2023 OUTLOOK — THE THREE I'S: INFLATION, INTEREST RATES AND INVESTMENT OPPORTUNITIES

What's important

- A mild recession in the United States is likely, and Europe will endure a deeper recession driven by energy in the first half of 2023.
- China will continue to see economic challenges based on its COVID policies and rising geopolitical tensions.
- 2023 is likely a highly bifurcated year for investing, with stronger fixed income returns, modest equity returns and a "stay-at-home" approach favoring U.S. equities versus international.

Macroeconomic outlook: United States

This is shaping up to be a year of certainty for most market watchers that:

- Inflation will fall sharply.
- The Federal Reserve (the Fed) will pause rate hikes.
- Earnings will decline.
- The stock market will fall in the first half of 2023 and rally in the second half, anticipating a stronger 2024.
- The United States will continue outperforming every other market.

While we share some of these views (albeit with less confidence), we see meaningful risks as well, including:

- Inflation is more stubborn than anticipated.
- If the Fed doesn't pause, earnings won't fall as much because inflation will disguise the fall.
- Stock markets will rally in the first half of 2023 in anticipation of the Fed no longer tightening rates, only to fall in the second half as the Fed must continue to battle inflation.

Each narrative has a very different outcome for stock and bond markets, but both come from the same element: inflation and whether it slows fast enough for the Fed in 2023. U.S. growth in 2023 is likely to continue to decelerate as the Fed continues to raise rates to slow demand, while inflation is moderating but still at historically high levels. We believe inflation will be sticky in 2023 and persistently high relative to historical levels. High levels of inflation and a Fed that's slowing demand at a quick clip are likely to leave the consumer in a fragile place.

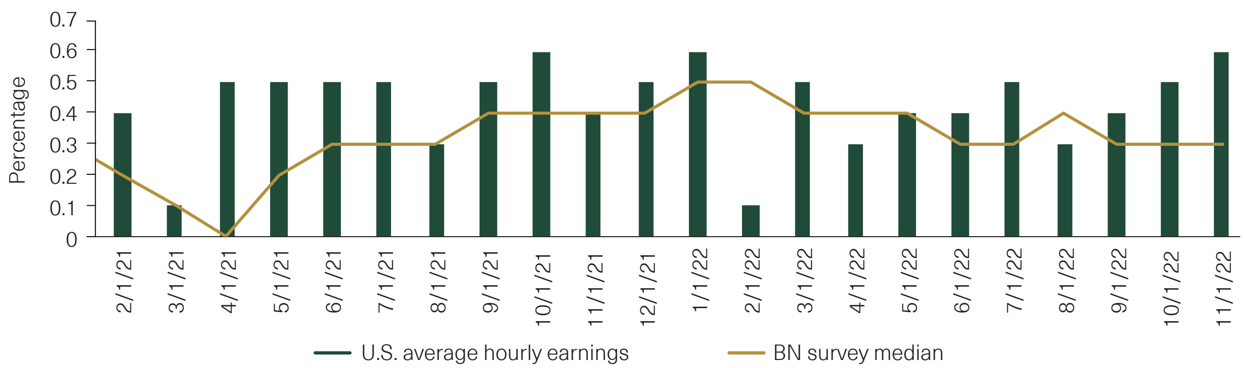
Figure 1 | The best economic growth is behind us; expect a recession by mid-2023

Forecasts for 2023	2022 Q4	2023 Q1	2023 Q2	2023 Q3	2023 Q4
U.S. real GDP (annual YoY%)	2.60%	0.30%	-3.70%	-1.10%	1.10%
Consumer price index	7.5	6.4	4.8	4.2	3.6
Consumer price index, total except food and energy	6.2	5.7	4.9	4.1	3.4
Interest rate, central bank policy, end of period	4.40%	5.00%	5.00%	5.00%	5.00%
Interest rate, 10-year government bonds, end of period	3.70%	3.70%	3.40%	3.20%	3.10%
S&P 500 Earnings per Share (EPS), end of period					$210

Sources: Oxford Economics, First Republic Investment Management, as of December 31, 2022.

However, the employment side of the economy remains the bright spot, and the Fed is likely to continue raising rates until the pace of employment growth slows. Finally, housing affordability will continue to decline as the level of current mortgage rates leaves new homeowners on the sidelines, and existing owners are unwilling to give up their pre-hiking mortgage rates.

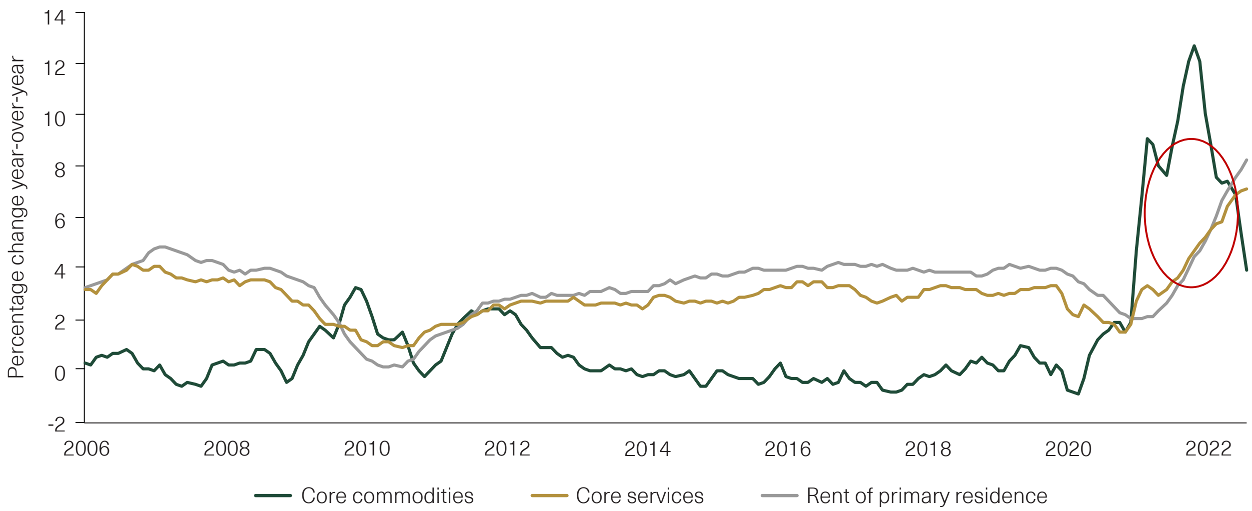
Figure 2 | Employee wage growth remains strong



Sources: U.S. Bureau of Labor Statistics, Bloomberg, First Republic Investment Management, as of December 31, 2022.

Despite the potential for a wide range of outcomes in 2023, our base case calls for a mild recession in 2023, sometime in the middle to the second half of the year. High inflation, particularly in the core areas of the economy, will keep the Fed in hiking mode early in the year. While much of the supply chain issues we experienced during the start of the pandemic have cleared up, there are still shortages and delays keeping inflation high. One of the themes we continue to believe in is consumers will rotate away from spending on goods and back toward spending on services. There's evidence that this rotation is taking place as goods are experiencing disinflation, while services inflation remains high.

Figure 3 | Disinflation is driven by slowing core goods prices



Sources: Bloomberg, First Republic Investment Management, as of December 31, 2022.

The Conference Board's U.S. leading economic indicators are in recessionary territory, as are the new orders-to-inventories ratios. Manufacturing and services purchasing manager indexes (PMIs) are in a downtrend. Recent data shows the deterioration in financial conditions that has occurred this year is pointing to a very significant decline in economic activity even though financial conditions indexes have recently ticked up.

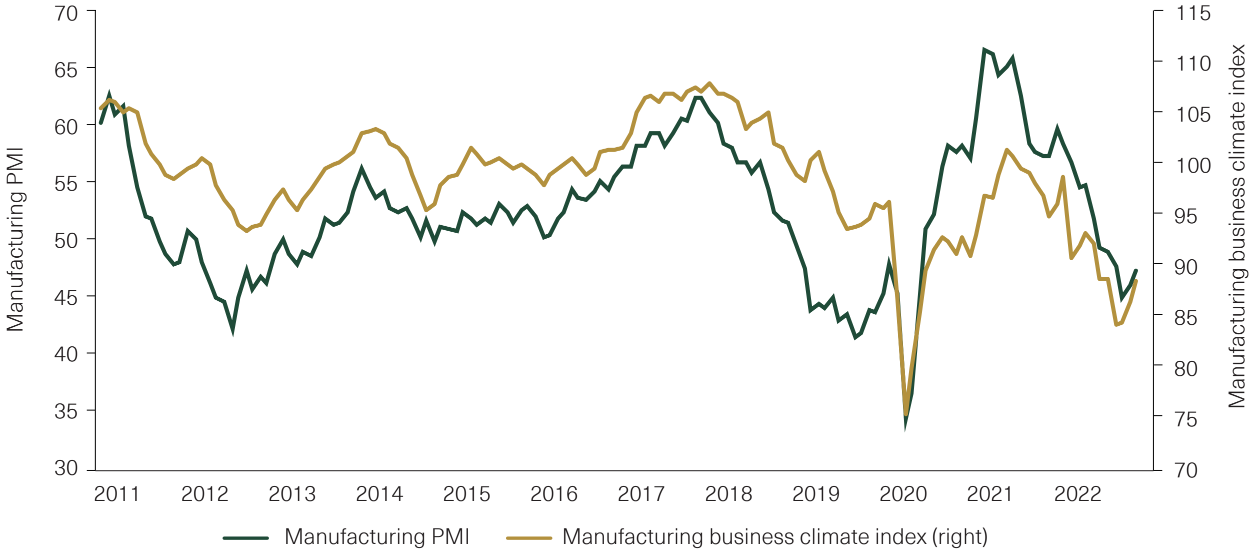
We believe that U.S. consumer prices are rising at a slower rate. Looking at alternate measures of inflation, the trimmed mean and median month over month, rates of inflation slowed meaningfully in November, led by core goods deflation and a significant slowdown in core services ex-shelter. We don't believe, however, that a slowing rate of inflation will be enough to meaningfully reduce the odds of a U.S. recession occurring this year. In our view, U.S. monetary policy has effectively reached tight territory for longer, which has historically acted as the catalyst for a recession. While the United States is in a better place relative to its global peers, we expect a mild recession in 2023.

Macroeconomic outlook: International

For Europe, the dire energy situation will shape the macroeconomic outlook again in 2023, keeping the economy in a recession at the start of the year and leading to a full-year contraction in growth. We expect a modest recovery once the energy shortage abates, as declining inflation should allow real household incomes to recover. But energy rationing will be a key risk to the outlook if Europe fails to secure enough gas or if households adjust their demand ahead of this winter.

By midyear, the situation in Europe should improve, as falling inflation should allow for gains in real incomes and therefore sentiment, and that should lead to a recovery in the industrial sector.

Figure 4 | Back to recession: The near-term outlook for Europe is firmly negative



Sources: S&P Global, IFO, First Republic Investment Management, as of December 31, 2022.

The outlook for Europe in 2023 remains highly uncertain with energy as the key driver. With almost zero Russian pipeline gas flowing into Europe this year, the continent will need to make significant efforts to replace the lost energy supplies. An improved outlook for alternate energy sources output combined with modified behaviors to conserve energy and substitution away from gas means that Europe should make it through the winter without Russian gas and avoid a deep recession.

For Asia, it's all about China this year. The most substantial impact from China on the region could come from multiple sources and most likely the uncertainty about its COVID policies. Even if you exclude COVID, the housing bubble is slowly deflating, and geopolitical tensions remain high. The blow to Asian economies from COVID lockdowns, higher oil prices and China's growth slowdown is unprecedented. However, not all is negative: We see stronger balance sheets for households, businesses and the government than in past years. The recovery to growth will take time, and the region will feel the pain, but Asia stands on more solid footing than in the past.

The outlook for China continues to look binary. Policymakers have gone "all in" to stabilize the housing market and loosen COVID restrictions. If that boosts household confidence, property sales may rebound, and the wave of bad debts may recede as the economy bounces back. The main impediment to opening the economy is the lack of a reliable domestically made vaccine. It's next to impossible to predict when that will come to market. Until there's a domestically produced vaccine, economic activity is likely to be choppy.

Policy outlook

The Fed anticipates hiking the target range for the Fed funds rate more than either we or financial markets believe. The Fed likely will reevaluate its rate hikes after the February meeting but not make the move to pivot until later in 2024. We think the Fed will continue to raise rates in the first half of 2023, pushing the target range for the Fed funds rate to greater than 5% in the first half, and then hold rates higher for longer through this year. The Fed anticipates raising rates by another 75 basis points and then cutting rates in 2024. In our view, the Fed will keep rates high throughout most of this year, then, based on the data, make the decision to cut or maintain rates higher for longer.

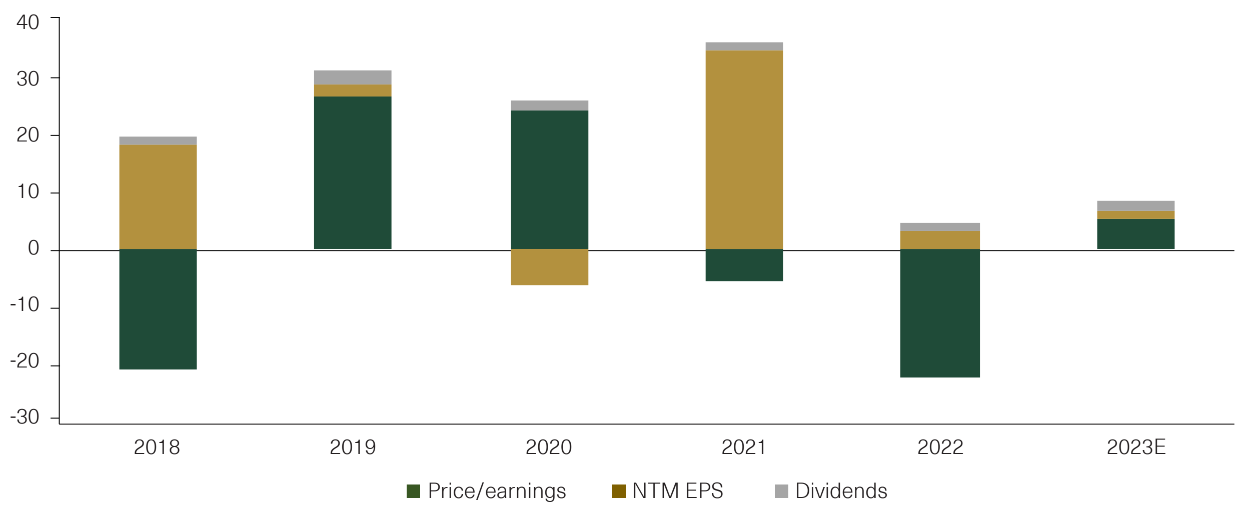
Some parts of the market are cooperating more than others, which is making the Fed's job more challenging. The U.S. economy isn't monolithic, and consumers with varying incomes are responding to higher rates differently. Lower-income consumers are struggling with inflation, but jobs are still plentiful. Higher-income consumers who rely on high home values are feeling more concern, but not enough to slow their spending. Currently, financial market conditions are tighter than they appear for some consumers, but not all. This raises the risk that the Fed will have to tighten more aggressively and may raise the odds of bouts of financial market stress in 2023 as recession fears intensify.

Based on November's declining inflation data, U.S. legislators went to work on spending bills. While the final details of spending bills continue to evolve, any significant increased spending will put the Fed in a bind as it will counter what they're trying to combat: inflation.

Financial markets outlook

We believe equity markets will be challenged as the Fed will hold rates higher for longer to quell inflation, and growth will further slow as the consumer pulls back. Fed policy will remain restrictive for equities, and the "Fed pivot" markets are hoping for may not come until 2024. Corporate earnings growth is already slowing rapidly and could fall even further.

Figure 5 | The majority of this year's modest returns in equities will be from valuation expansion, not earnings



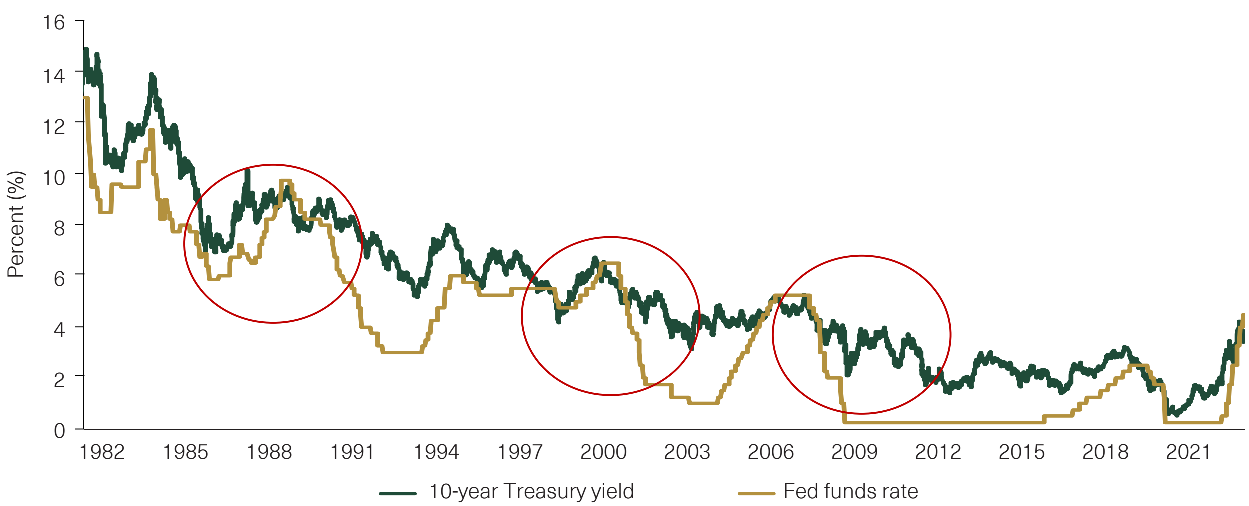
Source: Bloomberg and First Republic Investment Management Research. Data as of December 31, 2022.

Equities are also likely to feel pain as both the consumer and the corporate sector pull back on spending. We also expect mild returns and wide dispersion not only between asset classes but also within them.

Profit margins have been holding up well, but if inflation is stickier than we anticipate or the labor market remains strong, profit margins will come under considerable stress. We'll closely monitor margins this year, as last year we saw companies passing along higher input prices or labor costs, which we don't think will be possible in 2023. Consumers will become much more price sensitive as costs have increased across the board in all categories throughout 2022. Companies will have to be thoughtful on where and how they pass along price increases. There are some categories in which switching costs will have a low impact on consumers.

While our view may be negative for equities, on a relative basis, fixed income returns in 2023 could look quite attractive. As U.S. growth slows further, we expect the yield curve will remain inverted. We believe the Fed will continue to be laser focused on bringing inflation back to its 2% target level. Our view is that the Fed will continue to raise rates this year, but the magnitude will be much slower than last year. The Fed is likely to keep rates higher for longer as it looks to ensure it doesn't "jump the gun" and lower rates, then have to raise them if inflation starts to rise again.

Figure 6 | Peaks in bond yields usually happen in a narrow window



Sources: Bloomberg, First Republic Investment Management, as of December 31, 2022.

We believe positioning in fixed income will be very important in 2023. We recommend a barbelled approach to positioning with an overweight to short- and longer-dated bonds. Our view on credit is now negative as we're starting to see cracks in credit fundamentals amid higher rates and recent market volatility. For any positions within credit, we prefer higher-quality credits. Active fixed income portfolio management and fundamental credit selection will offer value in these volatile times.

Investment opportunities and portfolio positioning

We believe 2023 will be a year to avoid the crowds and get paid to wait, particularly within fixed income. We do view this as a year with two competing narratives with very different outcomes, and portfolio positioning needs to be more nuanced. It's also likely to be a highly bifurcated year for investing, with stronger fixed income returns, modest equity returns, and wide intra-year dispersion by asset class and within asset classes. 2023 will be a year of so many transitions, diversification and positioning will become more important — not just positioning on stocks/bonds but positioning within asset classes.

Equities will be challenged, and we prefer defensive positioning, favoring exposure to sources of quality, yield and lower cyclicality. 2023 will be a year of reshoring for the first part of the year as corporations look to bring operations home to avoid supply chain or shipping-related issues. Given our theme of reshoring, we take a "stay-at-home" approach within equities, favoring U.S. equities over international developed and emerging markets equities. In our view, downside risks to international markets are higher given the near certainty of a U.K. and Eurozone recession, a slowdown in China's growth due to its strict COVID policies and acute geopolitical risks.

For fixed income, we believe in focusing on curve positioning, as duration will still be important but less so than in past years. We expect credit spreads to move wider as credit fundamentals deteriorate on the back of higher rates, and while spreads will widen, this isn't the 2007/2008 type of spread widening event. We see opportunities in the mortgage-backed securities market as wider credit spreads have made select higher-quality parts of the market more attractive; higher mortgage rates also mitigate prepayment risk. We're also constructive on preferreds as long as they're from well-capitalized companies that offer additional yield for income-oriented investors. Within tax-exempt markets, essential service municipals are better positioned for an economic downturn.

More broadly, we believe investors should also consider a greater allocation across alternative investments that go beyond broad asset classes and can provide an additional layer of diversification. We see opportunities in value-oriented private equity, credit, hedge funds and select real estate. Past downturns have provided an attractive entry point for private equity, and funds that began investing in market downturns have delivered attractive returns. The slump in valuations provides a buying opportunity for firms looking to acquire assets at a discount. We see opportunities in multifamily and industrial real estate as fundamentals remain strong and are supported by increases in operating income driven by accelerating rents and elevated occupancy rates.

Finally, in our view, it's important to keep the risks for 2023 front and center. As most market commentators expect this year to be one of "two halves," with markets rallying later this year as the Fed pivots, we caution that the Fed and markets may have a different view. We continue to see risks to the year of two halves, as we could see inflation remain more persistent than expected and take longer to fall, and the Fed may not be so quick to slow the magnitude or stop rate hikes altogether. While risks remain, the common element continues to be inflation and whether the decline in inflation is quick enough for the Fed in 2023 to change its view on rates. While these risks remain, our view remains unchanged that inflation will slow alongside growth. This will be a year where you get paid to wait and avoid the crowds. Portfolio positioning will have to be more nuanced as intra-asset class dispersion will remain wide, and alternatives will play a bigger role in asset allocation.

Based on our views, we currently recommend the following asset allocation considerations:

Figure 7 | First Republic Investment Management asset allocation view

Asset class	Underweight	Neutral	Overweight
Global Equities			
U.S.		●	
Large Cap Value			●
Large Cap Growth	●		
Small Cap	●		
International Developed	●		
Emerging Markets	●		
Fixed Income			
Duration		●	
Credit	●		
Municipals		●	
Preferreds			●
TIPS		●	
MBS/ABS		●	
High-Yield	●		
Non-U.S. IG	●		
Emerging Market	●		
Alternatives			
Private Equity			●
Venture Capital		●	
Real Estate		●	
Private Credit			●
Hedge Funds			●
Cash			●

Source: First Republic Investment Management, as of December 31, 2022.

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