ECONOMIC & INVESTMENT PERSPECTIVES

DECEMBER: WEAK END TO A WEAK YEAR
2022 REVIEW

Figure 1: 12/31/2022 Returns (source: Bloomberg)
Conditional formatting: green (high) to red (low) for each time period

Bonds	ETF	Month	QTR	1YR	vs. 52-wk High	vs. 52-wk Low
US Aggregate Fixed Income	AGG	-0.9%	1.6%	-13.0%	-15.2%	4.1%
Investment Grade Corp Bonds	LQD	-1.6%	4.2%	-17.9%	-20.7%	7.1%
U.S. Treasury Bonds	GOVT	-0.7%	0.6%	-13.4%	-14.8%	2.7%
U.S. 20+ YR Treasuries	TLT	-2.6%	-1.9%	-31.2%	-33.2%	8.4%
Muni Bonds	MUB	-0.3%	3.7%	-7.3%	-9.3%	4.1%
High Yield	HYG	-1.8%	5.0%	-11.0%	-15.5%	4.6%
Non-US Corp Bonds	IBND	0.2%	10.8%	-19.4%	-20.0%	14.6%
Emerging Markets Bond LC	EMLC	0.9%	8.4%	-10.5%	-17.0%	8.3%
Global Equity						
ACWI Global Equity	ACWI	-4.6%	9.9%	-18.4%	-20.5%	12.1%
United States	VTI	-5.8%	7.1%	-19.5%	-21.7%	9.4%
International Developed	EFA	-1.8%	17.7%	-14.4%	-18.0%	20.2%
Emerging Markets	EEM	-2.6%	10.3%	-20.6%	-25.5%	13.2%
Global Equity by Region						
United States	VTI	-5.8%	7.1%	-19.5%	-21.7%	9.4%
Europe	IEUR	-1.5%	21.0%	-15.9%	-19.7%	23.2%
Asia ex-Japan	AAXJ	-1.7%	12.0%	-20.4%	-24.3%	19.1%
China	MCHI	2.5%	13.3%	-22.8%	-27.9%	35.6%
Japan	BBJP	-2.2%	11.6%	-17.3%	-20.2%	12.6%
Latin America	ILF	-5.4%	4.3%	10.0%	-26.7%	10.3%
US Equity						
US S&P 500	IVV	-5.7%	7.6%	-18.2%	-20.3%	9.9%
NASDAQ 100 QQQ	QQQ	-9.0%	-0.1%	-32.6%	-34.0%	4.7%
US Large Growth	IWF	-7.7%	2.1%	-29.3%	-30.8%	6.0%
US Large Value	IWD	-4.0%	12.2%	-7.7%	-11.5%	13.1%
US Eqwt S&P 500	RSP	-4.7%	11.4%	-11.6%	-14.3%	13.1%
US Mid Cap	IJH	-5.5%	10.8%	-13.1%	-15.6%	11.3%
US Small Cap	VTWO	-6.4%	6.2%	-20.5%	-23.2%	7.2%

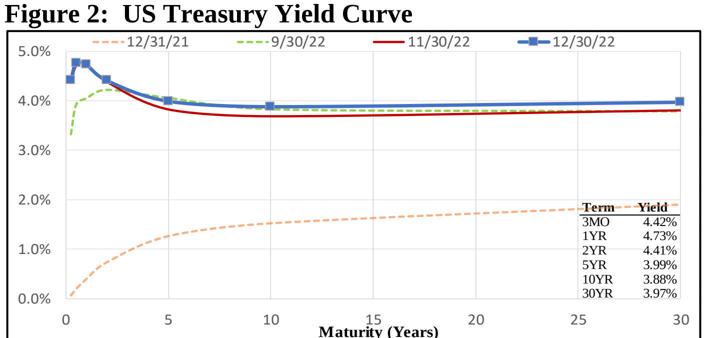
Stocks gave back a portion of their October-November gains in December as pessimism returned regarding the impact that inflation and interest rates will have on the economy and market valuations. Market highlights for December and the fourth quarter (Q4) are summarized below. A review of 2022 is on page two.

- Bonds: US bonds lost value in December as interest rates rose but had positive returns in Q4 as credit spreads narrowed. The US Aggregate index (AGG) fell 0.9% for the month (+1.6% Q4); long-term Treasuries (TLT) lost 1.6% (-1.9% in Q4). Corporate (LQD) and high yield bonds were down for the month, but each gained 4-5% in Q4. Non-US bonds (IBND and EMLC) were up 8-11% in Q4 as the dollar weakened.
- Global equity (ACWI): -4.6% in December (+9.9% in Q4).
- US Equity: The broad market (VTI) fell 5.8% this month (+7.1% Q4). The S&P 500 ETF (IVV) lost 5.7% (+7.6% Q4), while small stocks (VTWO) lost 6.4% (+6.2% Q4). Growth stocks (IWF, QQQ) have under-performed in 2022, as rising interest rates reduce the present value of future earnings. All sectors fell in December, but most logged solid Q4 gains.
- Non-U.S. Equity: Developed markets (EFA) fell 1.8% this month but were up 17.7% in Q4, led higher by European stocks (IEUR +17.7% Q4) as energy prices fell, economic fears eased, and currencies strengthened. Emerging markets (EEM) lost 2.6% in December but were up 10.3% in Q4, largely due to a rebound in China (MCHI +2.5% in December, +13.3% Q4) as their economy began to reopen amid easing Covid restrictions.

Interest Rates and the Economy

The yield curve (Figure 2) plots the yields (Y-axis) for various maturities (X-axis) of US Treasuries. As expected, the Federal Reserve raised the Fed Funds target rate by 0.50% this month (now 4.25-4.50%), indicating that they are nearing the end of this tightening cycle as rates approach 5%. The inverted curve (short-term yields higher than long-term yields) signals that investors believe the economy will weaken and force the Fed to start cutting rates by mid-2023. The 10-year Treasury now yields 3.88%.

Figure 2: US Treasury Yield Curve

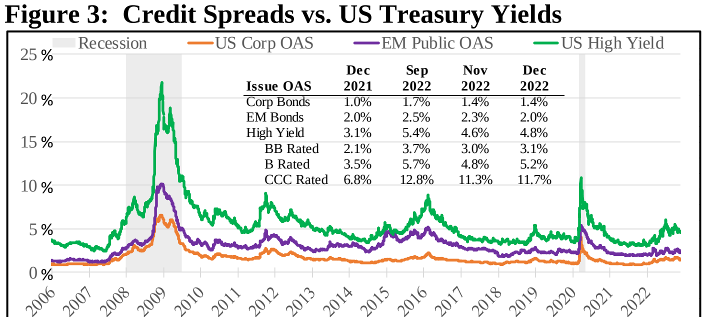


Source: Board of Governers of the Federal Reserve System via St. Louis Fed (FRED)

For bonds other than US Treasuries, we track the option-adjusted spread (OAS) between yields and Treasuries of comparable maturities (Figure 3). Low or narrowing spreads signal optimism, while high or rising spreads signal fear. Spreads widened in the December selloff but narrowed notably over the course of Q4.

- Investment grade corporate bond spreads were stable at +1.4%, down from +1.7% during the quarter.
- High yield (non-investment grade) spreads widened to +4.8%, down from +5.4% last quarter but well above year-ago spreads of +3.1%. The riskiest bonds (rated CCC & below) now yield +11.7% over Treasuries, much wider than +6.8% a year ago.
- Emerging market bond spreads have been much more stable, ending 2022 at +2.0%, unchanged versus a year ago but down over the last month and quarter. Returns on non-US bonds have been strong recently as the US dollar weakened.

Figure 3: Credit Spreads vs. US Treasury Yields



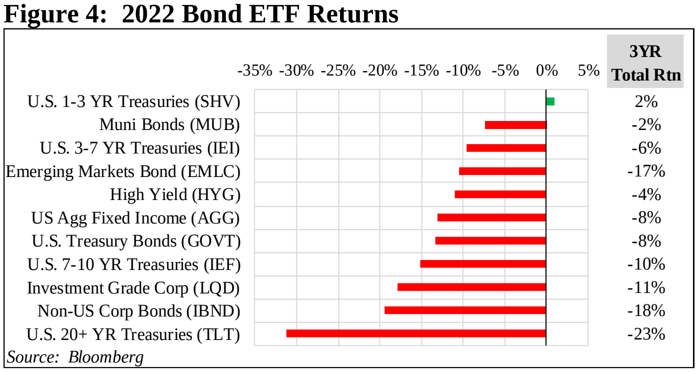
Source: Ice Data Indices, LLC via St. Louis Fed (FRED)

2022 Market Review

The global market recovery from the pandemic era recession was sharp but short-lived. Stocks and bonds posted significantly negative returns in 2022 amid a concerted effort by global central banks to tighten financial conditions by raising interest rates in order to tame decades-high inflation. The next three figures summarize 2022 and "pandemic era" returns across various stock and bond markets and segments, proxied by liquid ETFs. Each figure graphs 2022 total returns (sorted from best to worst); the cumulative return for the past three years is included in a panel inset.

Figure 4 plots the returns of various broad bond market ETFs, illustrating the historically negative fixed income returns as interest rates rose across the board in 2022. Most fixed income instruments lost value, more than offsetting solid 2020-21 returns.

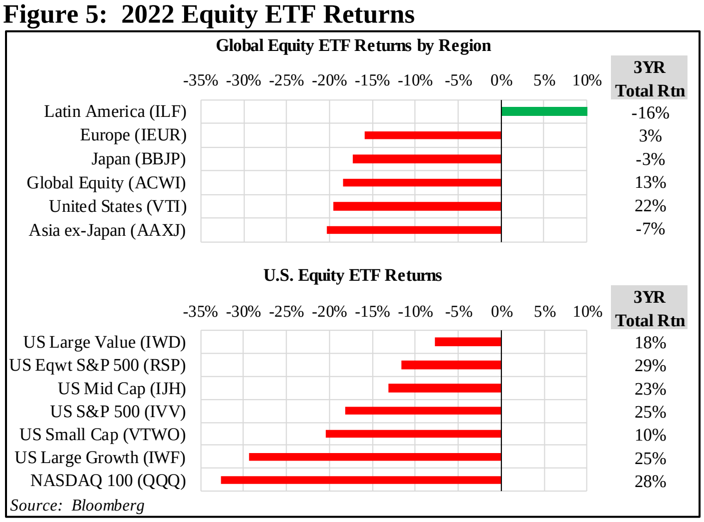
Figure 4: 2022 Bond ETF Returns



Long duration bonds are highly sensitive to interest rate changes, so it is not surprising that long-term Treasuries were hit hardest in 2022 (TLT -31%). By contrast, Treasuries of the shortest maturities (SHV) are minimally impacted by interest rate changes and were up slightly for the year. The strength of the US dollar added insult to injury for global investors as non-US bonds under-performed over the past three years, but emerging market debt actually out-performed in 2022 (EMLC -10% vs. AGG -13%) as their currencies were more stable than in developed markets.

Stock market returns were terrible in 2022 (Figure 5). US equity under-performed (VTI -20% vs. ACWI -18%) but was the strongest region over the past three years (VTI +22% vs. ACWI +13%). Latin American stocks (ILF) were up 10% but are still down 16% since 12/31/2019. Asian equities were led lower this year by weakness in China amid draconian Covid economic lockdowns.

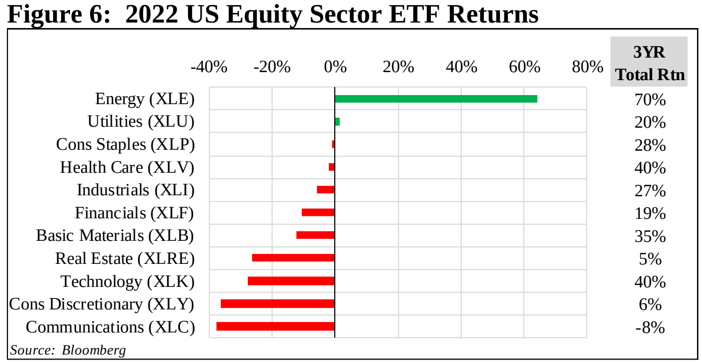
Figure 5: 2022 Equity ETF Returns



US equities were led lower in 2022 by large growth stocks (QQQ and IWF), the very same group that powered US markets higher in 2020-21. Much of the value of growth stocks is driven by future earnings growth, but the present value of those future earnings is diminished as interest rates rise. The NASDAQ 100 (QQQ -33% in 2022), the large growth index (IWF -29%) and the S&P 500 (IVV -20%) are dominated by these stocks, but all three are still up more than 25% since pre-Covid. By contrast, value stocks (more energy and financials, less tech, higher dividends, etc.) fared less badly in 2022 (IWD -8%). Small cap stocks (VTWO) are typically less global, so their 2022 under-performance is a reflection on the weakening domestic economy (VTWO -20%).

Figure 6 plots the performance of US stocks across the eleven economic sectors. Energy stocks (XLE) rose 64% in 2022 as oil and natural gas prices spiked in the wake of Russia's invasion of Ukraine, threatening global energy supply. Defensive sectors (Utilities, Staples and Health Care) held their value in 2022 as investors sought relative safety and stability. The worst performing sectors in 2022 were those that are dominated by the formerly high-flying growth stocks discussed above: Communications (XLC includes Meta/Facebook, Google and Netflix); Consumer Discretionary (XLY is dominated by Amazon and Tesla); and Technology (42% of XLK is in Apple and Microsoft).

Figure 6: 2022 US Equity Sector ETF Returns



Bottom Line

Investors were spoiled with extraordinary returns in 2020 and 2021, fueled by near-zero interest rates and unprecedented money supply growth as global central banks sought to avoid an economic meltdown in the wake of the pandemic. Markets emphatically reversed course in 2022 as those tailwinds became headwinds. The Fed and its global counterparts aggressively tightened financial conditions in 2022 (raising interest rates, withdrawing liquidity) to combat elevated inflation, wreaking havoc on stocks and bonds alike. Though the Fed appears to be nearing the end of this tightening cycle, inflation and tight monetary policy in the US and abroad has taken a toll on economic growth. Key economic and investment themes for 2023 include:

- Recession: Lower production and employment
- Monetary Policy Reversal: The Fed will likely be forced to cut rates as the economy weakens and/or enters recession.
- China Re-opening: Covid lockdowns appear to be easing; pent up demand could strengthen consumption and output, but export growth may be limited by weakness in western economies.

A diversified, lower risk portfolio (global stocks and bonds, cash and alternatives) remains appropriate for the near future, but 2023 may offer opportunities to increase exposures to riskier assets (credit, equity, emerging markets) if and when the Fed pivots.

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