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Maclura Investments

4Q22 Review - The Fed Will Continue to Drive the Market

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It has been fourteen years since investors have had to experience a market as detrimental to returns as this year. While the returns of the Morningstar U.S. Market index was not down as much as it was in 2008 (when it returned a negative 37.03%), the negative return of 19.43% for 2022 was felt throughout nearly all alternatives available to investors, as bonds had their worst year in at least 45 years with interest rates throughout the year.

Exhibit 1. Investment-Style Returns

	Morningstar Index Market Returns	2015	2016	2017	2018	2019	2020	2021	2022 1st Qtr.	2022 2nd Qtr.	2022 3rd Qtr.	2022 4th Qtr.	2022
Growth	U.S. Growth	5.54%	3.16%	29.52%	0.78%	35.90%	44.65%	24.79%	-11.97%	-25.33%	-3.84%	0.15%	-36.70%
Growth	Large Growth	7.71%	1.79%	31.15%	2.94%	33.81%	38.86%	21.47%	-13.55%	-29.81%	-2.74%	1.06%	-40.36%
Growth	Mid Growth	-0.71%	6.46%	25.67%	-3.16%	36.01%	46.17%	14.97%	-16.01%	-21.33%	-2.37%	4.84%	-32.37%
Growth	Small Growth	-0.18%	9.61%	23.77%	-5.67%	27.60%	43.52%	-1.00%	-13.37%	-22.41%	-2.49%	1.75%	-33.13%
	US Market	0.69%	12.44%	21.47%	-5.05%	31.22%	20.99%	25.78%	-5.33%	-16.85%	-4.56%	7.26%	-19.43%
Value	U.S. Value	-2.16%	20.79%	14.23%	-7.51%	25.09%	-1.31%	23.98%	2.35%	-9.44%	-6.60%	14.68%	-0.72%
Value	Large Value	-1.43%	18.91%	15.09%	-5.90%	25.70%	-0.62%	21.49%	1.63%	-8.16%	-7.09%	15.61%	0.26%
Value	Mid Value	-2.57%	25.21%	13.02%	-10.63%	24.81%	-3.76%	29.02%	4.85%	-12.65%	-5.11%	12.31%	-2.39%
Value	Small Value	-8.65%	27.96%	8.40%	-16.61%	19.96%	1.01%	31.79%	1.80%	-12.78%	-5.14%	10.88%	-6.60%

Source: Morningstar

With limited alternatives for a positive return for the year, the energy sector had the strongest returns for the second consecutive year. This benefited value indexes that typically have more weight in energy stocks and are underweight in the worst performing sector for the year, the technology sector. Bonds performed better on the short-end of the curve, as the Morningstar 1–5 year core bond index was down only 5.74% for the year, while the longer duration Morningstar 10 plus core bond index fell 27.57% for the year.

This past year marks two significant milestones: the end of the shortest bull market since the 1970's and the start of the current bear market on the first trading day of the year, January 3, 2002. The dates of bull/bear markets can only be known in retrospect by the movement of a general stock benchmark (for this purpose the S&P 500 index was used). Generally, the definition of the start of a bull market is determined after broad stock benchmarks have risen 20% from recent lows and end when the market declines by 20% after a period of rising greater than 20%. The definition of a bear market is the same, but the start date used is after stock prices have peaked and is confirmed after a 20% or greater drop in a general stock benchmark.

Duration of Bull Markets since 1974					
Dates		Calendar	S&P 500 Price		
Start	Ending	Days	Start	Ending	Return
10/3/1974	10/5/1987	4,750	62.28	328.08	426.8%
12/4/1987	9/1/2000	4,655	223.92	1520.77	579.2%
10/9/2002	10/9/2007	1,826	776.76	1565.15	101.5%
3/9/2009	2/19/2020	3,999	676.53	3386.15	400.5%
3/23/2020	1/3/2022	651	2237.4	4796.56	114.4%

source: factset

Duration of Bear Markets since 1974					
Dates		Calendar	S&P 500 Price		
Start	Ending	Days	Start	Ending	Return
10/5/1987	12/4/1987	60	328.08	223.92	(31.7%)
9/1/2000	10/9/2002	768	1520.77	776.76	(48.9%)
10/9/2007	3/9/2009	517	1565.15	676.53	(56.8%)
2/19/2020	3/23/2020	33	3386.15	2237.4	(33.9%)
1/3/2022	ongoing	362	4796.56	3839.5	(20.0%)

source: factset

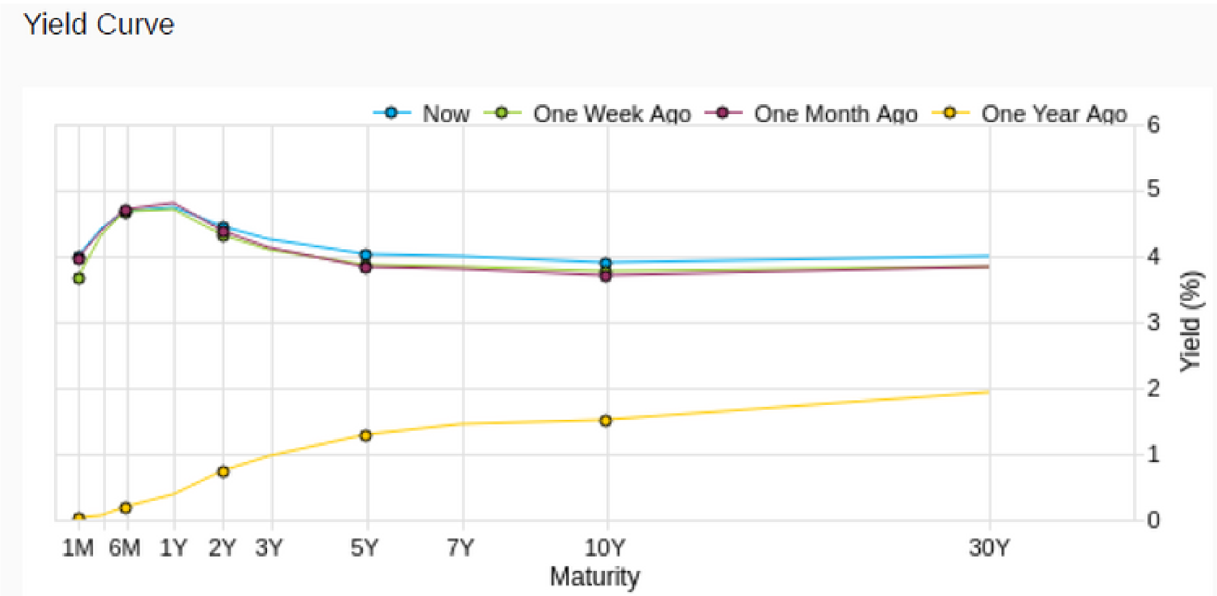
The past bull and bear markets starting in the mid-1970's illustrated in the table above are based on the daily closing prices of the S&P 500 index. Of the five bull markets over that time period, the average return has been approximately 325%, with the duration being multiples longer than the typical bear market over the same time period. While the length of the current bear market is similar to other bear markets, the negative return is much lower than historical returns of previous bear markets.

There were a number of factors influencing the market in 2022, but perhaps the most significant factor was the action by the Federal Reserve in mid-August to prioritize the reduction of inflation as its primary objective as Fed Chairman Jerome Powell warned in a speech that "some pain" for the economy would be needed to help the Fed achieve its inflation goal of 2%. The significance of the Fed's pivot to a more painful remedy to slow down inflation was that the market was up over 18% from its intra-year low (from June 16th when the Morningstar U.S. Market Index closed down 23.85% and recovered to only being down 9.85% year-to-date on August 16th). Investors had been incorporating a pause in the Federal Reserve's action on interest rates and were back to being enthusiastic about the market. Unfortunately, Chairman Powell eliminated all hope that the market would have a positive return for the year, and the market has been trading down since then.

Outlook for 2023:

As with this previous year, the 2023 outlook is heavily dependent on the actions taken by the Federal Reserve. The "pain pivot" last August by the Fed to prioritize returning inflation to 2% is an example of how a surprise turn of an event in a dynamic environment can alter expectations set earlier in the year. After the December Federal Reserve meeting, the committee members released their updated economic projections, lowering their expectations of real GDP growth in 2023 to 0.5% from the September median estimate of 1.2%, while increasing the unemployment and inflation expectations for the year. After the release, a number of journalists during the press conference tried to get Chairman Powell to quantify the probability of a recession in 2023, but he was consistent in saying that the projections, albeit near zero percent growth for 2023, are nonetheless positive and thus do not indicate a recession.

Exhibit 3: U.S. Government Yield Curve



Chairman Powell's perspective on this is important to consider since the majority of economists are predicting a global slowdown and recession in the United States in the second half of 2023. Perhaps the slowdown will be similar to the first two quarters in 2022 where there were two consecutive quarters of negative GDP growth, and it was not defined as a "recession," although by previous definitions it would have been defined as such. Regardless, bond investors are projecting a pivot in monetary policy by the Fed indicated by the inverted yield curve (long term yields lower than near term yields), see above graph.

At the December Federal Reserve meeting, the Fed raised the federal funds rate (short term rates) by a ½ percentage point (50 basis points), bringing the targeted range for the fed funds to 4.25% - 4.50%. It has been an extraordinary year of monetary policy change that is unprecedented in the magnitude relative to any historical time period. And while much attention has been put on the rates rising 4.25% this year alone, the Federal Reserve continues to aggressively reduce its balance sheet which takes money out of the system and has indicated no end in this process in the near-term. Central banks throughout the world are slightly behind the Fed, but nearly all of them have reversed their monetary policies to a more restrictive stance after over a decade of easy monetary policies. Chairman Powell mentioned in his December press conference that the committee anticipates that ongoing increases will be appropriate in order to attain a stance of monetary policy that is sufficiently restrictive to return inflation to 2% over time. Likely those additional increases could total 100 basis points, bringing short-term interest rates to a range of 5.25% - 5.5%, though committee members forecasted a median peak rate projection of 5.1%.

Before the financial crisis of 2008, it was common for the economy to operate in an environment of inflation and interest rates in the 3% to 4% range, while the economy grew near 2%. It will take time for investors to adjust to the new norm, but as the Fed starts to slow down and pause their rate changes, the markets should view this as a positive pivot in policy, resulting in the stabilization of the market and setting the stage for the bull market to return.

Labor availability, the Ukraine/Russia conflict, COVID resurgence, disrupted supply chains, deglobalization, and energy demand are just a few of the factors to watch going forward that will impact the market for years to come. It cannot be reiterated enough that the ramifications of the global policies concerning COVID since early 2020 will continue to reverberate throughout the world's economy for the foreseeable future. China's labor cost advantage has lessened over the years, and companies had been trending towards moving manufacturing out of China years before COVID impacted its economy. China's zero-COVID tolerance policy hastened the move of manufacturing out of China as companies start to prioritize a safe, dependable supply chain over a cheap, less dependent one.

While academia and economists will debate and attempt to quantify the cost of deglobalization as being less efficient and more inflationary, the impact of the supply chain disruptions to the world's economy over the last several years justify the move to a more regional basis of manufacturing. The difficulty that most economies will have to grapple with in the new age of deglobalization is the availability of labor. Like Kevin Costner's line from the 1989 movie Field of Dreams, "If you build it, they will come," it will be doubtful that a deglobalization will benefit all. The countries with the ability who field the workforce will be those to excel in the new environment.

In my thirty plus years in the investment industry, this past year ranks as being one of the most challenging and frustrating. Nonetheless, I believe there is a good probability that 2023 will mark a transition from the current bear market to a bull market before the end of the year. It will definitely be a volatile market, and there remains a lot of unknown, but all bear markets do come to an end. While we wait for this transition, we will continue to have clients well-diversified in companies that have strong balance sheets and solid competitive positioning which will benefit investors when the market stabilizes. This is the type of companies sought by Maclura Investments to build client's individual portfolios. While the short-term markets will fluctuate, investing in the right companies for the long-term should get you to your wealth destination.