M.C. BYRD
Wealth Management

Year-End Review: 2022

"You always leave me holding the bag."

- Moe Bandy & Joe Stampley, 1979

Introduction

The 1979 hit by Moe Bandy and Joe Stampley is an apt anthem for bullish investors in the broad market in 2022. With indices having relinquished multi-year gains, investors have been left empty-handed across various asset classes. There are many similarities between the two years, including an inflation spike, an inverted yield curve, an aggressive Federal Reserve and an economy on the edge of recession.

In our year-end letter 12 months ago, we wrote about an optimistic environment fraught with risk. A year later, we are in a significantly less optimistic environment. Many of the risks we detailed in overvalued and frothy markets have come to fruition. The speculative excess in NFTs, cryptocurrencies, SPACs, IPOs and meme stocks, already declining 12 months ago, is a shadow of its former self.

In 2022, global equity and bond markets collided with high inflation and high interest rates. As we enter 2023 we find ourselves at a crossroads. U.S. inflation appears to be decelerating, but faces a wildcard in the form of the Chinese reopening. At the same time, leading indicators of the U.S. economy are at levels consistent with recession.

Ambiguous outlooks on inflation and recession mean risks to investors remain significant and the range of outcomes for asset classes remains wide. We expect this range of outcomes to narrow as we make our way through the first half of the year and more clarity is gained regarding inflation and economic growth.

U.S. Equities

The U.S. stock market experienced a steep decline in 2022, with the Nasdaq plummeting 32% and the S&P 500 closing the year with an 18% decrease. This considerable fall eliminated much of the optimism that had been present in the previous year.

The market decline brought a dramatic shift in market leaders. Large cap growth stocks, high flyers since the financial crisis, dropped 33.13%, while large cap value stocks, which lagged considerably over the same period, fell only 2.01%. This year's market activity may herald the beginnings of a significant, long-term shift in the composition of the U.S. equity market away from tech-oriented growth stocks and towards more traditional, value-oriented companies.

U.S. Bonds

Bonds endured their worst performance ever, with long-dated U.S. treasuries experiencing a 31% drop. The U.S. bond market in its entirety was down 13.01%.

Conversely, bond yields, long suppressed, experienced a sizable increase. The interest rate on a 1-month Treasury bond began the year at 0.06% and wrapped up at 4.12%.

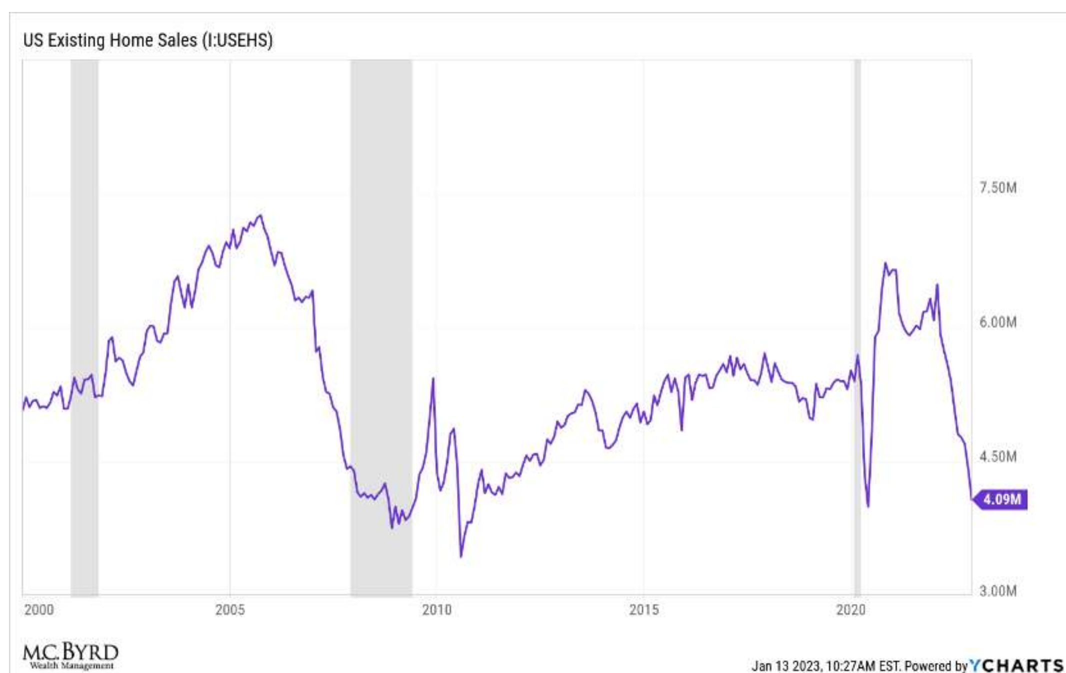
Foreign Markets

Outside of the United States, foreign markets experienced similar losses. Global equities fell 16%, international bonds 16.25% and emerging markets experienced a significant decline of 20.09%.

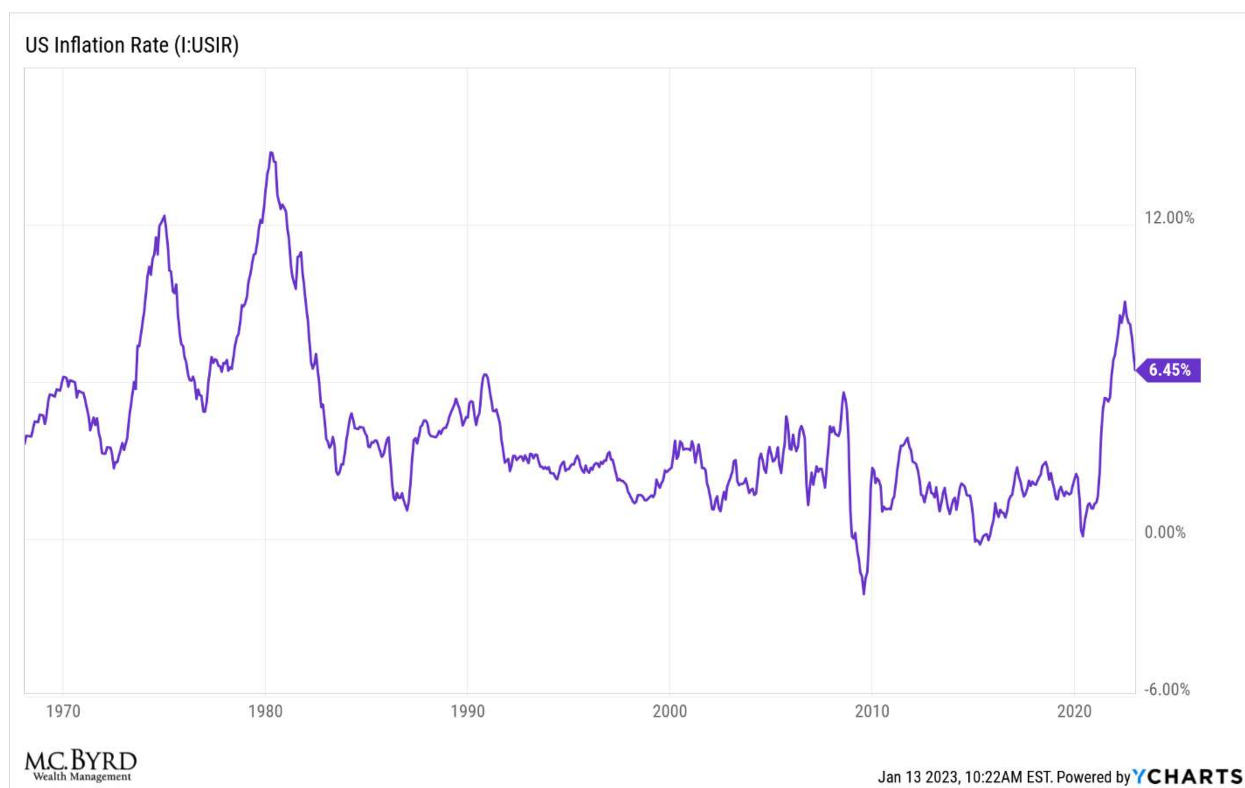
Regionally, Asian markets showed a 17.22% decrease, European stocks were down 15.06%, and Latin America saw a one-year increase of 8.92%.

Real Estate

Many investors were taken aback by the downturn in the real estate market in 2022. The 25.17% decrease in U.S. real estate was the most significant decline since the 2008 global financial crisis. The 22.4% slump in building permits was likewise the sharpest decrease since the Great Recession.



Inflation



Rising inflation was largely responsible for the weak performance of markets this year. A combination of the delayed effects of COVID-related fiscal programs, central bank monetary policies, and ongoing supply chain disruptions, high inflation put the Federal Reserve in an awkward spot throughout 2022. The Federal Reserve hiked rates seven times last year in an effort to combat increasing prices.

Bond prices are inversely proportional to interest rates, and when interest rates rise the prices of existing bonds fall. Inflation has been steadily rising over the past year, which has caused interest rates to increase and bond prices to decrease. This has been especially true for long-term bonds, and their prices have been particularly affected by inflation.

Inflation can have a major effect on the stock market when stocks are highly valued. We usually look at the Price/Earnings (P/E) ratio to value stocks, yet if we flip this equation and assess earnings yield (E/P), we can see how high inflation and interest rates can affect stock prices in a way that is similar to bonds. Historically, once inflation reaches the levels it has within the past year, the S&P 500 has been valued at a CAPE of 25 or less. For perspective, we began 2022 with a CAPE of around 40.

Alternatively, from an earnings standpoint, as inflation increases, the cost of goods and services rises, and companies must spend more money to stay competitive. This can lead to lower profits, putting downward pressure on overvalued stocks.

Inflation Deceleration

Inflation closed out December at a level of 6.5%. A number that would have been shocking a couple of years ago was welcomed as a sign of decelerating price increases.

The war in Ukraine significantly impacted prices in global energy and agricultural markets beginning March 2022. At the time of writing, western powers are reinforcing the Ukrainian military with additional armaments and the chance of a quick negotiated peace seems unlikely.

That being said, much of the commodity-related inflation we experienced in 2022 had faded by the time we entered the new year, with the exception of a few stray items. The fall in gas prices earlier in the year was particularly welcome. Poor manufacturing data, which we'll discuss in greater detail below, seems to indicate inflation has further to fall.

While an inflation rate around 6% is a decline, it is certainly not what Federal Reserve board members care to see as the long-term U.S. inflation rate. The majority of Fed officials see the inflation rate coming in above 5% through the end of the year. Inflation at these levels will remain a headwind for spending and the overall economy.

The Inflation Wildcard

Reaccelerating inflation is a significant risk.

A few years ago, the Financial Time's blog FT Alphaville used a fitting analogy in describing the global economy as revolving around two suns: the U.S. and China.

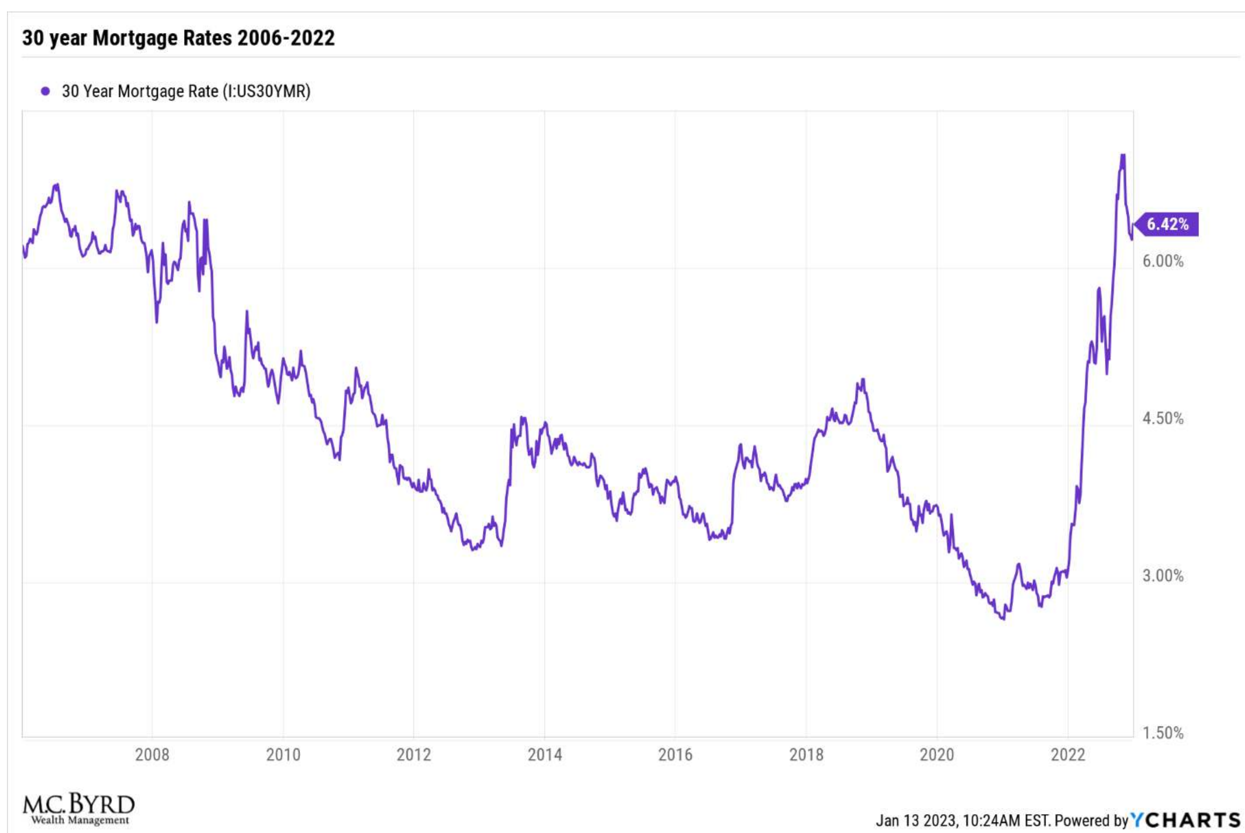
Both countries possess the only economies large enough to move global markets. The rebound of the U.S. economy in 2009 would have been far less robust without the massive stimulus provided by the Chinese government. Likewise, the 2014-2015 slowdown in the global economy was rooted in economic issues in China.

Today, China's post-COVID reopening has just begun. Under a strict lockdown regime many individuals have not seen close relatives for 3 years.

The sheer size of China's economy, with its population of roughly 1.4 billion, means that its reopening could reverse the effects of declining inflation globally, particularly when it comes to commodity prices. The decline in oil and gas prices was a prime factor in decelerating inflation in 2022. China's reopening is likely to have the opposite effect.

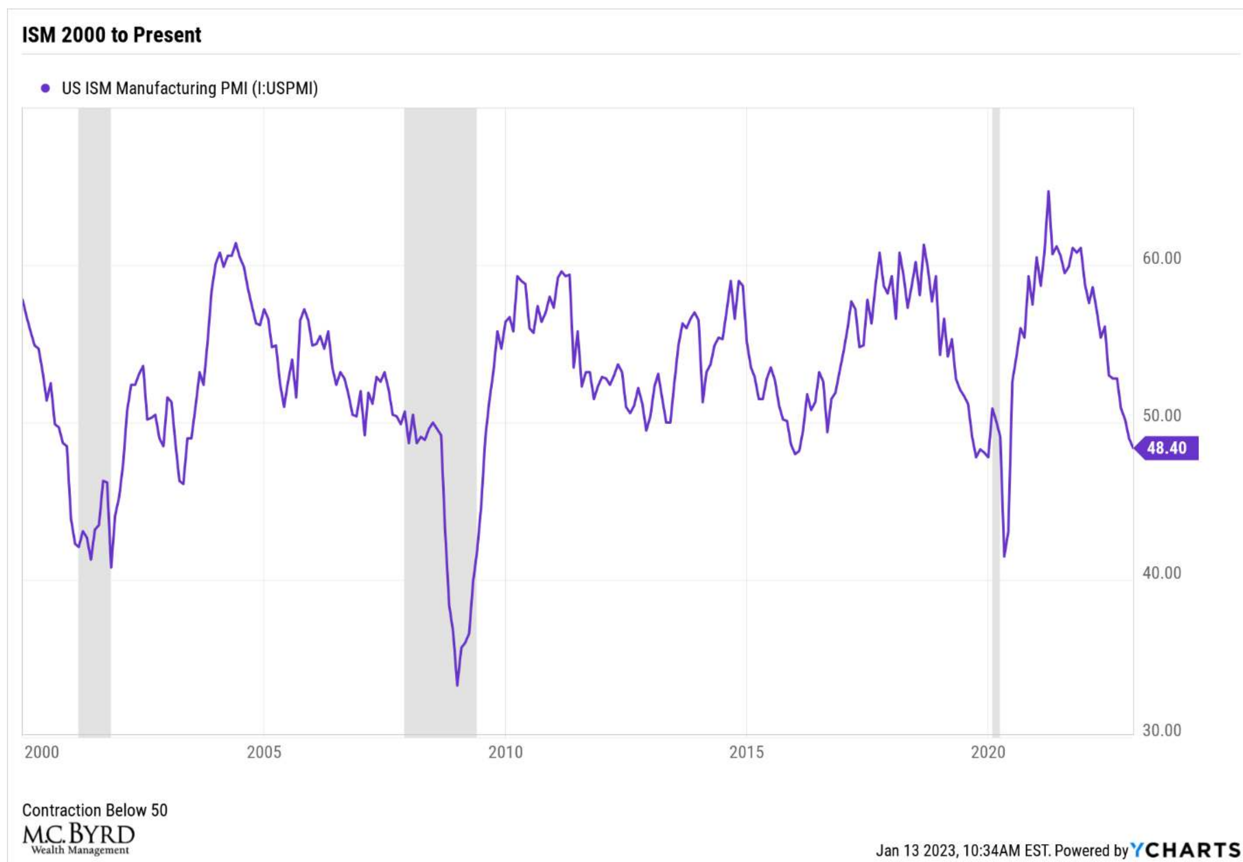
Such a reversal could place the Federal Reserve in a bind. High inflation provoked by a Chinese reopening combined with a slowing domestic economy in the U.S. could result in the Federal Reserve hiking rates to quell inflation even as the domestic economy experiences a significant slowdown. 2022 was a rough year for Federal Reserve Chairman Jerome Powell. 2023 looks to be just as challenging.

Housing



The price of residential housing is one of the longest leading indicators for the U.S. economy. It is also among the most sensitive to interest rates. 90% of homebuyers purchase homes using a 30-year fixed rate mortgage. Housing leads manufacturing data, profits and finally wages and unemployment by as many as 12-24 months. The large drop in residential housing prices in 2022 is consistent with recessionary levels of unemployment by mid-year and does not bode well for overall economic growth.

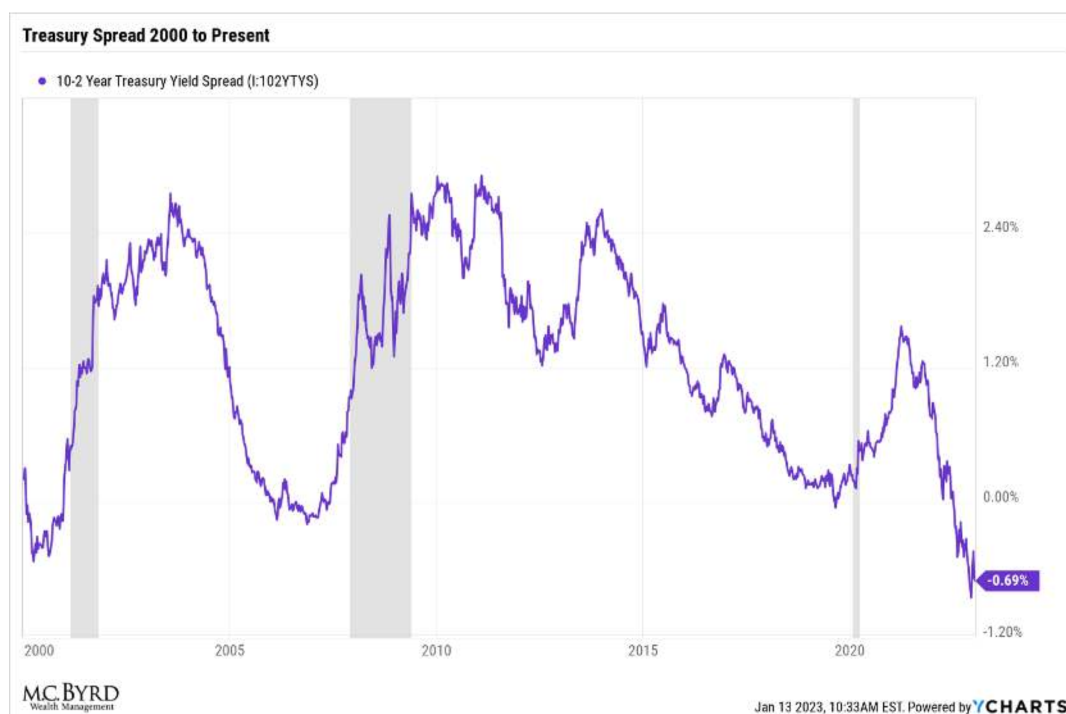
Manufacturing Data



One of the most widely followed metrics for determining the health of the U.S. economy is produced by the Institute for Supply Management based out of Tempe, Arizona. The ISM Manufacturing PMI uses a survey of purchasing managers to gauge the level of production, new orders, employment, supplier deliveries and inventory levels in the U.S. manufacturing sector. Declining all year, the ISM PMI closed the year below 50, indicating contraction, and leading indicators do not indicate growth in this sector moving forward.

While the share of manufacturing employment in the U.S has declined over the last half century, the multiplier effect of manufacturing activity means it carries an outsized importance to the performance of the U.S. economy.

Inverted Yield Curve



The yield curve ended 2022 at its most deeply inverted level since the early 1980s.

An inverted yield curve occurs when an investor can make more interest by investing in bonds with shorter maturities than by investing in longer-dated bonds. This is the opposite of what is usually expected; typically, investors should receive higher rates of interest when they loan their money for a longer period of time.

When the yield curve inverts, it can be a predictor of recession. Some believe this is because of the challenges it produces for banks, whose net interest margin comes from the difference between long and short-dated yields. If this margin is compressed, the theory goes, banks are less likely to lend, particularly to marginal borrowers.

Others believe it has more to do with what investors think is going to happen, or investor expectations. When the yield curve is inverted, bond prices reflect expectations that long-term yields will decline, as they often do in a recession.

While not infallible, this condition has preceded every recession within the last 30 years. Asset prices tend to suffer most significantly once the yield curve reverses course from inverted levels. This did not occur in 2022 but is likely to occur in 2023, indicating greater pain for markets may be on the way.

Leading Economic Index

The Conference Board Leading Economic Index (LEI) is a composite index of 10 economic indicators designed to signal peaks and troughs in the business cycle and is composed of four categories of indicators: consumer confidence, financial indicators, stock prices, and labor market indicators. It currently sits at a level consistent with the beginnings of recession.

Bond Market - High Chance Of A Credit Event

Another area we are keeping an eye on is the corporate credit market, specifically companies in financial duress. When interest rates rise, firms must pay more to borrow funds or refinance current debt, thus increasing the probability of default. Additionally, the value of collateral used to secure loans could decline in a high interest rate environment, making it increasingly difficult for businesses to satisfy their debt obligations.

The Federal Reserve's Senior Loan Officer Survey, a leading indicator of corporate credit markets, predicts a 7% default rate in high yield by mid-2023.

Bond Market - Attractive Yields

Following the sell-off of 2022, investors can now get a decent yield in fixed-income. Both short and long-dated bonds look attractive in the current environment. Once the Federal Reserve shifts to a more accommodative stance these opportunities will look even more attractive, particularly in an environment in which equities are facing earnings headwinds.

Equities - A Tactical Approach

The S&P 500 is 20% cheaper than a year ago, but whether it is cheap enough depends on your outlook for 2023. J.P. Morgan, Goldman Sachs, Morgan Stanley and Bank of America all included a recession in their year-end forecasts, prompting some to call this the "most forecasted recession in history". What kind of data is prompting such a response?

Using data like the Conference Board's Leading Economic Index there is at least a 70% probability of recession in the next 12 months. At the same time, we are not seeing equity valuations like those of October of 2002 (end of the Dot-Com Bubble) or March of 2009 (end of the financial crisis). This data together indicates investors face significant risk even after a difficult 2022.

Markets move on earnings, and earnings have declined in every recession since World War II. The market may be less expensive relative to today's earnings, but if tomorrow's earnings are 10-40% lower the price of the market is likely to reflect the decreased earnings power of U.S. corporations.

Even inexpensive markets can become substantially cheaper during recessions. The current forward Price Earnings ratio of the S&P 500 is still 20-40% higher than it has been at previous bear market lows, indicating our total drawdown could potentially reach 40-60% from the peak in early January of 2022. Such a drawdown would be of a similar magnitude to the those experienced in the early 2000s and the 2008-2009 financial crisis.

It is not our base case, but in the first two quarters of the year we may have what has been termed a goldilocks environment. In this scenario inflation begins to decline due to slowing economic growth but unemployment, typically the last data point to signal recession, remains low. Risk assets like stocks could rally substantially in the time-period between a collapse in inflation and the beginning of what is likely to be a recession.

Alternatively, if economic growth picks up due to China's reopening inflation is likely to remain higher for longer and a serious economic recession could be avoided for some time as the U.S. economy is buoyed by international trade. In this scenario equities would likely face the same inflationary and interest-rate related headwinds they did in 2022, making economic growth a bit of a mixed blessing for investors.

Due to the challenges of this environment, we are maintaining a tactical approach in which we are open to adding prudent amounts of equity exposure if the data supports such a move.

Conclusion

Our clients have joined us in taking a more conservative approach over the last couple of years. In 2022, a year characterized by a steep decline in stock prices, a dramatic shift in market leaders, and a significant rise in bond yields, we believe that approach paid off significantly.

The bad news in markets in 2022 and 2023 should be viewed positively. Volatility in the stock market and bond market has the effect of creating opportunities for long-term investors, particularly those maintaining conservative allocations.

While yields on both short and long-dated bonds look attractive in the current environment, we believe investors should remain vigilant for a potential credit event. Even as inflation decelerates, interest rates and inflation still have the potential to surprise to the upside, particularly as China reopens its economy.

When the Federal Reserve begins cutting interest rates long-dated bonds will likely present a significant opportunity.

Equity valuations are significantly lower than at the start of 2022; however, with a high potential for recession in 2023 we believe those valuations could decline further.

We remain vigilant in searching for opportunities in this challenging environment and look forward to taking advantage of those in the months ahead.

As always, we greatly appreciate your trust in our firm. Please reach out to the advisor you work with if there are any questions we can answer.

Sincerely,

Monte C. Byrd, ChFC®

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