January 2023

INVESTMENT REVIEW AND OUTLOOK

"So, the Last Shall Be First…

The complete phrase from Matthew 20:16 is "So, the last shall be first and the first shall be last" and this well sums up the year 2022. Equities, which have been among the strongest performing asset categories over the past decade, had a difficult year with the S&P 500 posting a total return of -18.1%. Value stocks greatly outperformed growth stocks with the Citigroup Value Index returning -5.1% versus the Citigroup Growth Index returning -29.4%. Bonds, which have also enjoyed attractive returns in recent years, also experienced disappointing results with the Bloomberg U.S. Aggregate Bond Index returning -13%. In contrast to the poor returns for most financial assets - "hard assets" such as gold, energy and agricultural commodities - produced flat or positive returns. The Energy Select ETF had a return of 45% for the year. The fourth quarter provided some respite in an otherwise challenging year and the S&P 500 had a total return of 7.6% with value stocks (+13.6%) again outpacing growth stocks (+1.4%).

Many of the themes that we have discussed in our letters in recent years came home to roost in 2022. Inflation accelerated in the first half of the year, and, in response, global central banks reversed a decade of ultra-easy monetary policy. Geopolitical tensions, which had been simmering for some time, spilled over into a ground war in Ukraine. Interest rates rose at a near-unprecedented velocity and the 3-month U.S. Treasury Bill which began the year with a yield of 0.05% ended the year yielding 4.4%. Given the severity of events in 2022, the impact of these developments on stock and bond markets was understandable; the decline in bond prices was the most severe in decades and the stock market correction was the largest annual decline since 2008. Speculative assets such as "meme" stocks, crypto currencies and richly valued growth stocks suffered valuation declines of a far greater magnitude than the broad stock market averages.

In managing investment portfolios, Peter Lynch, former manager of the Fidelity Magellan Fund, has been quoted as saying "Trim the weeds, not the flowers." One silver lining to the year just past is that it provided an opportunity to cull underperforming names from client portfolios while renewing our commitment to situations that offer long-term promise.

The Rolling Recession

The economic impact of higher inflation, higher interest rates and the ongoing tightening of monetary policy has received much attention in the business and mainstream media. Not infrequently, various reports have heralded an impending recession in the year ahead. Indeed, some sectors of the economy such as housing, have experienced a notable slowdown over the past year. The Census Bureau reported a year-over-year decline of 15% in new home sales in November 2022. More recently, sales of large ticket consumer items such as appliances and new and used automobiles have also begun to slow. Total light vehicle sales for 2022 declined 7.8% compared to 2021, according to industry data. Similarly, retail sales data from the Census Bureau also indicate a slowing trend after accounting for the year-over -year effects of inflation.

Amidst the multiple signs of a slowing economy, there are also some encouraging signals. Inflation, which had risen at a greater-than 8% annual rate in the first half of 2022, slowed considerably in the second half of the year. According to the Bureau of Labor Statistics, the month-over-month increase in the Consumer Price Index (CPI) for November 2022 was 0.1% with several categories - such as energy, medical services and used car prices - showing month-over-month declines. Another reason for encouragement is the low unemployment rate which stood at 3.5% in the month of December. There are several other long-term trends that stand to benefit the U.S. economy in the years ahead. One is “reshoring,” or the practice of returning manufacturing to the U.S. from abroad. The semiconductor industry is a prominent example, and several large new domestic fabrication plants have recently been initiated by Intel and Taiwan Semiconductor; the construction value of these new plants is estimated to reach over $45 billion from 2023-2026, according to Piper Sandler research. Across the U.S. economy, reshoring initiatives were expected to create over 350,000 new jobs in 2022 according to Deloitte Consulting.

While the housing sector of the economy is currently undergoing a painful correction, the long term demand for housing is strong due to demographic trends. The millennial generation (born 1981-1996), is the largest segment of the U.S. population numbering over 72 million and this cohort is now entering its prime home ownership years. While affordability remains an important challenge, the current softness in the housing market, combined with a decline in lumber prices, is expected to improve affordability in the coming year.

Although the possibility of an economy-wide recession cannot be ruled out in 2023, it seems likely that the economy may experience “rolling recessions” whereby various industries demonstrate softness as the overall economy shows modest growth. In some cases, such as housing and used car prices, the current softness represents a correction to the excesses following the COVID lockdowns of 2020-2021. In addition to the automotive and housing industries, there are sectors of the economy that may be at a competitive disadvantage and also show signs of stress. One example is likely to be commercial office space, particularly in urban business centers. The recent trend towards hybrid work environments has lowered the overall demand for office space in parts of the country, leading to increased vacancy rates in major urban markets.

One potential “wild card” for the economy in 2023 is the level of additional monetary tightening from the Federal Reserve and other central banks. Although there are encouraging signs on the inflation front, the U.S. central bank has been vocal about its intention to retain a tight monetary policy.

A More Challenging Road Ahead

The decade that ended in 2021 was remarkable in many respects. Real annual global economic growth averaged close to 3% for most of the decade according to the World Bank. Inflation, as measured by U.S. CPI, averaged 2.4% over the same period. Interest rates were also low by historical standards and the yield on the 10-year U.S. Treasury Bond fluctuated between 1.3% and 3% (excluding the steep decline related to COVID in 2020). Although there were regional conflicts in the Middle East, Africa and Afghanistan, the world was largely at peace. The global economy benefitted from the forces of free trade and globalization. Accommodative monetary policies from central banks also played an important role in supporting economic growth and provided a favorable backdrop for stocks and bonds. The S&P 500 had an annualized total return of 16.1% for the 10 years ending December 31, 2021.

Although one year does not make a trend, many of the developments witnessed in 2022 foreshadow a changing environment in the years ahead. The war in Ukraine is very different from the regional flashpoints of recent years. The size of the conflict as well as the number of western governments supporting Ukraine are on a scale not seen since World War II. Outside of Europe, geopolitical tensions remain elevated, particularly in Asia. The trend towards globalization, while not completely reversing, has slowed due to a combination of higher costs, tariffs and national security considerations.

Inflation, which spiked over the last year, is likely to recede from the high levels of 2022. However, a return to the very low rates of inflation that occurred in the 2011-2021 period is unlikely due to a combination of tight labor markets, slowing globalization and the after-effects of many years of stimulative monetary and fiscal policies.

Following the decline in stock and bond prices, both assets offer a better risk/reward ratio today. However, we should be mindful that financial markets have undergone an extended boom in the past decade. While many of the excesses of recent years have been corrected, restoring greater balance will take time.

Finding Opportunity

While the current setting is more sober than that of the recent past, opportunities still exist. Indeed, throughout history, periods of economic and financial stress often provide some of the best long-term investment opportunities. Today, there are several areas of interest. Given the steep rise in interest rates, the yields on high-quality fixed income securities are the most attractive we have seen in many years. Within equities, some sectors stand to benefit from the trend towards "reshoring". The housing and real estate sectors of the economy are in the early stages of a correction, and we feel that these areas may also provide investment opportunities in the year ahead. Finally, a number of the "anchors to windward" (financially strong multinational corporations with above-average cash flow and dividends) that we described in past letters remain at attractive levels and should also stand to benefit from the recent weakness in the U.S. Dollar.

As always, we welcome your comments and questions.

Announcement

You will notice the addition of David Walker's name to our masthead. David joined our firm as a Managing Principal in 2017 and he has served as our Chief Investment Officer since 2018. Along with Bob Lieberson, David serves as co-Managing Principal of Moody, Lynn, Lieberson & Walker LLC.