PERFORMA

2023 OUTLOOK

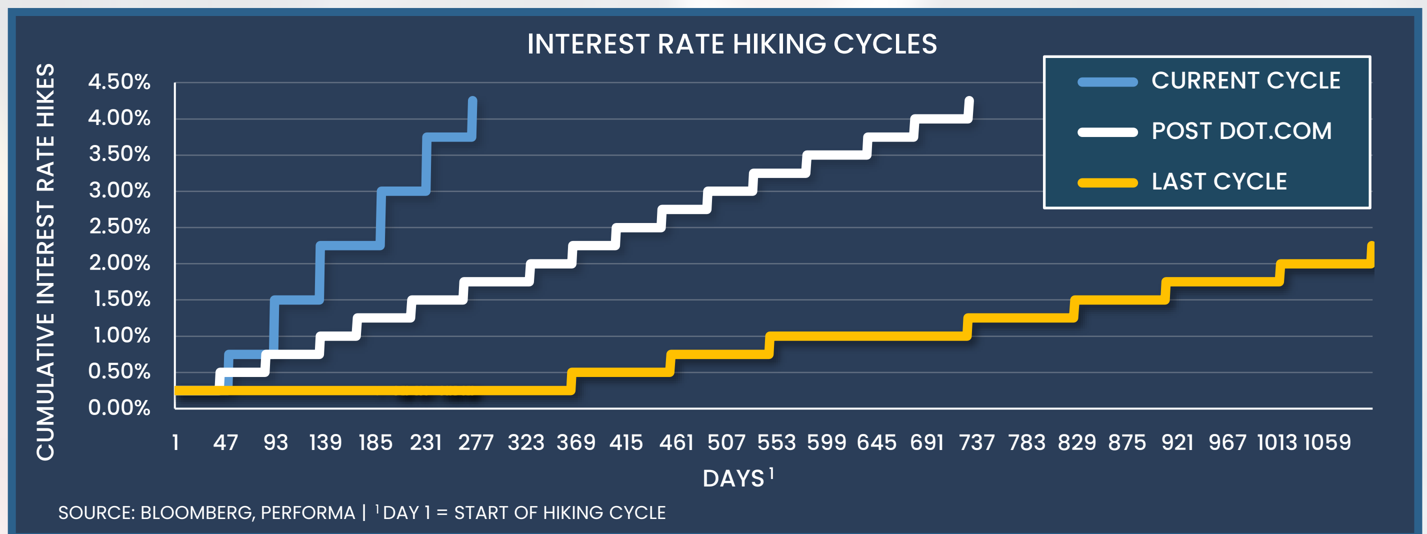
MARKET PERSPECTIVE

INSIGHTS & REVIEW FROM PERFORMA'S INVESTMENT TEAM

A QUICK REFLECTION & A LOOK AHEAD

We are approaching cruising altitude; the captain has turned off the seatbelt sign and you are now free to move about the cabin - if you're brave enough.

After falling considerably behind the curve in 2021, the Federal Reserve made up for lost time during 2022 as they announced and implemented plans to significantly tighten financial conditions. To this end, the Fed began balance sheet reduction and delivered 4.25% of cumulative rate hikes in less than 12 months.



The Federal Funds target range now sits at 4.25% - 4.50% after spending a couple of years at the zero bound. This dramatic shift in policy took aim at the highest rates of inflation since the early 1980's and caused a significant amount of market turbulence.

With no place to hide, it was a humbling year for most investors given the sizable repricing of both the bond and equity markets. As the Fed approaches cruising altitude (tempering the pace of interest rate hikes and ultimately taking a more passive approach in the face of slowing inflation and economic activity), we provide our thoughts on the year ahead and the implications for investment portfolios. We thank everybody for your continued support, especially during what was a historically volatile and extraordinary 2022.

2023 OUTLOOK

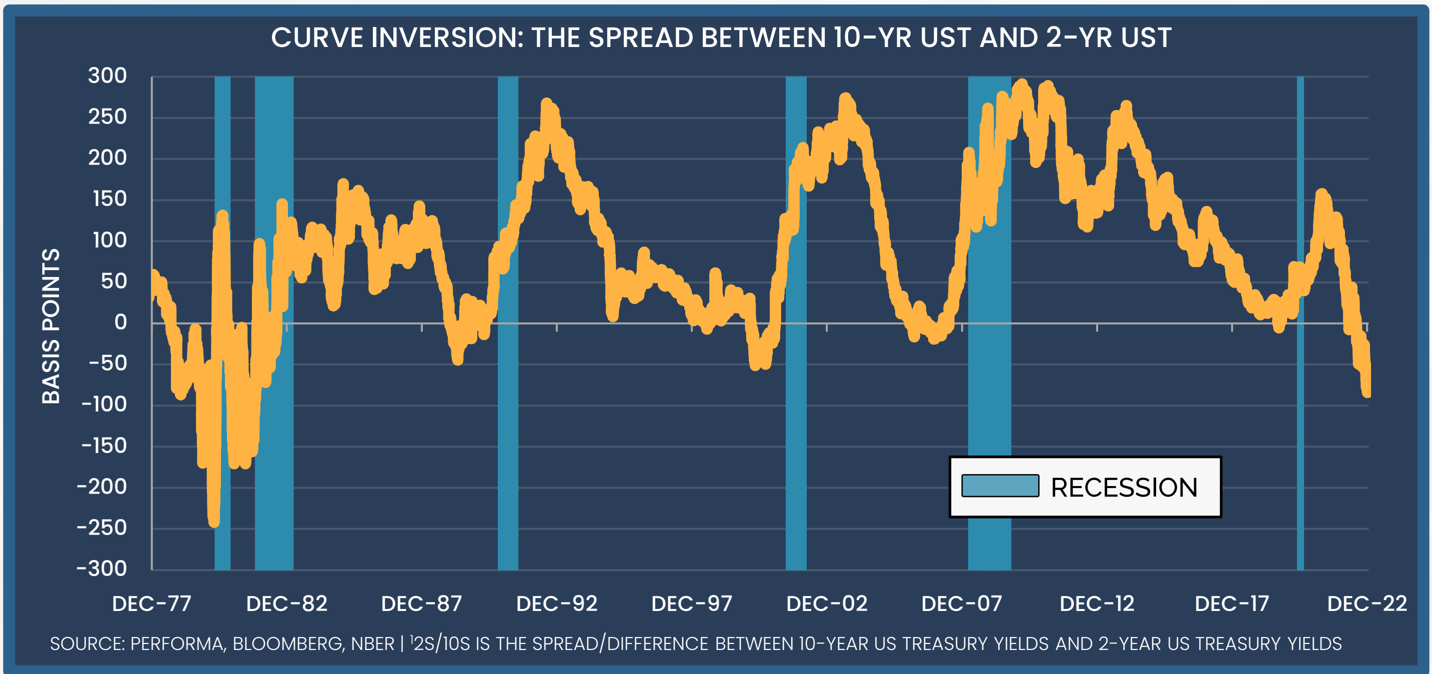
As we enter the new year, the outlook from both an economic and market perspective remains highly uncertain. While the Fed continues to combat inflation, the significant policy tightening delivered thus far has increased the risks of recession. Given this backdrop, it is difficult to dial up risk within investment portfolios despite the aggressive repricing experienced during 2022. Chair Powell continues to see a path to an outcome where inflation drops back towards its 2% target without a dramatic rise in unemployment and decline in economic activity. We are sympathetic to this view (given how resilient the economy was in 2022, the labor market in particular), however, with numerous recessionary indicators already flashing red, we are focused on the downside risks to growth. This makes it difficult, especially for equity strategies, to sound the "all clear" whistle.

While we see the Fed's decisive action in 2022 as the bulk of its tightening activity for this cycle, we still expect a few additional hikes early in 2023 and then, inflation permitting, a pause to let the full impact of tighter monetary policy filter through the economy. The Fed plans to take a gradual approach in the new year as it attempts to find the terminal level for its policy rate. This measured approach is an effort to avoid overtightening and choking economic growth which, if achieved, would provide the Fed with scope to hold rates steady for a stretch of time. It is undoubtedly a delicate balance for the Fed; raise rates far enough into restrictive territory to create the conditions necessary to put downward pressure on inflation, while not going so far that the economy falls off a cliff.

During a recent visit to the Brookings Institution, Chair Powell highlighted that he is not interested in hiking rates only to quickly reverse course shortly thereafter. Thus, with inflation set to moderate (barring yet another inflationary shock) and economic activity slowing, a key question for 2023 is how long will the Fed remain at their new, higher cruising altitude for interest rates?

THE MARKET CONTINUES TO DOUBT FED MESSAGING

From the bond market's perspective, the short answer is the Fed will not pause for very long. Recent Fed projections do not see interest rate cuts until sometime in 2024. Meanwhile, massive inversion in the U.S. Treasury curve highlights the market's view that the Fed will not have the luxury and/or the determination to hold rates in restrictive territory for a meaningful amount of time.



As such, market pricing continually incorporates potential rates cuts in the back half of 2023 - a rather short trip and minimal time spent at cruising altitude (like a quick flight from New York to Washington). Markets are betting that the captain is about to ask passengers to return to their seats and buckle up in preparation for a violent landing. The idea being that monetary policy acts with long and variable lags and the magnitude and pace of 2022 rate hikes will prove sufficiently restrictive to cause a rapid deterioration in economic activity during 2023. As a result, we would likely see a reversal to dovish monetary policy. Yes, this scenario does portend lower inflation, but at the cost of a significantly weakened labor market and, ultimately, a recessionary outcome.

KEEP ON THE SUNNY SIDE

Alternatively, if the markets are wrong to fight the Fed (an age-old adage of what not to do) and the economy proves more resilient and/or inflation stickier than anticipated, we could be in for a longer flight (New York to Omaha). In such a case, markets would be forced to push back expectations for rate cuts, inflation would prove more entrenched than currently perceived and the labor market would likely remain rather tight. Should this scenario play out, we would expect recessionary concerns to be delayed but not removed. From the Fed's perspective, this outcome is not ideal but far from their worst case.

Ideally, the Fed hopes that we are all onboard a trans-continental flight. A few additional hikes in early 2023 followed by steady rates for an extended period. In this scenario, their tightening campaign would be a massive success (realistically, the flight to Omaha would probably be considered a success as well, albeit not quite as much); inflation would be trending back toward the Fed's 2% target with minimal damage to the labor market and resilient economic growth. It would be a truly heroic outcome given the challenges the Fed faced coming out of the pandemic.

CAN'T ALWAYS GET WHAT YOU WANT

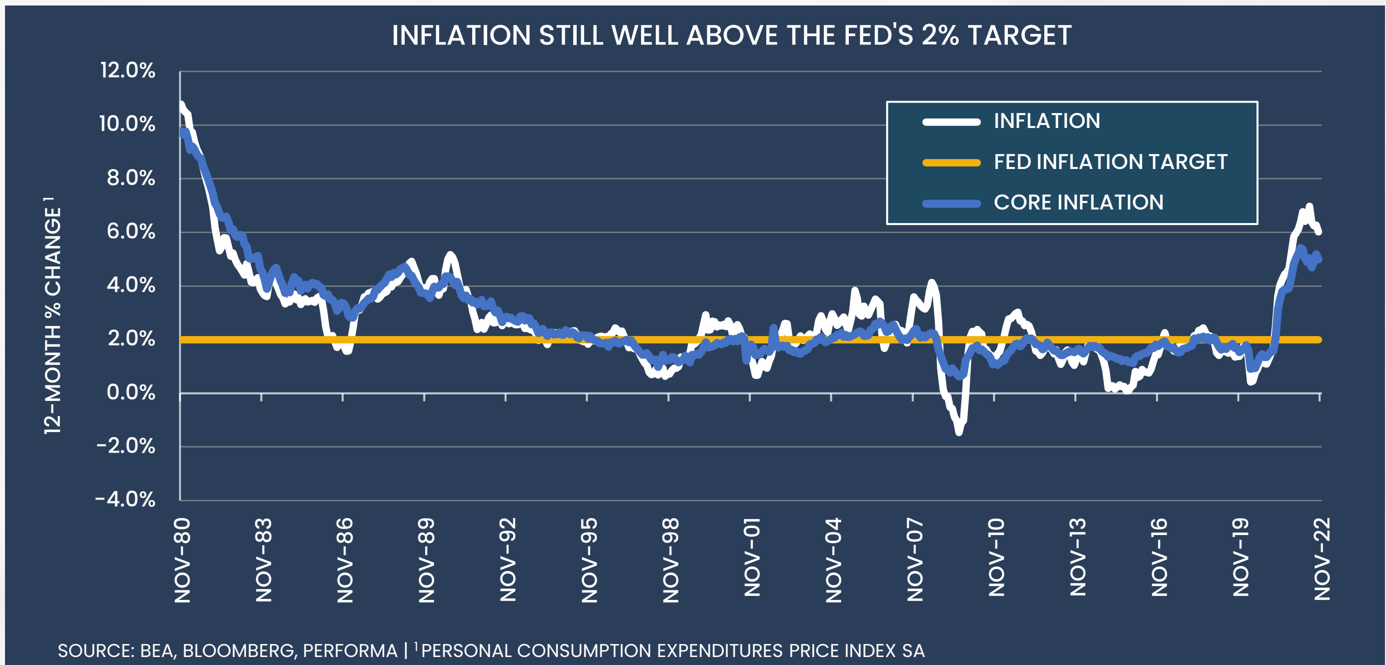
The more problematic scenario for the Fed would be inflation backtracking and starting to rise once again, forcing additional interest rate hikes beyond those expected in early 2023. In this case, the Fed would have to ignore any economic weakness and likely punish the labor market as it deals with unruly inflation. A higher-than-expected peak in rates would likely result in a deeper economic downturn. This path for interest rates would feel more like a rollercoaster than a flight and would contribute to elevated market volatility. Moreover, it would be the worst case possible for financial markets; likely resulting in another leg down for equities and potential further losses for bonds.

TRYING TO AVOID REPEATING PAST MISTAKES

The Fed has made it clear they do not want to make the same policy mistakes of the 1970's when the Fed eased too early, only to see inflation come roaring back. This line of thinking argues for a Fed that wants to sneak in a few more hikes for extra safety before hitting the pause button. The duration of this pause will be defined by prevailing macroeconomic conditions. Suffice it to say, the economy will need to fall apart rather quickly for the Fed to match market expectations and deliver rate cuts in the back half of 2023.

PERFORMA'S VIEW

While there are always risks to any outlook, we believe inflation is on trend and will continue to moderate further in 2023.



SOURCE: BEA, BLOOMBERG, PERFORMA | [1] PERSONAL CONSUMPTION EXPENDITURES PRICE INDEX SA

- Goods inflation, a primary driver during and post the pandemic, has been and will continue to slow as the pandemic related imbalances between demand and supply chain problems normalize.
- Meanwhile, housing sector demand has weakened considerably in the face of affordability issues driven by higher mortgage rates and elevated prices. Declining activity in the housing sector will begin to put more downward pressure on shelter inflation (with a lag), which is a key component propping up official inflation metrics today.
- Finally, we think the Fed has the resolve to bring service sector inflation (think travel, financial services, etc.) back toward target.

In total, moderating inflation will allow the Fed to take their foot off the gas in 2023 as their focus shifts to the cumulative impact of higher interest rates and balance sheet reduction on macroeconomic variables like the unemployment rate and growth.

OTHER FACTORS IN PLAY FOR 2023

What do we see as potential headwinds or tailwinds for the markets beyond what we have laid out above? Geopolitical activity is the largest factor. The Chinese economy has yet to fully reopen from its austere COVID protocols, which could provide a lift against declining global output. The other side of the equation is the ongoing tensions and economic fallout around the defense of Ukraine. With this backdrop, taking a cautious approach during the first quarter or two of 2023 is more than warranted. With that said, we believe that valuations in both the fixed income and equity markets are far more attractive today than at this time last year.

THE SHAPE OF 2023

We enter 2023 with a mostly neutral stance within client portfolios given more attractive valuations coupled with elevated uncertainty and downside risks to economic activity. The game has changed for fixed income investors as the higher rate environment has brought income back to fixed income. Throughout 2022, we generally bought back duration within fixed income portfolios, reducing the size of our duration short to the lowest in almost a decade. 2023 will be a year for fixed income investors to focus on yield as the largest driver of return – something sorely lacking for so long.

From an asset allocation perspective, we continue to allocate new cashflows to long-term targets given far more attractive valuations than a year ago. In the current environment, we believe patience and prudence will be rewarded. One thing we want to ensure is that we have capital to deploy if equity markets take another significant leg lower during 2023. For some time, bond prices and equity prices have traded with a positive correlation moving higher and lower together. One event that we will be watching for in 2023 is a true risk-off type of scenario where equity prices move lower and investors seek the safety of U.S. Treasuries, sending rates lower and prices higher. Should this scenario play out, we would consider making a change to our asset allocation strategy legging into an overweight to risk assets at the expense of bonds (dependent on each client's unique liability profile). However, given elevated uncertainty, we are not looking to force this trade. Having a core allocation to U.S. Treasuries and/or cash on hand will provide the flexibility necessary to capitalize on a true risk-off scenario.

It is impossible to know with certainty how markets will pan out in 2023. The potential paths are more nuanced than the high-level scenarios outlined above, but we believe clients are well positioned to take advantage of a wide range of outcomes while maintaining a slightly defensive stance. It is going to be important to watch the price action next year, being ready to take advantage should markets overshoot and conditions reach extreme territory.

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ABOUT PERFORMA

Combining our extensive knowledge of the insurance industry with the institutional expertise of our investment team, Performa has been managing assets on behalf of captive and other insurance clients for 30 years. Our capabilities include asset allocation, active fixed income and equity management through diversified mutual funds, ETFs (exchange traded funds) and separate account portfolios. With offices in the world's largest captive domiciles, including Bermuda, Vermont and South Carolina, we are focused on delivering customized solutions to meet the unique investment objectives and liquidity requirements of our clients. We are 100% employee-owned and have $5.12 billion in captive assets under management and advisement as of October 31, 2022. Our investment philosophy is value driven and long-term in nature. Whether approaching asset allocation, fixed income or equities, our ability to be nimble, contrarian and decisive sets us apart from our peers and promotes capital preservation.

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