Fundamentum Market Commentary
2022 Review and 2023 Outlook

Since the Global Financial Crisis (2008-2009), financial markets enjoyed easy money policies through low rates and quantitative easing. With the pandemic, additional stimulative monetary and fiscal conditions were also instituted. This excess liquidity along with demand being "pull-forward" drove the markets to all-time highs. Outsized-positive returns were delivered – the S&P500 Index annualized returns for the 10 years ending 2021 was an astonishing 16.5% almost double historical norms.[1] In 2022, on just the second trading day in January equity markets peaked. The massive liquidity bubble, strong demand, and constrained supply led to a sudden and significant increase in inflation that was not transitory. The Zero cost of capital regime came to an abrupt end. Replacing the Zero is a more difficult, higher cost of capital market which has been particularly problematic for companies/securities in growth areas heavily dependent on low discount rates. Worries surrounding inflation and the Federal Reserve's policy response led to increased volatility and a major negative market trend throughout the course of 2022. Responding to the inflation threat, the Federal Reserve's aggressive tightening policy drove bond yields higher (prices lower) and weighed on equities and other risk-on assets.

Total Returns by Asset Class	4th Qtr.	2022[2]
Dow Jones Industrials Index	+ 16.01%	- 6.86%
S&P 500 Index	+ 7.55%	- 18.13%
NASDAQ Index	- 0.78%	- 32.51%
Russell 1000 Value Index	+ 7.23%	- 19.14%
Russell 1000 Growth Index	+ 2.19%	- 29.14%
Russell 2000 Index	+ 6.20%	- 20.46%
MSCI EAFE Index	+ 17.40%	- 13.92%
MSCI EM Index	+ 9.62%	- 19.94%
US Aggregate Bond Index	+ 1.87%	- 13.01%
US Corporate Bond Index	+ 3.63%	- 15.76%
US Corporate High Yield Index	+ 4.17%	- 11.19%
HFRX Global Hedge Fund Index	+ 0.16%	- 4.41%

2022 was a unique year, both equities and bonds lost value for only the third time since 1926 – the other two occurrences were in 1931 and 1969.[3] The standard 60% equities / 40% fixed income asset allocation finished down -16.1%, the biggest decline in over 40 years.[4,5] Within the S&P 500 sectors, all sectors delivered negative returns for the year except for Energy. Sector outperformers year were Energy +59.0%, Utilities -1.4%, and Consumer Staples -3.2% while sector underperformers were Communication Services -40.4%, Consumer Discretionary -37.6%, and Technology -28.9%.[6] The three best-performing stocks in the S&P500 were Constellation Energy +128.6%, Occidental Petroleum +117.5%, and Hess +94.4% with Generac -71.6%, Match -68.8%, and Align Technology -67.9% being the worst performing stocks.[7]

Concerning the economy, Gross Domestic Product (GDP) surged by 5.9% in 2021; but saw a significant slowdown in 2022. After two consecutive quarters of negative growth in the first half of the year - powered by accumulated savings and strong employment gross domestic product rebounded in the third quarter and accelerated in the fourth quarter leading to an overall 2022 GDP of approximately +2%. Once thought dead and buried, inflation spiked (whether using the Consumer Price Index or Personal Consumption Expenditure Index) to levels not seen since the earlier 1980s. Over the last twelve months, the CPI soared over 9.0% while the PCE peaked around 6.8%.[8] The Personal Consumption Expenditures is the Federal Reserve's favored inflation gauge since it provides a more complete picture of costs for consumers. The PCE ended 2022 at 5.6%, a level far from the Federal Reserve's target goal of 2.0%.[9]

As inflation ran rampant and interest rates spiked, this year's equity declines were entirely due to price multiple compression from 22x to 17x earnings. Currently, the equity markets are fairly valued (16.65x Price-to-Earnings multiple compared to the 25-year average of 16.82x).[10] However, there are two items on the negative side of the scale detracting from this "fair" valuation. Despite slowing growth, consensus earnings are still expected to rise in 2023. Our expectations are for flat to declining earnings this year. Secondly, relative valuations are above-average after considering the current level of interest rates versus the last 10+ years.

In response to the dramatic rise in the level of inflation, the Federal Reserve began the transition from Qualitative Easy (QE) to Qualitative Tightening (QT) and launched one of the most aggressive rate hike programs in its future starting with a 25bps hike in the Fed Funds rate in March. The target range for the Federal Funds rate began the year at 0.00%-0.25% and ended at 4.25%-4.50%, an increase of 425 basis points with more rate hikes projected.[11] In addition to rate hikes, the Federal Reserve began to reduce the size of its balance sheet (QT) by $95 billion per month. Responding to rising inflation and the Federal Reserve's actions, U.S. Treasury yields rose dramatically through the year – starting at 1.44%, peaking at 4.25%, and settling at 3.87%.[12]

With inflation peaking in the Summer and economic data softening, market concerns rose about a policy mistake tipping the economy into a recession. Given the lagging effects of rate hikes on the economy, wage pressures, high input prices, and demand issues, corporate earnings for 2023 have become the focal point. Consensus earnings are still for single-digit growth in profits; however, during a recession earnings typically fall between 10% to 30%.[13]

Financial markets are drifting away from the direction the Federal Reserve is taking. The Federal Reserve continues to push back about a quick pivot in policy and maintained the theme of higher for longer with respect to rates. Federal Reserve Chairman Powell recently stated that the FMOC will only cut the discount rate when it is confident that inflation is moving down in a sustained way. The Federal Reserve is loath to repeat the policy mistake of the 1970s when it failed to contain inflation in the initial stages resulting in stagflation and economic malaise for a decade. However, The Federal Reserve has signaled that some slowdown in the pace of rate hikes is warranted. Currently, market expectations are for 25bps hikes in February and March with a pause thereafter. Markets are capping the terminal Fed Funds at 5% and are focused on rate cuts in the second half of 2023 which are at odds with the stance the Federal Reserve has taken. Hence, the Treasury yield curve has deeply inverted with short-term rates significantly higher than long-term – a historical predictor of recessions. The Treasury yield curve has fully inverted as seen by the 2yr-10yr and 3mth-10yr spreads – the most negative they have been since the early 1980s.[14]

So far, the Federal Reserve's aggressive rate hikes have had negligible impact on employment. In December, the unemployment rate edged down to 3.5% and has remained in a narrow range of 3.5 percent to 3.7 percent since March.[15] Although lagging indicators, weekly jobless claims and job openings still point to a robust job market. As the Federal Reserve continues to implement its higher-for-longer interest rate policy, expectations are for cracks to develop within the positive employment picture.

As the Federal Reserve reacted to rising inflation pressures, the U.S. housing market recoiled. High home prices, tight inventories, and rising mortgage rates crushed housing affordability, housing starts, and existing-home sales. Specifically, the 30-year mortgage rate topped out at 7.16% – the highest level in more than twenty years.[16]

Significantly higher market rates affected all risk-on assets because of the discounting of future earnings growth. Just like Icarus from Greek mythology, Cryptocurrencies fell back to earth – falling over 70% from their 2021 highs. The Federal Reserve's aggressive inflation-fighting policy and subsequent rise in cost of capital led to the collapse of various stablecoins and ultimately the demise of FTX – a major crypto exchange.

Internationally, China's zero-Covid policy and Russia's invasion of Ukraine introduced increased volatility and negatively impacted the markets. During the first half of the year, global growth slowed, supply shortages developed, and commodities spiked pushing inflation dramatically higher. During the Fall, China responding to domestic pressure reversed its zero-Covid policy and has taken steps to normalize the economy. The Russian/Ukraine war has developed into a stalemate with no near-term diplomatic solution. So, there is headline risk, but it has stopped being a significant day-to-day factor for the markets.

Politically, the 2022 U.S. Congressional midterm elections did not deliver the forecasted red-wave but only a small majority in the House for the Republicans. Although initially disappointed, the markets concluded that divided government is bullish since out-sized actions on spending and reforms are unlikely.

2023 Outlook

Although primary inflationary indicators have peaked and are heading lower, 2023 economic growth depends on how "sticky" inflation will be and the continued response of the Federal Reserve. Fundamentum expects inflation to continue to fall below 4.00% but stabilized at a level higher than the Federal Reserve's 2% target due to the strong jobs market and stickier components like rents and services. However, new concerns are developing for the markets: slowing growth, falling corporate earnings, and whether the economy enters a recession. Regardless of whether we have a "formally-defined recession" Fundamentum believes a profit slowdown will occur negatively impacting equities.

With the Federal Reserve's rate hike cycle ending, Fundamentum is turning more positive on fixed income as yields have risen and valuations improve. We expect bonds to stabilize, improve, and reassert themselves as the volatility anchor for a well-diversified portfolio. Equities are still problematic because they are less attractive amid higher interest rates. Only when sentiment, earnings, and valuations better reflect the current, difficult market conditions will Fundamentum look to be more positive on equities.

We are expecting weakness in the first half of the year but a rebound heading into the end of the year. Although not our forecast, the Federal Reserve could successfully deliver a victory over inflation and a soft-landing scenario with lower interest rates, higher P/E multiples, and growing earnings – a very market-friendly outcome. Fundamentum's base case scenario is single-digit returns for 2023, we continue to believe companies that are dividend payers with strong growth profiles, significant pricing power, and solid balance sheets will outperform as they can compensate for the back-and-forth calls for a recession or rebound in inflation. International equities strongly outperformed in the fourth quarter of 2022, and we look for that improvement to continue but at a slower pace.

Longer-term, Fundamentum believes future investment returns will still be below historical norms given slowing growth, high interest rates, and valuation levels. Therefore, we continue to encourage advisors to build diversified portfolios with lower capital market returns into their client's long-term financial plans.

One final note, for more than a generation, **Don't Fight the Fed** has been an investment principle that many are now fighting. The Federal Reserve's FOMC has become more hawkish over the last 3 months. In the Fall, none of the nineteen members thought the Fed Funds rate would finish above 5% in 2023; now, only two don't think so.[17]

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