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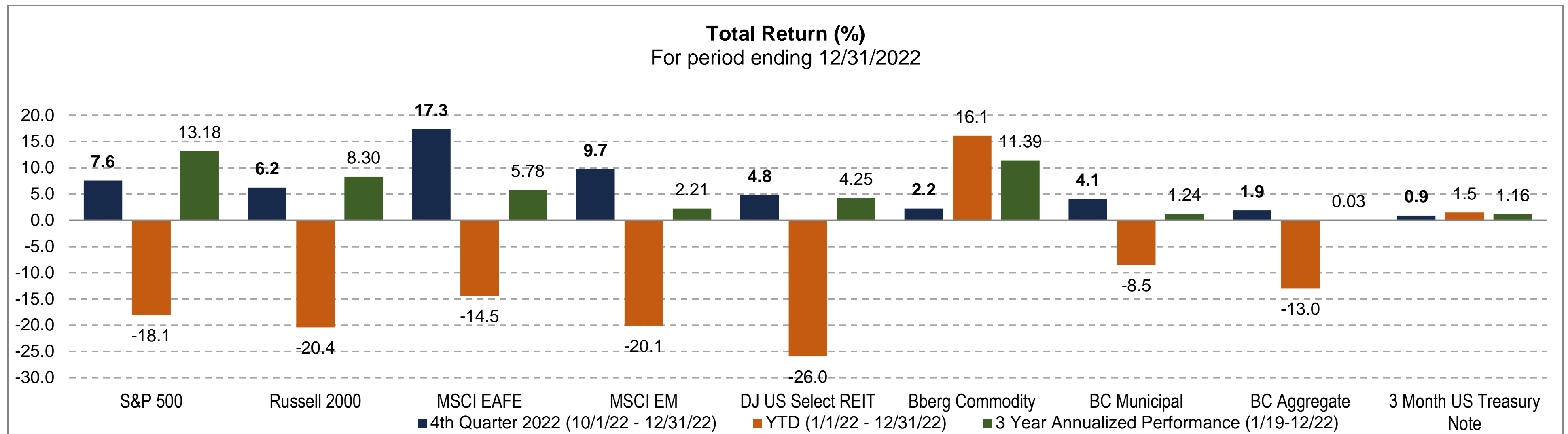
The New Normal Came in a Year Where There Was Nowhere to Hide

Schneider Downs Wealth Management Advisors, LP

Q4 2022 Market Commentary



The good news is that the year 2022 is over. What felt like a 365-day roller coaster ride for investors and capital markets is officially in the books and we are, to quote any number of acerbic professional coaches, moving on to 2023. The flip side to the "moving on to 2023" sentiment is that 2022 happened, and processing all of the events (and not giving short shrift to lessons learned) will be critical for investing success in 2023 and beyond. Throughout the year in 2022 one thing became abundantly clear: the new normal started in a year where there was nowhere to hide.

At this time last year everyone was excited to put the pandemic/COVID lockdowns in the rearview mirror and get back to the business of living. Vladimir Putin hadn't launched an unprompted attack on Ukraine[1], inflation was still "transitory[2]," Xi Jinping was still confined by China's two-term premiership, there was no energy crisis in Europe, TINA (there is no alternative to stocks) was still the prevailing investment sentiment, and savers and fixed income investors remained in the Federal Reserve penalty box receiving paltry yields on their hard-earned money. In less than one calendar year, everything that investors learned in the low-growth, low-inflation, low-interest-rate, easy monetary/fiscal policy years that characterized the post Great Financial Crisis period (2009-2021) had changed.

First and foremost, inflation, domestically and abroad, was most certainly not transitory. Not only did inflation reach an annualized reading of over 9% in June in the U.S.,[3] it remained elevated across the globe as fallout from easy monetary/fiscal policy, China's zero COVID policy and the conflict between Ukraine and Russia weighed on the global economic ecosystem. Elevated and persistent inflation ultimately triggered significant volatility in the stock and bond markets. As we discussed in previous letters, volatility in stock markets, while never comfortable, is not out of the ordinary. However, volatility in the stock market combined with significant stress in the bond market made for a particularly stomach churning 2022.

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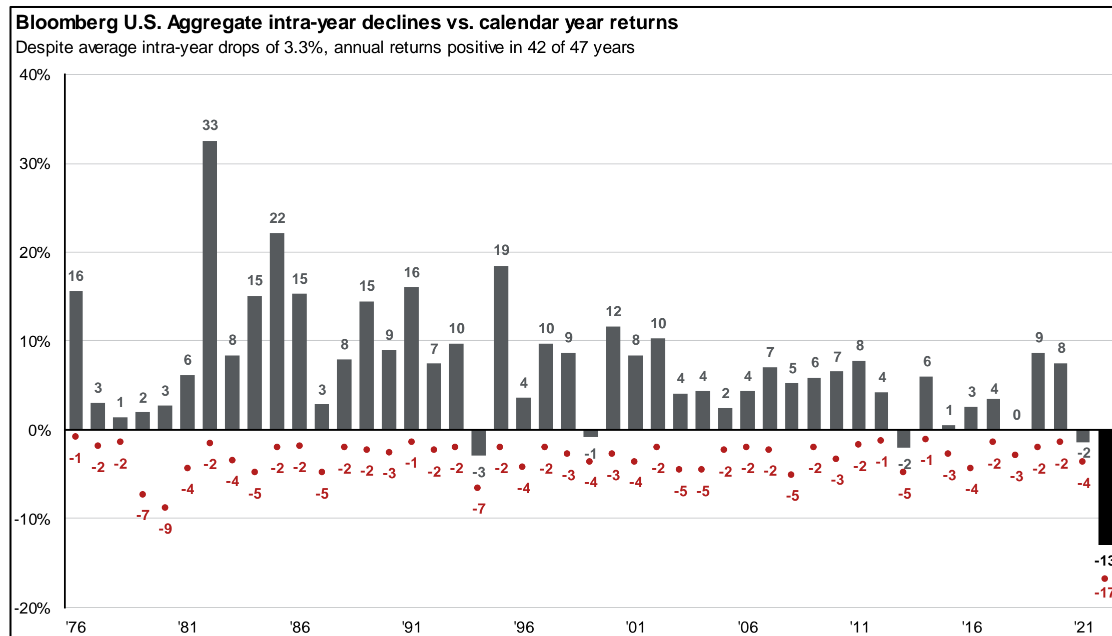
[1] https://www.cnbc.com/2022/02/24/russian-forces-invade-ukraine.html
[2] https://www.cnbc.com/2022/01/11/powell-says-rate-hikes-tighter-policy-will-be-needed-to-control-inflation.html
[3] https://www.bls.gov/opub/ted/2022/consumer-prices-up-9-1-percent-over-the-year-ended-june-2022-largest-increase-in-40-years.htm

Fixed income, the traditional ballast of the portfolio, went from shock absorber to shock contributor. Over a decade of low interest rates and low inflation left traditional fixed income vulnerable to a rise in interest rates.



While the rise in interest rates can take months (or years) to affect equities, the impact to fixed income is more direct. As the chart to the right shows, the benchmark Bloomberg U.S. Aggregate index, comprised mostly of U.S. Treasuries and Agencies, had its largest intra-year (-17%) and full year (-13%) decline going all the way back to 1976. Whereas with stocks there are many more variables to consider (economic growth, competition, sources/areas of revenue, capital structure, among others) fixed income is much more dependent on the level of interest rates.

For the past four decades, beginning in the early 1980's, when Chairman of the Federal Reserve Paul Volcker tamed high teens inflation,[4] we have been in a bond bull market. Bond prices and bond yields have an inverse relationship, and for the better part of 40 years, the direction of interest rates and inflation were on parallel downward trajectories. The trajectories of interest rates and inflation have reversed, and while inflation is showing signs of moderating, we remain well above the 2% inflation target of the U.S. Federal Reserve. As my own weight loss journey can attest, it is never the first ten pounds that are difficult to lose, it's the last five that prove the most difficult. In a similar vein, moving from 9% inflation this summer into the 4% to 5% that most economists expect the economy to hit in 2023 is the easy part. The last 2%-3% will prove difficult with a persistently tight labor market so far not budging in the face of the most significant and aggressive increases in interest rates since the early 1980's. [5] The U.S. Federal Reserve is going to keep interest rates higher and monetary policy tighter than most market participants have ever experienced, and that paradigm shift has ushered in the new normal that will require a different kind of playbook.

The fourth quarter of 2022 offered a glimpse of what we believe to be the new normal. Starting with volatility; in short, we expect more of it, across most, if not all, asset classes. Following volatility, the most important development is that for the first time in over a decade, fixed income is providing investors with a viable alternative to stocks. Short-term treasuries spiked to levels last seen during the 2007-2009 time period. Similarly, high-quality municipal and corporate bonds saw yields reach levels last seen during the taper tantrum of 2013.[6] Investors are no longer forced to own riskier assets to earn reasonable rates of return. While it was a painful exercise to get to this point, moving forward, fixed income looks attractive – something we haven't been able to say in quite some time.

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[4] https://www.federalreservehistory.org/essays/great-inflation

[5] https://www.cnbc.com/2022/12/14/fed-rate-decision-december-2022.html#:~:text=The%20Federal%20Open%20Market%20Committee,with%20no%20reductions%20until%202024.

[6] https://fredblog.stlouisfed.org/2021/08/no-taper-tantrum-this-time/#:~:text=As%20a%20result%2C%20the%20yield,as%20the%20%E2%80%9Ctaper%20tantrum.%E2%80%9D

Domestically, mega capitalization growth stocks that led the way for investors over the past five to ten years took a backseat to their small and medium sized counterparts. The S&P 400 (mid cap) and S&P 600 (small cap) returned +10.7% and +9.2% respectively in the fourth quarter, outpacing the S&P 100 (mega/large cap) which returned +5.5%.[7] A combination of less exposure to stocks like technology and consumer discretionary, which have prices that are much more sensitive to interest rates, along with being less effected by the U.S. Dollar made for a strong quarter for small and medium sized companies is a trend we expect to continue.

As the U.S. dollar declined against other global currencies, international equity markets perked up in the fourth quarter. International markets returned +14% in the fourth quarter, led by developed markets, which returned +17%. Emerging markets posted a solid +9.7% return in the fourth quarter with additional tailwinds coming in the last few days of the year as China announced its reopening plan and loosening of its strict COVID protocols. What international and U.S. small and medium sized companies have in common, relative to their U.S. large cap counterparts, are more attractive valuations and are less impacted (to the downside) by a weaker U.S. dollar. Most of the aforementioned markets also re-rated lower throughout 2022, whereas U.S. large cap markets continued to trade at a premium to historical valuations. As markets continue to adjust to the new normal, we expect the new leadership in portfolio attribution/contribution as compared to 2009-2021.

One of my favorite investment managers is fond of saying, and makes a core tenet of his investment philosophy, that betas and correlations are constantly changing, and as they do so must your mindset.[8] Another quote that conveys the same sentiment was delivered by Lt. Colonel J.L Schley of the U.S. Corps of Engineers in 1929 that said, “there is a tendency in many armies to spend peace time studying how to fight the last war.” Both mindsets/quotes will be critical to investment success in 2023 and beyond. Higher costs of capital to go along with higher yields on fixed income instruments have made investors more discerning. Betas and correlations changed as a result of inflation awaking from a 40-year slumber, and with that awakening, comes a paradigm shift in markets. In a year where there was nowhere to hide, many valuable lessons were learned, and you will see portfolios reflect those changes over the course of this year. The SDWMA team will heed Lt. Colonel Schley’s advice and keep it front and center as we attack 2023 with eyes wide open to the new normal.

As always, we appreciate the trust you place in our team. It is a privilege to work with you and your families and we come to work every day grateful for the opportunity. We look forward to getting together with you in person or virtually in the coming weeks and months. Happy New Year!

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[7] Returns generated by Morningstar Direct.
[8] Chris Lees, portfolio manager of the JOHCM International Select Fund