Investment Newsletter

Fourth Quarter 2022

The S&P 500 performed well during the quarter, rising +7.4%, but posted its worst annual performance in 2022 since 2008, falling -18.5%. International markets experienced a similar pattern, with the MSCI All-Country World ex-U.S. Index posting a strong +14.3% for the quarter but declining -16.0% for the year. For the S&P 500, it is important to note that while its performance in 2022 was disappointing, it came on the heels of its exceptional performance in 2021 with a total return of +28.0%, the sixth-best performance since 1990.

The strong fourth quarter performance was primarily the result of initial signs that the high levels of inflation that have caused significant pain in the economy may be abating, and therefore the Federal Reserve's interest rate hikes may soon be ending. The high prices of energy and other commodities have fallen, and pandemic-induced supply chain constraints are easing, which will be further aided by China's recent full reopening of its borders after three years. Additionally, employment is less tight, resulting in reduced wage pressure – especially with recent lay-off announcements from technology companies that benefited from the pandemic.

Aside from reducing inflation, the Federal Reserve's rising interest rates have hammered speculative investments, including cryptocurrencies, meme stocks, and Special Purpose Acquisition Companies (SPACs). Bitcoin alone has crashed -74% since its peak in late 2021. Moreover, the legal ramifications for some of the bad actors in those areas are favorable indicators of rationality returning to investment markets.

For fixed income markets, 2022 will be recorded as one of the worst in history. The Bloomberg Barclays U.S. Intermediate Government/Credit Index declined -8.2% and the Bloomberg Barclays Municipal Bond 1-5 Year Blend Index declined -3.6%. Like the equity indices, both fixed income benchmarks rebounded in the fourth quarter and recorded positive returns in the low single-digits.

Macroeconomic data, particularly ramping inflation, dominated the investment landscape in 2022. Beginning in March, the Federal Reserve decided to respond aggressively by raising interest rates seven times. This was the primary catalyst that generated negative investment returns for both equities and fixed income. The 10-Year Treasury yield began the year at 1.51% and ended the year at 3.88% - producing an historic annual loss of over -16% for the 10-Year Treasury. Even Municipal bonds, which typically are more defensive and outperform Treasuries in a rising interest rate environment, posted sharply negative returns. The only sector in fixed income that posted a positive return was Treasury Bills under one year – an unprecedented occurrence.

Throughout the year, our fixed income investment strategy remained steadfastly rooted in capital preservation, while maintaining a reliable income stream for client portfolios. As such, we structured portfolios with shorter-maturity bonds and took advantage of opportunities to purchase new securities with higher coupons. After many years of low-yielding bonds, one 'silver lining' for investors in this rising interest rate environment is that we are finally able to structure a portfolio with bonds featuring coupons over 3.0%, thus increasing annual income.

Looking forward, we expect continued volatility in interest rates because of the Federal Reserve's commitment to battling inflation. Our objective is to opportunistically take advantage of this volatility and focus new purchases on higher-coupon, slightly longer-maturity bonds. We want to lock in bonds with higher coupons and yields while interest rates are still relatively elevated.

While 2022 was a tumultuous year characterized by high inflation, rising interest rates, an exceptionally strong U.S. Dollar, volatility in equity and fixed income markets, war and geopolitical tensions, and the lingering effects of the pandemic, the stock market's fourth quarter ended the year on a positive note. If this momentum is to sustain itself, the following economic and financial events must continue to fully play out:

- Inflation must continue to fall. The Personal Consumption Expenditures Index (PCE) – the Federal Reserve's preferred gauge of inflation – has trended down four of the last five months. Since peaking in June at 7.0%, the latest PCE reading in November came in at 5.5%. Inflation has easy comparisons in 2023, precisely when the Federal Reserve's higher interest rates should really start to take effect.

- The Federal Reserve must finish raising interest rates. The Federal Funds Rate began 2022 at 0.00-0.25% and ended the year at 4.25-4.50%. Currently investors are expecting two more interest rate raises of 0.25% each, one in February and one in March, resulting in a peak Federal Funds Rate of 4.75-5.00%. Rising interest rates pressure asset prices lower and strengthen the U.S. Dollar, which makes U.S. goods more expensive overseas, hurting U.S. corporate growth and exporting inflation to other countries.

- Economic growth must reaccelerate. Most investment strategists are forecasting a recession this year, but the current consensus U.S. real GDP growth estimate for 2023 is still barely positive at +0.4%. That number compares to +1.9% in 2022 and +5.9% in 2021. The Eurozone is forecasted to post negative growth of -0.4% this year. Of the big three economic zones, only China is forecasted to show accelerating growth this year of +4.7% versus +3.1% in 2022. In the U.S., the labor market remains strong, with unemployment low – something that should help mitigate the depth of any potential recession.

- Corporate earnings growth estimates must stop falling and stabilize. The S&P 500's consensus earnings growth estimate for 2023 has fallen to +4.5% currently versus +9.7% back in April 2022. The good news is the valuation for the S&P 500 has been reduced -18% since this time last year when its price-to-earnings ratio was 20.6x versus 16.9x currently. This compares to its 10-year average of 17.2x and its 20-year average of 15.5x. When inflation has averaged +4-6%, the average price-to-earnings multiple for the S&P 500 going back to 1950 was 15.1x.

- The stock market must lap the tough sales and earnings growth comparisons for technology companies whose products experienced a two-year acceleration in demand from the pandemic. Unfortunately, the Information Technology Sector, which is over 25% of the capitalization of the S&P 500, is forecasted to continue to experience a deceleration in sales (+8.3% to +3.7%) and earnings growth (+4.4% to +3.8%) from 2022 to 2023. On a positive note, estimates currently call for a sharp rebound for the Sector in 2024.

- Corporate earnings and sales growth must reaccelerate. The S&P 500's earnings growth this year is forecasted to decelerate to +4.5% from +5.5% in 2022, and its sales growth is forecasted to decelerate even faster to just +2.7% this year from +11.6% last year. Both metrics are forecasted to rebound in 2024.

While the investment environment continues to prove extraordinarily complex and challenging, we expect investment fundamentals to improve, and for economic and financial comparisons to become easier, beginning in the second half of the year. To take advantage of this reacceleration in growth, we have made several new equity investments in companies with leadership positions in attractive markets with compelling innovation. These companies sell products that can generate resilient growth in any type of economic environment, and have low debt and dependable cash flow.

Sources: BEA, Coinbase, Federal Reserve Economic Data (FRED) and FactSet

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