Market Review
Fourth Quarter 2022

The fourth quarter provided a fitting end to the most significant down year for stocks in a long time.

During the period, stocks started to rally on increasing signs of policy traction in the economy. The Federal Reserve, however, shut the door (again) on the hope that the trends would lead to more relaxed financial conditions. The ensuing December sell-off blunted the tenuous optimism in the market.

When all was said and done, the S&P 500 and Russell 2000 indices gained 7.56% and 6.23% for the quarter, but declined 18.11% and 20.44% for the year. The result was the best quarterly gains in the worst year for the large and small cap benchmarks since 2008. But the only thing that anyone is likely to remember from the final quarter is the sell-off and pessimism into year-end.

The primary driver of the stock market decline in 2022 was the sharp shift in monetary policy from (abnormally) accommodative to desperate and aggressive. Once the Federal Reserve conceded that inflationary pressures in the economy had become entrenched, the situation deteriorated quickly. In February, consumer prices increased at the fastest annual pace since 1982. The tightening cycle commenced shortly thereafter, and advanced fervidly. The resulting 10-month 4.25% cumulative increase was higher, faster than in any of the previous tightening episodes since the 1990s.

The more pressing concern for investors going forward, however, is the intensifying signs of flagging growth. While the most interest rate sensitive indicators – like housing – have long rolled over, the deterioration has extended into the manufacturing and retail economic data. In the summer, the U.S. 2- and 10-Year bond yields inverted, which is widely considered a harbinger of recession. More recently, there was a foreboding spate of disappointing business updates from high-profile corporates, including stalled sales at Target and a massive earnings contraction at FedEx, as well as tempered outlooks (and layoffs) at Google, Facebook, and Amazon, among others.

Not surprisingly, the combination of intense policy and waning growth devastated sentiment. As a result, investors have been quick to dismiss the strong appreciation in October and November as a "bear market bounce." There were, however, several important events that sparked the rally and have the potential to change the narrative in 2023.

The most significant development in the fourth quarter was increasing indications that inflation had finally started to wane. In October, the CPI came in below expectations, bucking the long trend of hotter-than-expected prints. In November, the rise in core consumer prices slipped further to +0.2%, marking the lowest sequential increase since August 2021. The improvement freed up Fed officials to speak more openly about the lagging effects of policy and the risk of over-tightening. They were also key considerations in the decision to scale back the size of rate increases in December and beyond.

The other major change in the period was Beijing's abrupt decision to scale back its long standing zero-COVID-19 stance. This is important for two reasons. First, the policy has caused unpredictable fits and starts that have been another longstanding cause of uncertainty for business and investors. Second, the pivot also means that there is a strong possibility that China will be an incremental growth driver for the global economy in the new year.

Looking ahead, we do not expect the Federal Reserve to move away from its higher-for-longer messaging any time soon. We also believe the potential for recession is significant in 2023. Having said this, it is important to recognize that we are entering the new year under very different circumstances than twelve months ago.

To put this in perspective, when the first interest rate hike occurred in March, the federal funds' target range was 0.25-0.50% and the core PCE Price Index was up 5.2%. By contrast, the federal funds target rate ended the year at 4.25-4.50% while the core PCE Price Index increased 4.7% in November. Because the Federal Reserve's target inflation level is 2.0%, there is still a long way to go, and a lot of risk accordingly. Encouragingly, a lot of the bad news has been discounted, and the fourth quarter reinforced that (i) the monetary policy is working, and (ii) many of the economic and earnings headwinds have begun to recede.

Sources: *FactSet, GICS Sector Classification, U.S. Bureau of Labor Statistics, Visual Capitalist, Forbes Advisors, Briefing.com*

S&P 500 Index is widely regarded as the best single gauge of the U.S. equities market, this world-renowned index includes 500 leading companies in leading industries of the U.S. economy. Although the S&P 500 focuses on the large cap segment of the market, with approximately 75% coverage of U.S. equities, it is also an ideal proxy for the total market. S&P 500 is part of a series of S&P U.S. indices that can be used as building blocks for portfolio construction.

The Russell 2000® Index measures the performance of the small-cap segment of the U.S. equity universe. The Russell 2000 Index is a subset of the Russell 3000® Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership. The Russell 2000 is constructed to provide a comprehensive and unbiased small-cap barometer and is completely reconstituted annually to ensure larger stocks do not distort the performance and characteristics of the true small-cap opportunity set.

Consumer Price Index – The Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services. Indexes are available for the U.S. and various geographic area. Average price data for select utility, automotive fuel, and food items are also available.

Personal Consumption Expenditures (PCE) Price Index - A measure of the prices that people living in the United States, or those buying on their behalf, pay for goods and services. The PCE price index is known for capturing inflation (or deflation) across a wide range of consumer expenses and reflecting changes in consumer behavior.

Index Definition Sources: *Standard & Poor's, FTSE Russell, U.S. Bureau of Labor Statistics, Bureau of Economic Analysis*