Beacon Trust
INNOVATING WEALTH STRATEGY

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A LOOK AT THE YEAR AHEAD: Ten Investment Forecasts and Four Strategic Wealth Management Themes to Capitalize on Them

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As we acknowledge each December in presenting our outlook for the coming year, no one can know the unknowable or predict the unpredictable. However, as wealth managers that invest for our clients over the long-term, it is also our job to continually analyze the world around us and assess how the short-intermediate term economic landscape may impact our long-term investments. We have never believed in a "one size fits all" portfolio and have always provided custom tailored advice to our valued clients based on their personal goals and risk tolerances. With this in mind, we would like to share with you our perspective and predictions about some significant events that we believe are likely to unfold in the year ahead.

Beacon's Ten Investment Forecasts for 2023

1. U.S. stocks will rebound from the 2022 bear market and deliver positive returns in 2023.
2. Bonds will return to acting as ballast for portfolios and also deliver positive returns over the full calendar year.
3. The Federal Reserve will continue to raise short-term interest rates in the beginning of the year and then pause.
4. Inflation will continue to fall, but remain well ahead of the Fed's 2% target.
5. There will be a stock market correction in 2023, but it may represent a buying opportunity.
6. Real estate prices will continue to decelerate due to the recent surge in interest rates.
7. The U.S. economy will enter a recession in 2023.
8. The U.S. Dollar (DXY) will weaken over the remainder of the year, after the Fed pauses its rate hike campaign.
9. Technology stocks will rebound from a disastrous 2022.
10. The ongoing supply chain problems and computer chip shortage will largely disappear.

Beacon's Four Strategic Wealth Management Themes for 2023

Beacon's Four Strategic Wealth Management Themes for 2023 echo our forecasts for the coming year and reflect our best thinking to protect capital and improve returns:

1. Understand the paradox of a worsening economy, but improving financial markets.

2. Be prepared for the "New Normal – Part II," an extended period of slower than normal growth.

3. Build a portfolio for falling, but stubbornly high, levels of inflation.

4. Construct a portfolio that may thrive in a Cold War – Part II environment.

A Glance Back on the Year That Was

U.S. stocks had a difficult year with the S&P 500 falling roughly 18% in 2022, as of the time of this writing. A hawkish Federal Reserve (Fed) and surging inflation were among the main drags on performance on the domestic front. Internationally, Russia's invasion of Ukraine and snarled supply chains emanating from China in the wake of its "zero-COVID" policy were among the other reasons for the decline in U.S. and global equities. Bonds, in total, experienced their worst year on record with the Barclays Aggregate ("The Agg") down roughly 11% in 2022 thus far. The Fed's aggressive interest rate hike policy in 2022 was the main reason for the losses, especially considering the meager coupons most bonds sported as we came into the New Year.

Before we look ahead to 2023, it seems only fair to look back on our 10 forecasts for 2022. What did we get correct and where did we go wrong? In our view, six of our ten predictions were correct, two partially correct, and two incorrect. Let's provide some color to these assessments and then move on to our 2023 forecasts.

Let's start with our mistakes, which we always try to learn from. Consumer confidence, measured by the University of Michigan consumer sentiment survey, fell over the course of the year, although it bottomed in June which corresponded to the peak inflation reading. Although Beacon has no direct investments in cryptocurrency, we thought its surrounding ecosystems would continue to grow at a fast clip. The bear market in crypto, in concert with the FTX bankruptcy and arrest of its founder, has likely set the cryptocurrency market back years.

Moving on to our partially correct forecasts, we predicted relatively downbeat returns for both stocks and bonds in 2022, but believed that equities would turn in the better performance. As of this writing in mid-December, the S&P 500 has lost a bit more than the Bloomberg Barclay's Aggregate Bond Index (-18% vs. -11%).We also thought international stocks would outperform domestic ones since many foreign governments were adding stimulus and lowering interest rates, in contrast to the U.S., which was withdrawing stimulus post COVID and tightening financial conditions. The widely followed MSCI EAFE Index did outperform the S&P 500 (-16% vs. -18%), but we realize that the strong U.S. dollar may have negatively impacted the returns for several other international indexes, resulting in underperformance.

Let's move on to our clairvoyant calls from 2022. We thought the Fed would raise interest rates as we moved away from its post COVID stimulus actions. In fact, the Fed conducted one of its most aggressive rate hike campaigns ever, increasing the Federal Funds Rate 4.5% over the course of the calendar year. Inflation ended 2021 at a high rate and we predicted it would continue to sizzle due to prior accommodative Fed policies, COVID stimulus, and supply chain problems. Inflation hit the highest levels in more than 40 years, with the Consumer Price Index (CPI) peaking at 9.1% in June, and ending the year up 7.1%. We forecasted a stock market correction, the first since March 2020, which occurred and then some. At its lows the S&P 500 dipped into bear market territory, down 27% from its peak, before recovering to its current state of down roughly 18% YTD.

We forecast that the benchmark 10 Year U.S. Treasury Note would increase over the course of the year. It more than doubled at one point rising from 1.7% on January 1st to 4.3% in October, before resting as we approach year end at roughly 3.5%. Given our prediction for below average returns for equities and fixed income, we thought alternative investments would gather material new assets. Hedge funds and private equity both gained hundreds of billions of dollars of assets over 2022. Lastly, for the midterm elections we predicted a "gridlock," or balanced power scenario, which occurred with the Republicans gaining control of the House while the Democrats maintained control of the Senate. **Table 1** provides a summary scorecard for our 2022 forecasts.

Table 1: Review of Beacon's 2022 Financial Forecasts

Forecast	Assessment	Rationale for Assessment
Stocks > Bonds, both below historical avg.	Partially Correct	Both were well below ave, but stock losses > bond losses
The Fed will raise short-term interest rates	Correct	The Fed increased interest rates 4.5% in 2022
Inflation will exceed the Fed's 2% target	Correct	The CPI ended the year at +7.1%
Consumer Confidence will increase	Incorrect	Confidence fell according to the U Mich. survey
There will be a stock market correction	Correct	Stocks fell > 10% and had a max drawdown of 27%
The 10 Year U.S. Treasury yield will increase	Correct	The 10 Year UST increased from 1.5% to 3.5%
International stocks > U.S. stocks	Partially Correct	MSCI EAFE > S&P 500, but strong $ hurt in some markets
Hedge Funds and Private Equity assets ↑	Correct	HF and PE AUM increased as investors fled stocks/bonds
Crytpo assets, Web 3.0, will increase	Incorrect	There was a shakeout in crypto, led by the FTX implosion
Midterm elections will result in "gridlock"	Correct	Republicans won the House, Democrats kept the Senate

A Closer Look at Beacon's Ten Investment Forecasts for 2023

There is an element of risk in offering predictions since the future is uncertain. We can state with confidence that some forecasts we offer for 2023 are again likely to be correct, some incorrect, and some partially correct. We can also predict with great confidence that what will ultimately prove to be some of the major events of 2023 are neither on our list, nor likely on anyone else's. For example, few analysts predicted the close to double digit inflation levels (or higher) for the U.S. and much of Europe. Although many people predicted the demise in cryptocurrency, SPACs, and high flying stocks with no earnings, few people predicted the crash that occurred in big cap technology stocks which have led the market over roughly the past decade. It is often the events that few investment strategists are talking about that result in the most extreme market movements.

As noted in our Executive Summary section, Beacon portfolios are custom tailored to each client's unique risk tolerance. Hence, our investment ideas may be appropriate for some clients, while not consistent with the goals and objectives of others. With these important caveats in mind, we humbly offer you some color around our top ten investment forecasts for 2023.

1. **U.S. stocks will rebound from the 2022 bear market and deliver positive returns in 2023.**

   It will probably be a bumpy ride, but a year from now we expect U.S. stocks, as represented by the S&P 500, to be in the green. We think inflation peaked in June and the Fed will eventually pause its rate hike cycle in 2023, both bullish scenarios for equities. Furthermore, last year's bear market has incorporated many risks into current asset prices and the third year of a Presidential Cycle is usually the best for stocks. Quite simply, politicians like to get re-elected are inclined to have an agenda to improve the economy. Earnings are projected to grow roughly 5% in 2023. Assuming a 2% dividend yield and a flat earnings multiple, the S&P 500 may provide mid to high single digit returns, with more upside achieved by prescient security section. However, we think the road may be rocky due to the likelihood of a recession beginning in 2023, as noted in Forecast 7 below.

2. **Bonds will return to acting as ballast for portfolios and also deliver positive returns over the full calendar year.**

   As noted in our introductory section, it was the worst year on record for most bond indexes and funds. Although interest rates surged in the early 1980s, investors were at least comforted with attractive coupons that cushioned the blow. Most bonds entered 2022 with meager coupons, resulting in sizeable capital losses when interest rates spiked across the entire maturity spectrum. Although we expect short-term interest rates to increase further (Forecast 3), we think rises in rates will be offset by the income generated from coupons. Furthermore, when stocks inevitably gyrate, we think bonds will go back to their historical role of acting as ballast to cushion the losses.

3. The Federal Reserve will continue to raise short-term interest rates in the beginning of the year and then pause.

The Fed has boxed itself into a corner in order to regain or maintain its credibility. It needs to keep raising short-term interest rates in order to get inflation (better) under control. Despite raising short-term interest rates 4.5% in 2022, inflation still remains a massive problem for most consumers with year-end readings still hovering over 7%. We do know that monetary policy tends to be implemented with a lag. Hence, at some point during the first half of the year, we think the Fed will pause on hiking further to assess the cumulative effect of its prior rate hikes. In our view, a rate *cut* may occur near the end of 2023 once the deleterious effects of the recession become clear, but investors should not bank on it.

4. Inflation will continue to fall, but remain well ahead of the Fed's 2% target.

Yes, inflation is falling, but 7.1% is still way above the Fed's stated target of 2%. Furthermore, items of great concern to most consumers, such as "food at home" inflation, have increased an astounding 12% over the past year. Although inflation is trending in the right direction, we think it will be a while before inflation averages 2% over any sustainable period of time. The Atlanta Fed tracks a measure they call sticky price inflation. As the name indicates, it is hard to get rid of this type of inflation (e.g., college tuition prices), in contrast to flexible inflation items (e.g., gasoline prices). Unfortunately, the sticky price inflation number recently clocked in at 5.5% and it unlikely to drop to 2% overnight. The Russia-Ukraine War, snarled, but improving, supply chains, and long-term labor contracts, further exacerbate inflation tendencies.

5. There will be a stock market correction in 2023, but it may represent a buying opportunity.

The rebound in stock prices from its October lows are welcome, but we aren't ready to say the coast is clear and that we are off to the races like in April 2020. We expect worsening economic data and tepid earnings forecasts during the first half of 2023 which may result in some investor angst and falling stock prices. A 10% or more drop may be in the cards with the market retesting its 2022Q4 lows. However, the stock market is a forward looking mechanism and a sustainable rally may begin in earnest when high levels of inflation and weak to negative economic growth are in the rearview mirror. In short, if there is a noticeable pullback in 2023, we would view it as a buying opportunity for long-term investors.

6. Real estate prices will continue to decelerate due to the recent surge in interest rates.

Real estate prices are usually inversely correlated with interest rates. The rise in mortgage rates to 7% for some borrowers will certainly put a damper on future home price appreciation. We think home price appreciation will struggle to make it into the mid-single digits and would turn negative at the national level, if there still wasn't a substantial housing shortage in many areas of the country. Commercial real estate is likely to remain challenged too, as the work from home trend continues. Although real estate is a traditional inflation hedge, we think this time (2023) may be different.

7. The U.S. economy will enter a recession in 2023.

The telltale signs of an impending recession have arrived. An inverted yield curve, a negative Leading Economic Index (LEI), a contractionary Institute for Supply Chain Management (ISM) manufacturing reading, a dissipating savings rate, and a spike in credit card borrowings. Rather than cutting rates, the Fed needs to keep hiking rates and have unemployment increase in order to bring down inflation to its oft stated goal of 2%. However, if there is a recession we believe it will be a "garden variety" one lasting less than a year.

8. The U.S. Dollar (DXY) will weaken over the remainder of the year, after the Fed pauses its rate hike campaign.

The U.S. Dollar rose sharply in 2022 against most currencies around the world. The Fed's rapid increase in short-term interest rates relative to most other central banks resulted in strong capital inflows. Furthermore, Russia's invasion of Ukraine resulted in "flight to quality" investors seeking safe harbor in the greenback. In addition, U.S. economic growth has been decent over the back half of the year, in contrast to the economic and other problems throughout much of Europe and China. Nevertheless, the days of a super strong U.S. dollar may be coming to an end. In our view the U.S. Dollar index (DXY) will begin to decline once the Fed halts its rate hike campaign, which we expect to occur in the first part of the year. A weaker dollar would be beneficial for U.S. firms that rely on foreign markets for a sizeable part of their revenue, as well as for many international investments.

9. **Technology stocks will rebound from a disastrous 2022.**

Technology stocks were the biggest losers of 2022. Predicting the demise of stocks with little to no earnings is not likely to win anyone a Nobel Prize. However, forecasting a 65% drop for Meta/Facebook, a 60% drop for PayPal, a 50% drop for Tesla, a 50% drop for Netflix, a 46% drop for Amazon.com, a 35% drop for Alphabet/Google, and 28% drop for Microsoft would clearly have been met with a bunch of blank stares if predicted for most of these names. Now that most of these prior market darlings have come back down to earth, with several now trading in the Value category, we think many are poised for a recovery, albeit in a lower and more sustainable orbit. Investible proxies for big cap tech may include the exchange traded funds, XLK and QQQ.

10. **The ongoing supply chain problems and computer chip shortages will largely disappear.**

As we noted previously, problems in the global supply chain, and especially with a shortage in computer chips, were among the important contributors to high levels of inflation around the world in 2022. Economics 101 tells us that if supply is down and demand is the same or up, prices have to go up. Some progress has been made in fixing these problems, but much work remains to be done. For example, try buying a new car at a price close to dealer invoice. In our view, a recessionary type environment will destroy some demand and continued improvements in supply will largely fix the problem. Things may not immediately go back to "normal" due to the war in Ukraine and the length of time required to find alternative manufacturing sources to China, but as we approach this time next year there is likely to be an equal number of articles citing "inventory glut" as there is supply shortage.

Beacon's Four Strategic Wealth Management Themes for 2023

Investment forecasts in and of themselves are interesting, but of little direct value. They must be actionable if they are to be valuable for our clients. Therefore, coupled with our Ten Investment Forecasts we offer Four Strategic Wealth Management Themes for 2023, which are often tied to the specific investments in your portfolio.

1. **Understand the paradox of a worsening economy, but improving financial markets.**

"The stock market is not the economy" is an oft heard financial expression, but sometimes difficult to grasp fully. A typical sequence of events begins with the Fed raising interest rates, the economy slowing down, inventory accumulating, profits decreasing, and firms laying off workers. Each of these economic headlines are negative; however, the actions usually sow the seeds of a subsequent economic recovery. Financial market participants understand these lead-lag relationships and asset prices often move 3-6 months in advance of the economy. The investment implication for clients is not to panic when the economic news seems grim, since better days usually reside ahead in the not too distant future.

2. **Be prepared for the "New Normal – Part II," an extended period of slower than normal growth.**

Recessions and expansions are part of economic life in a capitalistic society, but not all recessions and recoveries are created equal. PIMCO popularized the phrase "new normal" coming out of the Great Recession, which refers to a long-term period of below historical average (e.g. 3%) economic growth. The finances of the U.S. government are increasingly perilous. It is highly unlikely that individual citizens will again be getting stimulus checks in the mail or receiving material tax cuts. In contrast, taxes are likely to increase in various forms and benefit increases are likely to be delayed or rise at rates below inflation. An increasing part of the federal budget will go to paying interest on our nation's debt. Growth in international trade, another source of economic growth, may be reversed given the increase in protectionist policies. In short, only a burst in technological productivity is likely to get the U.S. and the rest of the world on the path to trend or better economic growth. Companies that may thrive in a slow growth world, such as those benefiting from secular tailwinds, should be favored.

3. **Build a portfolio for falling, but stubbornly high, levels of inflation.**

   Until the past year or so, deflation was a bigger economic worry than inflation, dating back to the start of the Great Recession. A pithy expression regarding inflation is, "Once the toothpaste is out of the tube it is hard to put back in." In brief, both producers and consumers see their costs going up in an inflationary environment and ask for their own increases in prices or wages. Only when there is a glut of inventory or high(er) rates of unemployment does this vicious cycle come to an end. In our view, neither condition is here, so the world is skewed in the near-term towards continued elevated inflation. In this economic environment, we favor companies that have the power to raise prices or those that aid in bringing down inflation. We also recommend a diversified portfolio of inflation fighting assets.

4. **Construct a portfolio that may thrive in a Cold War - Part II environment.**

   According to some interpretations, the United States is currently engaged in a proxy war with Russia by supplying Ukraine with military equipment and financial support, in order to help Ukraine resist the ongoing, unprovoked invasion. A percolating trade war is continuing between the U.S. and China, with a recent development related to restrictions placed on the export of high-end computer chips to China. Trade tensions and COVID restrictions have resulted in many multinational firms re-engineering their supply chains away from China, with Mexico, Vietnam, and India among the nations expected to see an increase in direct foreign investment. Each of these events, and many others on the geopolitical stage, have secular investment implications that we consider at Beacon while picking individual securities, investment funds, and in constructing client portfolios.

We at Beacon look forward to the opportunity to discuss our Ten Investment Forecasts with you, as well as the ways in which our Four Strategic Wealth Management Themes can be custom tailored to your personal situation. As always, we close by thanking you for your loyalty and support. We consider our relationship with our clients a true partnership, and our sole mission as a firm is to add value to our clients in any way we can. It is with the fulfillment of this mission in mind that each of us at Beacon is focused on individual and collective improvements each day. We also wish you a happy, and especially healthy, holiday season and a wonderful New Year.