Bad – But, Not 1872 Bad Q4 2022

Q4 provided some relief from the unpleasantness of 2022. Large and small cap stocks bounced 7.5% and 6%, respectively, but the big story is the full year. According to Deutsche Bank AG, you have to go all the way back to 1872 to find double digit losses in both stocks and bonds. Doing a little digging, we found, to our amazement, in 1872 the country was staggering through an equine flu pandemic. Most horses got too sick to work, and other than railroads, horses delivered almost everything else. Panic ensued as essentials (coal, food, beer, etc.) ran out; prices skyrocketed. The economy fell into a deep recession - no horses! No horses to pull fire wagons, and in early November, downtown Boston was destroyed in a firestorm.

2022 was bad, but it wasn't firestorm bad. The S&P 500 fell 18.1%, reversing all the gains from 2021, almost to the exact point. That's some interesting symmetry. The returns from 2021 were clearly pumped up by ill-considered Fed and fiscal stimulus, the reversal of which has knocked us back a year. Stocks were ahead of themselves, especially the big tech companies, which led the market decline by a wide margin. They're much more reasonably valued now. Not so the meme stocks and crypto. They remain radioactive, in our opinion. Of course, every year there are winners, too. Energy soared on supply constraints and the war in Ukraine, and the play-it-safe sectors (utilities, staples, and healthcare) mostly did their job. As we've written several times over the last year, the 2021 investment party was epic, and the 2022 hangover has been most acutely felt by the drunkest. Do we have more to pay for our financial sins? A little more on that later.

As for the bond market, 2022 was the worst year in living memory. The Bloomberg US Aggregate Index fell 13%. This was unusually painful for balanced portfolios accustomed to the benefit of rising bond prices as interest rates typically fall during times of stress. But rates were inexplicably still near zero as the economy roared out of Covid-19. There may never be an adequate explanation for why the Fed kept up the extreme stimulus (rates near 0% and bond buying) even as inflation flashed past 6%, then 7%, then 8%. Once-in-a-lifetime losses were baked in as the Fed finally recognized their monumental error and embarked on one of the most aggressive rate hiking cycles in modern history.

So, where to from here? We'll begin with rates. The Fed funds target rate hasn't been anywhere near this high (4.5%) since the end of 2007. Fifteen years is a significant chunk of time and a near eternity in finance. It's well more than long enough to convince nearly everyone, including the Fed, that rates and inflation were permanently lower. Debt levels across the globe rose as confidence in a very low-rate world allowed and encouraged ever larger balances. Almost unbelievably, Covid-19 came along and cruelly flipped the script. As my ninth grade Spanish teacher loved to say, "truth is stranger than fiction." Rates at current levels don't work; they grow progressively more destructive the longer they persist. It's impossible to say whether or not a systemically important accident will occur before rates begin to come down, but they will be coming down as they bite into the financing of the world's economic machinery, suffocating growth and inflation. Timing? The second half of the year is a reasonable bet, resulting in investment grade bonds having positive returns in 2023. That's not a heroic prediction, by the way.

As for equities, they're reasonably valued, but not cheap. The excesses have been largely wrung out. Helpfully, Fed easing is eventually coming, but there's that much-discussed recession lurking out there. We continue to believe any downturn is likely to be mild given still robust excess consumer savings and a tight labor market. But EVERYONE knows all of this; it's been Topic One in financial news for the better part of a year. It's in the number, as they say, meaning everything that is known is reflected in the price. In fact, stocks really haven't gone anywhere in six months; they're waiting to see which way the economy and earnings break. My Spanish teacher had another favorite, "el borro sabe mas que tu." Literally, a donkey knows more than you. Regarding the future, we must confess he's right. We don't know. Our best advice? Avert your gaze and let your asset allocation and time work its magic.

We hope everyone has a healthy and happy 2023.

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