Investment Commentary

HANOVER ADVISORS

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2022 Review and 2023 Outlook

2022: Nowhere to Hide

The past year was the first time in more than a century that cash outperformed both stocks and bonds. Stocks posted their worst year since 2008, when the economy was in the midst of the Great Financial Crisis. The S&P 500 closed out the year down 19.4% and is down more than 20% from its recent peak. The tech-heavy Nasdaq tumbled 33.1%. The year's turmoil also led to a bloodbath in the bond market, with the Bloomberg Global Aggregate index falling 16.2%. By some measures, this was the worst year for the U.S. bond market since 1794. While bonds usually mitigate against losses in the stock market, both asset classes saw heavy losses. Foreign markets also fared poorly. Stocks in developed economies outside the U.S. were down 14%, and developing economies fared even worse, losing 22.4%.

The main cause of the recent turmoil is the Federal Reserve's efforts to combat surging inflation. The Fed was behind the curve with regard to inflation, insisting for much of 2021 that the current bout of inflation was transitory. By the end of 2021, they had finally gotten the message and signaled their intention to initiate a series of interest rate hikes to combat inflation, but they underestimated how aggressive they would have to be. Forecasts from the Fed at the end of 2021 indicated that the Fed funds rate was unlikely to surpass 1% by the end of 2022. Instead, an unprecedented series of aggressive hikes brought the key Fed funds rate to 4.5%, the fastest increase in modern history. This made the cost of borrowing more expensive and had far reaching consequences for consumers, businesses and investors alike.

Inflation's Winding Path

At the start of the year, inflation expectations were elevated, but the expectation was that the pandemic-era bout of inflation was subsiding. Estimates made in January suggested that the consumer price index (CPI), a common gauge of inflation, would be at about 3.5% later in the year. Instead, by June it would surge to 7.6%, the highest in more than four decades. The supply chain disruptions and material shortages that caused the initial bout of inflation among goods were subsiding in the early part of the year. Then Russia's invasion of Ukraine roiled global trade. A war between Russia, one of the world's major energy exporters, and Ukraine, a major producer of food, caused energy and food prices to surge. Then later in the year, as the economy reopened more fully, consumer behavior shifted to spending on services rather than goods, which led to higher services inflation. This "rolling" inflation resulted in the CPI reaching unexpected heights and remaining elevated for longer than many expected.

The seeds for our current inflationary cycle were planted with the government's generous pandemic-era stimulus. The M2 money supply, which tracks the total amount of cash and bank deposits in the economy, ex-

ploded after the pandemic. Most stimulus recipients deposited their checks and waited until the economy reopened to spend. This resulted in a massive amount of "excess" money in the economy, which fueled inflation. The good news is that the M2 money supply has been rapidly shrinking. Over the past 4 months, the M2 supply has fallen at an annualized rate of 4%. That is the slowest growth since at least the 1960s, possibly ever. At the start of the year, the M2 supply was nearly 30% above its pre-pandemic trend. At the year's end, it is about 22% above its long-term trend. This almost guarantees lower CPI readings in the future.

Beyond just the M2 money supply, there are clear signs that inflation is cresting. The producer price index, which tracks the wholesale prices that manufacturers pay, has fallen substantially in recent months. Commodity prices have settled since the early days of the war. Shipping costs and freight rates have turned down. Some inflation will prove to be "sticky" and will take some time to work its way through the economy. Housing in particular is likely to skew CPI higher for some time. The methodology that CPI uses to calculate housing costs is somewhat arcane and relies on government data, which results in a lag between the costs that consumers are actually paying and what is reflected in the CPI report. Between March 2020 to March 2022, the Case Shiller Housing index jumped 45.5%, but the Bureau of Labor Statistics (BLS) measure of housing inflation was up just 11%. During the same period, Zillow Rentals for apartments were up nearly 40%, and again BLS data indicated an increase of just roughly 10%. Relying on this lagged data means that the Fed underestimated inflation in the initial onset and is now similarly overlooking just how much it has turned down.

Key Question for 2023: How High Will Rates Go and How Long Will They Stay There?

The key question facing investors in 2023 is how high the Fed will hike rates and how long they will keep them there. At the most recent meeting of the Fed's Federal Open Market Committee, 17 of the 19 members indicated that rates would stay elevated above 5% through the end of 2023. However, this same committee indicated that rates would not exceed 1% in 2022, so their forward projections hold little insight into what it likely to happen. Instead, we believe in the aggregate wisdom of market participants. The Fed funds future markets are betting that interest rates will peak at about 5% in the early summer, then the Fed will be cutting rates by the second half of the year. The cause of this abrupt pivot from the Fed will most likely be a slowing economy and potentially a recession.

The Fed's track record with "soft landings"—meaning bringing the inflation rate down without causing a recession—is abysmal, with most economists agreeing that the Fed has managed this feat just once out of 11 attempts during the past 60 years. Economists surveyed by Bloomberg put the odds of the U.S. falling into a recession at 65%. There are signs of an impending recession, most notably the inverted yield curve, meaning that short-term yields are higher than long-term yields. Such an inversion has preceded every recession since the 1960s. Consumer and CEO confidence have both plummeted. The housing market has seen a pronounced downturn. The Leading Economic Index (LEI), published by the economic research group The Conference Board, has fallen below a threshold that typically signals an impending recession. In fact, it has never fallen below its current level without the economy entering a recession.

Fortunately, however, a recession is not inevitable. Industrial production and job creation are still growing at healthy rates, recessionary signals like 2-year credit swap spreads are still in normal territory, and real interest rates are not prohibitively high. Rather than an outright recession, it is possible that we will see something

of a "rolling recession" where different areas of the economy contract at different times for different reasons, which creates conflicting data. We have already seen a similar dynamic with inflation, which has "rolled" its way through the economy over the past few years.

The good news is that a period of moderating economic growth and even the possibility of a mild recession has already been priced into the markets. The bad news is that such conflicting data will make the Fed's job more difficult and may cause them to keep rates elevated longer than is necessary. By many indicators, it is already time for the Fed to consider adopting a more dovish stance. However, the Fed is unlikely to pivot until it is satisfied that the labor market has cooled. Despite the Fed's aggressive rate hikes, the labor market has remained red hot. Almost 4.2 million people left their jobs voluntarily in November, according to Labor Department data. The "quits rate" among U.S. workers was 2.7% in November, up from 2.6% the prior month. November was the first month since March that the quits rate increased.

This has implications for the Fed's fight against inflation. Workers almost only leave a job voluntarily if they are confident that they can easily find work elsewhere, usually for higher wages, which drives inflationary pressure. Average hourly earnings grew 5.1% from a year earlier in November, according to the most recent jobs report, and the annualized gain over the prior three months was the fastest since January. In the third quarter of 2022, the two-year percentage change for labor costs jumped 11.2%, the fastest increase since the early 1980s. At the same time, productivity for the quarter fell 1.4%, the worst decline since 1975. This means that businesses are paying more for less productive labor, a seemingly untenable long-term prospect. Despite some recent announcements from high-profile companies, layoffs have remained low. Some analysts attribute this to "labor hoarding," meaning that they are holding on to redundant or underperforming positions because hiring in the current labor market is difficult. As it becomes clear that the economy is slowing and earnings are falling, companies may "right-size" quickly and we may see a rapid cooling in the labor market.

Corporate earnings will be key for businesses and investors alike. The strong performance of the energy sector is masking what has already been a marked contraction in earnings. When the energy sector is excluded, earnings have actually been down year-over-year for three quarters in a row for the S&P 500. Estimates for 2023 have also been falling. Goldman Sachs recently cut its 2023 S&P 500 earnings per share (EPS) growth forecast to zero, citing weakening profit margins. Stocks have seen EPS forecasts fall by 15% in the past six months, according to FactSet. Earnings influence stock prices, so as earnings continue to diminish, we may see the losses in the stock market continue.

Our Outlook

As we head into 2023, uncertainty and volatility are likely to persist for the first part of the year. Markets are forward-looking and will begin to stabilize in anticipation of inflation cresting and a more accommodating Fed. It is widely expected that the Fed will pause their rate hikes soon, but it remains unclear how long they will keep them elevated. The Fed has held it at the peak level for as little as three months, or as long as 18 months. Despite the recent volatility and uncertainty in the early part of the coming year, 2023 presents a great deal of opportunity.

Among equities, we expect growth to be slower moving forward. A less accommodating Fed means less liquidity to pump up stock valuations, and while this is resulting in steep losses now, it has made many stocks, especially growth stocks, more attractive as their sky-high valuations come back down to historically normal levels. Much of the recent losses have been most highly concentrated among growth stocks, particularly in the

tech sector, which have relied on low interest rates to fuel growth. Many of the large-cap growth stocks also appear to have reached a growth plateau and will have trouble justifying their still-inflated valuations. Our current reallocation process is focused on minimizing exposure to growth stocks by equal weighting our holdings across industries and managing the capitalization of the S&P 500, which is skewed toward the tech sector. Our current preference is for mid-sized U.S. stocks, where valuations are much more attractive. The recent turmoil in the market has resulted in a sector rotation, with value stocks outperforming growth stocks for the first time in more than a decade. We believe value stocks are better positioned to continue performing well going forward. We will maintain our overweighted allocation of energy stocks, which have performed extremely well this year. They will remain an important hedge against inflation and the hefty dividends they are paying make them attractive, even as energy prices stabilize. We will also return our allocation of foreign and emerging markets to our target weight. We had previously been underweight with regards to these assets for several years, but their current valuations have made them more attractive.

We will maintain our defensive positioning with our fixed income holdings. In this uncertain period, we are focused on managing duration and maturity to best navigate fluctuating yields and allocating primarily to government bonds and highly-rated corporate bonds. We are currently opting to purchase Treasuries directly instead of through mutual funds and ETFs. Direct ownership gives us more control over maturity and allows us to ladder our bond holdings. This means allocating bond holdings so that a set portion reaches maturity each year over the next few years. Having a fixed maturity means there is a date certain that the principal will be returned to investors, and staggering them across a period of several years allows us to manage risk and minimize exposure to fluctuating interest rates.

As brutal as 2022 may have been, it highlights the importance of maintaining a long time horizon. There have been 14 bear markets since the end of WWII, some significantly worse than the most recent one. Despite those downturns, over the long term, stocks have returned 6.7% above the inflation rate. There is no way to predict where the markets will be a week, a month, or even a year from now. Instead, investors should assess their personal risk tolerance and focus on a 3-5 year time horizon and their long-term financial planning.

Hanover Advisor Bulletins

Special Reminders to all Hanover Clients

- Hanover's annual ADV form has been filed with the SEC. This important disclosure document allows clients to learn more about Hanover's investment practices and compensation model. The form can be accessed at hanoveradvisorsinc.com.
- We invite all clients to schedule an online portfolio review. Because we respect your time, we offer three different meeting formats that vary in length and level of specificity. For more information or to schedule a meeting, please contact us.
- The Hanover Advisors website can be accessed at hanoveradvisorsinc.com. There you will find our latest newsletter and investment commentary, articles, our blog, and videos. You can also learn more about our services, access both the Black Diamond performance reporting system and your Pershing brokerage account(s).
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