

OUTLOOK

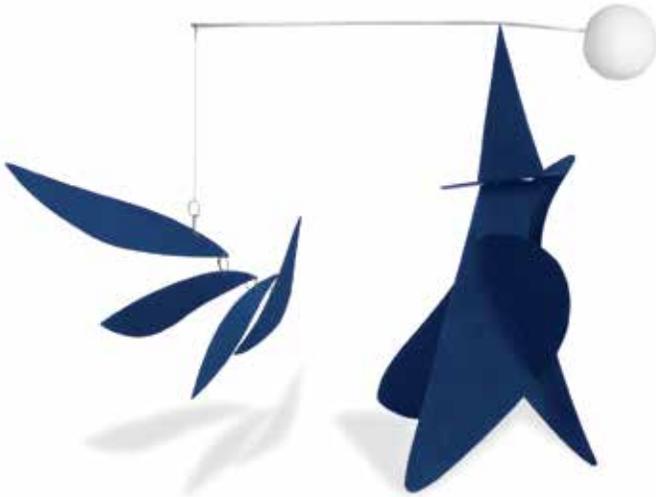
Ed.

2023

LPL RESEARCH PRESENTS:

FINDING BALANCE





Finding Balance

Through all the challenges, newfound opportunities, and every high and low we've experienced during the last couple of years, it's no surprise why we might be striving for more balance. Whether it's about the markets and global economy or what's happening in our local communities, the news we're hearing on a daily basis has the potential to disrupt the balance of our lives.

But with resilience, perspective, and the support of close connections, we can navigate through it all and regain our sense of equilibrium—even after another dizzying year, as 2022 proved to be.

After two years of disruption due to the COVID-19 pandemic, we were searching for some kind of return to normalcy, while at the same time, still experiencing the aftereffects of the pandemic. Some of those aftereffects included the imbalances created by the fiscal, monetary, and public health policy put in place to address the pandemic—and the process of addressing those imbalances has been disorienting at times. If 2022 was about recognizing imbalances that had built in the economy and starting to address them, we believe 2023 will be about setting ourselves up for what comes next as the economy and markets find their way back to steadier ground—even if the adjustment period continues.

The Federal Reserve (Fed) spent 2022 aggressively fighting inflation by raising interest rates. In 2023, we expect the Fed to find that point where it can stop raising rates, as inflation starts to come under control. The Fed's efforts to control inflation throughout 2022 pulled interest rates off of extremely low levels that were historically unprecedented. While that has been painful for bond investors, for the first time in a decade, savers can now get an attractive yield, and 2023 will be more focused on how to potentially benefit from this significant shift. Stock market expectations may also see some realignment heading into 2023. The projections for certain market segments became too high in 2022 following a decade of low rates and a burst of extraordinary technology adoption. We expect 2023 will likely be more focused on the opportunities that may emerge from a market sell-off.

LPL Research's *Outlook 2023: Finding Balance* is our guide to how the readjustments in the economy and markets may impact you in the coming year. The disruptions may not be fully resolved and there may be more challenges to come, but progress toward finding balance is well underway. And when those disruptions hit the market, it can be hard to find our footing and stay the course. Those are the times when sound financial advice is more valuable than ever, as it helps us find our center, remember our plan, and stay focused on our goals.



ECONOMY: The global economy will likely slow from the upper-2% range in 2022 down to the mid-1% range in 2023. Much depends on China's growth path. The divergence between domestic and international economies is most obvious in the inflation regime. Germany, for example, has still been experiencing accelerating rates of inflation in late 2022, whereas the U.S. has likely moved past the peak. The longer inflation is uncontained, the riskier the growth prospects. If the U.S. falls into a recession, chances are it would occur during the first half of 2023 and would likely not be as deep as the 2008 recession, which was initiated by a fundamentally flawed financial market.



BONDS: The path of interest rates will certainly be largely influenced by the Fed's behavior, which will be guided by economic growth and inflation data. Equally important is the level of non-U.S. developed government bond yields, as foreign investors are an important buyer of U.S. Treasuries. Higher foreign market yields, all else equal, generally dissuade foreign investment into our markets. There are a range of scenarios we think could play out over the next year. However, given our view that the U.S. economy could eke out slightly positive economic growth next year, we think 10-year Treasury yields could end the year around 3.5%.



INFLATION: We will likely enter 2023 with a slightly different trajectory for inflation, particularly services inflation. In recent months, durable goods prices have clearly decelerated—and in some cases, outright declined—but services prices have been stubbornly accelerating as rent prices and health services rose. We could potentially be entering a new regime as rents across the country are showing signs of abating. During this transition period for services prices, the coming year could be the time when inflation is convincingly decelerating closer to the Fed's long-run target of 2%.



STOCKS: If stocks are going to go higher in 2023, a prompt end to the Fed's rate hiking campaign will likely be a key component. The timing of the last rate hike of this cycle is uncertain and won't be clear for a while, but our view is that the Fed will pause during early spring of 2023 amid an improving inflation outlook and loosening job market. Should that occur, stocks would likely move higher, consistent with history. Stocks have tended to produce solid gains after hiking cycles end, including a 10% average gain one year later.



POLICY: The 2022 midterm election was closer than many expected, but in the end voters chose to rebalance the power dynamic in Washington. As expected, Republicans gained enough seats to win a narrow majority in the House, while Democrats held on to their slim majority in the Senate. Despite Republican's narrow House majority, their victory in the House significantly shifts the balance of power, since only legislation with broad bipartisan support will get passed once the new Congress is sworn in on January 3, 2023.



GEOPOLITICS: Uncertainty surrounding the course of the Ukraine-Russia conflict has thwarted diplomatic attempts to reach a negotiated settlement. The intense military campaign involves a significant contribution from NATO toward the Ukrainian war effort, specifically from the U.S. Depending on how long the fighting continues, it is expected that many of the NATO countries, including the U.S., may debate the financial burden. Markets historically have navigated regional conflicts fairly well despite the human toll. The largest market vulnerability remains the war's impact on inflation.



COMMODITIES: This year the global economy adjusted to a higher interest rate campaign initiated by most central banks in order to tackle inflationary pressures. As such, expectations are rising that several regions may face a recession or a significant economic slowdown will unfold, which would weigh on demand. Unless there are severe shortages, commodity prices typically tend to ease until there are signs that central banks are nearing the end of the rate hike cycle.



CURRENCIES: To say the U.S. dollar has vaulted higher during the Fed's rate hike cycle would be an understatement. Whether it is the result of the interest rate differential (that is, that the Fed has been more aggressive than other central banks) or that U.S. markets have been attracting more investments from foreign investors, the result has been staggering. The strong dollar, while making imports less expensive, has put pressure on many of the large multinational companies with a global footprint.



Gauging the slowdown in global economies

The global economy will likely slow from the upper-2% range in 2022 down to the mid-1% range in 2023 [Fig. 1]. Much depends on China's growth path. An important aspect for investors is that the U.S. appears to have fewer headwinds to growth compared with Europe and other developed economies. The divergence between the domestic and international economies is most obvious in the inflation regime. Germany, for example, is still experiencing accelerating rates of inflation, whereas the U.S. has likely moved past the peak. The longer inflation is uncontained, the riskier the growth prospects.

If the U.S. falls into a recession, the chances are that it would

occur during the first half of 2023 and will likely not be as deep as the 2008 recession, which was initiated by a fundamentally flawed financial market.

MORE CLARITY ON POTENTIAL FOR U.S. RECESSION

There are three factors for defining a recession: depth, diffusion, and duration—conveniently referred to as the “three Ds.” Depth refers to declining economic activity that is greater than any relatively small change. Diffusion describes an economy that has experienced a contraction in a wide range of sectors, such as trade, business activity, and consumer spending. Duration, likely the least important of the three Ds, measures the time between the previous business cycle peak and the

following trough. Since World War II, the average recession has lasted just over 10 months (down from an average of 17 months if you date back to 1854), according to the National Bureau of Economic Research. Given the unique cause of the 2020 recession, the time between peak and trough was the shortest on record—only two months.

One reason we're currently seeing a healthy debate on the likelihood of a recession is that for most of 2022, not all of the metrics were flashing warning signs. However, recent data may give us more clarity. The Conference Board's Leading Economic Index (LEI) has declined for seven of the last nine months, showing that the economy could enter a period of significant and broad-based contraction. The decline is predictable as many sectors, such as housing, started slowing months ago. Since the inception of the index, a decline of this magnitude over a six-month period has always foreshadowed a recession in subsequent quarters [Fig. 2]. As such, we think recession risks appear more probable by the beginning of 2023. If the economy does fall into a recession, the cause will likely be from the consumer sector retrenching after years of inflationary pressures, high housing costs, and slow real wage growth.

Economic forecasts

2023 annual forecasts	GDP growth (Y/Y%)	CPI (Y/Y%)
United States	0.50%	3.50%
Eurozone	-0.10%	4.80%
Advanced Economies	0.40%	4.50%
Emerging Markets	3.50%	5.60%
Global	1.70%	4.90%

Source: LPL Research 11/15/22

Forecasts set forth may not develop as predicted and are subject to change.

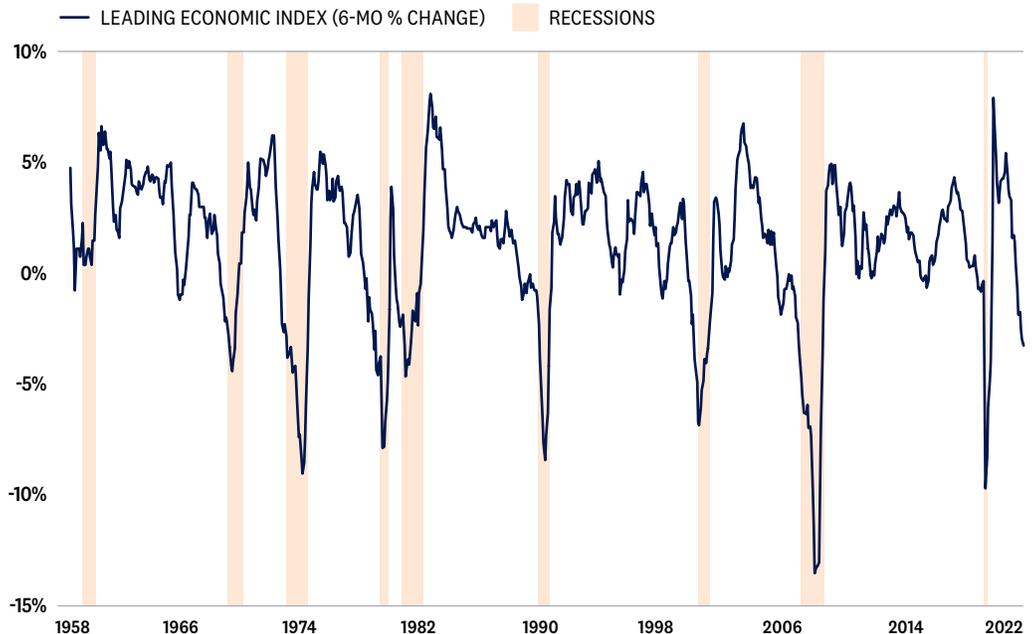
fig.

2 fig. Leading indicators point to more slowdown

Even though investors are tempted to say “this time is different,” we all can take note of general principles about business cycles and the markets. The Fed has warned that the current inflation fight will be painful, so a dip into a recession should not be that surprising.

READJUSTMENTS IN THE JOB MARKET COULD LESSEN PAIN

The Fed has repeatedly warned investors about the potential for pain from the fight with inflation. That pain is mostly likely associated with an expected increase in unemployment as the job market cools from a slowing economy. The Job Openings and Labor Turnover report was hardly on center stage, until Fed Chair Jerome Powell used a press conference to highlight the number of job openings in the economy. The pandemic caused these three metrics to become off balance: the ratio of openings to unemployed, the number of those not in the labor force, and the percent of firms having difficulty finding qualified

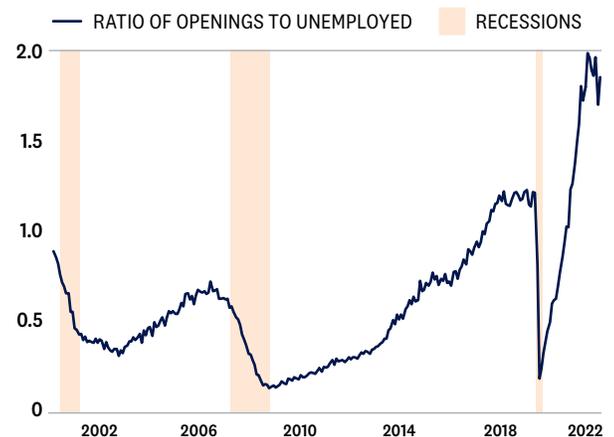


Source: LPL Research, Conference Board 10/20/22

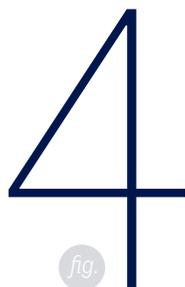
workers [Fig. 3]. Investors should watch these metrics throughout 2023 as the economy leads to a more balanced labor market.

We expect the ratio of openings to unemployed to fall as the economy slows and firms cut their number of job openings. Firms often quickly respond to a slowing economy: during the 2008 financial crisis, the number of openings fell by 50% in roughly 16 months, so this metric could revert quickly. The persistent problem of individuals out of the labor force has kept the labor market tight, but a potential improvement in labor force participation in the prime age population (25–54 year olds) with improved productivity would be a powerful remedy. And in terms of firms’ struggle to find qualified workers, the coming year will reveal how firms are responding to current labor market conditions and any potential impact this may have on businesses. If the labor force grows back to its pre-pandemic trend, many of these near-term conditions would improve.

3 fig. Not enough workers to fill job openings

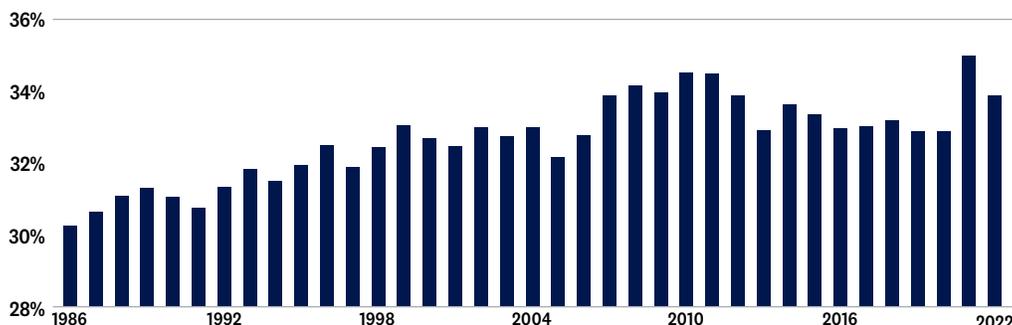


Source: LPL Research, Bureau of Labor Statistics, 11/07/22



A third of consumer spending goes to housing

HOUSING AS % OF TOTAL CONSUMER SPENDING



Source: LPL Research, Bureau of Labor Statistics 11/15/22

HOUSING MARKET SHOULD BEGIN TO NORMALIZE

The housing market is still normalizing in response to an economy under pressure from higher borrowing costs, nagging inflation, and uncertainty about future Fed activity. Slowing residential investment will create a drag on economic growth at the start of 2023, but demographics of Millennials and Generation Z could provide some support for housing demand later in the year. Nevertheless, in the near term, housing demand will likely fall further in the coming months, putting downward pressure on median prices.

Housing plays a significant role in consumer spending and investors should monitor the housing market as a bellwether for the health of the consumer. Consumers spend roughly 34% of their total spending on housing [Fig. 4], so a decline in housing-related costs should give consumers more for discretionary spending.

The hybrid work environment and the corresponding interest to move to areas with lower cost of living created an imbalance in the housing market, especially during the trough in mortgage rates. Regional variations will likely remain as geographic reshuffling continues. In 2023, the potential for more multi-family dwellings should help bring the demand and supply for rentals into balance, while more rentals and normalizing house prices should ease inflation.

INFLATION SHOULD BECOME CONVINCINGLY SOFTER

Investors and central bankers will likely enter 2023 with a slightly different trajectory for inflation, particularly services inflation. In recent months, durable goods prices have clearly decelerated—and in some cases, outright declined—but services prices have been stubbornly accelerating as rent prices and health services rose. We could potentially

be entering a new regime as rents across the country are showing signs of abating. During this transition period for services prices, the coming year could be the time when inflation is convincingly decelerating closer to the Fed's long-run target of 2%.

If inflation in 2022 was about supply constraints, then inflation in 2023 could center on demand constraints. For the past year, supply-related problems contributed more to inflation than demand-related imbalances. China's zero-COVID-19 policy was one of the biggest glitches in supply chains as metro areas and ports were shuttered by the Chinese government. However, things may be on the verge of changing as supply and demand get into balance throughout 2023, and as inflation likely becomes more demand driven and less supply driven. This is positive for policymakers because monetary policy tools do not work on supply shocks but rather, only on demand; thus, these tools are now more relevant than they were when inflation was primarily from supply bottlenecks. So as supply constraints ease and as Fed tools become more impactful, we could see the rate of inflation decelerating further in 2023.

Equilibrium between the macro and the micro



Equity markets lacked balance in 2022 as the challenging macro environment

overwhelmed business fundamentals. Stubbornly high inflation and sharply higher interest rates were the dominant market drivers, pressuring valuations and inciting fears of recession and falling corporate profits.

In 2023, we look to equity markets to find balance between key macroeconomic factors—inflation, interest rates, and Fed policy—and business fundamentals.

REACHING THE PEAK OF THE RATE CLIMB

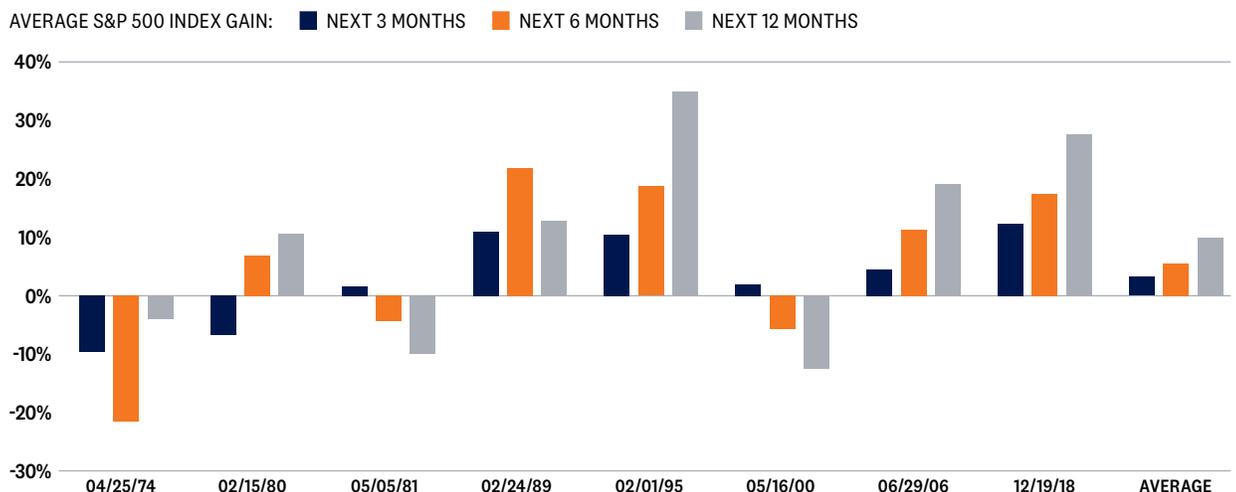
If stocks are going to go higher in 2023, a prompt end to the Fed’s rate hiking campaign will likely be a key component. The timing of the last rate hike of this cycle is uncertain and won’t be clear for a while, but our view is that the Fed will pause in early spring of 2023 amid an improving inflation outlook and loosening job market. Should that occur, stocks would likely move higher, consistent with history. Stocks have tended to produce solid gains after hiking cycles end, including a 10% average gain one year later [Fig. 5].

Note that the two instances when stocks struggled the most after a Fed rate hiking cycle ended, 1981 and 2000, were both during recessions. A recession in 2023 may be more likely than not, but our expectation is that if a recession occurs, it will be more mild than those cases. Fourth quarter 1981 marked the start of the second leg of the double-dip recession after Fed Chair Paul Volcker famously broke the back of inflation with significant interest rate hikes, while 2000 was the start of the burst of the tech bubble that contributed to the recession in 2001.

5

fig.

Stocks have historically risen after the end of Fed rate hike cycles



Source: LPL Research, FactSet, Ned Davis Research 11/15/22

Indexes are unmanaged and cannot be invested into directly. Past performance is not a guarantee of future results.

WHAT GOES DOWN TENDS TO GO UP

They say that what goes up must come down. For the stock market, it also works the other way. Through many economic downturns, recessions, and geopolitical crises over many decades, the stock market has always recovered. Those patient and courageous investors who were able to take advantage of those declines have usually been rewarded nicely. Following down years, the S&P 500 has risen an average of 15% with positive returns in 15 out of 18 years [Fig. 6]. Since 1950, a down year was only followed by another down year three times: in 1973, 2000, and 2001.

Looking at this another way, after losing 20% or more at any point in time, the S&P 500 Index has gained an average of 17.6% over the subsequent 12 months (monthly data). The positive post-midterm election year pattern, discussed later in this publication, provides another historical analog that should be supportive of higher stock prices in 2023.

WIDE RANGE OF POSSIBLE EARNINGS OUTCOMES

Corporate America faces significant headwinds as 2023 gets underway.

Cost pressures amid high inflation and still-snarled global supply chains are the biggest factors, but slowing economic growth and the strong U.S. dollar may make any earnings growth in 2023 difficult to achieve. Many companies over-earned during the pandemic, so some reversion back to normal still needs to occur. Inventories also need to be brought down. Even though some of these pressures have started to ease, lower commodity prices and slightly looser labor markets have, thus far, had limited impact on inflation overall.

Our base case for S&P 500 earnings per share in 2023 is \$220, similar to where 2022 is tracking and about \$12, or 5%, below the consensus estimate as of November 15, 2022 [Fig. 7]. Revenue will continue to get a boost from inflation, as many blue chip companies during third quarter earnings season have demonstrated an ability to pass along higher prices due to their pricing power. But margins will likely compress further over the next several quarters before support from lower costs potentially arrives.

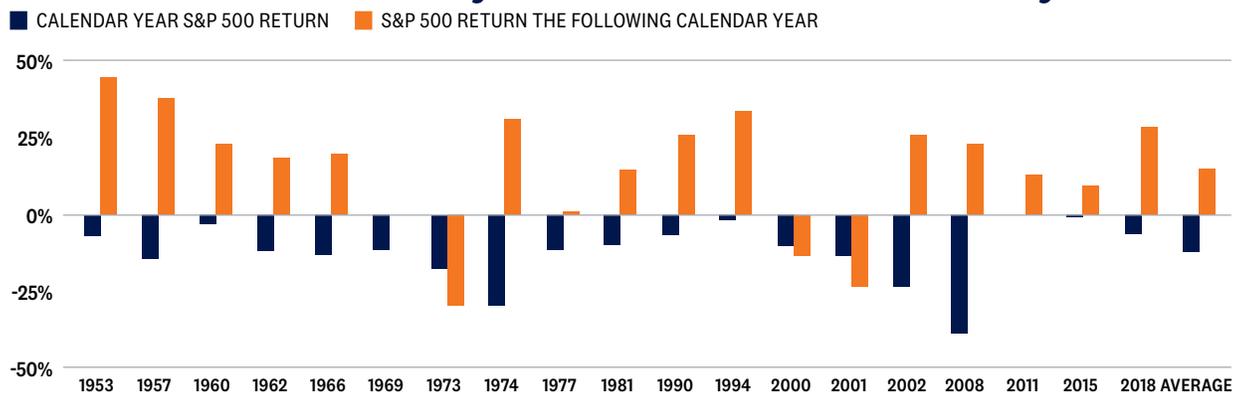
An upside scenario could materialize if inflation falls faster than we anticipate, propping up margins and potentially putting S&P 500

7 Potential slight 2023 earnings gain would be welcomed by markets



Source: LPL Research, FactSet 11/15/22 Earnings per share expressed as \$ of EPS Forecasts set forth may not develop as predicted and are subject to change.

6 Stocks have historically bounced back after down years



Source: LPL Research, FactSet 11/15/22 Indexes are unmanaged and cannot be invested in directly. Past performance is no guarantee of future results. Returns displayed are price returns, excluding dividends.

earnings per share as high as \$235 in 2023 and over \$250 in 2024. On the other hand, stubbornly high inflation and a more prolonged economic downturn could introduce downside risk, possibly down to \$200 per share in earnings in 2023 before a potential rebound to \$230 in 2024.

TILTING THE SCALES BACK IN FAVOR

In 2022, the bear market decline in stocks was all about the macro picture—high inflation, surging interest rates, and rising recession risks. Strong consumer and corporate balance sheets and growth in corporate profits were not rewarded by investors, who were focused on rising recession risk and concerns of higher interest rate levels affecting future earnings. Add to that a tense geopolitical landscape and a strong U.S. dollar, and stocks struggled to make any headway throughout the year.

Looking ahead to 2023, stock drivers are likely to be more balanced. Rather than the scales tilting toward rising interest rates and runaway inflation, we may see falling interest rates and lower inflation supporting higher stock valuations. Should the outlooks for economic growth and inflation improve as 2023 progresses, stocks may also get a lift from prospects for stronger earnings growth in 2024.

LPL Research’s Strategic and Tactical Asset Allocation Committee (STAAC) sees fair value for the S&P 500 at 4,400–4,500 at year-end 2023, based on a price-to-earnings ratio of 18–19 and \$240 per share in S&P 500 earnings in 2024. That target is also derived from probability-weighted scenarios and based on various paths for the economy, inflation, interest rates, and earnings [Fig. 8].

Our bear case fair value of 3,680 is based on 16 times \$230 per share in



2023 year-end stock market forecast scenarios

	Bear case	Base case	Bull case
ESTIMATED PROBABILITY	15%	60%	25%
ECONOMY	Recession	Flattish growth, possible mild recession	Soft landing
INFLATION	Remains stubbornly high	Gradually eases	Falls faster than expected
INTEREST RATES	Stay high or rise further	Move gradually lower	Fall materially
FEDERAL RESERVE	Fed tightening continues well into 2023	Fed pauses in early spring 2023	Fed signals pause before year-end 2022
EARNINGS	Recession drives double-digit decline	Stall amid growth lull, cost pressures	Margins rebound as inflation falls
GEOPOLITICS	U.S.-China tensions build, Russia-Ukraine escalation	Progress comes slowly in China, Ukraine	China eases COVID policies, Europe conflict contained
VALUATIONS	Modest P/E multiple compression	Modest P/E multiple expansion	Sizable P/E multiple expansion
ESTIMATED P/E	16	18	20
2022 EPS	220	220	220
2023 EPS	200	220	235
2024 EPS	230	240	255
YEAR-END 2023 S&P 500 FAIR VALUE TARGET	3680	4320	5100
TARGET	4400 – 4500		

Source: LPL Research 11/15/22
 Estimates may not materialize as predicted. Indexes are unmanaged and cannot be invested in directly. P/E is a price/earnings ratio.

S&P 500 earnings in 2024, while our bull case of 5,100, which we see as slightly more likely than the bear case, is based on 20 times \$255 per share in S&P 500 earnings in 2024.

We look for stocks to find better balance between the macro environment and business fundamentals in 2023, tilting the scales toward the bulls.

OPTIMISTIC ABOUT TECHNICAL TREND REVERSAL

It has been mostly downhill for the S&P 500 since kicking off the year with a record-high. The downtrend since January severely damaged market breadth and momentum. More recently, oversold conditions coupled with seasonal tailwinds underpinned a relief rally off the October lows.

While some technical damage has been repaired, the S&P 500 remains in a downtrend and below its declining 200-day moving average (DMA). We are optimistic for a trend reversal in 2023 and suspect it will be accompanied by a pullback and/or consolidation phase for Treasury yields and the US Dollar Index.

In terms of upside for next year, a confirmed reversal on the S&P 500 should open the door for a retest of the August highs near 4,300. Probabilities for a breakout beyond this level would meaningfully increase if Treasury yields and the dollar continue to decline. History is also on the market's side as the S&P 500 historically spends less than 30% of all trading days below its 200-DMA (since 1950). During this timeframe, whenever the index held below the 200-DMA for a six-month period, forward 12-month average and median returns were 14.2% and 18.3%, respectively.

Equity asset allocation recommendations



Market cap

LPL Research maintains a slight preference for small and midcap stocks relative to large caps for 2023. Small cap stocks tend to perform better in early-cycle economies, which we believe will characterize 2023, and they may benefit from attractive valuations and a potential rebound in the U.S. economy in the back half of 2023. Smaller companies are also relatively more insulated from economic risks in Europe.



Sectors

LPL Research recommends balanced exposure to defensive and cyclical sectors in 2023 in a still uncertain economic environment. Our favored defensive sector is healthcare, while we also like the defensive characteristics of the energy sector due to constrained global supplies. The conditions for a style shift toward growth—such as falling inflation, stabilizing economic growth, and lower interest rates—may also drive a turnaround in the leading growth sector, i.e., technology. Industrials is another sector to watch as 2023 gets underway.



Style

Growth-style stocks trailed their value counterparts throughout much of 2022. As the calendar turns to 2023, value still looks to have a slight edge based on the still very challenging inflation outlook, high interest rates, and our positive view of the energy sector. However, once inflation and interest rates start to come down, as we anticipate in the first half of 2023, growth performance may be poised to turn around.



Region

The energy crisis in Europe has strengthened our conviction in favoring U.S. equities over their developed international counterparts, as the U.S. is simply better positioned than Europe to withstand higher energy costs. Developed international equities likely require a synchronized global expansion to outperform, which seems unlikely in 2023. Our negative view of emerging markets is based largely on earnings weakness, heightened geopolitical tensions, and persistent COVID-19 lockdowns in China, though valuations are supportive, and the U.S. dollar's rally has cooled of late.



Uncovering alternatives in the bond market



Across the Treasury yield curve, U.S. Treasury yields were significantly higher in 2022 with shorter maturity securities higher by 4%. Additionally, intermediate- and longer-term Treasury yields were higher by over 2%, taking the 10-year Treasury yield to the highest levels since 2007. After years of falling

interest rates, 2022 was a year of steeply higher rates. So where do we think the yield on the 10-year Treasury security is headed in 2023?

The path of interest rates will certainly be largely influenced by the Fed’s behavior, which will be guided by economic growth and inflation data. Equally important is the level of non-U.S. developed government bond yields, as foreign investors are

an important buyer of U.S. Treasuries. Higher foreign market yields, all else equal, generally dissuade foreign investment into our markets. There are a range of scenarios we think could play out over the next year. However, given our view that the U.S. economy could eke out slightly positive economic growth next year, we think 10-year Treasury yields could end the year around 3.5% [Fig. 9].



Treasury yield forecasts

	Hard landing	Flattish growth/ mild recession	Stagflationary environment
Macro conditions	Economic growth contracts	Economic growth slows but still slightly positive	Economic growth slows but still positive
	Inflation expectations decline	Inflation expectations steady and falling	Inflation expectations increase
	Fed cuts rates from restrictive levels	Fed cuts rates but still restrictive	Fed hikes rate into more restrictive territory
	Global government bond yields fall	Global government bond yields steady	Global government bond yields elevated
Year-end Fed Funds Rate	2.00%	4.50%	5.50%
Market-Implied Inflation Expectations	2.00%	2.50%	3.50%
2-Year Treasury Yield	2.00%	3.75%	5.00%
10-Year Global Bond Yields	1.00%	2.00%	3.00%
10-Year Treasury Yield	2.75%	3.25 – 3.75%	4.75%

Source: LPL Research 11/15/22

Rate forecasts may not develop as predicted and are subject to change.

10

fig.

Hypothetical returns: Interest rate scenario analysis

Change in interest rates:	-1.0%	-0.5%	No change	+0.5%	+1.0%
Bloomberg US Aggregate Bond Index	12.3%	9.5%	5.2%	3.9%	1.1%
Bloomberg MBS Index	12.7%	10.0%	5.4%	4.4%	1.6%
Bloomberg US Treasury Index	11.0%	8.3%	4.5%	2.9%	0.2%
Bloomberg US Corporate Index	14.2%	11.0%	6.1%	4.7%	1.5%
Bloomberg Intermediate Corp Index	10.3%	8.5%	6.0%	4.9%	3.1%
Bloomberg US High Yield Corporate Index*	11.9%	10.2%	7.4%	6.6%	4.8%

Source: LPL Research 10/24/22

*Assumes 6% Default Rate and 40% Recovery Rate

Rate forecasts may not develop as predicted and are subject to change. Indexes are unmanaged and cannot be invested into directly. Past performance is not a guarantee of future results.



THE ROAD TO RECOVERY FOR CORE BONDS

The core bond index (as defined by the Bloomberg Aggregate Bond Index) is seeing losses unlike any year since its inception. Core bonds are down nearly 16% in 2022 and have wiped out five years of index gains. But because bonds are both financial instruments and financial obligations, which pay coupons and principal repayments at par when they mature, the potential for recovery is a bit more certain than in the equity markets that rely primarily on price appreciation. So, how long will it take to recover this year's losses?

Here are some expectations for various fixed income markets under different interest rate scenarios [Fig. 10]. If interest rates don't change at all, the best expectation

for performance over the next year would be the index's starting yield (dark blue highlighted section). Although, if interest rates decline by 0.5%, the Bloomberg Aggregate Bond Index could return more than 9% over the next 12 months. Moreover, if interest rates move back into the low 3% range, the core bond index could return around 12% over the next year. Also, and importantly, given where starting yields are, if interest rates increase by another 1% from current levels, fixed income markets broadly could still generate positive returns over the next 12 months. Given the move higher in yields we have experienced this year, we think the risk/reward for owning core bonds has improved.

However, for investors that don't want to take on a lot of interest rate

risk, the opportunity set in shorter maturity fixed income securities has improved as well. With 1- and 2-year Treasury securities both yielding above 4%, cash and cash-like instruments finally offer an attractive yield. Moreover, shorter maturity investment grade corporate securities are offering yields in line with longer maturity corporate credit securities—without the same level of interest rate or credit risk.

One thing to consider is that because starting yields are the best predictor of future returns over the maturity of a fixed income instrument, by taking on that additional interest rate risk and owning a full market core bond portfolio, investors would be “locking in” investments at higher yields for a longer period of time. If interest rates do fall from current levels, investors that are in shorter maturity securities would then have to reinvest proceeds at lower rate levels.

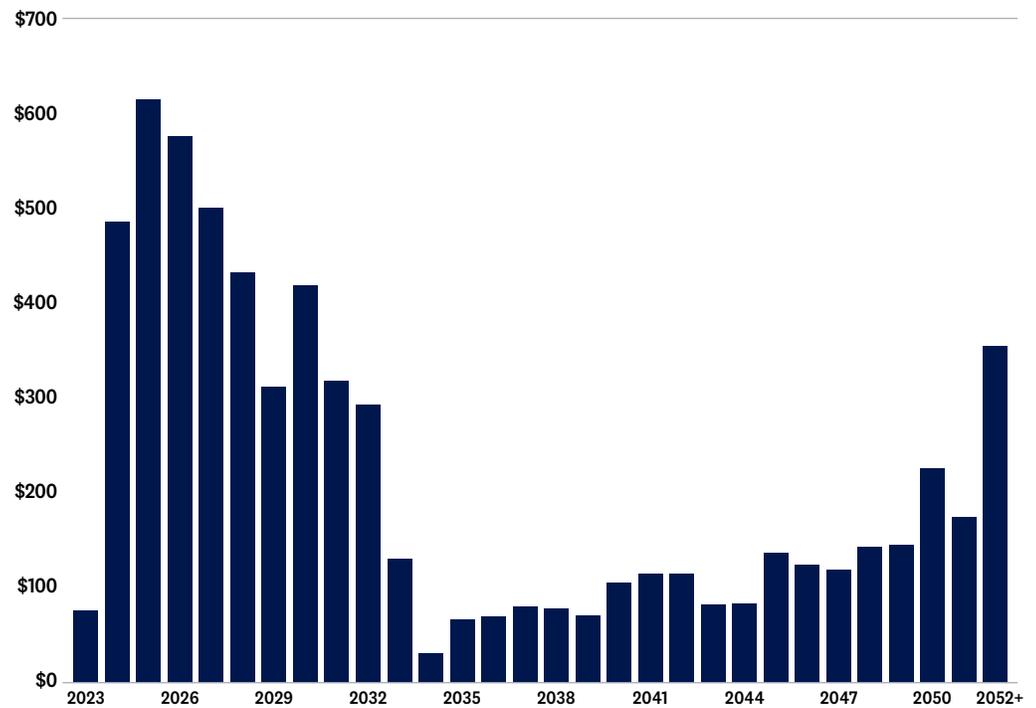
So for investors with an investment

11

Less than 10% of outstanding debt needs to be refinanced before 2025

fig.

AMOUNT OF INVESTMENT GRADE CORPORATE DEBT MATURING (BILLIONS)



Source: LPL Research, Bloomberg, 10/31/22

time horizon greater than five years, a full market core bond portfolio may make sense. Otherwise, shorter maturity securities offer attractive yields as well. Bottom line, after the back-up in yields in 2022, there are a number of attractive fixed income opportunities again.

WHAT'S NEXT FOR CORPORATE CREDIT?

Since Treasury yields are generally used as the base rate for consumer and corporate borrowers, this year's increase in Treasury yields pushed many borrower's borrowing costs to levels not seen in years. For corporate borrowers, after years of borrowing at ultra-low rates, the backup in yields we've seen this year has pushed corporate borrowing rates back above 6%, which is the highest levels since 2009. Could higher borrowing costs for corporates reduce profitability and potential growth opportunities?

Perhaps, but over the last two

years in particular, corporate borrowers have increased the amount of new debt issued seemingly to prepare for the rising rate environment we're currently facing. In fact, new corporate debt issuance for investment grade companies hit record highs in 2020 and 2021 when over \$3 trillion of new debt was issued. As such, corporate entities were able to term out debt by issuing a lot of debt at longer maturities and lower rates. Also, and notably, because companies were able to refinance existing debts over the last few years and push out maturities

[Fig. 11], only about 1% of existing debt needs to be refinanced in 2023, and less than 10% needs to be refinanced before 2025. So the need for companies to refinance existing debt at these higher levels seems to be currently muted.

That said, if the Fed is able to keep rates at these elevated levels, and as the need for corporate borrowers to access the capital markets increases, there's no doubt that corporate profitability will be negatively impacted by higher interest expenses. However, we don't think it will happen in the near term.



Navigating a year of increased uncertainty

Uncertainty surrounding the course of the Ukraine-Russia conflict has thwarted diplomatic attempts to reach a negotiated settlement. The intense military campaign involves a significant contribution from NATO toward the Ukrainian war effort, specifically from the U.S. Depending on how long the fighting continues, it is expected that many of the NATO countries, including the U.S., may debate the financial burden, especially if Europe and the U.S. enter a recession in 2023.

With Finland and Sweden seeking NATO membership, the relationship between Russia and the West is destined to deteriorate further and could prolong Russia's determination to overrun all of Ukraine. A complex geopolitical and military situation could evolve into an even more complicated scenario.

The relationship between the U.S. and China has become more challenging as China's President Xi Jinping began a third five-year term, underpinned by an extensive consolidation of power. At the Communist Party's 20th Plenum in 2022, Xi outlined China's objectives and focused on technological

advances, military strength, and explicit remarks that Taiwan "must and will be" reunited with China.

Because the U.S. has policy toward Taiwan and has become increasingly vocal in support of Taiwanese independence, Xi declared that China will never renounce the "right to use force" over Taiwan.

The Biden administration continues to ramp up its export policy banning sales of technology that can be applied to China's military efforts, which has become a source of contention between the two countries.

Despite having an economy weakened by a strict zero-COVID-19 policy that includes massive testing and lock-downs of entire regions for weeks and months, there is an overreaching concern that Xi will continue the policy. Foreign investors and businesses are hoping that the uncompromising measures are lifted so that normal commerce can be revived. Analysts are debating whether Xi, who sees the policy as the ultimate path toward eradicating COVID-19, will ultimately abandon, or even ease, the prohibitive regulations. Although the global supply chain has significantly improved, China remains an integral part of global trade.

THE COMMODITY CONUNDRUM

This year the global economy adjusted to a higher interest rate campaign initiated by most central banks in order to tackle inflationary pressures. As such, expectations are rising that a recession or a significant economic slowdown will unfold. Unless there are severe shortages, commodity prices typically tend to ease until there are signs that central banks are nearing the end of the rate hike cycle, and are perhaps poised to begin lowering rates to help bolster economic growth.

Importantly, given that the Fed has been especially aggressive with interest rate hikes compared with most central banks, the U.S. dollar has climbed dramatically higher versus a basket of major currencies. With most commodities priced in dollars, it has put pressure on the commodity complex in general, particularly for countries that rely on commodity exports for their income and overall budgets, specifically many emerging markets.

Another significant factor for commodity pricing is the role of China and its outsized projected need for commodities. This includes a broad spectrum of metals, agriculture, oil, and building materials.

The commodity super cycle spurred by China’s hyper-growth rate in the beginning of the century has waned significantly [Fig. 12]. As China’s leadership has focused on containing COVID-19 at all costs, the once strong economy has stagnated. Additionally, the boom in real estate projects has slowed dramatically as developers are mired in debt.

Analysts are continually debating when—and if—Xi will ease zero-COVID-19 lockdown regulations and introduce compelling stimulus measures to support the economy, a scenario in which commodity pricing could recover substantially.

Generally, important contributing factors to support commodity prices are the end of the interest rate cycle by central banks, particularly the Fed, which in turn, could weaken the dollar and help foster global economic strength. Moreover, when China’s economic backdrop begins to recover from the current malaise, the signals for commodity prices to recover should be in place.

In addition, an end of the Ukraine-Russia conflict could help extract some of the uncertainty embedded in agricultural, oil, and an assortment of metal commodities that have been whipsawed by the ongoing warfare.

CURRENCIES—THE END OF KING DOLLAR?

To say the U.S. dollar has vaulted higher during the Fed’s rate hike cycle would be an understatement. Whether it is the result of the interest rate differential (that is, that the Fed has been more aggressive than other central banks) or that U.S. markets have been attracting more investments from foreign investors, the result has been staggering.

The strong dollar, while making imports less expensive, has put pressure on many of the large multinational companies with a global footprint, particularly as global economies are facing slower growth.

Also, many emerging markets that export commodities and/or import basic commodities are

more vulnerable as the strong dollar weakens demand. Emerging markets with dollar-denominated sovereign debt and corporate debt tend to struggle to service the debt as the dollar strength intensifies.

Japan has suffered through the U.S. rate cycle, watching the yen fall to nearly defenseless levels against the dollar. Much of this is due to the Bank of Japan’s insistence on keeping the yield on the Japanese 10-year bond in an extremely low and tight range as it adheres to a policy called Yield Curve Control (YCC). Rather than raising rates, the world’s third largest economy has kept rates steady via YCC, but has been forced to intervene in currency markets to raise the yen against the dollar. Until the Fed or markets make it clear that the rate hike cycle is nearing an end, the yen will continue to be subject to bouts of extreme vulnerability as long as YCC remains in place. However, the weaker yen can help Japanese companies compete against U.S. companies in the competitive export market.

With China, the world’s second largest economy, also not raising interest rates as its economy languishes, the Chinese yuan has been hovering at lower levels against the dollar. Concerns over regulatory policies, transparency, and what actions the Xi regime will take to strengthen the economy have culminated in many questions rather than answers.

As the Fed moves toward its final interest rate hike, a path that could take many months, the dollar should lose some of its seemingly relentless force and fall to levels that are commensurate with offering stability to global markets, but also helping U.S. companies compete for business internationally.

12 fig.

Commodities index vs. China GDP growth rate



Source: LPL Research, Bloomberg 11/15/22

Indexes are unmanaged and cannot be invested into directly. Past performance is not a guarantee of future results.



Power dynamic rebalanced in Washington

The 2022 midterm election was closer than many expected, but in the end, voters chose to rebalance the power dynamic in Washington. As expected, Republicans gained enough seats to win a narrow majority in the House, while Democrats held on to their slim majority in the Senate. Despite Republican's narrow House majority, their victory in the House significantly shifts the balance of power, since only legislation with broad bipartisan support will get passed once the new Congress is sworn in on January 3, 2023.

KEY TAKEAWAY: IT'S OVER

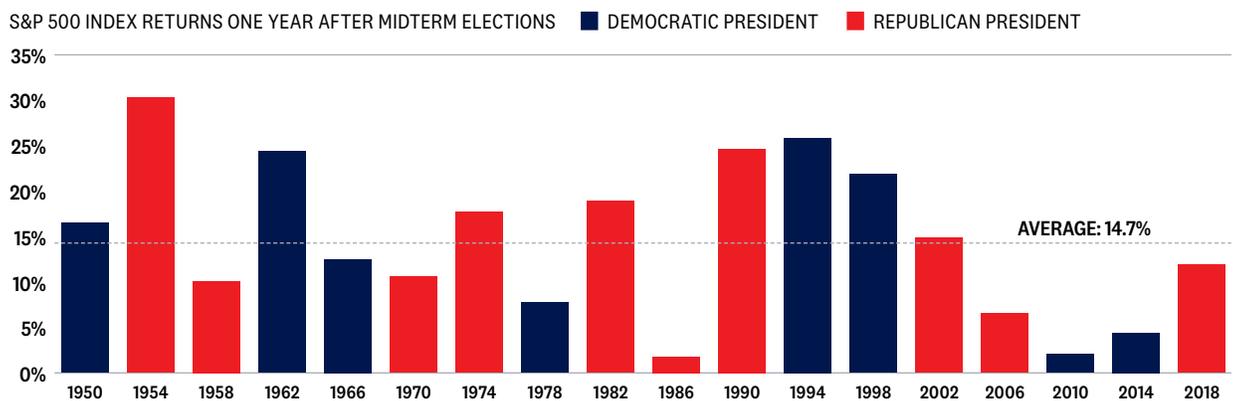
Perhaps the most important outcome of the election is simply that we have it behind us. Historically, midterm years have been volatile for markets, and 2022 has been no exception. But the third year of the presidential cycle has historically been the strongest [Fig. 13] and a weak 2022 may help set up that pattern again. We would add a note of caution, though, that increased fiscal stimulus in anticipation of the presidential election has often supported returns in the third year of the cycle and we are unlikely to see that added tailwind next year.

HISTORY SAYS GRIDLOCK IS GOOD

The other major takeaway from the election is that we now have "mixed government" with Democrats holding the Oval Office and a majority in the Senate while Republicans have a majority in the House. Markets have tended to favor mixed government [Fig. 14], since neither party is able to give in to its worst excesses and any legislation that does get passed is subject to compromise. It may also be that the government that governs best is sometimes the one that governs least, and mixed government has a tendency to create gridlock.

13
fig.

Stocks have always gained a year after midterms



Source: LPL Research, FactSet 11/15/22
All indexes are unmanaged and cannot be invested into directly. Past performance is no guarantee of future results. The modern design of the S&P 500 Index was first launched in 1957. Performance before then incorporates the performance of its predecessor index, the S&P 90.

14
fig.

Going back to 1951, a Democratic president with a Republican or split Congress has seen an average total return for the S&P 500 Index of 17.5% versus an overall average of 12.5% (excluding 2022).

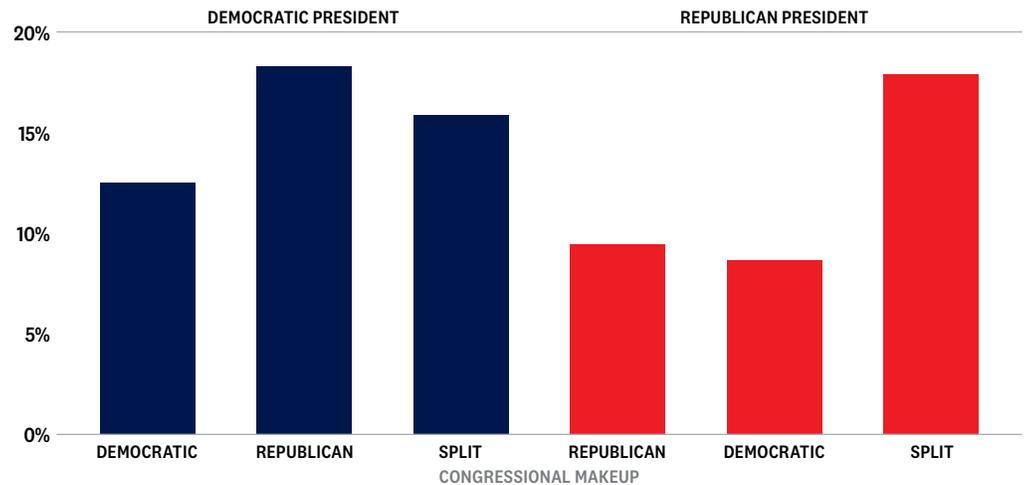
Perhaps the biggest policy takeaway from the election results is simply that it will be harder to pass any legislation if we have a mixed government, which likely takes any meaningful risk of tax increases on households or businesses off the table. We would consider this market positive, especially on the corporate side.

POLICY SUPPORT FOR ENERGY, FINANCIALS, AND HEALTHCARE

There is also typically incremental improvement to the policy environment for financials, energy, and defense when Republicans hold more power. Financials are unlikely to see legislated increases in regulatory oversight and would no longer face the risk of a new financial transactions tax with a Republican House. Energy is more likely to see progress on permitting reform. And Republicans tend to favor greater defense spending. On the other hand, a Republican House may lead to less Medicare spending, which could incrementally weigh on

Democratic president with a Republican or split Congress has been a strong combination for stocks

AVERAGE S&P 500 INDEX ANNUAL RETURN (1951-2022)



Source: LPL Research, FactSet 11/15/22
All indexes are unmanaged and cannot be invested into directly. Past performance is no guarantee of future results. The modern design of the S&P 500 Index was first launched in 1957. Performance before then incorporates the performance of its predecessor index, the S&P 90.

some areas of the healthcare sector, especially hospitals. However, we would highlight that historically the economic backdrop has typically dominated the policy environment when it comes to the policy impact on sector performance.

Other potential takeaways:

- The path to raising the debt ceiling may become more difficult, and markets have usually reacted negatively when it starts to look like there's some possibility the U.S. could default on its debt.
- A recession has the potential to be somewhat deeper, if we were to have one, due to a smaller fiscal response.
- A Republican House means increased scrutiny in areas where the House has oversight authority, contributing to gridlock.
- A still Democratic Senate gives President Biden some leeway on appointments that require Senate

approval, possibly maintaining regulatory risk in areas where instruments of the executive branch have oversight. However, a narrow Senate majority has given centrist Democrat senators (primarily Joe Manchin, WV, and Kyrsten Sinema, AZ) strong influence, as their votes are needed for any appointment that does not have bipartisan support.

Finally, we are often asked what the 2022 election might mean for 2024, especially the presidential contest. But it's difficult to forecast the political environment two years ahead, never mind the market implications for any given scenario. Our only forecast is that, like recent history, it's likely to be close but Republicans have a favorable mix of who is up for re-election in the Senate. Other than that, we'll wait and see how things evolve in 2023.

Staying balanced to stay on course



W

e experienced a turbulent year in 2022 as global central banks, led by the Fed, tackled

inflation and the global economy cooled. While we can't know exactly when the turbulence will end, the economy and markets have already made meaningful progress toward rebalancing.

Inflation has started to recede, a process we believe will continue in 2023, even if it will likely take some time to fully return to normal. Fed rate hikes will very likely end in the first half of 2023, although rates may remain at a restrictive level throughout the year. Labor markets, which had remained tight despite high inflation, have started

to loosen. Voters have even chosen a more balanced government in Washington—with a single party no longer controlling the presidency, House, and Senate.

Even as the environment remains uncertain, the ongoing process of finding a balance may be starting to create opportunities for investors. Higher interest rates bring a much improved outlook for bonds, which have not seen yields at these levels in many areas of the market in more than a decade. At the same time, segments of the stock market that had become expensive have become more fairly priced, while other segments actually look relatively cheap.

Knowing when to shift toward opportunities is also a balancing act. We need to account for the

ongoing risk from inflation, a possible recession, and global conflicts; while also understanding that markets are always forward looking, and thus anticipating the changes that they may respond to. By viewing 2022 and 2023 as a rebalancing process rather than as simply a downturn, *Outlook 2023: Finding Balance* provides perspective on what's been happening and what may lay ahead.

Ultimately, we believe the best path forward for staying focused in any environment is having a thoughtful plan and the right support. Together, they can help us maintain our balance even during the most challenging market periods. Please reach out to your trusted financial advisor with questions about how to stay on course toward reaching your financial goals.

STAAC

Our investment committee is your investment committee

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The committee is chaired by the director of research and includes investment specialists from multiple investment disciplines and areas of focus. The STAAC meets weekly to foster the close monitoring of all global economic and capital market conditions, and to ensure the latest information is being digested and incorporated into our investment thought.



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All index data from FactSet.

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GENERAL DEFINITIONS

Gross Domestic Product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period, though GDP is usually

calculated on an annual basis. It includes all of private and public consumption, government outlays, investments and exports less imports that occur within a defined territory.

The PE ratio (price-to-earnings ratio) is a measure of the price paid for a share relative to the annual net income or profit earned by the firm per share. It is a financial ratio used for valuation: a higher PE ratio means that investors are paying more for each unit of net income, so the stock is more expensive compared to one with lower PE ratio.

Earnings per share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock. EPS serves as an indicator of a company's profitability. Earnings per share is generally considered to be the single most important variable in determining a share's price. It is also a major component used to calculate the price-to-earnings valuation ratio.

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

EQUITY RISK

Investing in stock includes numerous specific risks including the fluctuation of dividend, loss of principal and potential illiquidity of the investment in a falling market. Because of their narrow focus, sector investing will be subject to greater volatility than investing more broadly across many sectors and companies. Value investments can perform differently from the market as a whole. They can remain undervalued by the market for long periods of time. The prices of small and mid-cap stocks are generally more volatile than large cap stocks.

EQUITY DEFINITIONS

Cyclical stocks typically relate to equity securities of companies whose price is affected by ups and downs in the overall economy and that sell discretionary items that consumers may buy more of during an economic expansion but cut back on during a recession. Counter-cyclical stocks tend to move in the opposite direction from the overall economy and with consumer staples which people continue to demand even during a downturn.

Growth stocks are shares in a company that is anticipated to grow at a rate significantly above the average for the market due to capital appreciation. A value stock is anticipated to grow above the average for the market due to trading at a lower price relative to its fundamentals, such as dividends, earnings, or sales.

Value stocks are anticipated to grow above the average for the market due to trading at a lower price relative to its fundamentals, such as dividends, earnings, or sales.

Large cap stocks are issued by corporations with a market capitalization of \$10 billion or more, and small cap stocks are issued by corporations with a market capitalization between \$250 million and \$2 billion.

FIXED INCOME RISKS

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and bonds are subject to availability and change in

price. Bond yields are subject to change. Certain call or special redemption features may exist which could impact yield. Government bonds and Treasury bills are guaranteed by the US government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value. Corporate bonds are considered higher risk than government bonds but normally offer a higher yield and are subject to market, interest rate, and credit risk, as well as additional risks based on the quality of issuer coupon rate, price, yield, maturity, and redemption features. Mortgage-backed securities are subject to credit, default, prepayment, extension, market and interest rate risk.

FIXED INCOME DEFINITIONS

Credit Quality is one of the principal criteria for judging the investment quality of a bond or bond mutual fund. As the term implies, credit quality informs investors of a bond or bond portfolio's credit worthiness, or risk of default. Credit ratings are published rankings based on detailed financial analyses by a credit bureau specifically as it relates to the bond issue's ability to meet debt obligations. The highest rating is AAA, and the lowest is D. Securities with credit ratings of BBB and above are considered investment grade. The credit spread is the yield the corporate bonds less the yield on comparable maturity Treasury debt. This is a market-based estimate of the amount of fear in the bond market. Base-rated bonds are the lowest quality bonds that are considered investment-grade, rather than high-yield. They best reflect the stresses across the quality spectrum.

Bloomberg U.S. Aggregate Bond Index represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment-grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities.

High yield/junk bonds (grade BB or below) are not investment grade securities, and are subject to higher interest rate, credit, and liquidity risks than those graded BBB and above. They generally should be part of a diversified portfolio for sophisticated investors.

Municipal bonds are subject to availability and change in price. They are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise. Interest income may be subject to the alternative minimum tax. Municipal bonds are federally tax-free but other state and local taxes may apply. If sold prior to maturity, capital gains tax could apply.

Commodities include increased risks, such as political, economic, and currency instability, and may not be suitable for all investors. The fast price swings in commodities will result in significant volatility in an investor's holdings.

Alternative Investments may not be suitable for all investors and involve special risks such as leveraging the investment, potential adverse market forces, regulatory changes and potentially illiquidity. The strategies employed in the management of alternative investments may accelerate the velocity of potential losses."

For a list of descriptions of the indexes and economic terms referenced in this publication, please visit our website at lplresearch.com/definitions

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