Capital Markets Review

Inflation, inflation, inflation...as they say in real estate it's about location, location, location and today the markets are focused, if not short term obsessed, about the future levels of inflation. Not surprisingly, this has led to higher volatility in the markets, especially against the backdrop of low market volatility since the Global Financial Crisis. Even the Covid correction looked to be a blip compared to the impatience towards the current FED/inflation induced "bear" market. Looking back over this year, direct FED action has resulted in a pullback in markets and industries that aren't necessarily unexpected. The FED raised rates from 0.25% to approximately 4.25% by the end of 2022. Seeking to and getting a reduction in inflation from 9.0% peak mid-year to now an estimate of around 6.5%, with the prospect of even more moderation. The big question is, has the FED tightened enough, will we see more acceptable levels of inflation and how do we stop the slow-down from going "too far"? The answer to this is driven by policies that have led us to this point long-term (government debt) and short-term (think Covid response).

The policies driving inflation higher have been in place for some time. Rising inflation became inevitable after 2008 when the Fed increased liquidity to stabilize capital markets when markets were thrown into chaos as defaults on sub-prime mortgages escalated. The Fed increased the monetary base from $900 billion to approximately $5 trillion during the 2008/2009 period. The Fed was attempting to reduce the money supply prior to the shutdown of the US economy in 2020 in response to the COVID-19 pandemic. The shutdown generated a sharp decline in real GDP and a substantial increase in unemployment. The Treasury ran large deficits as it tried to provide economic stimulus by supplying direct cash payments to individuals and corporations. The Fed was called upon to increase liquidity once again, and consequently the monetary base increased by more than $3.0 trillion.

We think it's defensible to think that the short-term policies of stimulus are done, if not strongly on the road to reversal and that the markets have discounted and reflected the bulk of this. Long term investors, despite the -18.1% decline of the S&P 500 in 2022, should be accepting of a 4-year annual return of over 13% annually through 2022 for the S&P and a very good 12.5% annualized 10-year return. In the long-term context, the 10-year real rate of return on stocks has been very good, while the 10-year return for the Bloomberg US Bond Aggregate was only 1.05% on an annualized basis.

We should expect the reset in bonds to create more attractive opportunities in fixed income, and a world of stocks in which returns will be muted by higher inflation. This would be coupled with the opportunity for equity returns to shine for companies that can grow earnings and that investors can invest in more discriminately. Lastly, for long-term investors both bond markets and stock markets will deliver returns closer to the risk attributable to those asset classes and styles. Most assuredly, going forward, it won't likely be a 12.5% return for stocks for the 10-year period going forward and not 1.05% for bonds, but closer to the 30-year average return of 9.61% for stocks and 4.5% return for bonds.

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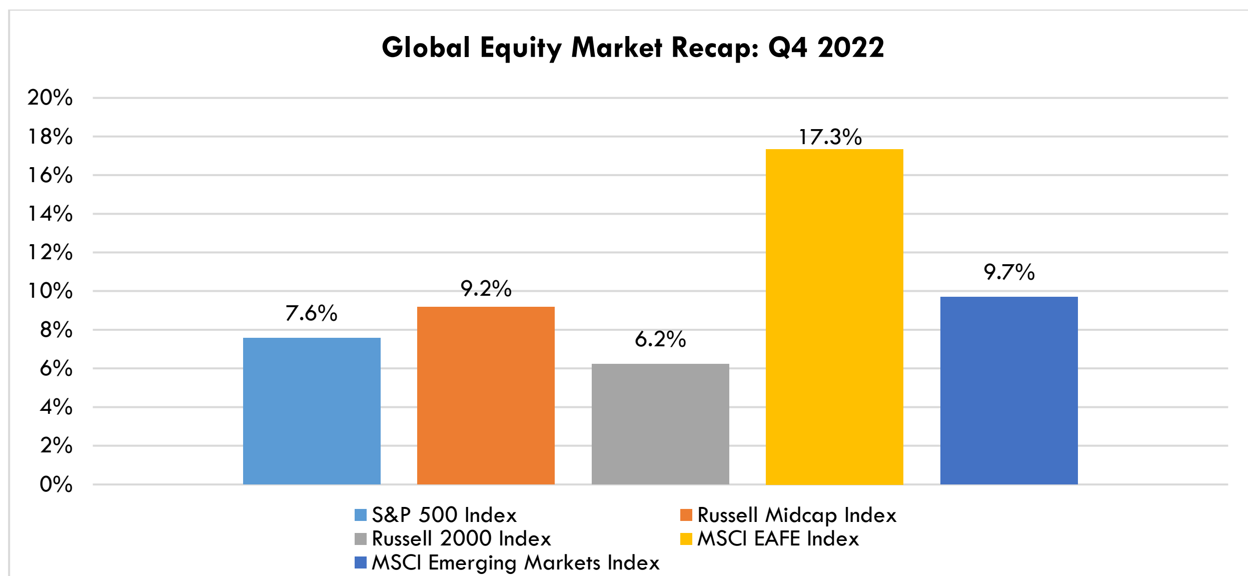
Equity Market Review

In the fourth quarter of 2022, the stock market, as represented by the S&P 500 Index, generated a positive return of 7.6%. For all of 2022 the Index returned -18.1%. While almost all sectors of the market experienced poor performance there was a substantial difference in the returns experienced by growth stocks versus value stocks. In the last quarter, the S&P 500 Growth Stock Index returned 1.5% while the S&P 500 Value Index returned 13.6%. For all of 2022 growth stocks produced a return of -29.4% while value stocks returned -5.2%. The favorable relative performance for value stocks over the last twelve months represented a significant reversal of a long-term trend favoring growth stocks.

Small cap stocks produced slightly better returns than did large cap stocks. The S&P SmallCap Index produced a return of 9.2% in the fourth quarter and -16.1% for all of 2022. Within the small cap sector, value stocks performed better than did growth stocks. Small cap growth stocks returned 7.0% for the fourth quarter and -21.1% for the full year. Small cap value stocks produced an 11.2 % return for the quarter and -11.0% for the full year. The one bright spot was Latin America where stocks in that region rose 3.6% for the quarter. The strength in this region was likely due to its link to commodity products and exports. The tables below display Q4 and year-to-date performance for a variety of equity indices.



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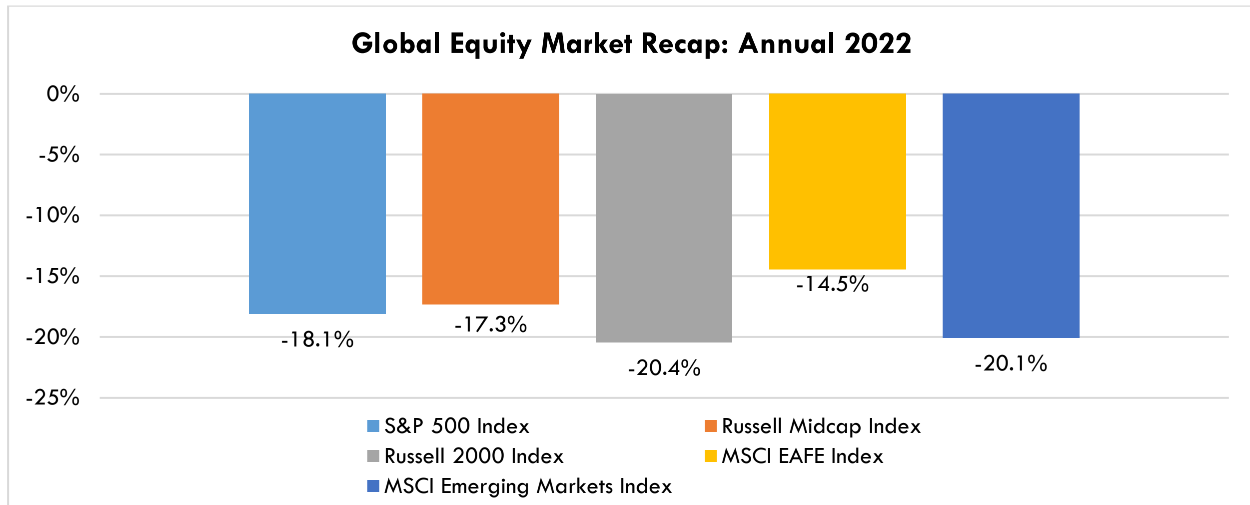

All data as of 12-31-2022; Source: Refinitiv

Large cap growth stocks dramatically lagged value stocks in the 4th quarter, a continuation of a trend that had persisted for most of the year. The prior trend – value stocks outperforming growth stocks – can be seen in the trailing one-year returns where the Russell 1000 Value Index demonstrated much better downside protection. Still, growth stocks have produced better results over the past 3-year, 5-year, and 10-year periods.

Performance Results	Q4 2022	1 Year	3 Years	5 Years	10 Years
Russell 1000 Growth Index	2.20%	-29.14%	7.79%	10.96%	14.10%
Russell 1000 Value Index	12.42%	-7.54%	5.96%	6.67%	10.29%

All data as of 9-30-2022; Source: FTSE Russell

Growth stock returns lagged value stocks in the 4th quarter, it was due to negative performance in Consumer Discretionary stocks (-10.1%), predominantly TSLA, and a much more muted return from Technology stocks (+4.7%). Recall that Consumer Discretionary stocks, which represent a meaningful weight in the growth index versus the value index, declined -37.2% in the full year 2022. The reality that the FED was more than serious in raising rates and the hypersensitivity to rates for TSLA and the like the general long duration attributes of high growth tech names. Higher rates and slower economy does not bold well for growth stock prospects in 2023.

Coming out of Covid coupled with the dramatic rise in inflation, in addition to the war in Ukraine as well as sales disruptions, allowed the defensive sectors like healthcare, consumer staples, and utilities to fare much better. Also interesting was the positive nature in returns for dividend paying stocks as the top 20% dividend payers in the S&P 500 were up almost 5% in 2022, while all the 20% lowest of non-dividend payers were on average down over 26%.

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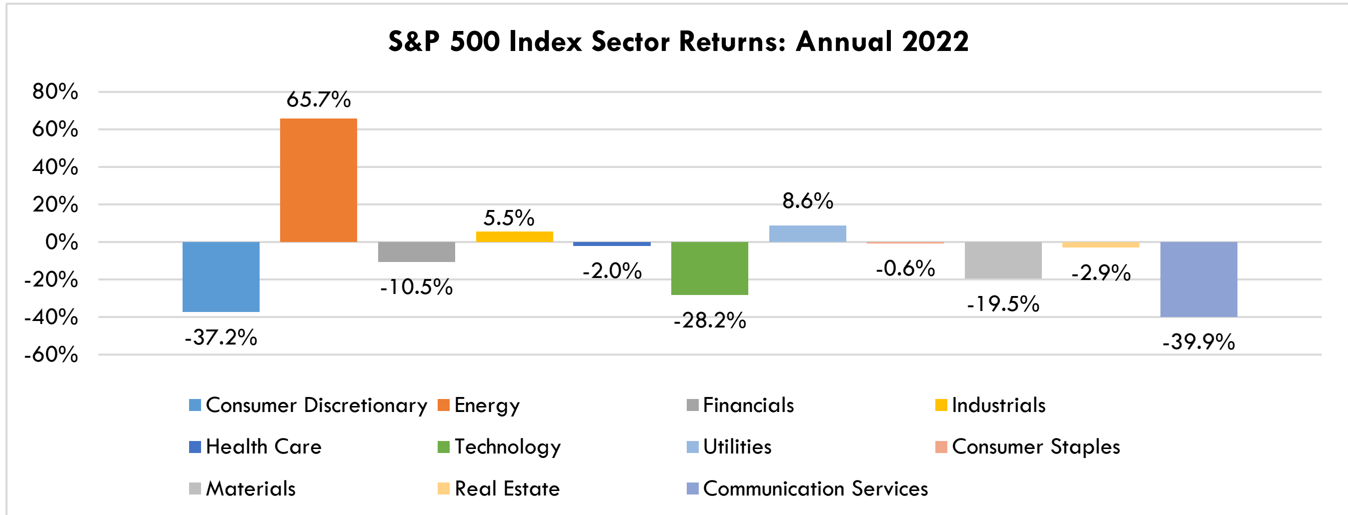
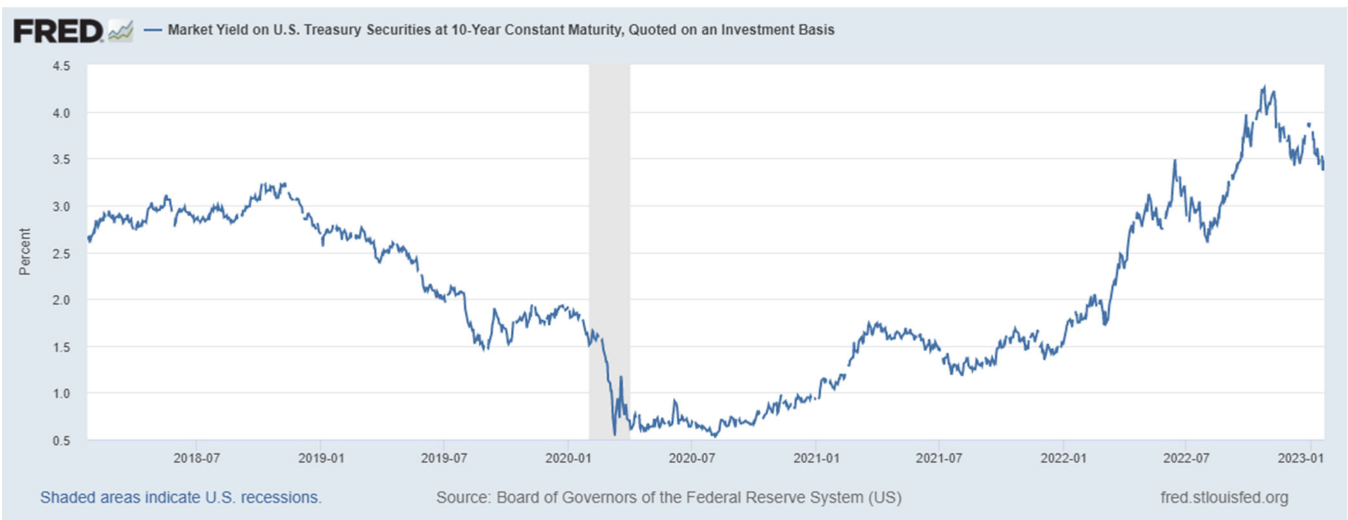
The table below shows the investment returns for 2022 for the eleven S&P sectors.



All data as of 9-30-2022; Source: Refinitiv

Fixed Income Markets Review

Interest rates dropped during the 4th quarter, giving some relief to bondholders. The chart below shows the yield on the U.S. 10-Year Treasury over the past decade. The yield has surpassed the most recent high set in 2018. The Bloomberg U.S. Aggregate Bond Index has fallen -13.0% in 2022, but has rallied at year end. Currently the yield curve is inverted, forecasting a recession of some level.



High yield bonds have held up better than some other fixed income categories, declining -11.2% for the year. So, credit spreads continue at a level that would signal confidence in the markets and have come in even more this quarter. The chart shows much more alarming levels being reached in 2016 and 2020.

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Demand for bonds should grow as risk averse investors see more opportunities for a reasonable return and potentially a lowering of risk around higher rates.

Capital Markets Outlook

Measures of economic activity show no clear trend. While unemployment is low, the labor force participation rate is below the February 2020 level. New jobs are being created, but total employment has increased by less than 1% in the almost three-year period since February of 2020. Retail sales have increased at a rate below that of the rate of inflation for much of 2022, and disposable personal income has declined in 2022. The overall rate of inflation has declined, but the rate of increase in food prices stands near a twenty-five year high.

Corporate profits for all of 2022 are likely to have increased at an approximately 3% to 5% rate on a year-over-year basis. The consensus forecast for 2023 calls for a 4% increase on the same basis. If these forecasts are accurate, nominal corporate profits will have increased at less than the rate of inflation in 2022, and at a rate only slightly above the anticipated inflation rate for all of 2023. If these forecasts prove accurate, there will be no increase in real corporate profits over the two-year period. That said, markets have repriced, and we feel that an upside surprise may be more likely than a deep recession. Not too long ago, investors were quite happy to argue over lower GDP and lower corporate profits.

The price-to-earnings ratio for the overall market has declined in line with the outlook for weak economic growth and a slow increase in corporate profits. The PER for the S&P 500 declined from 23 times trailing twelve-month earnings in early 2022 to approximately 20 times at the end of the year. The end of year PER was close to the long-term median for the measure. This is positive in that a good part of the correction may be over, particularly for the MEGA cap growth stocks. Clearly the market had driven to new high off the narrow leadership of the largest names. See chart below.

For the market to generate returns equal to or above the long-term average in 2023, the process of reducing the rate of inflation to below the Fed's 2% target must be eliminated or reduced as a source of downward pressure on real economic growth and corporate profits. The Fed has been alone in the effort to reduce inflation. The pressure to increase liquidity will arise as a matter of course as the Treasury continues to incur large budget deficits. The Congressional Budget Office estimates Federal budget deficits will average $1.6 trillion per year for fiscal years 2023 through 2032. Deficits of the estimated magnitude will put pressure on the Fed to help provide liquidity once again. The consequences will be the same as they were in the past when the Fed stepped up to fund the Treasury's deficits; inflation may increase, and interest rates may rise again.

A return to economic conditions characterized by moderate inflation and stable economic growth requires lower deficits than those forecast by the CBO. Favorable sustainable stock market returns will require a change in economic policies. In the short term, we'll watch for those policy shifts but in the longer term it seems that the worst is over and inflation trends are pointing in the right direction.

Sources: Federal Reserve Bank of St. Louis; Federal Reserve Bank of Atlanta; FTSE Russell; MSCI; S&P Global; Dow Jones; Bureau of Labor Statistics; the Conference Board; and Refinitiv.

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