Independence | Asset Advisors

MARKET MATTERS: 2022 YEAR IN REVIEW

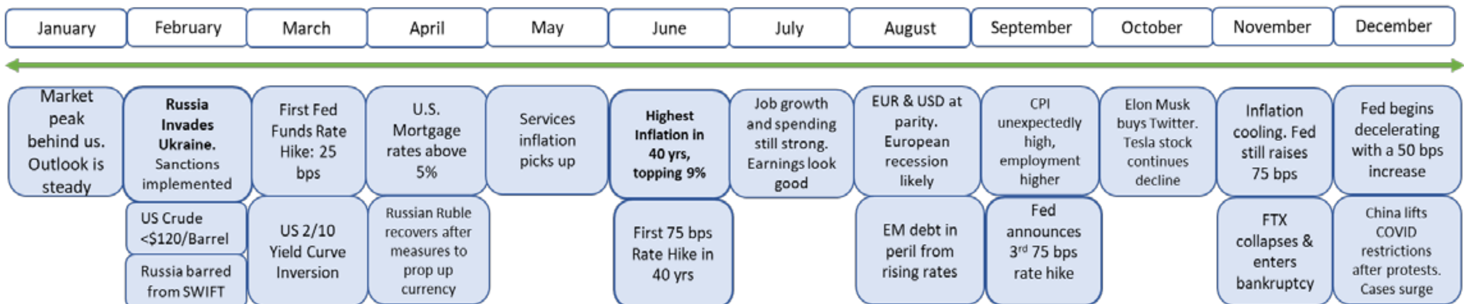
December 31, 2022

"Where will the S&P 500 close at the end of 2022? The current Wall Street consensus is 4,825 (Bloomberg), which represents a minor pick-up over its current level. Don't count on it…It may be humbling to see how wrong we can be." – Market Matters, Q4 2021

AFTER FLYING HIGH IN 2021, INFLATION MELTED THE MARKET'S WINGS

- Historic inflation peaked at over 9%.
- The Fed's base rate rose 4.25% to a target ~4.35%.
- Asset classes suffered broad losses across the board.
- A "soft landing" looks unlikely.
- Stocks are more fairly priced and slated to recover ahead of the economy in the case of a downturn.
- Fixed Income offers solid yields and upside potential.

HOW WE GOT HERE



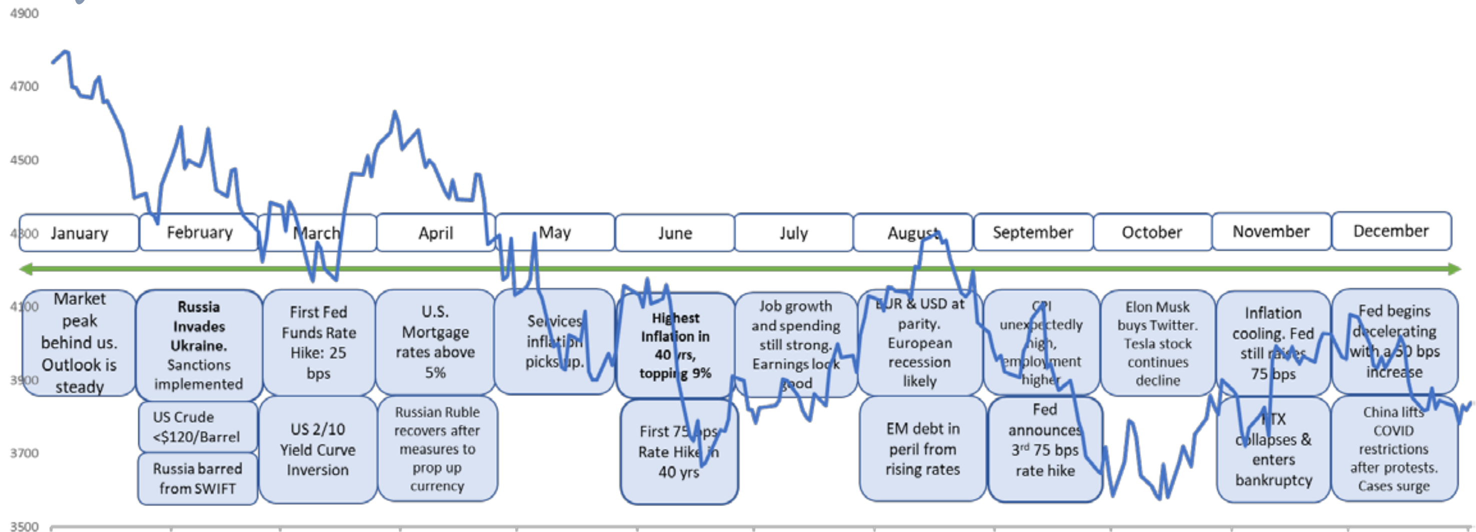
At the start of 2022, analysts forecasted positive single-digit market returns and a modest rise in interest rates (2% over *two years*). Tense geopolitical conditions were expected to continue their status quo. Inflation was expected to normalize. The focus was on China-U.S. relations and how the world economy would fare while recovering from two years of pandemic lockdowns and supply chain snarls. Now, it looks like those forecasts couldn't have been more wrong. Ukraine and Russia are locked in a deadly war. Equities are just off a bear market. Inflation is still over 7% for the year. Emerging markets are in peril and European economies are facing recession, with the U.S. likely to follow. Headlines worthy of Hollywood films have grabbed our attention as a "Crypto Winter" revealed a house of cards built on fraud and regulatory scarcity. Elon Musk, formerly the world's richest man and founder of Tesla, bought a social media platform and tanked his acquisition, along with both stocks. China is now facing the world's worst Covid wave since the Omicron variant.

Suffice it to say, it wasn't the year that anyone expected.

Sources: WSJ, IMF, BLS, Hedgeye, JP Morgan, Federal Reserve, S&P Global, TradingEconomics. St. Louis Fed, Ritholtz Wealth Management, Bryn Mawr Trust, Factset

What Happened? The worst exogenous shock was Russia invading Ukraine, which is causing widespread destruction and a large-scale humanitarian crisis. Commodities markets, including oil, gas, metals and grains, were upended by the war and resulting sanctions. Combined with preexisting persistent inflation and plenty of excess cash still flowing through the economy, the price spike in commodities was like gasoline on a fire. The only way to put out the blaze was for the Federal Reserve to raise interest rates quickly and steeply, which it did seven times throughout the year. Consumers spent with abandon, unemployment remained historically low, and big rate hikes continued. Currency and debt markets alike were roiled by rising interest rates. While the U.S. pondered the prospect of a soft landing, other countries were feeling the pain of recession by year-end from rising rates coupled with exceptionally high energy costs. Now, with rate hikes decelerating, inflation starting to moderate and growth slowing, everyone is waiting to see how the dust settles.

EQUITIES: FROM FLYING HIGH TO FALLING HARD



S&P 500 Performance, Full Year 2022

Equities ended the year down 18% after significant volatility in response to geopolitical events and monetary tightening. Tech and real estate led the decline. Energy and utilities were the only sectors with positive returns, while healthcare and consumer staples performed relatively well.

Stocks have been repriced to fair valuations, and emphasis is now being placed on earnings and margins. Tightened liquidity is taking the stock market "back to basics" where profits matter more than promises.

Excluding the Covid-crash of 2020, the price for equities hasn't been this discounted since the aftermath of the 2008 financial crisis. The current average P/E ratio for the S&P 500 is around 18, having fallen from over 24 in 2021. Stocks still aren't "cheap", but they are more reasonable. Dividend yields have ticked up as prices have fallen.

Value investors were finally rewarded in 2022, as growth stocks fell precipitously. The S&P 500 Growth Index fell over 25%, while the value equivalent index fell less than 5% - a 21% outperformance. At a time when tech is in disarray from exuberant hiring and slowing growth and fundamentals are in focus, value has room to outperform.

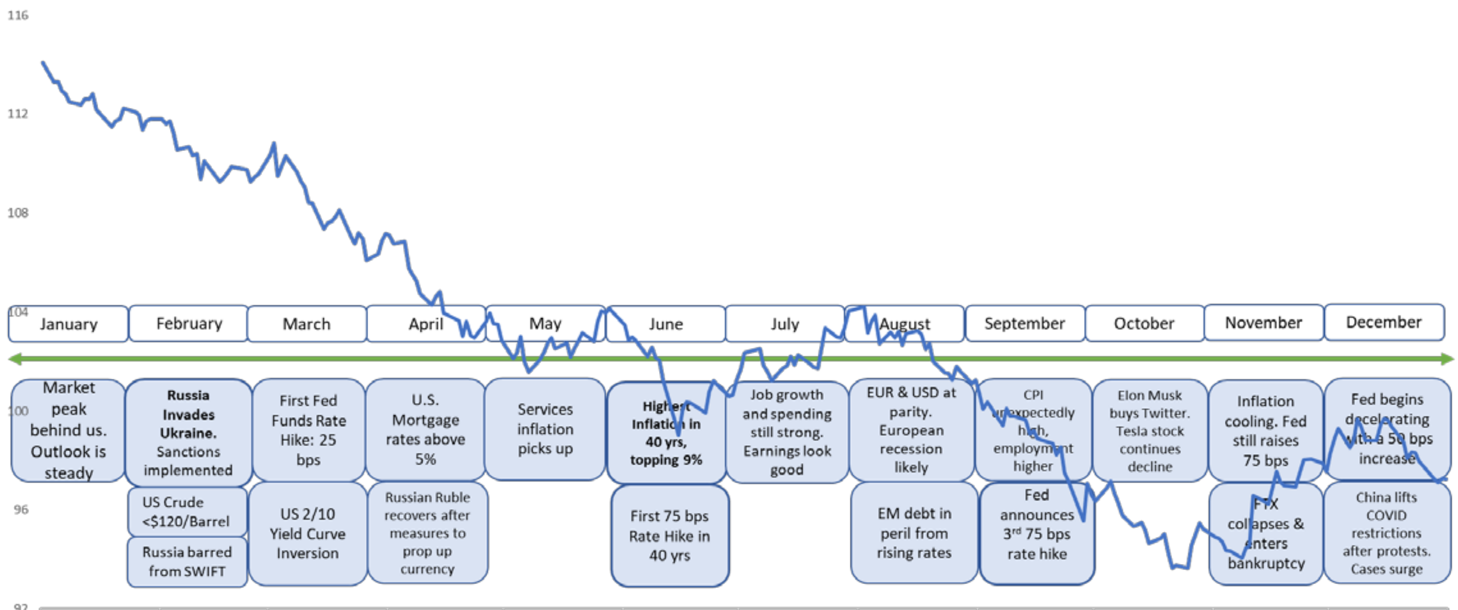
Putting It in Perspective:
The 12 Worst Years for U.S. Stocks

Year	S&P 500	Reason
1931	-43.8%	Great Depression
2008	-36.6%	Great Financial Crisis
1937	-35.3%	1937 Crash
1974	-25.9%	1973-74 Bear Market
1930	-25.1%	Great Depression
2002	-22.0%	Dot-Com Crash
2022	-18.1%	The Great Inflation
1973	-14.3%	1973-74 Bear Market
1941	-12.8%	WWII
2001	-11.9%	Dot-Com Crash
1940	-10.7%	WWII
1957	-10.5%	1957-58 Recession

Sources: WSJ, IMF, BLS, Hedgeye, JP Morgan, Federal Reserve, S&P Global, TradingEconomics. St. Louis Fed, Ritholtz Wealth Management, Bryn Mawr Trust, Factset

Corporate earnings met with sector-specific pressures in 2022 for a mix of results. Overall, corporate profits were resilient as companies passed on higher costs to consumers who seemed undaunted in the face of rising prices. Affordability hit the real estate sector the hardest, as mortgage rates climbed to over 6%, but prices were slow to correct amidst low inventory.

FIXED INCOME: RISING RATES SINK ALL SHIPS



iShares Core Aggregate Bond Performance (AGG), Full Year 2022

Bond markets experienced their worst year *ever*, ending the year down 13%. This is one of only two double-digit loss years in modern history (the other in 2009). The Fed Funds rate rose from near-zero to over 4.25%. This represents both the fastest pace of hikes in 40 years and the highest rate the economy has seen since prior to the 2008/2009 great financial crisis. Needless to say, fixed income markets declined steeply as bonds were repriced lower (and lower) throughout the year and spreads widened from recession fears and heightened credit risk. The current projection for the Fed's terminal rate is 5-5.25%, or 0.75% higher than today. That could mean an additional two or three interest rate increases in the beginning of 2023, but this looks like a minimum expectation.

Bonds don't typically offer the return potential of equities, but negative annual returns are relatively infrequent. 2022 saw an atypical, pronounced decline. However, when bonds fall into the red they tend to recover more quickly, having never had a subsequent down year in modern market history. As prices decline, yields increase, providing income and cushion against future losses.

Persistent yield curve inversions of U.S. government bonds are considered a harbinger for recession. The 10 year U.S. treasury currently offers a 75 bps lower yield than the 3 month treasury – a steep inversion. While not always a canary in the coal mine, drawn out inversions of very short and long maturities show that investors are betting on deflationary and recessionary headwinds.

How We Got to 4.25+%

FOMC Meeting Date	Change (bps)	Federal Funds Rate
Dec 14, 2022	+50	4.25% to 4.50%
Nov 2, 2022	+75	3.75% to 4.00%
Sept 21, 2022	+75	3.00% to 3.25%
July 27, 2022	+75	2.25% to 2.5%
June 16, 2022	+75	1.5% to 1.75%
May 5, 2022	+50	0.75% to 1.00%
March 17, 2022	+25	0.25% to 0.50%

While there are signs of a gloomier economic picture ahead, the opportunity to lock in higher rates in addition to potential gains as bonds amortize to par is a benefit for fixed income investors who haven't been able to earn a decent return on the asset class in over a decade. Higher yields, higher spreads and credit re-pricing are prompting investors to take a fresh look at the asset class.

Sources: WSJ, IMF, BLS, Hedgeye, JP Morgan, Federal Reserve, S&P Global, TradingEconomics. St. Louis Fed, Ritholtz Wealth Management, Bryn Mawr Trust, Factset

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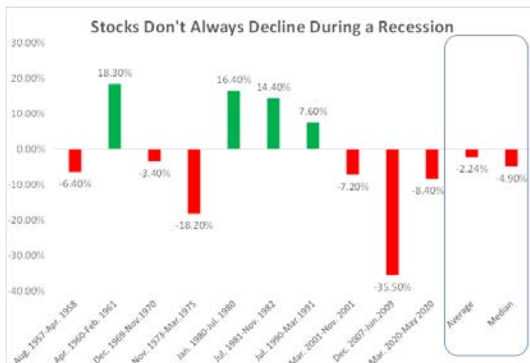
LOOKING AHEAD TO 2023

The majority of economists expect the U.S. economy to contract in a "mild" recession in 2023. Unemployment is expected to rise modestly from 3.7% to 4.6+%. Analysts also expect inflationary pressures to continue to subside, allowing the Fed to pause its rate hikes. A "Fed Pivot" could lead to both market gains and economic strengthening. The Fed's tightening program is working (inflation is easing), but this is coming at a significant cost.

2022 was a year when good news was bad news. Low unemployment, strong consumer spending and confidence, and solid corporate earnings all meant even higher interest rates. In 2023, predictions are for unemployment to rise, consumer spending to decline, and corporate earnings to stall or fall. If these pain points end up being short and shallow, they could provide an economic reset that restores some of the "normalcy" that has been conspicuously absent from the last three years.

WHAT'S ON THE HORIZON



While we see a light at the end of the tunnel when it comes to rising rates, a recession still looms large. Investors will benefit if they are prepared to take advantage of market selloffs if and when they occur. Historically, equity markets have seen their lowest points before the economy bottoms and prior to peak unemployment, but equities have never hit bottom before the actual onset of a recession. Still, stocks look reasonably priced for long term gains, even if they might fall further. The average decline for the S&P 500 while the economy is in recession is only 2.2%, representing the tail end of an average peak-to-trough decline of 36%. Real interest rates are positive for the first time in decades, spreads have widened to reward investors who take credit risk, and bond markets historically recover in short order. Bond investors may see a reversal of their currently poor fortunes in 2023, and equity investors may not be far behind them.

Are we humbled by the past year? Yes. Is the worst behind us? Maybe, but don't count on it. Bet on more turbulence in the coming months. We at Independence Asset Advisors remain firm in our convictions to stay the course, stay invested, and take opportunities to buy into future gains.

Sources: WSJ, IMF, BLS, Hedgeye, JP Morgan, Federal Reserve, S&P Global, TradingEconomics. St. Louis Fed, Ritholtz Wealth Management, Bryn Mawr Trust, Factset