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FROM THE DESK OF DARRELL L. CRONK

State of the Markets

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Darrell L. Cronk is the president of Wells Fargo Investment Institute, which is focused on delivering the highest quality investment expertise and advice to help investors manage risk and succeed financially.
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The straw that stirs the drink

"An optimist stays up until midnight to see the New Year in. A pessimist stays up to make sure the old year leaves." — William E. Vaughan

Year end brings reflection and perspective. With the passage of time and the swing of the pendulum, perspective has a habit of reintroducing itself to us — sometimes when we least expect or welcome it. 2022's swing brought some amazing and difficult moments, including:

- The U.S. Consumer Price Index hit a 40-year high at 9.1%.
- The unemployment rate at 3.5% was the lowest witnessed since 1969.
- The 30-year U.S. Treasury bond, at its low, sunk to a negative 35% return, the worst in over a century.
- Central banks across the globe hiked interest rates, collectively, more than 200 times.
- Natural gas prices rose 90%.
- Global equity market capitalization declined $33 trillion from its peak.

I could go on, but needless to say, we felt the hard vibrations of global shifts in key themes throughout this past year. As we happily close the books on 2022, what is crystal clear to us is that as inflation goes, so will 2023. Indeed, inflation will be the straw that stirs the drink — whether that drink is champagne or bitter medicine, remains to be seen. Undoubtedly, inflation's path will chart the course in 2023 for central bank policy, economic growth, stock prices, interest rates, earnings growth, and the trajectory of the U.S. dollar.

As I have repeated frequently, bear markets are a function of price and time. The bear market this past year is no different. Often knowing what *not* to do is as important as knowing what *to* do. Bear markets don't end simply because the calendar turns, or because enthusiastic investors hear what they want to hear and begin lining up to deploy cash. We advocated for defensive posturing in portfolios starting in the first quarter of 2022, and we arrive in the first quarter of 2023 with the same guidance that served investors well in 2022. What's different about 2023 is that we do believe markets will provide opportunities to once again turn more bullish.

What has been challenging for investors is that numerous times throughout 2022, markets experienced bear market rallies as they "listened" to Federal Reserve (Fed) Chair Jerome Powell's press conferences, but simply did not "hear" what he had to say. Markets often mistook his message as one of dovish optimism, only to be disappointed later by a steady dose of hawkish medicine that had those bear market rallies failing into resistance, leading to lower lows through 2022. As the holidays arrive, we're left with a fitting and timeless lesson of the substance of things hoped for.

So, let's "hear" what Chair Powell had to say at his December 14 press conference when asked if the Fed would need to reconsider its 2% inflation target:

> *"Changing our inflation goal is just something we're not — we're not thinking about and it's not something we're going to think about. We have a 2% inflation goal, and we'll use our tools to get inflation back to 2%. I think this isn't the time to be thinking about that. … The committee — we're not considering that, we're not going to consider that under any circumstances."*

We have no illusions that getting back to 2% inflation will be pain-free. There is promise, however, that a combination of slowing global demand, easing supply chains, elevated inventory levels inviting discounts on many core goods, and a cathartic slowdown (if not a nearly complete stop) in housing activity will apply downward pressure on inflation in 2023. Chair Powell understands that he has to break inflation, as history has taught us well that no economy has flourished for any extended period of time under high rates of inflation.

For much of the past decade, markets were conditioned to believe central banks were their friends. The Fed's job was clearly defined: Ensure financial stability, infuse liquidity to stabilize capital markets, step in to curb volatility when it arose, and protect growth and jobs at all costs. Even the slightest reduction in central bank support left markets frowning with concern. That is not the place we are at today. Secular shifts away from seemingly endless central bank liquidity, a world now challenged with limited supply instead of limited demand, and geopolitical risks that have companies focused on resiliency — and not just productivity — have changed the calculus of how investors need to think and engage.

As the economic wheel turns and central banks around the globe fight the good fight to arrest inflation, investors want to forget about 2022 as soon as possible — and as Mr. Vaughan says above, "make sure the old year leaves." They want to pull down the calendar and start fresh. But this cycle isn't likely to end so cleanly; it appears to be in no hurry to curl up and disappear into the history books.

Chair Powell has a tough battle ahead, and I don't for a moment envy him or the challenges that will come his way in 2023. He must balance financial stability with protecting growth and jobs and bringing inflation down. Not an easy task for even the most skilled. As many a world leader has said, "You don't choose the time. The time chooses you." Perhaps time has chosen Jerome Powell to have his own Paul Volcker moment — this generation's choice to break the back of inflation and return the U.S. economy to prosperity and growth. We do not yet know with full certainty. What we do know is the greatest strength of a wise investor is intellectual flexibility, the ability to assess fundamental, technical, and behavioral factors and apply it all with wisdom and discipline to portfolio management. That we will do in earnest in 2023 no matter what comes investors' way.

To be clear, we believe better days do lie ahead. If you squint your eyes, you can almost see it through the winter mist, a powerful U.S. economy finding its footing once again. As the Fed's bitter medicine takes hold, inflation has begun its journey. It may take all of springtime, maybe even much of the summer, for the U.S. economy to regain its strength, but capital markets will not wait for an overwhelming preponderance of evidence of a recovery to be revealed. They will look to price ahead as they always do. That's why in 2023, investors need to stay alert and be ready for when the risk-reward dynamics change. We will be right there with you, with both feet in the fight and with our best clear-eyed guidance translated into practical portfolio action.

As we raise a glass to toast the new year, don't lose sight of the straw, as it will prove vital in determining 2023's path. We hope this holiday season you enjoy time with family, with old friends and new, and find peace and rest.

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Definitions

Consumer Price Index (CPI) produces monthly data on changes in the prices paid by urban consumers for a representative basket of goods and services.

An index is unmanaged and not available for direct investment.

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