In Focus

Monthly Market Review & Outlook
1/11/2023

2022: A Year of Turbulence

It was a very unusual year for financial markets. As far back as 1977 – the first year the U.S. Aggregate Bond index was tracked – there had never been a year when both the S&P 500 index and the Aggregate Bond index declined in the same year. In other words, 2022 represented the first time in half a century that bonds did not provide protection against a falling stock market. The S&P 500 finished down -18% and the Aggregate Bond index finished down -13%.

Not only did the bond market not play its familiar protective role, it fell four times more than the second largest previous annual loss of -2.9% in 1993. The magnitude of the losses for bondholders in 2022 was nothing short of unimaginable. No traditional risk model picked up the risk that a sudden change in interest rates would have on bond prices. Yet it occurred, and we did our best to warn people a year ago.

One year ago, we gave our 2022 outlook and summarized it with a simple "Fasten Seat Belt" sign. The economy was coming off a stimulus-fueled binge and was destined to show significant signs of deceleration. This trend alone urged caution (hence, the seat belt imagery). However, what also transpired was forty-year high inflation and a Fed that raised interest rates in the fastest most aggressive manner since the days of Chairman Volcker. The pace and amount of rate hikes sent interest rates soaring and, hence, bond prices fell dramatically.

Interest rate sensitivity, however, is not exclusive to bonds. Stocks are also sensitive to interest rates with growth-oriented, technology stocks, particularly sensitive a year ago with their bubble-like valuations. While the more technology exposed Nasdaq Composite fell -33% last year, our analysis shows that of the 2,092 publicly traded Technology and Communications stocks in the U.S., 882 (or 42%) fell more than 50% last year. The ill-gotten gains of 2021 were given back in speedy fashion. The collapse in growth company valuations was reminiscent of the Dotcom bubble burst of 2000 and presented another minefield for investors.

In addition to bond and growth stock weakness, as interest rates rose the market was forced to price in the potential for economic recession that in turn placed pressure on less interest rate sensitive sectors as thoughts turned to potentially higher future unemployment and lower consumer spending. While neither of these have yet materialized, the market shed stocks in other industries, such as Consumer Discretionary and Financials, leaving very few places for investors to hide. The only real bright spots in 2022 were Energy stocks and Commodities – both of which we advocated last year. Aided in part by the surprising Russian invasion of Ukraine, these sectors offered a meager buffer against the broader market headwinds.

Indeed, 2022 was among the most unusual and difficult years of most investors' careers. While the losses generated in a year like last year are most unwelcomed, we are heartened by the opportunities the stock and bond shakeout now offer. **In fact, we feel better about the future today than we did a year ago.**

Market Update

After a two-month rally off the lows of the year, globally equity markets were trounced in December. December's dramatic sell-off summed up the entire year. The Nasdaq led declining -8.7% during the month to finish down -33% for the year. The S&P 500 index closed the month down -5.8% and the year down -18%. The Dow Industrial Average fared marginally better finishing the month down -4.1% and the year down -7.0%. Interest rate sensitivity was the defining attribute in 2022 and the more exposure a portfolio had the further it fell.

The fixed income market was not immune to weakness. The Bloomberg U.S. Aggregate Bond index fell -0.5% in December to round out its worst annual rout in half a century down -13%. The magnitude of this loss is unknown to investors. There is great consternation among, particularly, conservative investors when even your "safe" investments decline significantly.

The Bloomberg Commodity index fell -2.8% in December to finish up a robust +14% for the year. Natural gas, iron ore and agricultural commodities posted strong years even giving back an early surge driven by Russia's invasion of Ukraine. For most commodities, the invasion created extreme volatility. The Daily National Average Gasoline price per gallon surged from approximately $3.25/gallon a year ago to $5/gallon in May and then fell back dramatically to finish the year essentially unchanged at $3.25/gallon. In other words, in order to capture gains in commodities, investors had to endure records levels of volatility.

2023 Outlook

Our economic base case anticipates that the recession in the Goods producing part of the economy will continue into 2023 until such time as inventories are right-sized for demand. Reduced consumer demand for goods in favor of services will likely put pressure on the entire supply chain leading to some upward pressure on the unemployment rate. The Services part of the economy is likely to experience decelerating growth but may avoid recession, particularly as inflation economy-wide abates.

While the trajectory of the economy is important to the financial markets, the Fed's actions are of central importance. The market currently expects the Fed to stop raising the Fed Funds Overnight interest rate at approximately 5%, which is just 50bps higher than the current rate. Once there, the Fed is expected to pause to observe the effect higher interest rates are having on the economy. As of today, the Fed Futures curve implies that the economy will weaken enough during 2023 to warrant gradual interest rate cuts as the year progresses. This is all subject to change as new economic data, particularly inflation data, is digested.

For the bond market, the above economic scenario paints an attractive opportunity. Yields on various bonds are as high as we have seen in decades. In some cases, one can even earn equity-like returns on a bond. And, most importantly, bonds should begin to act as protection against stock exposure. In other words, bonds now offer an attractive return with much less risk providing a real alternative to owning stocks.

As for stocks, it is difficult for most investors to obtain their financial goals without owning some amount of stocks. It is important in light of the uncertainty over the Fed and the economy to be selective in one's stock ownership. The equity market could very well decline over the next few months as earnings expectations for many stocks are likely too high. The upcoming earnings season will be among the catalysts that will adjust these expectations to appropriate levels but could also bring some volatility in the near term. For now, we believe it is essential to own stocks that have durable earnings streams or where earnings expectations have already reset. Furthermore, there are some attractive individual stocks that were oversold in last year's correction that appear to have priced in the worst.

2023 is a year that requires investors to be patient. While we are bullish on the bond market, we are less certain that the stock market has truly bottomed. For now, we are comfortable with a defensive portfolio and patiently wait to add equity risk.

Conclusion

Down years in the stock market are not uncommon but a down year in both the stock and bond markets is a very rare occurrence. The dramatic reset in interest rates caused by forty-year high inflation created a sea change in financial markets. Gone are the days of easy money and zero interest rates. The adjustment was relatively abrupt, and every business and consumer is learning how to live in this new environment. For investors, it means tactically adjusting one's portfolio to also adjust. Going forward, the right adjustments will put you back on track to achieving your financial goals.

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Definitions

The **S&P 500 Index** consists of 500 stocks chosen for market size, liquidity, and industry group representation. It is a market-value weighted index (stock price times number of shares outstanding), with each stock's weight in the Index proportionate to it market value.

The **Nasdaq Composite Index** is a market cap-weighted index, representing the value of all stocks listed on the Nasdaq Stock Market. The composition of the Nasdaq Composite is a mix of long-established companies that have been on the exchange since inception, to IPO newcomers, companies that grew from OTC exchanges or switched from other exchanges.

The **Dow Jones Industrial Average** is a price-weighted average of 30 blue-chip stocks that are generally the leaders in their industry. It has been a widely followed indicator of the stock market since October 1, 1928.

U.S. Treasury securities are guaranteed as to the timely payment of principal and interest if held to maturity. Investment options are neither issued nor guaranteed by the U.S. government.

The **Bloomberg Aggregate Bond Index** represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities.

The **Bloomberg U.S. Investment Grade Corporate Bond Index** covers U.S. dollar denominated, investment-grade, fixed ratee or step up, taxable securities sold by industrial, utility and financial issuers. It includes publicly issued U.S. corporate and foreign debentures and secured notes that meet specified maturity, liquidity and quality requirements. Securities included in the index must have at lease 1 year until final maturity and be rated investment-grade (Baa3/BBB-/BBB+) or better using the middle rating of Moody's, S&P, and Fitch.

The **Bloomberg US High Yield Index** covers the USD-denominated, non-investment grade, fixed-rate, taxable corporate bond market. Securities are classified as high-yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below. A small number of unrated bonds are included in the index. The index excludes emerging markets debt.

The **Bloomberg Commodity Index** is comprised of futures contracts and is designed to be a highly liquid and diversified benchmark for commodity as an asset class.

The **Bloomberg U.S. Mortgage-Backed Securities Index** tracks fixed-rate agency mortgage-backed pass-through securities guaranteed by Ginnie Mae, Fannie Mae and Freddie Mac.