Making Sense of Finance

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Fourth Quarter 2022 Review

STOCK MARKET

The final quarter of 2022 ended on a positive note for two of the major US stock indexes. The S&P 500 index rose over 7% in the fourth quarter, finishing out the year higher than its mid-year level before the third quarter sell off. The Dow Jones Industrial Average increased significantly in the fourth quarter with a gain of more than 15%. The tech heavy Nasdaq Composite index however had a slight loss last quarter. This big divergence in returns for the fourth quarter was also evident in the yearly returns, with losses of 19%, 8% and 33% respectively for the above three major indexes. It was the worst year for the US stock market since 2008. Any stock that came into 2022 with a high valuation (ex. high price/earnings multiple) was punished severely. The value of a stock came into focus (not just what the company did) in the rapidly rising interest rate environment of 2022. Fundamentals mattered. The Federal Reserve raised the Fed Fund target rate twice in the fourth quarter, yet stocks rose in general despite those increases as the market looked forward to what the Fed may do in 2023. Although positive in the fourth quarter, major bond and stock indexes declined together in 2022 for the first time since the 1960's. The S&P 500 index hasn't experienced two consecutive negative years since 2002.

The energy sector was the best performing sector last quarter and for the year. Energy and utility stocks were the only stock sectors with positive returns in 2022. The second-best performance last quarter came from the industrial stocks. The materials stock sector also outperformed the general market in the fourth quarter as the prices of many commodities increased. Gold rose 9% last quarter; other precious metals posted even larger price gains. The consumer discretionary sector was the only loser in the fourth quarter as all other stock sectors had positive returns. This decline was exaggerated by the over 50% decline in the quarter for the second largest market weighted stock in that group, Tesla.

Stock market returns outside of the United States were for the most part greater than domestic stock indexes last quarter. In a reversal from earlier in the year, the U.S. dollar index declined in the fourth quarter which boosted

Making Sense of Finance

Everyone and their neighbor has an opinion. At Karagosian Financial Services, we have a combined 40 plus years of investment experience. We have seen the markets at their highest highs and lowest lows. Through this newsletter we attempt to convey our opinions on current events in the investment world and their likely outcomes. Forecasting is inherently difficult and our advice is geared toward making sensible and prudent choices based on logic and experience, and not based on emotion.

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the returns of the foreign markets when measured in U.S. dollar terms. The MSCI EAFE index of markets in developed countries increased 17% last quarter in U.S. dollar terms although still lower for 2022. European stock markets did well with most recording double digit percentage increases measured in US dollar terms. European stock valuations were at historically low levels at the start of last quarter; many of those same stocks rebounded strongly in the fourth quarter. Like here, there were hopes of inflation peaking abroad yet still with the strong possibility of interest rate hikes. Most stocks markets in emerging market countries did well last quarter except for Brazil (which outperformed in the previous quarter) and Taiwan.

BOND MARKET

The Bloomberg Barclays US Aggregate Bond index, an index of domestic investment grade bonds, had a total return of over 1% last quarter although returns were negative for 2022. This index has never experienced two consecutive negative years. Fifteen years of accommodative monetary policy ended abruptly last year. The Federal Reserve again raised the Fed Fund target rate to a range of 4.25-4.50% in the fourth quarter with more rate hikes anticipated. These rate hikes most likely will continue even though the latest CPI inflation rate showed a slight decline of 0.1% for the month of December, however it is at 6.5% when measured year over year. The Federal Reserve rate hikes are the primary reason behind short term rates continuing their epic ascent. The six-month Treasury Bill ended 2021 at 0.19%, rose to 3.92% at the start of the fourth quarter and finished 2022 at 4.76%. Short term Treasury bonds had a similar move, as rates in the Two-Year Treasury went from 0.73% to 4.22% and then 4.41% in that same time period. Intermediate and long-term Treasury yields though rose only slightly last quarter. In general, longer-term bonds outperformed shorter term bonds in the quarter. The 10-Year Treasury yield ended the fourth quarter at 3.88%. Mortgage rates usually move in the same direction as the 10-Year and have stabilized as of late in a range over 6%.

Corporate bonds, both investment grade and lower quality high yield, performed the best last quarter as credit spreads tightened. Meaning the difference between yields of similar maturity Treasuries and corporate bonds narrowed. Investment grade municipal bonds were laggards but had positive returns for the fourth quarter and were the best performing bond sector for the year, though still had negative returns for 2022.

OUTLOOK

Historically speaking, stocks and real estate (especially with leverage) are the only asset classes that have been able to consistently outpace inflation. That 4.7% 1-year Treasury bill looks juicy, but not during a 6.5% year-over-year increase in inflation. Looking out further in years, interest rates are inverted, which mirrors the sentiment that investors have for a darker future.

2022 was a painful year for nearly all asset classes; general equities, bonds, real estate, and crypto were down substantially. Even, gold and precious metals, which have a reputation for being safe havens during high inflationary periods were only up marginal levels. Still, we think the interest rate hikes last year were good for the long-term outlook for the economy. We expect rates to continue to rise, with short-term rates possibly surpassing 5%. There are signs that inflation has peaked, partially due to higher rates, but also due to a loosening of the supply chain with China finally relenting and giving up on mandatory lock downs. However, the Fed's goal of getting to 2% inflation by 2024/2025 seems unrealistic, in our view. The low inflation during the lead up to 2021-2022's spike in prices seemed an aberration even then. We think something in the 3%-4% range is more plausible for the next couple of years.

The supply chain is what will ultimately bring inflation down, in our opinion. Recent reports of auto companies ramping up production recently illustrate the improvements made in the supply chain. If these trends continue there is potential for the economy to reaccelerate. Furthermore, it's entirely possible that when inflation is finally under control, that the Fed could reverse course, cutting rates setting the economy up for even more gains.