WESTEND
Advisors
A VICTORY CAPITAL® INVESTMENT FRANCHISE

Economic and Market Commentary

December 20, 2022

2022 Year-in-Review
Unusual Correlations

The economic cycle has continued to progress rapidly in 2022, as various interconnected factors including persistent inflation, rising interest rates, aggressive Fed monetary policy, and increased recession risk have driven challenging markets with unusual correlations, particularly in the U.S.

As we near the end of 2022, we look back at some of the year's key economic and market developments, as well as how key portfolio allocation decisions evolved along the way (see call-out boxes).

A YEAR OF UNUSUAL MARKET ALIGNMENTS

2022 has been a challenging year for both equity and fixed income markets. By mid-October, the S&P 500 Index had declined about 25% and the values of longer-term Treasury and Corp bonds were down more than 30%. Stocks and bonds have since rallied somewhat in Q4, but with now less than two weeks left in the year, it seems likely both will close 2022 with significant losses. That would be only the fifth time since 1928 that both stocks and Treasury bonds declined in the same calendar year. This unusual correlation, partly driven by a series of geopolitical and economic surprises, is a material departure from what we envisioned at the start of the year.

Another unusual alignment in U.S. markets this year has been simultaneous outperformance of early-phase, economically sensitive sectors and late-phase, defensive sectors. Early-phase sectors like Industrials, Materials, Energy, and Financials typically benefit from strong economic growth at the start of a cycle. In contrast, the late-phase Utilities, Consumer Staples, and Health Care sectors tend to have relatively stable earnings throughout the cycle that makes them fairly defensive as economic growth deteriorates late in the cycle. Yet, through December 16, each of these sectors had outperformed the S&P 500 YTD. Only four U.S. sectors underperformed in this period: Information Technology, Communication Services, Consumer Discretionary (the sectors we consider mid-phase), and Real Estate.

While certain factors can help explain various sectors' specific relative performance this year, such as a "COVID demand hangover" for content streaming weighing on Communication Services, we also see a broader pattern at work: a bifurcation of investor focus. Some investors seem to have focused on rising inflation and allocated to early-phase sectors that might benefit from rising prices, while other investors seem to have focused on recession risk and allocated to late-phase sectors with more defensive characteristics. Our views have evolved toward the latter over the course of 2022, and we have adjusted allocations accordingly, but a significant allocation to mid-phase U.S. sectors has been a headwind for our portfolios this year.

FROM EXPANSION TO SLOWDOWN

Initial 2022 Outlook: At the start of the year, we noted this cycle was progressing rapidly and the U.S. economy seemed to be shifting from recovery to moderate expansion. Despite indications of slowing economic growth, we saw limited risk of recession in the near-term, as underlying consumer and business investment trends remained healthy. We expected consumer spending growth would shift from goods to services but remain supported by job gains and excess savings accumulated during the pandemic. Among various risks, we did expect elevated inflation to put upward pressure on longer-term interest rates and lead the Fed to begin normalizing monetary policy, but we also expected inflation would begin moderating as supply chains issues slowed and demand growth eased.

From a market perspective, we believed earnings growth could outpace valuation multiple compression to provide positive equity returns, while fixed income faced elevated risks from a likely rise in interest rates. We did not foresee a major land war in Europe that, along with China's continued lockdowns, would exacerbate commodity inflation and global supply chain issues. Further, despite our relatively hawkish outlook at the start of the year, we did not anticipate the Fed would embark on its sharpest monetary tightening cycle in four decades.

From War *and* Inflation to War *on* Inflation: U.S. inflation was elevated coming into 2022. After the initial shock of COVID-19, a sharp rebound in global demand, supported in the U.S. by stimulus and a labor market recovery, was met with an uneven supply response as many goods and services remained constrained by supply chain issues or the tight labor market. While U.S. real GDP growth was negative in both Q1 and Q2 this year, these declines largely resulted from inventory drawdown and net trade impacts rather than a material slowdown in underlying demand. Still, talk of recession, sometimes colloquially defined as two consecutive quarters of negative GDP, and a doubling of the 10-year Treasury yield likely weighed on markets in the first half of the year.

Meanwhile, Russia's decision to invade Ukraine in late February, along with related international sanctions, exacerbated already-high global inflation. Spiking oil prices supported Energy sector outperformance despite slowing economic trends, while more defensive sectors with typically lower market betas also outperformed as equity markets fell.

At the same time, the war essentially froze Ukrainian grain exports, a key part of the global food supply, thus further contributing to global inflation. Yet, even as prices rose globally throughout the year, overall U.S. demand remained relatively strong as consumers began to draw down excess savings accumulated during the pandemic. Demand for services like health care and travel continued to rebound despite (or even driving) high inflation in those areas. With this backdrop of rising inflation and continued demand, intermediate and longer-term interest rates rose throughout much of the year. We believe this initially reflected both inflation compensation required by investors, as well as flowthrough of anticipated and actual Fed hikes.

The Federal Reserve launched a rate-hiking cycle in late March as headline CPI moved above 8% year-over-year. The first two Federal Funds Rate hikes of 25 and 50 basis points, respectively, were not out of line with our expectations given inflation at the time. We were already seeing data suggesting an eventual peak in inflation, such as used car prices starting to move sideways after jumping about 40% in 2021, so a measured approach seemed appropriate.

To this point, we had modestly reduced the expected economic sensitivity of U.S. equity allocations in our portfolios and, seeing reduced risk of upside to longer-term rates, extended the duration of fixed income in balanced portfolios. However, after the May CPI reading showed a surprise uptick in inflation, the Fed enacted a 75-basis point hike and signaled more large hikes ahead, essentially declaring all-out war on inflation.

March/April 2022
We eliminated U.S. Industrials exposure and added to U.S Health Care across portfolios.

ELEVATED ECONOMIC RISKS

The Federal Reserve's shift to "faster and farther" on rates, which ultimately led to four consecutive 75-basis point rate hikes, was a turning point in our assessment of risk. We are already seeing the effects of Fed Funds rate hikes in some areas, like the Real Estate sector, where the average rate on a 30-year mortgage has more than doubled to over 6% since the beginning of the year, and home prices are starting to ease. The broad economic impacts of monetary policy, however, generally come with a significant lag of months or even years. While the Fed dropped back to a 50-basis point hike at its December meeting (and even if it were to pause hikes), we believe most of the economic effects of this sharp hiking cycle have yet to be felt.

May - July 2022
Continued to shift exposure from early- to late-phase U.S. sectors across portfolios, including elimination of U.S. Financials and a new allocation to U.S. Utilities. Eliminated overweight of equities, added Treasury exposure, and further increased duration in balanced portfolios.

At this point, we see increased risk of recession tied to the impacts of the Fed's recent actions. Forward-looking indicators like the inverted yield curve and negative growth in the Leading Economic Index suggest to us that the economy will slow substantially from here. It is possible the Fed might still engineer (or luck into) a so-called soft landing for the economy, and broad equity markets may not necessarily see significant downside from here. However, we expect slowing economic growth will be a material headwind for earnings of more cyclical, early-phase sectors. Even if stocks bounce along near current levels for some time, we believe relative sector performance going forward will more clearly reflect the disparate economic sensitivity of various sectors than it did in 2022.

August/September 2022
Continued to increase defensive allocations, eliminating U.S. Energy exposure and adding a new U.S. Consumer Staples allocation across portfolios. Modestly overweighted fixed income and increased Treasury exposure in balanced portfolios.

Our current portfolio positioning reflects these views, and we look forward to providing our full economic and market outlook for 2023 in early January. As always, please feel free to contact us in the meantime if you have any questions.

WestEnd Advisors Investment Team | December 20, 2022

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