Fourth Quarter 2022

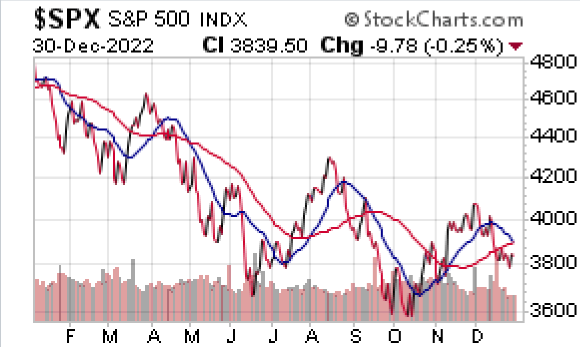

Figure 1 – S&P 500

Figure 2 – U.S. 10-Year Treasury Yield

Market Recap

Markets rose in the fourth quarter as corporate earnings provided investors with some reason for optimism. The S&P 500 index (**Figure** 1) gained 7.6%, finishing the year -18.1%. Most other stock benchmarks posted similar gains, with the S&P MidCap 400 index +10.8% and the Russell 2000 index of small caps +6.2%. Foreign stocks also rallied. Developed economies including Europe and Japan led all markets, up 17.3%, while emerging markets added 9.7%. U.S. value stocks, including energy and financials, jumped 13.6%, while growth stocks lagged, adding a meager 1.5%. The Bloomberg U.S. Aggregate Bond index rose 1.9%, small consolation after a very difficult year for most fixed income segments.

For the second consecutive quarter, corporate earnings reports provided investors with comfort, as profitability and growth prospects remained stronger than expected. In contrast to July's earnings season, many of the giant technology leaders dropped after disappointing quarters. At the same time, industrials and aerospace stocks rose on better than expected results and outlooks. European markets appeared to adapt to the Russian-Ukraine war and higher energy prices and were also boosted by the potential for China's loosening of COVID restrictions. Early signs that inflation was moderating also underpinned the market's recovery, raising hopes that the Federal Reserve and other central banks could pause their interest rate hikes. In December, however, the Federal Reserve reiterated its concerns about inflation, sparking profit taking and a broad selloff in U.S. markets.

Third quarter corporate earnings rose 1.6%, roughly in line with analyst expectations at the start of the reporting season. Sector performance diverged widely. Energy continued to generate robust profits, and was joined by transports (+61%) as airlines enjoyed a post-COVID travel rush. Without energy's strong results, earnings fell 5.7%. In contrast, technology earnings fell 14.3% on tepid revenue growth of 2.3%. After years of strong demand, companies have begun to cut back on technology spending, squeezing the margins of these economic powerhouses and leading to layoffs across the sector. According to research service Zacks, the forecast for the fourth quarter now calls for earnings to decline -7.3%, or -11.4% without the energy sector. These expectations have been declining steadily since September and are likely reflected in current stock prices. As companies report, investors will be looking ahead for signs that corporate earnings have troughed, with the hope that growth will resume in 2023.

Economic Perspective

In the third quarter, U.S. gross domestic product (GDP) rose at an annual rate of 3.2% as the economy resumed growth after narrow declines in the first and second quarters. Both services and fixed investment showed strength while construction contracted. Forecasts for fourth quarter GDP call for annualized growth of 3.8%, but the

Index returns taken from Morningstar.com economy is expected to slow again in the first half of 2023. Recent purchasing manager surveys in manufacturing and services support this view, as new orders and backlog readings indicate contraction.

The U.S. economy added more than 200,000 jobs each month in the fourth quarter, a sign of continuing strength. The unemployment rate reached 3.5% in December, matching the pre-pandemic low. At the same time, wages and salaries have risen, as employers have had to pay more to attract and keep workers. The pace of job growth has slowed gradually, providing hope that the economy will slow enough to bring inflation down. In addition, wage growth moderated in December, adding to signs that inflation is slowing. Markets rallied sharply on the news.

With inflation still well above its long term target of 2%, the Federal Reserve raised interest rates every month in the quarter. The December increase of 0.50% was lower than the previous 2 months' boosts, but the Fed reiterated its hawkish stance, increasing investor fears of further hikes and bringing stocks down. Higher interest rates do appear to be slowing the economy and moderating price increases. The most recent Consumer Price Index (CPI) reading of 7.8% year-over-year inflation was the lowest since January. Crude oil and natural gas prices are well off highs set earlier this year, and gasoline prices are also significantly lower. Home prices have plateaued, and started to decline in some cities, as the highest mortgage rates since 2008 reduce affordability. It is possible that the Fed may not have to raise rates significantly higher to bring inflation to a more tolerable level.

Looking Ahead

Growth stocks, including technology (**Figure** 3) and some consumer discretionary companies, took the worst of the 2022 bear market. Some of these companies, such as Amazon and Alphabet, are likely to remain dominant franchises in the U.S. and world economy. However, after years of stock market leadership, their stocks are struggling with declining growth rates while still priced at relatively high valuations. Industrials (**Figure 4**), which generally have growing dividends and more reasonable valuations, may provide better returns in the months ahead.

Figure 3 – Technology Select Sector Fund

Figure 4 – Industrial Select Sector Fund

Bond investors suffered through possibly their worst year ever, crushed by the rapid rise in interest rates. Historically, bonds tend to stabilize after a rough year. Regular higher interest payments bring investors back. In addition, if the economy does slow it will lead to the expectation of rate cuts in the future, a boost to bond prices. Investment grade corporate bonds, which offer yields of more than 5% and very low default risk, may remain attractive in 2023.

2022 was a challenging year for investors. While the fourth quarter provided some relief, many forecasters have called for a recession in 2023. We caution against making large portfolio changes based on these worries. It's extremely difficult to predict a recession, and even harder to effectively time market shifts. While this bear market may still drag on into 2023, our economy has a strong track record of resuming growth. Patient investors tend to prosper from those recoveries.

We hope that your new year is beginning beautifully and look forward to speaking with you soon.

Best regards,

Kenneth M. Bernard

Kenneth M. Bernard, CFA