Investment and Economic Update
Fourth Quarter 2022

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.

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 2022. Meanwhile, the Russell Midcap Index finished the 2022 calendar year down 17.32%. The Russell 2000 Small-Cap Index posted a 21.56% loss in the past 12 months. The technology-heavy Nasdaq Composite Index was the biggest loser in 2022, dropping 33.10% 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. In aggregate, European stocks lost 17.28% in 2022, while EAFE's Far East Index was down 17.20%. Emerging market stocks of less developed countries, as represented by the EAFE EM index, lost 22.37% in dollar terms in the year.

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.

What will the future bring? Of course, we don't know. It's certainly possible that the Fed will achieve a 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 tail wind 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 time 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 that next upsurge.

Below, we've summarized some of the widely quoted indexes for your reference. As a reminder the challenge is, the DJIA is not the same as the S&P 500, which is not the same as the NASDAQ – and none of these indexes perfectly match your own distinct mix of assets and their expected returns, especially if you own a globally diversified portfolio with exposure to stocks and bonds, large and small companies, value and growth companies, and U.S. and non-U.S. based companies. The following returns are quarter and year-to-date; respectively:

S&P 500: 7.08%, -19.44%
Dow Jones: 15.39%, -8.78%
NASDAQ Composite: -1.03%, -33.10%
Russell 2000 (Small-Cap): 5.80%, -21.56%
MSCI EAFE (International): 17.00%, -16.79%
Barclay's Capital US Aggregate Bond: 1.56%, -13.01%

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