are currently priced into the market, and more pain for stocks and bonds in 2023.

Our Economic Outlook – Let's dust off the crystal ball. We currently think 2023 will be a tale of two halves. In the first half we suspect investors will struggle to get a handle on where the economy and inflation are headed and how central bank policy will adapt. Markets will swoon on every hot CPI report and spike higher on hints of economic weakness (again, markets work in a perverse way). But ultimately, we think the economy softens and price pressures relent. The discussion about a recession is likely to pick up as the housing market stagnates, manufacturing continues to contract, and consumer spending slows. But the good news is that this means policy makers can take a pause. This implies that the markets find a footing in the second half of the year.

Market Implications – Let's address the bond market first. This time last year a well-diversified fixed income portfolio was yielding less than 2% annually. Today that same portfolio is generating 5% plus. This looks pretty attractive. Furthermore, if the economy does dip into recession later this year, there's a good chance fixed income investors will see some capital gains over the short-term. Now whether bonds offer good long-term opportunities today depends largely on where inflation normalizes at. If inflation is headed to between 2% and 3%, bond yields look pretty decent on an inflation adjusted basis. But they are far from a fat-pitch if inflation normalizes at 4% plus. It's going to take time to get a read on the longer-term inflation outlook. Currently we are positioned in relatively short maturity bonds where we can easily get yields over 5% without taking undue risk. But we are looking closely at our bond allocation to adjust strategy in 2023.

As for stocks, we think we see more of the same in the first half of 2023 – continued volatility with dissimilar returns across sectors. The good news is that much of the froth in the market has been taken out. Speculation has dried up and valuations in many areas are now normal to erring on the cheap side. This means any correction should be viewed as a buying opportunity for value-oriented investors. And we think value is key again in 2023. If you look at relative earnings trends, we could very well see meaningful earnings contractions in many of the growthier sectors such as online advertising, alternative energy, cloud computing, etc. Conversely, many of the value sectors could see modest growth (think energy stocks, healthcare, some financial sectors). This means another year of disparate returns in the market, and we have tilted our portfolios towards value exposures both domestically and internationally.

We are starting to change our minds on international stocks. For the first time in a long time, there's a chance the overseas markets gain some ground versus U.S. equities. This isn't so much a valuation story - European and emerging market stocks have been cheap for some time. But for once the earnings outlook for global equities looks better than that for large-cap U.S. stocks. International equities might have fits and starts in the first half as we get a handle on inflation and what China's reopening means for the global economy, but we think we could see relative outperformance for the full year.

Final Thoughts – To circle back to our original question as to whether investors should extrapolate the great repricing theme into 2023 and beyond? We think this would be a mistake – at least for this year. We think central banks will do what is necessary to cool price inflation, and it is quite possible they have done enough already. It may take a few months for the hard data to support the idea of cooling prices, but ultimately we think the markets will stabilize on signs of durable progress on the inflation front. And this will be more important for investors than worries about recession or earnings contractions. We do worry about longer-term inflation challenges, though, and will write more about this in coming quarters.

What risks could throw things off course? There's the usual laundry list of geopolitical worries. Maybe the biggest issue is what happens with energy prices. Could Putin weaponize Russian oil production? Could the end of China's zero-COVID policy spur energy demand? Both would prove problematic given the supply backdrop. Politics in the U.S. is another wildcard. Does the current mayhem in the House translate into a battle over the debt ceiling later this year? You can't rule anything out in our highly charged political environment. But ultimately, we think there are some decent opportunities in both the stock and bond markets today that should reward investors over the coming quarters, especially if we don't see a repeat of 2022's great repricing move in rates.

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Chief Investment Officer

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