Quarterly Insights – January 2023

Surging Inflation and Interest Rates Pressured Both Stocks and Bonds in 2022

2022 was the most difficult year for investors since the Global Financial Crisis in 2008. Multi-decade inflation rate highs combined with historically aggressive Federal Reserve interest rate hikes, combined with growing concerns about an economic and earnings recession put pressure on both stocks and bonds. The S&P 500 posted its worst performance since 2008 while major benchmarks for both stocks and bonds declined together for the first time ***since the 1960s***, highlighting both how disappointing and how unusual the year was for investors.

<u>Q4 and Full Year 2022 Performance Review</u>

Unlike the first three quarters of 2022, when all four major indices saw quarterly declines, performance was mixed during the fourth quarter as the Dow Jones Industrial Average rose sharply, while the S&P 500 and Russell 2000 were solidly higher. Like most of 2022, however, the Nasdaq lagged and fell slightly in the fourth quarter. Expectations for higher rates, slowing economic growth, and underwhelming earnings weighed on the tech sector in the fourth quarter, which was the case for much of 2022. Conversely, less economically sensitive companies that trade at lower valuations than tech stocks outperformed as investors continued to shift towards defensive sectors amid growing recession fears. On a full-year basis, all four major indices posted negative returns, with the Dow Jones Industrial Average relatively outperforming while the Nasdaq badly lagged the other major indices.

By market capitalization, large-caps slightly outperformed small-caps in the fourth quarter, but modestly outperformed throughout 2022. Concerns about future economic growth and higher interest rates (which can impact small-caps disproportionately due to funding needs) were the main drivers of large-cap outperformance and small-cap underperformance throughout 2022. Small-cap stocks did show some resilience in the fourth quarter with the Russell 2000 index registering a solid gain as investors' hopes for a peak in inflation and ultimately interest rates, led to some dip buying in the segment.

From an investment style standpoint, value outperformed growth all year and that trend continued in the fourth quarter. Weak earnings weighed on tech stocks in the final three months of the year, while concerns about slowing economic growth combined with rising bond yields hit richly valued tech stocks throughout 2022. Value stocks, meanwhile, were viewed as more attractive due to lower valuations and exposure to business sectors that are considered more resilient than high-growth parts of the market.

On a sector level, 10 of the 11 S&P 500 sectors finished the fourth quarter with a positive return, although only two of the 11 ended 2022 with gains. Energy outperformed other sectors not just in the fourth quarter but also for all of 2022. Defensive sectors, specifically utilities and consumer staples, were the next best-performing sectors finishing the year with small gains and losses, respectively, again as investors rotated towards less economically sensitive corners of the market amid rising recession risks.

The tech sector and those sectors with overweight exposure to high-growth companies badly lagged in the fourth quarter and over the course of 2022. In the fourth quarter, communication services were only fractionally positive while the consumer discretionary sector posted a negative return on weakness in high-growth internet and consumer stocks. For the full year, those same two sectors posted the worst returns in the S&P 500, as investors shunned richly valued, growth-oriented tech companies.

S&P 500 Total Returns by Month in 2022											
Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
-5.17%	-2.99%	3.71%	-8.72%	0.18%	-8.25%	9.22%	-4.08%	-9.21%	8.10%	5.59%	-5.90%

Source: Morningstar

US Equity Indexes	**Q4 Return**	**2022 Return**
S&P 500	7.56%	-18.11%
DJ Industrial Average	16.01%	-6.86%
NASDAQ 100	-0.04%	-32.38%
Russell 2000	6.23%	-20.44%

Source: YCharts

International markets handily outperformed the S&P 500 in the fourth quarter thanks to a large bounce in Chinese stocks as Beijing ended its “Zero-Covid” policy and commenced an economic reopening, while a falling dollar boosted global economic sentiment. Foreign developed markets outperformed emerging markets in the fourth quarter thanks in part to a large bounce in U.K. shares following the resignation of PM Truss and the abandonment of her fiscal spending and tax cut plan. For the full-year 2022, foreign developed markets registered solidly negative returns, but thanks to the fourth-quarter rally, relatively outperformed the S&P 500.

International Equity Indexes	Q4 Return	2022 Return
MSCI EAFE TR USD (Foreign Developed)	17.40%	-14.01%
MSCI EM TR USD (Emerging Markets)	9.79%	-19.74%
MSCI ACWI Ex USA TR USD (Foreign Dev & EM)	14.37%	-15.57%

Source: YCharts

Fixed Income

The leading benchmark for bonds, the Bloomberg Barclays US Aggregate Bond Index, realized a positive return for the fourth quarter but declined sharply for the full year of 2022, with sharp increases in interest rate by the Federal Reserve.

Longer-duration bonds outperformed those with shorter durations in the fourth quarter, as bond investors reacted to better than expected economic data. For the full year, shorter-term bonds handily outperformed longer-duration bonds as they were less impacted by the Fed rate hikes and spiking inflation.

Turning to the corporate bond market, both higher-yielding, lower-quality corporate bonds and investment grade bonds posted similarly positive returns for the fourth quarter, as investors reacted to the possible peak in inflation. Lower-yielding and safer investment-grade corporate debt underperformed for the full year, as investors shunned those bonds in favor of shorter-duration debt and corporate debt with higher yields.

US Bond Indexes	Q4 Return	2022 Return
BBgBarc US Agg Bond	1.87%	-13.01%
BBgBarc US T-Bill 1-3 Mon	0.89%	1.52%
ICE US T-Bond 7-10 Year	0.98%	-14.90%
BBgBarc US MBS (Mortgage-backed)	2.14%	-11.81%
BBgBarc Municipal	4.10%	-8.53%
BBgBarc US Corporate Invest Grade	3.63%	-15.76%
BBgBarc US Corporate High Yield	4.17%	-11.19%

Source: YCharts

Looking Forward - Q1 and 2023 Market Outlook

Markets ended 2022 on a decidedly negative note and the December losses helped to ensure that 2022 was the worst year for stocks since 2008 and the worst year for bonds in multiple decades, as both asset classes posted annual declines for the first time since the 1960s. For the year, the return on the average 60% stock and 40% bond portfolio was down roughly 16%.

The losses in stocks and bonds were driven by decades high inflation, a historic Federal Reserve rate hike campaign and significant geopolitical unrest. While those factors were clear negatives for asset prices in 2022, it is important to note that as we enter 2023, the market is approaching a transition period that could see each of these headwinds ease in the months ahead.

First, inflation has shown definitive signs of peaking and declining. The Consumer Price Index has fallen from a high of 9.1% in June to 7.1% in November, while other metrics of inflation have registered similar declines. Inflation remains much too high in an absolute sense, but if price pressures ease faster than expected, that will present a positive surprise for markets in the first several months of 2023.

Second, after a historically aggressive interest rate hiking campaign in 2022, the current Fed hike cycle is likely nearly complete. In December, the Federal Reserve signaled that it expected the peak interest rate to be just 75 basis points higher than the current rate. That level could easily be reached within the first few months of 2023 and the Fed ending its rate hike campaign will remove the single most significant piece of uncertainty from the market.

Finally, while both economic growth rates and corporate earnings are expected to decline in 2023, those negative expectations, in our opinion, are already priced into stocks and bonds at the current levels. As such, if the economy or corporate America proves to be more resilient than current forecasts, it could provide a positive spark for asset valuations in early 2023.

As we start the New Year, we should expect financial media commentary to be focused on the 2022 losses and current market risks, including earnings concerns and recession fears. But the market is a forward-looking instrument, and while there are undoubtedly economic and corporate challenges ahead in 2023, some of the known risks are priced into markets, and there are potential positive catalysts building as we start the new year.

More broadly, market history is clear: Declines of the magnitude we saw in 2022 are usually followed by strong recoveries, not further weakness. The S&P 500 has not registered two consecutive negative years since 2002, while bonds, represented by the Bloomberg U.S. Aggregate Bond Index, have never experienced two negative consecutive years. While it is certainly possible for this to happen, it is our view that there are substantial long-term investment opportunities with both stocks and bonds.

The stagflation of the 1970s and sky-high interest rates of the early 1980s eventually gave way to the strong economic growth and market rally of the 1980s. The dot-com bubble burst of the early 2000s was followed by substantial market gains into the mid-2000s. The financial crisis, which remains the most dire economic situation we've experienced in modern market history, was followed by strong rallies in the years that followed. In the wake of the worst global pandemic in over 100 years, the economic story is still unfolding, but using history as our guide, there is much to be optimistic about.

Consequently, while we are prepared for continued volatility in the coming months and focused on managing both risks and return potential, we understand that a well-planned, long-term-focused, and diversified investment portfolio can withstand virtually any market surprise and related bout of volatility, including multi-decade highs in inflation, historic Federal Reserve rate hikes, geopolitical unrest, and rising recession risks.

We understand the risks facing both the markets and the economy, and we are committed to helping you effectively navigate this challenging investment environment. This most recent market cycle has reminded all of us that successful investing is a marathon, not a sprint, and even intense volatility is unlikely to alter a diversified approach set up to meet your long-term investment goals.

Therefore, it is critical for you to stay invested, remain patient, and exercise discipline.

Please do not hesitate to contact us with any questions, comments, or to schedule a portfolio review.