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Market Newsletter
December 31, 2022

EXECUTIVE SUMMARY

- Global stocks and bonds rose in the fourth quarter of 2022 to cap the worst year since 2008 for stocks and the worst year ever for bonds.

- Historically, asset classes tend to perform well after such a poor performance.

- It seems like the Fed is on track to achieve its inflation target after the fastest tightening cycle on record. The economy is slowing, and inflation is dropping from a record high reached last summer.

- An index of Leading Economic Indicator is declining sharply reflecting a strong possibility of a recession.

- The Democrats are in control of the Senate and the Republicans are in control of the House, leading to a split congress. This is very likely going to lead to a gridlock in major issues especially around fiscal policy.

- While past performance has no bearing on the future, historically, the equity market (S&P 500) has returned on average over 13% during a split Government.

- Corporate earnings are expected to have grown by 5.1% in 2022 and are expected to grow by 5.5% in 2023.

- Stocks are cheaper than their 25-year average. Historically, when stocks were valued at this level, they had positive 1-year and 5-year forward returns.

- US stocks and international stocks move in long cycles and a diversified portfolio should have allocation to both.

- The stocks of profitless, innovative companies have crashed and are doing worse than old economy stocks.

Table 1: Market indices

(*Returns include dividends*)	**Quarter to date**	**Year to date**	**1 Year**	**3 Year Annualized**	**5 Year Annualized**
S&P 500	7.56%	-18.11%	-18.11%	7.66%	9.42%
S&P Mid Cap 400	10.78%	-13.06%	-13.06%	7.23%	6.71%
S&P Small Cap 600	9.19%	-16.10%	-16.10%	5.80%	5.88%
MSCI Emerging Markets	9.79%	-19.74%	-19.74%	-2.34%	-1.03%
MSCI EAFE	17.40%	-14.01%	-14.01%	1.34%	2.03%
Vanguard Total Bond Market Index (VBMFX)	1.64%	-13.26%	-13.26%	-2.85%	-0.11%
Investment Grade Credit (C0A0)	3.64%	-15.35%	-15.35%	-2.72%	0.56%
Non-Investment Grade Credit (H0A0)	3.91%	-11.30%	-11.28%	-0.25%	2.11%
Bloomberg Commodity Index Total Return	2.22%	16.10%	16.10%	12.65%	6.44%
Dollar Index (DXY)	-7.67%	8.21%	8.21%	2.41%	2.36%
10 Yr. Rate	3.88% 12/31/2022	3.88% 12/31/2022	1.51%% 12/31/2021	1.92% 12/31/2019	2.40% 12/3012017

Source: S&P Dow Jones, ml.com, MSCI.com, Morningstar, Bloomberg, Yahoo Finance

Table 2: Recent Major US Economic Releases (These indicators have a significant impact on the stock market)

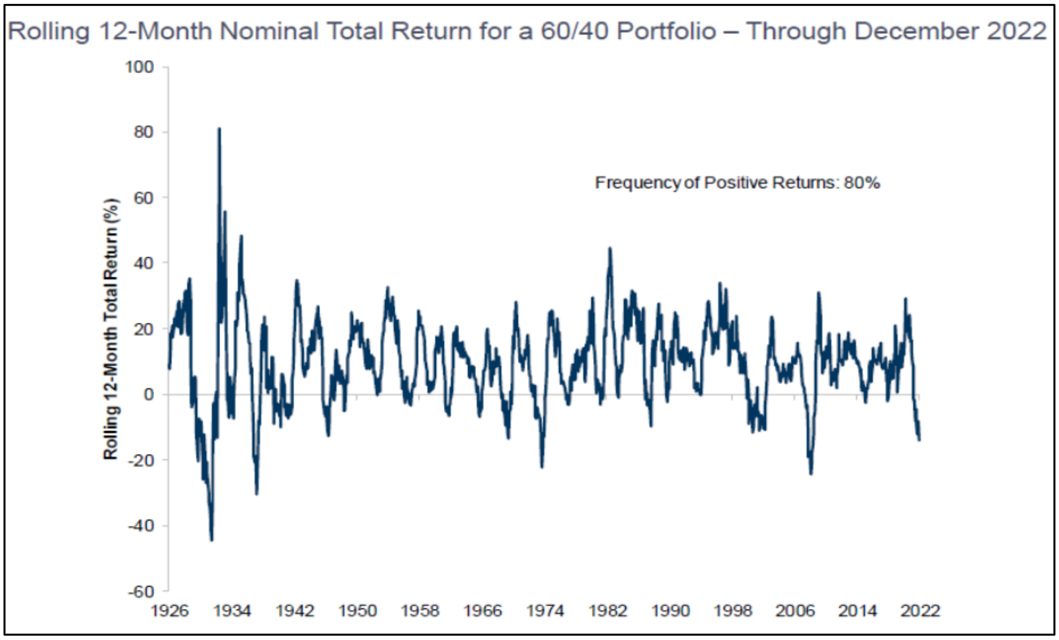
As of 01/06/2023			
	Latest Release	Recent Trend	Notes
Non-Farm Employment	223,000	Negative	The number of nonfarm jobs added in the economy continued to decline but this report was positive in that it managed to relieve inflation concerns. Average hourly earnings rose 4.6% from a year ago, lower than the 5% that was expected. Unemployment rate was a solid 3.5%.
Weekly Claims for Unemployment Insurance	204,000	Positive	Jobless claims fell significantly during the holiday season reflecting a strong employment situation.
ISM Manufacturing Index (over 50 indicates growth)	48.4	Negative	This was the weakest reading since May 2020. Manufacturing is now contracting as indicated by a reading below 50. The silver lining is that prices paid for goods is falling alleviating inflation pressures.
ISM Non Manufacturing Index (Over 50 indicates growth)	49.6	Negative	The service sector is contracting for the first time since May 2020. The efforts of the Federal Reserve to slow the economy to combat inflation seems to be working.

	Latest Release	Recent Trend	Notes
Consumer Prices (Month over month change)	0.1%	Positive	Inflation is moderating and the 12 month change was 7.1% sharply lower from a 4 decade high of 9.1% in June. Excluding food and energy, consumer prices rose 6% over the last 12 months.
Producer Prices (Month over month change)	0.3%	Positive	Producer prices rose more than expected in November as a surge in vegetable prices offset a drop in energy prices.
Retail Sales (Month over month change)	-0.6%	Positive	Retail sales dropped the most in 11 months as consumers pulled back in 9 of the 13 retail categories. Subsequent retail sales were stronger as evidenced by numbers released by Mastercard showing retail sales grew by 7.6% in the holiday season.
Consumer Confidence (Conference Board)	108.3	Positive	Consumer confidence rose sharply in December to an 8 month high as receding inflation and a strong jobs market buoyed up consumer's mood.
Durable Goods Orders (Month over month change)	-2.1%	Negative	Durable goods orders fell sharply in November. The core, non defense capital goods orders rose 0.2%.
Industrial Production (Month over month change)	-0.2%	Negative	Industrial production fell for a second consecutive month as economic uncertainty, high inflation and rising interest rates impacted demand for goods.
Capacity Utilization	79.7	Positive	Capacity utilization is holding up around its long term average.
Housing Starts	1.427 million	Negative	High inflation and interest rates eroded housing affordability and demand.
Home Prices (Case-Shiller Home Price Index- Year over Year)	8.6%	Negative	Home prices in 20 major cities were up 8.6% from a year ago, however, prices have been falling over the last 4 months. Prices were down in all 20 major cities in October.
GDP (Real, Annualized)	3.2%	Positive	Third quarter 2022 GDP growth was revised up, helped by consumer spending and business investment. A strong labor market has sustained economic growth in the face of high inflation and rising interest rates.

Source: Bloomberg, www.federalreserve.gov, www.bls.gov, www.ism.ws, www.nahb.org

Global stocks and bonds rose in the fourth quarter to end the worst year since 2008 for stocks and the worst year ever for bonds. A moderate risk portfolio of 60% in stocks and 40% in bonds suffered its worst performance since 2008. The good news for investors is that asset classes are positioned to perform well after such steep declines as seen in Fig 1. Within stocks, those of smaller companies and those of overseas companies did better than stocks of large domestic companies. Value stocks did much better than growth stocks, as rising interest rates hurt stocks of companies in industries such as information technology that tend to grow faster than others and are usually priced at a premium. Stocks of companies in defensive industries such as healthcare and consumer staples outperformed the rest of the market. Commodities continued rallying, and was the only asset class to have a positive performance for 2022. The US dollar which rallied significantly against a basket of currencies earlier in the year, fell in the fourth quarter but was up for the year.

Fig 1: A 60:40 stock bond portfolio tends to perform well after steep declines.



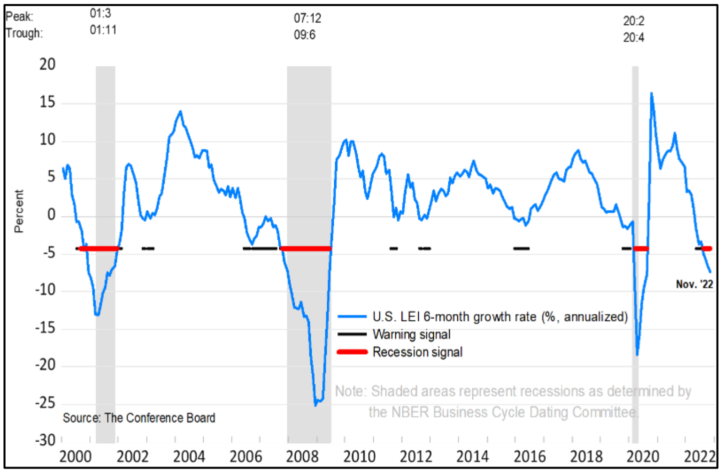
Source: Goldman Sachs

The economy is showing signs of slowing down in response to the Federal Reserve's (Fed) actions of increasing interest rates to curtail inflation. The latest measures of manufacturing and non-manufacturing indices are below 50, indicating these areas are contracting. On the other hand, although the number of jobs created in the economy has continued to fall since the high set last year, the jobs market is still relatively strong. The index of leading economic indicators released by the Conference Board includes forward looking economic indicators such as interest rate spreads and average weekly hours. This index has dropped significantly (Fig 2) and is currently forecasting a recession. A slowing economy is providing inflation relief – the Consumer Price Index peaked at 9.1% (annual rate) last July and has fallen consistently since then as seen in Fig 3. Forward looking indicators of inflation such as the 10-year Treasury Inflation Protected Securities (TIPS) are predicting that inflation is headed towards 2%, down from the 3% they were predicting in May (Fig 4). It seems like the Fed is on track to achieve its inflation target after the fastest tightening cycle on record. (Fig 5)

Mortgage rates which had been at record lows just a year ago, have more than doubled and 30-year fixed rates are currently 6.5%, making homes less affordable to buyers as seen in Fig 6. Home prices are falling at the fastest rate since 2008. However, stricter mortgage underwriting standards since the financial crisis have led to a housing market where homeowners have a significant amount of equity as seen in Fig 7, and could cushion steep price drops.

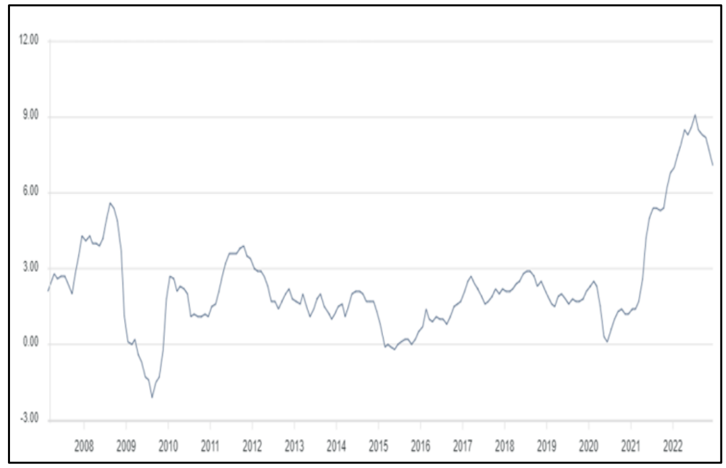
On the political front, the results of the midterm election last fall deviated from history in that the incumbent President's party did not lose a substantial number of seats. The result was that the Democrats narrowly maintained control of the Senate and the Republicans narrowly took control of the House, leading to a split congress. This is very likely going to lead to a gridlock on major issues, especially around fiscal policy. While past performance has no bearing on the future, historically, the equity market (S&P 500) has returned a higher than usual average of 13.6% during times when there was a Republican House, Democratic Senate and Democratic White House as per calculations by PIMCO.

Fig 2: Index of U.S Leading Economic Indicator



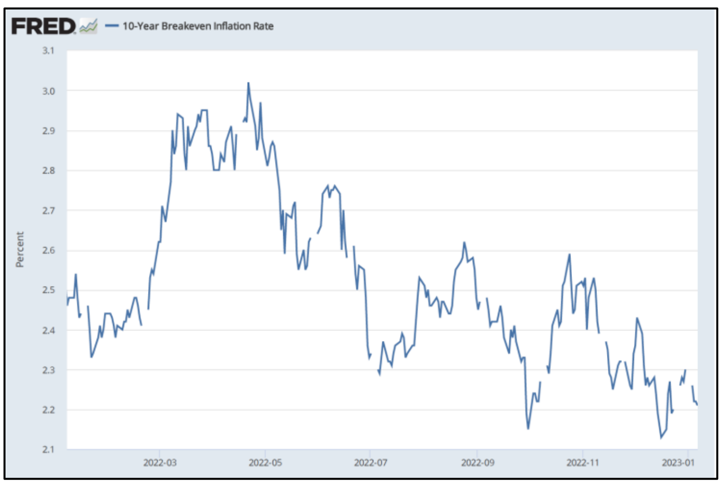
Source: Conference Board

Fig 3: Consumer Price Index Year over Year change



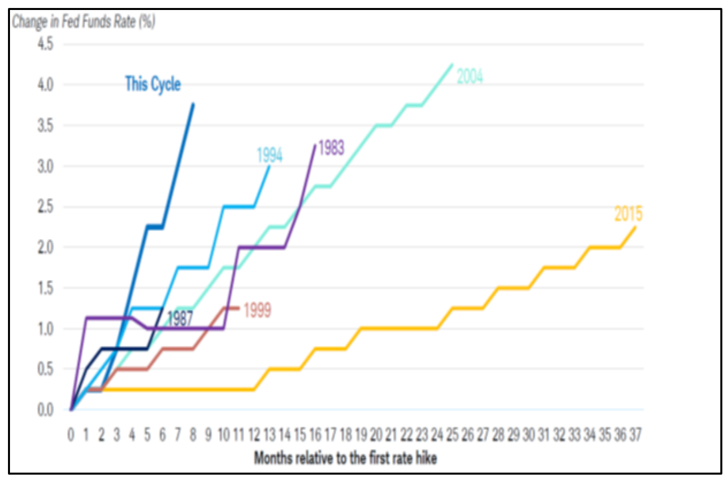
Source: US Bureau of Labor Statistics

Fig 4: Expected future inflation as predicted by bonds



Source: The Federal Reserve Bank of St Louis

Fig 5: The Fed is on the fastest tightening cycle ever



Source: Charles Schwab

Fig 6: Housing affordability has dropped sharply

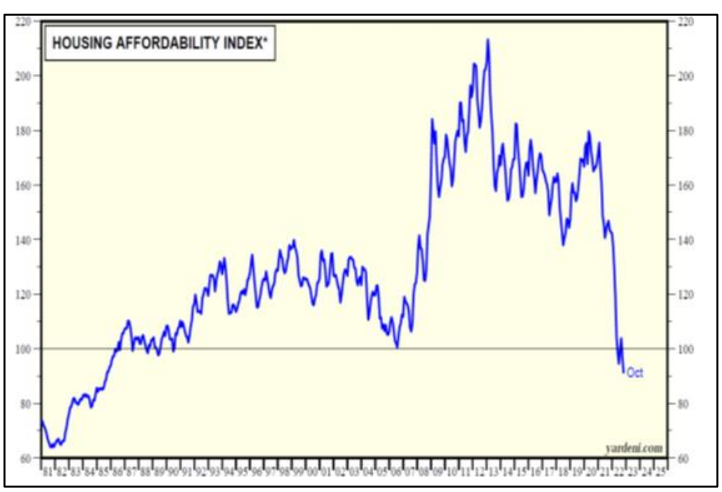
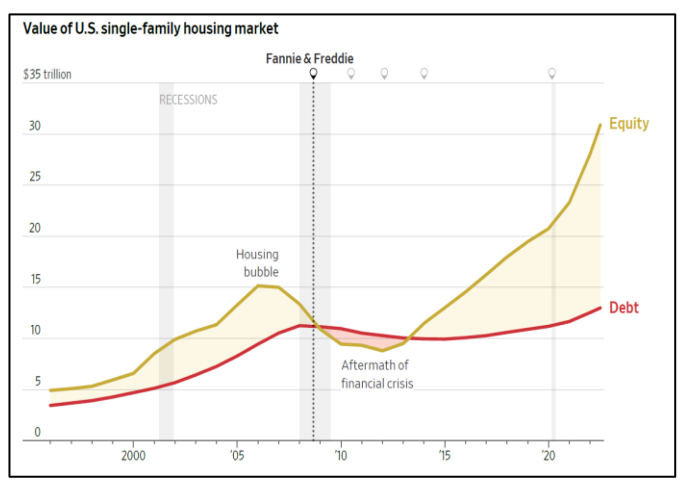


Fig 7: Homeowners have significant equity in their homes



Source: Yardeni Research, Inc.

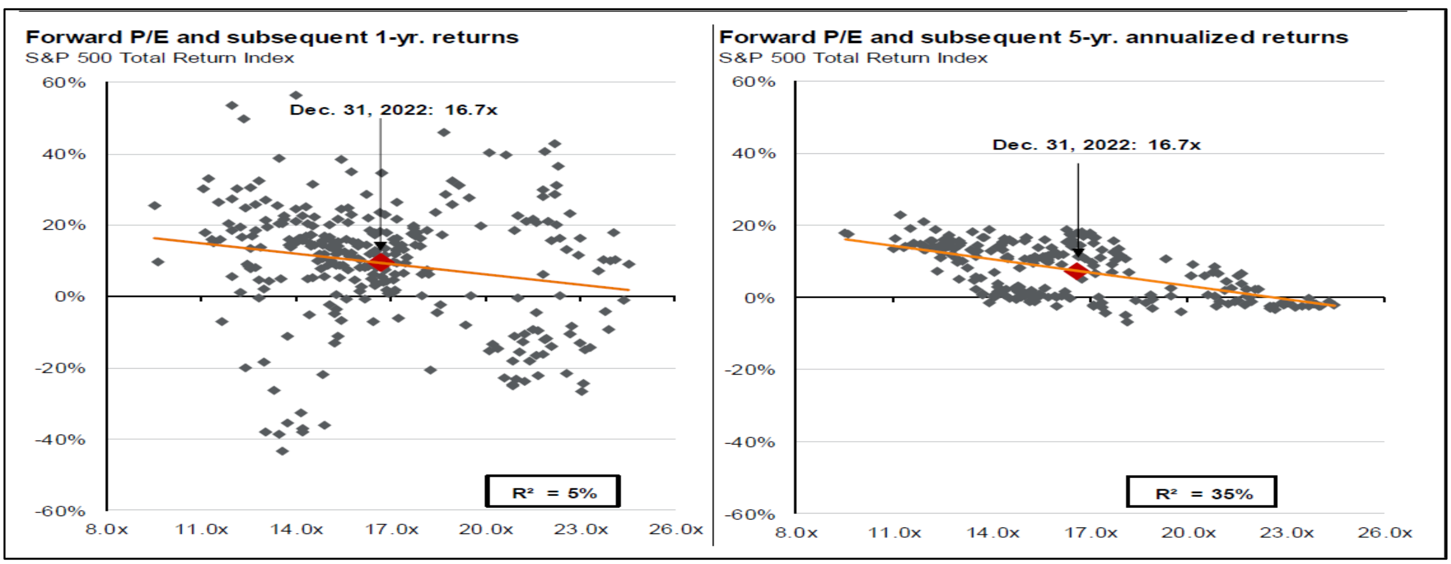
Source: The Wall Street Journal

Corporate earnings are expected to slow along with a slowing economy. Analysts say earnings of companies in the S&P 500 declined by 2.2% in the fourth quarter of 2022 as compared to a year ago, the first decline since 2020. For the full year, earnings are expected to have grown by 5.1%. However, most of the growth is because of the energy sector. Excluding the energy sector, earnings are expected to have declined by 1.8%. For 2023, earnings are expected to grow by 5.5%, however it is likely that this estimate will be revised down as the year progresses.

With the stock market down about 20% from its peak, stocks have become cheaper. The forward price earnings multiple (A measure of how cheap or expensive stocks are- lower means cheaper) is currently 16.7 times, which is just below its 25-year average. Historically, when stocks were valued at this level, they have experienced positive 1-year and 5-year forward returns according to calculations by J.P. Morgan (Fig 8).

Economies outside the US are facing a similar set of challenges around inflation and interest rates. For US investors, an additional headwind in foreign stocks has been the strength of the US dollar (USD-A strengthening USD causes a loss when foreign currencies are converted back to dollars). Towards the end of 2022 the USD retreated leading to an outperformance of foreign stocks. The reopening of the Chinese economy from rolling covid lockdowns also helped as Chinese stocks, which have been battered experienced a furious yearend rally.

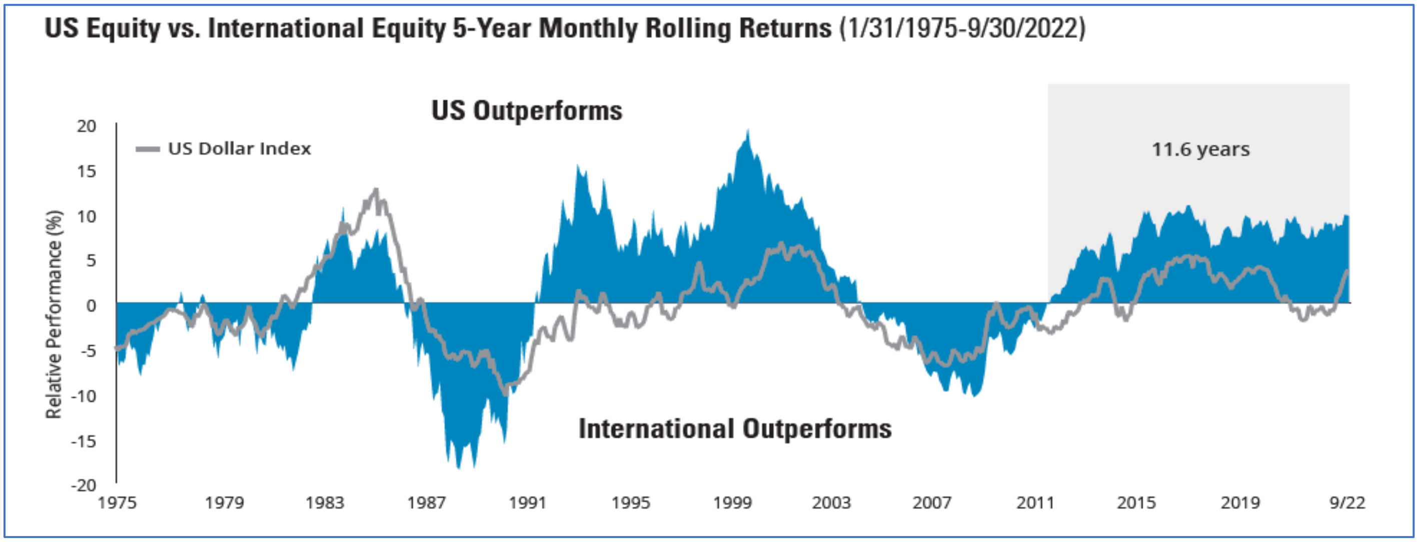
Fig 8: Starting Price Earnings multiples and forward equity returns.



Source: J.P. Morgan

Historically, the US and International stock markets have moved in cycles with several years of outperformance by one or the other, as seen in Fig 9. The current cycle of US stock outperformance has been unusually long so international stocks may be set to outperform in the future. From a diversification standpoint, investors will want to have a suitable allocation to international stocks.

Fig 9: US and International stocks tend to move in long cycles.



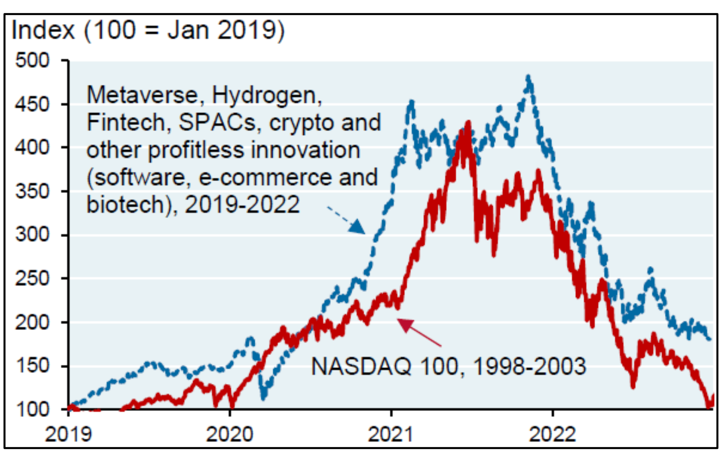
Source: The Hartford

<u>History repeats itself</u>

One (re)learning for investors this cycle is the perils of investing in innovative but profitless companies in emerging technology. The operations of these companies and the performance of their stocks were helped by the large amount of 'easy money' i.e historically low interest rates and quantitative easing. Now that the monetary tide has turned, with interest rates higher and the Fed executing quantitative tightening, these companies are struggling, and their stocks have been battered. As seen in Figures 10, 11, 12, 13 the stocks of these companies have crashed after soaring for many years just as they did during the internet crash of 2000 to 2002.

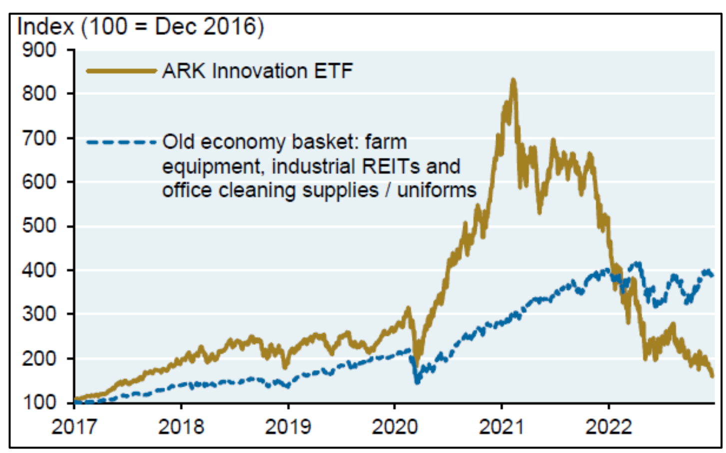
<u>Fig 10, 11, 12, 13: Stocks of profitless, Innovative companies have crashed and are doing worse than old economy stocks.</u>

Fig 10



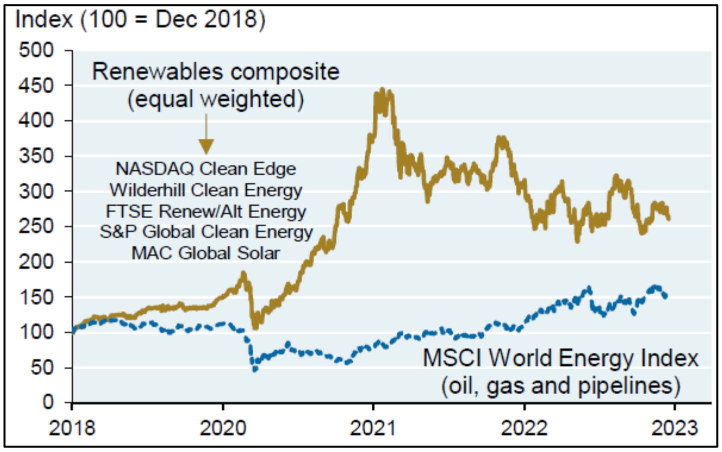
Source: J.P. Morgan

Fig 11



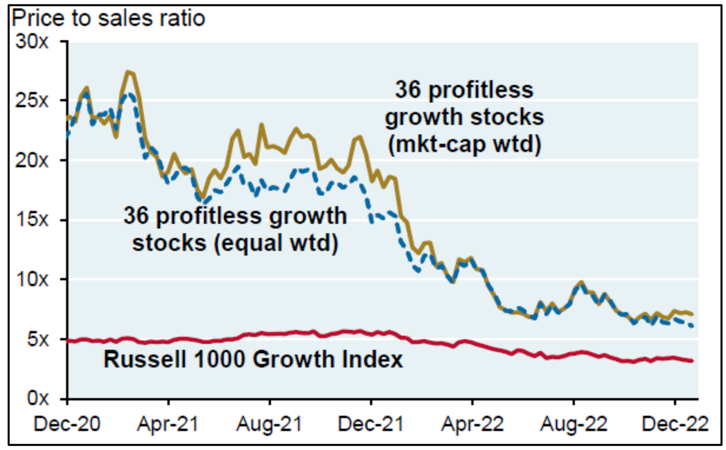
Source: J.P. Morgan

Fig 12



Source: J.P. Morgan

Fig 13



Source: J.P. Morgan