BRIDGES TRUST

December 30, 2022

# MARKET COMMENTARY

## "A PUDDLE OF MUDDLE"

We've often said that predicting where the stock market will be in a year's time is a fool's errand, and this time of year, it seems that fools are especially busy. Perhaps it's because investors find comfort in price targets and the false precision they imply, but each December market strategists lick their collective fingers, raise them to the wind and hazard a guess of where stocks will be in twelve months.

Unfortunately, their track record makes weathermen look omniscient. In 2021, consensus estimates for the S&P 500 Index ("S&P") began the year at 3,800, yet the S&P ended the year at 4,766. In 2022, their average price target was 4,825, while the S&P currently hovers around 3,800. It appears they can be wrong 20% in either direction. If that were a nail, we wouldn't hang our hats on it.

And yet, our clients trust us to help them navigate uncertainty. While we don't believe we can predict the direction of stocks in the short-term, we do believe we can assess their attractiveness in the *long-term* by identifying the issues most likely to impact their performance.

Many of you know that 2022 was the worst year for equity markets since 2008 and the worst year for fixed income since 1788. We typically welcome market declines as they periodically set the stage for strong subsequent performance. Since 1950, buying the S&P 500 every time it declined 20% resulted in a positive three-year return 89% of the time. It's also uncommon for equity markets to be down two years in a row. And despite these observations, we're entering 2023 with subdued expectations and a defensive posture.

Our primary concern is that a looming recession and a subsequent decline in corporate earnings have yet to be fully priced into the market. While a 20% decline removed much of the excessive froth in stock valuations, estimates for 2023 still suggest earnings growth, a scenario we find unlikely. While the trailing multiple of the S&P now approaches its 10-year average, we expect earnings could decline 10 – 15%, which leaves the S&P looking expensive, especially given the current interest rate regime and the potential for earnings disappointment.

We believe the Fed hiking cycle, while necessary, is likely to culminate in a recession. Because increases in interest rates impact the economy with a lag, central bankers have the unenviable task of making real-time decisions with backward-looking data. Consequently, they frequently over-tighten, and most rate hiking campaigns result in recession (13 of the last 14 by our count). Add an extremely inverted yield curve, declining corporate confidence and a recession could be a foregone conclusion.

We do believe we have seen the peak in inflation but wouldn't be surprised if it took longer than forecast to approach the Fed's target of 2%. While many of the categories of inflation are softening, a strong job market and left-over stimulus savings have buoyed purchasing power. The good news is Americans have money, which is bad news if you're trying to curb inflation.

We also suspect that we are closer to the end of the rate hiking cycle than the beginning. Many expect the Fed Funds rate to increase another 75 basis points in 2023, but we doubt the Fed will go straight from hiking to cutting. While it is possible that the Fed could cut interest rates sometime in the next year, it would likely be in response to a recession. While cost of capital matters, rooting for a rate cut means rooting for a weak economy. This strikes us as an odd wish for an equity investor.

The good news is that we expect the recession to be a mild one. Banks are well-capitalized, consumers' balance sheets are in excellent shape and the job market is strong. Although housing prices have yet to correct, pain seems unlikely to emanate from the consumer. While there are signs of excess in corporate and sovereign debt markets, we don't currently anticipate systemic risks or anything akin to 2008.

Perhaps the best news is that by our math, the expected returns of equities (and fixed income) have meaningfully improved from their 2021 lows. While our expectations for the next twelve months are modest, we are far more optimistic on returns for the next five years. It's worth mentioning that the stock market is not the economy; its decline often precedes it, as does its recovery.

Rather than try to time these inflection points, we remind our clients of the wisdom of staying invested. Missing even a few of the best days in the market can meaningfully curtail one's returns. Because a long-time horizon is a prerequisite to investing (otherwise, it's trading), that frequently requires a willingness to remain invested through recessions. While bear markets are less enjoyable than bulls, we believe the willingness to risk capital in the face of uncertainty is the exact reason why many equity investors have historically been rewarded for their patience. Though the outlook for 2023 is uncertain, we suspect forward returns from here could be satisfactory. We thank you for your continued trust, and should you have any questions, please don't hesitate to reach out to your relationship manager.

Sincerely,

The Bridges Trust Investment Committee

BRIDGES | TRUST®

## DISCLOSURES AND IMPORTANT INFORMATION

Bridges Trust and logo reference independent services offered by Bridges Trust Company ("BTC"), Bridges Trust Company of South Dakota ("BTC-SD") and Bridges Investment Management Inc. ("BIM"). Trust services are provided by BTC, a trust company chartered through the Nebraska Department of Banking and Finance, and BTC-SD, a trust company chartered through the South Dakota Division of Banking. BTC, BTC-SD, and certain individual clients of BIM directly utilize the investment management services provided by BIM. BIM is an investment adviser registered with the U.S. Securities Exchange Commission ("SEC") with further information including conflicts of interest among affiliates recommending affiliate services and material risks available in BIM's ADV Brochure at www.adviserinfo.sec.gov/firm/108028 and www.bridgesinv.com. Registration with the SEC does not imply a certain level of skill or training.

This client communication is provided for informational purposes only and is not a recommendation to purchase, hold, or sell any security. Information was obtained from sources we believe to be reliable, but the accuracy of the information cannot be guaranteed. Each investor's situation is unique so please work with your Relationship Manager to develop an individualized investment plan before investing.

Sources: Bridges Trust Investment Committee, BofA Global Research, FactSet Data and Analytics, Federal Reserve, Keith Lerner, US Bureau of Labor Statistics. References to the worst year for equity markets and fixed income are measured by S&P 500 Index and US 10-Year Treasury Bond annual returns, respectively.

**Investing involves risk and the possibility of loss.**

**Past performance is no guarantee of future results.**

**CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS** - This communication contains forward-looking statements that involve substantial risks and uncertainties. We believe it is essential to communicate our expectations to our clients. However, there may be events in the future that we're unable to predict accurately or have no control. Actual results or other conditions may differ materially from those contemplated by any forward-looking statements, and we are not under any duty to update the forward-looking statements contained herein. Given these risks and uncertainties, readers are cautioned not to place undue reliance on such forward-looking statements.

**CAUTIONARY STATEMENT REGARDING THIRD PARTY INFORMATION** - This communication includes financial information, market data, statistical information, and estimates based on materials prepared by independent sources, as well as management's own good faith estimates and analyses. We believe this third-party information to be reputable but have not independently verified it. Information based on estimates, forecasts, projections, market research, or similar methodologies or assumptions is inherently subject to uncertainties, and actual events or circumstances may differ materially from events and circumstances reflected in this information.