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The Beginning of the End of Global Tightening

We think the global tightening cycle will likely come to an end in 2023. Among the signs pointing in that direction: Growth is likely to slow, labor markets will likely soften, and inflation seems set to fall.

Most investors are probably happy to see 2022 in the rearview mirror. For a time during the fourth quarter, it looked like help was on the way for investors after a brutal first three quarters of the year. But by the end of December, the so-called "Santa Claus" rally failed to take flight.

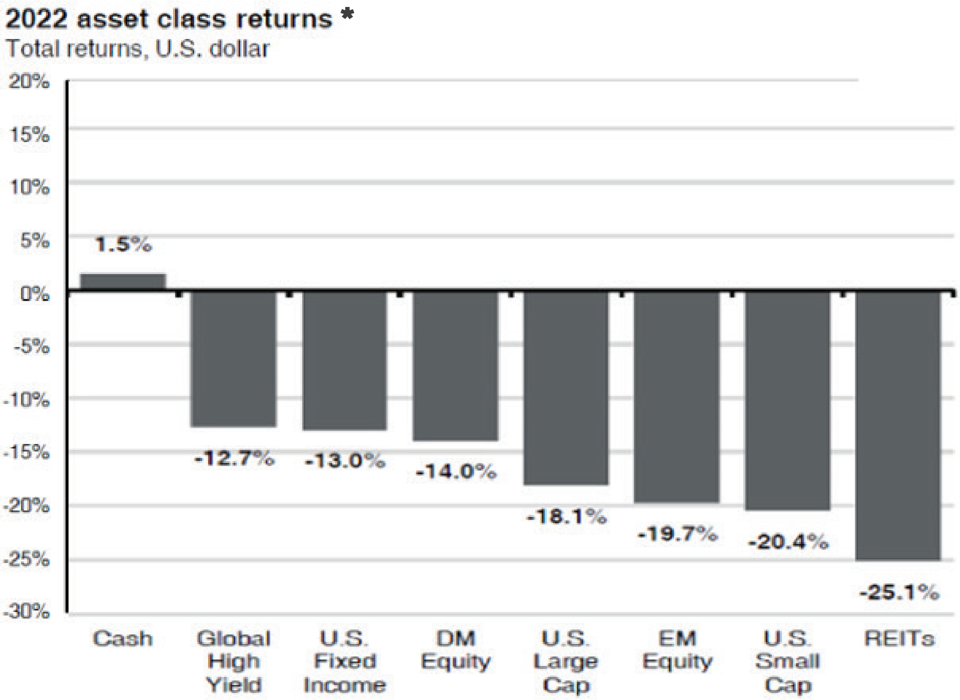
The year 2022 was very challenging for global equities. U.S. stocks were hurt disproportionately by the interest rate environment, as the S&P 500 was overweight growth stocks after years of outperformance. Low yielding, high-growth companies are more exposed to changes in interest rates.

But here's the good news. Precisely because markets are so battered, lower equity valuations and higher bond yields offer investors the most attractive entry point for a traditional portfolio in over a decade.

2023 will likely be a turbulent year as inflation and monetary policy fears pivot towards a weak global economy, but may also lead to lower inflation and central banks pausing their rate hike campaigns.

The combination of interest rate hikes, falling commodity prices and slower growth has started to push down inflation, and central banks have signaled the pace of rate hikes will slow. As the rate hiking cycle nears an end, and monetary policy uncertainty fades, investor sentiment may turn more positive.

With 2022 being the worst year for bond investors since the 1930s, and the fact that it occurred during a bear market for equities, some might be tempted to declare the 60/40 portfolio construction dead. We disagree, thanks in large part to the return of so-called bond vigilantes who had all but disappeared over the last 2 decades. As the chart below demonstrates, 1969 experienced a similar pull-back in both stocks and bonds, so 2022 was unusual but not unprecedented. We think they made bonds an interesting asset class once again, with sanity returning to the market pricing of rates.



2023 will bring some exciting changes and improvements to the Horizon Trust and Investment Management platform. During the 4 th quarter of 2022, we have built upon and enhanced partnerships to bring best in class investment solutions to our clients.

In the first quarter of 2023, we will announce the availability of the enhanced platform, including:

- Broader, more globally focused, research capabilities
- More investment solutions to implement our improved research capabilities
  - An expanded list of approved stocks
  - An expanded list of high quality fixed income issuers
  - A broader approach to the use of mutual funds, including the addition of index funds and ETFs
- More flexibility in portfolio construction
- Proactive tax management

60/40 annual returns **

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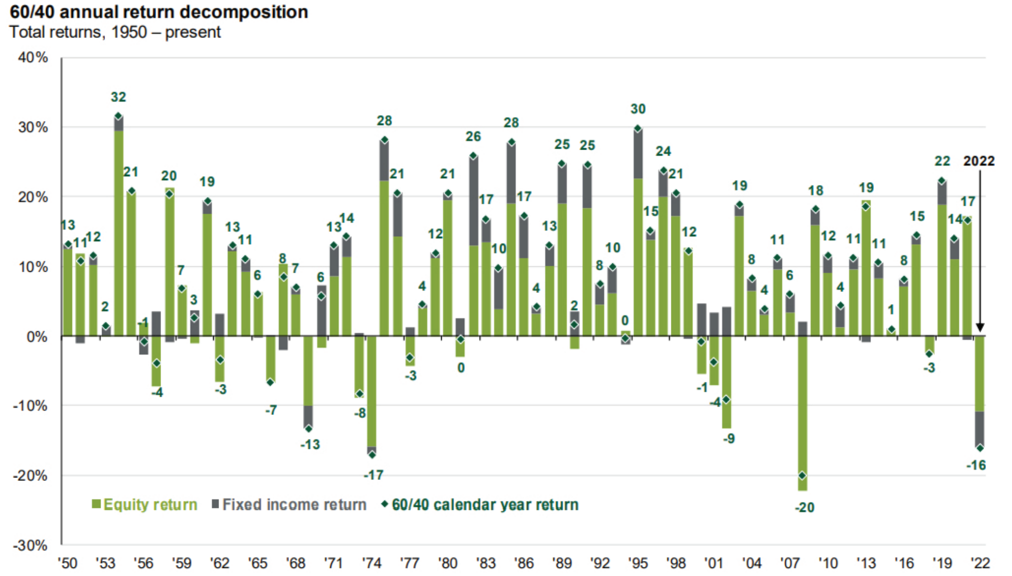

* Source: Bloomberg, FactSet, MSCI, NAREIT, FTSE Russell, Standard and Poor's and J.P. Morgan Asset Management.

**Source: FactSet, Standard and Poor's, Robert Shiller, Yale University, Bloomberg, Ibbotson/Strategas, J.P. Morgan Asset Management. The 60/40 portfolio is 60% invested in S&P 500 Total Return Index and 40% invested in Bloomberg U.S. Aggregate Total Return Index. S&P 500 returns from 1950 - 1970 are estimated using the Shiller S&P Composite. U.S. fixed income total returns from 1950 - 1975 are estimated using data *Guide to Markets - U.S.* Data are as of December 31, 2022.

Economic Outlook

Looking ahead to 2023, inflation and the possibility of recession remains the global market's focal point. Our base case is that inflation will further recede as supply chain pressures ease and central banks slow the pace of rate hikes. However, the result of this policy is likely to be a slowing of the economy, and this could create excellent opportunities for long-term investors.

Central banks in the developed world have simultaneously raised policy rates by 2% to 4%, the fastest pace in 40 years. Such a move is a headwind to economic growth, and the full impact of the tightening moves may still lay ahead. The combination of interest rate hikes and slower growth has started to push down inflation, and central banks have signaled rates are close to levels where policy is considered tight and rates should plateau. As the rate hiking cycle nears an end and monetary policy uncertainty fades, investor sentiment is likely to turn more positive.

The labor market will provide important evidence of inflation's ability to approach central bank targets. In light of these cross-currents, we continue our underweight to developed market equities as the potential for downside earnings risk and a disappointing economy is real. We expect those risks to balance with improving valuation and sentiment conditions as the year progresses.

The Atlanta Fed's GDP now currently shows fourth-quarter GDP at 4.1%, with consumer spending driving a healthy portion of the increase. Clouds may be gathering on the horizon, but the economic storm has not yet materialized. With inflation elevated, the Fed is focused on labor market weakness as a key signal in determining how far to tighten monetary policy, in particular a reduction in the amount of unfilled jobs. In our view, the Fed is nearing peak rates for this cycle.

Our long-term outlook on growth, inflation and monetary policy remain in play.

- Slow Growth Transitions are playing out (slowly), and that has been a problem for global economic growth – see China's slow move from pandemic to endemic or the uncertainty from the slow move from globalization to regionalization.
- Inflation Recalibration has proven a complex task. Moderating commodities prices should bring down headline inflation but continued tight U.S. labor markets suggest core inflation may be harder to tame. Overall, while moderating inflationary pressures may warrant a pause in tightening in early-to-mid 2023, a reversal in monetary policy – much less a move back toward pre-2022 monetary policy settings appears unlikely.
- This is the view expressed by our Monetary Drought theme, wherein investors should not count on a return to the zero interest rate policy and quantitative easing flood of the past decade anytime soon.

Growth Outlook

The global growth outlook cannot be disconnected from what held back growth in 2022; the war in Ukraine, China's COVID-19 struggles, high inflation and tighter monetary policy. We expect all of these factors to remain relevant in 2023, and as a result we have a cautious growth outlook. The U.S. economy has a bit more momentum than the rest of the world, but it still faces the headwind of higher interest rates. Even the vaunted U.S. consumer is vulnerable with a lower savings rate, a cooling labor market, and negative real wage growth.

While we expect below trend growth, we think significant downturn can be avoided. Europe may not be as lucky given headwinds from higher energy prices, interest rates, as well as slower and shallower growth.

Inflation Outlook

The world is still in the midst of a huge inflationary surge due to big increases in prices of energy, food, goods, services and housing. At the same time, the inflationary dynamics are starting to change. Tighter monetary policy and a global growth slowdown combined with the easing of pressures in energy markets and supply chains are starting to push inflation down.

Many data points signal that inflation is already past its peak. Durable goods prices are decelerating rapidly, as are import prices and producer input prices. U.S. crude oil and gasoline prices are at their lowest levels in over a year. We expect U.S. inflation rates to continue to trend lower, although labor market strength could lead to inflation proving a bit more durable than markets currently expect.

We expect European inflation to drift below market expectations, but note it is very sensitive to energy prices and the war in Ukraine. Inflation in the U.K. will be somewhat stickier but should still decline to levels similar to Europe. For Japan, we expect inflation to creep back down to a relatively healthy level. Finally, we expect China's inflation to stay relatively low and range bound given the difficult balancing act ahead for its government.

Monetary Policy Outlook

Monetary policy has been in overdrive with central banks across the developed world (ex-Japan) tightening much more than initially expected. In just 12 months, the Federal Reserve is expected to have delivered more than 4% in cumulative rate hikes. The Bank of England (BOE) has delivered 3% in cumulative rate hikes, and the European Central Bank (ECB) 2%.

Aggressive tightening of this scale highlights the inflation challenge facing policymakers globally. However, central banks are approaching their own estimates of neutral rates, and the lagged impact of rate hikes is already slowing economic growth.

In 2023 we expect policy rate hikes to slow materially before reaching plateau levels mid-year. Once there, central banks will take a forward-looking and data-dependent stance with inflation and labor market dynamics taking center stage. We expect the Fed will raise rates 50-75 basis points (bps) in the first half of 2023. At approximately 5% we expect monetary policy will be considered sufficiently tight to allow the Fed to pause at the highest level since 2007. The market is pricing in rate cuts in the back half of 2023, we think this will hinge on upcoming releases of corporate earnings and employment data. The path to a soft landing is dependent on moderate earnings adjustments, and on the health of the labor market.

Equities

Significantly higher and more persistent levels of inflation have elicited a significant monetary policy response as central banks sought to quell demand. This created two headwinds for equities:

- Higher interest rates are negative for stocks as future cash flows are discounted at a higher interest rate, thus bringing down equity valuations.
- Central banks seeking to bring balance to supply and demand by curtailing demand via tighter financial conditions has reduced growth expectations and increased the risk of recession.

U.S. stocks were disproportionately hurt by the interest rate environment, as domestic rates rose more significantly and the S&P 500 was overweight growth stocks after years of outperformance. Growth stocks are more exposed to changes in interest rates, given low dividend yields and reliance on rapid future earnings growth. European equities proved somewhat resilient against a challenging economic backdrop (because of higher yields and lower valuations), while emerging markets lagged on the greater sensitivity to higher food and energy prices, the strong dollar and the significant negative economic consequences of China's zero-Covid strategy.

Looking ahead, we see some downside risk to corporate fundamentals (both sales and profit margins). This will likely be balanced against an improving sentiment backdrop including; a likely plateau of central bank policy rates, continued improvement in inflation and the potential that a recession may be relatively short and shallow.

Given our cautious view, we enter the year underweight stocks overall, neutral-weighted in the U.S. and underweight international equities. In our view, the yields and valuations on developed international equities (Europe and Japan) look attractive, and we are slowly adding exposure. We acknowledge the potential for China to emerge from its zero-Covid policy in 2023, but expect it will be bumpy and prone to setbacks. With longer term structural challenges around demographics, real estate and de-globalization in place, we enter the year cautiously positioned in emerging markets.

Fixed Income

The good news for 2023 is that fixed income yields are higher, and there are several areas that can do well in 2023. With higher Treasury yields and higher risk premiums, here are three areas that we believe can perform well:

- Investment grade corporate bonds - These are companies with low leverage and high credit quality that don't have a lot of economic volatility. If economic growth slows, they are better prepared to handle it than lower quality companies.
- Municipal bonds – One silver lining of inflation is that tax revenues of many municipalities have also risen. Municipal bonds are trading at yields not seen in 20 plus years.
- Agency mortgage backed securities – These securities have government guarantee against default. Given the elevated level of interest rates and their attractive yields, they can provide good outcomes in a high quality asset class.

We feel that fixed income investors should avoid overexposure to high yield bonds. Lower quality companies that were able to make interest payments at 3 or 4% interest rates, may struggle at 8 or 9% interest rates.

We believe recession fears are real, Strategas Research estimates the odds of recession in the next two years is 75%, and economists' consensus view for a recession in 2023 at 63% probability. There's reason to be concerned that after aggressive central bank rate hikes, we could see a recession. That's also an environment often where inflation pressures come down and high quality fixed income (emphasis on high quality) tends to do actually quite well.

While caution on the economic outlook is justified, there is reason for optimism in the bond market. Investors need to remember that higher bond yields provide a cushion against future volatility. At the beginning of 2022, yields were exceptionally low and there was no cushion. Yields are significantly higher now, and even if the Federal Reserve that is continues to raise interest rates to fight inflation, the starting cushion is significant and can buffer price volatility and future returns can be much more attractive.

Conclusion

Even though the Fed tightening cycle is in the later stages, we don't think the world goes back to the low inflation, low interest rate environment of the last few decades. Instead, the future path of rates should depend on ongoing economic data, as the Fed will be more focused on inflation than any time in the last 30 years. The implications are higher interest rates, lower stock valuations, and a return to active investment management. This should favor value over growth stocks.

Fixed income and high quality credit should do well in 2023 based on the sell-off that has already taken place. We currently see value in the 2- to 5-year part of the yield curve.

We believe that equities may still have some work to do to establish a bottom. Valuations are reasonable, but not cheap. In addition to an adjustment in valuations given a new rate regime, there is a risk that earnings expectations are downgraded further in 2023 based on slowing economic growth.

Savvy investors should be prepared to capitalize on any opportunities presented by market volatility as the economy adjusts to the higher rate environment.

Thank you for being a client of Horizon Trust & Investment Management. Please let us know if there's anything we can do for you and your family.

The 4% Rule for Retirement Spending

The traditional rule of thumb for retirees who need to make their money last for 30 years is to spend no more than 4% of their savings in the first year of retirement, and in subsequent years raise those withdrawals enough to keep pace with inflation. Four percent is the historic starting spending rate that would have protected retirees from running out of money in every 30-year period since 1926, even when economic conditions were at their worst, according to financial planner Bill Bengen, who created the 4% rule.

However, researchers at Morningstar recommended a spending cut in 2022, advising those people taking their first withdrawal to spend only 3.3% due to expectations for lower future investment returns. In a recent report, they have again modified their recommended withdrawal due to current market conditions. They believe a 3.8% withdrawal rate is appropriate for new retirees with a 30-year time horizon. The reason: today's lower stock and bond valuations support an expectation of higher future investment returns when compared the market environment heading into 2022.

The recommended withdrawal rate for new retirees varies from one year to the next, rising and falling along with simulations of future market conditions. Using Morningstar's updated 3.8% spending recommendation, someone who retires today with a $1 million portfolio with 50% in stocks and 50% in bonds would spend at most $38,000 from that portfolio in 2023. If you are considering retirement, you can use the 3.8% figure as a test of the viability of the withdrawal you are considering.

According to Morningstar, the 4% rule is most reliable for portfolios with 30% to 60% in stocks and the rest in bonds. If you invest less than 30% in stocks, your returns may be insufficient to support a 3.8% inflation-adjusted withdrawal for 30 years. If you invest more than 60% in stocks, there is greater risk that portfolios may not recover sufficiently during bear markets to support the withdrawal rate.

History of the 4% Rule

The 4% Rule is a retirement planning rule of thumb that dictates a retiree withdraw 4% of their retirement funds in their first year and remove that dollar amount, adjusted for inflation, every year after.

Overall, the 4% rule is a useful guideline for retirees, but it is not a one-size-fits-all solution. It is important for retirees to consider their own unique circumstances, including their expected lifespan, their investment portfolio, and any unexpected expenses they may encounter, when planning for their retirement. A financial advisor can help you to build a plan that fits your specific needs and can give you peace of mind in your retirement.

If you are considering retiring, or would like to review your spending plans, please contact your Horizon Trust & Investment Advisor to schedule a consultation.