

Market & Strategy Overview - Fourth Quarter 2022

January 13, 2023

Investment returns were generally positive during the fourth quarter, with U.S. stock and bond markets clawing back a portion of the drawdown incurred over the first nine months of 2022. In spite of this, both stock and bond returns remained well into negative territory for the full year.

Stocks, as measured by the Russell 3000 index, bounced 7.2% in the fourth quarter. Most of that occurred in October, on the heels of a terrible September. November and December combined to be down modestly, bringing the total return for the full year to -19.2%. In addition to being significantly negative, stock returns were also volatile during the year. The index produced a return of more than 5% in either direction in 8 of the 12 months last year.

Investment-grade bonds, as measured by the Bloomberg Barclays U.S. Aggregate index, returned 1.9% in the fourth quarter. This was the only positive quarter during 2022. High inflation and rising interest rates caused 2022 to be a historically bad year for bonds, with the index posting a return of -13.0%.

It is rare for both stocks and bonds to produce a negative return in the same calendar year. And both asset classes experiencing a negative return of this magnitude at the same time is unprecedented over the last half-century.¹ For a typical balanced portfolio, this double whammy led to one of the most challenging years on record.

The markets' improved mood in the fourth quarter was driven in large part by data hinting that the rate of consumer inflation, while still quite elevated, may have peaked. As a result, markets began to price in the end of Federal Reserve rate hikes early in 2023 and even began to price in some amount of rate cuts later in the year.

Recent evidence does in fact support the conclusion, at least tentatively, that inflation has peaked and that the Fed's tightening program is having its desired effect. However, it is important to remember that several headwinds still exist.

Perhaps the most obvious is that *lower* inflation is not the same thing as *low* inflation. The Fed's preferred inflation metric is Personal Consumption Expenditures (PCE). The annual change in this metric as of November was 5.5%.² Core PCE, which excludes the more volatile food and energy categories, was up 4.7% year over year.² Though this represents clear improvement since the end of the third quarter, these numbers are still well above the Fed's long-term target of 2%.

The Fed has been clear in its determination to wrestle inflation down toward that target and equally clear that it will not consider easing until there is a high degree of certainty that the job is done. There were multiple instances during the latter half of 2022 where markets rallied substantially on the back of marginal improvements in inflation data only to have the Fed dump cold water on the rally by reiterating its determination to stay the course. Barring a significant deterioration in economic conditions or some type of exogenous shock, it still seems a bit premature to assume rate cuts will occur in 2023.

Another issue is that many market participants seem to have forgotten, or in some cases perhaps never knew in the first place, what “normal” monetary conditions look like. With a Fed Funds rate consistently below 3% and quantitative easing a regular part of the Fed’s arsenal, we have spent the entire period since the 2008 financial crisis with unusually loose policy. However, since 1954, the monthly Fed Funds rate has averaged about 4.6%, with a median of 4.1%.³ In other words, after all of the rate hikes in 2022, we are just now reaching a more typical policy rate.

As of its December meeting, Fed projections forecast another 1% increase in the Funds rate, implying a terminal rate in excess of 5%. Critics worry that the Fed is over-tightening and will drive the economy into a recession. So far, the Fed seems more than willing to accept that risk as a consequence of its inflation battle. Further, the Jerome Powell-led version of the Fed seems far more determined than its predecessors to wean markets off of the loose conditions that have become embedded in investors’ mindsets over the last decade and a half.

Outlook and Positioning

With that as a backdrop, what are the implications for markets and investment portfolios? We are emphasizing several core themes as we plan for 2023.

The first is a continuation of the main theme of our third quarter letter, which was titled “Don’t Fight the Fed.” The Fed’s determination to beat inflation requires that monetary conditions remain sufficiently tight in the near to intermediate term. That probably keeps a floor under interest rates and at least some type of ceiling on stock prices. Probabilities favor a better outcome for investors in 2023 than in 2022, but a fast, V-shaped snap-back may be difficult to achieve in this environment.

This ties into another, more secular, theme that we have been discussing for a couple of years now. Tighter monetary conditions may change the return pattern we have become used to. The tailwind of consistently low interest rates and easy money helped drive substantial price appreciation in both stocks and bonds since 2008. Going forward, with much of that tailwind removed, it may be that the income component (i.e., interest and dividends) will regain more importance in the composition of overall returns. This could mean that forward returns will be somewhat lower than what we have become accustomed to, but it might also provide a healthy dose of stability and rationality to markets.

Another theme is the acceptance of the fact that a high degree of uncertainty exists. To some extent, this is always true. However, it seems a bit more so today. The range of potential domestic economic outcomes is fairly wide, ranging from a soft landing to a full recession. Because it is nearly impossible to know the ultimate outcome with a high degree of confidence, it seems unwise to take any type of extreme position. Instead, it makes even more sense than usual to diversify exposures among a wide variety of styles and sectors.

On the topic of uncertainty, we would be remiss not to mention the ongoing geopolitical risk that markets face in 2023. The war in Ukraine has bogged down into somewhat of a stalemate. Nevertheless, it would be unwise to become complacent around potential escalation (or de-escalation) there. China also continues to be a point of concern for us. In the near term, markets are mostly focused on the country’s ability to reopen its economy after years of COVID-driven lockdowns. Ongoing posturing over Taiwan’s independence also continues to make headlines. However, as we have stated in the past, we believe that the excessive leverage in China’s real estate sector may be the most under-appreciated risk at this point.

A final theme is that after the negative experience of 2022, basic investment math has at least become more favorable. This is particularly true of bonds, where yields of more than 4% are available on high quality short maturity issues. These same securities would have yielded barely more than zero just one year ago. That additional income cushion makes the probability of a negative total return on high quality bonds much lower than it was in 2022, even if market rates move higher from current levels.

Last year's drawdown naturally makes stocks less expensive as well. The math is perhaps less compelling here than it is with bonds because of the uncertainty around how corporate earnings will fare in a slowing economy. To us, stocks appear priced for an economic soft landing, or a shallow recession at worst. There appears to be further vulnerability in the event of a deeper downturn. Nonetheless, investors are paying almost 20% less to purchase the broad U.S. stock market than they were a year ago, so there is little doubt the long-term risk/reward profile has improved.

The above themes lead us to remain fairly stable in our approach to portfolio construction as we head into 2023.

On the stock side, we continue to emphasize diversified exposure to value-focused sectors such as Health Care and Consumer Staples. Because overall market valuations may not yet fully reflect the likely decrease in corporate earnings, we think these more stable sectors can help to hedge against an adverse economic outcome while providing a steady, above-market dividend yield.

While we do have exposure to growth stocks as well, we have biased that exposure toward more profitable growth companies and away from the more speculative growth companies that led the market when interest rates were near zero. With money tighter, we expect that corporate fundamentals will remain more important than they were in 2020 and 2021.

We also continue to believe that a healthy allocation to small cap companies makes sense. Small cap outperformed large cap modestly in 2022. Yet, the gap in valuation between small and large cap companies remains historically wide in favor of small cap. This may take some time to manifest in relative performance, but we feel confident that the valuation gap should close over time.

With regard to fixed income, we favor the stability and solid income offered by high-quality short duration bonds. With short-term yields having increased substantially, U.S. Treasury bonds with three years or less to maturity offer an attractive income stream with relatively little risk. We view this as a classic case of taking what the market gives you.

While we are never advocates for taking significant credit risk in bond portfolios, we think it makes even less sense to do so now. The incremental yield available on corporate bonds does not seem wide enough to justify the additional risk in the event that the economy has a hard landing.

A final point on bonds is that 2022 marked only the second time since 1926 that bonds produced a negative total return for two consecutive years. There has never been an instance of three consecutive years.⁴ It is certainly possible that 2023 could be an exception given the historically low level of rates at the outset of this 3-year window. However, the overarching point is that probability and simple math are much more favorable to bondholders than they were one year ago.

2022 was challenging on many fronts. In the past, this type of environment has ultimately led to opportunity for patient investors, and we expect that will eventually be the case here as well. With that in mind, we are happy to turn the page and see what the coming year will bring. As always, if you have questions or want to discuss your portfolio, please do not hesitate to get in touch. We wish everyone a great 2023!

Notes and Disclosures

1. Source: Portfolio Visualizer. Comparison of annual returns for the U.S. stock market and intermediate duration U.S. Treasury bonds, 1972 - 2022.
2. Source: U.S. Department of Commerce Bureau of Economic Analysis.
3. Source: St. Louis Fed.
4. Source: BlackRock, "Student of the Market," December 2022.

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