Quarterly Booklet

Winter 2023

2022 was historically volatile. What’s in store for the new year?

Winter 2023

ONE DAY IN JULY

Issue XXII

A Note from our Founder

The 2022 economy faced an unprecedented set of variables. With trillions of dollars of federal money still coursing through the economy, the Federal Reserve struggled to get inflation under control. Yet high inflation, higher interest rates, and a slowing economy did not increase the unemployment rate in a material way, leaving the door open for more rate increases in 2023.

2022 had asset class correlation that was three standard deviations from normal. In light of this, lots of financial people are adjusting strategies now for the future. But the mistake is in the reaction. Statistical distributions contain outliers, and an outlier doesn't always imply a flaw, or brilliance, in a strategy. Outliers happen.

– Dan Cunningham

An Erratic Year for Stocks and Bonds

It was a roller coaster year in the markets. Stocks whipsawed back and forth, enduring more daily price volatility than usual. Most of the major traditional equity asset classes ended the year down double digits, with the S&P 500 lodging a loss of 18.31%. U.S. Value stocks were a notable exception, sustaining losses in only the single digits (U.S. Large Cap Value -2.18%, U.S. Small Cap Value -9.43%). The Fixed Income market disappointed investors as well, bucking the typical historical trend of moving inversely with equities. Investors sold off bond funds in anticipation of (and response to) the Fed's efforts to rein in inflation.

Facebook	↓	64.22%
Tesla	↓	65.03%
NVIDIA	↓	50.27%
Disney	↓	43.91%
Nike	↓	29.04%
Netflix	↓	51.05%

Many of the popular household name stocks got crushed in 2022, helping to illustrate the power of indexing and portfolio diversification.

Source: Asset Class and Individual Stock returns from portfoliovisualizer.com; U.S. Large Cap Value and U.S. Small Cap Value asset class returns represented by VIVAX and VISVX, respectively.

Raising Interest Rates: An Explainer

In an effort to temper inflation, the Fed was busy raising interest rates throughout last year. They anticipate an additional 0.75% hike by the end of 2023. Can the Fed dictate what rates banks charge each other for loans or what they pay customers for savings deposits? No, at least not directly. Exactly what "interest rates" are the Fed raising? The Federal Open Market Committee (FOMC) sets the *target federal funds rate*, aka the "fed funds rate" or "short-term interest rates."

Banks that hold customer deposits are required by law to hold a certain amount of cash in reserves, to ensure that when depositors need their cash back, the bank hasn't lent it all out. When banks have a surplus of cash on hand above their reserve requirement, they can lend it out to other banks that need it. The effective federal funds rate is the interest rate that banks charge each other on these overnight loans. When the FOMC targets a higher rate, they decrease the supply of money in the financial system by selling bonds or other securities. Once there is less money going around, banks who are short on their reserve requirements are willing to pay more for a loan, causing an increase in the effective fed funds rate. This rate increase on interbank loans impacts how much the banks charge consumers for other financial products and has a ripple effect on interest rates throughout the economy.

Where's my rate increase?

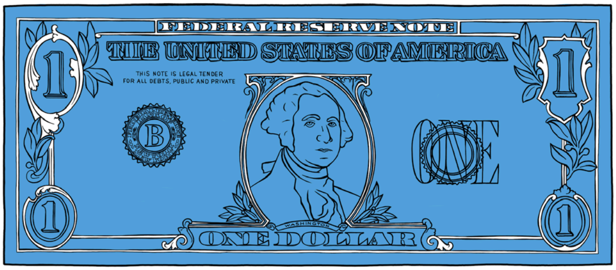
You may be thinking, "my bank must be raising the interest rate on my savings account, too." Hypothetically, this makes sense. However, banks don't always pass the entirety of rate increases along to their customers. This is the concept of deposit beta: the degree to which a bank adjusts its deposit rates in response to changes in prevailing market rates. A bank's deposit beta says a lot about its customer acquisition strategy, and possibly its funding and liquidity position.

In the past few years, there's been a proliferation of online neobanks popping up in direct competition to the more traditional brick-and-mortar banks like Citibank and Chase. These neobanks, hungry for customers, are the ones raising rates on their products more in line with market rates, although generally below the rate of the one-year Treasury. On the other hand, the large traditional banks already have a massive embedded base of customers. They can afford NOT to pay higher deposit rates largely due to the high degree of inertia in banking; plus, they might not need or want additional deposits. Their customers are unlikely to move their money, even if they can get a higher rate elsewhere. Inertia is powerful. That's why Chase still only offers a cool 0.01% savings rate.

Sources: Reuters, "Wall Street ends lower after latest Fed rate hike" 14 Dec 2022
a16z.com, "Deposit Beta: CAC in Disguise" November 2022 Fintech Newsletter
Chase.com, Chase Savings Interest Rates, retrieved 3 Jan 2023

Do you still have excess cash?

As mentioned, it is once again possible to earn interest on a savings account. Park your cash in a certificate of deposit (CD), and you could earn an even higher rate of interest. However, CDs come with a maturity date. Typically, you will pay a penalty if you want to withdraw your cash before the CD matures. This loss of liquidity should be considered a potential significant cost when weighing your options. Before you lock into a long-term CD, compare it to the yields on a U.S. Treasury bond. As of 12/30/22, a 1-year U.S Treasury bond was yielding 4.73% vs. 3.00% on a comparable CD. And the Treasury Bond does not have lock-ins.



Sources: Daily Treasury Par Yield Curve Rates, home.treasury.gov
3.00% 12 month CD rate is from Chase.com as of 1/3/23

“There are two kinds of forecasters: those who don’t know, and those who don’t know they don’t know.”

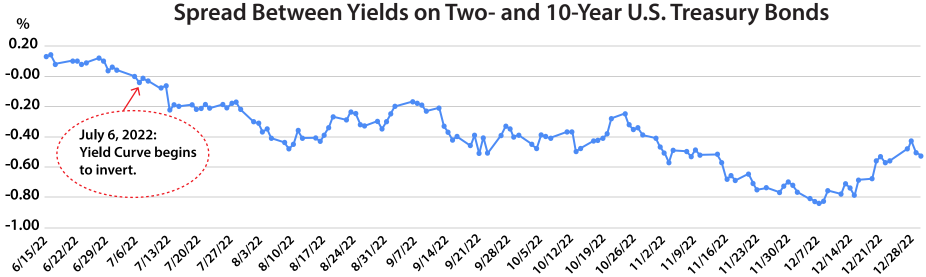
John Kenneth Galbraith

Canadian-American economist

Bracing for Recession

Is a recession coming this year? Are we already in recession? How long will it be, and how severe? These are all questions to which the answer is most certainly *uncertain*. One place we can look for clues is to a comparison of bond yields across varying maturities. Typically, the longer you agree to lend money, the higher the interest rate the borrower (i.e., bond issuer) will pay you. A longer bond term represents a higher level of risk, and the bond investor should be compensated for that. When short term bonds start yielding more than their longer-term relatives, it's an indication that the market is becoming more pessimistic about the economy. Wall Street calls this an inverted yield curve, and it's widely considered one of the best-known predictors of recessions. The curve between two-year and 10-year U.S. Treasury notes inverted prior to every recession since the 1960s. The yield curve inverted last July; the spread grew to its most extreme level in early December, tightened a bit during the last few weeks of the year, but remains inverted.

Spread Between Yields on Two- and 10-Year U.S. Treasury Bonds



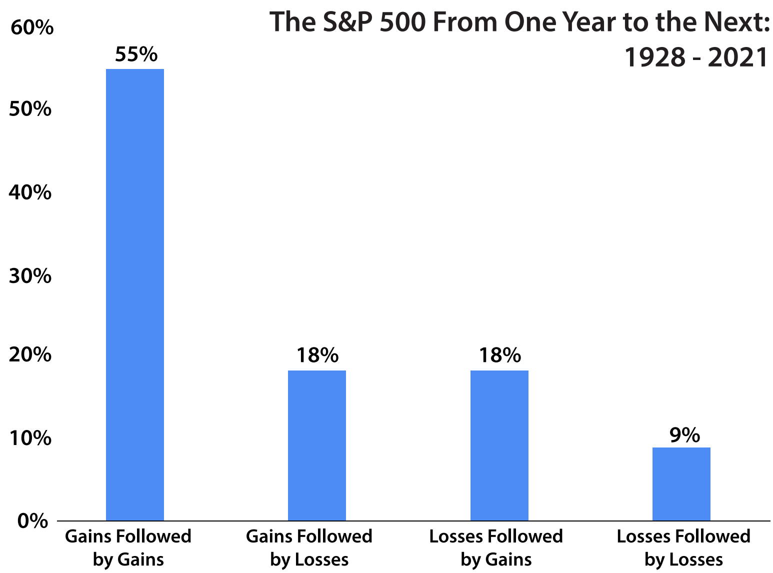
It's worth noting that not all yield curve inversions lead to recession; after an inversion in 1998, the Fed quickly cut rates and managed to avoid recession. However, many economists agree we will be facing one this year, but there is no widespread agreement on how long it will last or how much damage it will do. Fortunately, consumer and corporate balance sheets and the job market are generally healthy. This should help the economy withstand the pressure of further rate hikes.

According to the latest projections published after the Dec. 14th meeting, Fed central bankers do not broadly agree on how high rates need to go and in turn, how much worse unemployment and GDP growth (or lack thereof) will get, reflecting the competing fundamentals underlying the current economic landscape. Notably, FOMC members were more pessimistic than they were at their last meeting, forecasting rates to end the year half a percentage higher than predicted in September and a swelling of unemployment to 4.6% by year end, 20 basis points higher vs. the prior forecast.

Sources: Morningstar, "The US Treasury Yield Curve Recession Indicator is Flashing Red," 21 Nov 2022
Reuters, "Fed policymakers see higher interest rates for longer," 14 Dec 2022
U.S Department of the Treasury, "Daily Treasury Par Yield Curve Rates" retrieved 3 Jan 2023

What will this mean for the markets?

We don't pretend to know how the market will behave this year, but there is reason for hope. Historically, it's rare for stocks to have back-to-back down years. Based on the performance of the S&P 500, it's happened only 9% of the time since 1928. In fact, down years in general are relatively uncommon.



It's even more uncommon for bonds to lose money two years in a row. 2021-2022 represents only the third time that has happened since 1926. What's more, bonds have never lost money 3 years in a row.

Sources: awealthofcommonsense.com, "How Often is the Market Down in Consecutive Years?" Ben Carlson 13 Dec 2022
BlackRock, "Student of the Market." December 2022

Ready to improve your investments?

The new year is a great time to evaluate your investment portfolio to see if you could be earning (or saving!) more. Clients who transition their investments to the care of One Day In July can do so "in kind," meaning that you do not need to sell your current securities before you move them. This helps to avoid triggering unnecessary tax implications. After the transfer, your accounts will generally be held with Charles Schwab. From there, we can begin to methodically transition your assets into your new personalized investment plan. Give us a call or email us today to schedule a free consultation with one of our fiduciary financial advisors.

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