HIGHTOWER
Westchester

Market Commentary Q4 2022

To say that conventional wisdom was upended in 2022 is an understatement. A year ago, inflation was rising, but the consensus, not to mention the Federal Reserve ("Fed") itself, believed it would be transitory. Since then, the Fed has responded by raising benchmark rates from near zero to nearly 4.5%, and it looks like they will continue hiking. The Fed's hawkish stance created a rollercoaster for investors. The rapid rise in interest rates forced the macro-economic narrative to the forefront, lifting the U.S. Dollar and Treasury yields to decade highs. A widening inversion of the yield curve also raised concerns about a looming recession. Growth stocks came under pressure, especially in the technology, communication, and discretionary sectors. By year-end, the coveted "F.A.A.N.N.G." leadership had lost its shine.

With a dour "street" consensus outlook for 2023, many portfolios have opted to raise cash. During December, we witnessed extreme equity or stock fund outflows that even exceeded March 2020.[1] Money market funds were a frequent recipient of those funds, seeing large inflows.

With an aggressive shift in Fed policy, 2022 also turned out to be a challenging time in the fixed income markets. Most long-term bond indices had double digit declines, the worse performance in over 40 years.[1] In fact, last year was the first year that both equity and bond markets declined double digits since 1981.[1]

After three consecutive years of positive performance, 2022 marked a period of negative performance for all major U.S. equity indices. There was also a significant gap in performance among the major equity indices. The Dow Jones Industrial Average outperformed the NASDAQ Composite Index by over 20% last year, a difference not seen since the dot-com crash of 2000.[1] An investor in a common energy ETF made over 50% in 2022, while a holder of a common semiconductor ETF lost over 30% for the same period.[1] Value investing, which has been largely out of favor since the Great Financial Crisis of 2008, had a strong year. Given the current macroeconomic environment, we believe value and dividend-oriented investments are in a unique position to continue to perform well relative to their growth counterparts as we move into the new year. Dispersion is back and stock selection matters in the current market environment.

Major Indices

	2020	2021	YTD 12/30/2022
DJIA	7.25%	18.76%	-8.78%
SPX	16.26%	26.89%	-19.44%
Nasdaq	43.64%	21.39%	-33.10%
Stoxx Euro 600	-4.04%	22.25%	-12.90%
FTSE 100 Index	-14.34%	14.30%	0.91%
Shanghai Composite Index	13.87%	4.80%	-15.13%
NIKKEI 225 Index	16.01%	4.91%	-9.37%
Gold	24.85%	-3.41%	0.08%
Oil	-20.54%	55.01%	6.71%
Bitcoin	303.95%	59.92%	-64.21%

Source – FactSet[1] – 01/04/2023

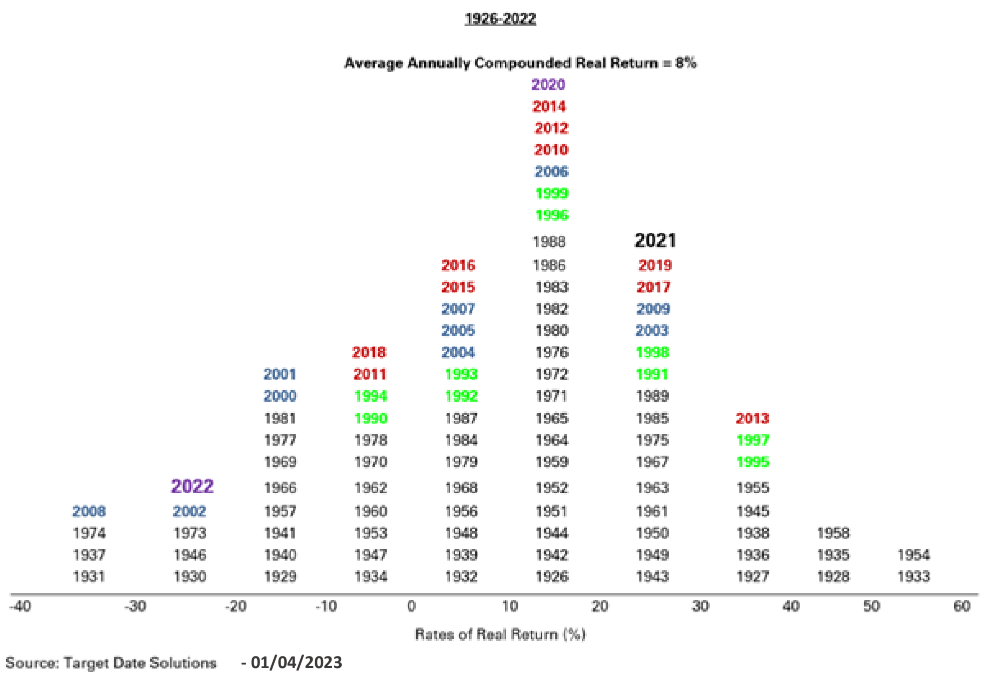
I think it needs to be recognized that there are legitimate reasons for the capital markets volatility we've endured this year. We are finally paying the piper for many years of reckless monetary and fiscal policy, the likes of which have no historical precedent. The Fed suppressed short-term interest rates to near zero for years and bought trillions of dollars in bonds to minimize the economic pain associated with several "Black Swan" events (dot-com bubble, 9/11, the Global Financial Crisis, and COVID-19) that occurred in short succession since the turn of the millennium.

Simultaneous with the Fed's monetary largesse, the federal government elected to support the economy through tax cuts, spending increases, and COVID-related support payments that have ballooned the ratio of federal debt to GDP to levels not seen since WWII. These actions have consequences, which we all knew were coming. The only question was when.

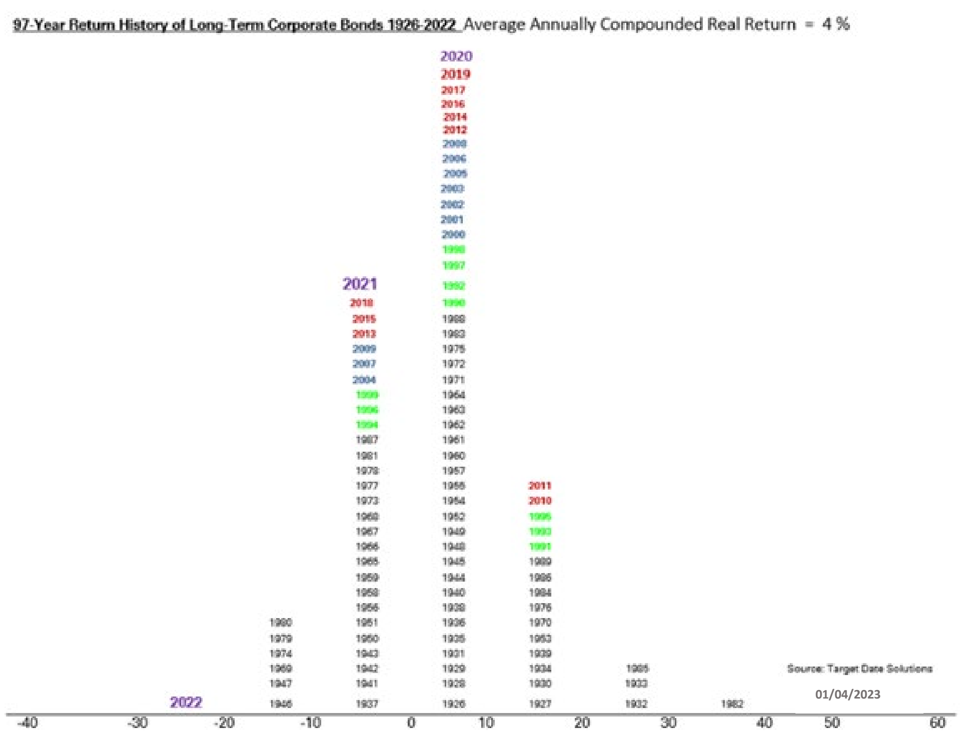
Some of these factors are starting to resolve as asset prices (housing, stocks, bonds) come down, supply-chain disruptions improve, and the savings accumulated during COVID become depleted. But the Fed has made it clear that the most pervasive threat to price stability remains the mismatch between the supply of and demand for labor. What is to be done about the 4.3 million gap between the number of job openings and the number of people considered "unemployed"? This gap, if sustained, could exacerbate the wage inflation that has clearly stoked more widespread inflationary pressures throughout the economy.

The job market is very unsynchronized, with COVID-benefited industries slow to fire, and COVID-hit industries still trying to hire, e.g., leisure and hospitality. Unsynchronized markets mean we have lots of moving parts to watch as we head into the new year.

In short, 2022 was a tough year to navigate as relationships and trends that investors have come to rely on either broke down or, worse still, reversed. Stocks, as measured by the S&P 500, lost 18.6% which is a 25% real (inflation adjusted) loss, placing 2022 in the bottom decile of stock returns over the past 97 years:



Bonds, as measured by the Vanguard Total Bond Index, lost 13.7%. This is -20.3% inflation adjusted, making it the worst annual bond return in the past 97 years.



As you can see, the barbell pattern in returns over this almost 100-year history shows that on average, returns are positive for both stocks and bonds and that remaining invested is important for long-term outperformance.

Switching to fixed income markets, the Bloomberg Barclays US Aggregate Bond Index, the leading benchmark for bonds, realized a positive return for the fourth quarter but declined sharply for the full year of 2022 (-13%), as more-aggressive-than-expected Fed rate hikes combined with decades-high inflation pressured most bond classes.[1]

Looking deeper into the fixed income markets, despite longer-duration bonds outperforming those with shorter durations in the fourth quarter, for the full year, shorter-term bonds handily outperformed longer-duration bonds as they were less impacted by Fed rate hikes and spiking inflation.

Turning to the corporate bond market, both higher-yielding, lower-quality corporate bonds and investment grade bonds posted similarly positive returns for the fourth quarter, as investors reacted to the possible peak in inflation. Lower-yielding and safer investment-grade corporate debt underperformed for the full year, however, as investors shunned those bonds for shorter-duration debt and corporate debt with higher yields.

After a long drought, the bond market is awash in yields that are attractive relative to other income investments. A portfolio of high-quality bonds, such as Treasuries and other government-backed bonds, and investment-grade corporate bonds, can yield in the vicinity of 4% to 5% without excessively high duration. Tax-adjusted yields in municipal bonds are also attractive for investors in higher tax brackets. In addition to the relatively attractive yields, higher coupons for newly issued bonds should help dampen volatility.

After a long and difficult 2022, the municipal bond market should fare better in 2023. We think that rates will be volatile due to Fed policy and concerns about economic growth. However, for the first time in a long time, investors can finally earn attractive yields without having to take on undue risk.

Commodities saw gains in the fourth quarter as both oil and gold logged positive returns. A falling dollar paired with an improving outlook for Chinese demand as the government moved towards reopening their economy pushed oil higher throughout the quarter.

Gold, meanwhile, saw steady gains in the final three months of the year thanks primarily to the decline in the U.S. dollar. For 2022, commodities posted a large, positive return due to the significant gains in oil futures and other energy commodities that came in response to geopolitically driven supply concerns following Russia’s invasion of Ukraine. Gold, however, saw only a slightly positive return for 2022 as sharp rises in the U.S. dollar and Treasury yields midyear weighed on the yellow metal, limiting gains.

Internationally, foreign markets handily outperformed the S&P 500 in the fourth quarter thanks to a large bounce in Chinese stocks as Beijing ended its “Zero-COVID” policy and commenced an economic reopening, while a falling dollar boosted global economic sentiment. For the full-year 2022, foreign developed markets turned in negative returns.

In the Eurozone, leading indicators are deep in contraction, and we expect a difficult road ahead for the region. Energy rationing looks less likely given the build-up in gas storage. But this only makes Europe's recession less severe, rather than preventing one.

In the UK, gross domestic product (GDP) continues to contract, but the weakness of leading indicators and sharp rise in interest rates mean a more fundamental recession is likely setting in.

In China, the data make clear that rising COVID cases are driving a near-term worsening in growth. Over in China, we're hoping December's COVID surge and activity collapse may mark a near-term bottom, as high frequency data edged up at month end. But any meaningful rebound is unlikely in the near-term. Support for the property sector is welcome, but it won't drive a robust recovery with developer funding and property activity so depressed, and a still-large overhang in housing supply.

Chinese equities have just about halved since their 2021 highs, but it's hard to ignore the risk-reward balance from these levels. We caution that reopening will be volatile amid high case numbers.

There is likely no quick fix to the economy at this point in time. The Fed has been explicit that it is willing to put the economy in recession if that's what's needed to conquer inflation. From where we sit, and notwithstanding the near -20% drop in stock prices last year, investors seem a bit too complacent. The complacency is perhaps most evident when we look at S&P 500 earnings estimates for next year. Given that earnings typically drop over 25% in an average recession, these forward-looking estimates seem a bit elevated. Stock prices are still not trading at a multiple that suggests any imminent downward revisions to expectations for 2023. And the Fed is still hiking rates at a historically rapid pace.

Having said all that, we also need to recognize that things could be a lot worse. Today's vast amounts of home equity mean that the magnitude of the housing downturn should be contained (especially relative to the Great Financial Crisis of 2008). For all the worries about inflation, it is still a positive that jobs are plentiful, and wages are rising at a respectable pace. Inflation appears to have peaked, and inflation visibility has improved now that rental rates for shelter are beginning to recede. Consumers still have a lot of cash, and the Fed's interest-rate increases will allow them to earn a respectable rate of return without undue risk for the first time in a while.

Looking forward, investors could take the view that trends of the 2011-2021 decade remain in place, and 2022 marked a pause to shake out "weak" or "leveraged" players. On the other hand, they could conclude that there is a deeper reason for the current bear market; namely, to mark a structural shift in the global economy and facilitate a shift in leadership from one group of stocks to another.

In recent months, most metrics pointed to this latter scenario and today the investment landscape is indeed shifting from globalization to deglobalization; from plentiful energy to scarce energy; from Washington consensus to great power conflict; from population growth to rapid aging, and from disinflation to inflation.

This should make for shifts in portfolio construction. Yet, amazingly, many in our field are slow to accept this shift as the classic 60/40 aka “60% equity and 40% bond” exposures still ring out. Needless to say, this strategy worked like a charm for 30 years, for both clients and money management firms, but it stopped working recently. Perhaps 2023 will be the year when investors accept that the good old days of a set it and forget it standard stock/bond portfolio might not be the place to be. As we have expressed in our writings and portfolios in recent years, alternative investments help provide an uncorrelated and differentiated return that in these difficult market environments, stand out.

Focusing on the long-term is the basis of what we do. If we do enter a recession, it will eventually end and expansion in the U.S. economy will be underway. While the next 12 months will likely try our nerves, fortitude, and patience, it will pass. Long-term investors not only earn their stripes by enduring difficult times, but they also find opportunity. Anyone can buy high and sell low. Develop a plan now to protect yourself from emotional decisions. At the very least, resolve to stick with your plan and discipline and better yet, have a strategy to take advantage of a downturns should they come.

This is another way of saying, ignore the noise and remain focused on the long-term. If you want to gamble, go to a casino, but investing requires a dispassionate fortitude that should remain immune to the daily fearmongering that is so prevalent in the media.

Any experienced investor knows that they can see their well-considered long-term plan upended in the short term by these types of surprises. But that doesn’t mean a course correction is needed. We at Hightower Westchester continue to hold a carefully vetted selection of relevant investments with wide moats and effective management, because we are confident in our long-term approach. No investment strategy is going to outperform the market every single year, but we know through our long-term approach that staying the course is appropriate in both good and bad times.

As we begin the new year, we want to again thank all our clients for entrusting us and express our deepest gratitude for your patience and support as we look forward. We hope 2023 brings you and yours great health and happiness.

To discuss this commentary further, please contact us at 914-825-8630.

hightowerwestchester.com

[1] FactSet – 01/04/2023

[2] Strategas Securities, LLC – 01/04/2023

[3] https://www.advisorperspectives.com/articles/2023/01/03/2022-stock-and-bond-returns-in-a-97-year-perspective?utm_source=Klaviyo&utm_medium=campaign&utm_campaign=Special%20Edition%202023-01-04%206808%20%28surz%29&_kx=4xVFi0Ck1vFCKnonI5h_mhQOsyAFZzhAG81UNpF_a4l9jnCfHhAyHb21RQGPCimW.REsC4z – 01/04/2023