2022 Review & Outlook

Reckoning: A Settling Of Accounts. A Summing Up.

After dismissing inflation as transitory, 2022 was a year of reckoning for monetary authorities around the world. Interest rate policies have turned aggressively higher and central-bank-supplied liquidity is being curtailed. Cheered by savers who now enjoy money market rates of 3.5%, the policy shifts have negatively impacted both bond and stock values. Highly speculative portfolios have endured generational losses.

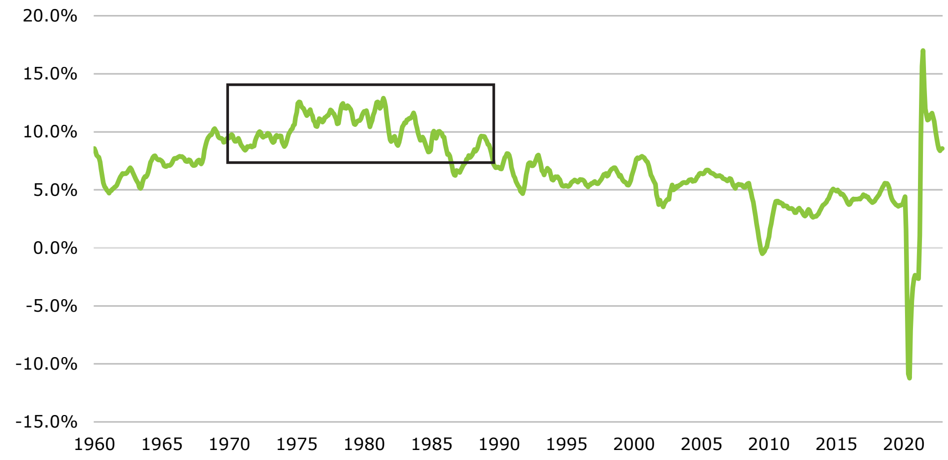
		Equity Index Returns				Bond Index Returns	
	CPI (11/30/2022)	S&P 500	S&P Midcap Index	S&P Smallcap Index	EAFE Index (Foreign Stocks)	Barclays Agg. Bond Index	Long Term Treasury Bond Index
2022 Return	7.1%	-18.1%	-13.1%	-16.1%	-14.5%	-13.0%	-31.1%

	Selected Sector Returns		Speculative Asset Returns			
	Technology Stock Sector	Utility Stock Sector	Digital Asset ETFs (Average of 24)	Greyscale Bitcoin Trust	Renaissance IPO Index	S&P SPAC Index
2022 Return	-28.2%	1.6%	-70.7%	-75.8%	-57.3%	-17.6%

What Keeps The Fed Up At Night

Monetary authorities had insisted that inflation would recede as pandemic-induced supply chain issues were resolved. They were correct in a narrow sense as increases in some goods prices have recently slowed and some measurements of supply issues have eased. For example, new car prices have plateaued and used car prices have declined. Housing prices have begun to recede, which will eventually flow into lower rental prices. These large ticket items will help reduce future inflation. However, there are some other components (food, energy costs) that remain persistently high. The Federal Reserve is also concerned about the cost of services, which are heavily impacted by wages.

PCE Services Index (Six Month Moving Average)



The job market remains tight, resulting in continued wage pressures. The cost of services is the largest component in inflation indices, and it remains stubbornly high.

Over the last six months, services inflation has averaged 8.6%. Every communication from the Fed has essentially been, “we will keep at it until our job is done”. They are attempting to avoid the entrenched inflationary environment of the late 1960’s to early 1980’s which encompassed many starts and stops in monetary policy changes.

Over the last nine months, short-term interest rates have increased from 0.25% to 4.50%. The liquidity provided by the Fed’s balance sheet has declined from $8.9 Trillion to $8.6 Trillion. Outside of the Fed’s control (and widely accepted as contributing to the 1970’s inflation) were the fiscal policies of that era. Today’s increasing deficit spending and transfer payments have represented a historically high percentage of economic activity. In other words, fiscal policy is not making the Fed’s job any easier. As we have covered many times in past commentaries, the Fed has put themselves in a precarious spot. We believe something in the economy will “break” before they achieve their goal of 2% inflation. Unless there is a significant disruption from a geopolitical or market liquidity event, we expect the Fed to continue signaling their inflation fighting stance into 2023.

The Bond Market

Long term interest rates increased in 2022 delivering significant losses to holders of long-term bonds. The 20 year plus U.S. Treasury bond index lost 31.1%. However, something has changed on the journey towards higher rates. Short term rates finished the year at their high, pushed higher by Federal Reserve policy. Yet, ten year Treasuries hit their peak rate in October at 4.25%. At year end the yield was 3.88%. Two months of stability in the ten year suggests the bond market is anticipating a slowing economy, falling inflation, and an eventual “Fed pivot” away from fighting inflation.

The Economy Has Been Resilient

Historically, inflation is difficult to tame without an economic recession. So far, macro indicators suggest the economy has been resilient in the face of tightening monetary conditions. GDP has not noticeably declined, and the unemployment rate is holding near historic lows. It is possible that 14 years of easy money policies were so extreme that it will simply take longer to reverse. And, while inflationary, Federal deficit spending and transfer payments are a cushion to the economy and may forestall a recession that most would expect, given the (so far) rapid tightening of monetary policy. The Federal Reserve holds out hope for the proverbial “soft landing”. The alternative scenario may simply be a “delayed crash”.

Corporate Earnings

Current estimates for 2022 S&P 500 operating earnings indicate a modest 3.9% decline versus 2021. Estimates for next year currently point to a gain of 13%, although expectations have been falling. It is important to examine the trend of index earnings expectations over time and to drill down to sector trends. Higher growth sectors have seen the largest drop in expectations for 2023 earnings.

Expectations for more defensive sectors have been more stable. Energy (a small segment of the S&P 500) is helping support the aggregate index earnings with its expected sharp earnings gains.

		Higher Growth Sectors		
	S&P 500	**Telecom**	**Cons. Discretionary**	**Technology**
Change of 2023 Earnings Expectations	-3.0%	-14.4%	-11.7%	-10.2%

	Defensive Sectors			Outliers
	Cons. Staples	**Healthcare**	**Utilites**	**Energy**
Change of 2023 Earnings Expectations	-5.6%	-1.5%	0.9%	79.8%

*Indicated changes represent the difference between current 2023 earnings estimates and the first published 2023 earnings estimates.

Earnings forecasts usually tend to begin overly optimistic and then gradually converge to a lower reality as the actual figures are reported. However, the slope of the trend is important as expectations are a key component of stock market and sector valuations. The divergence among sector earnings trends continues to demonstrate the relative attraction of more defensive sectors in the volatile stock market.

Stock Market Valuation

The economy and aggregate corporate earnings have been relatively resilient, yet stock prices are lower for the year. At the beginning of 2022 stocks were priced for perfection, with a forward price earnings ratio of 21.6. This high multiple required low interest rates, a friendly Fed, and optimistic growth expectations. Within six months those assumptions were stripped away. Stock prices declined (while corporate earnings were unchanged) leaving the forward P/E at 15.3. A forward P/E of 15 represents neither exuberance nor despair—it is a fair price and near the long-term average. However, long term averages can disguise significant short-term swings.

S&P 500 Forward Price to Earnings Ratio

Stock prices in 2022 experienced three distinct declines and three distinct recoveries. Each decline could be associated with a market realization that the Federal Reserve would be more persistently aggressive with monetary policy. Each recovery was associated with hope that the Federal Reserve could soon justify a pivot away from its inflation fight and back toward "easy money". The changing sentiment left the P/E fluctuating between 15 and 17 as stock prices recovered and fell anew.

The market closed the year at 17 times forward earnings which matches the high of the range over the last six months. If earnings expectations are stable, a 15 P/E (the low of the six-month range) would suggest an S&P price of 3,400 (down 11% from the current level). If inflation, Federal Reserve tightening, and economic growth were to deviate significantly from current expectations, it would not be surprising to see market valuation spike lower. A forward P/E of 12 times would imply an S&P price of 2,720 (down 29% from the current level). Of course, a return to the priced-for-perfection level from 12 months ago would develop a market at 4,530 (18% higher). This is a wide range of potential outcomes but the heightened volatility of inflation, interest rates and economic growth normally translates to increased volatility in equity market valuation.

Behind the scenes of daily price volatility, earnings expectations have been declining. In order for stock prices to stabilize, we believe it will require a reversal of the declining trend of earnings expectations.

What To Remember For 2023:

- Inflation is a problem, and the markets are focused on inflation expectations.
- Fighting Inflation is normally a multi-year project.
- The Federal Reserve sees retreating too soon as their biggest potential error.
- Optimism for a "Fed Pivot" should be considered judiciously.
- Earnings expectations are declining.
- Government spending as a percent of GDP has averaged 36% over the last 2.5 years and is likely unsustainable.
- Stock valuations are near the long-term average but can easily spike higher or lower by 3 to 5 P/E points as investor sentiment ebbs and flows.
- No quality fixed income instrument offers a yield above the inflation rate.
- Once baseline inflation settles down, bonds SHOULD be priced to offer a modest return in excess of long run inflation expectations.
- A significant amount of wealth has been erased over the last 12 months.
- Despite high inflation, the American consumer is in relatively good shape, financially.
- During periods of uncertainty, quality companies with predictable and stable earnings growth are much safer than companies with high growth expectations or non-earning companies.

Moving Forward

Your investment team at AAMA continues to diligently monitor and evaluate the markets and position your portfolio accordingly. We are grateful for your confidence in us, and look forward to continuing to serve you as we work through the prevailing market conditions with our time-tested, fundamental investment process.

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