ICR® 4th Quarter Newsletter – January 2023

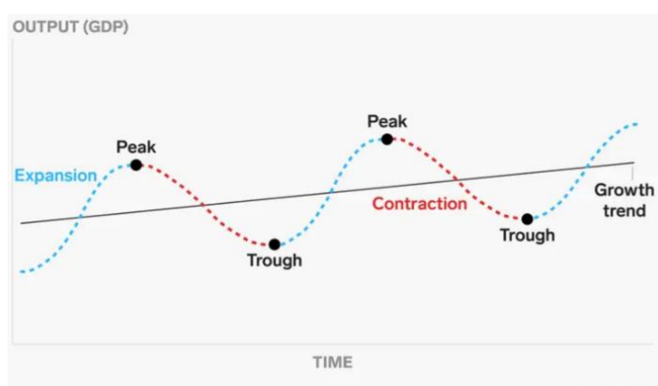
The S&P 500 recorded its only positive quarter of 2022, rising just over 7% in the year's final three months. Even after a strong last quarter, the index still lost over 19% for the year, marking its worst performance since 2008. Also, for the first time since 2016, value stocks (down 9.6%) outpaced growth stocks (down 29.8%), as measured by the Russell 1000 Value and Growth indexes. Two sectors that usually fall into the value category – energy and utilities – were the only positive sectors for the year, while more growth-oriented sectors like technology and communication services were among the worst performers.

Foreign markets rallied strongly into the end of the year, with the MSCI EAFE index for developed markets rising 17% and the MSCI Emerging Markets index gaining almost 10%. Both still finished down for the year, though, losing 16.8% and 19.7%, respectively. Some of the gains in foreign markets were due to the weakening U.S. dollar – a force that had been steadily working in the opposite direction for almost two years prior to this. The dollar's slide also provided a tailwind for gold, which rose 9.5% in the fourth quarter.

Longer-dated bond yields finally stopped their ascent and were mostly flat for the quarter with the ten-year Treasury yield going from 3.83% to 3.80%. However, the Fed continued raising the overnight lending rate which caused the short end of the yield curve to continue its rise. The one-month Treasury bill rate soared from 2.77% to 4.03%, a boon for conservative investors with money market holdings.

The question from here is how long the Fed will continue to raise rates. Through their rhetoric, at least, Fed members are holding firm in their position that inflation should reach their 2% goal. But if the economy falls into recession – or even starts to head in that direction – will the Fed flinch? Most narratives surrounding the recent stock rallies have focused on the idea that the Fed will pivot to a more dovish stance in the coming quarters as the economy shows signs of weakness.

The current push and pull of the Fed trying to tame inflation without sending the economy into a bad recession actually feels like what we all learned from our economics textbooks. Before 2021, the previous 12 years made some question whether the classic business cycle was dead. Inflation hovered between 0.6% and 2.4% and GDP growth was positive every quarter – somewhere between 0.8% and 3.8%. It was a period marked by low interest rates, low-but-positive growth, and a Federal Reserve that could be counted on to come to the rescue at any hint of economic or financial disruption. Of course, it was much easier for the Fed to be accommodative when inflation was so subdued. That granted them the leeway to err on the side of propping up the economy – and inflation still never really became a problem during that time. We've discussed the multitude of reasons why inflation has become an issue recently, so we won't rehash that now, but the Fed has been forced to shift its approach to battle high inflation.



This is the classic business cycle which we haven't seen in some time. An overheated economy (along with other factors) brought about inflation, which necessitates a tighter policy response, which leads to weaker economic growth, which then leads to accommodative policies to revive the economy, and so on. From 2009 until the pandemic hit, there were no troughs as shown in the figure to the right. It was just a steady – though often slow – expansion of the economy. Now, the Fed's response to inflation will likely lead to a trough of some kind. The depth and duration of that trough will depend on how stubborn inflation is and, consequently, how much the Fed needs to tighten monetary policy – and for how long.

Some of the more transitory aspects of the inflation spike have already subsided and will likely continue to do so. But, labor markets are still tight and wages are rising, which will continue to exert an upward pressure on prices. That is, it could be that inflation continues to come down but can't quite reach the Fed's 2% target. Whether the Fed sticks to that 2% goal in the face of likely rising unemployment and slowing growth remains to be seen. They're talking tough now, but that's not surprising since they need to display resolve to maintain credibility. This is especially important when it comes to inflation, which has a psychological component. That is, if consumers think inflation will stay elevated, they're incentivized to buy things now, which pushes prices up further – a sort of sell-fulfilling cycle. The markets, however, are calling the Fed's bluff by pricing in rate cuts during the second half of 2023. In their official forecasts, meanwhile, none of the Fed's members are forecasting rate cuts until 2024 at the earliest.

If it seems like this newsletter and our other recent ones have focused almost entirely on the Federal Reserve, it's because that's almost all the markets are paying attention to. There are plenty of other issues affecting the markets. Politicians refusing to pay the nation's bills by not raising the debt ceiling would certainly rankle markets. And there are always geopolitical factors like the effects of China lifting its Covid restrictions and the ongoing war in Ukraine. But the big questions that investors are asking right now remain: 1) how quickly will inflation come down? and 2) how much is the Fed going to harm the economy to get inflation to its target?

It's tempting to say, if the economy is going into a recession (if not already there), why be invested in any risk assets? Why not wait until the recession has passed? One concept that is always worth revisiting is that markets are forward-looking. Historically, on average, markets have recovered about five months *before* recessions ended, as investors began to price in the path to expansion. In addition, it's never clear in real-time when a recession has begun or when it has ended. It's only after the fact that things become clear. For those reasons, the most prudent investment approach is always the one you can stick with through various economic and market conditions. Sure, you'll take some lumps along the way, but over time, the economic growth that the world experiences will continue to be a tailwind.

A challenging 2022 is in the rearview mirror and we appreciate the confidence you've placed in us. We will continue to strive to help you meet your financial goals in the new year.

Sincerely,

James A. Heine

James L. Cobb

Market Report (as of 12/31/22)

Index	**2022 (%)**	**3-Year Annualized (%)**	**5-Year Annualized (%)**
S&P 500	-19.4	5.9	7.5
Dow Jones Industrial Average	-8.8	5.1	6.0
U.S. Aggregate Bond Index	-13.0	-2.7	0.0
MSCI EAFE (Foreign Index)	-16.8	-1.6	-1.1

Disclaimer: The views expressed herein are those of ICR as of January 15, 2023 and are subject to change at any time based on market and other conditions. This is not a recommendation or solicitation for the purchase or sale of any security and should not be construed as such.