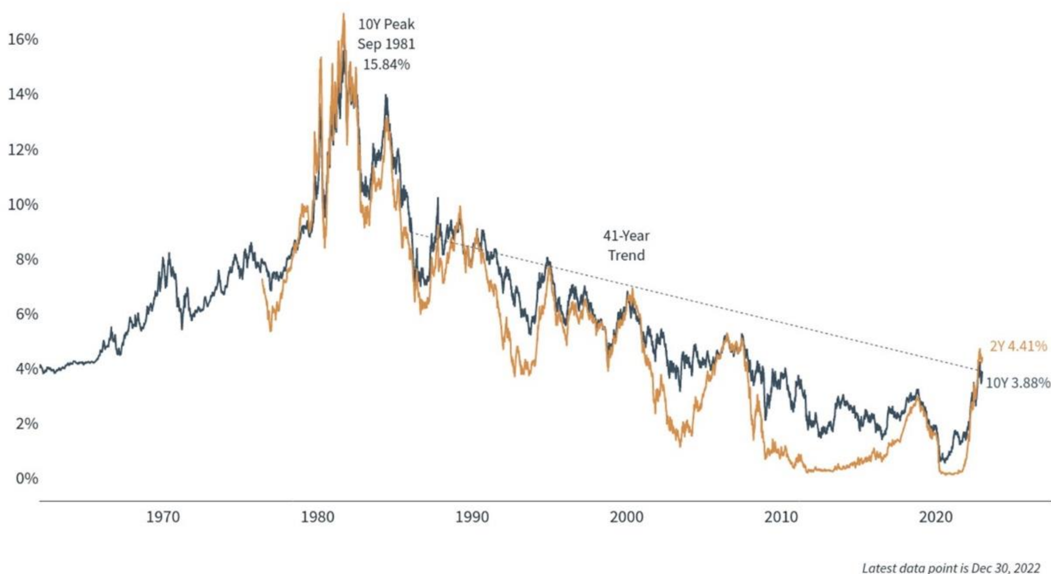
LEGACY WEALTH MANAGEMENT | Right by you.

Fourth Quarter 2022 Investment Insight

I'm often told that I play the role of "Captain Obvious" well.  With that in mind, I will say that 2022 was a difficult year in the investment markets.  The fact that both stock and bond markets suffered made 2022 unique and more difficult than normal.  In the following chart, you can see that the bond market (gold bars) generally produces a positive return when the stock market (blue bars) is falling, offering some level of stability and protection in difficult years.  Not so this year – the broad U.S. bond market as represented by the Bloomberg U.S. Aggregate bond index has fallen 13% while the stock market represented by the S&P 500 index fell 18% through December 30.




A review of bond fundamentals will help us understand what happened to bonds in 2022.  When interest rates rise, bond prices fall (and vice versa).  Bonds have been in a long-term bull market with interest rates falling and prices rising since the early 1980's.  The Federal Reserve's (the Fed) "easy money" policy of the last fifteen years helped push bond valuations to very high levels, particularly in the last couple of years.  With the rise of inflation and the Fed's need to fight it, the trend of ever-lower interest rates has finally reversed.

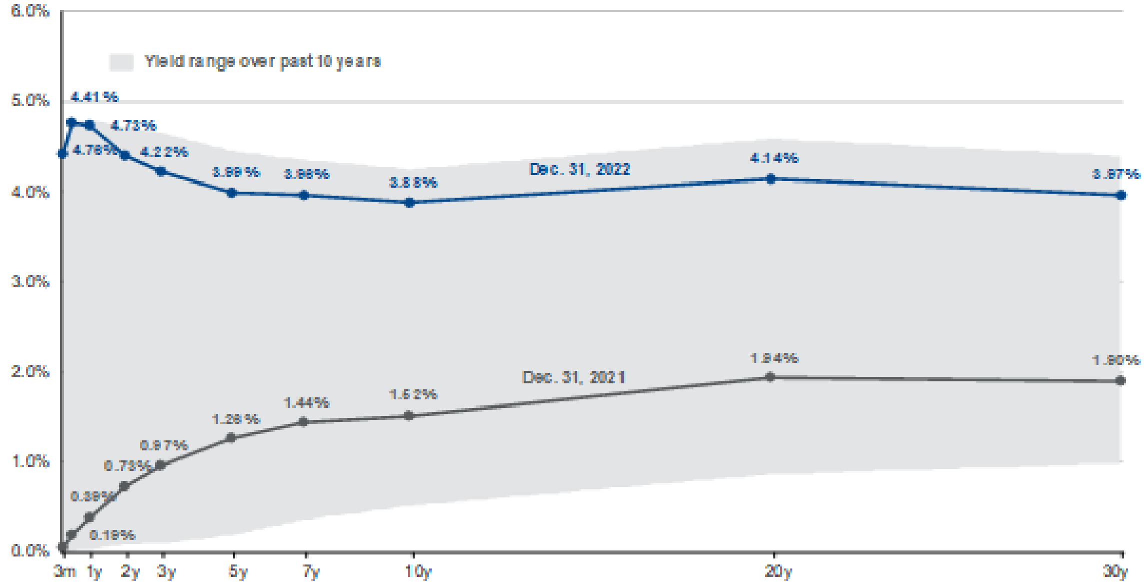



The Fed Funds Rate is the short-term interest rate established by the Fed. At the beginning of the year, it was near zero. At that time, expectations were that the Fed would raise rates three times during 2022 at a pace of 0.25% each time, moving the Fed Funds Rate up to around 1%. Those expectations were demolished as the Fed and others realized that inflation would be a more persistent and stubborn problem to tame. For most clients, Legacy adjusted our bond holdings early in the year to improve credit quality (safety) and to shorten the average maturity of our bond holdings. As rates move up, short-term bonds earning lower rates will mature quickly and be reinvested at higher interest rates, improving the overall return to the portfolio.

As of the December meeting of the Fed, the Fed Funds Rate had been raised to a range of 4.25-4.5%. The chart below shows the change in yields for different time periods ranging from three months to thirty years. The gray line at the bottom reflects rates as of 12/31/21, while the blue line at the top reflects rates as of 12/30/22. The speed at which the Fed raised rates was unprecedented, and it led to the worst performance in bond markets in at least 50 years. A Wall Street Journal article earlier in the year said that, at the time the article was written, it was the worst since 1842 (Jason Zweig article May 6, 2022). Our changes to the portfolio earlier in the year helped improve our returns, but that is a relative statement in a market as difficult as 2022.

## Yield curve

GTM | U.S. | 38




Source: FactSet, Federal Reserve, J.P. Morgan Asset Management.
*Guide to the Markets – U.S.* Data are as of December 31, 2022

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Fixed Income

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Looking forward to 2023 and beyond, the increase in interest rates provides the opportunity to earn much better returns on bonds than we have seen in several years. As seen on the top blue line in the chart above, new bonds purchased today have yields of 3.5% to over 4% in some cases. The Fed plans to raise rates by another 0.5% in February with possibly another hike of 0.25% later in the spring. If those expectations are met, then bonds prices will remain fairly stable, and investors will be able to earn the higher yields with little price risk. The latest inflation readings have been improving slowly, so it is reasonable to believe that, relative to recent history, the Fed will be able to proceed with rate hikes at a much slower pace. Should the economy stall, the Fed may even need to lower rates late next year or into 2024 in which case bond prices could rise a bit. In any event, we do not expect a repeat of the historical rise in interest rates that impacted bond portfolios in 2022.

What about the stock market? In the near term, it is impossible for anyone to know what the stock markets may do. To highlight how manic markets have been, we have only to look at the many swings in sentiment in 2022. Markets fell from their all-time highs at the beginning of the year due to concerns that the Fed wasn't reacting quickly enough to inflation. Markets then rallied in March when the Fed began to raise rates, only to then plummet into bear market territory as the inflation data worsened. Markets then rallied 17% from June to August in hopes that the Fed would slow its rate hikes for fear of a recession. These hopes were dashed when Fed Chair Powell doubled down on the inflation battle by maintaining

0.75% rate hikes, causing markets to give up their gains. Markets then jumped 8% in October and 5% in November, some of the best monthly gains in history, before once again stalling out. The Fed is playing tug-of-war against inflation and based on recent reports, seems to be making some progress. If inflation continues to subside, even slowly, this would be good news for the economy and the markets.

The counterbalance to the improving news about inflation is the risk that the Fed will persist in raising rates and slowing economic growth for too long, causing the economy to enter a recession. The Fed is actually trying to slow economic growth by raising interest rates. Earnings growth for companies has been slowing and the Fed is hoping that this will lead to some adjustments in the labor market. Slightly higher unemployment would take pressure off wage inflation, helping the Fed achieve its lower-inflation goal. The fact that longer-term bonds are yielding less than short-term bonds (known as an inverted yield curve) is one indication that investors believe that the Fed will be successful. That is good news – the Fed has their foot on the brakes and the brakes seem to be working. The question is whether they will ease off the brakes at the right time to allow for a smooth rolling stop before they allow the economy to speed up again. Uncertainty around the answer to that question may lead to continued volatility early in 2023.

The result of the Fed's efforts to slow the economy and bring inflation under control will likely be continued volatility in the near term. If we get a good inflation report, markets may respond favorably. If we get a poor earnings report or forecast, or see unemployment headed higher, markets may respond poorly. We may very well be headed into a recession, but that need not mean the stock market runs off a cliff. It is important to remember what we pointed out in our Investment Insight for the second quarter of 2022:

> A final point that we have made many times over the years that warrants repeating is that market recoveries are often as unexpected as the market declines that precede them. Recoveries from Bear Markets are front-loaded, and they often begin before the economic data indicates that they should. While an official recession has not been declared in 2022, it is instructive to look at prior recessions and stock market returns to appreciate this point. The following chart is reproduced based on data from the June 27, 2022 JP Morgan "Eye on the Markets" newsletter. We see that stock market (S&P 500 Index) declines bottomed out anywhere from 61 days to 182 days before the economy did (measured by Gross Domestic Product, or GDP). By the time GDP started rising again signaling the economic recovery, the stock market had already risen substantially (see the far-right column). In other words, by the time the economy showed signs that would lead to rising consumer confidence . . . the stock market was already well on its way to higher returns/recovery.

**The opportunity cost of waiting for economic recovery before investing**

| Equity market bottom | GDP bottom | Days in between | Equity market return by the time that GDP bottomed | Equity market return by the time GDP started rising again |
|---|---|---|---|---|
| 3/31/2020 | 6/30/2020 | 91 | 20% | 30% |
| 2/28/2009 | 6/30/2009 | 122 | 25% | 44% |
| 10/31/1990 | 3/31/1991 | 151 | 23% | 22% |
| 7/31/1982 | 9/30/1982 | 61 | 12% | 31% |
| 9/30/1974 | 3/31/1975 | 182 | 31% | 50% |
| 12/31/1957 | 3/31/1958 | 90 | 5% | 13% |

Source: Bloomberg, JPMAM. 2022.

We trust that you have had a good holiday season and are looking forward to a great and prosperous New Year. We will do our very best to help you toward that goal. If you have questions or concerns, please call us. If you want to dive back into an existing financial plan or put a fresh one in place to gain some assurances that the future is bright, please do not hesitate to contact your Relationship Manager. As always, thank you for your trust in Legacy Wealth Management.

The views of this commentary are not intended to be a forecast of future events, a guarantee of future results, or investment advice. We do not undertake to advise you of any changes in the views expressed herein. Investors should not use this information as the sole basis for investment decisions. The performance of an index is not an exact representation of any particular investment, as you cannot invest directly in an index. Past performance is no guarantee of future results. Any statistics have been obtained from sources believed to be reliable, but the accuracy and completeness of the information cannot be guaranteed.