

2022 was a very challenging year for investors. The global macroeconomic environment was dominated by much stronger than expected inflation, which hit multi-decade highs and led central banks to embark on their most aggressive tightening cycle in a generation. In addition, geopolitical unrest brought on by Russia's invasion of Ukraine and ongoing supply chain problems added to investor anxiety and led to greater financial market volatility. U.S. stocks, as measured by the S&P 500® Index, moved in and out of "bear market" territory repeatedly in 2022 (a bear market is defined as a decline that exceeds 20% from the peak value of the index). After initially dropping into a bear market in June 2022, and then partially recovering, stocks slipped again, reaching a new low for the year in October

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2022 before recovering modestly into year end. Again, it was the Federal Reserve's (the "Fed") rate hike campaign and growing fears of a recession brought on by a potential central bank policy error that made it a difficult year for equities. The S&P 500 saw its biggest annual decline since 2008, finishing the year down 18.13%, despite a 7.55% gain in the fourth quarter. International markets experienced the same issues as the European Central Bank and Bank of England tightened monetary conditions to offset inflation caused by the COVID re-opening and the war in Ukraine. Foreign developed markets, as represented by the MSCI EAFE Index, fell 13.92% during the year. Emerging markets endured another tough year with the MSCI Emerging Markets Index slumping 19.94% in 2022. Fixed income markets have also been negatively impacted by central bank actions as returns for the leading bond benchmark were the worst in its history. The Bloomberg Barclays U.S. Aggregate Bond Index declined 13.01% for the year. Looking deeper into the fixed income markets, it is interesting to note that it was also an incredibly bad year for U.S. Treasuries. The iBoxx USD Treasury Total Return Index posted its worst annual performance since it began keeping track of the data in 1973 (down 12.95%). Longer-term data released by Bank of America's Global Research team showed that it was the worst year of total returns for the U.S. 10-year Treasury Note since 1788!

## ARE WE OUT OF THE WOODS YET?

During 2022, we suggested that the performance of financial markets would be dependent upon actions taken by the Fed. Looking ahead to 2023, we believe that corporate earnings will be a key determinant of the future direction of equity markets. After a historically aggressive rate hiking campaign in 2022, the current Fed rate hiking cycle is likely close to completion. Inflation has shown definitive signs of peaking and declining. The Consumer Price Index has fallen from a high of 9.1% in June to 7.1% in November, while other metrics of inflation have registered similar declines. Many economists are forecasting CPI to be under 4% by late spring. As such, in December, the Fed signaled that it expects the peak Fed Funds rate to be 0.75% higher than current levels,

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with the market expecting the Fed to reach the peak rate (a range of 5.0%-5.25%) within the first few months of 2023. While the end of the Fed rate hike cycle should remove a

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considerable headwind to asset prices, we believe they may have waited too long to adjust policy. Many real-time and forward-looking indicators are showing signs that the Fed rate hikes have had a dampening effect on the economy. First, the housing market is weak with existing home sales falling for the 10th straight month in November due to high mortgage rates. In addition, housing starts also continue to fall. Second, the Institute for Supply Management’s (“ISM”) manufacturing and non-manufacturing indices have shown contraction in both factory activity and the services sector. Lastly, the Leading Economic Indicators (“LEI”) were at -4.5% as of its last reading in November. As a reminder, the LEI is a composite of ten economic data points designed to signal peaks and troughs in the business cycle, and recessions have historically occurred when LEIs are negative. While we are not definitively saying that we are going to experience a recession in 2023, the odds of one occurring have increased, as the Fed has been too aggressive at tightening policy. Therefore, we believe corporate earnings will have a key impact as to how equity markets perform in the coming quarters.

Tightening financial conditions should create a more challenging backdrop for earnings. Economic growth will likely continue to slow down since the effects of firmer monetary policy over the past ten months have yet to be felt. According to FactSet, analysts are currently estimating that earnings for the S&P 500 are going to grow 5.3% in 2023. That seems somewhat optimistic in our opinion given the slowing economy. However, Wall Street analysts are perennially overoptimistic when it comes to future earnings expectations. So instead, we will look at what the equity market may be assuming for future earnings growth using the historical Equity Risk Premium (“ERP”) for the S&P 500. The ERP is the level of excess return required by investors, to compensate for the additional risk of investing in equities over bonds. It is calculated by taking the earnings yield on the S&P 500 less the inflation adjusted yield on the U.S. 10-year Treasury Note. If we were to take the historical ERP of 4.47% and add the inflation adjusted yield of the U.S. 10-year Treasury Note as of December 30th, which was 1.35%, we

come up with an earnings yield of 5.82%. Using the quarter end value of the S&P of 3,840, we would calculate that the market is expecting EPS of \$223.49 for 2023 (5.82% X 3,840). The current estimate of EPS for the S&P 500 for 2022 is \$220.33, so based on the historical ERP, the market appears to be pricing in an earnings increase of 1.4% or  $(\$223.49 \div \$220.33) - 1$ . It would appear, based on this method, that the market is not pricing in any negative impact to earnings from a slowdown in economic growth. As such, if corporate earnings come in better than expected (with flat or positive growth), then we are probably near the bottom of the current correction in equities. However, equity investors may need to lower their return expectations for 2023 as current market pricing leaves little room for disappointing news on the economic front. Again, we are not 100% certain that we will experience a recession in 2023, much of that will depend on how much of an impact higher interest rates will have on the economy (which is not yet known). According to data compiled by Goldman Sachs, S&P 500 earnings have dropped an average of 14.5% from peak-to-trough during the 12 recessions that have occurred since World War II. So, if a recession were to occur, we would expect to see continued weakness in equities.

Whether or not we do enter a recession, it is still important to have exposure to equities. In all cycles since 1950, bull markets had an average return of 265%, compared to a loss of 33% for bear markets. The strongest gains have often occurred immediately after a bottom, which is nearly impossible to determine (there is an old Wall Street proverb that says, “Nobody rings a bell at the top or the bottom of a market”) so sitting on the sidelines waiting for an economic turnaround is not a recommended strategy. Given the current conditions we believe it is best to have exposure to companies capable of generating earnings no matter what the environment happens to be. We prefer businesses with large strategic moats, and low levels of leverage, that provide critical products or services and have a proven track record of EPS growth.

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## NOWHERE TO HIDE

It was a difficult year for investors looking to reduce risk by diversifying their portfolios amongst stocks and bonds. Bonds have traditionally provided “ballast” to portfolios as their ability to generate income and provide low correlation to stocks make bonds a leading choice as a diversifier and a way to manage risk. In theory, bonds ought to perform well during periods of rising risk – slower economic growth, war, general uncertainty – serving as a defensive asset within a portfolio. Even in past periods of sharply rising interest rates, bonds have usually delivered positive returns since the income from a bond’s coupon offsets bond price declines. However, with interest rates starting the year near historical lows (the yield on the U.S. 10-year Treasury Note was 1.51%), returns were weak without the cushion of higher coupon income. Despite this year’s poor performance in fixed income, we see a silver lining in 2023. Given the higher yields

now offered, the risk/reward tradeoff for bonds has improved, and we believe there is a compelling opportunity in short-term U.S. Treasuries. With yields over 4%, and inflation appearing poised to come down, investors have the chance to earn some positive inflation adjusted income. Even if rates were to increase by 1%, the income earned will provide a buffer for returns. Remember, an increase in rates from 4% to 5% is much less punitive on returns than an increase from 1.5% to 2.5%. In addition, if we enter into a recession, and the Fed decides to cut the Fed Funds rate, bonds could realize some capital appreciation as well.

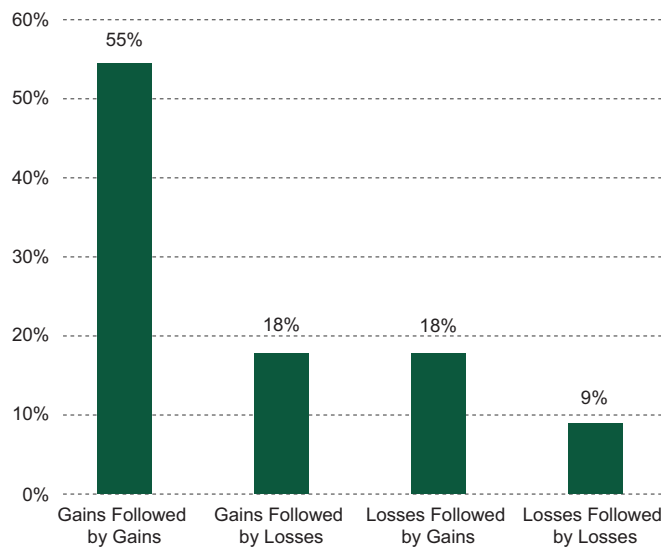
2022 was the second consecutive year in which the Bloomberg Barclays U.S. Aggregate Bond Index posted a negative return, as the index was down 1.54% in 2021. This is a very rare occurrence. The table below shows the annual return of the U.S. 10 year Treasury Note going back to 1928

### 10 Year U.S. Treasury Note Annual Returns: 1928–2022

Year	Annual Returns	Year	Annual Returns	Year	Annual Returns	Year	Annual Returns
1928	0.84%	1952	2.27%	1976	15.98%	2000	16.66%
1929	4.20%	1953	4.14%	1977	1.29%	2001	5.57%
1930	4.54%	1954	3.29%	1978	-0.78%	2002	15.12%
1931	-2.56%	1955	-1.34%	1979	0.67%	2003	0.38%
1932	8.79%	1956	-2.26%	1980	-2.99%	2004	4.49%
1933	1.86%	1957	6.80%	1981	8.20%	2005	2.87%
1934	7.96%	1958	-2.10%	1982	32.815	2006	1.96%
1935	4.47%	1959	-2.65%	1983	3.20%	2007	10.21%
1936	5.02%	1960	11.64%	1984	13.73%	2008	20.10%
1937	1.38%	1961	2.06%	1985	25.71%	2009	-11.12%
1938	4.21%	1962	5.69%	1986	24.28%	2010	8.46%
1939	4.41%	1963	1.68%	1987	-4.96%	2011	16.04%
1940	5.40%	1964	3.73%	1988	8.22%	2012	2.97%
1941	-2.02%	1965	0.72%	1989	17.69%	2013	-9.10%
1942	2.29%	1966	2.91%	1990	6.24%	2014	10.75%
1943	2.49%	1967	-1.58%	1991	15.00%	2015	1.28%
1944	2.58%	1968	3.27%	1992	9.36%	2016	0.69%
1945	3.80%	1969	-5.01%	1993	14.21%	2017	2.89%
1946	3.13%	1970	16.75%	1994	-8.04%	2018	-0.02%
1947	0.92%	1971	9.79%	1995	23.48%	2019	9.64%
1948	1.95%	1972	2.82%	1996	1.43%	2020	11.33%
1949	4.66%	1973	3.66%	1997	9.94%	2021	-4.42%
1950	0.43%	1974	1.99%	1998	14.92%	2022	-17.83%
1951	-0.30%	1975	3.61%	1999	-8.25%		

Source: NYU

## Large Cap U.S. Stocks From One Year to the Next: 1928–2022



Source: NYU; Returns from 1928-1956 calculated using the S&P 90 Index, S&P 500 was used from 1957 to present

(note we used the U.S. Treasury as a proxy for bonds, as the Bloomberg Barclays U.S. Aggregate Bond Index only has data going back to 1976). As you can see, the only other occasion in which bonds posted consecutive years of negative returns in the past nine-plus decades was in 1955-1956 and 1958-1959, which coincidentally was another time period when rates rose from a low starting point. During that same timeframe, U.S. Treasuries have never posted three consecutive years of negative returns. Given the historical data, the prospects for bonds look encouraging in the coming months.

We would also be remiss if we didn't highlight the fact that back-to-back down years for equities are also a rare occurrence. Declines of the magnitude witnessed in 2022 are usually followed by recoveries, not further weakness. Since 1928, large cap U.S. stocks have posted consecutive losses just 9% of the time (see chart at left).

Lastly, if you want to look at the bright side of things from a diversification perspective, there has never been a period where both stocks and bonds were both down in consecutive years at the same time.

## IN SUMMARY

With U.S. inflation set to cool and policy rates set to peak in early 2023, investor focus shifts to the slowing economic growth and the earnings outlook. As such, we remain cautious about equities until we get more clarity about the ultimate impact Fed policy will have on the economy and corporate earnings. A recession in 2023 can't be ruled out. If we do enter into a recession, we would expect additional weakness in stocks before the start of a new bull market in anticipation of a new economic cycle. Again, it is not 100% certain that we will have a recession, therefore it is important to maintain an allocation to equities that corresponds to your financial position, risk tolerance, and investment time horizon. Successful investing is a marathon, not a sprint. Even during periods of intense volatility, it is always critical to remain patient and adhere to the asset allocation set up to meet your long-term investment goals.

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On behalf of the team at Beaumont Financial Partners, we hope you had a wonderful holiday season and wish you a happy, healthy 2023!

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Past performance is no indication of future results.

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The MSCI EAFE Index is a stock market index that is designed to measure the equity market performance of developed markets (Europe, Australasia, Far East), excluding the U.S. & Canada. The MSCI EAFE Index is an equity index which captures large and mid-cap representation across Developed Markets countries around the world, excluding the U.S. and Canada. With 913 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country. Indices are not managed and do not incur fees or expenses. Performance numbers for the index are total return with dividends reinvested in the index.

The MSCI Emerging Markets Index captures large and mid-cap representation across 24 Emerging Markets (EM) countries\*. With 838 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country. Performance numbers for the index are total return with dividends reinvested in the index.

The Bloomberg Barclays U.S. Aggregate Bond Index provides a measure of the total return performance of the U.S. dollar denominated investment grade bond market, which includes investment grade government bonds, investment grade corporate bonds, mortgage pass through securities, commercial mortgage backed securities and asset backed securities that are publicly for sale in the United States.

The iBoxx USD Treasury Total Return Index is a broad, comprehensive, market-value weighted index that seeks to measure the performance of the U.S. Treasury Bond market.

The Consumer Price Index (CPI) is issued by the U.S. Bureau of Labor Statistics and is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services. Indexes are available for the U.S. and various geographic areas.

Institute for Supply Management® (ISM®) is the first and largest not-for-profit professional supply management organization worldwide. Founded in 1915, ISM has over 50,000 members across 100 countries. It's Manufacturing (PMI®) and Services (PMI®) are two of the most reliable economic indicators available, providing guidance to supply management professionals, economists, analysts, and government and business leaders. The reports are issued by the ISM Manufacturing and Services business survey committees. An index reading above 50 indicates expansion in activity, while a reading below 50 represents contraction.

Leading Economic Indicators (LEI), a composite of economic data points put together by The Conference Board designed to signal peaks and troughs in the business cycle. The Conference Board is a global independent business membership and research association working in the public interest.

The Equity Risk Premium (ERP) refers to the excess return that investing in the stock market provides over a risk-free rate. This excess return compensates investors for taking on the relatively higher risk of equity investing. The size of the premium varies and depends on the level of risk in a particular portfolio. It also changes over time as market risk fluctuates. It is most commonly viewed as the level of excess return required by investors, to compensate for the additional risk of investing in equities over Government bonds.

Please contact us at 781-400-2800 for more information on how we can assist you with your financial needs.