William Blair

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Private Wealth Management
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Market Review and Outlook

- The global economy was thrown a huge curve ball at the start of the year with the war in Ukraine, the ramifications of which—including major sustained disruptions to food and energy supplies, as well as a major shifting of geopolitical alignments —are still playing out today.
- Inflation ended the year far higher than had been anticipated, but there is growing evidence that it has now peaked and is moderating.
- Higher prices forced central banks globally into the difficult position of having to aggressively tighten, knowing that growth was already slowing.
- Financial market participants across just about all asset classes responded by aggressively de-rating growth expectations and, thus, the net present value of those assets.
- Looking forward, while the bulk of the market correction may be behind us, the high probability that most major Western economies are likely to dip into recession in the coming year – a known-unknown, implies continued caution for investors.

Economic Developments Over the Last Year—War and Inflation

While no year ever turns out to be exactly as predicted at its start, this past year's expectations were thrown for a particularly large loop following the Russian invasion of Ukraine. The invasion was a wake-up call, or reminder, of just how delicate geopolitical stability is, and just how globalized and interconnected our world has become on the back of that stability. The war, as with every war, has had tragic consequences, not only for those Ukrainians and Russians most directly involved in the conflict, but also more indirectly as a result of the soaring inflation and major food and energy shortages, which have acted as a highly regressive consumption tax across most parts of the world.

One of the most important shifts that took place in 2022 was a switch from being in a world of energy abundance to one of energy scarcity. The energy supply disruptions have exposed the global lack of investment in nonrenewable energy supply at a time when the supply of renewable energy was far from sufficient to fill the void, and likely will not be for many more years to come. The upshot of this has been that non–primary energy producing countries that have been successful in recent decades specializing in value-added manufacturing built on the back of cheap and abundant energy from the likes of Russia have suddenly seen their business models torn apart—the poster child here being Germany, though this also includes many other parts of Eastern Europe and Asia. The winners, meanwhile, will continue to be those primary energy and commodity producing countries, such as the United States, Canada, and parts of Latin America, with natural gas prices in the United States as much as 6 times lower than those in Europe or Asia.

These energy supply disruptions, coupled with very strong demand related to the excess stimulus from the pandemic, resulted in a surge in prices and inflation soaring globally to levels not seen for decades.

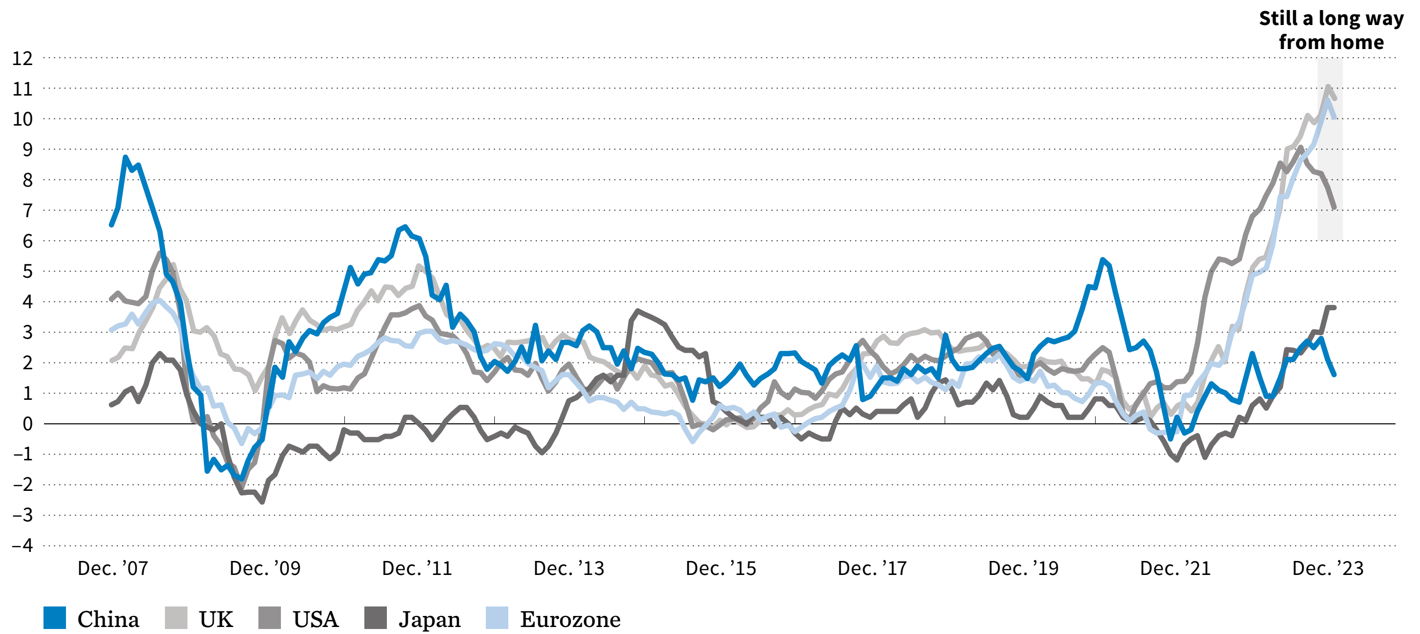
Inflationary expectations at the start of 2022 had been for a gentle deceleration to 2.4% by year-end. This forecast proved to be very wide of the mark, with inflation now at 7.1% in the United States despite falling from a peak of 9.1% in June. In the United Kingdom and Europe, inflation is still above 10%. And even Japan, a serial underachiever when it comes to raising inflation, has managed to eke out a rate of 3.8%—the highest since 1991 (exhibit 1).

The End of Easy Money

Central banks have unsurprisingly been scrambling to tighten policy as quickly as possible to quell this inflation, but have also had to balance these increases against the risk of generating another major financial and economic crisis. The most aggressive of these banks has been the Federal Reserve, which has increased rates from 0%-0.25% to 4.25%-4.5%, with its latest guidance being for them to move even higher to between 5.1% and 5.4% in 2023. This has already proved the fastest tightening cycle in the post-war period (exhibit 2). Both the ECB and the Bank of England have followed suit and are showing no signs of pivoting away from rate tightening mode, despite the high probability of their economies already being in recessions. The higher inflation in Japan, meanwhile, also prompted the Bank of Japan to surprise financial markets late this past year with an easing of its yield curve control policy, resulting in a widening of the bands around which it allows its government bond yields to fluctuate.

EXHIBIT 1

International Inflation Rates, Annual % Change in Headline Inflation at End of Period

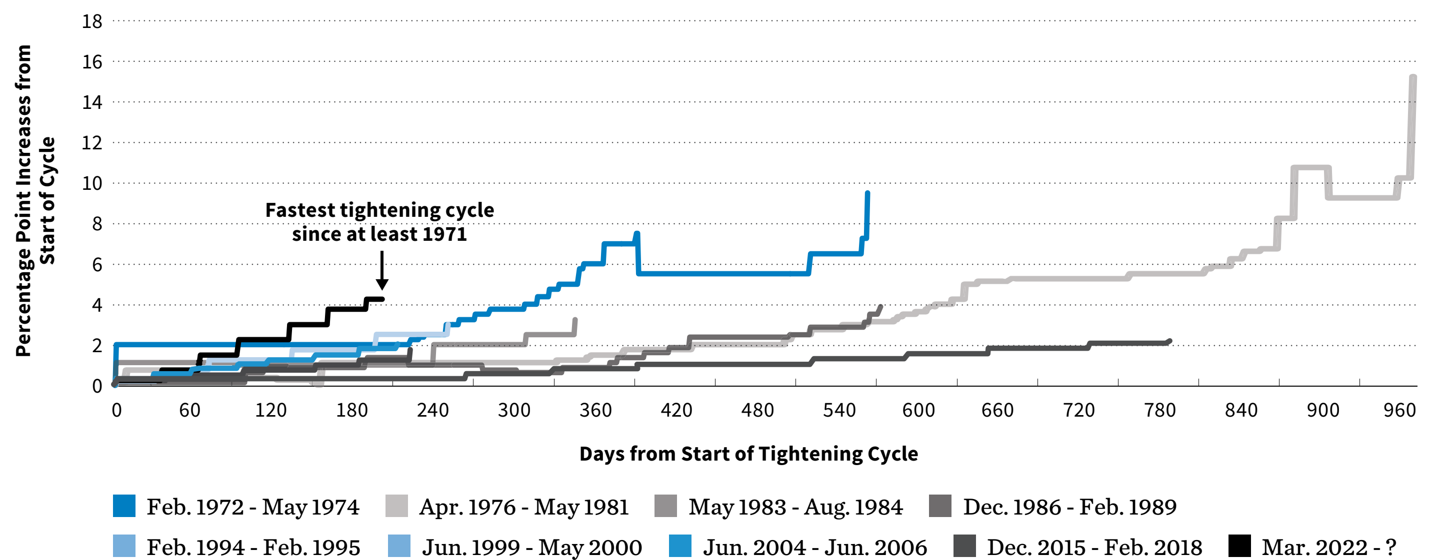


Sources: OECD, William Blair Equity Research

EXHIBIT 2

Fed Tightening Cycles Compared from 1971-2022

(Fed Funds Upper Target Band Rate 1971-2022)



Sources: Bloomberg, William Blair Equity Research

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The past year also brought with it the end of easy credit. With the fed funds rate now the highest since 2007, many areas of glaring market excesses have now been purged. In 2022, this included sharp corrections in meme stocks, SPACs, the crypto space, highly speculative tech stocks, and to some extent U.S. house prices.

The reality had been that with rates at effectively zero, just about all other risky assets looked attractive. However, higher discount rates have meant a sharp reduction in the net present value of those expected future cash flows, which were duly (and rather painfully) marked down by investors over the past year. Even historically safe assets, such as U.S. Treasurys, witnessed their largest drawdown since at least 1976. This decline, in conjunction with the 25% fall in the S&P 500, had the effect of also dampening the return of the classic 60-40 portfolio, one of the most relied-upon strategies for decades now. When this strategy recovers in the future will largely depend on the Fed's success in taming inflation once again.

What is important to note, however, is that none of these market corrections has (yet, at least) resulted in a major financial crisis. The key missing ingredient here has been leverage. Many of the most speculative assets (e.g., crypto currencies, meme stocks, and SPACs) were seemingly viewed more as lottery tickets by investors—assets to have a punt on with some excess funds from the pandemic. This is in sharp contrast to the last GFC, where "can't lose" subprime debt was packaged up, stamped as AAA, and sold as safe assets against which banks and other financial sector companies could leverage their balance sheets up as much as 40-to-1.

This should be no reason for complacency, however. History also shows that Fed tightening cycles have rarely managed to result in soft landings, and that recessions have a strong tendency to expose those entities that have been flying by the seat of their pants. Often such an unravelling can take time to play out—the implosion of Lehman Brothers, for example, did not happen until September 2008, eight months following the onset of the actual recession.

What the New Year Might Bring: In a Word, Recession

Despite the word "recession" being on just about everyone's lips in 2022, and actually experiencing two consecutive quarters of negative GDP growth in the first half of the year (often seen as a crude rule-of-thumb definition of recession), the U.S. economy has so far managed to avoid entering one. Unfortunately, this is a trick that is unlikely to be repeated in 2023, when just about all predictive economic models of recessions are now flashing red. The consensus among most economic prognosticators is that there is a 65% probability of a U.S. recession in 2023, and this probability rises to 80% for the EU and 90% for the United Kingdom.

Recessions are always considered "fat tail" (low probability, but high impact) events, which bring with them a lot of uncertainty. Yet, there are a number of reasons this expected U.S. recession could prove to be a more mild one than the historical average. These include many companies keen to hold higher levels of inventories—"just in case" rather than "just in time"; strong consumer, corporate, and financial sector balance sheets; and perhaps most importantly, what is potentially a structurally tight labor market, where demand for labor continues to far outstrip the available supply. Nevertheless, we should only take modest comfort in this likelihood, given that recessions are never pleasant experiences. Rising interest rates crimp investment demand, raise economic uncertainty, and reduce consumption growth, which, in turn, squeezes corporate profit margins, resulting in layoffs, weaker wage growth, and slower inflation. The difference this time around compared to the last two recessions is that without a pandemic or major financial crisis, the impact from higher interest rates could take longer to work its way through the system.

For equity market investors, given that much of 2022 was spent adjusting their expectations lower to reflect this potential recession, our view is that much of the coming slowdown has already been priced in, and 2023 will be more about tweaking those expectations to reflect the unfolding reality rather than witnessing another major shift downward. Much will depend on exactly how high the Fed decides to take interest rates. The market is currently expecting a peak rate of 4.97% and for rates to start falling swiftly thereafter; this compares with the Fed now guiding rates between 5.1% and 5.4% in the coming quarters, and also hanging around those levels for longer.

History shows that the stock market tends to peak around 8 months prior to the start of a recession and trough roughly around the middle of the downturn; the average downturn since 1945 has lasted 10.3 months (or 17.0 months going back to 1854). Today, after briefly dipping to a near-term low of 15

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times, the market's P/E ratio has since increased again to 17 times. Meanwhile, there remains plenty of uncertainty related to geopolitics, economic growth, inflation, and corporate profitability, as such investors should be wary of overly concentrated portfolios. In such an environment, with volatility expected to remain high, we continue to believe that agile and active portfolio management should be seen as essential.

Wealth Management Planning Tip

The Consolidated Appropriations Act (omnibus spending bill) was signed into law on December 29, 2022. A portion of that law, dubbed "SECURE 2.0," as it builds upon the foundation laid by the 2019 "Setting Every Community Up for Retirement Enhancement" Act, included several noteworthy terms that may impact your retirement planning or that of your business. Of the law's 92 provisions, the most immediate impact relates to the age at which required minimum distributions (RMDs) must begin, increasing to age 73 in 2023 and rising to age 75 by 2033. The bill also provides an increase in catch-up contribution limits for older workers, automatic enrollment, student loan repayment matching, penalty-free emergency withdrawals, contribution incentives and tax credits for new plans for small businesses, among other enhancements. Please reach out to your William Blair Wealth Advisor for further information that may impact your retirement planning.

Index		YTD	Q4	1Y
S&P 500	US Large Cap	–18.11	7.56	–18.11
DJIA	US Large Cap	–6.86	16.01	–6.86
Russell 3000	US All Cap	–19.21	7.18	–19.21
Russell 2000	US Small Cap	–20.44	6.23	–20.44
MSCI EAFE	Developed International	–14.45	17.34	–14.45
MSCI EM	Emerging Markets	–20.09	9.70	–20.09
Bloomberg Barclays US HY	US High Yield	–11.19	4.17	–11.19
Bloomberg Barclays US Agg	US Core Bond	–13.01	1.87	–13.01
Bloomberg Barclays Muni	US Muni Bond	–8.53	4.10	–8.53
MSCI US REIT	US Real Estate	–24.51	5.22	–24.51

Source: Bloomberg

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