Retirement Income Solutions

Helping to grow and preserve your wealth

CELEBRATING 30 Years

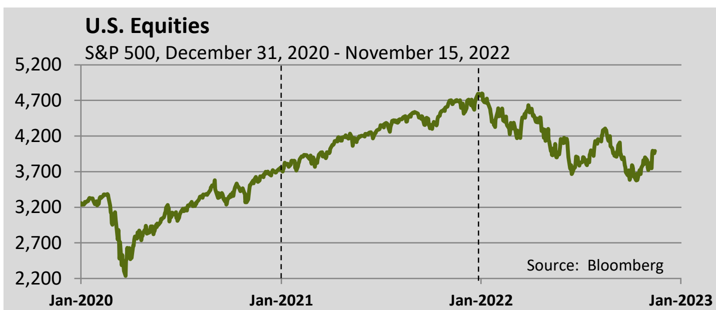
Navigating Uncertainty

November 2022

Summary

2022 has been a year of change and surprises. Soaring inflation, war in Ukraine, and the rapid rise in interest rates were not on many people's radars a year ago. The two biggest surprises of the year were the resiliency of the U.S. economy in the face of aggressive Fed action and dramatic losses in bond markets.

In December 2021, the Fed set expectations of three rate hikes in 2022 totaling 0.75%. Monetary policy changed significantly throughout the year, and the Fed has been quite aggressive, raising rates from effectively zero to an expected 4.5% by the end of the year. It is the fastest pace of monetary tightening in 40 years. Despite the economic pressure from higher rates, unemployment hovers near historical lows, job openings are still 50% higher than before the pandemic, and corporate profits are steady. A year ago, if an investor had forecasted the Fed would raise interest rates by 4.5% in less than a year, the corresponding expectation for stock market returns would have been much worse than the -24% drawdown at the October low point.



Worries of recession were likely premature this year, but chance of a recession in 2023 has increased over the past few months. Analysis on a few aspects of markets and the economic include:

- **For the first time in history, bonds were not a ballast when stocks were negative** in a calendar year. Bonds saw the biggest losses on record, down -16% so far this year.
- **The Fed is hiking at the fastest pace since the 1980s**. Six rate hikes over eight months totaling a 3.75% increase with another 0.50% to 1.00% expected in the next two months.
- **Mortgage rates skyrocketed from 2.8% two years ago to 7.1%** today. Monthly mortgage payments have doubled.
- The end of midterm elections ushers in the **strongest period in the four-year presidential election** cycle, but the influence may be much weaker this period.

Chen Zhao of Alpine Macro summarized the environment succinctly, "Stocks have been caught in a tug of war. A hawkish Fed and lingering economic strength are clashing with weakening inflation momentum, much-cheapened stocks, very-oversold market conditions and growing signals of a softening economy. This tug of war means that the market may be in for an extended bottoming phase with enormous volatility, until the economy softens markedly or core PCE inflation begins to break."

The labor market may be at an inflection point. Fed policy will weigh on both employment and corporate profits. Inflation is a wild card in terms of how difficult it will be to bring down. This means that Fed policy is also a question mark. Even though a mid-year stock market correction lines up very well with the strong presidential election cycle, future outcomes are too variable at this point to increase exposure to stock allocations to the maximum level. Client portfolios were recently rebalanced to a neutral level.

Bonds were not a ballast to portfolios in 2022

One of the basic tenets of investing is to diversify portfolios with bonds. Stock allocations are targeted as the growth engine of a portfolio, and bond allocations are included to provide stability and act as a ballast when stocks returns are negative. Historically, such diversification benefited portfolios in times of distress. In all eight of the years since 1977 (as far back as data is available on the Bloomberg Aggregate Bond index) when stocks were negative for the year, bonds generated positive returns. The average return for bonds in those prior years was 6.7%.

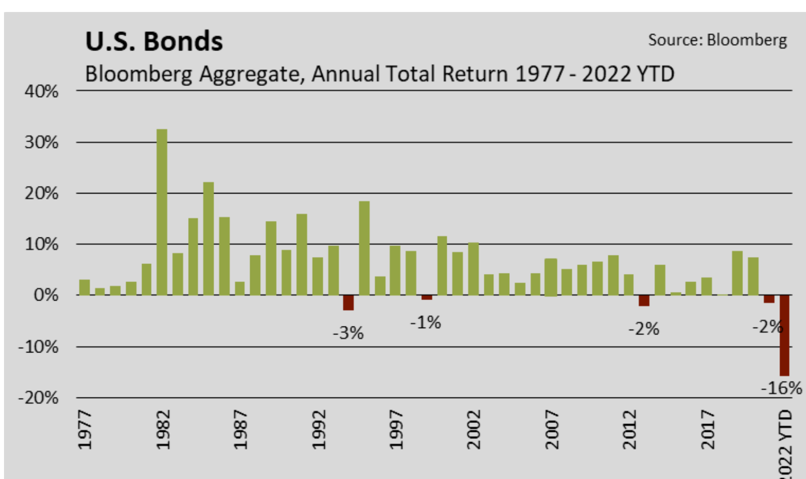
Calendar Years with Negative Returns

1977-2020

Year	U.S. Stocks (S&P 500)	U.S. Bonds (Bloomberg Agg)
1977	-7.5%	3.0%
1981	-5.1%	6.2%
1990	-3.2%	9.0%
2000	-9.1%	11.6%
2001	-11.9%	8.4%
2002	-22.1%	10.3%
2008	-37.0%	5.2%
2018	-4.5%	0.0%
2022 YTD	-17.7%	-15.7%

Source: Bloomberg

The bear market in 2022 did not see such a ballast from bonds. The return so far in 2022 is a loss of -15.7%. The combination of the post-pandemic record low interest rates with the Fed fighting inflation through raising short-term rates generated significant losses with bond investments. Not only were bond returns negative, but they also generated the worst return by far since the index was created. Bonds only saw losses in four other calendar years due to rising rates – 1994, 1999, 2013 and 2021 – all of which were -3% or less.



In a year with significant risk, there were good investment choices that could help mitigate losses. Many of those tools were utilized in large percentages in client portfolios, avoiding or minimizing use of the traditional Bloomberg Aggregate type bonds. Stable value and other guaranteed return tools generated small positives, short-term bonds on average lost only -4.9% (1/3 of the traditional bond losses), and other non-equities ranged from small negatives to solid gains.

Fastest Fed rate hiking cycle since the 1980s

The axiom of "don't fight the Fed" is a phrase that describes the strong correlation between Fed policy and financial market returns. When the Fed is easing financial conditions, markets tend to do well; when the Fed is tightening conditions, markets tend to struggle. It is not a concept to be applied blindly, but it is an important theme to keep in mind. One of the Fed's main tools is setting short-term interest rates (via the Fed Funds Rate, which is the rate at which banks lend to one another).

Fed Policy

Fed Funds Rate, 1990-2022

First hike	Last hike	Beginning rate	Ending Rate	Change	Months	Change per month
2/4/1994	2/1/1995	3.00%	6.00%	3.00%	13	0.23%
3/25/1997	3/25/1997	5.25%	5.50%	0.25%	1	0.25%
6/30/1999	5/16/2000	4.75%	6.50%	1.75%	11	0.16%
6/30/2004	6/29/2006	1.00%	5.25%	4.25%	25	0.17%
12/17/2015	12/20/2018	0.00%	2.25%	2.25%	37	0.06%
3/17/2022	11/2/2022*	0.00%	3.75%	3.75%	8	**0.47%**

Source: Bloomberg

The policy action by the Federal Reserve in 2022 is currently the fastest tightening of monetary policy since the 1980s. The Fed has raised rates by 3.75% over a short eight-month window, including four 0.75% increases. In the last 30 years (prior to 2022), the Fed has only bumped rates by 0.75% once, in 1994. There are still likely a few more increases to come in the next few months*. While rate hikes are deemed necessary to fight inflation, the full impact on the economy of such a dramatic change in monetary policy is not clear. When in doubt, keep the mantra "don't fight the Fed" in mind.

Home prices and mortgage financing demonstrate coming economic challenges

Fed policy affects many aspects of the economy, and the impact of higher interest rates can be seen in the housing sector. When combined with higher home prices, increased mortgage rates create a challenge to the affordability of home ownership. Two years ago, a 30-year mortgage rate was 2.84%, and the average new home price was $337,500. Today, a 30-year mortgage rate is 7.08%, and the average new home price is $454,900. Not only does the average purchaser need to come up with $23,480 more in down payment, they also must be able to pay $15,907 per year more (a 119% increase) to cover principal and interest.

Mortgage Affordability

	November 2020	November 2022	Change
Median sales price (Q3)	$337,500	$454,900	+35%
20% down payment	$67,500	$90,980	+35%
30-year fixed mortgage rate	2.84%	7.08%	+149%
Monthly mortgage	$1,115	$2,441	+119%

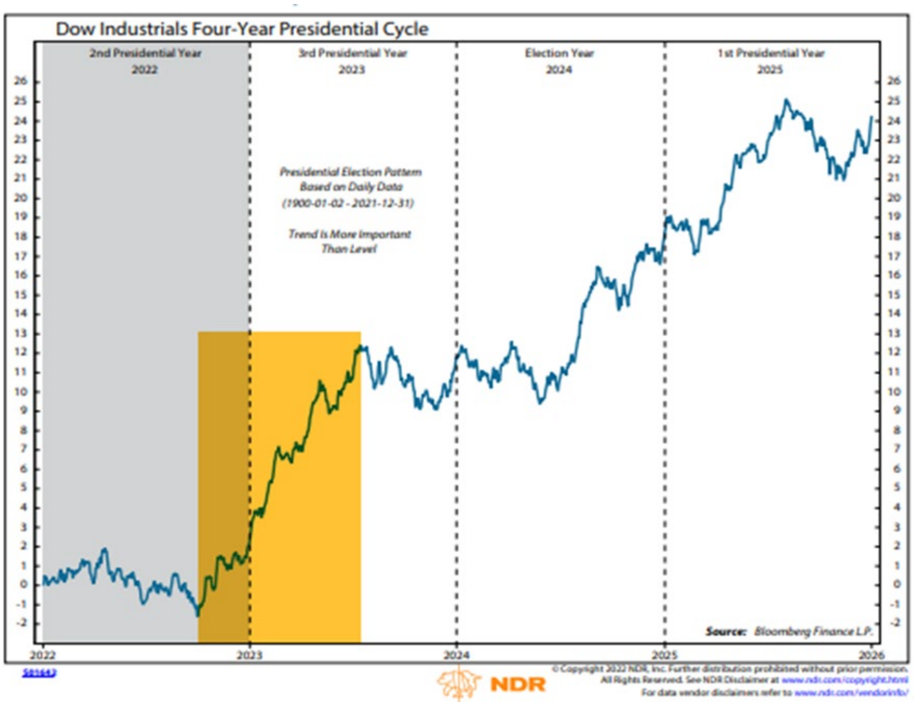
Source: FRED, Federal Reserve

While it seems likely that interest rates will fall at some point in 2023, higher mortgage payments will be a challenge for many families.

Presidential cycle influences

During an election cycle, emotions run high. It will be a nice reprieve that political ads will be gone for a while. It is important to remember that while politics are important, politicians do not run companies, generate ideas on what new products or services are needed, make decisions about whether to expand or close a business, or make hiring or firing decisions. A President typically receives too much credit for strong periods as well as too much blame for weak ones.

Specific election outcomes are not typically gauges of future stock market results. However, the four-year presidential cycle can be an important indicator for evaluating financial markets. The period immediately following midterm elections has a historical tendency to be quite strong. Ned Davis Research illustrated the strong influences of the four-year cycle with a chart of the average market returns since 1928. The study indicates that the strongest returns of the entire four-year cycle typically occur after the midterm election and into the first half of the year (yellow shaded area). Risks may increase in the back half of the year and into the election year.

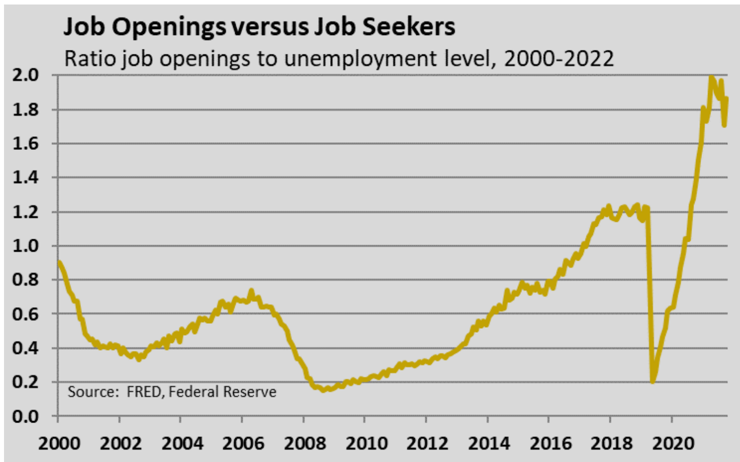


It is also important to note that post-midterm returns are not quite as strong for second-term presidents as those of those in the first term. This may occur since a lame duck president cannot be re-elected and has less incentive to stimulate spending.

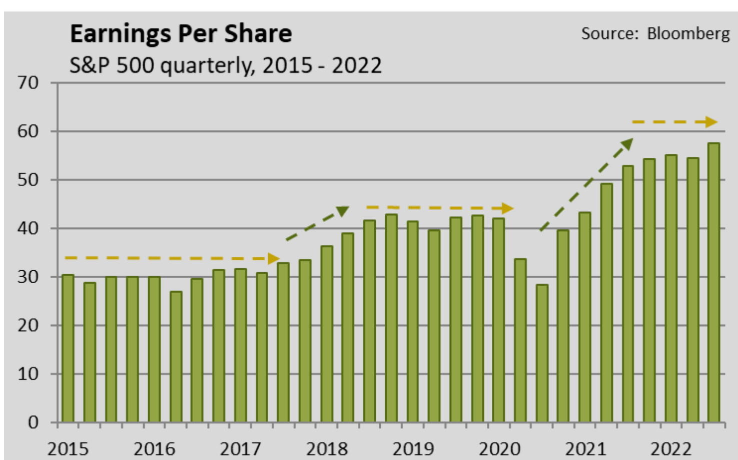
Considering the cycle for 2022-2023, the influences may not be as strong this period. The key factor behind this cycle is higher levels of stimulus and cash flow. When politicians want to get reelected (all incumbents!), they tend to favor policies and projects that stimulate the economy, particularly in the pre-presidential election year. However, there are a few factors that make such stimulus less likely in the year ahead. The massive stimulus related to the pandemic may have pulled in the spending to earlier years. A politically divided Congress is unlikely to embrace new programs or large spending increases. At the same time, surging inflation will put pressure on spending in the other direction (spend less, not more to help fight inflation).

Recession calls over the summer were too early

Various aspects of the economy slowed this year. Home prices have started to fall over the last few months, and single-family housing starts dropped significantly throughout the year. Manufacturing PMIs (activity in the manufacturing sector) fell steadily since January. Inflation has been the main story for the year, reaching 9% year-over-year in June and exemplified by gasoline prices which reached $5 per gallon over the summer. The slowdown and inflation combined to weigh on consumer sentiment which fell throughout the year.

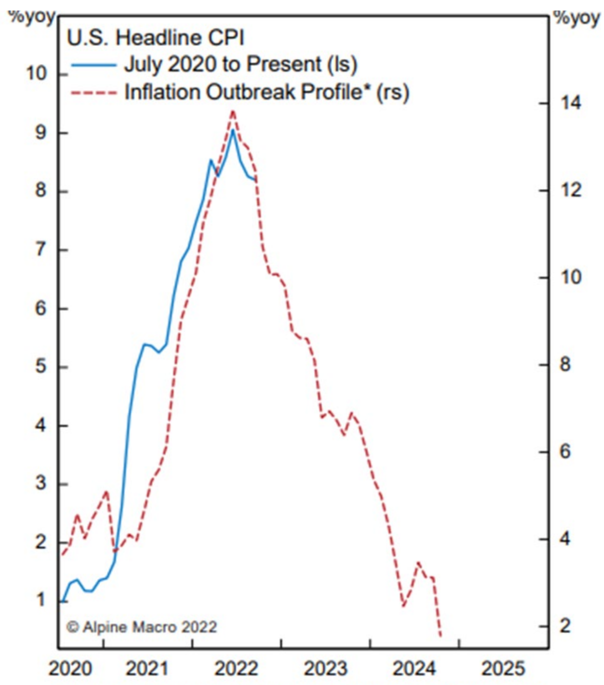


Over the summer, the news media focused intently on the impending recession. While GDP growth was negative and certain sectors have slowed, the economy has been quite resilient. Unemployment hovered most of the year near historic lows of 3.5% with an October reading of 3.7%. Another way to view this resiliency is to compare the number of job openings to job seekers (see chart, above). While the ratio has declined slightly, there are currently 1.8 job postings for every person that is unemployed – still significantly higher than any period prior to the pandemic. This is observable in daily activities since many restaurants and businesses are still short-staffed.



Corporate profits have also been resilient. Walmart (WMT), for example, exceeded both earnings and revenue estimates in the third quarter and lifted its fiscal year outlook. Earnings per share surged after the pandemic and have flattened since. Earnings growth is currently decelerating but not yet contracting. The speed of the slowdown in earnings matters; faster drops in earnings are more difficult for markets to digest.

While the U.S. economy saw two quarters of negative GDP growth in 2022, the bigger uncertainty from a slowing economy will likely occur next year, possibly in mid to late 2023. Financial markets have rebounded somewhat from the lows in October, and that recovery could continue through the end of the year. The resiliency of the economy has been impressive, and the stock market may continue to celebrate the expected pause in Fed actions. How long the recovery lasts is an important question; the Fed will win in its effort to defeat inflation, and it may be difficult for markets to sustain the current recovery next year.



*Average of 5 major inflation outbreaks from the 1940s through the 1980s

Inflation seems to have peaked and should continue to lessen into 2023. Alpine Macro conducted a study of the 16 inflationary cycles since 1930, determining that most cycles develop unexpectedly, are non-linear, and tend to be symmetrical in their rise and fall. Using history as a guide, inflation could remain well above the Fed's target of 2% for most of 2023.

It seems likely that the Fed will pause the series of interest rate hikes in early 2023 given that it takes months for policy to be reflected in the economy. Expectations of such a pause have helped the market recover somewhat in November. However, if inflation does not clearly trend towards 2% next year, the Fed will likely restart the process of raising interest rates. A second round of rate hikes may be difficult for the market to absorb. Since inflation has been much stickier than expected in 2022, it could continue to run hotter than expected, which would be disruptive for financial markets.

There is still room for the Fed to "stick the landing" with its policy in 2023. This would entail meaningful reductions to inflation with limited impacts to employment, corporate profits, etc. Such an environment could happen, but it should not be the base case for managing portfolios. If the Fed does not execute perfectly, the volatile markets of 2022 may continue into 2023.

Current positioning

Inflation is at a 41-year high, and the Fed is in its most aggressive tightening cycle since the 1980s. Those two conditions differentiate this period from those leading up to the last few recessions. In this market, not fighting the Fed means accepting the idea of a longer hiking cycle and bigger swings in stock market returns. The stock market saw six swings of 10% or more this year alone. While a year-end rally is likely, aggressive Fed policy may trigger increased uncertainty and stock market drawdowns in 2023. An environment where inflation spiked from very low to very high has not occurred since the 1960s, so the outcome after fighting such an inflation spike is very difficult to gauge.

Subsequently, portfolio allocations remain at reduced exposure with a "neutral" allocation, which is halfway between minimum and maximum equity levels.

If you have questions on the investment environment or your portfolio, please call us at 734-769-7727. To find an electronic copy of this document and other recent commentaries, please visit our website at www.risadvisory.com.

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