

**Lincoln Variable Insurance Products Trust
President's Letter**

Dear Fellow Investors,

2022 has been a year of many significant changes and challenges to global capital markets, characterized by persistently high inflation, sharply rising interest rates and negative returns for most asset classes.

Despite the previous talk of transitory inflation by many economists, there was a worldwide inflation surge from mid-2021 to 2022, driven by rapid recovery of consumer demand and widespread supply shortages. The Covid-19 pandemic has been waning but continued to cause disruptions to global supply chains, as exemplified by the chip shortages. Fueled by sharply surging commodity and shipping prices in early 2022, U.S. inflation readings experienced a persistent and structural increase to alarming levels and reached the highest point in four decades during 2022. Furthermore, the abrupt Russian invasion of Ukraine, on top of enormous human toll, exacerbated economic disruptions and supply shortages that added to inflationary pressure and market volatility.



In order to control high inflation, the U.S. Federal Reserve (Fed), along with other major central banks, took drastic measures by rapidly reversing decade-long accommodative monetary policies. From a near zero rate, the Fed hiked interest rates by 4.25% in 2022, which was the fastest pace of rate hikes ever. The Fed has hiked interest rates by 75 basis points five times in the past 30 years, with four of these rate hikes occurring in 2022. Moreover, it moved from quantitative easing to the opposite – quantitative tightening, which involved shrinking a \$9 trillion balance sheet and reducing liquidity. As a result, U.S. Treasury yields reversed their long decline during the past 4 decades. The yield on the 10-year treasury bond rose sharply from 1.51% in the end of 2021 to 3.87% as of Dec. 31, 2022. Accordingly, fixed-income investments suffered the worst year in history as interest rates rise, prices for bonds tend to fall. For the first time ever, Bloomberg U.S. Aggregate Bond Index and Bloomberg U.S. Treasury Index both had double digit negative returns in 2022, 13.1% and 12.5% respectively, which were the worst yearly returns since their respective inceptions in the 1970s. To put it to a historic perspective, both indices posted positive returns in 2008 during the Great Financial Crisis (GFC), as they did every year in the early 1980s during the prior notable rate hiking cycles.

After rising for three consecutive years from the beginning of 2019, the S&P 500 Index (total return) doubled and the Nasdaq Composite Index more than doubled by the end of 2021. The remarkable bull market came to an end in 2022. While earnings growth was positive in the first three quarters, financial conditions were materially tighter, and equity market volatility as indicated by CBOE Market Volatility Index stayed elevated throughout the year. Furthermore, sharply rising interest rates diminished equity risk premium and compressed price multiples. During 2022, the U.S. domestic equity market entered the longest and one of the worst bear markets since the GFC. The S&P 500 Index returned a negative 18.1% (-18.1%), and the Nasdaq Composite Index returned a negative 32.3% (-32%), the latter of which echoed its severe decline during the first quarter of 2020. Dispersed performance across investment styles and geographies continued in 2022. Value equity outperformed growth equity across all market capitalization by double digits, which is a continuation for mid cap and small cap, but a sharp reversal for large cap as large cap growth outperformed consistently every year since 2017. In addition, while non-U.S. equities in developed markets outperformed U.S. equities, emerging markets continued to lag.

As we move into 2023, we believe that four key macroeconomic themes are front and center:

Declining inflation – The global supply chain began to recover and commodity prices fell in the second half of 2022. With that, we believe inflation has likely peaked and is on its course of decline from current high levels, especially in the U.S. We expect the easing of inflationary pressure to continue throughout 2023. The 1-year US TIPS breakeven rate is a popular gauge of the markets' inflation expectations. As of the end of 2022, it signaled that investors expect a sharp drop to near 2% by the end of 2023. If this proves true, we may be able to gradually put inflation into the backseat, even if there might be bumps on the road.

Likely Fed pause – Thanks to the decline of inflationary pressures, we may be able to put the recent string of aggressive interest rate hikes behind us as well. As stated in their most recent dot plot, the Fed projected an equivalent of three more 25 bp hikes in 2023, before hitting a terminal rate of 5.1%. At that point, the Fed is likely to pause and allow the impact of tighter policy to make its way through the economy. There is a chance that quantitative tightening may end in 2023. Therefore, the pause, if not the end, of Fed rate hike cycle is approaching. However, restrictive monetary policy may remain in effect throughout the year with continued high interest rates, testing the strength of U.S. economy.

Looming economic slowdown and risk of recession – The path to a soft landing for U.S. economy has narrowed significantly in 2022. U.S. 2-year vs. 10-year yield curve inversion, which preceded each of the past seven recessions, has hit the deepest level since the 1980s. Personal savings rate for American households has fallen to a 17-year low of only 2.3% recently. Corporate earnings, housing market and manufacturing activities have all been showing signs of weakness. In addition, the Russia-Ukraine war has become a war of attrition, having a risk of escalation and long-term geopolitical ramifications. With the Euro Zone and U.K. likely in a recession already, according to a survey of professional forecasters by the Philadelphia Federal Reserve, the highest percentage of respondents since the survey began more than 50 years ago expected a recession in the U.S. within 12 months.

Despite tightened financial conditions and signs of economic slowdown, U.S. labor market continues to be strong, as the unemployment rate still nears the lowest in the past five decades and there are plentiful job vacancies. Corporate and consumer balance sheets remain healthy and resilient in general. If we do end up entering a recession, it is the consensus view that the recession will likely be relatively mild.

Dawn of a post-rate hike new market cycle – General George Patton once said, “if everyone is thinking alike, then somebody isn’t thinking.” Given the consensus of recession forecasts after a dismal 2022, we believe that it is wise to stay invested and navigate prudently through market volatility. Capital markets, as leading indicators of the economy, have historically experienced most of their declines during the period leading up to a recession, and often begun their recovery well in advance. The Fed’s pause of current interest rate hiking cycle may bring tailwinds to equity market recovery. With higher yields, fixed-income investments appear more attractive than they were in more than a decade, providing opportunities and diversification benefits to both balanced and income generating portfolios.

Considering this evolving economic backdrop, it is an important time to evaluate the risks in your portfolio with your financial advisor to ensure you are properly diversified based on your time horizon, financial goals and risk tolerance. We are continuing to enhance our LVIP funds in order to provide a more robust and cost-effective universe of actively managed, rules-based and passive investment options across major asset classes including equity, fixed income, and multi-asset that can help you achieve your unique objectives.

December 31, 2022

We hope you find the materials included in this annual report helpful as you evaluate your investments with us. Thank you for your continued trust in Lincoln Financial Group, and we wish you a healthy and prosperous 2023.

Sincerely,

A handwritten signature in black ink, appearing to read "Jayson R. Bronchetti". The signature is fluid and cursive, with a large initial "J" and "B".

Jayson R. Bronchetti, CFA, CAIA
President, Lincoln Variable Insurance Products Trust