Quarterly Update – December 31, 2022

I have good news and bad news. If you are like me, you want to hear the bad news first. So let's start with the bad news. 2022 will go down in history as the worst year for investors since 2008. What made it so bad was the fact that diversification did not work as both the S&P500 and the bond index posted losses for the year. That's the first time since 1969 that both the stock and bond markets declined in the same year.[1] We are all accustomed to volatility in the stock market, but historically the bond market holds up pretty well when stocks sell off. That didn't happen in 2022 as FED rate hikes and rising long term interest rates severely hurt the bond market. The only place to "hide" was in dividend stocks, primarily in the energy and utilities sectors.

Now the good news. We made it through the rate hikes and inflation spike of 2022 and bonds finally pay a decent yield again. We believe the carnage 2022 left behind creates opportunities for investors looking for investment income and long term growth. We now have CDs and money market funds yielding about 4% and investment grade bonds are looking attractive as well. We have not seen yields at this level in over a decade and investors can actually get paid some yield if they want to reduce risk. In addition, the labor market is strong and we expect that to continue.

Quickly reviewing 2022, most stocks and bonds had a decent rally into the end of the year, however almost all the major asset classes we track were down during the year. The S&P500 lost –18.11% while bonds (the Barclay's Aggregate Bond Index) were also down -13.01%. Growth stocks fell the most this year as the NASDAQ lost -33.1%. The Dow and international stocks performed the best during the 4th quarter, but still ended the year down –6.86% and –14.45% respectively. Dividend paying stocks represented by the Dow Jones Dividend Index was the best performing asset class as it squeaked out a small gain for the year.
Here are the returns of the major asset classes in 2022:

Asset Class	Index	4th Qtr	YTD	1yr	3yr*	5yr*
US Large Cap Stocks	S&P500	7.56%	-18.11%	-18.11%	7.65%	9.42%
US Mid Cap Stocks	Russell Midcap	9.18%	-17.32%	-17.32%	5.87%	7.10%
US Small Cap Stocks	Russell 2000	6.23%	-20.44%	-20.44%	3.10%	4.12%
Dow Jones Industrial Avg	DJIA	16.01%	-6.86%	-6.86%	7.31%	8.37%
US Dividend Paying Stocks	DJ Select Dividend	13.77%	2.31%	2.31%	8.88%	8.37%
NASDAQ	NASDAQ	-1.03%	-33.10%	-33.10%	5.26%	8.67%
Int'l Developed Mkt Stocks	MSCI EAFE	17.34%	-14.45%	-14.45%	0.87%	1.54%
Int'l Emerging Mkt Stocks	MSCI EM	9.70%	-20.09%	-20.09%	-2.69%	-1.40%
US Bonds	Bar Aggregate Bond	1.87%	-13.01%	-13.01%	-2.71%	0.02%

YTD = Year to Date *return is annualized

[2]

[1] Source: https://www.cnbc.com/2022/10/18/stocks-and-bonds-both-down-what-to-do-with-your-money.html
[2] Source: Raymond James Client Center Reporting

The most recent inflation data has come in soft for both the US and Euro region. The high CPI readings at the end of 2021 and throughout 2022 have started to subside. The significant rate increases from central banks around the globe have clearly made an impact. This opens the door for central banks, including the Federal Reserve (FED), to consider reducing or pausing further rate increases. This pause may allow economists time to evaluate the effectiveness of the current monetary policy and the expected impact on the economy moving forward.

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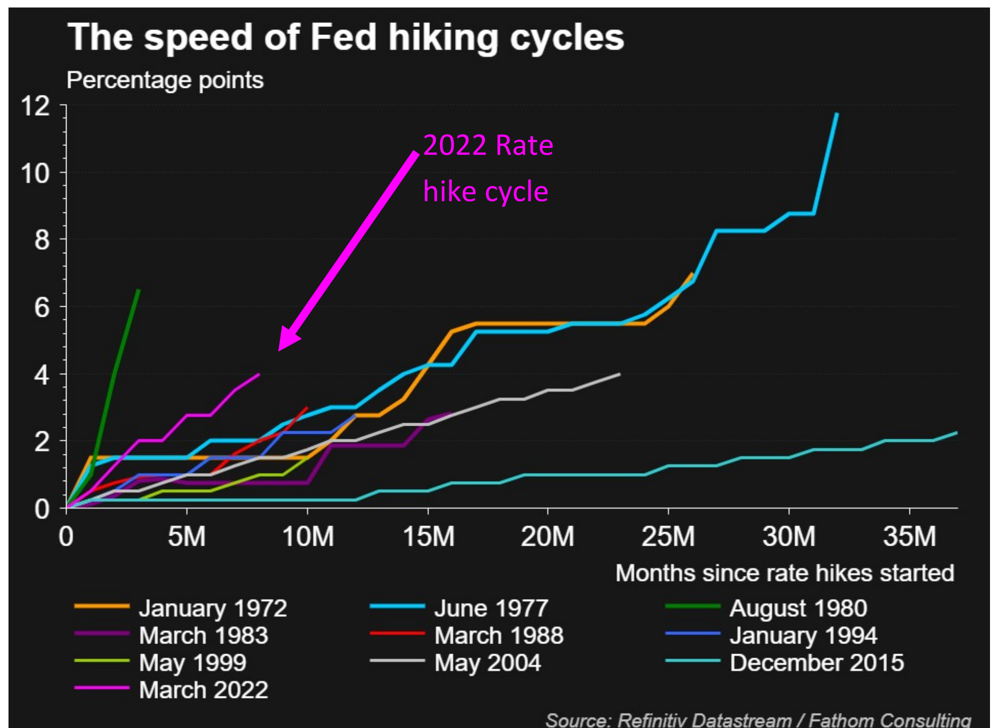
Remember the FED started raising rates in March 2022 and there is typically a lagged impact to the economy. Many economists point out that rate hikes have historically taken 6 to 18 months to fully impact and work through the economy.

The bright pink line in the chart to the right shows just how quickly the FED has moved compared to other historical rate increasing cycles. This inflation fighting effort is already the second fastest rate cycle in history. The market participants are pricing in two more 0.25% interest rate increases in the 1st quarter of 2023.



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[3] Source: Refinitiv Datastream, Global macro charts
[4] Source: Refinitiv Datastream, Global macro charts

Although US CPI has started to fall, we think the Fed will maintain its tough stance due to the possibility of second-round inflation effects. The FED is focused on avoiding a 1970s style inflation cycle that required multiple rounds of rate hikes in order to control rampant inflation. We think the FED maintains a high policy rate throughout 2023. They will not "take its foot off the brake" too soon and risk inflation re-accelerating in late 2023 or 2024.

We believe this aggressive monetary policy stance, high inflation, high inventories relative to new orders, and an inverted yield curve sets the stage for slower economic growth, earnings and margin contraction, and an increased probability of recession this year. Corporate earnings held up reasonably well in 2022, but the expectation for 2023 is less encouraging. Despite this being the most well-tracked and expected recession on record, we think equity investors are overestimating the prospect of a Fed pivot, and are failing to fully grasp the impact that the coming recession will have on corporate earnings.

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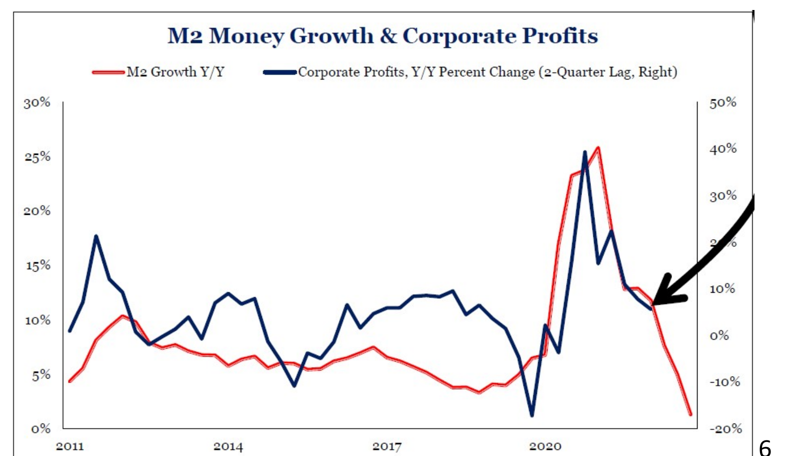
As you can see in the chart above, the market generally follows the path of earnings. If S&P 500 earnings fall in 2023, we would expect the market to follow. Some expect earnings to fall towards $200/sh. In addition, there is a high correlation between M2 money supply growth and corporate profits in the US. Considering the M2 money supply has been shrinking significantly over the last year, we expect this to have a negative impact on earnings as well.



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[5] Source: John Hancock Investment Management, "1Q23 Outlook-Market Intelligence" p. 8
[6] Source: Strategas, "Investment Strategy Viewpoint—1/13/23" p. 3

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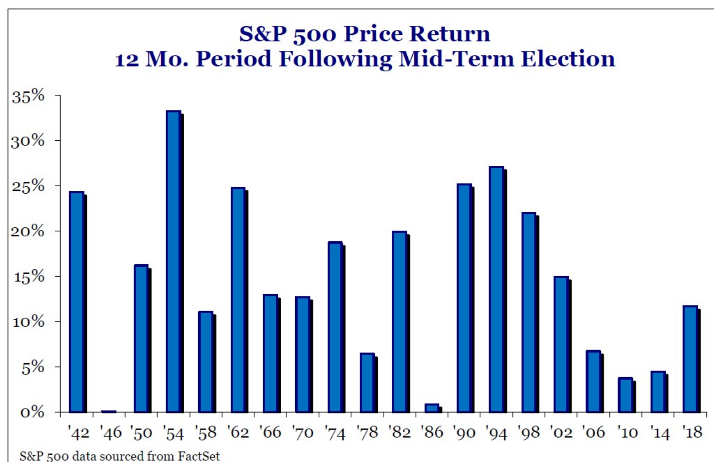
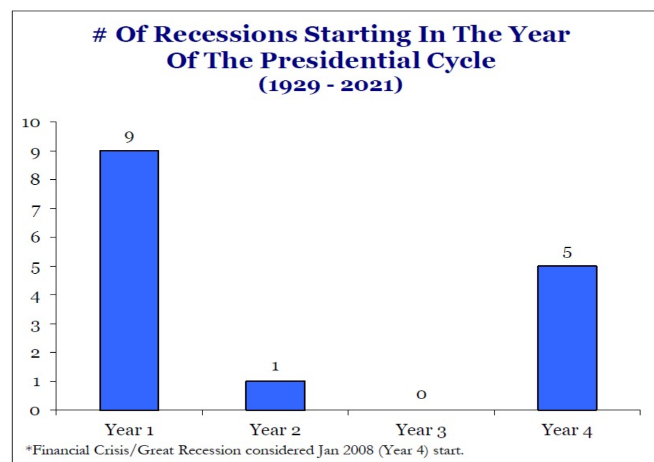
In this current environment, we think it is prudent to maintain a neutral to underweight position in the equity portion of most portfolios. Even though there are headwinds to stocks, we want to stay aware of the reasons stocks can move to the upside. Many times stocks rally following an extended period of poor performance just because prices are lower. Investors will eventually jump back in the market to buy stocks they like for the long term as they perceive them to be cheap. In fact, since 1928, the S&P500 was up 70% of the time following a down year. [7]

This year, the calendar and history appear to be friendly to equity investors as several long standing trends suggest a positive return for stocks. Both the election cycle and market history suggest we should be more constructive on stock returns this year. Since1940, every 12-month period following a mid-term election has been positive. Also, since 1929 there has never been a recession that started in the 3rd year of a Presidential term and that year has been positive 83% of the time with an average return of 13.5%. Biden is currently in his third year of his Presidential term.





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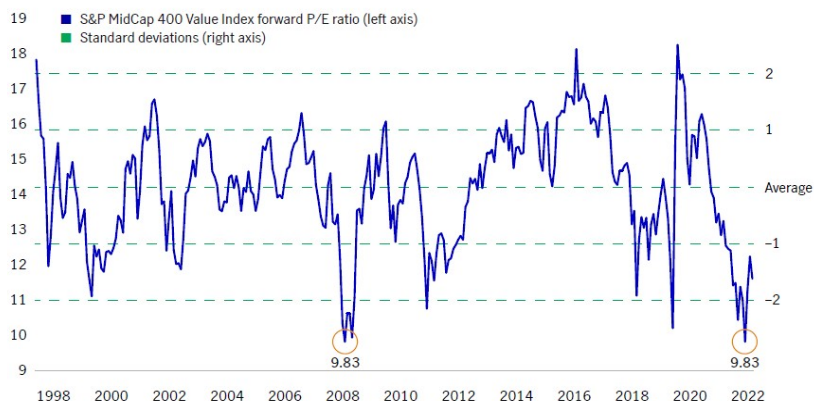
That said, there are still opportunities to consider in both the equity and fixed income markets. We continue to like dividend paying stocks and would expand that to include dividend growers as well. These companies usually have the characteristics we believe are crucial to pay and grow the dividend, such as sound balance sheets, positive free cash flow, and a manageable amount of debt.

We also think small and midcap stocks are particularly cheap in today's market. If you look specifically at midcap value stocks, they recently reached the cheapest valuation since 2008. That doesn't mean that they are risk free, but it does give us some comfort knowing we can invest in quality companies at a favorable valuation.



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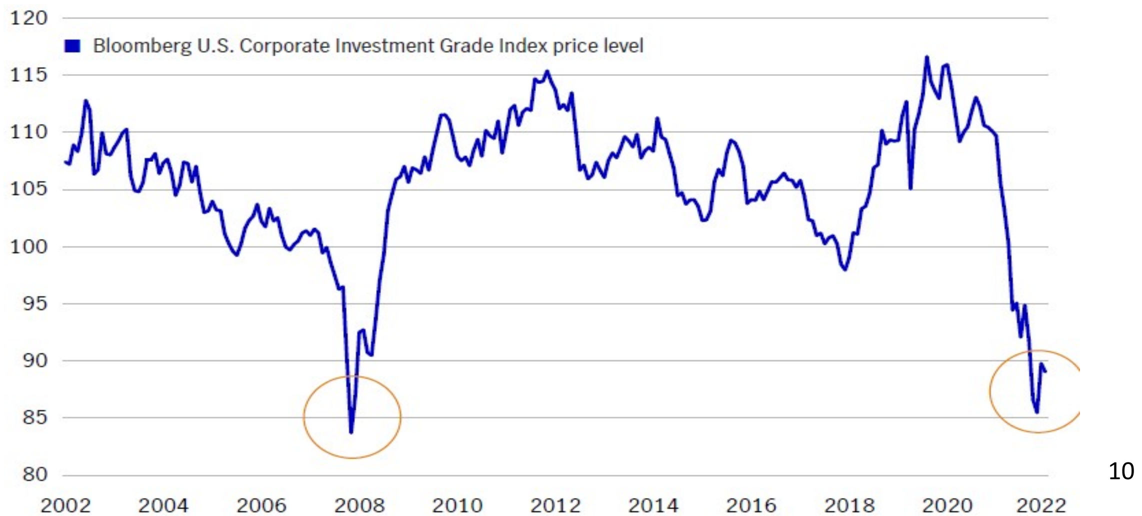
[7] Source: MFS, "Beyond the News, 1/10/23" p. 1
[8] Source: Strategas, "Quarterly Review in Charts, 1/3/23" p. 50
[9] Source: John Hancock Investment Management, "1Q23 Outlook-Market Intelligence" p. 10

When we consider best ways to position portfolios going forward, we continue to like bonds. We like short duration corporate and high yield bonds and find investment grade corporates and municipals particularly attractive. In fact, investment grade corporate bonds have not been this attractive in well over a decade. The chart below shows the average price of an investment grade corporate bond today.



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Much like the last few quarters, we continue to like absolute return focused strategies, long-short funds, market neutral funds, and other alternative investments. We think the market will trade in a relatively tight range over the course of the year and that leads us to be more tactical with the stock allocation. We expect to be slightly underweight to stocks but will increase our allocation if the market pulls back sufficiently to make purchases at favorable valuations. We are content increasing our allocation to bonds in the short term while we wait for the economy to heal from the inflation problems and the market to give us better entry point for stocks.

Thank you for the trust you place in our team. Please reach out to us with any questions.

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Steve Quach
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[10] Source: John Hancock Investment Management, "1Q23 Outlook-Market Intelligence" p. 21

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