Asset Strategy Consultants

MARKET REVIEW

Fourth Quarter 2022

We are pleased to present *Market Review*, featuring a discussion of the Capital Markets during the Fourth Quarter 2022 and a summary of historical performance for the major asset style passive indices for the period ending December 31, 2022. We hope you find the information useful and helpful in your investment considerations.

We welcome your comments.

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ASSET STRATEGY CONSULTANTS

Founded in 1991, Asset Strategy Consultants provides investment consulting services to institutional clients representing $6.6 billion under advisement. Asset Strategy Consultants is headquartered in Baltimore, with a consulting office in Harrisburg, PA.

Amidst the Wreckage, Silver Linings Are Visible

THE MACROECONOMIC ENVIRONMENT

Markets sank in 2022 as the Fed embarked on an aggressive path of rate hikes to combat unexpectedly high and persistent inflation. Global stock and bond markets posted double-digit losses for the year, with U.S. bonds posting record-breaking calendar year losses and several U.S. stock indices falling the most since 2008.

And we would be remiss not to mention the crypto crash, which shrank the value of these digital assets from a high of $3 trillion in November 2021 to roughly $800 billion at year-end, according to data from CoinMarketCap. Commodities were a lone bright spot, buoyed by soaring energy prices in the first half of the year and metals later in the year.

The fourth quarter provided a welcome rebound across many markets, spurred by signs that inflation was moderating. The MSCI ACWI Index rose nearly 10% for the quarter, with gains broad-based across countries. Global bond markets were mixed; the Bloomberg Global Aggregate Bond Index gained 4.6% (unhedged), largely due to U.S. dollar depreciation, with the hedged version up only 1.0%. The U.S. dollar lost some of its gusto in 4Q, retreating from its 20-year high and bolstering returns for unhedged investments overseas. The greenback lost nearly 8% vs. a basket of developed market currencies (DXY).

Inflation, while still high, has shown signs of moderating. The labor market remains resilient despite aggressive rate hikes.

As we enter 2023, uncertainty remains around the degree to which the Fed can navigate a “soft landing” while combatting inflation. Outside of the U.S., a war that shows no signs of ending and China’s path forward as it moves away from its “zero-COVID” policies pose challenges. However, there are a few notable silver linings and reasons for optimism that we choose to highlight to start the new year. Most importantly, valuations in both stock and bond markets have improved. Inflation, while still high, has shown signs of moderating. The labor market remains resilient despite aggressive rate hikes. And China’s reopening, albeit rocky, may lead to an economic rebound and contribute to global growth in 2023.

Given the sharp sell-off in stocks, valuations are more reasonable. The forward P/E ratio for the S&P 500 Index was 16.65x as of year-end vs. a 16.82x average over the past 25 years, according to data from JP Morgan. For fixed income investors and savers, the sharp rise in interest rates provides immediate benefits in the form of higher income and muchimproved forward-looking returns. Callan's 10-year projection for core U.S. fixed income returns more than doubled from the end of 2021, from 1.75% to 4.25%.

Headline CPI was 7.1% (ex food and energy: +6.0%) in November, off its June peak of 9.1%; the Personal Consumption Expenditures (PCE) Index rose 5.5% (Core PCE: +4.7%). These year-over-year (YOY) figures remain well above the Federal Reserve's long-run inflation rate objective of 2%, but most components of the CPI registered smaller gains or even price declines in the most recent reading. Energy and core goods (especially used car prices) fell in November while food prices (at and away from home) and shelter costs continued to rise. The average price of unleaded gas declined from a June high of $5.00/gallon to about $3.20/gallon at year-end, according to AAA. The lagged impact of higher rates, a moderation in supply chain-related price increases, and falling home prices suggest that inflation has peaked. On the flip side, higher wages and a tight labor market, uncertainty around energy prices, and increased demand from China (especially for commodities) pose a threat to inflation's downward trajectory.

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The Federal Reserve raised its target range for the Fed Funds rate by 50 bps to 4.25% - 4.50% at its December meeting, the highest since 2007. The 2022 cumulative rate hike totaled 425 bps. The Fed has been explicit in its intent to aggressively fight inflation and is willing to see the economy slow and unemployment rise to bring it down. The median Fed Funds rate projection from the Fed for year-end 2023 is now 5.1%, up 50 bps from the September projections. The median expectation for 2023 unemployment also rose a bit to 4.6% (from 4.4%) while the projection for real GDP growth fell sharply to 0.5% from 1.2%. A mid-December Bloomberg survey of 38 economists revealed that 70% think that there will be a recession next year with growth averaging only 0.3% for the year. Notably, markets and the Fed both expect inflation to fall over longer periods; the "longer-run" median projection from the Fed for the Core PCE Index is 2.0% and the five-year breakeven inflation rate (the difference between nominal and real five-year Treasury yields) was 2.3% as of year-end. Real GDP in 3Q22 was +3.2% (annualized), up from the -0.6% rate in 2Q. The Conference Board forecast calls for 0% real growth in 2023, recovering to 1.7% in 2024.

The labor market remained strong despite well-publicized layoffs across the tech industry. Unemployment held steady at 3.7% and payroll growth, while moderating in 4Q, remained robust. Just over 260,000 jobs (non-farm payrolls) were added in November, above expectations, and while down from higher figures earlier in the year it is well above the pre-pandemic average of 150,000–200,000. Further, the ratio of job openings to job seekers remained elevated. The Job Openings and Labor Turnover Survey (JOLTS) for November showed that open positions outnumbered available workers by a ratio of 1.7 to 1, down only slightly from October, and higher than expected. Continued labor shortages, however, do pose a risk as higher wages filter through to inflation. Average hourly earnings for nonfarm payrolls were up 5.1% in November YOY.

While rents continued to rise, rising mortgage rates impacted home sales. Data from Freddie Mac show that 30-year mortgage rates dipped slightly from 7.1% in November to 6.4% at year-end, but they are markedly higher than one year ago (3.1%). According to the National Association of Realtors, existing home sales dropped nearly 8% in November (35% YOY), with all regions reporting both monthly and yearly declines. Affordability remains low, due both to relatively high home prices and higher mortgage rates. The median house price, which hit a record high of $413,800 in June, fell to $370,700 in November but remained above the $358,200 price tag one year ago.

The battle to bring inflation down is not limited to the United States. Shortly after the Federal Reserve's 50 bp rate hike in mid-December, the European Central Bank (ECB), the Bank of England, and the Swiss National Bank followed suit with 50 bp rate increases of their own. As in the U.S., policymakers recognize that slower economic growth will likely be an outcome; the ECB lowered its forecast for growth for 2023 to 0.5%, down from a previous forecast of 0.9%. Economists in the U.K. expect the country to face one of the worst recessions among the G7 countries, and Kristalina Georgieva, International Monetary Fund director, recently warned that half of the European Union may experience a recession next year.

Japan surprised markets in December with an unexpected change to its monetary policy around yield curve management. The Bank of Japan (BOJ) raised the band for the 10-year bond yield to fluctuate 50 bps around 0%, more than the previous 25 bps band. Following the announcement, the bond yield rose sharply, briefly touching 0.46%, and the yen strengthened 3% vs. the U.S. dollar. While not specifically a tightening move, it was unexpected and perceived by the markets to be a first step. Core (ex-food) inflation in November exceeded the Bank's 2% policy target and hit a 40-year high of 3.7%. The yen lost almost 13% vs. the U.S. dollar in 2022 and has been a contributor to inflation.

While many countries are facing the prospects of a recession in 2023, China could be poised for a recovery. The country is opening its borders to foreigners on Jan. 8, 2023, after being closed for more than 1,000 days. Though China is currently facing a surge in COVID cases, the lifting of its zero-COVID policy has important economic ramifications for the rest of the world. While GDP growth was likely well below the official target (+5.5%) in 2022, this policy shift is expected to boost consumer spending and economic growth, which in turn should help global growth as demand for commodities, global goods, and services rises. China uses a large portion of the world's oil and various metals, and the downside to China's recovery is that escalating demand from the country could further inflationary pressures around the globe. ■

GLOBAL EQUITIES

U.S. stock indices posted positive returns in 4Q as investor sentiment improved, but the YTD results remained dismal with most indices posting double-digit declines. The S&P 500 Index rose 7.6% for the quarter, lowering its YTD loss to 18.1%. Returns were quite mixed across sectors with Energy (+22.8%) being the best and Consumer Discretionary (-10.2%) faring the worst. Value stocks trounced growth for the quarter (Russell 1000 Value: +12.4%; Russell 1000 Growth: +2.2%) and the year (Russell 1000 Value: -7.5%; Russell 1000 Growth: -29.1%). In 4Q, the Growth Index was hurt by relative underweights in Health Care, Financials, and Energy as well as significant underperformance from Tesla (-54%) and Amazon (-26%). Looking back three years, growth is only modestly ahead of value (Russell 1000 Value: +6.0%; Russell 1000 Growth: +7.8%). Small cap stocks exhibited the same pattern in 4Q (Russell 2000 Value: +8.4%; Russell 2000 Growth: +4.1%) but value's full year margin is smaller in the small cap space (Russell 2000 Value: -14.5%; Russell 2000 Growth: -26.4%).

Global ex-U.S. markets also participated in the 4Q rally, and currency appreciation vs. the U.S. dollar further bolstered returns. The MSCI ACWI ex USA Index gained 14.3% (Local: +7.8%), reducing its YTD loss to 16.0% (Local: -9.6%). Across developed market countries, gains were broad-based and value outpaced growth, but by a smaller margin than in the U.S. (MSCI ACWI ex USA Value: +15.7%; MSCI ACWI ex USA Growth: +12.9%). Unlike in the U.S., all sectors of the ACWI ex USA Index delivered a positive return in 4Q of 10% or more.

Emerging markets (MSCI Emerging Markets: +9.7%; Local: +6.6%) also rebounded in 4Q, but returns were mixed across countries. While many countries were up double-digits, India (+2.0%) and Brazil (+2.4%) weighed on broad market returns. China (MSCI China: +13.5%) outperformed. Quarterly returns were also mixed across regions: Latin America (+5.7%), Emerging Europe (+43.1%), and Emerging Asia (+10.8%). The 2022 return for the MSCI EM Index was -20.1%. ■

GLOBAL FIXED INCOME

U.S. fixed income experienced its worst year—ever—in 2022, by a wide margin. The Bloomberg US Aggregate Bond Index sank 13.0%; the next worst calendar year was 1994 when the Aggregate fell 2.9%. The silver lining lies in the 4.68% yield-to-worst for the Index, up from 1.75% at the beginning of the year. The yield curve remained inverted at year-end; the 10-year Treasury yield was 3.88% and the 2-year yield was 4.41%. The inversion reflects investor expectations for the economy to slow and an eventual need for the Fed to lower rates. The fourth quarter brought some relief to bond investors as longer rates fell modestly and most "spread" sectors outperformed Treasuries. The Aggregate gained 1.9%. High yield corporates (Bloomberg High Yield Index: +4.2%) were star performers, but this Index was down 11.2% for the year.

The Bloomberg Municipal Bond Index rose 4.1% in 4Q, dampening the year's loss to 8.5%, the worst return in 20 years but ahead of most other fixed income sectors. The ratio of AAA municipal yields to the 10-year U.S. Treasury fell to 68%, below its 10-year average (88%). Outflows from municipal bond mutual funds were $122 billion in 2022, a record.

While rates across developed markets rose broadly in 2022, changes were mixed in 4Q. Rates fell in the U.K. but rose across most of Europe and in Japan. The Bloomberg Global Aggregate ex USD soared 6.8% (hedged: +0.2%) due largely to weakness in the U.S. dollar. Still, the YTD differential for hedged and unhedged investors is nearly 9% (unhedged: -18.7%; hedged: -9.8%). Emerging markets also had a good quarter with the JPM EMBI Global Diversified up 8.1% and the local currency JPM GBI-EM Global Diversified up 8.5%. For the year, the indices were down 17.8% and 11.7%, respectively. ■

REAL ASSETS

Real assets as a group performed well in 4Q. The S&P GSCI Index rose 3.4%; Gold (S&P Gold Spot Price Index: +9.2%), REITs (MSCI US REIT: +5.2%), infrastructure (DJB Global Infrastructure: +9.6%), and TIPS (Bloomberg TIPS: +2.0%) all posted solid returns. Full year results remained poor, however, for most real assets outside of those related to energy. REITs posted the worst returns (MSCI US REIT: -24.5%) while MLPs (Alerian MLP Index: +30.9%) benefited from higher energy prices. ■

CLOSING THOUGHTS

Stock and bond markets sank in 2022 as interest rates rose sharply. The ability of central banks to raise rates sufficiently to harness inflation without causing recessions remains a key question for investors. The unending war in Ukraine and its toll on human life and global economies continues to weigh heavily. While COVID worries have faded (outside of China), they have not disappeared. That said, as we enter 2023 there are reasons for optimism alongside acknowledgement that risks and uncertainty persist. With this in mind, we continue to recommend a disciplined investment process that includes a well-defined long-term asset-allocation policy. We wish everyone a healthy and happy new year! ■

Source: Asset Strategy Consultants and Callan Associates

PRELIMINARY RETURNS FOR VARIOUS PERIODS: 4Q22

		October	November	December	Last Quarter	Year to Date	Last Year	Last 3 Years	Last 5 Years	Last 10 Years	Last 15 Years
	1 Russell:3000 Index	8.20	5.22	(5.86)	7.18	(19.21)	(19.21)	7.07	8.79	12.13	8.66
	2 Russell:1000 Index	8.02	5.41	(5.81)	7.24	(19.13)	(19.13)	7.35	9.13	12.37	8.77
	3 Russell:1000 Growth	5.84	4.56	(7.66)	2.20	(29.14)	(29.14)	7.79	10.96	14.10	10.32
	4 Russell:1000 Value	10.25	6.25	(4.03)	12.42	(7.54)	(7.54)	5.96	6.67	10.29	6.96
	5 Russell:Midcap Index	8.88	6.01	(5.40)	9.18	(17.32)	(17.32)	5.88	7.10	10.96	8.44
	6 Russell:Midcap Growth	7.86	5.44	(6.00)	6.90	(26.72)	(26.72)	3.85	7.64	11.41	8.61
	7 Russell:Midcap Value	9.45	6.32	(5.08)	10.45	(12.03)	(12.03)	5.82	5.72	10.11	7.96
	8 Russell:2500 Index	9.59	4.22	(5.95)	7.43	(18.37)	(18.37)	5.00	5.89	10.03	8.10
	9 Russell:2500 Growth	8.13	2.98	(5.95)	4.72	(26.21)	(26.21)	2.88	5.97	10.62	8.39
EQUITY	10 Russell:2500 Value	10.56	5.02	(5.94)	9.21	(13.08)	(13.08)	5.22	4.75	8.93	7.45
	11 Russell:2000 Index	11.01	2.34	(6.49)	6.23	(20.44)	(20.44)	3.10	4.13	9.01	7.16
	12 Russell:2000 Growth	9.49	1.63	(6.42)	4.13	(26.36)	(26.36)	0.65	3.51	9.20	7.26
	13 Russell:2000 Value	12.59	3.06	(6.56)	8.42	(14.48)	(14.48)	4.70	4.13	8.48	6.81
	14 S&P:500	8.10	5.59	(5.76)	7.56	(18.11)	(18.11)	7.66	9.42	12.56	8.81
	15 S&P:400 Mid Cap	10.52	6.12	(5.54)	10.78	(13.06)	(13.06)	7.23	6.71	10.78	8.87
	16 S&P:600 Small Cap	12.37	4.17	(6.71)	9.19	(16.10)	(16.10)	5.80	5.88	10.82	8.89
	17 MSCI:ACWI ex US	2.99	11.80	(0.75)	14.28	(16.00)	(16.00)	0.07	0.88	3.80	1.52
	18 MSCI:EAFE	5.38	11.26	0.08	17.34	(14.45)	(14.45)	0.87	1.54	4.67	1.81
	19 MSCI:EM	(3.10)	14.83	(1.41)	9.70	(20.09)	(20.09)	(2.69)	(1.39)	1.44	0.65
	20 MSCI:ACWI	6.03	7.76	(3.94)	9.76	(18.36)	(18.36)	4.00	5.23	7.98	4.84
	21 Blmbg:Aggregate	(1.30)	3.68	(0.45)	1.87	(13.01)	(13.01)	(2.71)	0.02	1.06	2.66
	22 Blmbg:Gov/Credit	(1.24)	3.57	(0.48)	1.80	(13.58)	(13.58)	(2.57)	0.21	1.16	2.77
	23 Blmbg:Credit	(1.03)	4.97	(0.43)	3.44	(15.26)	(15.26)	(2.86)	0.42	1.82	3.73
	24 Blmbg:Corporate High Yld	2.60	2.17	(0.62)	4.17	(11.19)	(11.19)	0.05	2.31	4.03	6.09
	25 Blmbg:Municipal Bond	(0.83)	4.68	0.29	4.10	(8.53)	(8.53)	(0.77)	1.25	2.13	3.38
FIXED INCOME	26 Blmbg:US TIPS	1.24	1.83	(1.02)	2.04	(11.85)	(11.85)	1.21	2.11	1.12	3.05
	27 Blmbg:Glob Agg ex USD	(0.14)	5.58	1.31	6.81	(18.70)	(18.70)	(5.94)	(3.07)	(1.64)	0.54
	28 S&P:LSTA Levg Loan	1.03	1.24	0.44	2.74	(0.60)	(0.60)	2.55	3.31	3.67	4.33
	29 ML:US Treasuries 1-3 Yrs	(0.10)	0.63	0.20	0.74	(3.65)	(3.65)	(0.41)	0.77	0.67	1.22
	30 LIBOR - 3 Month	0.32	0.40	0.41	1.13	2.25	2.25	1.06	1.58	1.07	1.05
	31 3 Month T-Bill	0.16	0.32	0.36	0.84	1.46	1.46	0.72	1.26	0.76	0.68
	32 S&P GSCI	6.70	(1.71)	(1.38)	3.44	25.99	25.99	10.49	6.46	(3.30)	(4.93)
	33 MSCI:US REIT Index	4.87	5.78	(5.14)	5.22	(24.51)	(24.51)	(0.06)	3.69	6.48	6.18
	34 Alerian:MLP Index	14.32	1.06	(4.69)	10.11	30.92	30.92	9.38	4.08	1.99	5.39
	35 DJB:Glbl Infrastructure	4.51	8.31	(3.19)	9.58	(6.62)	(6.62)	1.36	4.31	6.39	5.87
	36 US DOL:CPI All Urban Cons	0.41	(0.10)	(0.31)	0.00	6.45	6.45	4.92	3.78	2.60	2.33

Source: Callan Associates