Q4 2022: Look Back at a Tough Year

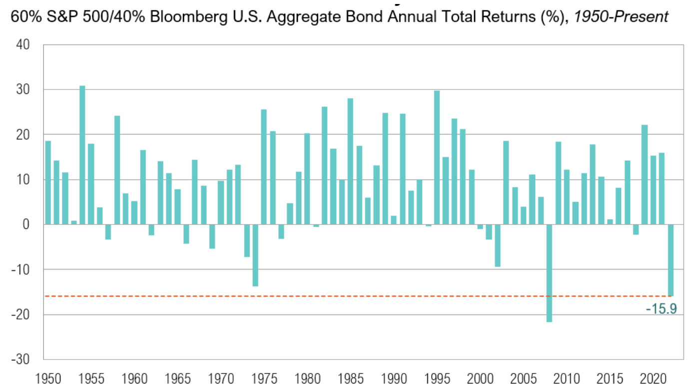
By Peak Trust Company's Chief Investment Officer, Lisa Russell, CFA. February | 2023

HIGHLIGHTS

- As inflation showed signs of slowing in the fourth quarter, both stocks and bonds recovered some of their losses from previous quarters, and most assets ended the quarter with positive returns.
- Despite a relatively good final quarter, 2022 was one of the worst years in history for markets: stocks and bonds shed more than $30 trillion globally, and 60/40 portfolio returns were their worst since the Global Financial Crisis in 2008.
- Although inflation has started to subside, so has economic activity; whichever slows faster will likely determine the severity of a recession, if one occurs.
- The interplay between policymakers and their decisions on fiscal and monetary liquidity has the potential to heavily influence inflation, economic activity, and market performance in 2023.

Overview

2022 Was One of the Worst Years in History for the 60/40 Portfolio



Source: Bloomberg

This past year was certainly one to remember, characterized by a four-decade-high inflation rate, rapidly tightening monetary policy, and geopolitical uncertainty. As the Federal Reserve's efforts to curb inflation showed signs of success in the fourth quarter, both stocks and bonds managed to recover some of their losses from previous quarters. U.S. large-cap stocks ended the quarter up 7.6%, and bonds ended up 1.9%. Nevertheless, overall, it was one of the worst years for markets since 2008, with stocks and bonds shedding more than $30 trillion globally. The S&P 500 ended the year down 18.1%, and the Bloomberg U.S. Aggregate Bond Index ended the year down 13%—its worst year since its inception in 1976. A traditional 60% stock and 40% bond portfolio had its second-worst year since 1950, losing 15.9%, or 17.2% including a global allocation. This is a rare phenomenon, as bonds normally cushion extreme downside in equities. Historically, inflation has been a rare phenomenon, which was the main cause of the bond rout. Based on normal risk-return relationships since the advent of modern bond-market data in the 1970s, the typical 60/40 portfolio's extreme losses last year had a probability of occurring only once every 130 years, according to T. Rowe Price Group, Inc.

Inflation and the Fed

Inflation, the intense focus of 2022, has seemingly peaked. After hitting a high of 9.1% in June 2022, it ended the year with a December reading of 6.5%. A slowing but still-too-high inflation ushers in the next phase of this cycle and poses a key question for investors: Will tighter monetary policy dampen the economy so much that it enters a recession, or not? The answer will depend on the relative speed of the decline of growth relative to inflation. Should inflation decrease more quickly than economic activity, the U.S. could experience a soft landing (i.e., no recession), which would be positive for risky assets. If, however, economic growth slows faster than inflation, then a recession ensues. As it stands, a recession may be the most likely outcome, unfortunately. The Treasury yield curve, as measured by the 2-year minus the 10-year Treasury yield, has been inverted since July. This inversion has correctly anticipated the past half dozen recessions, going back to the early 1980s. Even the Fed's staff noted in the November Federal Open Market Committee (FOMC) meeting that "the possibility that the economy would enter a recession sometime over the next year as almost as likely as the baseline".

The interplay between monetary and fiscal policy will be another key factor in 2023, and it could significantly complicate the Fed's efforts to further rein in inflation. Both monetary and fiscal policymakers are focused on what's best for consumers, but this could lead to counteracting policies. For its part, the Federal Reserve is tightening monetary policy through interest rate hikes and shrinking its balance sheet to remove liquidity from the financial system. The goal is to weaken the labor market and bridle demand to get inflation back to its 2% mandate.

> *"I would like to underscore for the American people that we understand the hardship that high inflation is causing and that we are strongly committed to bringing inflation back down to our 2 percent goal."*
>
> – Jerome Powell, Chairman of the Federal Open Market Committee (December 14th, 2022, FOMC Press Conference)

However, politicians will likely be compelled to add fiscal stimulus (i.e., liquidity) to the economy and pressure the Fed to ease interest rate hikes if consumers' financial situation continues to erode and a recession ensues.

> *"For working Americans who already feel the crush of inflation, job losses will make it much worse. We can't risk the livelihoods of millions of Americans who can't afford it. I ask that you don't forget your responsibility to promote maximum employment and that the decisions you make at the next FOMC meeting reflect your commitment to the dual mandate."*
>
> – Sherrod Brown, Chairman U.S. Senate Committee on Banking, Housing & Urban Affairs (October 25th, 2022, Open Letter to Jerome Powell)

Because the U.S. labor market staged a remarkable recovery from its pandemic downturn and remained robust throughout last year, the Fed's tightening strategy still has work to do. Throughout 2022, unemployment levels remained near all-time lows, ending 2022 at 3.7%. Given the tight labor market, nominal wages remain elevated, growing at a pace well above sustainable levels and contributing to elevated inflation. As the Fed continues to try and clamp down on demand, the unemployment rate should start to rise.

Despite a tough backdrop for real (inflation-adjusted) wages, consumers continued spending throughout 2022. The personal savings rate is currently 2.4%—its lowest level since 2005. In addition, total consumer credit increased to a record $4.7 trillion. Should economic activity slow further, the labor market start to dive, and consumer finances worsen, politicians will likely look to pump more cash into consumers via fiscal support, just as they have in the past three recessions. Such measures would counteract the Fed's efforts to reduce demand.

Historically, the U.S. government has responded to recessions by providing stimulus predominantly in the form of tax cuts and stimulus checks. Should the federal government continue to spend money to rescue the consumer and the economy in 2023, it will be doing so from a substantially weakened financial position, which makes any decision a very delicate one.

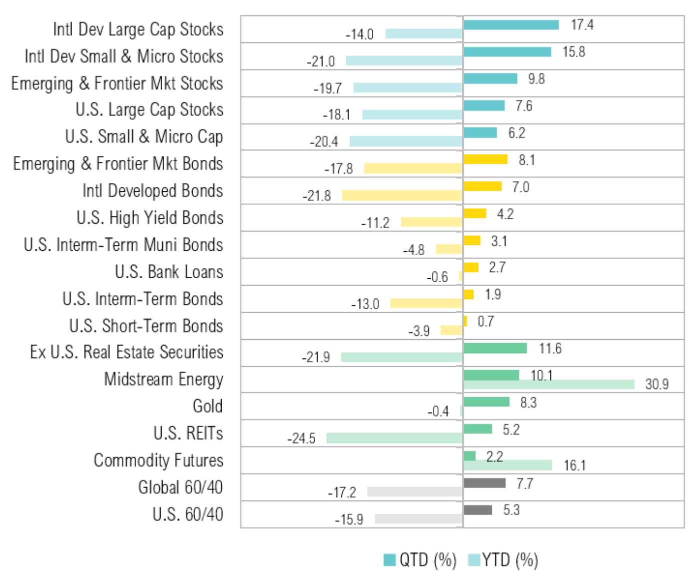
Fiscal Spending and the Debt Ceiling

There is a recent precedent for concern around excessive fiscal spending. Complicating fiscal spending decisions in 2023 is the fact that the debt ceiling (or debt limit) was hit in November at $31.4 trillion. The debt ceiling is the total amount of money that the U.S. government is authorized to borrow to be able to meet its existing legal obligations, such as Social Security, Medicare, military salaries, interest payments on the national debt, and tax refunds. When the debt ceiling is raised, it allows the government to borrow more to cover the gap between spending and taxes already approved by Congress. Since 1960, Congress has raised the debt ceiling 78 times—49 times under Republican presidents and 29 times under Democratic presidents. On December 23, Congress passed a nearly $1.7 trillion spending bill to fund the federal government through September 2023, yet failed to address this key issue. While the political negotiations and ultimate resolution in previous debt ceiling increases never were considered material risks, the current situation has the potential to lead to market volatility.

Markets

Asset classes rebounded in the last quarter of 2022. International developed market large-cap stocks were the top performers over the quarter, ending up 17.4%. The Russell 1000 Value Index significantly outperformed the Russell 1000 Growth Index, returning 12.4% and 2.2% over the fourth quarter, respectively. This is similar to what we saw last year and in the previous quarters this year. The S&P 500 ended the quarter up 7.6%. In a year in which only three asset classes ended with positive returns, the top performer was Energy, which generated a one-year return of 30.9%. The worst-performing asset class of 2022 was U.S. REITs, ending the year down 24.5%.

Q3 2022 Key Market Total Returns



Source: Bloomberg

Both U.S. and international fixed income ended the fourth quarter with positive returns. Despite international developed market bonds being one of the best fixed-income performers in the last quarter of 2022, they were the worst performer for the year, ending down 21.8%. Across the board, it was a tough year overall for fixed income. The best-returning asset classes for the year were midstream energy and commodity futures, ending 2022 up 30.9% and 16.1%, respectively.

Looking Forward

All is not grim, however; we can see the light at the end of the tunnel. Unlike last year, when we were decidedly negative on almost all risk assets except for commodities, opportunities are starting to emerge. While we still need to tread lightly, back-to-back negative years for fixed-income assets rarely happen. Inflation would most likely need to start increasing again for this to occur. Short-term government bonds are earning between 4% and 5% returns last experienced 15 years ago. Longer duration bonds should do well if we enter a recession as rates should decline. Equities have had back-to-back negative years more often than fixed income, but this situation is still relatively rare. Certain asset classes, such as international and emerging market equities that have had headwinds because of the strong dollar for the last decade may have an opportunity to outperform with a falling dollar and much lower valuations than in the U.S. While the path of all commodities is much harder to predict, gold is seemingly breaking out with the falling dollar as well.

From our perspective, the interplay between fiscal policymakers, the Federal Reserve, and market participants will determine the trajectory for markets in 2023. With an inverted Treasury yield curve strongly suggesting a U.S. economic recession, policy decisions become even more critical to determining the magnitude and duration of the economic slowdown and how markets respond to it.

We are not out of the woods yet, as incoming economic data and the policy developments they help shape are fluid and highly uncertain. It is fruitless to try and predict what will happen in the short term. After all, 14 of the top economists last year predicted that the S&P 500 would end 2023 with 4400 on the low end and 5330 at the high end. The S&P 500 closed at 3839. While we wait for clarity on these topics, we can opportunistically look to take advantage of dislocations in asset classes. Was the last quarter just another bear market rally like we saw all last year, or will it be the start of a new bull market? It is still too early to determine, yet balancing elevated levels of portfolio liquidity with a diversified portfolio of assets that emphasizes quality and cash flow as much as possible, we believe, is prudent.

About Lisa

Lisa Russell started with Peak Trust Company in 2003 and currently serves as Chief Investment Officer. Lisa brings over 25 years of investment experience to the Peak team. She specializes in designing unique investment programs for high-net-worth clients and trust accounts. She is highly attuned to the tax consequences of investment actions.

Lisa holds a Master of Business Administration in Finance from Emory University and a Bachelor of Science in Business Administration from the University of Southern California. Lisa holds the designation of Chartered Financial Analyst (CFA), and is a member of the CFA Institute and the CFA Society of Seattle.

LISA RUSSELL, CFA
Chief Investment Officer

IMPORTANT INFORMATION

PURPOSE OF THIS MATERIAL

ABOUT PEAK TRUST COMPANY

"Peak Trust Company" is the brand for a group of affiliated federally and state chartered professional trust companies headquartered in Anchorage, Alaska. Peak Trust Company maintains separate state charters for operations in Alaska and Nevada as Peak Trust Company-AK and Peak Trust Company-NV. Peak Trust Company has established a federally chartered, non-depository trust company, "Peak Trust Company, NA", headquartered in Anchorage, with a branch office in Wilmington, Delaware. More information about Peak Trust Company, including our services, investment strategies, fees and objectives, are available upon request by calling (888) 544-6775, or visiting www.PeakTrust.com.

Talk to a Trust Expert

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