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GROUP

Investment and Financial Consultants

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2022 ECONOMIC AND FINANCIAL MARKETS REVIEW

The financial markets were more volatile in 2022 than they have been in many years. Last year started with significant declines for stocks and bonds as investors became concerned about rapidly rising inflation and its negative economic impact. Market turmoil intensified when the Federal Reserve Board began raising interest rates to fight inflation. In addition to worries about inflation and rising interest rates, investors became anxious about economic and geopolitical uncertainty resulting from the Russian invasion of Ukraine. This conflict further drove up energy prices, which added to inflation concerns. The overriding fear last year was that high inflation, rising interest rates, and rising energy prices would lead to a global economic recession. As a result, the S&P 500 Index ended 2022 down 19.44%, while the Dow Jones Industrial Average lost 8.78% last year. The Bloomberg Barclays U.S. Intermediate Government/Credit Bond Index declined by 8.23% during 2022.

Since the great recession in 2008, the Federal Reserve Board has kept interest rates extremely low to support the economy. Although this loose monetary policy helped propel the economy out of an economic catastrophe, it eventually ended up fueling inflation. Prices also rose when the pandemic ended because the demand for goods and services strengthened while supply chain problems and a shortage of workers developed. Reversing the Fed's easy money policy has meant raising interest rates, leading to increased consumer and business borrowing costs. The Fed is attempting to create a "soft landing" whereby they increase interest rates just enough to slow the economy and inflation without causing a recession. However, stock market investors are concerned that they will create a "hard landing," with rising financing costs sending the economy into recession. Recessions are bad for stock prices because they reduce consumer and corporate spending, leading to lower corporate earnings on which stock prices are based.

The reason investors are concerned that the Fed will create a recession is because of how rapidly they are increasing interest rates after not raising rates for so many years. The size of last year's interest rate increases was unusual as well. The Fed regularly announced interest rate increases of .75% rather than the usual .25% rate hikes that the financial markets have been accustomed to. Also, the Fed initially announced that rising inflation was "transitory," so when the first signs of inflation occurred, they did not begin to raise interest rates soon enough. That left them needing to raise interest rates more quickly and substantially during 2022 than market participants liked.

In the meantime, another problem with the Fed raising interest rates so much last year is that bond prices also significantly declined. When interest rates rise, the value of existing bonds decline as new, similar bonds issued with higher interest rates are made available to investors. Much of the time, when the stock market declines, the bond market rallies because bonds are seen as a safe haven during times of stock market turmoil. However, stock and bond values declined simultaneously last year as interest rates rose more significantly than anticipated.

Although the bear market in stocks and bonds that began last year may not be over yet, there are many reasons to be optimistic about the future. For example, as the Fed has raised interest rates, yields on certain newly-issued fixed-income securities have increased. This means that investors can now earn a better interest rate on many bonds, CDs, and money markets. Also, due to last year's stock market decline, stocks are more fairly valued than they have been in a long time.

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Furthermore, the stock market is typically a leading indicator of the economy. Therefore, even if the Fed causes a recession by raising interest rates to reduce inflation, the stock market decline that has already occurred may have already partially priced in the worsening economy. Just as the stock market has declined in anticipation of a recession, it would not be surprising to see the stock market begin to recover during an economic downturn as it anticipates an eventual economic recovery.

For this reason, we continue to recommend that investors remain focused on the long term without letting short-term market declines or cyclical economic downturns change their overall investment strategy. Recessions are part of the normal business cycle, and they often result in good buying opportunities for stocks. Finally, if a recession occurs, we do not expect it to be a very deep or long-lasting one due to the strong labor market and relatively strong corporate balance sheets.

We continue to favor large-company stocks that have held up the strongest through up and down market environments. However, we may begin to favor smaller-company stocks for investors with a relatively high risk tolerance during an eventual market recovery. We continue to underweight foreign stocks, believing that U.S. companies will outperform foreign companies in the near term. We also continue to recommend short-term bonds rather than long-term bonds because short-term bonds are less sensitive to rising interest rates and have outperformed longer-duration bonds.

As always, we will continue to monitor ongoing economic and financial market conditions. In the meantime, please contact us if you have any questions regarding your portfolio or the financial markets in general.

* *Index returns were obtained from the Wall St. Journal and Bloomberg Barclays on January 2, 2023.*

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