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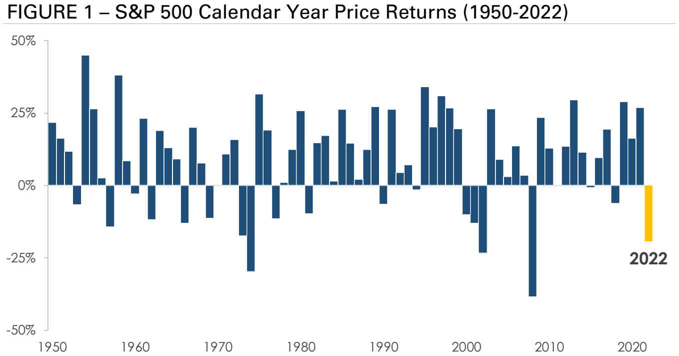
Client Letter | 4Q 2022 Recap & 1Q 2023 Outlook

Good Riddance 2022

Markets faced tough challenges in 2022, including high inflation, historically hawkish central bank policy, the war in Ukraine, and Covid lockdowns in China. Inflation was a significant factor in markets throughout the year, with the headline consumer price index reaching a 40-year high of 9.1% in June. High inflation prompted the Federal Reserve (and its global central bank peers) to raise interest rates aggressively, putting downward pressure on asset prices. Figure 1 shows the S&P 500 index declined -19.4% in 2022, its worst annual return since 2008. Figure 5 shows the Bloomberg U.S. Bond Aggregate index produced its worst return since its inception in 1976. This letter reviews the fourth quarter, recaps 2022, and discusses what the market will focus on in 2023.

FIGURE 1 – S&P 500 Calendar Year Price Returns (1950-2022)

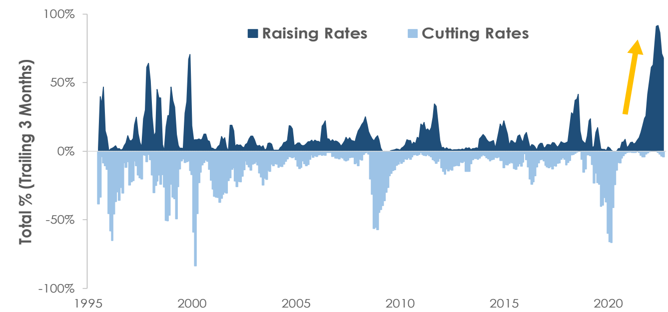


Source: MarketDesk

2022's Interest Rate Hikes in Perspective

The main story of 2022 was the reversal of monetary policy from the extraordinarily accommodative levels of the Covid-19 pandemic. Figure 2 shows the speed and size of interest rate hikes as global central banks worked to bring inflation under control. Figure 2 illustrates that 2022 was the quickest, largest, and most aggressive global tightening cycle since the late 1990s.

FIGURE 2 – Global Central Bank Activity (Interest Rate Cuts vs Hikes)



Source: MarketDesk, Various Central Banks. Data through November 30, 2022.

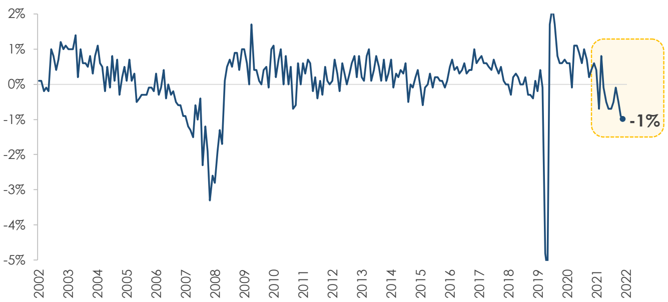
Central banks continue to hint that they are approaching the end of their rate hike cycle, citing recessionary concerns. Importantly, data suggests that inflation may have peaked in June 2022. While the year-over-year headline consumer price index rose by 7.1% in November 2022 (still historically high), it was down from 9.1% in June 2022.

Lagged Effects of Higher Interest Rates May Still Show Up in Economic Data

While the Fed's rate hikes occurred in 2022, the full impact may not yet be evident in the economy. While the U.S. economy contracted during the first half of 2022, it expanded at a robust +3.2% annualized pace during the third quarter. Consumer spending remained strong throughout 2022 despite high inflation, and the U.S. labor market added more than four million jobs through November. The data indicates the U.S. economy has withstood tightening thus far, but the real test will come in 2023 as the cumulative impact of higher interest rates becomes clearer.

While a recession is not a foregone conclusion, most economists believe one is still possible. An index of leading economic indicators shows the U.S. economy is already starting to slow as the impact of higher interest rates takes hold. Figure 3 graphs the month-over-month change in The Conference Board's Leading Economic Index, which tracks ten economic components that tend to precede changes in the overall economy. The chart reveals that the Leading Economic Index has decreased every month since March 2022, indicating the economy is slowing after a period of solid growth during the pandemic recovery.

FIGURE 3 – Leading Economic Index (% Month-Over-Month Change)



Source: MarketDesk, The Conference Board

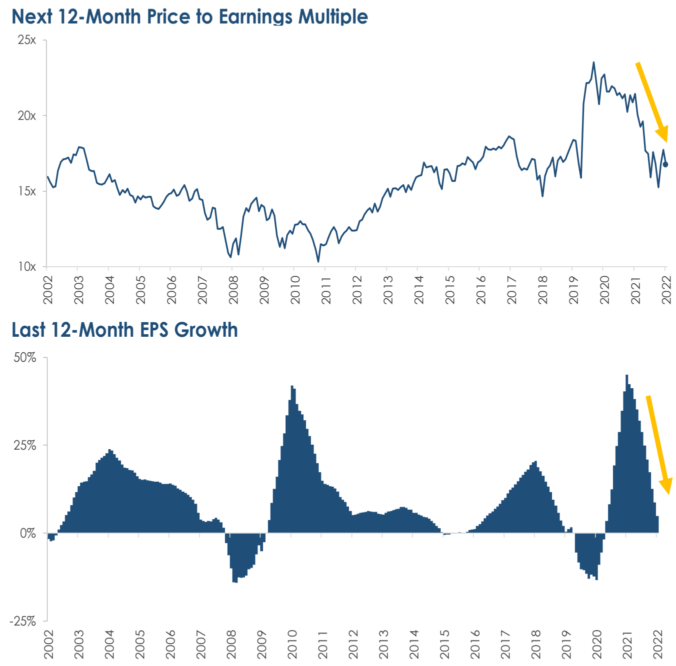
Company Valuations Are More Attractive, But Earnings Are an Open Question

Whereas inflation and central bank policy were the primary drivers of markets in 2022, corporate fundamentals will play a more prominent role in 2023. Figure 4 tracks two important S&P 500 metrics. The top chart tracks the next 12-month price-to-earnings ratio, which divides the S&P 500's projected next 12-month earnings by its current price. It shows that valuation multiples expanded during the pandemic as interest rates fell. Then, valuation multiples reversed lower as rising interest rates pressured company valuations.

While current valuations are more attractive today than at the beginning of 2022, corporate earnings are an open question entering 2023, with the potential for an earnings reset as the economy slows. The bottom chart in Figure 4 tracks the S&P 500's trailing 12-month earnings growth, showing the jump in corporate earnings during the pandemic. Recall the massive fiscal and monetary stimulus of that period.

Despite expectations for an economic slowdown, Wall Street analysts still forecast single-digit earnings growth for the S&P 500 in 2023. The optimistic earnings growth forecast is encouraging, but it creates a risk. If actual earnings growth falls short of projections, stock prices could decline as markets price in those lower-than-expected actual earnings.

FIGURE 4 – S&P 500 Valuation Multiple & Earnings Growth



Source: MarketDesk

Stock Market Recap – Stocks Trade Higher in 4Q'22

The S&P 500 Index of large-cap stocks returned +7.6% during the fourth quarter, outperforming the small-cap Russell 2000 Index's +6.2% return. The Dow Jones Index returned +15.9%. In comparison, the Nasdaq 100 Index of technology and other growth stocks produced a -0.1% return during the fourth quarter.

The top performer was the MSCI EAFE Index of developed international stocks, returning +17.7% during the fourth quarter. The MSCI Emerging Market Index returned +10.3%.

Bond Market Recap – The Great Reset

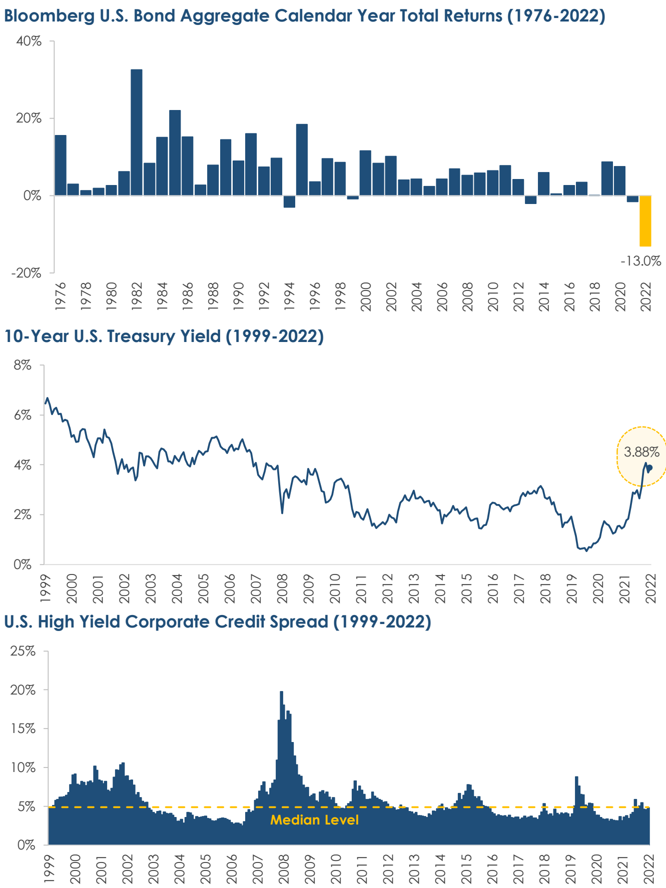
The bond market experienced a significant resetting of interest rates in 2022. During the year, yields steadily rose as the Fed raised interest rates seven times. Despite positive returns during the fourth quarter, bonds declined significantly in 2022. The top chart in Figure 5 shows that the Bloomberg U.S. Bond Aggregate index produced a -13% total return during 2022, its worst since tracking began in 1976, 46 years ago.

The bottom two charts in Figure 5 examine the current state of the bond market after 2022's rate hikes. The middle chart shows that the 10-year Treasury yield sits at its highest level since 2007, and yields are now higher across much of the bond market.

Investors can now earn a yield of 4% to 5% on high-quality bonds, such as U.S. Treasuries and investment-grade corporate bonds, even at shorter durations.

The bottom chart shows the high-yield corporate bond spread, which is the extra yield investors demand to loan to lower-quality borrowers. That spread is now in line with its median since 1999.

FIGURE 5 – State of the U.S. Credit Market Entering 2023



Source: MarketDesk, Bloomberg, U.S. Treasury, ICE

The bottom line is that the starting point for bonds in terms of yield is now more compelling than it has been in an awfully long time. There is still significant uncertainty regarding how high the Fed will raise interest rates and how long it will keep rates elevated. However, the economy will start feeling the effects of 2022's rate hikes well into 2023, which could make bonds even more attractive. That said, high inflation, uncertain monetary policies, and a volatile global economy could keep interest rate volatility elevated and test bond investors' nerves again in 2023.

2023 Outlook – Turning the Page on 2022's Historic Tightening Cycle

2023 has the potential to be a year of two halves. In the first half, the focus is likely to shift from the number of future interest rate hikes to how much those rate hikes will slow the economy. Some data, such as the housing market, indicate that tighter monetary policy is rapidly showing up in the real economy.

Home sales are slowing, and homebuilder confidence weakened every month during 2022. At the same time, consumers continue to spend, and employers continue to add jobs. There is still a wide range of outcomes, and the unique nature of significant interest rate volatility makes the path forward anything but certain.

The second half has the potential to be different depending on how severe the economic slowdown is in early 2023. Markets are forward-looking, and investors will watch closely for signs that the economy has bottomed and is recovering. Figure 1 shows that there have only been two consecutive negative S&P 500 years since 1950, in 1973-1974 and 2000-2002. There is no guarantee that the S&P 500 will produce a positive return in 2023, but Figure 1 provides an essential historical perspective. And perspective is key to successful investing.

We wish you and your family happiness and health in the New Year! We look forward to helping you make the most of your financial lives.

Happy New Year & Thanks for Taking a Look!

THIS QUARTER IN NUMBERS

FIGURE 6

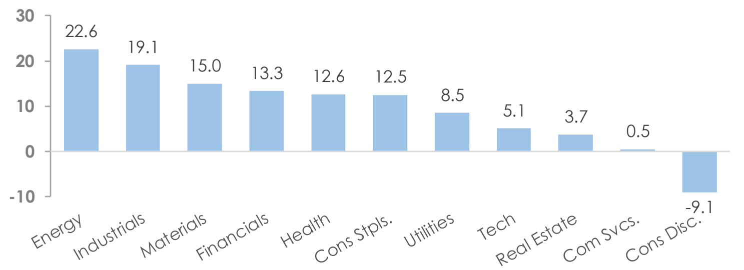
U.S. Style Returns (4Q 2022 in %)

	Value	Blend	Growth
Large	12.2	7.6	2.1
Mid	10.3	9.1	6.9
Small	8.3	6.2	4.1

Data Reflects Most Recently Available As of 12/31/2022

FIGURE 7

U.S. Sector Returns (4Q 2022 in %)



Data Reflects Most Recently Available As of 12/31/2022

FIGURE 8

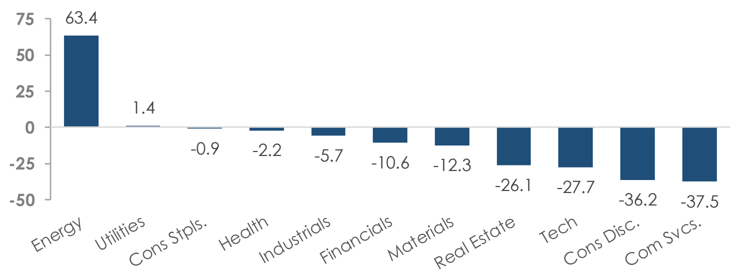
U.S. Style Returns (2022 in %)

	Value	Blend	Growth
Large	-7.8	-18.2	-29.3
Mid	-12.3	-17.5	-26.9
Small	-14.7	-20.5	-26.2

Data Reflects Most Recently Available As of 12/31/2022

FIGURE 9

U.S. Sector Returns (2022 in %)



Data Reflects Most Recently Available As of 12/31/2022

FIGURE 10

Market Data Center

Stocks	1 month	3 months	6 months	YTD	1 year	3 years	Dividend Yield	NTM P/E	P/B
S&P 500	-5.8%	7.6%	2.3%	-18.2%	-18.2%	24.3%	1.65%	16.4x	3.7x
Dow Jones	-4.1%	15.9%	8.7%	-7.1%	-7.1%	22.5%	1.91%	16.5x	4.3x
Russell 2000	-6.5%	6.2%	4.0%	-20.5%	-20.5%	9.3%	1.48%	19.1x	1.9x
Russell 1000 Growth	-7.7%	2.1%	-1.5%	-29.3%	-29.3%	24.7%	0.91%	21.1x	8.7x
Russell 1000 Value	-4.0%	12.2%	5.9%	-7.8%	-7.8%	17.6%	2.15%	13.9x	2.3x
M SCI EAFE	-1.8%	17.7%	5.5%	-14.3%	-14.3%	3.1%	2.69%	12.2x	1.6x
M SCI EM	-2.6%	10.3%	-4.0%	-20.5%	-20.5%	-9.6%	2.50%	11.7x	1.6x
NASDAQ 100	-9.0%	-0.1%	-4.6%	-32.5%	-32.5%	27.9%	0.80%	20.9x	5.6x

Fixed Income	Yield	1 month	3 months	YTD	1 year	3 years
U.S. Aggregate	4.68%	-0.9%	1.6%	-12.9%	-12.9%	-7.6%
U.S. Corporates	5.51%	-1.5%	4.2%	-17.8%	-17.8%	-9.6%
Municipal Bonds	3.96%	-0.3%	3.7%	-7.3%	-7.3%	-1.4%
High Yield Bonds	8.97%	-1.7%	5.0%	-10.9%	-10.9%	-3.0%

Key Rates	12/31/2022	11/30/2022	9/30/2022	6/30/2022	12/31/2021	12/31/2019
2 yr Treasury	4.42%	4.38%	4.20%	2.93%	0.73%	1.57%
10 yr Treasury	3.88%	3.70%	3.80%	2.98%	1.51%	1.92%
30 yr Treasury	3.97%	3.82%	3.77%	3.12%	1.90%	2.39%
30 yr Fixed Mortgage	6.66%	6.67%	7.06%	5.91%	3.27%	3.86%
Prime Rate	7.50%	7.00%	6.25%	4.75%	3.25%	4.75%

Commodities	Level	1 month	YTD
Oil (WTI)	80.26	-0.4%	65.4%
Gasoline	2.37	3.5%	73.4%
Natural Gas	4.10	-40.8%	62.5%
Propane	0.69	-11.8%	7.2%
Ethanol	2.20	-5.4%	76.0%
Gold	1,826	3.8%	-3.6%
Silver	24.04	10.4%	-9.0%
Copper	3.81	2.0%	8.3%
Steel	744	13.6%	-22.7%
Corn	6.78	1.7%	40.2%
Soybeans	14.97	2.0%	14.2%

Data Reflects Most Recently Available As of 12/31/2022