OXFORD | HARRIMAN & COMPANY

Fourth Quarter 2022 Commentary

An Oxford Harriman & Company Market Commentary

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Recapping A Challenging 2022

Markets faced many challenges in 2022, including high inflation, historic interest rate increases, the war in Ukraine, and COVID lockdowns in China. Inflation was a key concern in the markets throughout the year, with the headline consumer price index reaching a 40-year high of 9.1% in June. High inflation prompted the Federal Reserve and its global central bank peers to aggressively raise interest rates, which was a sharp reversal in monetary policy from the extraordinary accommodative levels during the COVID pandemic. In the U.S., the Federal Reserve raised rates 7 times for a total of 425bp (100bp = 1%), which included the first 75bp rate hike since 1994 and an unprecedented series of four consecutive 75bp rate hikes from June through November.

This policy reversal caused both stocks and bonds to trade lower. From an investment perspective, there was "no place to hide" as central banks rapidly tightened monetary policy. The S&P 500's decline of 19.4% in 2022 was its worst annual return since 2008. The market's decline was mostly consistent throughout the entire year. Seven of the months in 2022 registered a decline in equities of at least 2.5%, while five of these months had declines of more than 5%. Additionally, there have only been ten other years in which the S&P 500 has fallen 15% or more for the calendar year. To make matters worse, the Bloomberg U.S. Bond Aggregate produced its worst total return since 1976.

Impact of Interest Rate Hikes

The Federal Reserve began raising interest rates in 2022, but the full impact of these restrictive measures has not yet been fully felt in the economy. While the U.S. economy contracted during the first half of 2022, it expanded at a robust 3.2% annualized pace during the third quarter. Consumer spending remained strong throughout most of 2022 despite high inflation, and the U.S. labor market added more than 4 million jobs through the end of November. Data indicates the U.S. economy has withstood interest rate tightening thus far, but the real test will come this year as the cumulative impact of higher interest rates becomes clearer. Additionally, we do not expect that the Fed has ended its rate hikes, but perhaps the pace of such raises will slow down.

While the Fed appears to be cognizant that rising rates can push the economy into a recession, its primary goal is to reduce inflation. Recent data suggests price pressures may be easing. While the year-over-year headline consumer price index rose by 7.1% in November 2022, which is still high compared to historical levels, it was down from the 9.1% rate seen in June 2022.

Equity Valuations Are More Attractive, But Corporate Earnings Are an Open Question

The current valuation is at a more attractive starting point today than at the beginning of 2022, but corporate earnings are uncertain entering 2023. There exists the potential for earnings to retract as the economy slows.

While inflation and central bank policy were the primary drivers of markets in 2022, economic data and corporate fundamentals are expected to play a larger role in determining the market's direction in 2023. The S&P 500 traded at a multiple of 24 times trailing 12 months earnings at the beginning of the year and 20.5 times at year end. The current valuation is at a more attractive starting point today than at the beginning of 2022, but corporate earnings are uncertain entering 2023. There exists the potential for earnings to retract as the economy slows. Despite expectations for an economic slowdown, Wall Street analysts still forecast single-digit earnings growth for the S&P 500 in 2023. This optimistic growth forecast creates a risk for the market if actual earnings growth falls short of forecasts.

Equity Market Recap – Stocks Traded Higher in the Quarter

Stocks traded lower during December but still ended the fourth quarter higher. The S&P 500 Index of large cap stocks gained 7.6% during the fourth quarter, outperforming the Russell 2000 Index's 6.2% return.

Energy was the top performing S&P 500 sector during the fourth quarter with a gain exceeding 20%, followed by the cyclical sector trio of Industrials, Materials, and Financials. Defensive sectors, including Health Care, Consumer Staples, and Utilities, were middle of the pack performers.

Energy was the top performing S&P 500 sector during the fourth quarter with a gain exceeding 20%, followed by the cyclical sector trio of Industrials, Materials, and Financials. Defensive sectors, including Health Care, Consumer Staples, and Utilities, were middle of the pack performers. Growth-style sectors, including Technology, Communication Services, and Consumer Discretionary, and interest-rate sensitive Real Estate underperformed as higher interest rates continued to weigh on valuations. On an absolute basis, all sectors, except for Consumer Discretionary, generated a positive return.

International stocks outperformed U.S. stocks during the fourth quarter. The MSCI EAFE Index of developed market stocks returned 17.7% during the fourth quarter, while the MSCI Emerging Market Index returned 10.3%. A weaker U.S. dollar boosted the returns of international stocks, with U.S. dollar weakness driven by a shrinking monetary policy gap as other central banks catch up with the Federal Reserve's aggressive policy. Also, China's decision to relax its COVID-zero restrictions raised the prospect of stronger global growth as one of the world's biggest economies reopens.

Bond Market Recap – The Great Yield Reset

The bond market experienced a significant resetting of interest rates during 2022, with yields steadily rising as the Federal Reserve pushed through large interest rate hikes. Despite posting positive returns during the fourth quarter, bonds produced losses in 2022. The Bloomberg U.S. Bond Aggregate had a -13% total return during 2022, its biggest negative total return since tracking began in 1976.

The starting point for bonds, both in terms of yield and credit spreads, is now more compelling than it has been in a decade. However, there remains the potential for continued volatility in the bond market.

As a result of the 2022 rates hikes, the 10-year Treasury yield exceeded 4% in the fourth quarter, its highest level since 2007. The starting point for bonds, both in terms of yield and credit spreads, is now more compelling than it has been in a decade. However, there remains the potential for continued volatility in the bond market. There is still significant uncertainty regarding how high the Fed will need to raise interest rates and how long it will need to keep interest rates at restrictive levels to reduce inflation. Additionally, there is a risk that inflation could remain above the Fed's 2% target, leading to an extended tightening cycle. The crosscurrents of uncertain central bank policy and the direction of the global economy could keep bond prices volatile again during 2023.

2023 Outlook – Turning the Page on a Historic Tightening Cycle

There is still a wide range of possible outcomes, and the unique nature of the pandemic followed by rapid interest rate cuts and hikes makes the path forward less certain.

2023 brings the next phase of the tightening cycle where the lagged effects of tighter monetary policy will be felt. It has the potential to be a year of two halves. In the first half, the focus is likely to shift from the number of future interest rate hikes to how much those interest rate hikes will slow the economy. Some data, such as in the housing market, indicate that tighter monetary policy is being transmitted into the economy at a rapid pace. Home sales are slowing, and homebuilder confidence weakened every month during 2022 and now sits at its lowest level since 2012. At the same time, consumers continue to spend, and employers continue to add jobs. There is still a wide range of possible outcomes, and the unique nature of the pandemic followed by rapid interest rate cuts and hikes makes the path forward less certain.

The second half has the potential to be different depending on how severe the slowdown is in early 2023. Markets are based on forward-looking expectations, and investors will be watching closely for signs that the economy has bottomed out and is recovering. Interestingly, there have only been two instances of consecutive negative S&P 500 return years since 1950, in 1973-1974 and 2000-2002. However, in the years where the S&P declined by more than 15%, six times the index posted gains the next year, while four times the index posted further declines. As is often the case, historical performance can provide context, but certainly does not provide any guarantees.

We will continue to analyze macro-economic data, as well as company-specific commentary, to help navigate through these volatile markets. Please contact us if you have questions regarding your individual situation.

Sincerely,

Dennis P. Barba, Jr.
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Sources:

The Wall Street Journal

CNBC

S&P Global

Macro Trends

The Federal Reserve