Wealth Enhancement®

Review of the Markets

Fourth Quarter, 2022

Index	4th Qtr Return	YTD Return
S&P 500	7.56%	-18.11%
MSCI ACWI Ex USA IMI	14.15%	-16.58%
Bloomberg Bond Index	1.87%	-13.01%
Consumer Price Index	0.46%	6.42%

Market Commentary

While 2022 lacked some of the drama that pervaded 2020, results were significantly worse across nearly every asset class over the course of the full calendar year. The final quarter of 2022 started off poorly with most markets bottoming out in early October before rallying and finishing the year off of their lows, ending a streak of three consecutive negative quarters for both stocks and bonds. The S&P 500 declined 18.1% for the year. Despite a rally in the fourth quarter of 14.1%, international stocks still ended the year down 16.6%. U.S. small cap stocks and emerging markets stocks fared the worst in 2022, both ending down over 20% for the year.

In what might be the most jarring return number for 2022, the Bloomberg U.S. Aggregate bond index fell 13% for 2022 as interest rates rose significantly across the entire yield curve. The most substantial increases occurred at shorter maturities, where yields increased over 4%. This marks the first time the bond market has experienced two consecutive years of negative returns.

Finally, it is worth pointing out that 2022 will go down as a year in which diversification failed investors. This is the first ever calendar year in which both stocks and bonds fell more than 10%. This is a trend that we do not expect to persist.

Economic Outlook

We can never know how 2020 would have developed without colossal monetary and fiscal stimulus, but it's clear the treatment had some side effects, and the weaning from the medicine of accommodative monetary policy this year has brought troubles of its own.

The combined effect of a) physical limitations that constrained supply, b) direct fiscal stimulus to consumers and companies and c) very easy monetary policy (i.e., zero interest rate policy and massive asset purchases) created an inflationary spiral that

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hopefully peaked in terms of year over year change in June. Supply constraints have eased for most goods and services while government stimulus has ended. The very easy monetary policy has certainly reversed this year as the U.S. Federal Reserve ("The Fed") has not only stopped asset purchases (known as "Quantitative Easing" or "QE") but they've actively begun reducing the size of their balance sheet in addition to increasing interest rates dramatically. The size of the Fed's balance sheet grew by a staggering $4.7 trillion over two years from February of 2020 through March of 2022. To put that in context, the output (as measured by GDP) of the entire US economy in 2022 is estimated to be about $25 trillion. Since March, the Fed has managed to reduce their swollen balance sheet by about $0.4 trillion, suggesting there is still a long path ahead to balance sheet normalization. In terms of rates, the Fed has increased the federal funds rate by more than 4% over the past 12 months, which is the most they have ever increased rates in a twelve-month period since they began targeting the Fed Funds rate in the late 1980s. It is likely that inflation will continue to moderate, though the degree and timeline remain open questions. If indeed inflation has peaked for now, we may have seen the highs on intermediate term interest rates, although that does not mean yields have to fall substantially from their current levels.

Generally speaking, as monetary policy tightens, the economy slows. This has led to justifiable fears about the markets in 2023 as the Fed has not yet indicated that they are ready to stop tightening monetary policy. However, after the dramatic tightening seen in 2022, the economy appears to be holding up well on many metrics that are key for markets. The labor market remains strong, as confirmed by the December jobs report, and real personal income remains in an uptrend. Real manufacturing and trade industries sales are also strong. Industrial production has shown signs of stalling out, although at levels higher than pre-pandemic. Retail sales look to be holding up, however auto sales seem to be a big drag. This is helpful information on the inflation front as well, since the increasing cost of autos has grabbed many headlines. Used car prices peaked in February at a 62% change from a year earlier but have since reversed dramatically and as of November were down 6.7% over the previous twelve-month period. As sales slow, auto manufacturers may return to bigger discounts and incentives to move cars. As a side note, this could have negative consequences on auto-related securitized consumer debt (bonds tied to auto loans).

As we have written previously, the yield curve remains inverted and the magnitude of that inversion continues to deepen. This means that the yield on short term bonds remains much higher than intermediate or longer-term bonds. Historically, this has been a consistent (though not perfect) harbinger of recession. Typically, the inversion of the yield curve leads a recession by about a year, and the yield curve initially inverted in early April. A review of the economic data continues to suggest that we

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enter 2023 likely not in recession, though the probability of a recession in the next 12-18 months remains quite high in our estimation. If we do see a recession this year, it will be amongst the most widely anticipated in financial market history. Even if we do manage to avoid recession, a significant economic slowdown looks a near certainty.
. We appreciate the trust our clients have placed in us to navigate this difficult market. We wish you a happy, healthy, and significantly more prosperous 2023.

Please contact us at fingroup-info@wealthenhancement.com.

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