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Market Review and Outlook 4Q22

Highlights

Despite posting a positive fourth-quarter return, the S&P 500 Index reported a -18.1% loss for 2022—its worst annual return since the great financial crisis in 2008.

A durable rally in equity prices seems unlikely until inflation is brought back under control and global central banks pivot toward a pause in the rate-hiking cycle.

With inflation still well above the Federal Reserve's 2% target, additional rate increases are expected into at least mid-2023.

It appears increasingly less likely that the Federal Reserve will be able to tame economic expansion just enough to curtail inflation without triggering a recession.

But a severe economic downturn does not appear to be imminent. There are still supportive underlying fundamentals that could keep the economy afloat.

The broader equity indices could remain mired in a 10% positive/negative trading range over the near term, but a select number of individual stocks with solid fundamentals still offer attractive return potential.

The fixed income market has been roiled by negative returns the past two years, but with yields now hovering at much higher levels and the pace of future interest rate hikes likely to slow, the outlook for bonds is more compelling that it has been for quite some time.

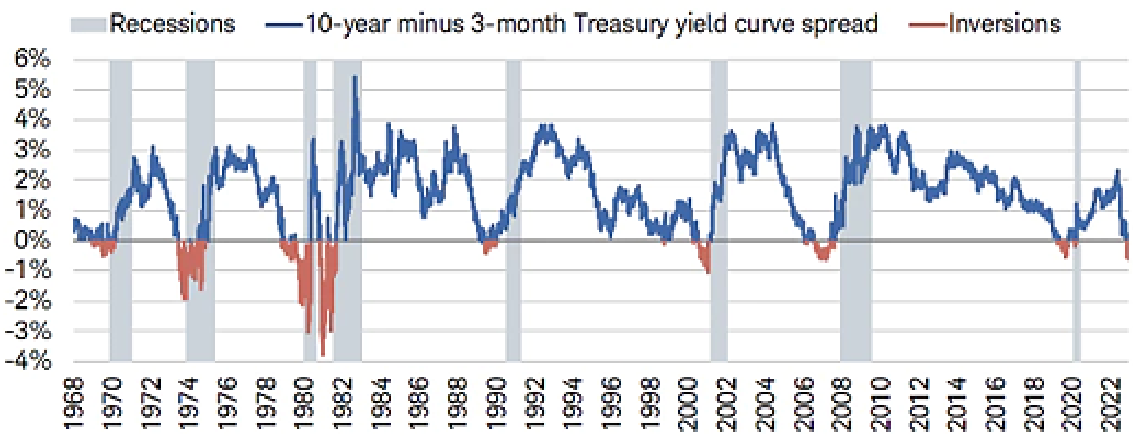
Market Review and Outlook

Global equities reversed their downward spiral during the fourth quarter of 2022, as signs of receding inflation pressure and decelerating interest rate increases spurred a rally in stocks off their September/October lows. The three major global indices each reported healthy gains for the fourth quarter, but were only able to partially offset the substantial losses incurred throughout the first three quarters of 2022—resulting in their worst annual declines since the global financial crisis in 2008. Domestic stocks finished the year appreciably lower, with the S&P 500 Index posting a negative total return of -18.1% for 2022. International markets also suffered double-digit annual declines, with developed markets (EAFE) reporting a -14.5% loss for the year and emerging markets (EM) tumbling -20.1% during 2022.

Investors can take some solace in the positive momentum that stocks displayed in the final quarter of an otherwise tumultuous year. Whether or not that momentum can be sustained remains uncertain, however, with most of the fourth-quarter gains coming early in the quarter—before starting to fade in December. A durable rally in equity prices seems unlikely until inflation is brought back under control and global central banks pivot toward a pause in the rate-hiking cycle. Inflation has slowed in recent months, with the latest Consumer Price Index reading of 7.1% declining sharply from June's 9.1% peak, but it remains well above the Federal Reserve's 2% inflation target. Thus, while the Fed moderated its pace of interest rate hikes to 0.5% in December (versus 0.75% in each of its prior four policy meetings), additional rate increases are still expected into at least mid-2023.

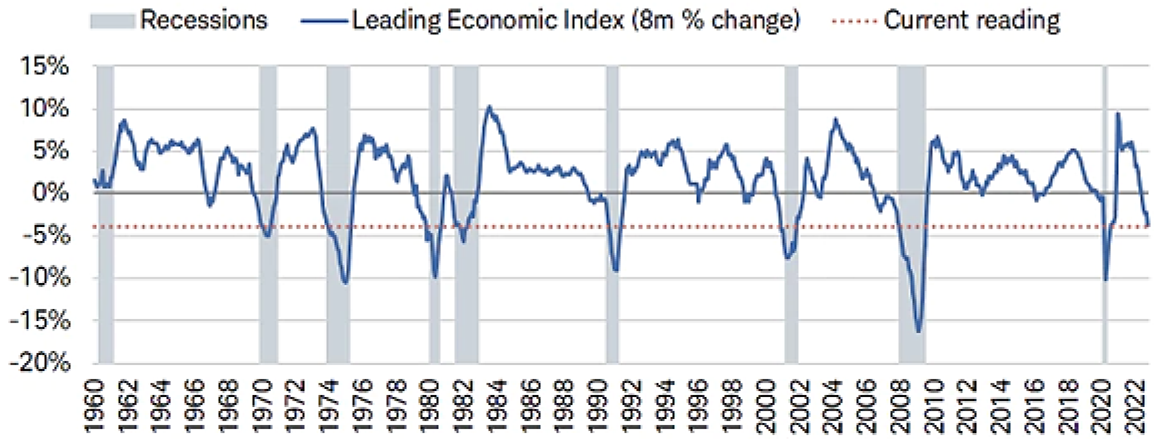
With the prospect of a still active Fed over the next several months and the likelihood that interest rates will need to be held "higher for longer" to ensure inflation pressures abate, the threat of a looming recession continues to escalate. Closely watched economic indicators that have signaled previous downturns—such as the inversion of the yield curve and changes in The Conference Board Leading Economic Index® (LEI)—suggest the economy is now headed toward recession.

Yield curve spread
(1968 - 2022)



Source: Charles Schwab, Bloomberg

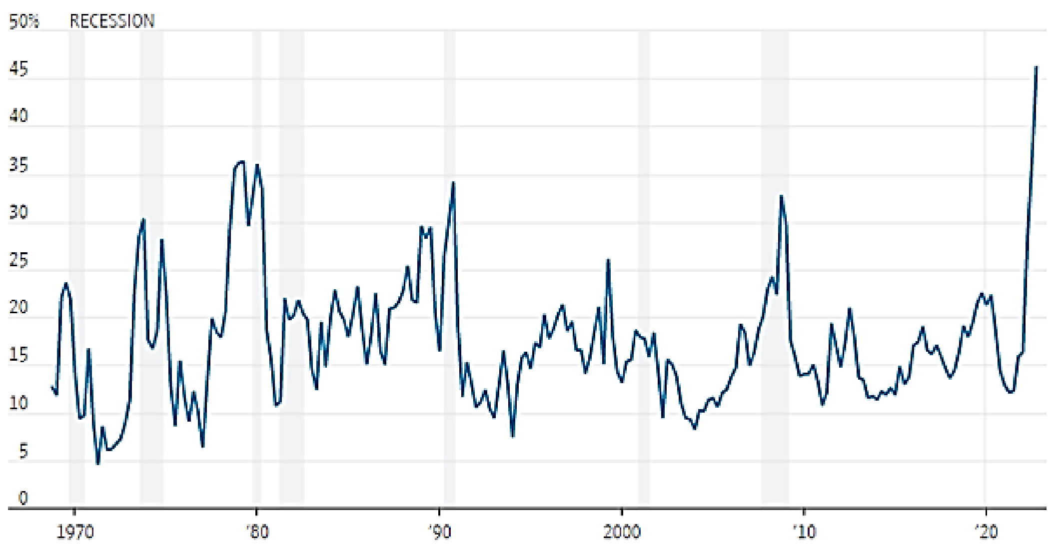
Change in leading economic indicators
(1960 - 2022)



Source: Charles Schwab, Bloomberg, The Conference Board

Due in large part to those negative tilting indicators, economists believe there is a 63% chance of recession in the next year (according to an October Wall Street Journal poll) and a Federal Reserve Bank of Philadelphia survey of economists/investors puts the probability of shrinking GDP over the next four quarters at the highest on record.

Average probability of shrinking GDP four quarters ahead
(1968 - 2022)



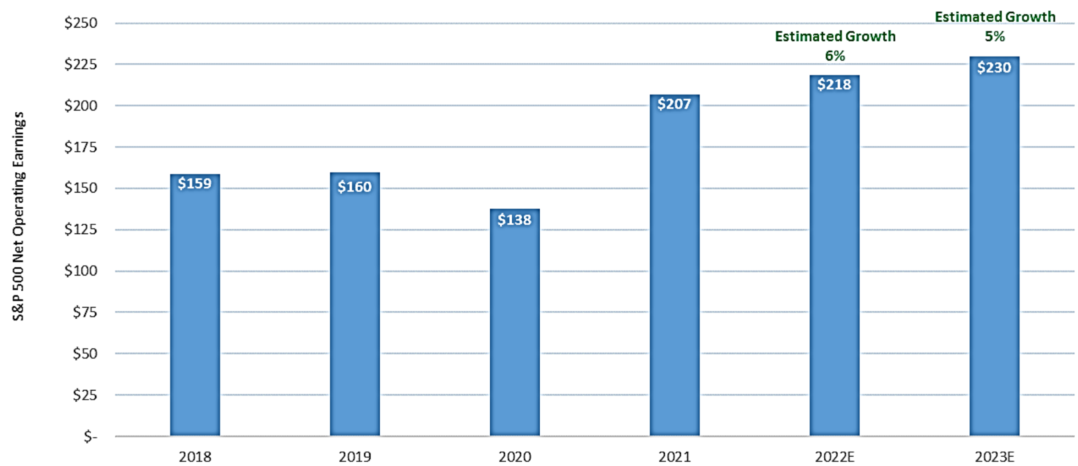
Source: Federal Reserve Bank of Philadelphia

That doesn't mean an economic downturn is imminent. Economists in general have a mediocre record of accurately predicting recessions ahead of time. Moreover, there are still supportive underlying fundamentals that could keep the economy afloat. The labor market continues to create new jobs and unemployment (3.7%) remains extremely low; oil/gasoline prices are back in line with year-ago levels; consumer spending is still healthy; and the service sector (more than two thirds of the U.S. economy) continues its sustained recovery from the pandemic as spending on goods has shifted towards services/experiences. Nonetheless, it appears increasingly less likely to most observers that the Federal Reserve will be able to tame economic expansion just enough to curtail inflation without triggering a recession.

Curiously, a tougher economic environment does not appear to be appropriately reflected in corporate earnings estimates. While 2023 consensus EPS estimates for the S&P 500 Index have been cut by 8% in recent quarters (from a peak of $250 in June to $230 currently), earnings are still projected to grow 5% over 2022.

Actual and projected corporate earnings

(2018–2023 Est.)



Source: FactSet

During the past six recessions, corporate earnings fell by an average of 27%. Profits could be more resilient during this downturn, as an inflationary backdrop provides more pricing/revenue support than typically seen during other economic slowdowns. That said, the inflation-driven recessions of both 1973-1974 and 1982-1983 still saw S&P 500 profits fall 15% and 14%, respectively. So it seems unrealistic to assume earnings will actually grow 5% in 2023 if the economy is indeed headed for recession.

Given the steep market selloff in 2022, equity valuations are certainly more reasonable than they were a year ago. The S&P 500 Index ended the year trading at forward P/E of 16.7x, down from 21.5x at the start of 2022 and in line with the 25-year average of 16.8x. Stocks could continue to periodically enjoy risk-on rallies during 2023, but limited upside for P/E multiple expansion in a higher interest rate environment and a prospective reduction in earnings expectations amid a slowing economy suggests a subdued near-term return outlook for equities overall. It could take until late 2023 or 2024, when inflation/monetary policy is no longer a headwind and GDP growth reaccelerates back to the 2-4% range, for the next bull market to begin.

As a result, we think the broader equity indices could remain mired in a 10% positive/negative trading range from current levels over the near term (with additional downside risk if central banks make a policy mistake and push up interest rates too high for too long). That said, we believe the return outlook for a few sub-segments of the market and an a number of individual stocks with solid fundamentals (i.e., strong profit margins, low volatility, high free-cash flow) still offer attractive return potential. We plan to maintain a healthy allocation to equities by targeting those select opportunities.

The sizable losses investors sustained during 2022 were painful, but those losses should be (more than) fully recouped in the next bull market—consistent with every prior full-market cycle. Just as downturns often catch the markets off guard, recoveries are often just as swift and difficult to predict. Thus, staying invested in the market through temporary pockets of turbulence in order to fully participate in the rebound on the other side has historically proven to be the most practical and profitable strategy for long-term investors.

Core Portfolio

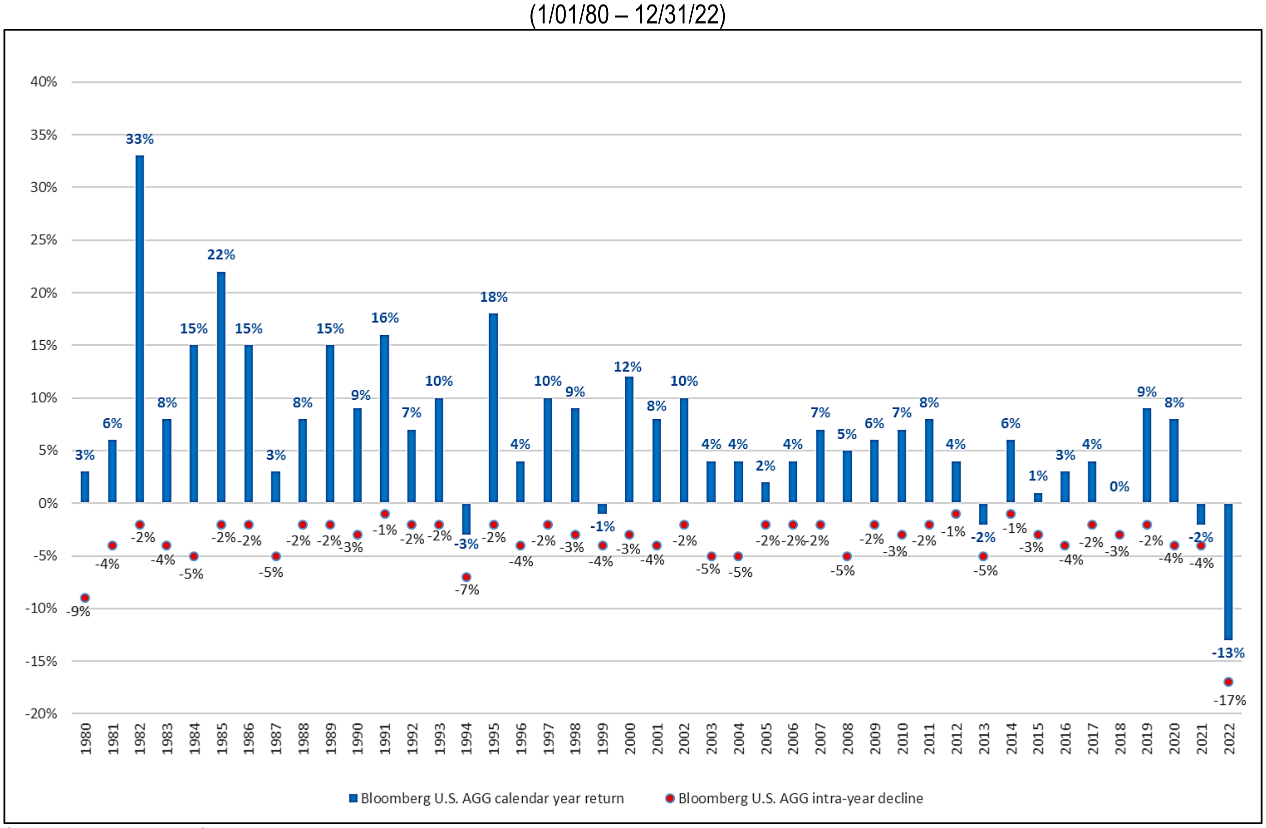
The fourth quarter was quiet from a transaction perspective, as we neither added nor completely exited any existing portfolio positions. We did, however, spend some time realizing capital losses in taxable accounts to offset gains taken early in the year. Despite the potential near-term headwinds a possible Fed-induced recession may produce, our existing investments maintain several attributes that we believe justify holding over the intermediate and long term. In general, our positions remain undervalued relative to their future earnings prospects; they have seasoned management teams with a demonstrated history of overcoming challenging economic times; they are growing market share in their key businesses; and/or they are pursuing shareholder friendly capital allocations (including buying back stock and/or reducing debt levels). Absent a deep and/or prolonged recession (not our base case scenario), we expect an eventual rally in these profitably run companies as the market appropriately reassesses the relative value of high-quality businesses.

Fixed Income

For the first time in over 60 years, the fixed income market posted its second year in a row of negative returns during 2022. Bond prices were roiled by a major inflection in interest rates, as the 10-year Treasury yield spiked 273 basis points from 1.52% at the start of the year to a peak of 4.25% in late October. Indications that inflation pressures had peaked and that future rate hikes would decelerate ultimately pushed yields back down to 3.88% by year end, but the fixed income benchmark Bloomberg U.S. Aggregate Index still closed the year with a loss of -13%—the worst annual (and intra-year) decline in more than 40 years.

Bloomberg U.S. Aggregate intra-year declines vs. calendar year returns

(1/01/80 – 12/31/22)



Source: Bloomberg, FactSet, J.P Morgan Asset Management

Returns based on total return. Intra-year drop refers to largest market drop from a peak to trough during the year.

On average, the 10-year Treasury yield peaks one to two months prior to the last rate hike of the tightening cycle. Given that the Fed Funds rate (currently 4.25%-4.50%) has always been higher than the Consumer Price Index (currently 7.1%) at the end of prior tightening cycles, at least a couple more rate hikes are expected (even if inflation continues to decelerate). Thus, the 10-year yield could continue to move higher over the short term—putting additional downward pressure on bond prices.

Nonetheless, we are currently more constructive on the fixed income asset class than we have been for quite some time. At the start of 2022, yields were much lower so the coupon payment that bonds provided wasn't large enough to offset the substantial decline in bond prices as interest rates spiked. With yields now hovering at much higher levels, however, and the pace of interest-rate hikes likely to slow (before pausing/reversing) as inflation pressure moderates, the risk-adjusted return outlook for bonds is much more appealing. We would be surprised if U.S. bonds failed to deliver positive returns for an unprecedented third consecutive year in 2023.

Final Thoughts

After the first calendar year on record where both the S&P 500 Index and the U.S. Aggregate Bond Index posted double-digit declines, and the worst year for a 60% equity/40% fixed income portfolio since 1937, we're happy to have closed the books on 2022. While 2023 could remain challenging given a number of outstanding uncertainties (anemic/negative economic growth, overreaching Fed policy, continued geopolitical risks), we believe the worst of the market turmoil is likely behind us. At some point in the coming quarters, the Fed will pause (and potentially reverse) interest rate hikes and the markets could prospectively start to price in a better economic backdrop for 2024. Thus, we are cautiously optimistic the market climate will feel a lot better by this time next year. In the interim, investors may have to continue to patiently weather elevated bouts of volatility.

While unpleasant, bear markets are an essential phase of the investing cycle as they help balance the market by clearing excesses/speculation and creating new investment opportunities. While recognizing this fact does little to quell the anxiety felt during punishing downturns, it's reassuring to know that markets have always delivered rewarding long-term returns on the other side. This time should be no different.

As always, we appreciate your continued trust and confidence. Please reach out to us if you have questions or concerns.

All the best in 2023!

Parkside Investments, LLC

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