Market Review & Outlook

January 2023

For most investors, 2022 was a year they'd rather soon forget, as stock, bond, and crypto currency markets all experienced steep declines. Unless you were short the stock market, held significant amounts in US dollars, energy stocks, or certain commodities, you most likely experienced double-digit percentage losses in your investment portfolio. Not only did global stock markets suffer their worst year since 2008, but the global bond index fell by a shocking 16.25%. We only have data for the Bloomberg US Aggregate Bond Index going back to 1976, but its 13.01% loss last year was by far the worst ever for the benchmark, with a 2.9% decline in 1994 being the previous worst mark. Indeed, the traditional 60% stock, 40% bond "balanced" portfolio lost 17.5% last year, its 3rd worst performance ever after 1931 and 1937, which were perhaps the two worst years for financial markets during the Great Depression.

It's normal for investors to enter a new year with hopeful optimism, especially after such a lousy year for markets. Unfortunately, as we begin 2023, the markets and economy will continue to face many of the same headwinds that have kept financial assets off balance since US stocks peaked a year ago, namely a slowing global economy and tightening financial conditions. For a more detailed look at how various asset classes performed in recent periods, please refer to the table.

Index	Dec 2022	4th Qtr. Perfo-mance	YTD Performance	One Year Performance	Description (what the index is com-prised of)
S&P 500	-5.76%	7.56%	-18.11%	-18.11%	Large Cap US Stocks
DJ Industrial Average	-4.09%	16.01%	-6.86%	-6.86%	Large Cap US Stocks
Nasdaq Composite	-8.67%	-0.79%	-32.54%	-32.54%	Large & Mid-Cap US Tech Stocks
Russell 1000 Growth	-7.66%	2.20%	-29.14%	-29.14%	Large Cap US Growth Stocks
Russell 1000 Value	-4.03%	12.42%	-7.54%	-7.54%	Large Cap US Value Stocks
Russell 2000 Growth	-6.42%	4.13%	-26.36%	-26.36%	Small Cap US Growth Stocks
Russell 2000 Value	-6.56%	8.42%	-14.48%	-14.48%	Small Cap US Value Stocks
MSCI EAFE	0.08%	17.34%	-14.45%	-14.45%	Foreign Developed Market Stocks
MSCI EM	-1.41%	9.70%	-20.09%	-20.09%	Emerging Markets Stocks
Credit Suisse High Yield	-0.53%	3.77%	-10.55%	-10.55%	US High Yield Corpo-rate Bonds
Bloomberg US Aggregate Bond Index	-0.45%	1.87%	-13.01%	-13.01%	Primarily U.S. Gov-ernment Bonds plus investment grade corporates

In our view, recessionary fears, the ongoing war in Ukraine, and tighter monetary policy mean that markets will likely remain volatile, especially during the first half of the year. While most Wall Street forecasts see moderate improvement for stocks by year-end, many of these firms also see declines from current levels between now and then. A 2023 recession in the US is not a consensus Wall Street forecast, but many firms do see a mild recession as a base case scenario. Through November, the index of leading economic indicators has fallen for 9 straight months. Going back to 1959, there have only been 5 such declines, and each foreshadowed a recession within months.

Meanwhile, the Fed has already raised rates at the fastest pace in history, and most of the effects of last year's hikes won't hit the broader economy until this year. Furthermore, Fed Chair Powell has pledged to not only hike rates further, but to leave them higher for longer once the Fed reaches the so-called "terminal" rate. The terminal rate is what economists call the natural or neutral interest rate. It is the rate that is consistent with full employment and capacity utilization and stable prices.

These rate hikes are happening against a backdrop of quantitative tightening (QT), as the Fed allows $95 billion/month of bonds on its balance sheet to mature without reinvesting in new bonds. This reverses an easy money policy that had been in place since the financial crisis, and which has helped the Fed hold interest rates artificially low and support markets since 2008-2009. Moreover, outside of the US, most global central banks are also raising rates to fight the worst inflation in more than 40 years. This all adds up to a massive withdrawal of liquidity from global markets and the slowest annual growth in the US money supply in 60 years.

The housing market was a prime beneficiary of easy monetary policy, and it was the first sector of the economy affected when the Fed reversed those policies early last year. From May 2020 until June 2022, the Case-Shiller national home price index rose more than 40%. However, since June 2022, the index is down 2.4%, with larger declines in cities like San Francisco, Seattle, Phoenix, San Diego, and Las Vegas. Also, every major metropolitan area is down in the past three months, no exceptions.

Much higher mortgage rates have had a dramatic effect on home affordability, and existing home sales are down by almost 40% annually since January 2021. Assuming a 20% down payment, the rise in mortgage rates and home prices since December 2021 amounts to a 52% increase in monthly payments on a new 30-year mortgage for the median existing home. While analysts expect more price declines, few are predicting a 25% correction in prices nationally like we experienced from 2006-2011. Still, housing should continue to be a drag on the economy this year.

According to FactSet, analysts are still predicting 5.5% growth in corporate earnings per share for 2023, despite tightening financial conditions and the recession forecasts. Analyst estimates are based mostly on company guidance, and most companies have not adjusted their 2023 guidance down yet. While it's possible the Fed may engineer a so-called "soft landing" where the economy avoids recession, during "hard landings," corporate earnings estimates are cut on average, by about 20%. We fully expect companies to revise guidance down, likely beginning during Q4 earnings announcements, meaning that fundamentals for stocks should deteriorate further as the economy slows.

Nonetheless, stock market bulls have been itching to call a "bottom" in the market, first back in mid-June after stocks hit lows for the year, and again when stocks hit fresh new lows in mid-October. While stocks rallied strongly over the latter half of October and into November, the lack of a follow-through "Santa Claus" rally in December faded some of that bullish optimism. The bears will point to market positioning data and sentiment indicators as proof that investors are still too bullish given the worsening outlook. They will also mention the lack of any capitulatory selling climax in the stock market since the bear market started a year ago. Of course, there's no rule that says the market must experience a volatile selling climax for a bear market to end.

However, there's no real precedent for a Fed continuing to hike rates into a yield curve this inverted with stocks already in a bear market, and there's no way to really know when the Fed might pivot to rate cuts, though markets are starting to price one in towards the end of 2023. In a recent interview, economist David Rosenberg said, "for everybody that's thinking about the pivot, first comes the pause, and historically the stock market bottoms — believe it or not — 16 months after the Fed pauses." An actual pivot to rate cuts would help asset prices, but if inflation remains higher for longer, the Fed may be forced to postpone any pivot.

The sell-off of 2022 has made stocks more reasonably valued, but it would be incorrect to call them "cheap," as the S&P 500 was still trading at 18.6 times trailing 12-month earnings as of 12/31. The consensus S&P 500 earnings per share (EPS) estimate for 2023 currently sits at $231, meaning the S&P 500 could reach about 4,300 by the end of the year if it continues to trade at this same multiple (current level is ~3,850). The problem is, bear markets have typically ended with the S&P 500 trading between 12- and 14-times EPS, which would mean a level of between 2,775 and 3,235, and that assumes EPS still come in at $231. The low end here seems awfully pessimistic, but we have seen commentators cite 3,200 or even 3,000 as fair value on the S&P 500.

Based on this uncertain market setup, we believe a cautious, defensive investment approach remains prudent as we enter the new year, especially if you are close to retirement age. With rates having gone way up, fixed income investments are finally providing value, and we believe overweighting fixed income may serve more defensive investors well this year. Short-term debt instruments and cash money market funds are finally providing some yield after years of paying next to nothing! Of course, if you are young or have a longer investment time horizon, it makes less sense to react to short-term events in the market, but we still believe that more aggressive, stock-focused investors may be better served this year by overweighting value-oriented, defensive, and high-dividend stocks.

If you have a general administrative question about your account, please contact our customer service at 800-535-4253 option 1. If you would like to set up an investment consultation, please contact our customer service line or send us an email at advisors@wespac.net. We would be happy to schedule a call or Zoom meeting to discuss your portfolio.