

Monthly Market Commentary

2022's investment environment has been incredibly challenging. We have seen the effects of high inflation, tightened monetary policy, and slowed growth environments worldwide. This month, we compare our expectations from January with the actual market outcomes.

From our January 2022 Commentary:

"VOLATILITY is expected to be the norm in the market in the short term. Equities, specifically growth companies, have moved significantly lower on speculation around Fed policy and the rising rate environment. This has been in response to elevated inflation data released over the last 6 months. We expect to have another year of large divergence in sector returns. We believe there is significant value in technology and healthcare companies. We believe there are many good companies trading at "sale" prices today."

Outcome: Volatility was present all year and we had substantial divergence in sector returns:

| S&P Sector Returns | Prior Close | 1 Week | YTD | 1 Year |
|---------------------------------|-------------|--------|-------|--------|
| S&P 500 Communications Services | 165 | -3.3 | -37.6 | -37.3 |
| S&P 500 Consumer Discretionary | 1084 | -1.2 | -32.1 | -32.3 |
| S&P 500 Consumer Staples | 797 | 0.4 | 1.5 | 6.1 |
| S&P 500 Energy | 645 | -3.2 | 58.8 | 56.0 |
| S&P 500 Financial | 580 | -0.1 | -9.1 | -8.7 |
| S&P 500 Healthcare | 1622 | 0.7 | 0.2 | 5.3 |
| S&P 500 Industrials | 850 | 0.2 | -3.5 | -2.7 |
| S&P 500 Information Technology | 2331 | 0.4 | -23.0 | -23.3 |
| S&P 500 Material | 512 | -0.5 | -8.3 | -5.4 |
| S&P 500 Real Estate | 242 | 0.8 | -23.6 | -18.8 |
| S&P 500 Utilities | 366 | 2.6 | 3.5 | 7.9 |

Sources: Bloomberg, Wells Fargo Investment Institute; as of December 12, 2022.

Healthcare proved to be one of the best defensive allocations through the volatility while the Technology sector posted returns below the broader market.

"INFLATION reads are expected to be elevated for the first half of the year, calming down in the second half. We expect to see a steep rise in the short end of the curve, while the curve itself will flatten. 4-6 rate hikes over the next 24 months is the consensus across wall street."

Outcome: Inflation steadily increased throughout the first half of the year, peaking at 9.1% in June. A steep rise in short-term Treasury yields caused a flattening of the yield curve. A 50bp increase to the Fed Funds rate happened yesterday at the conclusion of the Federal Open Market Committee meeting. including this most recent rate hike on December 14, we have had seven rate hikes this year.

"DOMESTIC EQUITIES we believe there are many great companies with good cash flows and solid capital structures that have been dragged down to sale prices. This is not the case for everything out there, but many companies are oversold. We are still managing on a longer term timeframe and believe that many of our Core positions that have taken a recent hit will get through this volatility and serve as an opportunity to add to at these levels. We are not completely through the volatility, but sellers are starting to get exhausted. We do have a growth tilt in portfolios, and many of you are seeing that come through in the performance to start the year. We believe this is still the best place to be long term."

Outcome: This year, value stocks have outperformed growth stocks, though some oversold companies in our portfolios recovered later in the year. We shifted from a growth tilt to a value tilt in portfolios in April of 2022 and have been rewarded in relative performance since then after underperforming in Q1.

Monthly Market Commentary (Cont.)

“**FIXED INCOME** the environment is incredibly challenging. We are staying on the shorter end of the curve but in higher quality. We expect longer duration fixed income to be very difficult to allocate moving forward. Credit spreads suggest high yield may not be the best option either. We believe there is value in floating rate, interest rate hedged debt, and private credit opportunities.”

Outcome: Fixed Income markets have had one of the worst years on record, specifically in the duration and credit areas of the market, which we avoided. The short-term and high-credit-quality exposure tilts that we had in portfolios resulted in our largest relative outperformance of any asset class this year (through the time of this publication).

LOOKING FORWARD

Overall, we saw a tremendous amount of activity in 2022, and we expect to see the same in 2023. Here are the themes and outcomes we are evaluating as we head into next year:

ECONOMY – We expect to fall into an official recession in 2023, driven by slowing growth. We expect the labor market to be much more resilient than in prior recessions and expect the current unemployment rate of 3.8% to rise to 5 – 7%. We expect that higher interest rates and slowing demand will soften housing prices. However, given the severe shortage in housing inventory, we anticipate that prices will fall only 5 – 15% nationally (as opposed to the severe downturn which occurred in 2008-2009). We expect that inflation will cool from its current 7.1% year-over-year rate but stay above the Fed’s 2% target rate.

MONETARY POLICY PIVOT – The market is currently pricing in 1-2 more 25bps rate hikes in Q1 of 2023, followed by the Fed pivoting and lowering rates throughout the remainder of 2023. We believe a much more likely scenario is that we see 1-2 more rate hikes followed by a Fed PAUSE where they hold rates at higher levels throughout 2023 until they see inflation come closer to their target.

EQUITIES – We expect volatility in equities to continue throughout the first half of 2023. Historically, the market has never bottomed out before the Fed has finished hiking rates. We believe that we will see a deterioration of profit margins as companies experience slowing consumer demand and higher costs of capital. Although it is difficult at this point to forecast when and how recovery will begin, we do believe that the second half of 2023 will provide relief for investors.

FIXED INCOME – This market saw a tremendous amount of movement in 2022, and even in the last month as the yield on the 10-year Treasury Bond dropped from 4.5% to 3.5%. We believe its yield will move higher in the short term to a range of 4.00-4.50%, putting pressure on higher duration fixed income, before ultimately falling back down in the second half of the year as a result of economic deterioration and turbulence. We believe we will see a rise in bankruptcies and credit events, which will increase the spreads between high yield bonds and investment grade bonds and put pressure on higher-risk credit areas of the market. Longer term, we believe the times of “free money” and 0% Fed Funds rates are over, and that over the next decade investors will be able to achieve higher yields from corporate bonds as compared to the last decade.

We will continue to actively manage portfolios through the shifts we see in the marketplace and believe that 2023 will provide a great environment to enter the market, especially for long-term investors. As always, please reach out to your financial advisor with questions or concerns, and have a wonderful holiday season!

-The Seventy2 Capital Team

Commentary and Research provided by:

Michael Levitsky, CFA®, CAIA® - Director of Investment Strategy