Market Commentary

Fourth Quarter 2022

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Many investors wish good riddance to 2022. To quote a phrase once used by the recently departed Queen Elizabeth II, it was an annus horribilis. Although the fourth quarter of 2022 saw a move upwards for US equity markets, the gains only slightly reduced the full year losses. US stocks, as measured by the benchmark S&P 500 Index, increased by 7.6% on a total return basis during the quarter. This brought the full year return on US equities to -18.1%, the worst calendar year return since 2008 during the financial crisis. Despite the poor returns, we remind you to keep a longer-term perspective. Trailing three-, five-, and ten-year annualized total return figures for the S&P 500 are 7.6%, 9.4%, and 12.6%, respectively. Fixed income yields fluctuated during the quarter, as investors were caught between better-than-expected inflation reports combined with stronger than anticipated employment growth. The benchmark 10-year US Treasury note ended 2022 yielding 3.88%, more than double the 1.51% at year-end 2021. Larger interest rate movements were seen in shorter-dated Treasury securities. For example, the 1-year Treasury bill ended 2023 with a yield of 4.71%, more than ten-fold the rate of 0.38% a year prior. The combination of the double-digit percentage declines in both the major US equity and longer-term bond indices over a calendar year was an extremely rare event and left investors feeling worse off than they normally would by an equity decline of this magnitude. In fact, we need to go back to 1974 to find a year in which both major asset classes declined for the same calendar year.

Economic and Market Outlook

The Federal Reserve spent the bulk of 2022 in catch up mode, with continuous aggressive rate hikes as they moved the Fed Funds rate from essentially zero in March to a range of 4.25-4.50% at year end. This stands in stark contrast to their December 2021 projections which showed inflation during 2022 estimated at 2.6% and the December 2022 Fed Funds rate forecast at 0.75%. We bring this up not to cast aspersions on the Fed, but rather to show how even an organization with hundreds of statisticians and economists at its disposal can be blind-sided by actual events. The Fed knows the best way to control inflation is to reduce the growth in labor costs. This is most simply achieved by reducing labor demand which leads to higher unemployment. The Fed currently estimates that unemployment will rise to 4.6% by the end of 2023 from the current 3.7%. They also forecast real GDP growth in the US will be a meager 0.5% next year. We must point out that in all the years economic data for the US has been collected, the economy has never avoided a recession when unemployment rises more than 0.5%. Thus, the Fed is predicting it can achieve a feat never before accomplished in the US.

At current levels, stocks have declined about 20% from their early 2022 peaks and bonds have experienced their worst two-year period in memory. We have always said Americans want to buy everything on sale except stocks (and lately bonds). With both asset classes markedly cheaper than they were 12-18 months ago, investors remain wary of another leg down. Although we cannot predict the next few months, we know equities are a discounting mechanism and it will not be long until investors are looking past 2023 into 2024 and beyond, when the imbalances in the economy should be behind us. The year will be remembered as one in which "income" returned to fixed income making bonds a more desirable investment class. From a global peak of $18.4 trillion two years ago, only $250 billion in bonds remain yielding less than zero – all in short Japanese government securities.

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Turning to oil markets, the price for benchmark West Texas Intermediate began October at $79.74 and traded in a relatively modest band of $70-$90 for most of the quarter, ending the year at $80.26, a modest 7% higher than the year ago price. Our estimate for the fair value of oil remains in a range of $70-$90 per barrel with upside risks based on geopolitics and downside risks tied to economic troubles. More important to US consumers than the absolute price of crude oil is the continuing decrease in US refining capacity. Since the start of 2020, almost 7% of refining capacity has been shut down or taken off-line. There are many reasons for the decline in refining capacity but the two primary ones are the decision by companies to shutter underperforming refineries along with the current administration's regulatory stance. We can understand the reluctance for companies to invest tens of millions of dollars to expand capacity in the face of a government that is pushing both regulatory and tax burdens on their industry. While green energy is likely the future, we will need oil and gas for several decades to help get us through the transition. The end of releases from the Strategic Petroleum Reserves could push prices higher in coming months.

Earnings estimates remain stubbornly high in our opinion. As companies fine-tune their 2023 projections and reflect higher input costs, wage hikes, and higher borrowing costs, we believe earnings estimates for 2023 will come down, likely by 5-10% from the current $230. The year-end valuation of the S&P 500 is approximately 16.6x forward earnings estimates, in line with the 25-year average but significantly below the 22x forward estimates during 2021. If earnings for 2023 are modestly lower than forecast, as we expect, the market is priced at about 18x forward earnings.

Regarding the Fed, we remind you that it is not just the destination, but also the duration. Said another way, we are less concerned with the ultimate peak level in Fed Funds rate than we are in how long the Fed plans to leave rates at peak levels before beginning to reduce them. If we believe the Fed's most recent prognostications, they plan to raise interest rates by an additional 75 basis points during 2023 and do not plan their first reduction in interest rates until sometime in 2024. Markets on the other hand, see an initial rate cut in the summer of 2023. The resolution between these differing forecasts will go a long way towards determining financial market returns during the next 12-18 months. If the Fed holds rates above 5% for an extended period of time, that should mean that employment is holding relatively firm. Rapid increases in unemployment (above the rate the Fed is predicting) could be the catalyst for earlier than expected rate cuts. We expect inflation to continue trending lower over the next few months with the year over year rate declining to approximately 5-6% in early 2023. Continued improvements in supply chain disruptions could push the rate a bit lower than that. After that, it will be a slow grind as the cumulative effect of interest rate increases work through the economy. At its December meeting, the Federal Reserve updated its economic forecasts. They now expect real GDP to rise by an infinitesimal 0.5% in both 2022 and 2023. These estimates were closer to 2% just six months ago. While they modestly raised their unemployment rate forecasts to 4.6% during 2023, we still do not believe they can limit the pain in the job market to the extent they are forecasting if they remain vigilant in reducing inflation to 2%. We hope to be pleasantly surprised. For the past six months, the unanswered question has been whether or not we are in a recession. We have continuously opined that it is irrelevant if we are in a recession, but we cannot ignore the fact that the economy is showing signs of strain. However, the labor market remains far stronger than anybody anticipated, and that strength should keep us from a long and painful recession.

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Portfolio Positioning

During 2022, a large part of the speculative froth in sections of the markets were removed. Tandem focused on high quality investments with below market valuations throughout 2022 which led to positive relative performance. We were in defensive mode for the bulk of 2022, not chasing returns, but rather protecting capital. We still believe earnings estimates for corporations remain 5-10% too high and expect estimates to begin declining when earnings for the prior quarter are released later in January. Until we see signs of renewed economic growth, we expect to remain defensively positioned, choosing to collect dividends and interest rather than risking principal on speculative investments. Yield can make up a significant portion of total investor returns during periods of market turmoil, and we enter 2023 with more investment choices to provide income than we have had in over a decade.

Conclusion

During the past year, we have counseled patience. Emotions can destroy portfolios rather quickly and it behooves investors to cast an unemotional eye at markets during volatile times. The stock market is a discounting mechanism and investors are already looking to latter-half 2023 and 2024 earnings. Aside from the once in a generation interest rate surge which hammered fixed income investments, a good deal of the carnage in 2022 was centered on higher-growth, more speculative investments. Bitcoin declined 64% during 2022. SPACs - which were all the rage during late 2020 and 2021 - collapsed with many falling 80% or more during the year. Companies with very high expected growth rates (and thus stratospheric earnings multiples) declined far more than benchmark indices. Amazon, Netflix, Meta (Facebook), and Tesla declined 50%, 51%, 64%, and 65% respectively, collectively vaporizing trillions of dollars of market capitalization. In sum, the market is cheaper than it has been in several years. Bonds are now generating meaningful income again which helps investors by providing stable income streams from the fixed income portion of portfolios. By retaining perspective, investors can focus on highly profitable and financially strong companies, rather than chasing “must own” stocks and other fad investments.

In closing, we wish each of you a Happy and Healthy New Year. We hope your families and loved ones remain safe. Please inform us of any significant changes in your financial situation or if you have any specific questions or concerns about your investments.

December 31, 2022

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