Economic and Market Commentary

Q4 2022

WESTEND Advisors

A VICTORY CAPITAL® INVESTMENT FRANCHISE

To Everything, A Season

With a weakening economic backdrop, we see opportunity in less economically sensitive areas of the market and fixed income. We also stand ready to adjust our outlook and positioning when markets begin to look past the downturn.

SUMMARY

- Weakening economic fundamentals and aggressive monetary policy suggest an economic downturn ahead.
- We expect significant performance dispersion among sectors, with economically sensitive, early-phase sectors facing the greatest risk to earnings and returns.
- A likely decline in longer-term interest rates presents unusual opportunity for strong fixed income returns in balanced portfolios.

2022 REVIEW

The past year was challenging for both equity and fixed income markets. In the U.S., despite a moderate rally in Q4, both stocks and bonds closed out 2022 with significant losses, marking only the fifth time in 95 years that both the S&P 500 and Treasury bonds were down in the same year. At the start of the year, we saw the rapidly advancing economic cycle shifting from recovery to moderate expansion with only limited risk of recession in the near-term. 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.

Elevated inflation and, perhaps, anticipation of Fed rate hikes began pushing up longer-term interest rates early in 2022. While there were signs that inflation could start to ease, Russia's invasion of Ukraine in late February, along with related international sanctions, compounded upward pressure on global energy and food prices. Then, in late March as headline CPI moved above 8% annual growth, the Federal Reserve launched a rate hiking cycle. 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. 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 – a stance which we believe materially increased the risk of recession.

The combination of inflation and the Fed's increasingly aggressive monetary policy continued to push up interest rates through most of the year, weighing on equity and fixed income valuations and ultimately leading to a significant inversion of the Treasury yield curve. In our view, this combination also contributed to unusual sector performance correlations. Some investors seem to have focused on rising inflation and allocated to early-phase sectors that might benefit from higher prices, like Industrials, Materials, and Energy (which outperformed the S&P 500 by over 83 ppts). Other investors seem to have focused on rising recession risk and allocated to more defensive, late-phase sectors like Consumer Staples, Health Care, and Utilities. Our views and positioning evolved toward the latter over the course of 2022, but we also maintained a significant allocation to mid-phase U.S. sectors that proved a headwind across our portfolios last year. Only four U.S. sectors underperformed the S&P 500 in 2022: Information Technology, Communication Services, Consumer Discretionary (the sectors we consider mid-phase), and Real Estate.

International markets were mixed in 2022. Some overseas regions outperformed the U.S., even when measured in U.S. dollars which rose against major currencies. The U.K. and commodity-focused Latin America even posted positive returns, while China and Eastern Europe lagged amid headwinds from COVID lockdowns and the war in Ukraine, respectively.

OUTLOOK

Late-Phase Conditions

We see the global economy moving into a late-cycle slowdown with the full effect of Fed tightening in the U.S. yet to be felt.

The global economic cycle has progressed rapidly following the initial COVID downturn. We now see the U.S. and many regions abroad moving into late-cycle, economic slowdown with an elevated risk of recession. While there is evidence that inflation may be peaking, particularly in the U.S., we believe the broad economic effects of the Fed's aggressive monetary tightening have yet to be felt. In this environment, we see the greatest risk to earnings of the most cyclical, early-phase sectors in the U.S.

Internationally, we expect developed markets, and specifically Japan, should prove somewhat resilient to slower growth, while emerging markets face greater headwinds from the global economic slowdown (though China's reopening may help somewhat). For fixed income, we see limited risk and likely positive returns from elevated current yields and potential declines in interest rates.

U.S. Economy and Equities: We see a range of indicators pointing to late-cycle conditions. Broad composite measures of economic activity are slowing, such as the Leading Economic Index (LEI) and the Chicago Fed National Activity Index, even as GDP growth was likely positive in Q4. The LEI is now negative on both a year-over-year and six-month basis to a degree typically associated with recession. While the labor market has yet to show material signs of weakness, the LEI tends to presage labor market shifts by six months or so. Another key warning signal is the broadly inverted yield curve. Whether it is seen as a symptom of, or contributor to an impending recession (or both), yield curve inversion, typically driven by Fed rate hikes, has historically been one of the most reliable indicators of late-cycle slowdown.

For now, the consumer remains buoyed by the strong labor market and excess savings accumulated during the pandemic. However, U.S. consumers facing inflated costs began to save less than normal in 2022, essentially dipping into excess savings in order to sustain their level of spending. The November reading for the savings rate (the percentage of disposable income saved rather than spent) was 2.4%, which is less than half the long-run average of 6.4% over the 30 years leading up to COVID-19. In aggregate, consumers still have above-trend savings accumulated that could help to sustain nominal spending into 2023. However, they cannot afford to drop their savings rate indefinitely and, while an apparent peak in goods inflation provides some relief to consumers, services inflation remains stubborn.

Meanwhile, we believe the full impact of the Fed's aggressive monetary tightening has yet to be felt broadly. Higher interest rates, and particularly mortgage rates, have clearly dampened real estate activity. For example, pending home sales in November dropped to the second-lowest level on record (above only the April 2020 reading at the height of pandemic lockdowns). Our concern is that Fed hiking cycles have always had a broader negative impact on the economy beyond just rate sensitive areas like real estate. In line with many studies, our research suggests that a 100-basis point increase in the Fed Funds rate lowers cumulative real GDP growth over the next one to two years by about 1.5%. Thus, even if the Fed paused rate hikes at current levels, the aggressive hikes enacted over the past nine months are likely to weigh heavily on growth in 2023, and growth was already moderating before the rate hikes began. Thus, while some strategists are calling for a "mild" downturn, we see potential for a more "average" recession.

Given a likely economic slowdown, we believe current consensus S&P 500 earnings expectations for about 5% *growth* in 2023 are too optimistic. In particular, we see risk to earnings for the most economically sensitive, early-phase sectors. The broad market could see downside or bounce around from current levels, as falling interest rates could boost valuations and help offset downward earnings revisions. We could even see stocks rebound at some point in 2023 as markets anticipate an eventual economic recovery, but we believe relative sector performance is likely to reflect disparate earnings trajectories in the near term. The outperformance of economically sensitive sectors in 2022 seems unsustainable to us as markets realign with the macroeconomic backdrop, while less economically sensitive sectors have the opportunity for significant outperformance.

Opportunity In Dispersion
Equity markets may decline or bounce around, but differences in sector and regional performance create opportunity.

International: We generally expect developed markets to show greater resilience in an economic downturn than emerging markets. Emerging markets tend to have greater sensitivity to global economic conditions, given their stage of development and sector mix. China, the largest emerging market, does have the potential for improved GDP growth with the end of its zero-COVID policy, but any rebound is likely to be bumpy given rampant post-lockdown COVID spread, its unstable property market, and weakening global demand.

Within developed markets, we see Europe facing relative headwinds from ongoing energy constraints tied to the Ukraine war, surging prices, monetary and fiscal tightening, and a smaller savings cushion than other developed regions. Japan, in contrast, remains below its economic output potential and retains stimulative monetary and fiscal policies. It could also benefit more directly from China's reopening and has a less cyclical sector mix than Europe or emerging markets.

While the dollar was up overall in 2022, it has trended down versus major currencies since October, boosting recent international returns for dollar-based investors. This could continue in the near-term, but we expect a global economic downturn to boost the dollar, which, along with U.S. investments, is widely viewed as a relative safe-haven.

Fixed Income: Given our economic outlook, and particularly an expectation that inflation and longer-term interest rates will ease as economic demand slows, we see the potential for strong positive returns in fixed income markets in 2023. We do see a risk that the Fed could focus on near-term wage inflation, which could mean expectations for the Fed to pivot soon are too dovish, and we believe sustained monetary policy tightness could put more downward pressure on the economy and long-term interest rates. Thus, in balanced portfolios, we are currently overweighting fixed income, with an emphasis on longer-term securities for appreciation potential and floating-rate Treasury securities for stable yield.

CONCLUSION

While our broad economic outlook is less than rosy, we see significant opportunity in 2023 from disparate sector performance across our portfolios and for fixed income in balanced portfolios. As always, we are actively assessing our outlook and positioning, and we are prepared to adjust both as we see signs of economic stabilization and the market eventually starts to look past negative economic trends.

WestEnd Advisors Investment Team | January 3, 2023

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