DANN ASSET ADVISORS, LLC

Fourth Quarter 2022 Update

January 11, 2023

4Q22 Highlights

- Stocks rebound modestly during a volatile quarter
- Inflation remains high but is showing signs of moderating
- Interest rates fall from recent highs, potentially indicating that inflation will continue to decline
- Fed raises rate forecasts, prioritizing inflation reduction over the risk of recession

The table below summarizes the performance of some key indices during the fourth quarter and year to date:

Market Performance		
Index	% Ch. 4Q22	% Ch. YTD
S&P 500	7.6	(18.1)
S&P Mid Cap 400	10.8	(13.1)
Russell 2000 (small cap)	6.2	(20.4)
MSCI All Country World ex US	14.3	(16.0)
US Aggregate Bond	1.9	(13.0)
High Yield Corp. Bond	4.3	(10.8)

Source: Morningstar, iShares

<u>Equities</u>. The S&P 500 index of large-company U.S. stocks rebounded 14% through November but fell 6% in December as markets reacted to the Fed's projection that interest rates would remain higher for longer than previously indicated. Even with the fourth-quarter gain, 2022 was the worst year for the S&P 500 since the 37% decline in 2008, and first down year since 2018.

Looking beyond the S&P 500, there were broad divergences in performance across other major indices. The Dow Jones Industrial Average, which has a much lower concentration of high growth and technology companies, was down only 7.0% for the year. The NASDAQ 100, with its much higher proportion of growth/tech companies, returned -32.5%, dragged down in particular by large-company tech stocks that had done especially well during the pandemic. These types of stocks were likely hurt by higher interest rates (reducing the multiple of earnings investors were willing to pay) and too optimistic earnings estimates that were inflated by extrapolating the acceleration in growth rates that had occurred during the pandemic.

Mirroring the outperformance of the Dow relative to the NASDAQ 100, value stocks shone relative to growth stocks during the year, with the Russel 1000 Value index returning -7.6% vs. -29.1% for the Russell 1000 Growth index. Small company stocks trailed the S&P 500 for the quarter and year and were especially weak during periods when investors were most focused on the potential for recession. Helped by a weakening U.S. dollar, international stocks had a strong fourth quarter and outperformed the U.S. for the year.

<u>Fixed income</u>. Fixed income continued on the roller coaster of the first three quarters even though the 10-year treasury yield ended the quarter at 3.78%, nearly even with the 3.80% of September 30. The yield had been as high as 4.23% in late October and as low as 3.41% in early December, with the fluctuations stemming from investors' changing expectations around inflation and Fed

policies. The two-year treasury yield fluctuated between 4.73% and 4.10%, ending the quarter at 4.41% vs. 4.21% on September 30. We note that 10- and two-year treasury yields began 2022 at 1.51% and 0.73%, respectively.

For the year, the highest inflation since the early 1980s and the Fed's substantial rate increases combined to produce the worst year for bonds in 40 years. This result is reflected in the -13.0% return for the Bloomberg US Aggregate Bond index (benchmark for U.S. investment grade bonds), and especially in the -30.8% return of the longer dated iShares 20+ Year Treasury Bond exchange traded fund (ETF), a proxy for long-term U.S. treasury bonds. Although credit yield spreads widened substantially over the first half of 2022, they've since compressed to levels consistent with only modest economic stress(1), resulting in high yield bonds' (as measured by the iShares High Yield Corporate Bond ETF) total return exceeding that of the Bloomberg investment grade index for the full year.

Market sectors(2). The three best performing sectors during the fourth quarter were energy, industrials, and materials, with gains of 21%, 17%, and 15%, respectively. It's surprising to us that these three economically sensitive groups led the market during the quarter given consensus expectations of low growth to a modest recession in 2023. With stocks usually a leading indicator, this positive performance may indicate that the economy will do better than expected in 2023. For the year, energy was by far the best performer with a gain of 63%, as supply issues caused by the war in Ukraine and past years of underinvestment supported underlying commodity prices. Utilities were the only other up sector (+1%) with consumer staples the third best performer with a 2% decline. These latter two sectors typically hold up relatively well during periods of slowing growth.

Generalizing, the largest growth stocks that led the market during the height of the pandemic in 2020 and 2021 were among the worst performers in both the fourth quarter and for full-year 2022. In the fourth quarter, consumer discretionary (Amazon and Tesla together account for roughly 32% of sector value), communications services (Alphabet and Meta, 32%), and technology (Apple, Microsoft, and semiconductor stocks, 55%), returned -7%, 0%, and 4%, respectively. For the year, these same three sectors declined from 30% to 39%.

Portfolio Positioning

Most clients' fixed income portfolios remain 90% or more in investment grade mutual funds and 70% or more in short duration (which we define as three years or less) funds. However, with interest rates having risen substantially during the year, for some clients we added modestly to intermediate term exposures during the quarter. On equities, we sold an international, growth-focused mutual fund, with proceeds into already-owned positions.

2023 stock market outlook. We continue to believe there's a good chance the market will be up by the end 2023 even though there could be downdrafts getting there. Our belief is based on inflation moderating further and the Fed raising rates less or reducing rates sooner than they've most recently communicated (3). However, we also believe Fed actions could have an outsized impact on the economy and earnings in 2023, and this is a risk to our optimistic outlook.

In March 2022, the Fed began tightening monetary policy, including increasing the fed funds rate by more than 400 basis points, the fastest pace since the early 1980s (4). In its recent mid-December meeting, the Fed targeted raising rates further in 2023, with no decrease projected until at least 2024(5). In the same meeting, the Fed acknowledged that several factors that had contributed to inflation have improved (supply chain issues, commodity prices) or were likely to improve in 2023 (rents). Given these improvements, the Fed is now most focused on wage inflation, which remains high.

Given the lag usually associated with changes in monetary policy, the full impact of 2022's rate increases likely haven't yet shown up in economic numbers. We expect already implemented rate increases to begin to slow the economy and consumers to feel less flush (due to inflation, fewer available jobs, and a further drawdown of savings built up during the pandemic). In this environment, employees may become more flexible on compensation, enabling wage inflation to ease. Typically, this is what occurs when the Fed significantly raises rates, and we believe the same scenario will play out in 2023.

With the economy likely slowing and potentially headed for a recession, earnings are likely to come under pressure. As of January 3, 2023, Yardeni Research indicated consensus estimates that S&P 500 earnings would increase 4% in 2023, to an estimated $230[(6)]. However, Morgan Stanley is calling for earnings to decline roughly 11%, to $195[(7)], and we've seen similar predictions from other analysts whose views we respect. Our guess is that earnings will decline over the first half of the year (potentially pressuring the market near term) but will be rising again by year end, leading the market to end the year higher.

(1) ICE BofA US High Yield Index Option-Adjusted Spread, Federal Reserve Economic Data from Federal Reserve Bank of St. Louis.
(2) Market sector performance numbers based on Vanguard sector ETFs.
(3) Federal Reserve Bank transcript of Chair Powell's December 14, 2022, press conference.
(4) Wall Street Journal, *Fed Raises Rate by 0.5 Percentage Point, Signals More Increases Likely*, December 14, 2022.
(5) Federal Reserve Bank transcript of Chair Powell's December 14, 2022, press conference.
(6) Yardeni Research, Inc., S&P 500 Earnings Forecast, January 3, 2023.
(7) Morgan Stanley December 12, 2022, US Equity Strategy piece.