2023 Outlook

Finding the path forward

Commerce Trust
Banking | Investments | Planning™

As the new year dawns, we find the global economic and investment environment surrounded by uncertainty. The worldwide surge in inflation and the efforts of global central banks to tame costs through campaigns of aggressive interest rate hikes are slowing economic activity. At the same time, elevated market anxiety continues to be the investment story as noted by highly volatile capital markets.

Against this economic backdrop, increasing geopolitical tensions and concerns are contributing to the uncertainty. We expect our domestic trajectory will be a departure from the past decade as the Federal Reserve's monetary policy stance is increasingly less accommodative.

Commerce Trust believes the 2023 economic picture will be defined by whether the Federal Reserve and other policymakers can continue to fight higher inflation without triggering a severe economic downturn. Our team of investment professionals provide their views and forecasts for the year throughout this commentary.

From an investment perspective, we remain committed to helping our clients navigate through an uncertain investment landscape. Together, we are finding the path forward while staying focused on your long-term outcomes and goals regardless of events going around us.

Thank you,

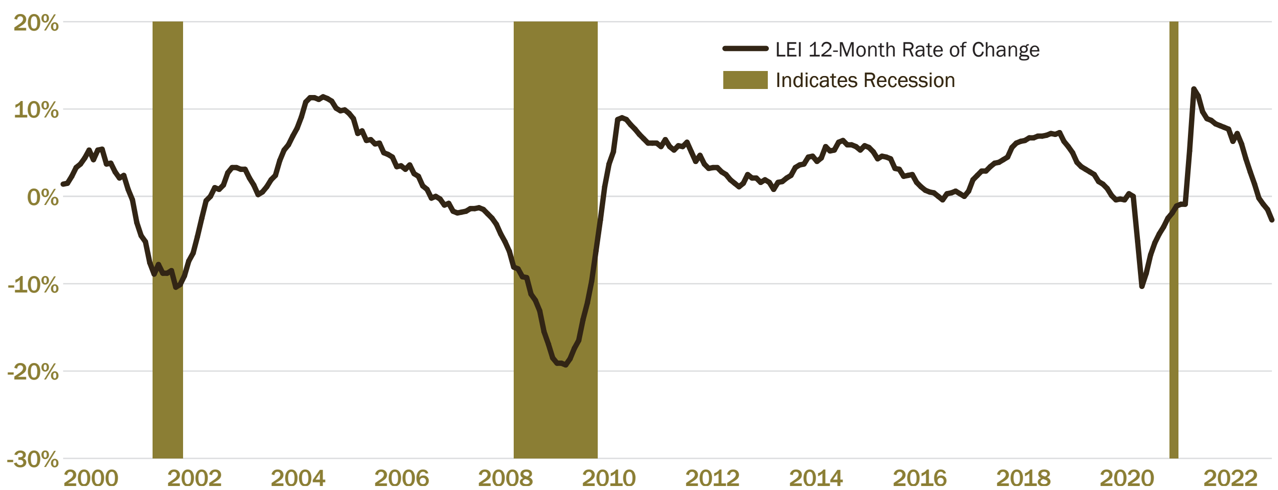
David Hagee
Chief Investment Officer

Can the Fed accomplish a soft landing of the economy?

It's been an exceptionally difficult year for both financial assets and "real" (inflation-adjusted) economic growth. Stocks and bonds have conspired to hand even well-diversified investors one of the worst years they've witnessed in their lifetimes. Unfortunately, historic indicators point toward an even rockier road for the U.S. economy in 2023, as the probability of a recession continues to grow while the Federal Reserve (Fed) continues its fight against stubborn core inflation.

By now we are all familiar with this year's storyline. Surging inflation, sparked by unprecedented fiscal/monetary stimulus, and pushed along by the war in Ukraine, forced foreign central banks and our own Fed to aggressively reverse course from their zero percent interest rate policies. While a Fed tightening campaign was baked into expectations for 2022, the speed and scale of the operation certainly was not — even by the Fed's own forecasts. In its last monetary policy meeting of 2021, the Fed projected an increase of just 0.75% in its overnight rate by the end of 2022, and futures markets generally agreed with that leisurely pace. Instead, the Fed has delivered a whopping 3.75% of rate hikes as of November 2022, a pace rivaled only by Paul Volcker's central bank more than 40 years ago. This rapid rise in interest rates around the world has crushed global bond prices — delivering their worst year ever — along with every major equity index. And with their typical lag, the higher rates have suppressed economic output as well. U.S. growth for the first three quarters of the year, adjusted for inflation, was effectively zero.

Leading Economic Indicators Foretell a Downturn

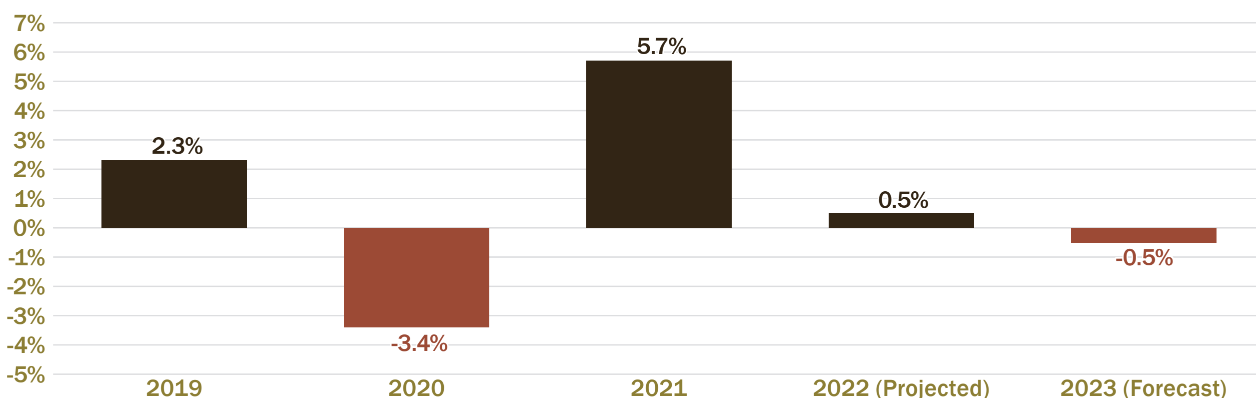


Source: Commerce Trust, Bureau of Economic Analysis

Unfortunately, signals from economic and market data portend that the Fed's high-speed interest rate attack may well tip the U.S. into recession in 2023. Few will be surprised if spiraling natural gas prices haven't already done the same for Europe. From a U.S. perspective, the inversion of the Treasury yield curve (when 2-year yields are higher than 10-year yields) has predicted eight out of the past eight U.S. recessions. Ominously, we've seen that inversion in the Treasury market since July 2022. And when overnight cash rates confirm the 2/10-year inversion — cash rates surpassed the 10-year Treasury yield as we entered November — this typically signals the onset of a recession within the next 12 months. The Conference Board Leading Economic Index® (LEI) also tells a similar story, having fallen for eight consecutive months. Collectively, the LEI's ten components are contracting at a -2.7% year-over-year pace, a forward barometer also highlighting the likelihood of a near-term recession.

There are positive surprises that could stop what feels like an inevitable downturn this coming year. The Fed might pull off the elusive soft landing: cooling inflationary pressures through higher interest rates without triggering a severe economic downturn. If so, we believe the Fed would pause its rate-hiking policy sooner than expected, which would allow the labor market to remain resilient as the recent rollover in inflation accelerates. Warm weather and a constructive resolution to the Ukrainian war could spare Europe from recession. China may opt for an early exit from its zero-COVID policy and pull global growth forward. Some of those hoped-for possibilities came into view in early November when markets rallied on the lower-than-expected U.S. inflation reading of the consumer price index (CPI), continued Ukrainian progress, and indications of some loosening in China's COVID response. Even if these rosier growth scenarios don't come to pass, a cheaper and perhaps oversold stock market and the hint of a top in interest rates might bring investors back to the risk table to start betting on a recovery somewhere over the economic horizon.

U.S. GDP: Growth Likely Contracts in 2023



Source: Bloomberg

Still, our post-pandemic economic terrain remains marred by the massive accumulation of debt, not to mention a tragic human toll. With minimal capacity for additional fiscal help to push us along, higher interest rates that work with a lag (but are already hurting the cyclical housing sector,) and several nearly flawless historic indicators that point toward an economic contraction, it's tough to be overly optimistic.

If you're looking for a silver lining, we offer several. Financial assets are materially cheaper today, the Fed will slow and probably eventually pause its rate-hiking process sometime in 2023, jobs are still plentiful, and U.S. inflation has likely peaked and is beginning to roll over. All these factors hold out the possibility for a potential soft landing. Unfortunately, history tells us it's also exceptionally difficult to gently land the massive plane that is the U. S. economy once it enters its descent.

Equities likely rebound in second half of year

As previously noted, 2022 presented unique market challenges, especially for global equities. Turbulent market conditions, unsettling stock performance and general investor anxiety induced by a shifting economic backdrop all conspired to pressure equities, as most indices have posted double-digit negative returns for much of the year. Of the 11 major sectors the S&P 500 Index follows, only energy has delivered consistent, albeit volatile, gains as of November 30, 2022, with utilities and consumer staples being the only other sectors in positive territory over the same period. However, more recent market moves offer the hint of a recovery. Stock prices began a nice rebound in the fourth quarter 2022 on the news that surging inflation, which peaked at 9.1% in June's CPI reading, began to head lower. We believe the declining trend in inflation will continue to be a tailwind for equities as we head into 2023.

Investors now are trying to determine the implications of a potential worldwide recession on corporate earnings. A recession occurring in the next 12 months could be the most telegraphed economic downturn in history, and earnings expectations for 2023 have already been ratcheted lower by 10% over the last several months as analysts brace for such an outcome. If the economic downturn is worse than expected, then earnings expectations could decline another 15%, further pressuring stock prices.

2023 Sector And Market View

Looking ahead, we anticipate equity markets to remain choppy for the near term. However, we are resolute in the belief that 2023 could present more selective opportunities, with greater emphasis on company fundamentals as the economy slows.

- **Consumer Discretionary:** Overall consumer spending is likely negatively impacted by higher rates and elevated inflation with likely higher unemployment pressuring the consumer.
- **Energy:** The heightened possibility of a global economic slowdown could lower demand for fuel; however, we are longer-term bullish on the sector due to structural shortage of the commodity.
- **Real Estate:** Higher interest rates are likely to continue to raise expenses for real estate companies and real estate investment trusts (REITs), pressuring valuations.
- **Defense:** We believe defense spending will remain elevated for a multi-year period, with geopolitical tensions flaring up in areas around the globe.
- **Financials:** While higher rates generally bode well for financials, rising credit costs likely pose a headwind to the sector in 2023.
- **Technology:** IT companies' earnings and valuations are likely to come down in early 2023 as management teams likely lower guidance due to slowing sales growth and margin pressures.

We believe equities are likely to have a positive year in 2023. Based on 2022 performance, valuation levels have come down considerably but are still on the high side on a historical basis. Short-term interest rates need to stabilize in the 4% to 5% range, which we estimate is likely to occur in the first half of the year, hopefully in the first quarter. Global investor sentiment remains quite skeptical. However, we wouldn't be surprised to see all markets — international and domestic — rebound as equity markets typically discount what is going to happen six months from now.

History provides some much-needed perspective to the current state of equity markets. For more than 100 years, equities have delivered investors an average annual return of 10%. However, a closer examination of recent activity shows the S&P 500 has had three corrections of 20% or more in the past five years: a 20% decline in 2018, the 34% pandemic-fueled drop in 2020 and the 24% downdraft in 2022. During that time, the S&P 500 has still posted an 11% average annual return.

Fixed income returns to its role of counterbalance

Surging inflation, an aggressive Fed response, and potential credit concerns played havoc with the bond market in 2022. When combined with global economic shocks, the result is the worst 12-month period of performance for the U.S. bond market in modern history. These poor returns could rebound somewhat as we close out 2022, even with the near unanimous consensus the Fed will once again raise rates at its December meeting. Fortunately, today's higher yields will likely deliver a much more favorable outcome to bond investors in 2023.

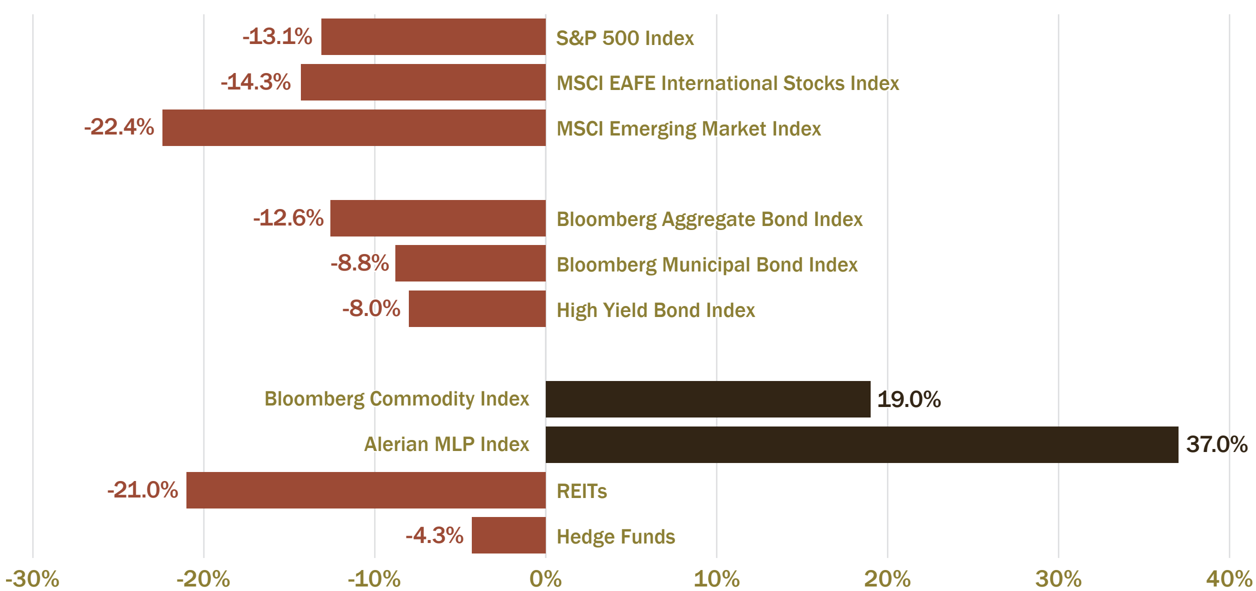
Bonds historically have provided investor protection during most equity market pullbacks. However, bonds failed to behave as a safe counterbalance to equities in 2022. The breakdown in this relationship has some investors wondering if bonds are still a reliable hedge for stocks. We believe they still are. The "flip" in correlation this past year has happened before, particularly when inflation is rising like it did in the 1970s and early 1980s. Fortunately, once inflation settles down — as it appears to have begun to do — the typical role of bonds as a counterbalance to stocks will eventually return.

All fixed income sectors are reporting deeply negative returns so far this year. Through November 30, the Bloomberg U.S. Aggregate Bond Index has a return of -12.6% year-to-date (YTD.) Corporate bonds have been the laggard of the investment grade market, as increased risk aversion led to credit spread widening and additional price depreciation. Longer maturity bonds suffered the most in the rising interest rate environment. Asset-backed securities (ABS) were one of the few sectors that did not have double-digit losses YTD, as their higher quality and shorter duration relative to other sectors provided some downside cushion.

Municipal bonds also have produced negative returns but fared a bit better than taxable bonds. The Bloomberg U.S. Municipal Bond Index has delivered a YTD return of -8.8%. Tax-exempt bond returns were further pressured by record investor selling and mutual fund outflows. Fortunately, municipal credit remains on solid footing, even as the threat of recession looms. Municipal downgrades and defaults should remain relatively low compared to other credit-oriented sectors of the bond market. New supply will also remain subdued. Issuers have little incentive to borrow given both the elevated rate environment and their healthy balance sheets supported by robust tax revenues. As the past year's interest rate headwinds subside, growing investor demand for tax-exempt income should support municipal returns into the new year.

The only bright spot from 2022's dismal performance means investors purchasing bonds today enjoy materially higher yields. The 10-year Treasury bond, for example, yields 3.6% as of November 30, more than 2% above the 1.5% yield that greeted investors when 2022 began. Additionally, the Fed will slow its rate-hiking process and likely pause by midyear, affording bondholders more downside protection. The bond market's defensive orientation will also likely come back into play in 2023 as the looming threat of a recession hangs over the equity markets. As such, bonds offer much better value today. While it's difficult to time the peak for interest rates, we remain fully allocated to the sector.

Year-to-Date Performance Across Asset Classes *As of 11/30/22*



Source: Bloomberg

A look at alternative investments

Investments tied to rising inflation, such as commodities and energy infrastructure, were a persistent area of positive returns throughout 2022. Commodities performed strongly in the first half of the year as energy and food prices rose due to strong demand and constrained supply. The trend leveled off midyear but began to climb again during the third quarter. The Bloomberg Commodity Index, which is composed of 23 exchange-traded contracts on physical commodities, returned 17% as of November 30, 2022.

Conversely, REITs did not provide much diversification benefit as rising interest rates created significant headwinds in both commercial and residential transactions.

As persistent inflation and higher interest rates pressure equity and fixed income investments, we continue to recommend an allocation to hedged equity and absolute return strategies for a portion of a balanced portfolio. Hedged-equity strategies YTD have performed better than equity indices and inline with aggregate bonds. Absolute-return strategies, which have a lower risk and return profile than hedged equity, have outperformed both broad equity and bond indices.

How Commerce Trust has responded

We are maintaining our slight underweight in equity exposure as we begin the year, until we get a clearer picture on the path of the economy. Our cash position in portfolios could be used to take advantage of areas of opportunity in equity markets. In addition, we are maintaining our preference for domestic over international equity.

To help protect portfolios as interest rates rise and the economy weakens, we are maintaining a slightly below-average maturity exposure in the taxable bond market and focusing on improving credit quality. As 2023 progresses and the Fed moves closer to a monetary policy pivot, we will look for opportunities to add duration/maturity and re-enter high yield and emerging market debt sectors. Simply put, the bond market is poised to produce much better results as we move through 2023.

Our Forecast and Portfolio Biases

Highest Conviction

1. **Short term interest rates will continue to rise, and bond returns will be negative for both taxable and the municipal bond markets in 2022**

   We were 15% short our durational/maturity target, but are now only 10% short the portfolio's benchmark

2. **We have added to growth exposure to neutralize our initial value overweight.**

   Early in the recovery, as expected, value outperformed growth. With the economy now slowing and earnings growth having moderated, growth is likely to rebound.

3. **Slightly more defensive in general from an equity perspective**

   We are holding some cash (about 5%) in most portfolios, have underweighted our equity exposure a similar amount as we sold into the strong rebound at the end of July. We have also reduced our overweight to alternatives and used those proceeds to increase fixed income back to our targeted bond allocation.

4. **Reduce high yield exposure**

   We have moved up in credit once again at mid year favoring Investment Grade bonds and recommend minimal exposure to the riskier higher yielding sectors of the bond market.

5. **Mid cap stocks will outperform both large cap and small cap stocks**

   We prefer the higher profitability and stronger balance sheets of Mid Cap vs. Small Cap and the domestic orientation of Mid Cap vs. Large Cap equity

6. **Domestic stocks should continue to outperform international markets**

   We are one-third underweight our International targets and expect the dollar to remain relatively firm

7. **We are overweight international developed equity versus emerging market**

   80% of our International allocation is in Developed Equity

Lowest Conviction

Conclusion: Maintaining a long-term view

Let's state the obvious: the near-term prognosis for 2023 calls for economic uncertainty and anticipated market volatility. As investors, we must remain steadfast in our focus on long-term financial outcomes despite the torrent of negative headlines and market anxiety we're likely to see throughout the year.

Here are some key considerations to remember. The history of stock market performance over time reveals some constant truths. Bear markets don't last forever. The most memorable short-term declines over the past 35 years all produced double-digit returns within 12 months from the market bottom.

In addition, periods of high market volatility tend to produce investment opportunities. At Commerce Trust, we believe investment success is more likely the result of a consistent approach, one that accounts for price fluctuations in asset classes that can occur during uncertain market conditions.

Your investment strategy must align to your goals, no matter the level of complexity or resources required to achieve them. Be mindful of the need for occasional course corrections to address headwinds like higher inflation, rising interest rates and economic change.

Lastly, partner with a team of advisors who will stand shoulder-to-shoulder with you. Contact Commerce Trust today — we can help you determine the right pathway to help you achieve your financial future.

*Data and/or commentary as of November 30, 2022.

2023 Economic Outlook: Commerce Trust Authors

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