Economic Overview

Steve Scranton, CFA, SVP, Chief Investment Officer and Economist

The 4th quarter saw economic growth start strong and then fade as the quarter ended. After posting a 3.2% annualized growth rate in the 3rd quarter, the current estimate for 4th quarter economic growth stands at 3.9%. The first estimate of 4th quarter GDP growth will not occur until late January.

Consumers

Consumers remained under pressure as expense growth outpaced income growth for the 21st consecutive month. Typically, consumers will prioritize their core expenses (food, energy, shelter) and cut back on discretionary purchases when under financial stress. Currently, consumers have maintained their spending by either drawing down their savings or incurring more debt.

- The personal savings rate has fallen from 7.5% at the end of 2021 to 2.4% as of the most recent data (11/30/22).
- Consumer borrowing (excluding mortgages) has risen $267.3 billion this year compared $194.2 billion for the same period last year.

Businesses

Business activity clearly showed evidence of slowing in the 4th quarter. The housing and construction industries have shown the clearest negative impact from rising interest rates.

- Construction spending
  - As of 11/30/22, private construction spending was down 0.4% compared to 9/30/22.
- Housing
  - Housing starts fell throughout the 4th quarter as a combination of labor shortages, high material costs, home prices and mortgage rates reduced activity.
  - Total home sales (new and existing) were down 10.2% as of 11/30/22 compared to 9/30/22.
  - In a sign that the future supply of homes may be reduced, building permits fell during the 4th quarter as well.
- Manufacturing
  - All of the manufacturing indices also showed declines during the 4th quarter. A combination of reduced demand from domestic buyers, as well a strong dollar reducing demand from foreign buyers, led to the declines in manufacturing activity. Both of the major manufacturing indices dropped below the 50 level, which indicates that manufacturing activity is contracting.

Government

Government spending looks to be a positive addition to economic growth in the 4th quarter. This is a combination of some of the funds from the infrastructure spending bill starting to be spent (private construction spending was up $5.5 billion as of 11/30/22 compared to 9/30/22), and many state and local governments still spending the funds they received from one of the earlier fiscal stimulus packages.

The 4th quarter results show an economy that is still growing but with clear signs of stress developing. The risk of recession in 2023 remains in place.

Fourth Quarter 2022 – Wealth Management Insights

Strategy Review

Derrick Wilson, CIMA®, VP, Portfolio Manager

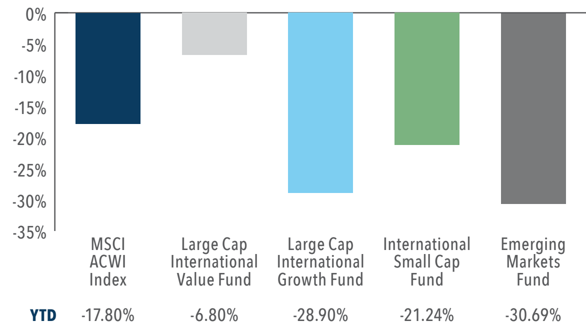
Another volatile quarter to end a volatile year. In a rare occurrence, both equities and bonds declined at the same time, ending the year negatively. The 4th quarter saw gains in both stocks and bonds to help ease some of the losses year-to-date as some notable drivers changed market sentiment, at least temporarily. Expectations of a Fed pivot increased as inflation looked to be turning the corner and slowing. Internationally, a different pivot by the Chinese government putting an end to its strict zero-COVID policies stoked optimism for an economic reopening in China.

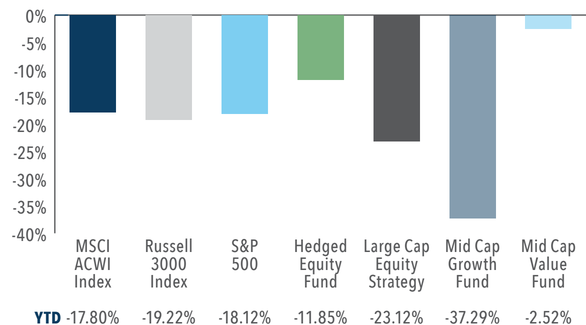
A story throughout 2022 was the strength of the US dollar, which ended the year gaining nearly 8%, but only after a sharp decline of over 7% in the last quarter. International equities outperformed domestic equities in the 4th quarter aided by a weaker US dollar. Within international equities, developed markets finished ahead of emerging markets and both gained more than domestic equities in the quarter. These quarterly gains also saw international equities finish the year ahead of domestic equities. Further weakening of the US dollar could be a boon for international markets going forward.

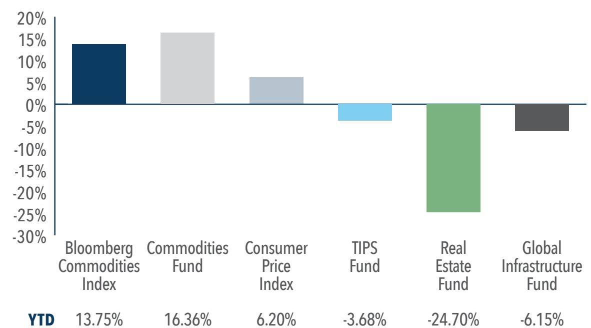
Fixed income experienced historic declines over the year with the furious pace of interest rate increases not seen in 30 years. Rate expectations began to ease during the 4th quarter and with that brought modest gains for bonds in this period. Standouts in the quarter were emerging market bonds up over 8% and high yield up 4%; however, these two fixed income asset classes were hit the hardest year-to-date. Higher starting yields for bonds now help to support returns going forward, although some downside risk remains as rates can still go higher than expected.

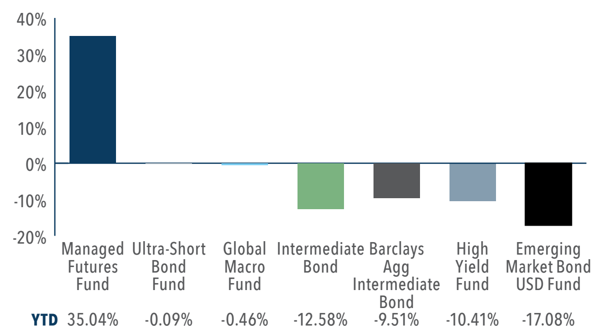
Alternatives remained mixed over the quarter, led by global infrastructure gaining 11% and real estate higher by 4%. Commodities saw gains of 2%, adding a little back to its 16% yearly gain. With very few places to hide, some of the diversifying strategies like trend-following managed futures aided the portfolio in turbulent times. Despite its decline of 6% in the 4th quarter, managed futures was a clear leader for the year with a very strong 27% gain.

As we settle into a new year, expect market volatility to remain elevated. Rate increases may be closer to an end, but recession could be looming on the horizon. While there is always something for markets to fret over, it is important to remain patient and stay disciplined.









Domestic Equities

Gayle Sprute, VP, Senior Portfolio Manager

US stocks opened the 4th quarter with a roar, but ultimately closed out the year with a whimper. Major US indices finished mostly higher in the quarter with the S&P 500 Index up 7.5%. October and November gains were propelled by the peak inflation theme and ensuing market hope for a policy pivot from the Federal Reserve (Fed). As hopes of a policy pivot faded throughout the quarter, so did investor risk appetite, with recession fears weighing on market sentiment in December. Despite 4th quarter gains, US stocks posted a lackluster year of performance, with the Dow Jones Industrial Average down 6.9%, the S&P 500 Index down 18.1%, the Russell 2000 Index down 20.5%, and the Nasdaq Composite down 32.5% in 2022.

Although inflation may have peaked, it remained well above the Fed's target. As such, Fed officials maintained their hawkish commentary throughout the quarter, messaging that higher-for-longer interest rates were needed to combat still historically high inflation. Although the pace of interest rate hikes slowed at December's Federal Open Market Committee's meeting, expectations for a higher terminal rate, against an already uncertain macroeconomic backdrop, further fueled concerns a Fed policy error may be on the horizon.

As recession fears built throughout the quarter, 2023 earnings projections were continually highlighted as having yet to fully incorporate the risk of recession. Persistent inflation, growing demand concerns, and uncertainties regarding the ultimate impact of higher interest rates on the US economy portend looming headwinds in 2023. Given mounting macroeconomic uncertainties, a company's ability to cut costs may prove critical to support margins in 2023. Company management's messaging will be heavily scrutinized this coming earnings season as investors seek clarity on how macroeconomic uncertainties may impact 2023 results.

Nine of eleven sectors traded higher over the 4th quarter. Energy, Industrials, and Materials were performance leaders while both Consumer Discretionary and Communication Services were laggards; the latter two posting negative 4th quarter returns. The value style added to its 2022 outperformance of growth in the quarter, rising 13.6% versus a 1.4% gain for the growth style. The still unknown economic impact of Fed policy tightening remains a market overhang. As such, further market volatility is perhaps in store.

Fixed Income

Brian Brill, CFA, VP, Senior Portfolio Manager

Treasury yields experienced a high level of volatility during the 4th quarter as investors attempted to predict when the Federal Reserve (Fed) will end its most aggressive hiking cycle in decades.

With the Fed already having hiked rates 300 basis points by the start of the quarter, expectations were that they would continue the 75-basis point per meeting pace, possibly bringing the Fed funds rate to 4.75% - 5.00% by year end. This frenzy of expectations peaked in late October / early November as yields rose to their highest levels since 2007.

This was all a consequence of high inflation, which saw its year-over-year rise, as measured by CPI, at 9.05% for June. Nine percent inflation is drastically higher than the Fed's 2% target and therefore commanded the Fed's complete attention, thus the rapid increases in rates.

Over the last quarter, investors began to worry that this pace would be detrimental to the economy and that the Fed would be forced to decrease the rapid rate hike pace. Some were even thinking the Fed would be forced to decrease rates possibly in late 2023 due to the bitter aftereffects of rate increases. Economic data that were once strong began to show signs of weakness, which only reenforced these beliefs.

Yields began to decrease in the longer maturity securities as investors sought to lock in the high yields, especially if the Fed would have to cut rates. Over a one-month period (November 7th – December 7th) the 10-year Treasury note decreased 80 basis points.

The Fed recognized the changing economic conditions, but with inflation still too high for their liking, raised rates by 50 basis points in December, thus bringing the Fed Funds rate to 4.5%.

The new year will probably see the Fed decrease this pace once again and pause to take stock of last year's actions.

The rate increases in 2022 were the most aggressive in decades. The losses to bond investors have been a shock to many with negative year-to-date returns ranging between -3.5% and -27%. The silver lining is that "income" has returned to fixed income.

Fourth Quarter 2022 – Wealth Management Insights

International

Matt Clarke, CIMA®, VP, Senior Client Portfolio Manager

The final quarter of 2022 marked the end of a challenging year for the international markets. The war in Ukraine, surging inflation and tighter monetary policy from central banks continued to weigh heavily on the global markets. Unlike the prior three quarters of 2022, **international stocks found some footing and finished the 4th quarter on a positive note.** After stumbling in October, stocks gained in November and then pulled back a bit as the year came to a close.

In the 4th quarter, the **majority of upward momentum for the markets came from developments in two primary areas: speculation about change in the direction of monetary policy and relaxed restrictions in China.** Hope that inflationary pressures have peaked had investors believing that global central banks would begin to ease off the economic brakes. In the United States, Federal Reserve (Fed) Chair Jerome Powell suggested that the Fed may dial down future interest rate hikes and the global markets responded favorably. By December, a combination of disappointing economic data (slower growth and negative earnings) and a renewed hawkish tone from central banks began to weigh on investor enthusiasm. At the same time, China began to respond to protests by easing key elements of its "zero-Covid" policy. By doing so, investors became more confident that the world's second largest economy would reopen for business as usual and help to smooth out many of the supply chain wrinkles that have plagued the global economy all year. By late December, however, reports surfaced that Covid related deaths in China were on the rise. The news sparked concerns that China may not have the capacity to reopen as expected and dented what momentum was in place.

In the end, **developed international outpaced emerging markets, and international as a whole outpaced the S&P 500.** The MSCI EAFE Index (developed international), finished the quarter higher by 17.40% and the full year, down -13.92%. The MSCI Emerging Markets Index finished the quarter higher by 9.62%, and the year down -19.94%. At the same time, the MSCI ACWI ex US Index (developed international and emerging markets) closed out the quarter up 14.32% and the full year, down -15.57%. For reference, the S&P 500 ended the quarter up 7.55% and the full year down -18.13%. Like stocks, bonds also found some reprieve in the 4th quarter. The Bloomberg Global Aggregate (measure of global investment grade debt) closed out the quarter higher by +4.55% and the full year down -16.25%.

Looking forward into at least the first half of the year, we expect the international markets to continue to face familiar headwinds. While global inflationary pressures appear to be trending in the right direction, many of the same frictions are still in place. **We continue to remain disciplined in our approach, focused on the long term and are working hard to seize opportunities as we identify them.**

Additional and expanded information to this newsletter discussion may be obtained by contacting your Relationship Manager. We will be happy to expand our discussion with you to meet your individual requirements as a client of Wealth Management & Advisory Services.

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