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ADVISORY GROUP

In Focus

Monthly Market Review & Outlook
12/9/2022

Interest Rate Stabilization

Global equity markets continued to march materially higher in November even as expectations for a recession in 2023 seemed to grow. Partly driving market momentum is interest rate stabilization. As more and more economic data suggests that inflation is declining, there is growing consensus that the Fed will stop hiking the Fed Funds overnight interest rate at approximately 5%. With increased confidence in where interest rates will peak, the environment for risk taking improved.

With inflation in the rear-view mirror (or at least heading in the right direction), attention is now focused on the economy and whether it will weaken to the point of recession. Recall that we forecast at the beginning of the year that the Goods part of the economy would fall into recession, and it appears that is happening as the ISM Manufacturing index posted 49[1] indicating a contraction in manufacturing activity. Additionally, the Goods Merchandise stores and Transportation & Warehousing sectors shed jobs last month, according to the most recent labor report[2].

The key open question is: Will the Services sector follow and enter a recession? So far there is no indication to suggest it is, but it could, which is creating a substantial amount of uncertainty regarding the accuracy of earnings estimates. This sort of environment is not beneficial for stocks and, therefore, the recent rally could be just another bear market rally that may evaporate. While this does not portend well for the equity market, the fixed income market looks much more attractive with interest rates generally stable. The sell-off this year in fixed income has created an extraordinary opportunity to obtain attractive yields with substantially less risk than stocks.

Market Update

Globally equity markets continued to rally in November. In the U.S., the dispersion between markets was more even that last month. The Dow Jones Industrial index fared best rising 6.0% while the Nasdaq posted a more meager increase of +4.5%. The S&P 500 index gained +5.6%. However, on a year-to-date basis the performance dispersion remains stark with the Dow down just -2.9%, the S&P 500 down -13.1% and the Nasdaq down -26.1%. Value has vastly outperformed growth this year as interest rates surged.

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[1] The Institute of Supply Management, November 2022.
[2] Bureau of Labor Statistics, November 2022.

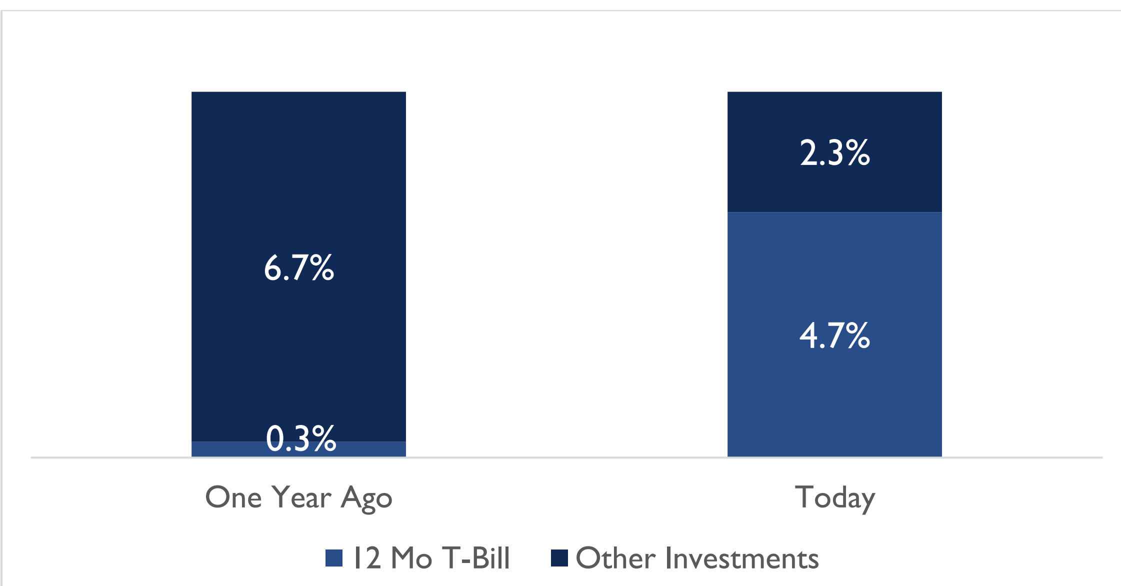
The fixed income market rose in November marking only the second month this year to finish higher and this was directly attributable to a decline in interest rates. The U.S. 10 Year Treasury bond yield declined 44bps to 3.6%. This decline drove a gain of 3.7% in the Bloomberg Aggregate Bond index. Other fixed income indices also benefited. The Bloomberg U.S. Mortgage-Backed Securities index rose 3.3% during the month recouping some of it losses the year and the Bloomberg U.S. Investment Grade Bond Index increased 5.3%.

The Bloomberg Commodity index rose 2.4% and is now up over 15% for the year. After expressing our frustration last month with gold, which has failed to live up to its reputation as an inflation hedge this year, in November gold rose +8.5%. As we pointed out, gold tends to be inversely correlated with the U.S. Dollar. The speed and magnitude of the upward move in interest rates relative to other major economies has significantly strengthened the dollar this year. The dollar's recent sell-off breathed new life into gold.

Yield!

The sell-off in bonds this year has been very painful for investors, particularly for more conservative investors. The silver lining is that today investors can receive yields that have not been available without taking undo risk in decades. For example, the U.S. 12 Month Treasury Bill today yields approximately 4.7%. Why is this important?

While return expectations vary, many investors in our experience would be happy if their portfolio returned 7% annually on average over time. This return has historically been achieved by combining stocks and bonds. As shown below, a year ago the 12 Month T-Bill yield was barely above zero meaning an investor had to rely on stocks to deliver essentially all of the required 7% return. Today, an investor can get a 4.7% of their required return from a risk-free T-Bill that in turn means that do not need very much of a return from riskier assets, like stocks. This is good news for investors.



This simple example is meant to illustrate that investors today do not have to take excessive risks to earn an acceptable return. For years, investors have had to bear materially more risk to achieve acceptable returns. Fixed income now acts like the defensive asset class is has historically been and now provides real yields. High quality fixed income, such as mortgage-backed securities, municipal bonds and investment grades corporate bonds now offer attractive yields.

Outlook

As inflation trends in the right direction thereby creating interest rate stability, fixed income is the place to be for now. There could still be bumps in the road as various inflation and labor data points are absorbed over the coming months, but so long as the general trend continues fixed income should offer both yield and protection from potential economic weakness.

The stock market, on the other hand, is still hampered by economic uncertainty. To be sure, there are always interesting idiosyncratic ideas and those driven by strong secular themes, like Clean Energy, but the broader stock market indices are still facing material downward risk should the economy enter a full-blown recession. Earnings estimates have not declined sufficiently nor has the market's valuation to protect against a full-blown recession where the Services part of the economy joins the Goods sector in recession.

Patience is the word of the moment.

Conclusion

Navigating 2022 was the equivalent of walking through a heavily mined field. The deceleration in economic growth from the lofty levels of 2021 occurred largely as forecasted. The Fed took aggressive actions to confront surging inflation and, in the process, drove interest rates upward in the fastest, steepest pace since the late 1970s. Valuations declined as interest rates rose placing significant downward pressure on equity indices and, in particular higher multiple Growth stocks. The correction in the Nasdaq where many of these Growth stocks are listed was particularly hard hit and certain individual Growth stocks declined over 50% in value. Bonds – normally a safer place to invest – will finish the year down nearly as much as the S&P 500, which is extraordinary. Commodities were the only bright spot. The Bloomberg Commodity Index is likely to finish 2022 approximately 30 percentage points higher than the S&P 500 and Bloomberg Aggregate Bond Index. By all accounts, 2022 was a very unusual year.

However, as we exit 2022, there is hope. The economy has withstood enormous inflationary pressures and dramatically higher interest rates at a time when fiscal and monetary stimulus faded away. The labor market has remained strong by any historical measure and that has supported strong consumer spending. We would expect some softening of both as the economy works through excess inventories and weakening demand. The extent of the economy's weakening in 2023, the extent of disinflation and the Fed's reaction to any weakening are the key unknowns going forward. As such, the path of the stock market is difficult to predict at this moment and will continue to favor tactical portfolio adjustments and stock picking. While navigating the equity market may remain tricky, the fixed income market could offer some shelter from any forthcoming economic storm. As we enter 2023, it is important to remember that difficult times like these can create incredible opportunities for future wealth creation.

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Definitions

The **S&P 500 Index** consists of 500 stocks chosen for market size, liquidity, and industry group representation. It is a market-value weighted index (stock price times number of shares outstanding), with each stock's weight in the Index proportionate to it market value.

The **Nasdaq Composite Index** is a market cap-weighted index, representing the value of all stocks listed on the Nasdaq Stock Market. The composition of the Nasdaq Composite is a mix of long-established companies that have been on the exchange since inception, to IPO newcomers, companies that grew from OTC exchanges or switched from other exchanges.

The **Dow Jones Industrial Average** is a price-weighted average of 30 blue-chip stocks that are generally the leaders in their industry. It has been a widely followed indicator of the stock market since October 1, 1928.

U.S. Treasury securities are guaranteed as to the timely payment of principal and interest if held to maturity. Investment options are neither issued nor guaranteed by the U.S. government.

The **Bloomberg Aggregate Bond Index** represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities.

The **Bloomberg U.S. Investment Grade Corporate Bond Index** covers U.S. dollar denominated, investment-grade, fixed ratee or step up, taxable securities sold by industrial, utility and financial issuers. It includes publicly issued U.S. corporate and foreign debentures and secured notes that meet specified maturity, liquidity and quality requirements. Securities included in the index must have at lease 1 year until final maturity and be rated investment-grade (Baa3/BBB-/BBB+) or better using the middle rating of Moody's, S&P, and Fitch.

The **Bloomberg US High Yield Index** covers the USD-denominated, non-investment grade, fixed-rate, taxable corporate bond market. Securities are classified as high-yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below. A small number of unrated bonds are included in the index. The index excludes emerging markets debt.

The **Bloomberg Commodity Index** is comprised of futures contracts and is designed to be a highly liquid and diversified benchmark for commodity as an asset class.

The **Bloomberg U.S. Mortgage-Backed Securities Index** tracks fixed-rate agency mortgage-backed pass-through securities guaranteed by Ginnie Mae, Fannie Mae and Freddie Mac.