Q4

2022

MARKET REVIEW

After a weak 2022, 2023 is off to a strong start.

4Q 2022 Review and 2023 Outlook

LEEWARD FINANCIAL PARTNERS, LLC

2022 Review

Investors worldwide suffered in 2022 as markets dealt with a litany of foreign and domestic challenges, from surging commodity prices and the war in Ukraine to political uncertainty and the impact of a shutdown in China. Hanging over it all were the ramifications of the highest levels of inflation we've experienced since the early 1980s, which led central bankers in most major economies to increase interest rates, leading to further declines in asset prices.

Nearly every major asset class suffered declines. Even if you held your portfolio in cash over the last year, your real return in 2022 (accounting for inflation) would still have been -5.2%. What made 2022 a particularly challenging investment environment was that asset classes which have traditionally provided some downside protection in bad markets failed to provide that downside protection last year. Gold delivered an inflation-adjusted total return of -7.2% over the year, and the U.S. bond market (Bloomberg U.S. Aggregate Index) returned -19.0% in real terms. Weakness in bond markets was due to the magnitude of interest rate increases (which move inversely to bond prices). On the equity side, the rise in interest rates pushed stock valuations lower, particularly for big tech companies (the FAANG stocks, Meta, Amazon, Apple, Netflix, and Alphabet fell 46% in 2022), which comprise a substantial share of the total U.S. equity market. The result was a very rare simultaneous sell-off of the two largest asset classes in most investors' portfolios – stocks and bonds.

Thankfully, the fourth quarter (S&P 500 +7.1%) was the strongest of the year, though we ended up limping over the finish line as solid returns in October (+8.1%) and November (+5.6%) were followed by a pullback in December (-6.2%). For context, the fourth-quarter rally canceled out the negative returns in the third quarter, resulting in a bumpy but flat market over the second half of the year. Still, it was disappointing to see the breadth of the December sell-off. All major equity sectors, including the most defensive sector – utilities – registered declines. In the bond market, returns held up better in December as longer-term interest rates traded down from the recent high-water-marks established in late October.

Economic Outlook

Inflation, which rose above 9.0% year-over-year in June (the highest level since 1981), drove the market last year as investors debated its origins,

drivers, and staying power. The rate of inflation began to fall in the second half of the year but remains at high levels relative to long-term averages. The impact of the War in Ukraine has become more muted as the current drivers of price increases have shifted away from goods (like oil, gas, agricultural commodities, and used cars) to services (like rent and restaurant prices). While gasoline prices have fallen, diesel prices, which represent a large portion of cost structures for suppliers, remain elevated. The case for services inflation to fall going forward is based on indigestion in the housing market, which is starting to flow through to rent prices at a lag, as well as the deceleration in wage increases, which should help to ease prices paid to other service providers, like servers in restaurants. Last June marked the high point, and inflation will continue to fall back to earth, although that process may take some time. In December, the year-over-year inflation rate fell from 7.1% to 6.5%, and we believe we could be back to around 3-4% inflation by mid-year. Just as we expect inflation to fade, we expect markets will largely move on from the inflation narrative and focus more on corporate earnings, GDP growth, and the Fed's stance on monetary policy as we move through 2023.

The consensus is that we will enter a mild recession in 2023. Sentiment indicators have come off the lows but remain in depressed territory, industry surveys gauging the manufacturing and services sectors within the economy have moved into contractionary territory, industrial production is slowing, consumer credit balances are starting to grow at a slower rate, and the housing market hasn't been in this bad of shape in a decade.

The labor market remains tough to read. On the one hand, unemployment fell to 3.5% in December, the lowest level since 1969. On the other hand, the participation rate, which measures the percentage of the population that is either working or actively looking for work, fell 3% during the pandemic and has only recovered by 2% since, leaving us around 1% below where we were pre-pandemic. The concern here is that about 2 million people left the labor force during the pandemic, either to take care of kids or to retire early, and they may not return. If those people were to come back into the labor force and start looking for a job, the unemployment rate could rise from around 3.5% to approximately 5.0%. So, the low unemployment rate we have today needs to be viewed within the context of a depressed labor force, which could be evidence of a weakening economy.

We are halfway through Q4 2022 earnings season, and so far, earnings growth is expected to come in around -5.0% year-on-year, marking the first year-over-year earnings decline since Q3 2020. More critical than Q4 earnings, however, will be the commentary companies provide around their outlook for 2023. Earnings expectations for the S&P 500 Index in 2023 fell from about $241 to $230 over the fourth quarter, which, paired with a modest price increase in the index, increased valuations, though valuations remain below 5- and 10-year

averages. The key question will be how much further earnings expectations are cut and what that says about the attractiveness of current valuations.

Risks

While 2023 should be far less painful than 2022, risks remain. Front and center is monetary policy – the Federal Reserve is expected to hike interest rates in each of the next two meetings (in February and in March) and then keep rates steady until potentially cutting rates toward the end of the year. If inflation surprises to the upside, or if the Federal Reserve policymakers feel that they need to defend their credibility, rates could increase more than expected or stay at elevated levels for longer than the consensus expectation. In this scenario, the Fed would likely push the economy into a deeper recession than anticipated.

Another risk stems from the composition of Congress. The slim majorities of the Republicans in the House and the Democrats in the Senate will make it very difficult to enact new legislation, even during a recession, when fiscal support is needed the most. Additionally, the wrangling around the debt ceiling and whether it should be lifted may inject a bit of volatility into markets this year. Luckily, markets have seen this movie many times, notably back in 2011. Typically, markets have tended to shrug off this issue until a government shutdown appears likely, at which point bonds start to sell off before recovering as an agreement is reached. On balance, this issue will be noisy and politically charged but is unlikely to have substantial and lasting market impacts.

Markets have been weak over the last year, and we're probably moving toward a mild recession. Still, we're not seeing any flashing signs of the types of major economic and market risks that would push us to position portfolios substantially more defensive.

Opportunities

While it's painful to experience a significant market sell-off, the upside is that return expectations increase once the market has bottomed. With stock valuations low and bond yields relatively high, today's investment environment appears quite attractive for the long-term investor. While the market narrative seems to be shifting toward the probability of a recession, it is worth noting that markets are pricing mechanisms and tend to lead the economic data by six to nine months. By the time the economic data indicate that we are in a recession, markets have usually already sold off and are often beginning to recover. So, while there remains some downside risk to the market if the economy deteriorates more than expected and earnings come in far below estimates, we view this downside risk as limited and believe it is more likely markets will pivot in an upward direction. The tricky part is timing. To be early is to be wrong, but we also want to take advantage of depressed prices where possible. As a result, we prefer a cautious approach,

putting cash to work at a measured pace.

Portfolio Positioning

We view U.S. equities favorably relative to international and emerging market equities, domiciled in parts of the world where central bankers have a bit more wood to chop in the battle against inflation. The U.S. economy remains the cleanest dirty shirt in our view, but so long as the economic outlook remains uncertain, our preference remains to be invested in high-quality companies with solid management teams.

In terms of sectors, we have focused on slightly reducing healthcare exposure, leaning a bit more into the oversold companies within the technology and consumer discretionary sectors, and increasing exposure to the communication services sector overall. Energy may still have room to run, especially given the recent shift toward reopening in China, but we're not as bullish there as we have been in previous quarters.

Should markets start to bounce higher in Q1, and we see widespread participation across indices, we will transition into companies in sectors that capture the upside in a cyclical recovery.

On the bond side, we are ratcheting up duration exposure, given higher yield levels and evidence that inflation is continuing to decline. The risk here is that the Fed may decide to keep rate levels high in the face of falling inflation, but we don't believe that the price risk of unexpected interest rate increases will erode completely the higher coupons currently available. Within taxable accounts, we favor building up some municipal bond exposure where we view tax-equivalent yields as attractive.

Conclusion

Last year was incredibly painful for investors, with stocks notching their third worst year since 1976 and bonds turning in performance four times worse than their worst year since 1976. The fading of stimulus measures, the fight against inflation, and the fight within Ukraine all played a role in the market declines.

Fortunately, many of the issues are showing signs of improvement. Inflation is coming down stateside, Fed officials appear to be easing off the gas with regard to interest rate increases, supply chains are adjusting to become more robust, the market impacts of the War in Ukraine are fading, and markets have reset to a lower level, resulting in higher expected returns.

We could reenter recession this year. Still, market risks are skewed to the upside overall and should do much better in 2023. We understand the urge to get more defensive when news anchors are talking about the potential of recession, but over our many years of managing money, we've found the best time

to be invested is when it feels the worst to do so. Of course, we will remain watchful of any developments that may make us feel less confident in the trajectory of the economy and markets and will make changes as necessary.

Please reach out if you have any questions about how we're viewing markets or if you would like to discuss how we're investing your portfolio.

We appreciate your partnership.

Sincerely,

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