Review & Outlook

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Review and Outlook

In December 2021, the Federal Reserve ("the Fed") announced that it no longer views inflation as transitory. Supply chain woes and multiple waves of COVID caused prices of various goods to climb for longer than expected. The Fed also announced in December 2021 that they would raise interest rates aggressively to try to bring inflation back to their target level of 2%. Russia's invasion of Ukraine, and the subsequent disruption to energy and commodity markets, only made the challenge of controlling inflation that much harder. Moreover, the vast sums of money pushed into the economy to help minimize the impacts of Covid, a robust job market, and measures such as student loan deferment meant consumers still had money in 2022. Consumers continued to spend, even in the face of higher prices.

Index Performance Data
Total Return as of 12/31/2022

Indices[1]	Q4 2022	Trailing 12 Months
CRSP U.S. Total Stock Market Index	7.15%	-19.71%
MSCI Global ex-U.S. Total Stock Market Index	-23.80%	-24.06%
Bloomberg Barclays U.S. Aggregate Bond Index	1.87%	-12.88%

In 2022, interest rates moved up, but unemployment remained low, and employers had to offer higher wages to attract workers. Higher wages meant more persistent inflation and a tougher fight for the Fed. We continue to see a large number of people not only not working, but also not looking for work. It seems almost like many have retired early. The curious part is the large number of people, especially working age men, who have simply stepped away from the workforce.

Sadly, financial markets were notable casualties of the tumultuous year. The bond market had one of the worst years on record, with the Bloomberg Aggregate Index for U.S. bonds falling almost 13%. And stocks were no better, with the tech-focused Nasdaq index falling almost 34% this year, and the broader CRSP index falling 20%.

Looking at 2023, investors will continue to try to guess what the Fed is going to do with interest rates, likely resulting in continued volatility into the early part of the year. Many indicators point to a looming recession. An oft-cited recession indicator, the inverted yield curve, has been in place now since last October. Slowing home sales and declining home prices in many markets, combined with more modest retail sales, make some people say a recession is imminent or even happening now. But some point to the labor market with very low unemployment and say things look okay. However, 2023 is not like previous years given all the early retirements and people who have simply dropped out of the labor market.

In Focus

As we think of what financial markets might do in the coming year, we have to think about the larger trends influencing economic and financial activity. Inflation is likely to fall in 2023, but remain elevated compared to the past decade. It may remain above the Fed's 2% target for quite a while. One reason is that globalization has fallen out of favor. If countries focus on reshoring, or trading with countries they feel they can trust or that follow desired norms, then the deflationary pressures of true globalization will fade. Demographics will also play a role. In the U.S., we are just a few years away from a long-anticipated enrollment cliff for students. Between 2025 and 2029, the number of college age students will fall by roughly 100,000 students per year. Birth rates declined in the wake of the 2008 financial crisis, and we are about to see the effects of that on colleges, and eventually the workforce.

Presently, many workers are still away from the labor force for reasons including COVID morbidity, as well as shifts in views on job quality, status, and satisfaction. There won't be much of a break before the new demographic reality hits with fewer people entering the labor force in their 20s. Tightness in the labor market will keep upward pressure on wages and make the fight against inflation a bit more challenging, perhaps suggesting higher interest rates in the coming years relative to what we've seen over the past decade.

Higher interest rates and less robust trade should also mean slower economic growth globally. China's reversal on COVID lockdowns should help add to growth, but with short-term uncertainty and delays. China now has to work through the impacts of so many people contracting COVID in a short period, with a strained healthcare system and people missing work. In the end, we think more growth in China will help the global economy, however "re-shoring" the supply chain and the high level of distrust will likely keep inflation above the Fed's 2% target through 2023.

The war in Ukraine appears to be ongoing at least through 2023. The main economic impacts affecting markets follow from how the war affects energy and food prices. While energy prices spiked through the first months of the war, oil and gas prices are now at or below pre-war prices. This is partly due to an abnormally warm winter in Europe with less demand for heating gas. Arrangements to export significant amounts of grains from Ukraine have been put in place, and seem to be holding up. Renewed economic growth in China should also have a positive impact on the global economy. Ongoing background noise includes North Korean missile launches and Iran's development of nuclear weapons capacity. It is not clear what impact, if any, the latter two have on financial markets. Possibly some low risk of a large downside event. We believe these probabilities are too low to incorporate it into an investment portfolio, save that defense stocks should continue to perform well.

Many people think the financial markets will face new challenges in the first half of the year. Specifically, investors will have to decide how to react to corporate earnings. In late 2022, earnings reports reflected activity through the middle of the year. Earnings reports in 2023 will reflect activity in late 2022, which should show the impacts of higher interest rates and slower spending by consumers. The reports could include lower expectations for earnings in 2023. The concern is that lower earnings will mean lower stock prices. We think weak earnings reports do present risks for stocks, and that additional price drops are likely. However, we do not think the reports will be a complete surprise or shock to anyone, so the drops should not be as surprising as in 2022, and we are more likely to see gains later in the year.

Rising interest rates in 2022 meant that existing or outstanding bonds decreased in market value. Longer-dated bonds are more sensitive to changes in interest rates, and market prices can fall significantly with rising rates. We viewed higher interest rates as a potential risk, so we focused on very short-term bonds and cash. As the year went on, and interest rates rose sharply, we started to purchase new, short-term bonds, especially short-term U.S. Treasuries paying 3%-4%. As rates reach their peak, we will start buying longer-dated bonds. The goal is to lock in the higher return or yield, with a view that rates will stabilize and potentially decrease over time. The decrease could come more quickly if there is a recession. With a weakening economy, the longer-dated bonds should increase in value.

For stocks, we focused on quality and value. Rising interest rates has meant bigger price drops for more speculative companies that have had their valuations stretched (like Peloton). We avoided some of the larger losers in the mega-cap space this past year such as Meta (Facebook), Amazon, and Tesla. Higher rates also meant bigger challenges for companies with a lot of debt that has to be refinanced. Companies with good cash flow and more modest valuations have done much better, seeing larger price increases in the fourth quarter and smaller price drops for the year. When we sold stocks in 2022, we did not always replace those positions, as we have been holding some cash and short-term Treasuries instead of stocks. Our intention is to be somewhat conservative heading into 2023, so we have the ability to buy into the market should prices fall a bit more.

1. Index performance data provided by ICE Data Services, and calculated by Black Diamond, an SS&C Advent company.