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Q1 2023 Newsletter | Jeff Griggs, CFA

Due to the wide range of risk tolerances of our clients, some topics or asset classes may have more, less, or no importance to your portfolio. For a detailed analysis, give us a call, or request a detailed performance review.

Big Picture

The fourth quarter provided a small reprieve from what will go down as one of the worst years in history for diversified portfolios. Equities rose 10% in the quarter, led by non-US developed markets (+16.3%), while US stocks rose 7%. Bonds rose 4.5% as rates were volatile but ended the quarter relatively flat. For the full year, stocks fell -18% while bonds lost -16.2%, absolutely wreaking havoc on investor portfolios as bonds provided none of relief they are usually relied upon for when stocks drop. Out-of-control inflation and a Fed-induced recession remained the top concerns for investors in the quarter, however, some signs and narratives emerged throughout the quarter that inflation may be rapidly moderating and the Fed may slow their tightening quicker than previously expected. In fact, 12 month inflation expectations have fallen to just 2%, and the Fed is now expected to raise rates just 25bps in February and March before pausing their hikes and indeed initiating rate cuts as early as September. This contributed to the positive quarter, but no substantial evidence exists to support these hypotheses just yet. While it is nearly a certainty that the market will shift and enter the recovery before macroeconomic data turns over, it remains too early to call whether we have truly exited the despair phase and entered the next hope phase of the economic cycle.

Looking Ahead

The hope phase nearly always starts during recessions when the economy is weak, news is bad, and corporate earnings are still deteriorating. In fact, most bear markets trough around 6 to 9 months before a recovery in corporate earnings and roughly 3 to 6 months before any trough in growth momentum. Additionally, the hope phase is the shortest, yet strongest, of the four phases of an economic cycle (despair, hope, growth, optimism), accounting for around two-thirds of bull market returns. So, while predicting when the shift occurs is exceedingly difficult, being positioned for the shift from the despair to hope phase is quite important. Asset corrections that are primarily driven by tight monetary policy usually end around the point when the Fed shifts towards easing. A Fed pivot, defined as the first time in at least a 3-month window that the fed futures market implies less than a 12.5bp increase in the target rate within the subsequent six months, is now predicted by the market as occurring sometime after the March meeting. To me, this would imply that the time to position to take advantage of the coming hope phase is now.

The major risk to this position being the Fed hiking rates either more aggressively (50bps+ at a time), and/or for longer (beyond the March meeting) than the market is currently predicting. With that said, I believe the biggest risk investors face in 2023 is missing out on full participation in an eventual recovery. However, the markets fate rests squarely in the Fed's hands and while I am wary to rely on the so-called "Fed Put" if we face a more severe recession, I do tend to believe the market provides a more accurate forecast of future rates than the Fed's own projections.

On the Fridge

Developed Market Stocks

Developed market stocks (excluding the US) led the quarter rising 16.3%, more than double that of their US counterparts (7.1%). Much of the outperformance can be explained by currency fluctuation as the US dollar index fell -7.7% in the quarter.

Energy

The energy sector continued its dominance rising 22.8% in the fourth quarter which brings full year 2022 returns to 65.7%, the next best sector, utilities, rose only 1.6% while all other sectors finished in the red.

In the Dog House

Government Bonds

US Treasuries returned just 0.7% in the fourth quarter, even underperforming cash which returned 0.9%.

Consumer Discretionary

The consumer discretionary sector was the worst performing sector in the fourth quarter, falling –10.2% while the next worst sector, communication services, fell only –1.4% and all other sectors posted a positive return. Losses were led by Tesla (TSLA) which is the second largest holding in the sector and fell –54% in the quarter.

Links and Articles

6 Reflections on 2022
Several brief insights illustrated by FactSet in their year in review.

5 Numbers to Watch This Year
Ben Carlson highlights 5 numbers that might tell us how the economy is doing this year.

China's Road to Recovery
A brief blog post from Loomis Sayles highlighting the uncertainty surrounding China's new COVID-19 policy.

Silver Linings Playbook
Phil Huber of Savant gives his read on the lessons learned from 2022 and insights to the year to come.

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Performance

This quarter, developed market equities benefited from both lower valuations (which they have carried for years), and a weak US Dollar (-7.7% US Dollar Index), which bolstered returns. International bonds benefited from the same currency fluctuation and led all other fixed income classes returning 6.8% in the quarter. Still, developed market equities (-19.7%) and international bonds (-18.7%) finished the year as the worst performing sub-classes within their respective asset classes. On a longer term time frame, developed markets have significantly underperformed their US counterparts returning just 5.1% annualized over the last 10 years.

	Benchmark Index	2022 Q4	YTD	LTM	3yr	5yr	10yr
Cash	**Bloomberg US Treasury Bill 1-3 M TR USD**	0.9%	1.5%	1.5%	1.4%	1.2%	0.7%
Fixed Income	**Bloomberg Global Aggregate TR USD**	4.5%	-16.2%	-16.3%	-4.5%	-1.7%	-0.4%
Fixed Income Blend	Bloomberg Global Aggregate TR USD	4.5%	-16.2%	-16.3%	-4.5%	-1.7%	-0.4%
Government	Bloomberg US Government TR USD	0.7%	-12.3%	-12.3%	-2.6%	-0.1%	0.6%
Inflation Protected	Bloomberg US Treasury US TIPS TR USD	2.0%	-11.8%	-11.9%	1.2%	2.1%	1.1%
Municipal	Bloomberg Municipal TR USD	4.1%	-8.5%	-8.5%	-0.8%	1.3%	2.1%
Floating Rate	Bloomberg US Trsy Floating Rate TR USD	1.0%	2.1%	2.1%	0.9%	1.4%	0.0%
Corporate	Bloomberg US Corp Bond TR USD	3.6%	-15.8%	-15.8%	-2.9%	0.5%	2.0%
High Yield	Bloomberg US Corporate High Yield TR USD	4.2%	-11.2%	-11.2%	0.0%	2.3%	4.0%
International Bond	Bloomberg Gbl Agg Ex USD TR USD	6.8%	-18.7%	-18.7%	-5.9%	-3.1%	-1.6%
Equity	**MSCI ACWI GR USD**	9.9%	-18.0%	-18.0%	4.5%	5.8%	8.5%
Equity Blend	MSCI ACWI GR USD	9.9%	-18.0%	-18.0%	4.5%	5.8%	8.5%
US Equity	MSCI USA GR USD	7.1%	-19.5%	-19.5%	7.5%	9.3%	12.5%
Developed Markets	MSCI World ex USA GR USD	16.3%	-13.8%	-13.8%	1.8%	2.3%	5.1%
Emerging/Frontier	MSCI EM GR USD	9.8%	-19.7%	-19.7%	-2.3%	-1.0%	1.8%
Alternatives	**Wilshire Liquid Alternative TR USD**	1.8%	-5.6%	-5.6%	0.7%	0.8%	1.3%
Alternatives Blend	Wilshire Liquid Alternative TR USD	1.8%	-5.6%	-5.6%	0.7%	0.8%	1.3%

Sector	2022 Q4	6mo	YTD	1yr	3yr	5yr	10yr
Information Technology	4.7%	-1.8%	-28.2%	-28.2%	11.6%	15.8%	18.3%
Financials	13.6%	10.1%	-10.5%	-10.5%	5.9%	6.4%	12.2%
Health Care	12.8%	7.0%	-2.0%	-2.0%	11.9%	12.5%	15.1%
Consumer Discretionary	-10.2%	-6.3%	-37.0%	-37.1%	1.5%	6.1%	11.7%
Consumer Staples	12.7%	5.3%	-0.6%	-0.6%	9.3%	8.8%	11.0%
Industrials	19.2%	13.6%	-5.5%	-5.5%	8.3%	7.4%	11.9%
Energy	22.8%	25.7%	65.7%	65.8%	19.3%	9.3%	6.0%
Utilities	8.6%	2.1%	1.6%	1.6%	6.3%	9.6%	11.1%
Materials	15.0%	6.9%	-12.3%	-12.3%	10.5%	7.5%	9.8%
Communication Services	-1.4%	-13.9%	-39.9%	-39.9%	-3.3%	1.0%	4.3%
Real Estate	3.8%	-7.6%	-26.1%	-26.1%	1.8%	5.9%	7.8%

Source: Morningstar; The 1,3,5, and 10 year performance is annualized.

While the fourth quarter differed in that it provided positive returns, it was similar to the rest of 2022 in that results varied drastically across factors and sectors. Essentially, the only winning trade in 2022 was the energy sector which returned a whopping 65.7%. The headline S&P 500 numbers, while gruesome, hide the true pain most investors felt if they maintained exposure to the previous decade's winningest trade, the growth factor.

Even after rising 66% while the tech sector fell -28%, 10yr annualized returns on the energy sector are only 6% compared to 18% from tech. Similarly, after falling -32% in 2022, the growth factor still retains 10yr annualized returns of 13.4% vs. 9.8% for the value factor.

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Asset Class	Benchmark	Description
Cash	Bloomberg US Treasury Bill 1-3 M TR USD	Measures US dollar-denominated, fixed-rate, nominal debt issued by the US Treasury.
Fixed Income	Bloomberg Global Aggregate TR USD	The Bloomberg Global Aggregate Index is a flagship measure of global investment grade debt from twenty-four local currency markets. This multi-currency benchmark includes treasury, government-related, corporate and securitized fixed-rate bonds from both developed and emerging market issuers.
Government Bonds	Bloomberg US Government TR USD	The Bloomberg US Government Bond Index comprises the US Treasury and US Agency indices. The index includes US Dollar-denominated, fixed-rate, nominal US Treasuries and US agency debentures (securities issued by US government owned or government sponsored entities, and debt explicitly guaranteed by the US government).
Inflation Protected	Bloomberg US Treasury US TIPS TR USD	The Bloomberg US Treasury Inflation-Linked Bond Index (Series-L) measures the performance of the US Treasury Inflation Protected Securities (TIPS) market.
Municipal	Bloomberg Municipal TR USD	The Bloomberg U.S. Municipal Index covers the USD-denominated long-term tax exempt bond market. The index has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds and prerefunded bonds.
Floating Rate	Bloomberg US Trsy Floating Rate TR USD	The Bloomberg US Treasury Floating Rate Index measures the performance of floating rate bonds issued by the US Treasury.
Corporate Bonds	Bloomberg US Corp Bond TR USD	The Bloomberg US Corporate Bond index measures the investment grade, fixed-rate, taxable corporate bond market. It includes USD-denominated securities publicly issued by US and non-US industrial, utility and financial issuers.
High Yield Bonds	Bloomberg US Corporate High Yield TR USD	The Bloomberg US Corporate High Yield Bond Index measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below.
International Bonds	Bloomberg Gbl Agg Ex USD TR USD	The Bloomberg Global Aggregate Index is a flagship measure of global investment grade debt from twenty-four local currency markets. This multi-currency benchmark includes treasury, government-related, corporate and securitized fixed-rate bonds from both developed and emerging market issuers. This version excludes USD-denominated debt.
Equity	MSCI ACWI GR USD	The MSCI ACWI captures large and mid cap representation across 23 Developed Markets and 23 Emerging Markets countries. With 2,477 constituents, the index covers approximately 85% of the global investable equity opportunity set.
US Equity	MSCI USA GR USD	Captures broad US equity coverage. The index includes 3,108 constituents across large, mid, small, and micro capitalizations, representing about 99% of the US equity universe.
Developed Market Equity	MSCI World ex USA GR USD	Captures large and mid cap representation across 22 of 23 Developed Market countries, excluding the United States. With 1,023 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.
Emerging Market Equity	MSCI EM GR USD	The MSCI Emerging Markets Index captures large and mid cap representation across 23 Emerging Markets (EM) countries. With 829 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.
Alternatives	Wilshire Liquid Alternatives TR USD	Measures the collective performance of the five Wilshire Liquid Alternative strategies that make up the Wilshire Liquid Alternative Universe, including the Wilshire Liquid Alternative Equity Hedge, Global Macro, Relative Value, Multi-Strategy, and Event Driven indices. This index is meant to provide a representative baseline for how the liquid alternative investment category performed as a whole. Constituents comprised of '40 Act mutual funds.
US Large Cap Equity	S&P 500	Widely regarded as the best gauge of large-cap US Equities. The S&P 500 is a market-weighted index that includes 500 leading companies and captures approximately 80% coverage of available market capitalization.