BERNSTEIN

# Four Years in One

We tend to be wary of consensus views. However, there's currently one where we find ourselves and our clients in full agreement: We're all happy to have 2022 behind us.

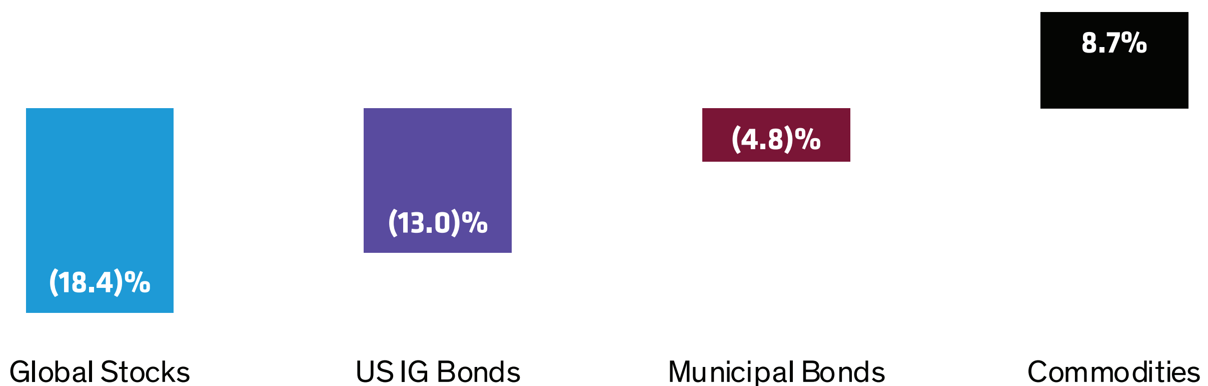
Make no mistake, we have seen our fair share of positive economic statistics during the year. The US economy created roughly five million jobs and wage growth surged 5.1%. On top of that, corporate earnings rose 15% through the third quarter relative to the prior year.

Yet, the three major stories of the year—and their ripple effects on the markets—were far more negative. Indeed, between all these stories, it felt like four years' worth of news packed into one. Russia invaded Ukraine, creating a humanitarian crisis in Europe while stoking an inflationary backdrop that central bankers were already struggling to smother worldwide. Inflation became ***the*** dominant driver of the global economy, moving squarely away from the initial "transitory" track. This shift forced both policymakers and the markets to raise interest rate forecasts dramatically, with the Fed hiking rates by 4.25 percentage points versus their expectation for 0.75 percentage points last December. This truly historic rate pivot has had few rivals. Previous moves of a similar magnitude only occurred in 1994 and back in the 1970s.

The combination of prolonged inflation and rapidly rising interest rates took both stock and bond values out to the proverbial woodshed. The net result was that investors endured the worst performance for 60/40 stock and bond portfolios since the Global Financial Crisis. Global stocks fell 18.4%, US investment grade bonds fell 13.0%, and high quality intermediate duration municipal bonds fell 4.8% (**Display 1**).

Each season seemed to come and go with its own set of leaders and laggards. For instance, given the inflationary pressures and supply constraints caused by the Russian invasion, commodities enjoyed several months in the sun, rising by almost 50% through the middle of the year. But even they gave back nearly all their gains, ending the year up just 8.7%.

**DISPLAY 1: 2022 TOTAL RETURNS OF KEY ASSET CLASSES**




As of December 31, 2022. Stocks are represented by MSCI ACWI IMI, investment grade bonds by Bloomberg Barclays US Agg, municipal bonds by Bloomberg Muni 1-10 year Blend Index, and commodities by S&P GSCI Index.

**Source:** MSCI, S&P, Bloomberg, and Bernstein analysis

As the year wound down, the market's focus turned from the inflationary picture to the question of growth. Will a recession emerge in 2023? Corporate earnings expectations appear too high, but just how overly optimistic will they prove to be?

### The Seeds of Tomorrow's Returns

While it may feel like little consolation for 2022's market pain, we hope long-term investors will be able to forget this year in relatively short order. We also see a chance to benefit from heightened future returns created by the broad sell-off across asset classes.

Indeed, after a decade of frustration with paltry bond yields, this year finally put the "income" back in "fixed income." Beyond that, we've moved from an era of TINA ("There Is No Alternative"), which forced investors to allocate more to stocks, to an era of TARA ("There Are Reasonable Alternatives"), which argues for more diversification.

Ultimately, the silver lining of a down year is the potential for higher future returns. Across asset classes, our long-term return expectations ended 2022 materially higher than where they stood at the end of 2021 (**Display 2**).*

### Looking Ahead

As we lay out our expectations for 2023, we do so with a generous helping of humility. Forecasting is always difficult. With a turbulent backdrop generated by several years of major global surprises, it's especially difficult today. Our full views for the year and beyond will be featured in our team's 2023 outlook, coming out next week.

In general, the macroeconomic backdrop appears weak. Our base case calls for the US to undergo a light recession in 2023, with real GDP growth roughly flat for the year, unemployment rising, and many sectors of the economy feeling the impact. This is the price the Federal Reserve seems willing to pay to put the inflation genie back in the bottle. And we do expect inflation to decline throughout the year, though not all the way back to the Fed's 2% target.

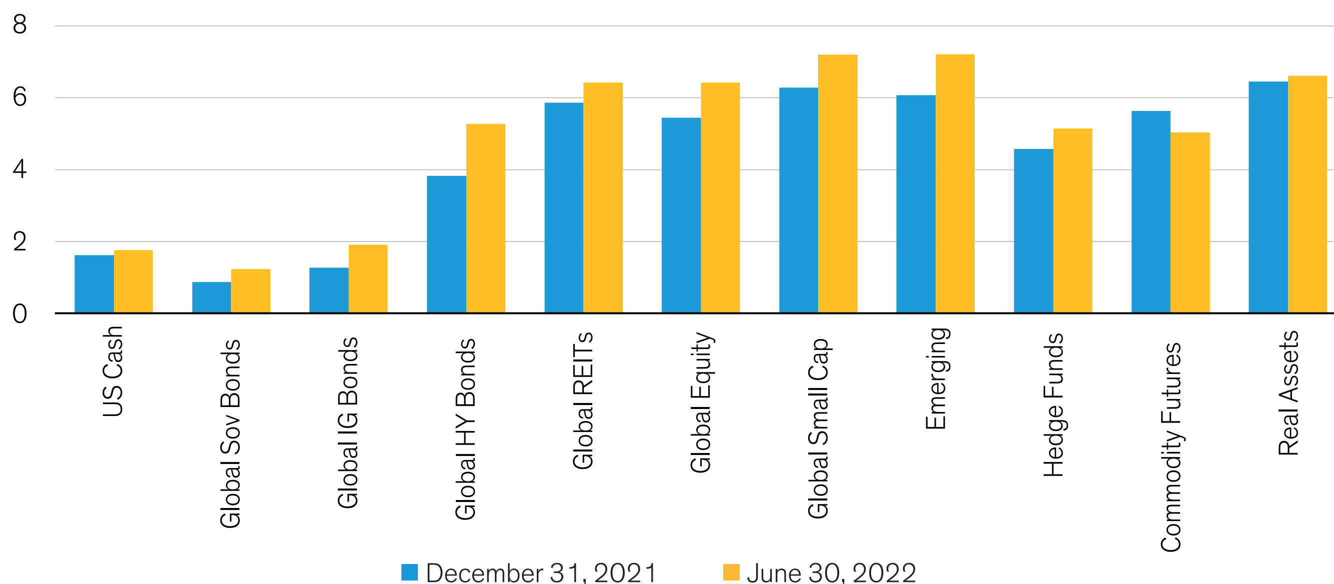
The picture remains largely the same around the world, with Europe and the UK seemingly poised to suffer more severe contractions due to more acute inflationary pressures and greater need for a policy response. In China, we'll be watching the emergence from COVID lockdowns and the impact on local growth, international supply chains, and global inflationary pressures.

As a whole, the situation could improve if recent inflationary pressures reverse more quickly than anticipated, allowing interest rate policy to stabilize or even slightly ease. That could drive economic and earnings growth higher, along with improved sentiment from consumers, companies, and investors.

The risks to our base case remain a more severe recession and market decline, which could be prompted by curtailed consumer spending, worse corporate cost cutting, or central bankers getting it wrong with more aggressive action than necessary.

**DISPLAY 2: THE RETURN OUTLOOK HAS IMPROVED ACROSS ASSET CLASSES**

December 2021 Forecasts vs. June 2022 Forecasts (Percent)




**Source**: Bernstein analysis

*Our updated long-term capital market expectations, based on economic and market data as of December 31, 2022, will be available in several weeks. However, we can roughly estimate they'll be higher than those from a year ago and close to those of June 30, 2022 due to similar levels for major stock market indices, similar credit spreads, and higher yields for sovereign bonds at the ends of Q2 and Q4 2022.

## Focus on What You Can Control

As the new year gets underway, our team is focused on areas where clients can help themselves rather than wistfully waiting for the market's cooperation.

At the top of the list sits proper financial and tax planning—maximizing the use of tax-advantaged accounts, adopting tax-loss harvesting strategies, and putting temporarily depressed assets to their best tactical use.

In addition, with meaningful yields resurfacing in the fixed income markets, we reiterate our longstanding view that investors should have 6-12 months of cash on hand. Depending on your time horizon and risk tolerance, there are now more options for that cash—from money market funds to short duration bonds (and even intermediate duration bonds), with muni yields ranging from 3-6%.

Finally, we believe that many individual investors still have too little allocated to alternative assets.

Depending on which strategies investors choose, alternative investments may enhance portfolio performance over time by adding to total return potential and diversifying exposures to various macroeconomic risks. 2022 represents a prime example—while not all alternatives succeeded during the year, many of them stood out as bright spots in investors' portfolios.

Our goal, as always, is to create long-term portfolios that address whatever surprises the world throws our way—from pandemics to wars, growth shocks to inflation woes. In addition, we look for opportunities to take advantage of mispricing whenever short-term events cause the markets to disconnect from reality. Our portfolio managers and investment strategy team are constantly on the lookout for the best risk-adjusted returns for individual securities and asset classes, respectively. With appropriate diversification and an allocation that matches your risk tolerance, we can fortify a sturdy long-term portfolio that's designed to achieve your financial objectives over time.

Once again, thank you for trusting us as the stewards of your wealth. We'll continue to work every day with your best interests in mind and feel optimistic for a more prosperous partnership in 2023.

**Alex Chaloff**

**Beata Kirr**

Alex Chaloff and Beata Kirr are Co-heads of the Investment Strategy team at Bernstein, a group of senior investment professionals who develop our investment advice and are responsible for investment outcomes. The team oversees Bernstein's investment offerings, ensuring that our asset allocation advice, suite of strategies, and development of new investment ideas are continuously focused on moving our clients forward with strong after-tax risk-adjusted returns. Both Alex and Beata have spent their Bernstein careers refining our investment platform, listening to clients, and conducting deep research into investment topics that are critical to achieving clients' goals.

**Past performance does not guarantee future results.** Alternative investments involve a high degree of risk and are designed for investors who understand and are willing to accept these risks. **There can be no assurance that any alternative investment strategy will achieve its investment objectives.**

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