Wealth Management

Newsletter

Winter Issue 2023

KEY POINTS

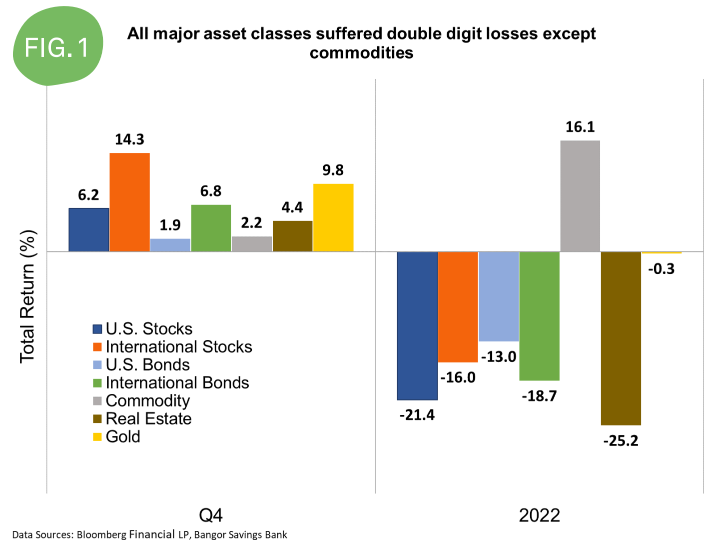
- Nowhere to hide in stock or bond markets during 2022
- Rising interest rates, inflation, a strong dollar and geopolitical tensions were the dominant narratives throughout 2022
- The evolution of inflation statistics and central bank policy will likely remain a prevailing theme in 2023
- Volatility may remain elevated given the uncertain economic backdrop which will require continued investor patience

2022: BY THE NUMBERS

The year 2022 will be remembered as one of the most challenging investing environments since the financial crisis. A shift from an environment of easy monetary policy and stimulus to tightening financial conditions, a breathtaking rise in global interest rates, the highest inflation we have seen in 40 years, and a war unfolding in continental Europe resulted in a global bear market in financial assets. Investors had nowhere to hide, with all major asset classes suffering double digit losses except commodities. Bonds failed to provide investors with protection from falling equity prices as interest rates rapidly rose, resulting in the sharpest decline in bond markets in many decades. Even the classic 60/40 portfolio, a popular strategy among moderate-risk seeking investors, posted a loss of 17% for the year.

With regards to U.S. markets, the S&P 500 finished the year -18%. The Dow Jones Industrial Average outperformed on a relative basis, finishing the year -7%, while the growth sensitive Nasdaq lagged other major indices, finishing the year -32%. Small and mid-sized U.S. companies also struggled, returning -20% and -13%, respectively. As depicted in Figure 1, the broad basket of U.S. Stocks, as represented by the Wilshire 5000, finished the year -21%.

International stock markets were in a similar position, despite lower relative valuation metrics, partly due to the relative strength of the U.S. Dollar. Developed international and emerging international finished the year -15% and -20%, respectively. As noted in Figure 1, the majority of asset classes rallied into year-end, in hopes that inflation had peaked and the Federal Reserve would soon be able to slow the pace of its interest rate increases. International markets fared better than domestic during the quarter, partly due to a reversal in the strength of the dollar.



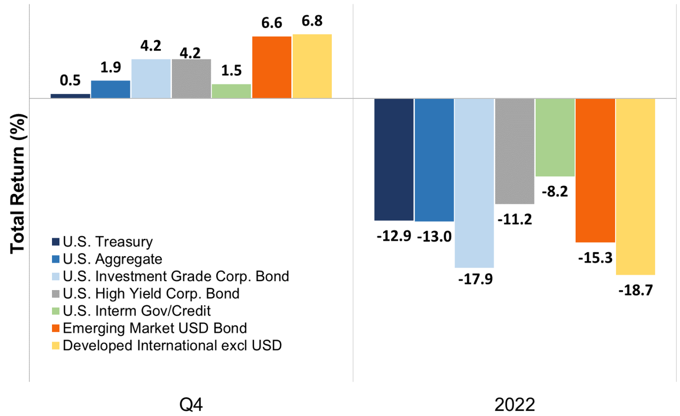
From an investment style standpoint, value outperformed growth during the year as investors favored companies with current earnings and lower multiples in a rising rate environment. On a sector level, 9 of the 11 S&P 500 sectors finished the quarter with a positive return, although only energy and utilities stocks finished the year in positive territory. Energy finished the year up 65% as rising oil and commodity prices in response to geopolitical concerns helped push energy stocks sharply higher. Defensive sectors such as utilities, consumer staples, and healthcare finished the year roughly flat as investors rotated towards less economically sensitive pockets of the market with fears of a recession on the horizon. Buoyed by years of record low rates, many high-expectation growth stocks, SPACs, cryptocurrencies, and "meme stocks" finished the year with losses greater than -50%.

FED RATE-HIKE PACE SLOWING – HAS INFLATION PEAKED?

After the sharpest rate-hike path embarked upon by the Federal Reserve since the late 1970's in response to spiking inflation, the Fed took a step back and increased short-term rates by only 50 basis points at their December meeting (as opposed to the previous four meetings in which they raised rates 75bps). Year-to-date the Fed has hiked rates from zero to 4.50%. These actions, along with many other hawkish global central banks, have wreaked havoc on all fixed income markets. Futures markets are currently pricing in a peak of a 5% Federal Funds rate in mid-2023 and then are forecasting the first rate cut by the end of the year with long-term monetary policy rates plateauing around 3% from 2025 on. Consumer prices (as measured by the CPI) appear to have peaked, at least in the near-term, in June at 9.1% and have since declined by 2% to finish 2022 at a still-elevated 7.1%. In response to the hopes of a Fed "pivot", fixed income markets began to price in the prospect of the end of the current Federal Reserve interest rate hikes and bonds rallied to produce their first positive quarterly returns of the year (see Figure 2). That said, Fed rhetoric remains on the hawkish side with the continued theme of doing whatever is necessary to quell pricing pressures, and while the majority of rate increases are likely behind us, policy rates may stay elevated for some time to ensure that inflation returns to the Fed's 2% target.

FIG. 2

All major fixed income markets suffered equity-like declines in 2022 as a result of rising interest rates globally



Data Sources: Bloomberg Financial LP, Bangor Savings Bank

While overall headline inflation remains historically elevated there are some reasons for optimism for disinflation over the medium term. Commodity prices are well off their highs and shelter/rent prices are declining and are expected to continue to move lower (shelter is a lagging indicator in CPI). Accordingly, over the past 3 months, the Consumer Price Index has risen at less than 4% on an annualized basis and market-based inflation expectations indices are moving lower as well.

THE ECONOMY

U.S. economic data was mixed at best throughout 2022 and future growth expectations appear to be slowing which has forced economists to mark down their 2023 forecasts. Overall, GDP is expected to be marginally positive for 2022 once we receive the Q4 results in late January, despite two consecutive negative quarters to start the year which is generally the definition for a technical recession. Looking forward the majority of market participants are predicting some form of recession in 2023 with the main debate being as to how deep and prolonged the negative growth may be. The labor market continues to be strong with the unemployment rate currently at 3.5% and weekly jobless claims hovering around historic lows. As mentioned previously, inflation likely peaked in mid-2022 and hopefully, as COVID-related supply constraints and geopolitical concerns subside, CPI will continue to decline. However, the question remains as to how long it will take to get back to the Fed's stated long-term inflation target level around 2%.

MARKET VIEW AND PORTFOLIO CHANGES

As we look forward to 2023, the Bangor Wealth Management Team expects volatility to remain elevated as market participants seek clarity on the timing and depth of a possible recession, where currently high inflation levels settle over the intermediate term, and the monetary policy actions of the Federal Reserve. With regards to equities, the expectations of reduced economic and earnings growth, a high cost of capital, and heightened volatility pose headwinds for stocks in 2023. While the S&P 500 has been trading in a broad 3,600 to 4,100 range since late 2022 as a result of these cross-currents, the investment team has been focused on positioning portfolios to take advantage of the relative leadership in the energy, industrials, and materials sectors, while continuing to be cautious in our capital allocations to the information technology, consumer discretionary, and communication services sectors. The normalization of interest rates will require a more patient and discriminating approach to markets, and returns across sectors and investment styles will vary. Therefore, as always, we remain focused on investing in high quality companies with pricing power and stable cash flows that are trading at reasonable valuations. On the other hand, historically the S&P 500 has posted positive annual returns following a down year more than two-thirds of the time. Accordingly, we remain fully invested, albeit with a defensive bias and slightly higher cash allocations as we enter 2023. With regards to fixed income, after a dreadful year, bonds are beginning to look more attractive and should behave more "bond-like" in 2023. Pending any unforeseen surprises in inflation or monetary policy, the risk of a significant selloff, relative to 2022, seems limited as inflation appears to be trending downwards and markets have priced in hawkish outlooks for most central banks. We have increased our allocations to short and intermediate term fixed income, specifically U.S. Treasuries, while avoiding the high yield area of the market.

Despite expectations of a sluggish economy and challenging capital markets as we begin 2023, history has shown repeatedly that the best defense against an uncertain investing landscape is having – and sticking with – a long-term financial plan. Therefore, please don't hesitate to reach out to our team to either help, develop or to review your customized financial plan, and to ensure that your accounts are properly aligned with your investment goals and timeframe. Happy New Year and as always, we look forward to working with you to help accomplish your financial goals in 2023!