Quarterly Economic Update
First Quarter 2023

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It's probably a fair assumption to say that most investors are happy 2022 is in the books. After enjoying the longest bull market in history, from after the financial crisis in 2009 to the beginning of the COVID-19 pandemic, the bear finally officially rose from its slumber and dominated Wall Street. There's no sugar-coating the fact that if you had money invested in the financial markets in 2022 it was an unpleasant year, perhaps even one of the worst you will experience as an investor.

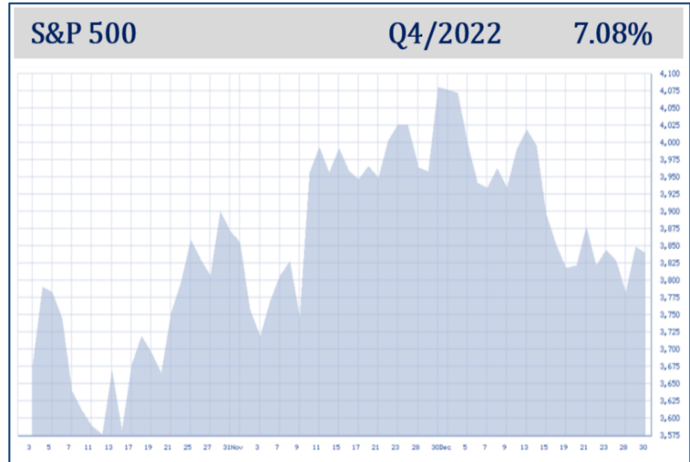
The major indices all declined last year – ranging anywhere from the New York Composite's return of -11.5% to the Nasdaq Composite's return of -33.1% (*the S&P 500 closed down 19.4% for the year*). The biggest outlier, however, was the decline in the overall bond market (*which had a larger decline than some of the stock market indices*). A traditional balanced portfolio (*60% stocks, 40% bonds*) had its worst performance in over 50 years.

The last three years investors have faced a number of unusual circumstances, moving from pandemic shutdowns and a bear market in 2020 to all time equity market highs in 2021 with a sporadic recovery, rising inflation, and supply-chain disruptions.

In 2022, major market reaction to macro events has been devastating with the worst U.S. stock market performance since 2008. International conflicts increased, highlighted by the Russian invasion of Ukraine and its consequence of an energy crisis. Soaring inflation pressures this year led to aggressive rate hikes from central banks causing the equity price valuations to plummet. A contentious U.S. domestic political environment also continues, with unprecedented government spending programs and record-setting budget deficits.

As we look toward a new year, multiple factors remain key issues for the direction of equity markets, most particularly, the continuation of rising interest rates and speculation around rates, and how long and how deep of a recession the U.S. and global economy could see in 2023 and beyond. Uncertainty remains and wise investors should have a sufficiently diversified portfolio that looks for balance in times of volatility. This is a key time to practice patience and to remain focused on your personal long-term goals.

As we close out what was undoubtedly a rough year for equity markets, investors are bracing for another potentially mercurial year. **As your financial professional, we are committed to keeping you apprised of any changes and activity that could directly affect you and your unique situation.**



MONEY RATES

(as posted in Barron's 12/26/2022)

	LATEST WEEK	YR AGO
Fed Funds Rate*	4.34%	0.08%
Bank Money Market[z]	0.25%	0.07%
12-month Certif[z]	1.35%	0.14%

z – Bankrate.com (Source: Barron's; bankrate.com)
** - Average Effective Offer*

Inflation & Interest Rates

During 2022, Americans saw seven federal interest rate increases. In their efforts to use interest rate increases to lower inflation, the Federal Reserve (Fed) ended a decade of historically low interest rates and raised rates twice in the fourth quarter of 2022. In November, rates increased 0.75% for a target rate range of 3.75 – 4.00%. Then, as planned, the Fed again raised rates at the December meeting. However, because inflation started to show potential signs of slowing down in the months prior, the Fed raised it by only 50 basis points, to a range of 4.25 – 4.50%. This marked a 4.25% total rate increase in 2022, the fastest upward cycle of interest rates in history.

It has been hypothecated that the return of inflation readings out of the 1970's has brought the curtain down on the decade-plus experiment with extraordinarily accommodative monetary policy. 2022 may have marked the end of a monetary policy era. We don't necessarily expect a return to zero interest rate policy or gargantuan asset purchase programs in the near future.

Due to the continued rise of interest rates, here are some key areas we like to remind clients of:

- The cost of borrowing is up, therefore, proactively pay off all non-essential higher interest-bearing debt and maintain liquidity for short-term purchases.
- If you have a mortgage, we would be happy to review your rates.
- Review all income-producing investments.

It's always possible that the Fed can engineer that most sought after and magical of resolutions, namely a soft landing. However, it takes six months or more for the effect of interest rate hikes to show up in the real economy. That is why managing economic growth with interest rates is so difficult and why a cycle of rate hikes by the Fed often leads to a recession. As of yet, the full impact of the Fed's policy tightening has not had time to percolate through the economy. Current and prospective tightening may eventually generate greater than anticipated economic weakness ahead once policy rates have well exceeded their neutral rate for a period of time.

We will keep a vigilant eye on the federal interest rate movements and inflation. When rates will stagnate and for how long they will remain there is yet to be seen.

The Bond Market and Treasury Yields

Simply put, bonds had a terrible year and the bond market had one of its worst years ever. The total return of the Bloomberg Aggregate Bond Market Index (which dates back to 1976) of -13% in 2022 was far and away the worst loss ever for this total bond market index.

Now that rates have risen, treasury yields in this environment can be a viable asset class for a diversified portfolio. As of December 30, 2022, 5-year notes yielded 3.99%, 20-year notes yielded 4.14%, and the 1-year treasury rate closed at 4.73%. *(Source: ycharts.com)*

Bonds are often a good diversification option for a conservative, balanced portfolio, as they are typically considered more stable than stocks. However, bond investing can be tricky. The window of opportunity to get lower-risk, higher yielding bonds could be short-lived if the Fed's feel the need to cut rates to prevent a recession. Keep in mind, bond prices and interest rates move in the opposite direction. Should the Fed decide to do a reversal and cut rates, the opportunity for this strategy would shift (*as it always does through changes in the Business Cycle*). Hence, this strategy requires active portfolio management. Also, please remember, while diversification in your portfolio can help you reach your goals, it does not ensure a profit or guarantee against loss.

KEY TAKEAWAYS

- The Fed raised interest rates twice in the fourth quarter, to a range of 4.25 – 4.50% for a 4.25% total rate increase in 2022, the fastest upward cycle in history.
- The Fed is positioned to further increase federal interest rates in 2023.
- Inflation showed slowing signs, with a rate of 7.1% for the 12-month period ending November.
- Recession concerns are on the rise.
- With the Fed's increase in interest rates, bond yields may provide favorable returns.
- Volatility remains an investor fear in 2023.
- Staying the course and maintaining a well-devised, long-term focused plan has historically served investors well.
- ***We are here for you to discuss any financial concerns you have.***

Navigating An Unusual Cycle

It is now clear that monetary policy was much too easy last year. Cheap and plentiful money ALWAYS leads to inflation as we see today, just as we saw in the 70's and early 80's. In this respect, the normalization of interest rates should be viewed positively; it has greatly reduced an economic imbalance which could have sowed the seeds of a destabilizing future economic shock.

The popular view has it that a recession is an odds on probability for early 2023. As such, it is the most widely forecasted business cycle contraction in history. While the odds of a U.S. recession on a 12-18 month horizon are somewhat elevated, still solid prospects for consumption (*backed by still-sizable excess savings, good income growth and the tailwind of cooling headline inflation*) argues in favor of a delayed recession. Flush households underpin the call that the recession may arrive later than the consensus expects, or that it may be a mild one. Households have only worked through about a third of their excess pandemic savings and it is estimated their remaining $1.5 trillion will afford them ample capacity to stave off a recession until late 2023/early 2024.

Anything but Ordinary, Expecting the Unexpected in 2023

Many experts maintain that the current inverted yield curve (short-term rates are higher than some long-term rates) is indicative of a recession. However, if, when, and how severe a recession should occur in 2023 is all still speculation.

We won't enter the fray of those calling for or against a recession in 2023. As the timing of it is under debate (*early 2023, late 2023, 2024),* and with so much of the outcome dependent upon the inflation trajectory (*how sticky will it be?),* **we believe there is higher than normal uncertainty in the path of the economic cycle this year.** At this point, it is better to err on the side of caution. If we sound like we are pessimistic, nothing could be further from the truth. We think 2023 will bring a wonderful opportunity once inflation is clearly on the decline and the Fed begins to hint at an end to the rate hikes. That may not happen immediately, but it will happen.

We realize that our beginning-of-the-year positioning may have a shorter shelf life than usual. We begin 2023 in a moderately balanced position – with a nimble bent, ready to make adjustments as the economy and stock markets indicate (*as well as protect against choppy markets*). We will be looking for opportunities in late cycle leaders such as health-care and financials, as well as other potential opportunities such as international and maybe even a little gold (*just for fun*). A pivot to Fed rate cuts is likely needed to improve the outlook for early-cycle sectors such as consumer discretionary and technology.

Zephyr's two-tier strategy is designed to grow wealth during favorable business cycle conditions and protect clients' assets during difficult periods. Looking back, we regret that we did not turn more bearish in the spring last year when the transitory inflation narrative began to crumble (*we have since used that period as an opportunity to fine tune our research process*). In 2022, we know with 100% clarity that nearly every investment style suffered one of the worst single years in modern history. Looking forward, we believe timing the shift in overweighting-underweighting major asset classes, such as **stocks** (*e.g. growth vs. value vs. international),* **bonds** (*e.g. short-term vs. long-term)* and **cash** may be one of the most important asset allocation decisions for investors to get right over the coming year.

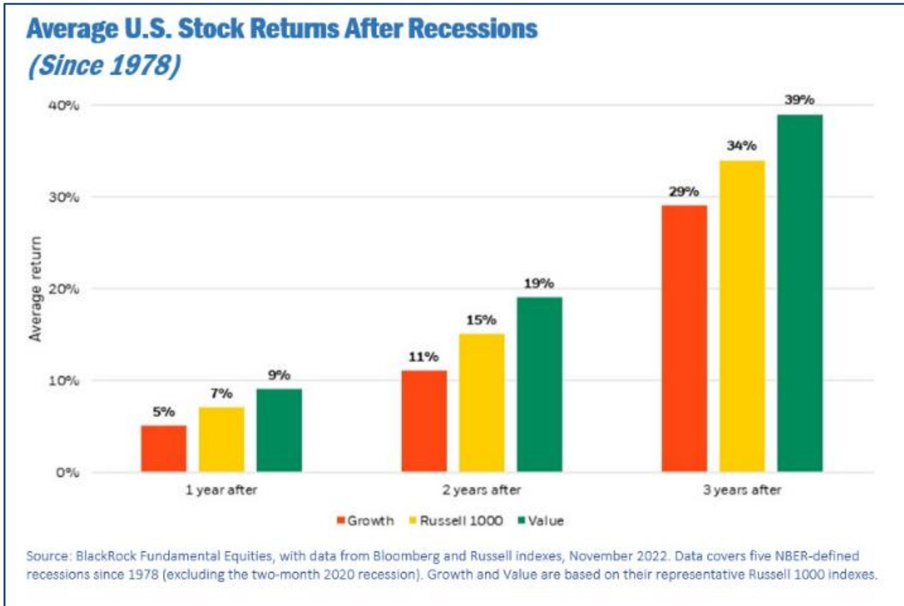
Investor's Outlook

As the Feds keep tightening monetary policy, consumers may need to continue to tighten their budgets. From food, fuel, energy, and everything in between, Americans are paying more for just about everything. Refocusing and revamping your budget now could provide direction and clarity on where your money is going, what is a necessary expense, and what is discretionary in this new year.

The bear market is expected to continue at least into the first part of 2023. Bear markets are a very normal and reoccurring part of the investment experience. While we can all try to foresee the future, no one can predict the length or severity of any recession.

Some key areas we are watching for in 2023 include:

- Inflation rates
- Continued rising interest rates
- Economic growth rate
- Tightening of monetary policy
- The Russian-Ukraine war



- China's "re-opening" after their strict "zero-COVID" policy
- The continued slowdown in global growth

2023 may test the patience of many investors. **The greatest risk of all time for investors in the throws of a deep and lasting bear market is the risk of giving up**. Giving up is that moment when you can't stand to lose another single dollar to a market that feels hopeless. Giving up by those whose patience has run out happens at or near the very lows of every bear market. The market has a way of punishing the greatest majority of investors possible so we might stay open to some dramatic reversals in 2023. The best time to add risk to a portfolio is when the economic data looks its worst. We should also be aware that significant bear market BOTTOMs occur smack in the middle of labelled and acknowledged economic recessions. **Historically, investors who did not give up during a bear market were rewarded for their patience with healthy returns.**

Our goal as the steward of your wealth is to help you through challenging times like these. As a skilled professional we always attempt to help you create a well-crafted plan customized for your unique situation and goals that takes into consideration how you will react to the markets ups and downs, including your time horizon, tax implications, liquidity needs, risk tolerance, and your overall personal objectives.

We recommend discussing with us any changes, concerns, or ideas that you may have prior to making any financial decisions so we can help you determine your best strategy. As always, please feel free to contact us with any questions you may have. Remember that as a valued client, we are always accessible to you!

Complimentary Financial Check-up

Our goal this year is to help others with their financial decisions.

If you are currently not a client of Zephyr Investment Management, we would like to offer you a complimentary, one-hour, private consultation with one of our professionals at absolutely no cost or obligation to you.

To schedule your financial check-up, please call Cher at (805) 496-6810

"We Cannot Direct the Wind, But We Can Adjust the Sails."

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