

Jan. 20, 2023

Market Update: On Course for Soft Landing

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Off To a Good Start

We are leaving 2022 behind and starting out fresh in 2023 with two positive performance weeks in a row for the stock market. Investors are optimistic after receiving favorable inflation data. The year-over-year consumer price index (CPI) growth fell to 6.5%, the lowest level since October 2021, and the sixth consecutive drop. More importantly, core inflation (which excludes more volatile food and energy prices) fell to 5.7%, its slowest pace in more than a year and the third consecutive drop.

The reason for optimism is it increases the expectations of a soft landing. Meaning the Federal Reserve (Fed) has raised interest rates just enough to slow inflation, and not throw the economy into a recession. The data also increases the chances of a smaller 0.25% hike at the next Fed meeting on February 1 and one final hike in March to bring the rate to around 5%, matching market expectations and Fed projections.

After March, the Fed may pause and evaluate economic conditions based on inflation, the job market and economic strength. **The current trajectory of consistently lower inflation would suggest that the rate hikes are near an end and the economy potentially avoids a severe recession.**

Diversification Works!

If the expectations for a Fed pause are correct, what are the implications for the market? Looking at historic data within BlackRock's January 2023 report, "Student of the Market," when the Fed stops hiking rates, it's a catalyst for both stronger stock returns and bond returns. As we know, the traditional 60/40 stock/bond portfolio had a historically tough year (see the [January 6 Market Update](#)); it could be poised for a rebound in the year to come.









You'll often hear in the media that the "60/40 is dead" or "diversification no longer works," something that's not new. Diversification doesn't always feel good over the short-term, but if you take a step back and look at the long-term view, diversification often wins.

Let's evaluate the ups and downs of the market over the last 20 years and have an apples-to-apples matchup between the S&P 500 and a diversified portfolio. In the chart on pg. 2, "A Diversified Portfolio Can Work, Even though It Never Feels Good," a few things stand out:

1. **Bad Years:** When the overall market is down, investors often don't care as much about the magnitude of the loss. They're simply upset that, "I lost money." AKA: Loss aversion, the pain of losing is more powerful than the pleasure of gaining.

- Good Years:** During a strong bull market, all of a sudden the magnitude of gains becomes very important to investors and they're upset that, "I didn't make as much" (as the S&P 500 or my neighbor's latest hot stock pick). AKA: Fear of Missing Out (FOMO).
- And the WINNER is...**The diversified portfolio! Diversification DOES work over the long-term because investors don't lose as much during the down years and can rebound and compound faster during the up years, resulting in stronger risk-adjusted returns over the long-term (typically higher returns with lower risk). AKA: Win more by losing less.

A Diversified Portfolio Can Work, Even though It Never Feels Good (Last 20+ Years)

Years	S&P 500	Diversified Portfolio	
2000–2002*	-40.1%	-15.7%	 "I lost money"
2003–2007	82.9%	87.1%	 "Diversification worked"
2008	-37.0%	-26.6%	 "I lost money"
2009–2019	351.0%	219.7%	 "I didn't make as much"
Q1 2020†	-30.4%	-23.1%	 "I lost money"
Q2 2020–2021‡	119.0%	66.6%	 "I didn't make as much"
2022	-18.1%	-15.5%	 "I lost money"
Total Return	288.6%	301.6%	 "Diversification can work even when it feels like its losing"
Gr \$100K	\$388,610	\$401,550	

Diversified portfolio example: 25% U.S. large stocks, 19% U.S. mid cap stocks, 7% international stocks, 5% U.S. small cap stocks, 4% emerging market stocks, 25% U.S. bonds, 15% high yield bonds.

Source: Source: Morningstar as of 12/31/22. *Performance is from 9/1/00 to 12/31/02. †Performance is from 1/1/20 to 3/23/20. ‡Performance is from 3/24/20 to 12/31/21. Diversified Portfolio is represented by 25% S&P 500 Index, 19% Russell Mid Cap Index, 7% MSCI EAFE Index, 5% Russell 2000 Index, 4% FTSE Emerging Stock Index, 25% Bloomberg US Aggregate Bond Index, 15% Bloomberg US Corporate High Yield Index. Past performance does not guarantee or indicate future results. Index performance is for illustrative purposes only. You cannot invest directly in the index.

As always, Dynamic recommends staying balanced, diversified and invested. Despite short-term market pullbacks, it's more important than ever to focus on the long-term, improving the chances for investors to reach their goals.

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