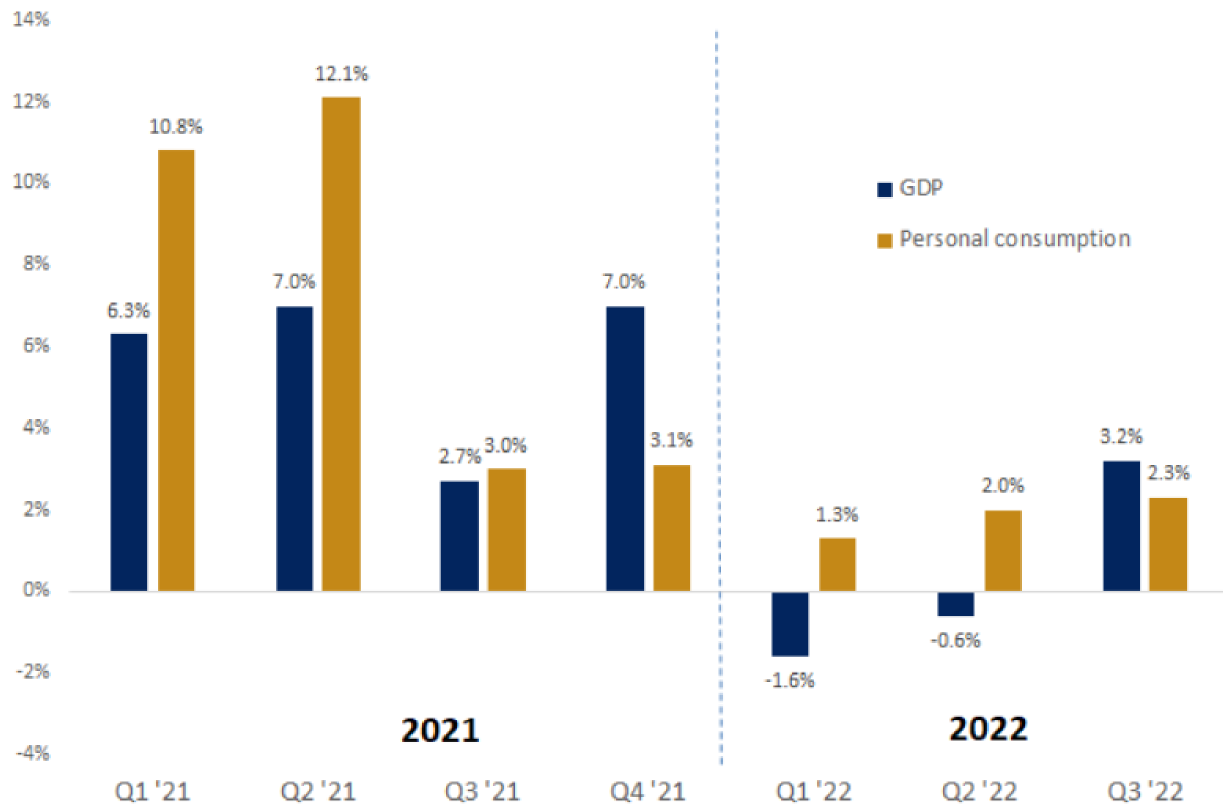
Tuesday, December 27, 2022

Good afternoon:

We hope everyone had an enjoyable holiday and are looking forward to wrapping up 2022 and ringing in 2023 on Saturday night. Unfortunately, the so-called "Santa Claus rally" in the stock market failed to materialize last week or so far today. As we start this year's final week of holiday-shortened trading, it is worth remembering just why 2022 was such a difficult year for investors. Multiple headwinds hit the economy and financial markets simultaneously. Four-decade-high inflation, aggressive central bank tightening, a war in Ukraine and lockdowns in China, all contributed to a rapid adjustment in interest rates, valuations, and sentiment. The result was the longest bear market in equities since 2008 and the largest sell-off in bonds since records started in 1926.

Perhaps surprisingly, the labor market stayed tight all year. Averaging about 390,000 net job gains per month in 2022, the unemployment rate is now back to pre-pandemic levels of 3.5%, a 53-year low. As a result, consumer spending, accounting for 70% of GDP, stayed healthy despite rising prices and interest rates. This led to a sharp reduction in economic growth, with more harsh consequences of the Fed's aggressive rate hikes to the nation's GDP perhaps yet to come.

Economic growth stalled, but consumption proved resilient in 2022

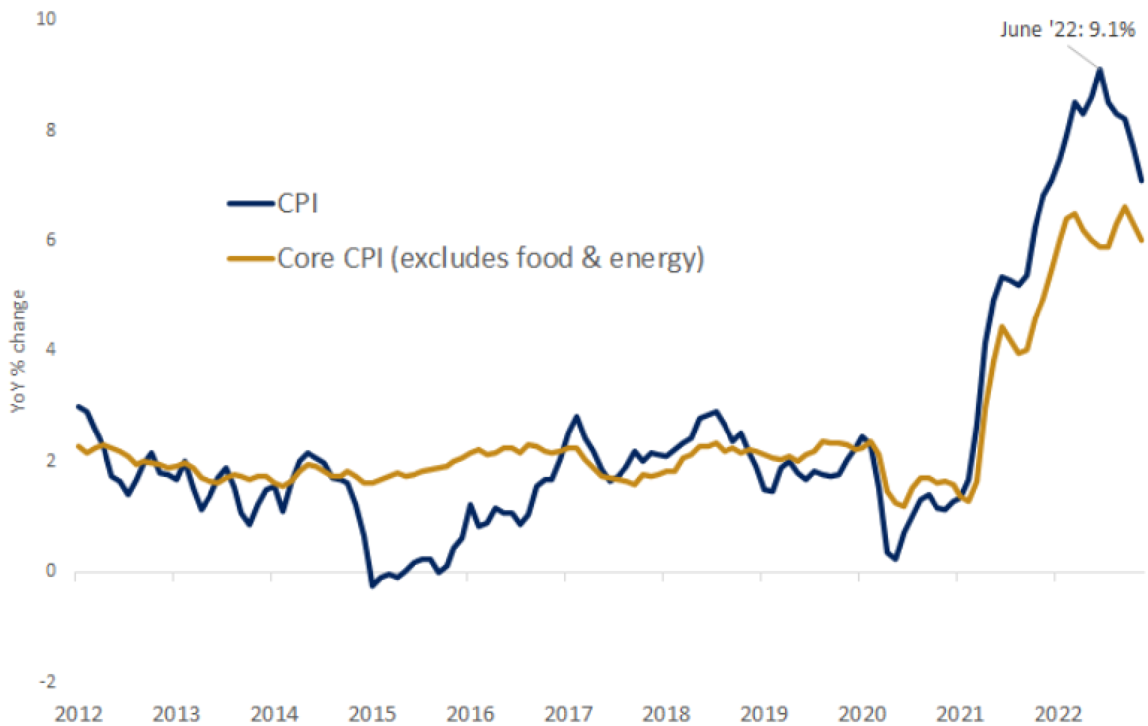


The graph shows U.S. and Canadian real GDP growth which slowed sharply this year. Yet consumer spending staying resilient.

Source: Bloomberg, Edward Jones

Inflation was by far the biggest driver for the markets throughout this year with one successive upside surprise after another, each prompting higher interest rate expectations and selling pressure in both stocks and bonds. Headline CPI hit a 41-year high at its peak of 9.1% in June before slowly easing since then. One potential catalyst for a market rebound in 2023 would be if inflation continues or hastens its decline. Slowing consumer demand, easing supply shortages, a cooling housing market, and a less tight labor market may help ease the pressure on prices.

Better news are likely ahead on the inflation front



The graph shows the U.S. consumer price index (CPI). Headline inflation peaked in June and has started to moderate.

Source: Bloomberg, Edward Jones

Perhaps the most important result of easing inflation would be the conclusion of the Fed's tightening cycle. Even their acknowledgment of a shift to a less aggressive posture would likely be celebrated as the beginning of the end to the rate hiking campaign. Fed funds futures in the bond markets are projecting a peak near 5% in May of 2023. With economic growth weakening and inflation falling, the Fed will likely be able to conclude its rate hikes, probably in the first half of the year, and that could start to relieve the upward pressure on bond yields and equity valuations.

Fortunately, odds of 2023 being a positive year for investors are fairly good. Since 1928, there have only been four instances where the S&P 500 has fallen for two consecutive years. With the currently lowered equity valuations, falling inflation, and potentially diminishing headwinds on the horizon from the Fed, 2023 has the potential to surprise to the upside by year end. However, despite some cautious optimism, we continue to expect heightened volatility for next year with both the Fed and many traders very data dependent. Numerous economic reports each month will continue to spark reactions as investors try to handicap the Fed's and the market's next moves. We remain committed to a diversified approach, utilizing higher quality more defensive areas of the market during these difficult and challenging times for all investors.

As a reminder, the markets and our office will be closed on Monday, January 2, 2023.

Have a great week and a very happy new year!

Mark and Jeff

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Market return and statistical data obtained from: https://am.jpmorgan.com/blob-gim/1383452890099/83456/weekly_market_recap.pdf?segment=AMERICAS_US_ADV&locale=en_US

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