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Investment Market Review, January 2023

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Stocks rallied in the fourth quarter, but it was not enough to overcome the losses registered earlier in the year. The S&P 500 suffered its first calendar year decline since 2018 and only the fourth such occurrence in the last 20 years. The tech-heavy NASDAQ performed even worse, falling more than 30%. Inflation, and the Federal Reserve's efforts to contain inflation, drove much of the market activity in 2022.

Entering the year, investors were expecting four ¼ point rate increases from the Fed in 2022. Instead, the Fed embarked on the most aggressive rate raising campaign since the 1980s. They delivered seven increases totaling 4¼ percentage points over the course of the year. The Fed is trying to quell the recent period of elevated inflation through higher interest rates.

Inflation emerged as a concern in the middle of 2021 and accelerated to a peak of 9.1% in June, 2022, a 40-year high. Inflation has been trending lower since June, but remains too high, especially compared to the benign levels we have grown accustomed to over the last few decades. The recent deceleration in inflation has been driven, in large part, by falling energy prices and used car prices. Service sector inflation has remained stickier and will be of the utmost importance to the Fed at the next several meetings. There are a number of statistical reasons that headline inflation will continue to trend lower in the near future, but the Fed will want to see evidence that wage pressures are not causing service sector inflation to become entrenched.

Markets have been volatile as investors attempt to discern the magnitude of future Fed rate increases. On several occasions during the year, markets rallied on hopes that the Fed would not need to raise rates as high as feared or that they may cut rates to ward off a recession. The rallies generally faded as investors came to accept the reality that the Fed was determined to extinguish inflation through any means necessary.

The Fed took its first steps toward moderating the pace of rate increases at their December meeting when they raised rates by a ½ point. They had bumped rates up by a historically high ¾ of a point at each of the previous four meetings. This latest increase put the federal funds rate at a 15 year high. Expectations are for rate increases to slow even further in 2023 so the Fed can assess the impact of policy changes enacted thus far.

One of the dilemmas facing the Fed is the disconnect between where they estimate rates need to go and where investors expect rates will end up. Futures markets (where investors speculate on the future price movement of an asset) are pricing in a lower terminal rate for the federal funds rate than the Fed has indicated is needed to bring inflation under control. Loosening financial conditions (i.e., higher stock prices and lower bond yields) that result from the more sanguine outlook of investors counteracts the tighter financial conditions the Fed has been trying to implement to fight inflation. In other words, if investors push stock prices higher and bond yields lower, the Fed might find it necessary to raise rates even higher to reduce demand in the economy and push inflation back down to its 2% target. Where the terminal rate for the federal funds rates lands will be an important factor for stocks in 2023. An important take-away from all of this is that the stock market despises uncertainty; as long as there is uncertainty with respect to the direction of interest rates and inflation, the stock market will likely remain volatile in 2023.

Nine of the eleven sectors in the S&P 500 posted positive returns in the fourth quarter. For the year, only two sectors, Energy (+66%) and Utilities (+2%), were positive. The worst performing sectors in 2022 were Technology, Consumer Discretionary, and Communications Services which were down 28%, 37%, and 40%, respectively.

The key factors to monitor as we enter 2023 will be the trend in inflation, how high the Fed needs to raise rates to feel their mission has been accomplished, and how well corporate earnings fare. The decline in stocks during 2022 brought the valuation of the S&P 500 index in line with the 25-year average; neither cheap, nor too expensive. And while 2023 corporate earnings estimates have come down some since the middle of 2022, they have held up remarkably well in the face of aggressive Fed policy.

The last time the S&P 500 registered declines in consecutive years was 2001 and 2002. If inflation continues to moderate and the Fed successfully engineers a soft landing, a consecutive full-year decline in 2023 might be avoided. As mentioned earlier, the stock market does not react well to uncertainty. If inflation continues to be a problem, with the Fed responding in-kind, and if investors do not have good visibility for an end to this inflation cycle, the market will likely remain volatile

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