

Investment Review & Outlook 2022 Year-End Investment Report

Many investors are no doubt glad to see 2022 in the rear-view mirror, and if they do look back, the picture is not pretty. Stocks were buffeted by the Federal Reserve Board's aggressive rate hikes (the fastest since the 1980s stagflation era) and the reverse of the QE policies which, for a decade or more, flooded the markets with liquidity. It didn't help that there were persistent fears of a recession all through the last 12 months, and a certain level of alarm over the Russia-Ukraine war. 2022 saw the three main stock indexes post their first yearly drop since 2018, and market economists with long memories were comparing this perfect storm of headwinds to the declines triggered by the 2008 financial crisis.

A breakdown shows that just about every U.S. investment asset was showing double-digit declines. Looking at large cap stocks, the widely-quoted S&P 500 Index of large company stocks gained 7.08% during the year's final quarter and overall finished down 19.44% in calendar 2022.

For small cap stocks, the Russell 2000 Small-Cap Index posted a 20.44% loss in the past 12 months. The technology-heavy Nasdaq Composite Index was the biggest loser in 2022, dropping 28.27% of its value over the last 12 months.

The foreign markets were no better. The broad-based EAFE Index of companies in developed foreign economies gained 17.00% in the final quarter of 2022, but still lost 16.79% of its value in dollar terms for the year just ended. Emerging market stocks of less developed countries, as represented by the EAFE EM Index, lost 22.37% in dollar terms in the year.

Real estate securities produced even greater losses, albeit for small portions of most investment portfolios. The Wilshire U.S. REIT Index posted a truly awful 26.81% loss in 2022.

Perhaps the most dramatic market movements in 2022 occurred in the bond markets, where yields on 10-year Treasury bonds rose dramatically over the course of the year, from 0.95% a year ago to 3.87% currently. 30-year government bonds rose from 1.88% yields at this time last year to 3.96%. Five-year municipal bonds were providing, on average, a meager 0.60% yield last January; now the rate is a comparatively robust 2.56%, while 30-year munis are yielding 3.63% on average. Of course, for bond investors, these yield gains represented losses; when rates go up, the lower-yielding bonds that investors had purchased previously lose value proportionately.

The broad market downturn, in stocks and bonds, marks the end of an extraordinary period of investment history, a three-year run that saw many investors at or near doubling their portfolio values. The interesting thing is that, despite the declines, we are not currently in bear market territory--usually defined as a 20% decline.

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What will the future bring? Of course, we don't know, but perhaps we don't know more deeply now, with all the mixed signals swirling around us, than we usually don't know. It's certainly possible that the Fed will achieve that mythical 'soft landing' for the economy in the coming year. Inflation seems to have peaked and is falling faster than many expected—the CPI is up just 0.1% in November, 7.1% year-over-year. The GDP, which measures growth in the economy, recovered in the third quarter; total economic activity in the U.S. expanded a healthy 2.9% for the three months ending September 30, and a survey of economists suggests that growth could reach 1.0% in the fourth quarter. Unemployment is still low, at 3.7%. Low unemployment, wage gains and near 1% gains in personal income are fueling an increase in consumer spending. U.S retail sales posted their strongest gains in eight months this past October.

But... investors may be cautious about feeling too optimistic quite yet, especially with that glimpse into the rear-view mirror. 2022 marks the first year in history when the S&P 500 and 20-year Treasury bonds both experienced double-digit losses; the previous 'record' was 1969, when the S&P 500 lost 8.5% and long Treasuries declined by 5.1%. Global diversification also didn't help, as both the MSCI EAFE and emerging markets experienced double-digit losses.

The problem for the investment markets is that what had been a strong tailwind is now a brisk headwind.

The U.S. Central Bank is engaged in quantitative tightening, shrinking its \$9 trillion balance sheet by roughly \$100 billion a month. As the Fed economists continue to bring inflation down to a 2% annual rate, they are likely to raise the Fed funds rate to at least 5%, which makes short-term bond instruments competitive with stocks and reduces demand in the equities markets.

Meanwhile, the housing market recently experienced the ninth consecutive month of declining sales—almost certainly due to higher mortgage rates. And the Conference Board's October index of leading economic indicators recently declined for the eighth straight month, which may signal an increasing risk of a recession in the coming year. That gloomy prediction is reinforced by the inverted yield curve. The recent spread between three-month and 10-year Treasury bonds has reached -0.77%. When investors buy long-term bonds at lower yields than short-term bonds, it means they're expecting turmoil on the horizon.

When the markets decline as they did this past year, history tells us that they become a buying opportunity; in effect, they go on sale, and become more attractively priced than they were before the downturn. But there is no guarantee that stocks won't become even more attractively priced at some point in the coming year; we just don't know what to expect. What we do know is that in virtually every historical period, stock prices have recovered, usually unexpectedly, and the biggest danger has always been to move to the sidelines at the wrong time and miss out on that next upsurge.

As always, we are here to assist you. Please reach out with any questions or if your financial circumstances change.

The FAM Team