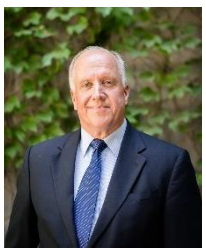
# 2022 – 4th Quarter Review & Outlook

## Economic and Investment Review

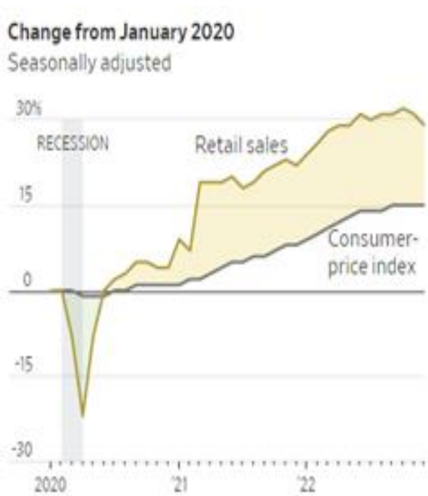


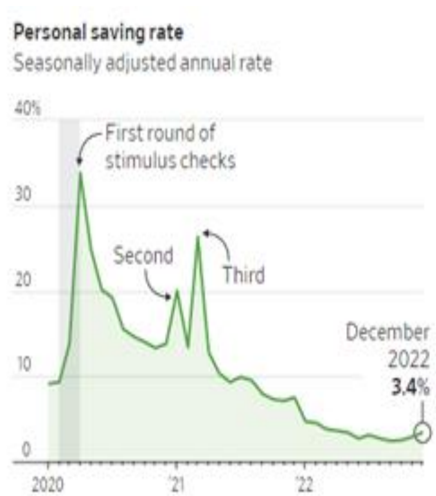
**Mark Anderson**

Chief Investment Officer

**Economic Growth:** The U.S. economy exceeded growth expectations in Q4 2022. Q4 GDP growth was 2.9% q/q compared with the consensus estimate of 2.4% for the period. The economy grew by 2.1% for the full year of 2022 despite two negative quarters in the first half. Even though the quarterly report was relatively solid, cracks are beginning to appear in consumer spending. The holiday shopping season was disappointing as consumers stressed about the impact of inflation on their wallets and rising rates on their ability to borrow.

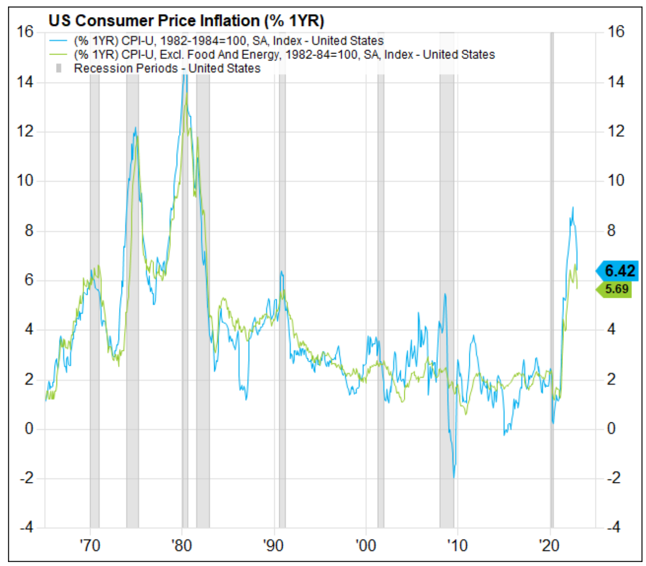
Retail purchases have declined in three of the past four months and savings rates have declined as consumers struggle to make ends meet.




Source: The Wall Street Journal

Inflation, as measured by the Consumer Price Index, peaked in June of last year at 9.0%, the highest level since high inflationary periods of the 1970's and 1980's. Inflation has been steadily trending down since the June peak but remains at elevated levels.

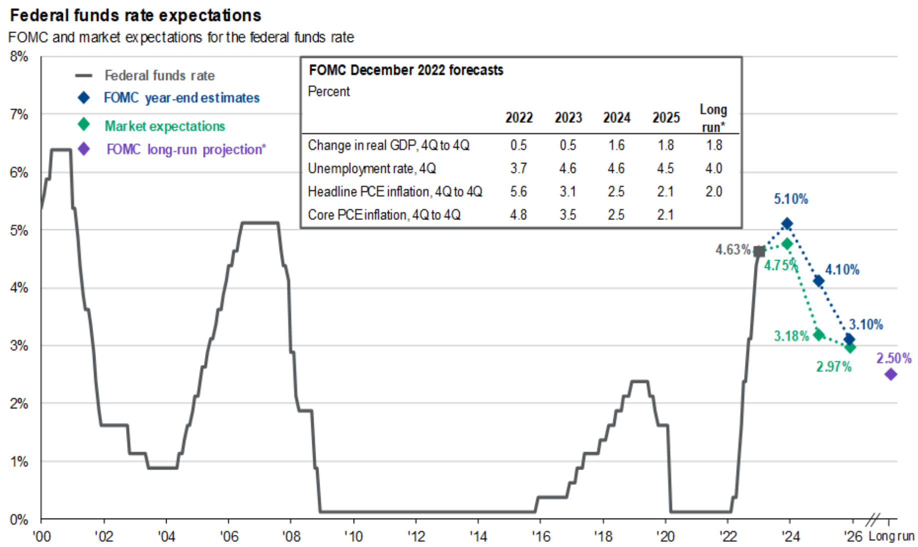



Source: FactSet

CPI was reported at 6.4% for December.

Consumers continue to be significantly negatively impacted by rising food prices. Food has been up more than 10% on a year-over-year basis every month since May of last year. Energy prices shot up in the 1st and 2nd quarters of 2021 and did not begin to see moderation in year-over-year price increases until the end of 2022. Many economists and strategists expect inflation to continue to trend down this year. The consensus estimate for year-end CPI is 2.4% and 3.1% for core CPI. The FOMC (Federal Open Market Committee) forecasts core PCE inflation to decline to 3.5% by the end of the year.

The Fed began raising the Fed Funds Target Rate in March of last year. Since that time the target rate has been increased from 0.0-.25% to 4.50-4.75%.




Source: JPMorgan Asset Management

Following the February 1 rate increase, the FOMC stated that it "anticipates that ongoing increases in the target range will be appropriate in order to attain a stance of monetary policy that is sufficiently restrictive to return inflation to 2 percent over time. This would seem to indicate at least two more 0.25% rate increases before the terminal rate is reached." If this is the case, a terminal rate of 5.0-5.25% could be reached at the May 3rd meeting. The question then becomes – how long will the terminal rate be maintained.

The Committee acknowledged that inflation pressures have eased but remain elevated. Chairman Powell stated that "decisions will be made meeting by meeting and that the historical record recommends staying the course and not relenting on our decisions." Chairman Powell indicated that it will likely be 2024 before the 2 percent inflation target is achieved.

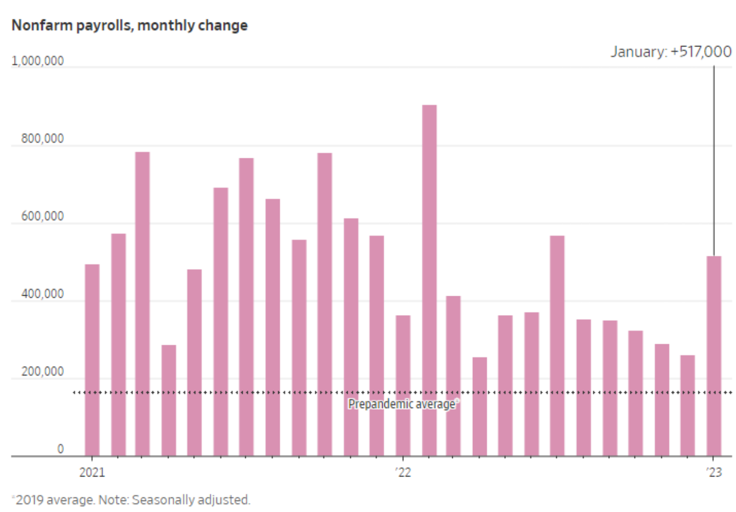
The market does not seem to completely believe that an additional 0.50% increase is likely or warranted. The consensus estimate is for the target rate to peak at 4.75-5.00% and to begin declining by the end of the year. However, we would not be surprised if the peak rate is maintained through the remainder of 2023 and possibly into 2024.

Ultimately, the Fed would probably prefer to fall on the side of doing too much rather than doing too little. The last thing that the Committee wants is for inflation to become entrenched at higher levels.

Higher rates and elevated inflation will likely lead to reduced consumer spending and job losses. As a result, the possibility of a recession in 2023 is increased.

Dr. David Kelly, Chief Global Strategist at J.P. Morgan Asset Management, states that because of decreased savings and increased debt, consumer spending will likely decline and act as a drag on the economy in 2023. However, he expects that the worst outcome is a mild recession and that there is still a possibility that the economy manages to avoid recession altogether. The consensus estimate for 2023 GDP is 0.5% with negative growth in the second and third quarters. A Wall Street Journal survey puts the probability of a recession at 65%. Jan Hatzius, Chief Economist of Goldman Sachs, places the probability at just 25% and recently reduced the probability based on continued strength in the labor market and early signs of improvement in the business surveys.

U.S. nonfarm payrolls trended down in Q4 2022 but started out 2023 with a bang. Even as some



companies have been announcing large layoffs, employers added 517,000 jobs in January, pushing the unemployment rate to a 53-year low of 3.4%. The resilient labor market may cause the Fed to be more aggressive in its use of raising rates to blunt inflation. However, the increase in hiring may turn out to be somewhat of a job sector rebalance. A large part of hiring took place in the services sector where the leisure and hospitality industries have been understaffed.

U.S. existing home sales for 2022 was the weakest it had been since 2014. Existing homes, which makes up most of the housing market, fell 17.8% in 2022. Home sales were negatively impacted by higher mortgage rates. Mortgage rates moved from about 3% a year ago to 7% and back down to about 6% currently. Mortgage applications have increased recently due to the 1% decline, but affordability remains a significant problem due to overall higher rates, limited supply and elevated prices.

According to the Institute for Supply Management (ISM), the U.S. manufacturing sector began to contract in November of last year and has now declined by 2.6% since last October. However, the U.S. services sector saw a slight dip in December but has rebounded to expansionary territory in January. Other than December, the services sector has expanded every month since May 2020.

## Equity Markets

Equity markets in the U.S. and around the globe posted their worst year last year since the financial crisis in 2008. The S&P 500 declined -18.1% in 2022. The S&P 500 Growth index and the NASDAQ lost nearly a third of their value during the year. Value stocks held up better but were still down -5.2% for the year. Small Cap stocks were down -16.1%. Developed International stocks (MSCI EAFE) were down slightly less than the S&P 500 but Emerging Market stocks (MSCI Emerging Markets) were down slightly more.

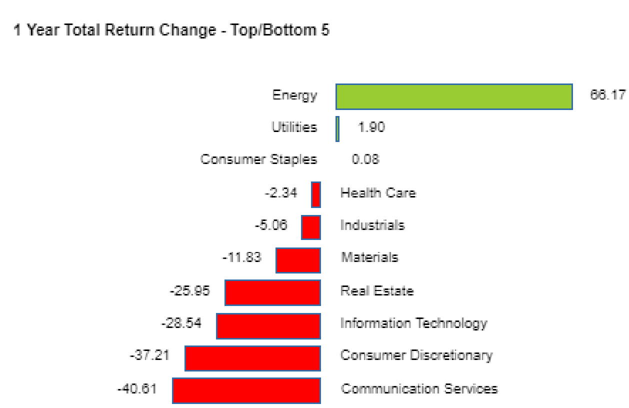
| 2022 Q4 Returns | | | | |
|---|---|---|---|---|
| EQUITY | Q4 2022 | YTD 12.31.22 | 1 Year 12.31.22 | 3 Years Annualized |
| S&P 500 | 7.56 | -18.11 | -18.11 | 7.66 |
| S&P 500 Value | 13.59 | -5.22 | -5.22 | 6.26 |
| S&P 500 Growth | 1.45 | -29.41 | -29.41 | 7.54 |
| Dow Jones Ind Avg | 16.01 | -6.86 | -6.86 | 7.32 |
| NASDAQ Composite | -0.79 | -32.54 | -32.54 | 6.10 |
| S&P Mid Cap 400 | 10.78 | -13.06 | -13.06 | 7.23 |
| S&P Small Cap 600 | 9.19 | -16.10 | -16.10 | 5.80 |

Source: FactSet

The bottom of the market cycle (at least so far) ocurred on October 14, when the S&P 500 closed at 3583. The index finished the year at 3839, up 7.1% (price return) from the bottom. The total return for the S&P for Q4 2022 was 7.6%. Most other equity benchmarks rebounded strongly in Q4 lead by MSCI EAFE, up 17.3%, and the Dow Jones Industrial Average, up 16.0%. The rebound corresponded with the beginning of a downward trend in inflation.


Source: FactSet

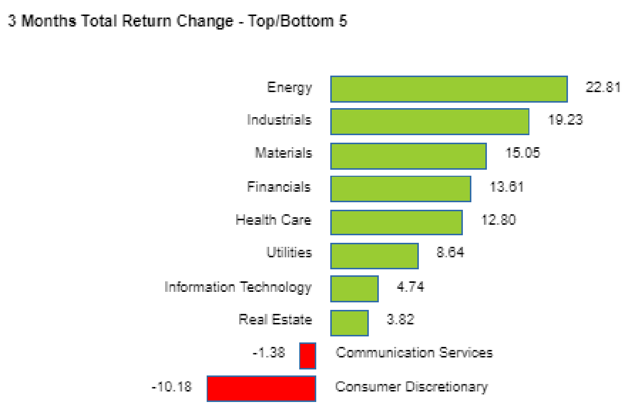
Only 3 of 10 economic sector related stocks had positive returns in 2022. Energy had a stand out year due to supply constraints caused primarily by




Source: FactSet

Russia's war against Ukraine. Utilities and Consumer Staples were slightly positive due to their perceived defensive nature. Higher growth and higher valuation sectors took the brunt of the sell-off and re-valuation.

The sector story improved greatly in Q4. There were only 2 of 10 economic sectors with negative returns in the quarter.

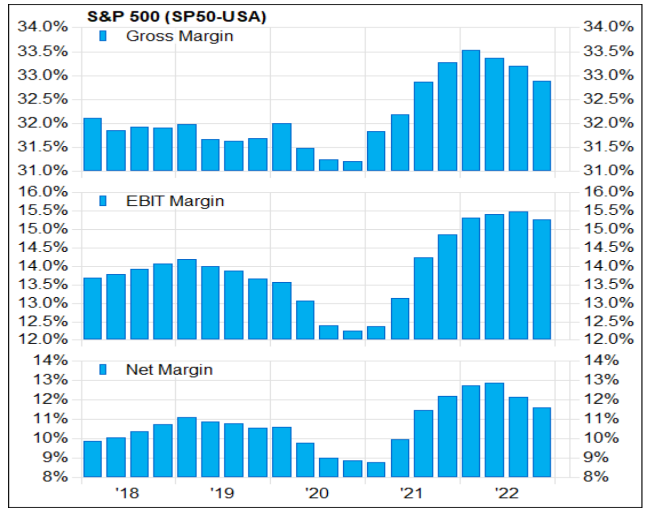



Source: FactSet

Earnings growth for the S&P 500 in 2022 declined from earlier estimates of over 10% to 5.2% for the year. The consensus estimate for 2023 exceeded 14% in Q2 2022, but has declined significantly to just 2.6% currently. Goldman Sachs forecasts just 0.2% earnings growth for 2023. J.P. Morgan and Raymond James expect earnings growth to be flat-to-down for the year. It is typical for analysts to reduce annual earnings estimates during the first month and quarter of the year but reductions have been larger and faster so far in 2023.

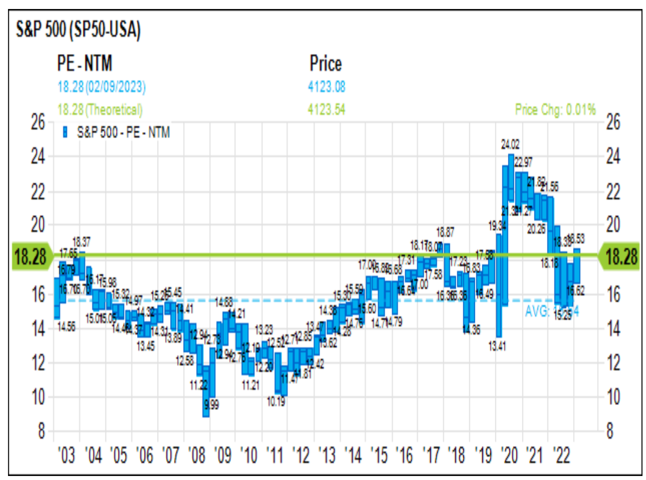
About 50% of the S&P 500 have now reported Q4 results. Approximately 70% of those companies reported EPS above reduced consensus estimates. However, the percent of companies with positive surprises and the amount of the actual surprise above the estimates are below 5 and 10-year averages.

Margins continue to be under pressure but remain elevated on a historical basis.




*Source: FactSet*

Valuations have declined considerably over the past two years but remain well above the 20-year average. Surprisingly, investors have been willing to assign higher than long-term average multiples in the face of rising interest rates and weak earnings expectations.




*Source: FactSet*

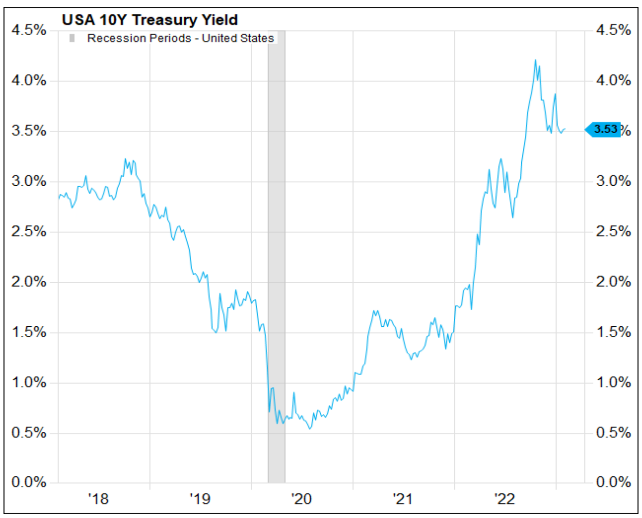
The S&P 500 is currently trading at 18.5X the 2023 earnings estimate of 222.81 and 18.3X for the next 12 months. The index is currently trading above 4,100. Goldman Sachs maintains a forecast of 4,000 for 3, 6 and 12 months. Raymond James expects the S&P 500 Index to rise to ~ 4,400 by year-end 2023 based on an expanded P/E multiple of ~20.5X supported by a forecast for lower interest rates later in the year.

We forecast the S&P 500 to end the year near 4,200. The forecast is based on 1.1% earnings growth in

2023, compared with the consensus estimate of 2.6% and a rebound of 10%+ earnings growth in 2024 and 2025. At the same time the P/E multiple is expected to regress slowly towards the long-term mean. If the S&P 500 reaches 4,200, the market would be up nearly 10% for the year.

## Fixed Income Markets

Intermediate and longer-term yields moved down from recent peaks in Q4 based on expectations that inflation will continue to trend down in the coming calendar quarters. The 10-year U.S. Treasury yield declined from 4.16% in early November to 3.88% at year-end and 3.53% currently in early February.




Source: FactSet

Investment grade bond returns turned positive in Q4. The Bloomberg Aggregate Bond Index was up 1.87% in the period. Still, returns for the full year were by far the worst experienced by the index. The index was down -13.01% for the year compared with the previous worst year of 1994, down -2.92%.

| 2022 Q4 Returns | | | | |
|---|---|---|---|---|
| FIXED INCOME | Q4 2022 | YTD 12.31.22 | 1 Year 12.31.22 | 3 Years Annualized |
| Bloomberg US Agg Bond | 1.87 | -13.01 | -13.01 | -2.71 |
| ICE AMT-Free Nat'l Muni | 3.84 | -7.73 | -7.73 | -0.56 |
| Markit iBoxx USD Liquid High Yield Index | 4.31 | -10.74 | -10.74 | -0.80 |

Source: FactSet

Municipal bonds posted the best quarter since Q3 2009 but still finished the year well in negative territory. A lack of new supply has acted as a support for municipal bond valuations. The front end of the municipal curve remains rich (lower taxable equivalent yields) compared to Treasuries and corporate bonds with less than 5-year maturities. Investors looking to add shorter-term fixed income securities may want to consider taxable bonds. Municipal bonds continue to compare favorably on a taxable equivalent basis in intermediate and longer maturities.

A slower economy results in less taxes collected by states, cities and other government agencies. However, there is little concern about credit quality as most states are in strong financial position.

High yield bond funds are yielding over 5.5%. Normally there would be considerable concern about spreads with the potential of recession looming. Spreads are higher than they were a year ago but they have not reached levels of previous recessions or downturns.

Fixed income is much more productive in portfolios than it has been for some time due to higher rates. The opportunity should be taken to bring fixed income allocations to target since rates generally decline in a recession and prices should respond positively to lower inflation.

We continue to recommend focusing on high credit quality but look to extend duration from the shorter posture that was maintained in 2022.

## Real Assets

The Dow Jones U.S. Real Estate index is a benchmark for Real Estate Investment Trusts (REITs). The benchmark traded off significantly during the COVID pandemic, then regained lost

| 2022 Q4 Returns | | | | |
|---|---|---|---|---|
| Real Assets | Q4 2022 | YTD 12.31.22 | 1 Year 12.31.22 | 3 Years Annualized |
| Dow Jones U.S. R/E | 4.43 | -25.17 | -25.17 | -0.45 |
| S&P GSCI | 3.44 | 25.99 | 25.99 | 10.49 |

Source: FactSet

ground only to trade lower again in 2022. The index was down -25.2% for the year but rebounded somewhat in Q4.

Commodities were up 26.0% in 2022 and were one of the few places to generate positive returns in the year. The S&P GSCI commodities benchmark allocates 57.8% to Energy, 19.4% to Agriculture and 11.0% to Industrial Metals.

## Asset Allocation

The 60% equities/40% fixed allocation had a disastrous year in 2022 because bonds did not offset equities like they have done many times in the past. Goldman Sachs reports that bonds have lost money over a 12-month period just 2% of the time since 1926. A 60%/40% allocation made up of the S&P 500 Index and the Bloomberg Aggregate Bond Index declined -16.1% in 2022. A broader balanced allocation including international assets, commodities and real estate utilized by J.P. Morgan in their Guide to the Markets returned -13.9% for the year.

Stocks and bonds started out the year expensive on a relative basis. Valuations are now in a more reasonable range which should allow a 60%/40% allocation to function as an appropriate starting point for a balanced investment portfolio.

**Disclosures**