CAUBLE & HARRE
WEALTH MANAGEMENT

Fourth Quarter 2022 Market Commentary

2022 could qualify for the record books for the wrong reasons. It was a difficult year for the stock and bond markets. Global stocks fell 18% and bonds fell 13%. Within stocks, value outperformed growth by a wide margin: -8% to -29%. Returns listed here are VT (Vanguard Total World Stock ETF), AGG (iShares Core US Aggregate Bond ETF), IWD (iShares Russell 1000 Value ETF) and IWF (iShares Russell 1000 Growth ETF).

The first half of the year was the worst half, with consistent declines throughout. Over the last six months, global stocks have actually increased 1%. Interest rates continued to rise during the second half of the year resulting in another 4% of losses for bonds. Value continued to outperform growth, with value increasing almost 5% during the last six months vs. growth's decline of 2%.

A Tale of Two Phases: Phase 1

There are I believe two phases of changes that markets are working through, the first of which might be largely complete, but will still be present as we enter 2023. That phase is one where global central banks make borrowed money actually have a cost for borrowers for the first time in over a decade. We have written about this before, but it represents a sea change for many global investors and speculators. Investments and strategies that made sense with free money suddenly do not make sense anymore. We see the impact in things like cryptocurrencies declining significantly and also technology companies with formerly sky-high valuations falling 60% to 90% from their highs. It can take time for higher interest costs to work through complex and interconnected global systems but work through they will and the impacts will be felt.

Digital currencies were in the news a lot last year, and there were announcements that the Federal Reserve is exploring the implementation of a US Central Bank Digital Currency. What is a central bank digital currency? The briefest explanation I can come up with is the following: Visualize a past or present political figure that you least like or trust. Then imagine giving that person your username and password to your bank and investment accounts. That, in my opinion, is a central bank digital currency.

The decline in market valuations (expressed as Price Earnings multiples) that stems from money becoming more expensive is more permanent in nature. Equity markets are close to their levels from June 2022, and as we wrote then, back also to their 25-year average valuation. While additional events may occur related to phase 1 and extending its impact, Phase 2 is more likely to make its impact known during 2023.

Phase 2, Recession?

Perhaps the good news is that almost everyone is expecting a recession in 2023. When most market participants believe that something will happen, it usually does not, or at least happen as they expected. Perhaps this means that a recession will not be as severe as feared. It is instructive to review, though, what happens in a recession. Corporate earnings fall and markets fall in the beginning when the timing for the 'bottom' or worst of news is uncertain. Markets will then begin to recover, before the economy does, as it anticipates the recovery in earnings.

In January of 2022, consensus estimates for S&P500 earnings was about $210 per share. By June, the estimate had increased to $230 per share. Since then, it has declined to $203 per share, below a year ago. While sales per share for the S&P500 companies have been increasing (thanks to inflation), profitability has been declining. From September 2021 to September 2022, sales per share increased 13%, but profitability fell 14%. Higher labor costs and input costs were the culprit. These trends may continue. It is the strength in the labor market that the Federal Reserve in intent on changing. This may result in them keeping interest rates higher than expected even if inflation begins to come down. The recent decline in earnings expectations may indeed be the beginning of recessionary events.

What is the good news? As we wrote last quarter, higher yields on bonds make them more attractive. For stocks, recessions usually bring selling from those that were ahead of their skis, so to speak, and then from investors that get scared. I believe we have seen a lot of the selling from the former already in 2022. Perhaps we will get less selling from those 'scared' investors as the current version of recession begins, and market volatility will be less that what we have already experienced.

Last year, 2022, could be described as a year when the stock market performed much worse than the economy. I think that 2023 could be one where the stock market performs better than the economy. But that does not mean that the trend will begin in January or February.

As always, we are happy to discuss any specifics with you.

Regards,

Peter B. Harre, CFA