January 18, 2023

Dear O'Brien Client,

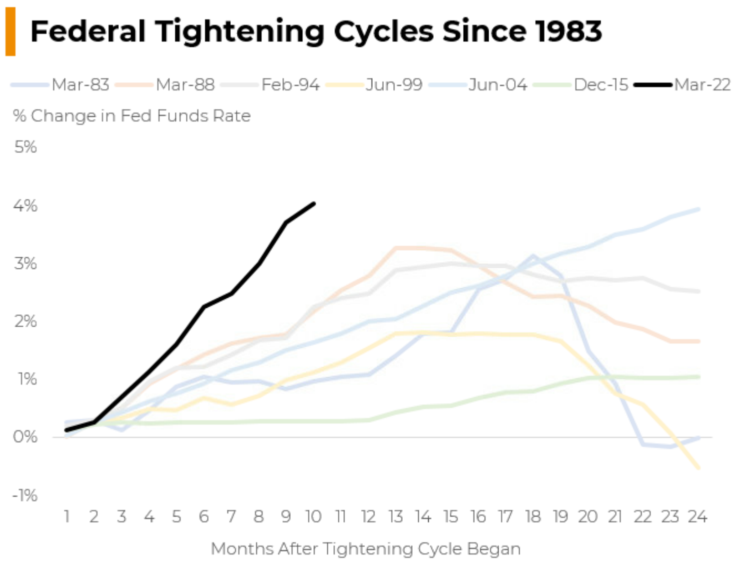
After three quarters of declines, markets rallied into year-end on the back of slowing inflation and a deceleration in the pace of Federal Reserve (Fed) interest rate hikes. Stocks outperformed bonds, and within stocks, international outperformed the U.S. Within bonds, credit-sensitive assets, such as high yield, outperformed. Yet stocks and bonds were still both down for the year, as shown by the table below summarizing most major asset classes.

	4Q	2022	3 Years		4Q	2022	3 Years
Non-U.S. Developed Market Stocks	17.3%	-14.5%	0.9%	Real Estate Stocks	4.1%	-24.9%	0.2%
Non-U.S. Stocks	14.3%	-16.0%	0.0%	Municipal Bonds	4.1%	-8.5%	-0.8%
Global Stocks	**9.8%**	**-18.4%**	**3.8%**	High Yield Bonds	4.0%	-11.2%	-0.3%
Emerging Market Stocks	9.7%	-20.1%	-3.1%	Investment Grade Bonds	3.4%	-15.3%	-2.9%
Gold	9.5%	-0.7%	4.7%	Commodities	2.2%	16.1%	12.7%
U.S. Mid Cap Stocks	9.2%	-17.3%	5.9%	Mortgage-Backed Bonds	2.1%	-11.8%	-3.2%
U.S. Large Cap Stocks	7.6%	-18.1%	7.7%	**U.S. Aggregate Bond Index**	**1.9%**	**-13.0%**	**-2.7%**
U.S. Small Cap Stocks	6.2%	-20.4%	3.1%	Treasuries	0.7%	-12.5%	-2.6%

Past performance is no guarantee of future returns. You cannot invest in an index. 3 year returns are annualized.
Source: Morningstar Direct, O'Brien Wealth Partners, as of 12/31/22.

Clearly, 2022 was a challenging year to be an investor. Yet we are encouraged that a repeat performance for markets is unlikely in 2023, as the driver of the compression in asset prices – specifically the rapid increase in interest rates by the Federal Reserve – is already moderating.

As shown by the black line in the chart on the left below, the pace of tightening last year was significantly stronger than in every other tightening cycle over the past 40 years. This trend dominated all other fundamental dynamics – continued economic expansion, corporate profit growth, below average defaults, and the diversification benefits of owning stocks and bonds together (to name a few) – for asset markets.



Fed: Federal Reserve. **LEFT:** Source: Federal Reserve, JPMorgan, S&P Global, O'Brien Wealth Partners, as of 12/31/22.

Entering 2023, the magnitude of tightening is slowing, but additional hikes are likely to occur. In each of the prior eight tightening cycles the Fed continued to raise the Fed funds rate (currently 4.5%) until it was higher than headline inflation (currently 6.5%). That threshold may be achieved this year by a combination of more tightening and – more importantly – cooling inflation, although outright rate cuts seem less likely to occur.

If Fed tightening could play a less impactful role on the markets going forward, then those fundamental dynamics are likely to play a more impactful role in 2023.

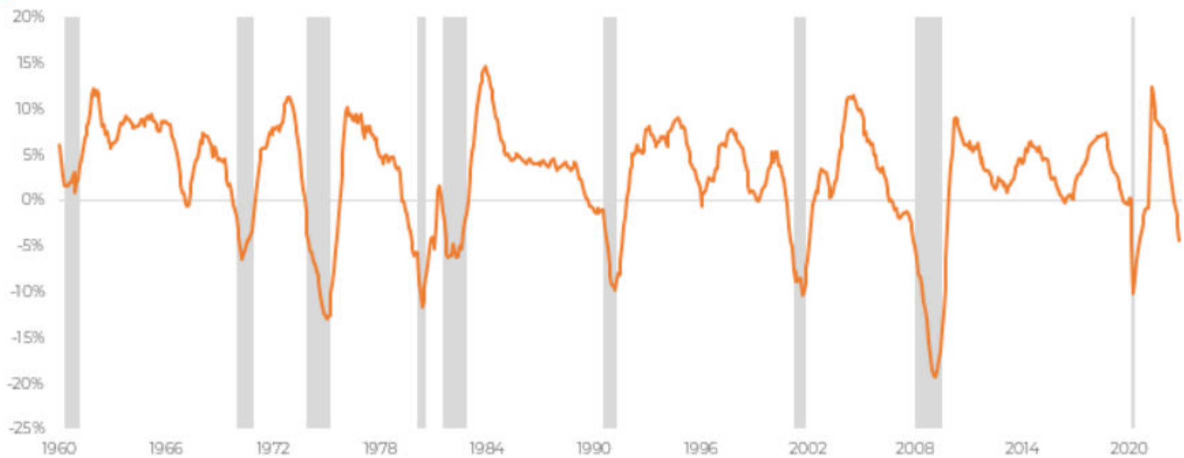
Let's start with the positive fundamentals. Inflation is slowing in many countries around the world. Importantly, the drivers of this slowdown are widespread. Take the U.S. for an example. Energy, which was a key contributor to inflation earlier in the year seems to be cooling – costs have fallen for five of the past six months. The cost of durable goods, which were impacted by supply chain challenges from COVID, has fallen the past five months and service costs outside of shelter have been roughly flat over the same period. Food costs are still rising but at less than half the pace seen last summer.

The primary exception has been shelter costs, which continue to rise at a high pace. But the gains showing up today are reflective of the rapid rise in house prices experienced in 2021. Forward-looking indicators for these costs, such as increases in asking rents, have cooled meaningfully and suggest shelter costs will start to rollover as well.

If inflation continues to slow and central banks follow, then the focus of markets could shift to the outlook for growth. Here 2023 fundamentals are starting out less positive. While financial markets react in real-time to changes in central bank policy, those policy changes impact economic activity with long and variable lags. Those impacts are just starting to be felt.

In the U.S., leading economic indicators – such as initial unemployment claim filings, single-family building permits, and manufacturing new orders for consumer goods and materials – are contracting (orange line below) at a pace that historically has only occurred before recessions (gray bars). These dynamics suggest it is probably more a question of when, rather than if, a recession occurs.

U.S. Leading Economic Indicators (Year-Over-Year %)



Gray bars denote U.S. recession as identified by the National Bureau of Economic Research (NBER). Source: S&P Global, The Conference Board, NBER, O'Brien Wealth Partners, as of 11/30/22.

When discussing recessions there is a tendency to assume what happened in the most recent recessions is a reasonable base case for future recessions – a behavioral finance concept known as recency bias. Yet these recent recessions were unusually bleak, with widespread shutdowns occurring during the COVID recession, and the bursting of a housing bubble driving the Global Financial Crisis.

Today's economy is different, with important supports that make the magnitude of the economic decline the past two recessions less likely to re-occur. For example, both business and household balance sheets, as exemplified by interest coverage ratios and debt service ratios, respectively, remain solid – particularly compared to their levels during the Global Financial Crisis. In addition, companies may also be reticent to lay-off workers given that qualified workers are scarcer to come by today.

There are certainly unknowns entering 2023 as well. A major one is how the Fed will react if the economy slips into recession. During recent recessions, inflation has been relatively subdued – allowing the Fed to both reduce interest rates and inject stimulus via quantitative easing as needed. Inflation today is slowing but still elevated. Whether this prevents the Fed from providing stimulus if a recession occurs remains to be seen.

Another unknown is how the looming debt ceiling debate in Congress will unfold. The U.S. is projected to hit its debt ceiling limit again this year. This year's debate around raising that limit may be more disruptive than usual given the current political environment. This could create pressure on treasury bills maturing around the time the ceiling is hit and increased volatility in the markets more broadly. If progress is not made on these discussions as the year progresses, we will take action to move away from treasury bills before the problems become acute.

These macro crosscurrents point toward more uncertainty than usual for asset market performance in the upcoming year.

For stocks, if the economy slips into recession, corporate profitability will likely weaken and could result in additional downside. Yet markets are also forward-looking and could look through near-term profit weakness if it is viewed to be temporary. And, of course, if a recession is avoided, the recent rally could extend further.

High-quality bonds, on the other hand, are starting 2023 in a much brighter spot than they were in entering last year. Higher starting interest rates provide bonds with more insulation from additional rate increases and potentially more room to rally and help mitigate any stock downside if the economy slips into recession. Treasury yields tend to rally once the Fed pauses its rate hike cycle as well[1], even if a recession does not occur.

Over the long-term, stock markets have tended to rise more often than they decline. Silver linings, such as more attractive valuations, are also starting to appear and provide a glimpse at the opportunities that may arrive as the year progresses and near-term uncertainties are resolved.

In the interim, as always, we aim to remain disciplined by staying invested in markets, rebalancing your portfolio if the deviations become too large, looking to de-risk portfolios within asset classes if economic conditions deteriorate, and adding opportunistic investments if the backdrop improves.

We will also continue to try to harvest capital losses where available that can be used to offset future capital gains in taxable accounts.

We hope you are all taking care and staying healthy. If you have questions, or would like to talk, please reach out to your Advisor or any member of our investment team.

Your O'Brien Team

[1] Past performance is no guarantee of future returns.

5. In general, investment in foreign issuer securities entails additional risks such as limited transparency and accounting overview, varying frequency, availability and quality of financial information, limited enforcement opportunities by US regulators, and limited shareholder rights and/or remedies.
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