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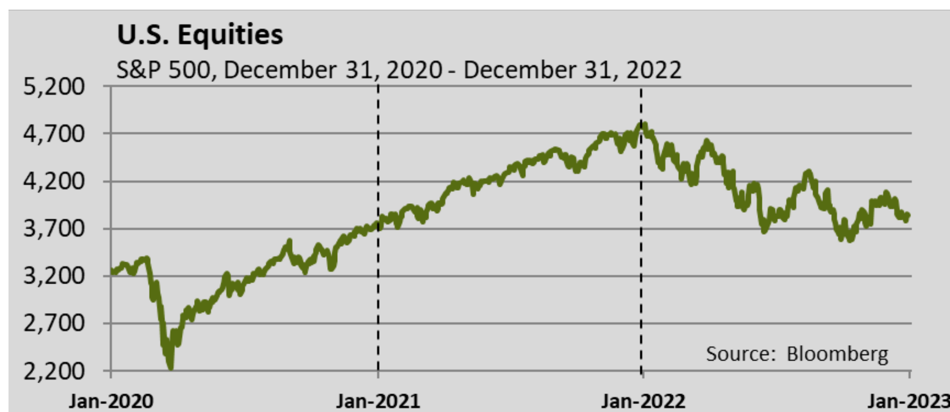
The Economy is Slowing, and That's the Plan

January 2023

Summary

2022 was a tough year for financial markets. Both stocks and bonds saw double-digit losses. Surging inflation forced the Federal Reserve to aggressively raise interest rates. Fears that the tightening monetary policy would cause a recession sparked a -25% drawdown in the S&P 500 as well as a -36% drawdown in the technology-heavy NASDAQ. Bonds are normally a safe haven during stock market angst, but almost all major asset classes saw negative returns and cash was one of the only places for safety during the year.



The economy is slowing, and a recession is a real possibility for 2023. Such an environment is concerning, but much of the bad news may already be factored into current prices. Swings in the stock market are likely to continue as markets wrestle with the timing and severity of the economic slowdown.

1. The biggest impact on portfolios in 2022 was not the stock market drawdown but the largest losses ever in the bond market. Prior to 2022 when stocks saw meaningful losses, every case saw positive bond outcomes with an average return of +7%. Last year, bonds provided no ballast to diversified portfolios and ended the year down -13%.

2. Financial markets have been anticipating a slowdown, and there is a good chance that the U.S. economy sees a recession this year. While the adage "Don't fight the Fed" continues to be appropriate, a lot of the damage to the stock market has already taken place. Certain indicators point to underlying strength which could imply a relatively mild economic slowdown.

3. The presidential election cycle lined up well with a weak 2022 and provides some optimism for 2023. The period immediately following midterm elections has tended to kick off the strongest 18 months in the four-year cycle.

4. Stock market drawdowns are not uncommon. While the stock market has generated strong returns over time, there are periods of market weakness which have been regular and long-lasting. Such periods of weakness have occurred every three to four years since the Financial Crisis in 2008. In the past, weakness has helped set the stage for the next leg up.

While both stocks and bonds have room for positive returns in 2023, a neutral equity position for portfolios is still warranted for now.

Analysis & Current Positioning

A year ago, markets peaked after an extended period of low volatility. The stock market in 2021 was not only strong but extremely steady as well. The biggest drawdown in 2021 was -5.2%, the second lowest calendar year volatility in the last 25 years. Consequently, our outlook from 2022 was titled “A Transition Year,” warning of the late stage in the market cycle, rising interest rates, and expectations of higher volatility. The main expectation for the year was that changes to monetary policy can be disruptive, “While there is no timer set for when volatility will strike more deeply, it has been almost two years since the start of a 10% correction… While markets were stable in 2021, it is unlikely that such stability will continue in 2022… history reminds us that sometimes ‘stuff happens’ when monetary policy pivots.”

Unfortunately, “stuff happened,” and both stock and bond markets saw double-digit losses. However, expecting volatility is a lot easier than experiencing it. Since most asset classes were strongly negative in 2022, a basic 60% equity / 40% bond portfolio saw double-digit losses and was almost as negative as the 2008 Financial Crisis (see page 3). Two things helped managed portfolios significantly in 2022: first, reduced equity allocations helped shelter from some of the drawdown; second, and probably most important, reduced allocations to normal bond allocations sheltered from losses in the traditionally stable bond environment.

Multi-week periods of gains and losses are more frequent during transition periods, and the S&P 500 endured eight corrections of at least 5% last year. That is more than double the average of 3.4 and ties 2020 and 1974 for the second most 5%+ corrections since the 1930s, after 2008. The index also saw three 10% corrections, tying 2008, 2002, and 1987 for the most since the 1930s.

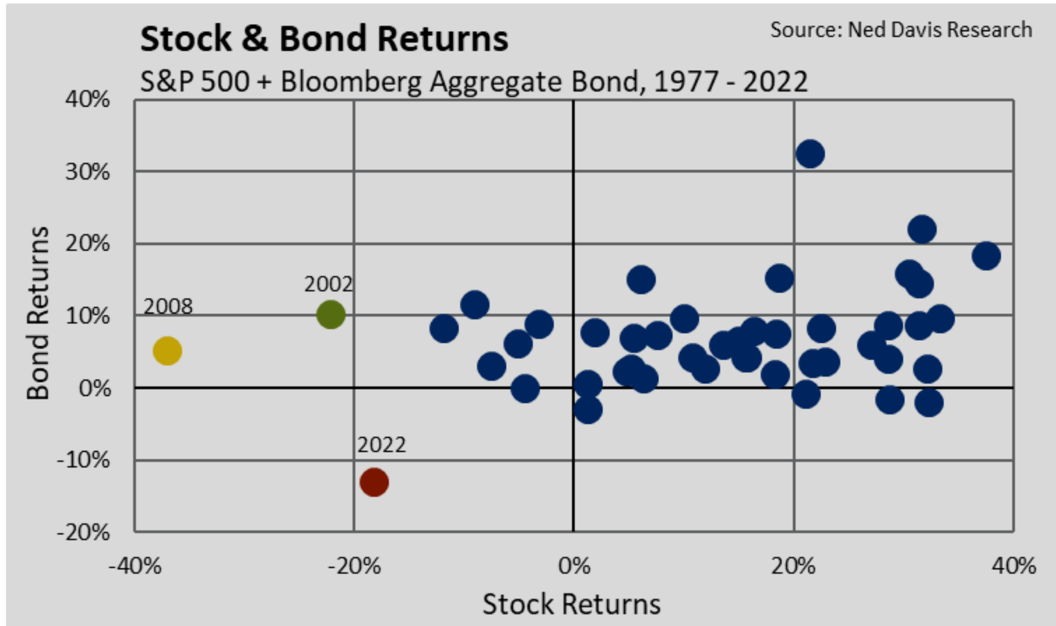
Looking forward at 2023, volatility is likely to continue but the downside risk is significantly less than last year. The well-anticipated recession is on the table for 2023, but the severity of the slowdown is still unclear. The Fed is near the end of the most aggressive rate hiking cycle since 1980 by taking the Fed Funds Rate from 0-0.25% to 4.25-4.50%, including four consecutive 0.75% hikes. Higher interest rates are intended to slow the economy, and such policy action has always led to a recession in the past. While the history of Fed tightening is concerning, most of the damage to markets has likely already taken place.

Economic growth is slowing, but there is underlying strength in employment. After a year of aggressive rate hikes, unemployment remains at its historical low of 3.5%. A common complaint from businesses over the past three years has been the problem of attracting and retaining good workers; such concerns may make businesses more reluctant to lay off workers than in prior economic slowdowns. This could keep wage inflation high. Past inflationary cycles have been symmetrical, meaning that a spike peaking after 18 months of increases should be followed by a proportionate reduction over roughly 18 months. Inflation has been slowing since last summer, implying that it may return to acceptable levels by the end of the year. For inflation to fall meaningfully, an economic slowdown is not only expected but also necessary. So, the main question is the severity of the slowdown. If inflation continues the current downward trend, then the Fed can stop increasing rates and just hold them steady. It will take a while to confirm that this balancing act will be successful, and the result is likely to be continued swings in financial markets. Improving inflationary expectations will generate positive upswings. A vigilant Fed will continue to weigh on markets until inflation is under control.

Portfolios continue to be positioned near their neutral equity targets (halfway between maximum and minimum). While a recession seems probable at some point this year, it is likely to be mild. However, volatility is expected until there is more certainty around how much the economy contracts. After painful stock and bond returns in 2022, this year seems to be positioned for improvement. The strength of any stock market recovery will take a while to sort out, but bonds seem better positioned for recovery.

2022 – An Infamous Year

The U.S. stock market saw a tough year in 2022 with losses of -18%. While double-digit losses in stocks are fairly common, the bigger surprise for portfolios came from bond returns. One of the most basic tenants of investing – diversify portfolios using bonds to reduce volatility – did not hold up. Historically, stock investments generate stronger returns, and bond investments provide a ballast to portfolios in the years when stocks are down. Since 1977, the stock market has been negative in nine calendar years, and bonds generated positive returns in all eight prior cases (but not in 2022).



Data for the most widely recognized bond benchmark, the Bloomberg Aggregate Bond index, is available going back to 1977. Below is some interesting data on the infamous year…

- Of the 46 calendar years since 1977, nine years saw negative stock market returns. This fits with the expectation that, on average, one out of every five years will realize poor stock market returns.
- **Bonds are usually a ballast.** Of the negative years prior to 2022, 100% (eight out of eight cases) saw positive bond outcomes with an average return of +7%.
- **Bond losses are not common.** Prior to 2022, bonds saw negative returns only four times (1994, 1999, 2013, 2021).
- **The negative bond returns in 2022 were significant.** The loss of -13% in 2022 was larger than all prior loss years combined.
- In some ways, 2022 was **the worst year for balanced portfolios since the Great Depression.** To go back further, the only data available on bonds is an index based on U.S. Treasuries. The only other year when stocks saw double-digit losses and bonds did not act as a ballast is 1931 when stocks were down -43% and U.S. Treasuries saw losses of -2%.
- **A basic 60-40 portfolio in 2022 realized almost the same losses as the Financial Crisis in 2008.** Using a simplified 60% U.S. stock and 40% Aggregate Bond portfolio… in 2008, bonds provided a ballast generating a 60-40 return of -20%. In 2022, stocks saw losses that were only half of 2008, but bonds compounded the losses generating a 60-40 portfolio return of -16%.

Year	Stocks	Bonds	60-40
2008	-37%	5%	-20%
2022	-18%	-13%	-16%

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A Widely Anticipated Recession

For almost a year, financial markets have been anticipating a recession. There is a good chance that the U.S. economy sees a recession this year, but markets have been well ahead of any meaningful slowdown in economic activity.

As a response to the highest inflation since the 1980s, the Federal Reserve raised interest rates quickly. A year ago, markets expected two or three rate hikes in 2022; the Fed ended up increasing rates seven times throughout the year with a current target of 4.25% to 4.5%.

As a result, the cost of borrowing has gone up significantly. As evidenced by mortgage rates, the average rate when financing the purchase of a home increased from under 3% in 2021 to 7% at the end of 2022.

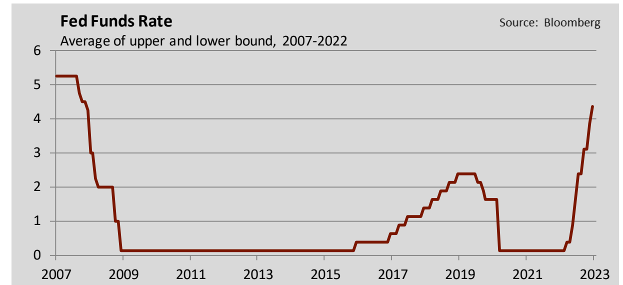
Higher rates have constrained economic growth. The post-pandemic surge in economic activity has slowed significantly, and further slowing could push GDP to a negative level which is indicative of a recession.

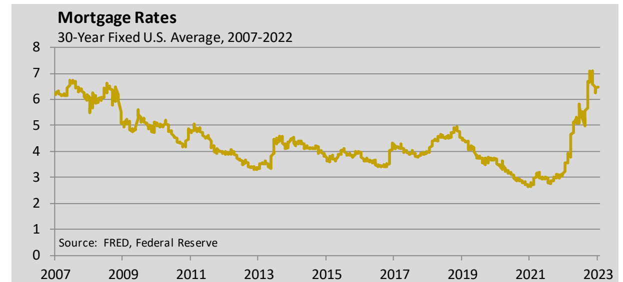
The higher rates and slowing economic activity are bringing down inflation. It took inflation approximately 18 months to hit its peak and will likely take a similar period to return to normal levels.

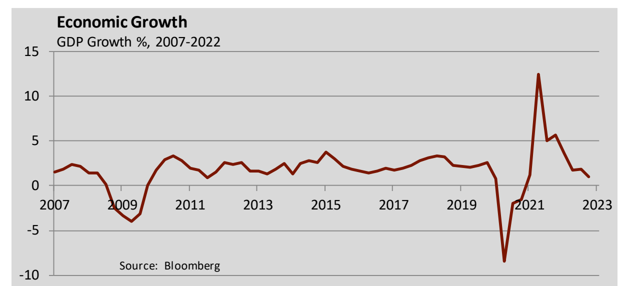
A recession in 2023 seems to be the most probable outcome, but several indicators show underlying economic strength. Hourly earnings are an important indicator of labor cost inflation and of tightness of labor markets. Such earnings growth is still quite strong and higher than any reading in the ten years prior to the pandemic. The December data shows wages still growing at 4.6% higher than a year ago.

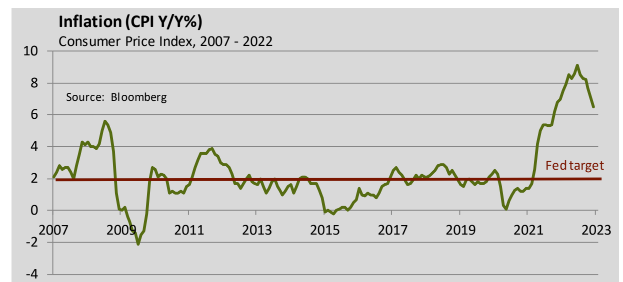
Another indicator showing some resilience towards rising interest rates is initial jobless claims which have stayed steady and quite low for all of 2022. While this number will likely increase in 2023, unemployment remained at a historically low level of 3.5% in December.

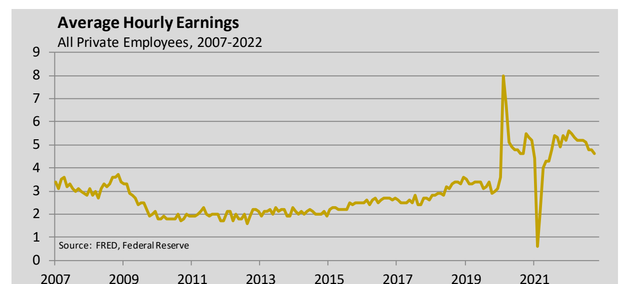
Fears of a recession were the key driver to the bear market last summer. While the adage "Don't fight the Fed" continues to be appropriate, a lot of the damage to the stock market has already been incurred. Certain indicators point to underlying strength which could imply a relatively mild economic slowdown and therefore most of the stock market turmoil could be in the rear-view mirror.

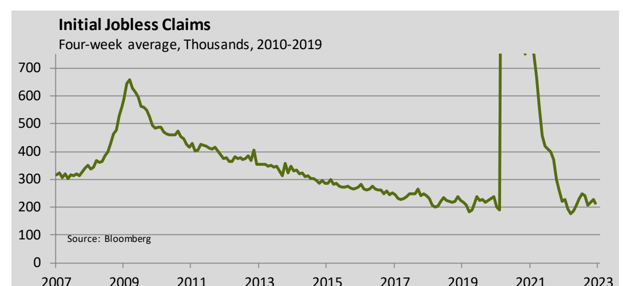












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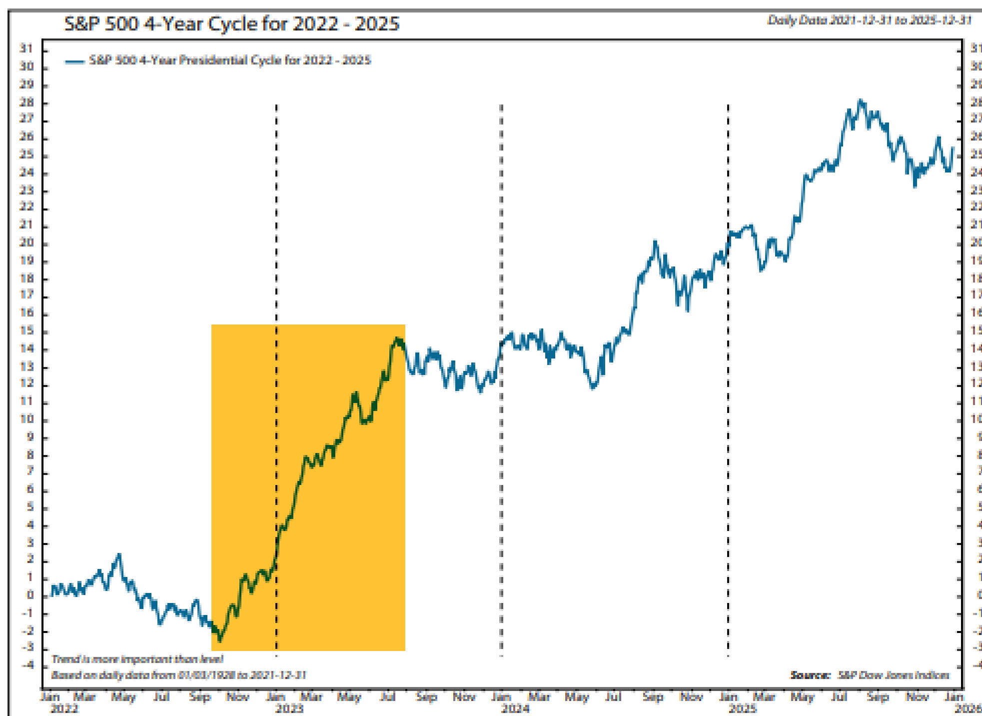
Presidential Election Cycle

One important influence on market returns is the presidential election cycle. While not perfect, the cycle lined up well with a weak 2022 and provides some optimism for 2023. Historically, the post-election year brings positive results from optimism after the conclusion of the election. In the second year, translating ideas into legislation turns out to be more challenging than expected. Monetary and fiscal stimulus typically lessen. The combination of disappointment and lack of stimulus weighs on markets. As a result, the mid-term election year is the weakest year in the four-year cycle. Since 1948, the S&P 500 is positive only 63% of the time, and the median gain per year was only 6.3%, significantly less than the other three years. The mid-term year tends to be even weaker in periods after the incumbent party loses an election.

While monetary and fiscal policy typically weaken in a mid-term year, 2022 saw big shifts in Fed policy via large rate hikes and a large reduction in post-pandemic fiscal spending. The stock market responded with a double-digit drawdown that concluded in October… right in line with the midterm trends.



The period immediately following midterm elections has tended to kick off the strongest 18 months in the four-year cycle. Ned Davis Research illustrated the strong influences of this period with a chart of the average market returns since 1928. With election uncertainty and lackluster (or negative) midterm returns in the rear-view mirror, markets tend to recover. The pre-election year is typically the strongest as monetary policy improves and politicians pursue policies (and spending) that will help them get re-elected. There is no guarantee the market will mirror historical trend, but the presidential cycle indicates a more favorable period could be ahead.

Election Year	Example	Median	% Positive
Mid term	2022	6.3%	63%
Pre-election	2023	22.6%	100%
Election	2024	11.9%	89%
Post-election	2025	12.3%	63%

Source: Bloomberg

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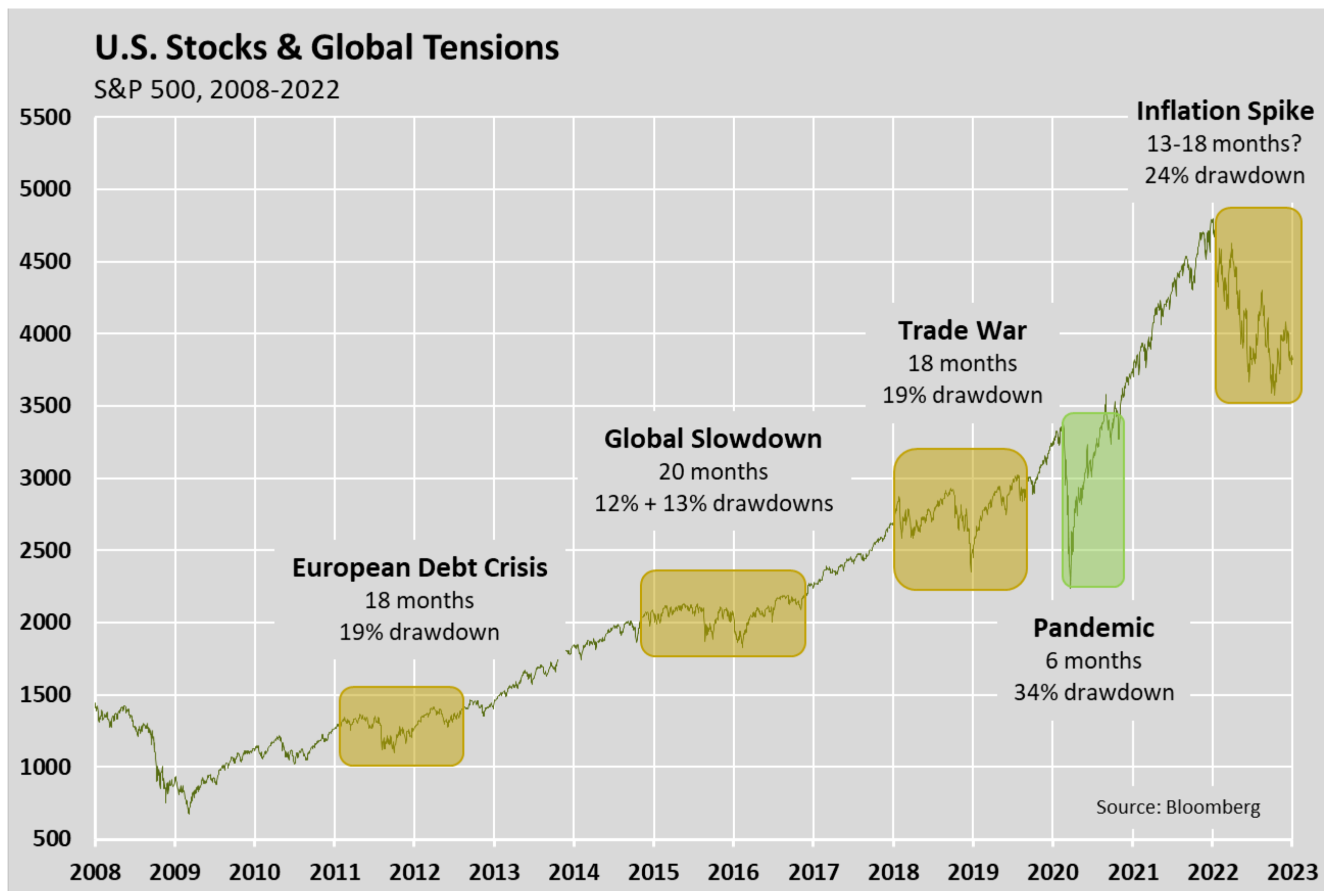
Stock Market Drawdowns are Not Uncommon

The business cycle is a normal part of the U.S. economy. There is a rhythm of sequential ups and downs to the economy which lead to a similar cycle of stock market advances and declines. While the stock market has generated strong returns over time, there are periods of market weakness which have been regular and long-lasting.

Roughly every three to four years since the financial crisis, fears of recession have interrupted the stock market advance. In 2011-2012, economic growth slowed as banks in Europe were in distress from rapidly rising interest rates. Fears of a double-dip recession led to a -19% drawdown in stocks. In 2015-2016, global output slowed dramatically, China manipulated their currency, and oil prices plummeted. Stocks fell by -12%, briefly recovered, and then fell again by -13% a few months later. In 2018, consequences of tariffs and the trade war began to set in. Manufacturing slowed and businesses delayed decisions until more clarity was available on tariffs and treaties. Fears of a recession led to a -19% drawdown.

The pandemic is somewhat of an exception to the normal pattern since it was such a strong and unforecastable event. In some ways, it was just a compressed version of the normal cycle. After the strength of the pandemic recovery, inflation spiked causing the Fed to tighten monetary conditions in an accelerated fashion. Worries of a recession caused a -34% drawdown in stocks. The full period of stock market woes is not yet known but is likely to follow the pattern of past cycles. Just as weakness in 2011, 2015, and 2019 set the stage for stock market gains, the 2022 weakness should help set the stage for the next leg up.



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2022 Asset Class Returns

Driven by fear of a global slowdown and recession, equity markets fell throughout most of the year. October is the month in which most bear markets end, and after a -25% drawdown concluding on October 12, the U.S. stock market recovered a bit at the end of the year, finishing at a -18% loss for the year. The losses were consistent across all major asset classes. The technology-heavy NASDAQ lost -33% while the 30-stock Dow Jones Industrial Average was down -7%. International stocks were down slightly less than the U.S. at -14%, and emerging markets were down -20%. The broadest measure of stock performance, the All Cap World Index, lost -18%.

2020		2021		2022	
Small Caps	+20.0%	Commodities	+30.1%	Commodities	+20.6%
S&P 500	+18.4%	S&P 500	+28.7%	Dow Jones	-6.9%
Emerging	+18.3%	Dow Jones	+21.0%	High Yield	-11.2%
LT Treasuries	+17.7%	All Cap World	+19.1%	Invest Gr Bonds	-13.0%
All Cap World	+16.9%	Small Caps	+14.8%	International	-14.5%
Dow Jones	+9.7%	International	+11.3%	All Cap World	-18.0%
International	+7.8%	High Yield	+5.3%	S&P 500	-18.1%
Invest Gr Bonds	+7.5%	Invest Gr Bonds	-1.5%	Emerging	-20.1%
High Yield	+7.1%	Emerging	-2.5%	Small Caps	-20.4%
Commodities	-3.0%	LT Treasuries	-4.7%	LT Treasuries	-29.3%

Source: Bloomberg

Interest rates rose at the fastest pace since the 1980s, and bonds suffered their worst year ever (at least since the inception of the Bloomberg Aggregate Bond Index in 1977). Rising interest rates are bad for bond returns because the old (lower) rates are no longer competitive, and prices must fall to make the new yield higher. Prior to 2022, the worst year for investment grade bonds was a loss of -3% (1994). The 2022 results were four times worse, ending the year at -13%. The other three loss years were all relatively small with losses of -2% or less (1999, 2013, and 2021). High-yield bonds typically pay a higher yield, so their losses were slightly less at -11%. Long-term treasury bonds, which carry the most interest rate risk, ended the year down -29%.

While the negative returns were widespread amongst almost all asset classes, several allocation decisions in 2022 helped mitigate the losses significantly.

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Final Thoughts

The end of the Fed's hiking cycle is in sight, but it may take some time before the full impact of the Fed's aggressive policy actions are known. The resilience of employment and wages demonstrates some underlying economic strength, and inflation is slowing. The stock market typically bottoms six months before the end of a recession, but the October low likely occurred before the recession even started. The recent spike in inflation was stickier than most expected, and the Fed is determined to get it under control. Markets should continue to recover as inflation improves, but market swings may continue as the economy slows. While both stocks and bonds have room for positive returns in 2023, a neutral equity position for portfolios is still warranted for now.

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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