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January 3, 2023 – Investment Commentary

After a prolonged period of historically easy monetary policy, inflation and rising rates became the driving force behind markets in 2022. While catalysts of the Russia-Ukraine crisis and zero-COVID lockdowns in China had real implications on global equities, they were overshadowed by how aggressively central bankers moved to tackle inflation at the expense of growth. Stretched valuations deflated significantly in the US and abroad, with longer duration growth stocks especially sensitive to rising rates over the past 12 months.

Returns

The S&P 500 returned -18.1% in 2022 (-5.8% in December, +7.6% in 4Q), the worst annual return in over 40 years, except in 2002 and 2008. Value topped Growth -7.5% vs. -29.1% for the year, with Energy up 65.8% and Tech declined -33.3%. The largest 4 US stocks (AAPL, MSFT, GOOGL and AMZN) each fell -25% to -50%. Both stocks and bonds fell by more than 10% for the first time on record and US Treasuries experienced back-to-back losses for the first time since 1958-1959. Non-US developed markets declined less than the US equity market by approximately 300bps which in part is explained by the value vs growth factors where the S&P500 index is approximately 25% big tech.

Rates & Dollar

Fed funds rose from 0.1% to 4.4% in 2022 (the largest annual move since 1973), Treasury yields moved from 1.5% to 3.9% (the primary catalyst for falling multiples). High Yield spreads widened from 3.5% to 5.2%, and mortgage rates increased from 3.1% to 6.4%. The US Dollar (DXY) started at 95.7, peaked at 114.1 in October, and has fallen to 103.5, where a weaker dollar provides potential support for investing in non-US securities.

Economic Growth and Inflation

2022 GDP forecasts fell from 3.9% to 1.9%, and ISM Manufacturing survey declined from 58.8 to 48.5 (December projection). A reading below 50 suggests an economic contraction and typically does not bode well for the stock market because it indicates an economic slowdown, which translates to weaker corporate profits. Gasoline increased from $3.30 to a peak of $5.00 per gallon in June and declined to $3.20 while we monitor peak wage growth and housing rents/prices declines.

Earnings per share (EPS) and Valuations

EPS projections for the S&P 500 declined just -1.3%, from $223.5 to $220.5 in 2022. The S&P 500 market multiple fell from 21.4x to 16.7x, in line with long-term averages, while the Growth index declined from 30.2x to 20.9x, and Value declined from 15.1x to 13.6x.

2023 Outlook

This year will be a delicate transition year where it's important to be mindful not to fall into a permanent bearish mindset. We believe whether we are in recession or not is a bit irrelevant when considering in 2001 the NBER, who declares recessions, was unsure and the tech heavy NASDAQ declined over 40 percent. Corporate margin stability and profit growth are what we care more about because of their impact on equity markets. We anticipate aggregate corporate 2023 earnings guidance and performance will be below 2022 levels. We expect inflationary pressures to ease but remain stubbornly high with continued equity volatility and corporate spread widening. As a result, we continue to focus on idiosyncratic public and private market opportunities across sector/geography. In addition, we continue to emphasize companies with pricing power, offering essential services and inflation beneficiaries.

If we lean on recession history, equities tend to bottom out well before GDP, payrolls, corporate earnings, housing, peak delinquencies in corporate debt and household credit. As a result, the Investment Office is closely monitoring the ISM survey and its outlook, which tends to be the best coincident indicator as to when there is a potential bottom in equities. Arguably the biggest mistake made by investors during the Global Financial Crisis and peak COVID was to exit equities near the bottom, thereby monetizing losses and missing out on participating in the stock market rebound that followed. Looking at asset class and sector performance by calendar year over time, it's clear that markets can adjust quickly; today's leaders can be tomorrow's laggards, and vice versa providing support of a diversification. We expect earnings to be downwardly revised in the coming months, which should also spark volatility. We don't have the crystal ball to know the perfect entry point. However, we believe we are likely to see elevated volatility early in the year as we expect earnings to be downwardly revised, and we wait for greater clarity on when the Fed will hit the pause button. In an environment of low capital appreciation, income can make a significant difference in total return, and we believe the benefits of thoughtful diversification into high-quality credit and equities will help investors achieve their financial plans.

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Disclosures

Investment Commentary Sources: Bloomberg and Morningstar

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