BALLENTINE PARTNERS

Market Update

2022 Market Review: In the Rear View Mirror, Happily

BALLENTINE PARTNERS | BRUCE D. SIMON, CFA, CPWA®

Market Recap

It was a year that most investors would like to forget. Both stocks and bonds suffered double-digit losses in 2022, providing little solace to those who own fixed income securities as a buffer from the volatility of the stock market. The MSCI All-Country World Index dropped 18.4% in 2022 and the Bloomberg US Aggregate Bond Index fell 13%. A traditional mix of 60% US stocks (S&P 500) and 40% bonds lost more than 16%.

The primary culprits: 1) stubbornly high inflation that refused to slow until late in the year, caused by COVID-related supply and demand disruptions, fiscal stimulus that boosted consumer spending, and the Russian invasion of Ukraine; and 2) the Fed's increasingly aggressive efforts to restrain inflation by ratcheting up interest rates without sending the US economy into a recession. Higher interest rates are intended to dampen demand by making it more expensive for businesses and consumers to borrow or invest.

Below the surface, some interesting changes in longstanding patterns were evident. Despite the negative impact of a strong dollar, the MSCI EAFE index of non-US developed international markets (primarily Europe and Japan) outperformed the US for the first time in 5 years. Despite high inflation, soaring energy costs, and constant political turmoil, the MSCI Europe Index fell "only" 15% in 2022, outpacing the S&P 500 by more than 300 basis points. In the US, investors witnessed a major rotation out of growth stocks and into value stocks. Longtime tech leaders such as Amazon, Facebook, and Tesla were crushed. Although still negative on the year, the Russell 1000 Value Index's 7.5% decline was much more palatable than the 29% hit taken by the Russell 1000 Growth Index.

There were few places to hide in 2022. Real estate stocks, usually considered a strong hedge against inflation, fell 25% as the impact of higher interest rates on highly leveraged real estate companies outweighed the relative price stability of the underlying properties. Infrastructure stocks, one of our preferred inflation hedge strategies, performed relatively well, falling 6.6%. Gold was essentially flat on the year, reinforcing its reputation as an important (but historically unreliable) inflation hedge. Commodity prices, boosted by supply constraints arising from the war in Ukraine, gained more than 10%. And we know what happened to crypto.

Outlook and Strategy

As we begin a new calendar year, many of the same issues that confronted financial markets in 2022 are still present. How quickly will inflation fall to more comfortable levels? How many more interest rate increases will the Fed implement before deciding that their job is done? Will the US enter a recession in 2023, and if so, how severe will it be? Is a cessation in the war in Ukraine a possibility this year? A positive resolution to these questions should result in a buoyant recovery in stock prices. The opposite is likely to trigger more market declines.

While the answers to these questions are largely unknowable, there are other factors at play which give us confidence that 2023 will be different (and better) than last year. Inflation appears to have peaked in October and is now falling, with further declines likely as weakening housing prices and rents flow through to the official data. The Fed is expected to end its rate tightening effort sometime in 2023, with perhaps only another 1% increase ahead. Importantly, the 18% decline in the S&P 500 last year has relieved the excessive valuation problem in US stocks that was present at the start of 2022. While not cheap, valuations on US stocks look far more reasonable now. At the same time, the higher yields available in the fixed income market today have significantly reduced the risk of owning investment-grade bonds. In other words, the risk/return tradeoff for both stocks and bonds looks far better than it did a year ago.

As we noted last year, we believe the underlying strength of the economy is far greater than during the last major downturn in 2008-’09. Consumer and corporate balance sheets are healthy and much more capable of weathering a slowdown in growth. Unlike 2008, banks are well-capitalized. Unemployment rates remain near multi-decade lows and earnings growth is expected to remain positive. For these reasons, we expect a US recession, if one does occur, to be relatively mild.

Long-term investors savor the opportunities created by the market selloffs that occur every few years. This time is no different. The most expensive mistake an investor can make is to deviate from a long-term investment plan by selling equities at the wrong time – while perhaps incurring a tax liability – in anticipation of further price declines. Even if the sale occurs before the market drops, one must buy back in before all the losses have been recouped in order to be better off than doing nothing. Easier said than done.

Trying to capture the bottom is a fool’s errand. But adding exposure when prices are down, consistent with an investor’s long-term strategic allocation plan, has proven to be a winning strategy for those able to tolerate the bumpy path ahead.

We wish everyone a happy and productive 2023!

About Bruce D. Simon, CFA, CPWA®

Bruce is a Partner and the Director of Research at the firm. In addition to working directly with a number of family clients, Bruce serves on Ballentine's Investment Management Committee, which is responsible for the oversight of all of the investment activities for the firm.

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