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2022 Year-End Review and 2023 Forecast

21 January, 2023

I like to start these year-end reviews by looking back at the predictions I made at the beginning of the previous year. Quite often this analysis shows just how difficult it is to predict market and economic events – usually I get some things right and some wrong as well.

At the beginning of 2022 I was generally positive about stock markets, although I didn't think we would have as good a year as 2021. I was negative on bonds because of the expectation that interest rates would rise and suggested it would be better to invest in dividend-paying investments rather than bonds. I also felt that value stocks should outperform growth stocks (although I had been wrong about this the year previously), and that once interest rates started to stabilize most likely the US dollar would reverse course and weaken relative other major currencies. I thought that perhaps we might enter an extended period where non-US markets outperformed US markets, which would be in stark contrast to the last ten years or so of US market outperformance. I also thought that at some point gold would be a good investment again and that once things started opening up post-covid in China and the Chinese government stopped beating up on their large international companies, these would be good investments.

Clearly I was wrong about the most important point, which was that stock markets would do OK in 2022. As the chart below shows, stocks and bonds both did poorly. Gold about broke even for the year. We did well to steer clear of bond investments in 2022; out of the major asset classes, long-dated treasuries

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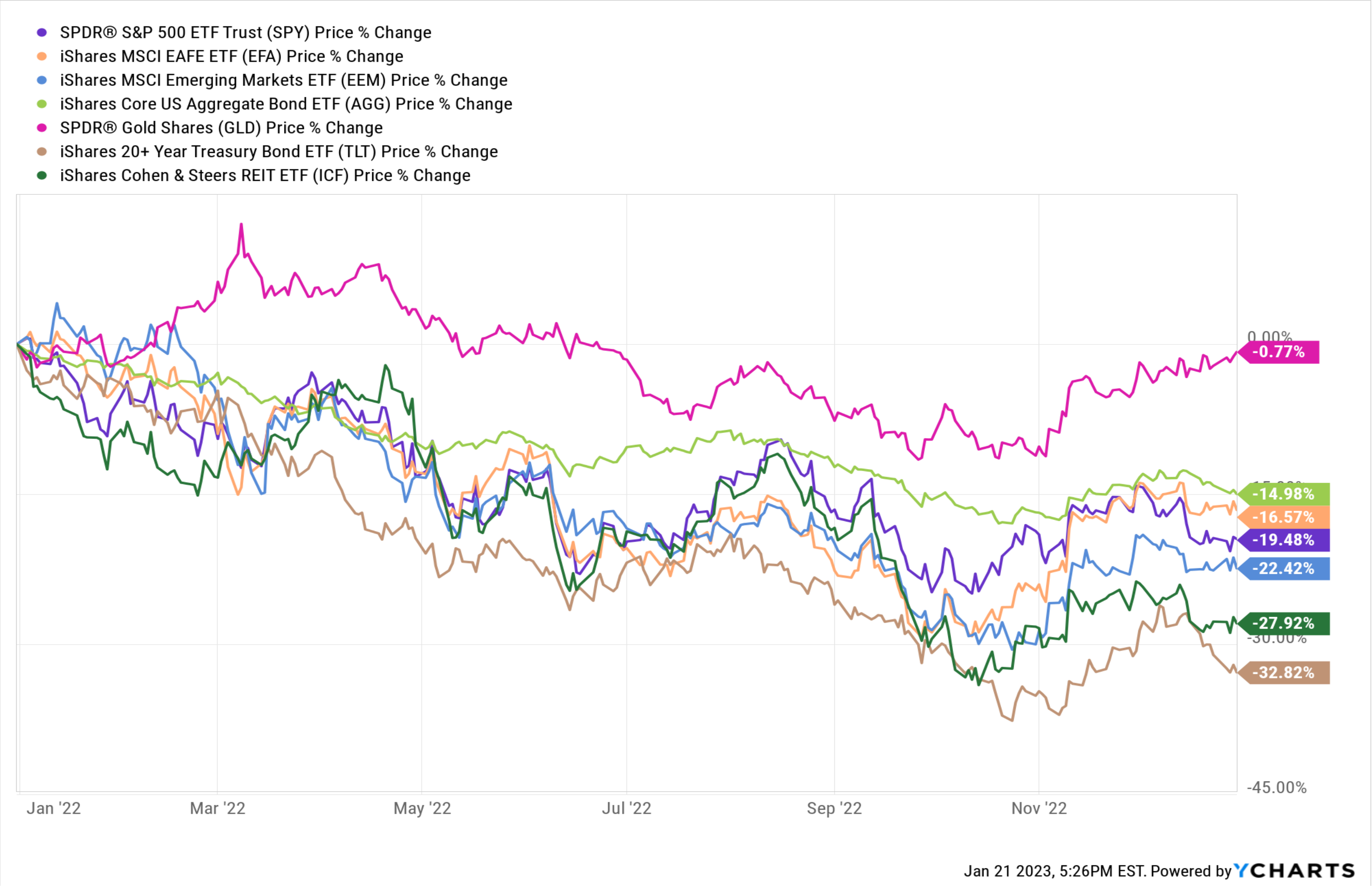
performed worst, down over 30% on the year. This was actually a no-brainer, since as interest rates rise, bond prices must fall and the longer the bond the more the price swings.



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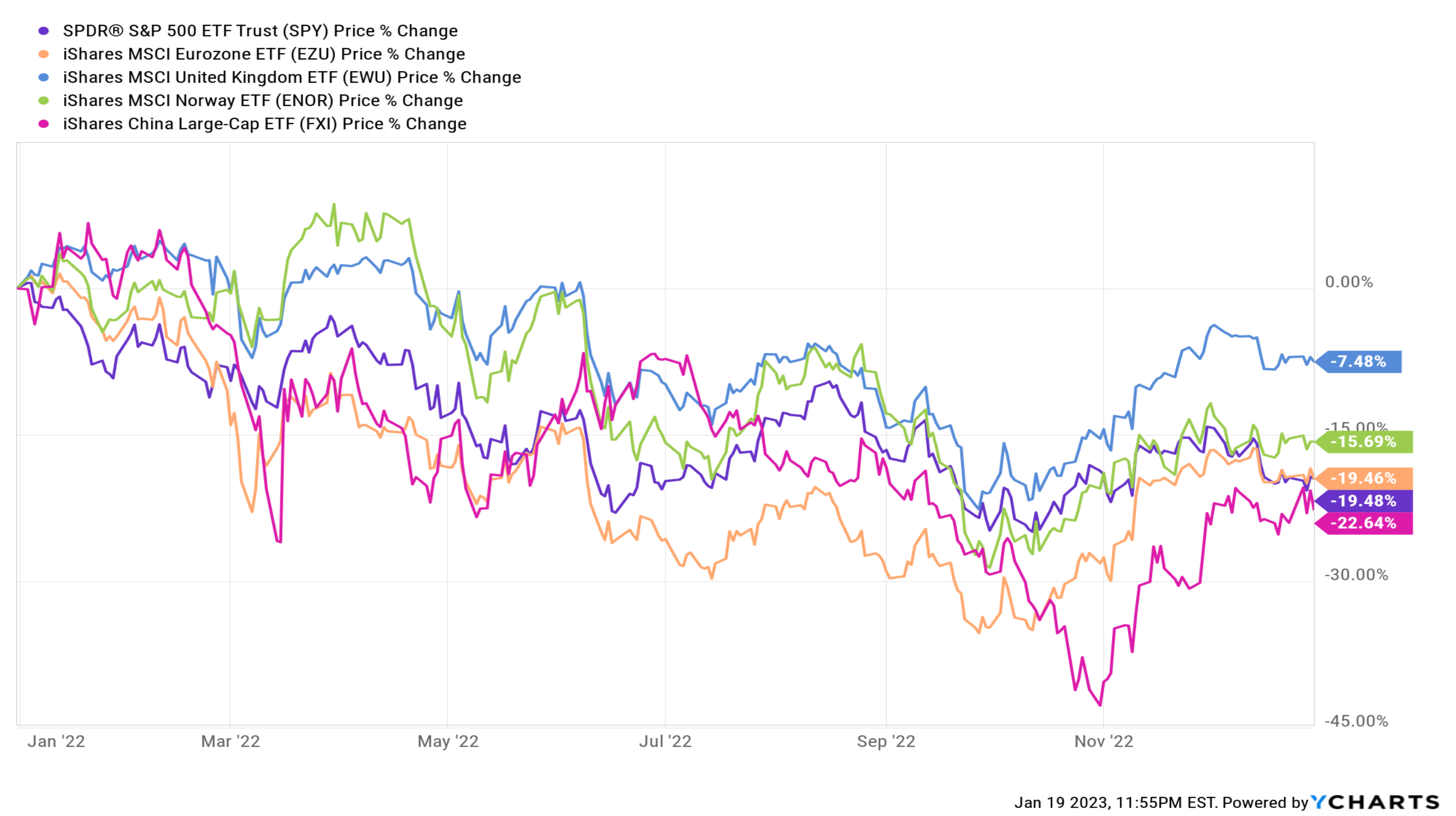
This unusual combination of down stock market and also down bond market must have been quite disconcerting for conservative investors who place their faith in bonds as a diversifier to the stock market and as a conservative investment. The traditional approach, where a conservative investor might have a 60% stock allocation and 40% bond allocation, did not work well last year. Indeed, diversification as a risk management strategy didn't work well since pretty much all asset classes were down substantially. Only some commodities did well, with oil and gas prices up, and gold prices about even for the year. Our own defensive and balanced strategies did relatively well, although they were still down for the year, as a result of the fact that we chose to hold cash or short-dated bonds instead of longer-dated bonds.

As predicted, the US dollar continued to strengthen throughout the first three quarters of 2022 as the Federal Reserve rapidly raised interest rates to combat high inflation. Then, once inflation seemed to have stabilized and started to decrease in November, the USD started to weaken with the expectation that interest rate increases would become smaller and eventually stop altogether. The trade-weighted US Dollar increased about 13% from January to November but ended the year up about 6.5%. The Euro lost 6.5% and the British Pound was down 11% vs USD for 2022, with the Pound being down about 20% vs USD over the first three quarters of the year. The Japanese Yen had some wild swings, down 24% vs. USD at one point and falling 13% on the year.

The United Kingdom was widely considered to be an economic basket case in 2022 and into 2023, with dire economic projections abundant, very high inflation expectations, political upheaval in 2022, and now strikes in many industries in England. Perhaps this is what weighed on the British Pound. It seems that it would have also been a good year to avoid UK investment markets and yet, as the chart on the next page shows, the British stock market outperformed US markets substantially, even including currency effects.

The S&P500 index was down almost 20% in 2022, as were Eurozone markets, but a measure of the broad UK stock market was down only 7.5%. Another interesting bit of trivia is that the Norwegian market was down 15% - one might have expected this market to do well given that Norway is a country that exports oil & gas and would therefore seem to be well-positioned given the energy crisis in Europe brought on by the Russia/Ukraine conflict.

We avoided UK and European markets in 2022 as a result of the energy crisis there and the expectation that this would lead to a deep recession and significantly affect European companies, and also because of the expectation the US Dollar would strengthen, which would be negative for stock markets priced in non-US currency. Yet these markets did not do worse than the US market, and in the case of the UK did much better. The explanation lies in the weighting of the types of companies that make up each region's stock market.



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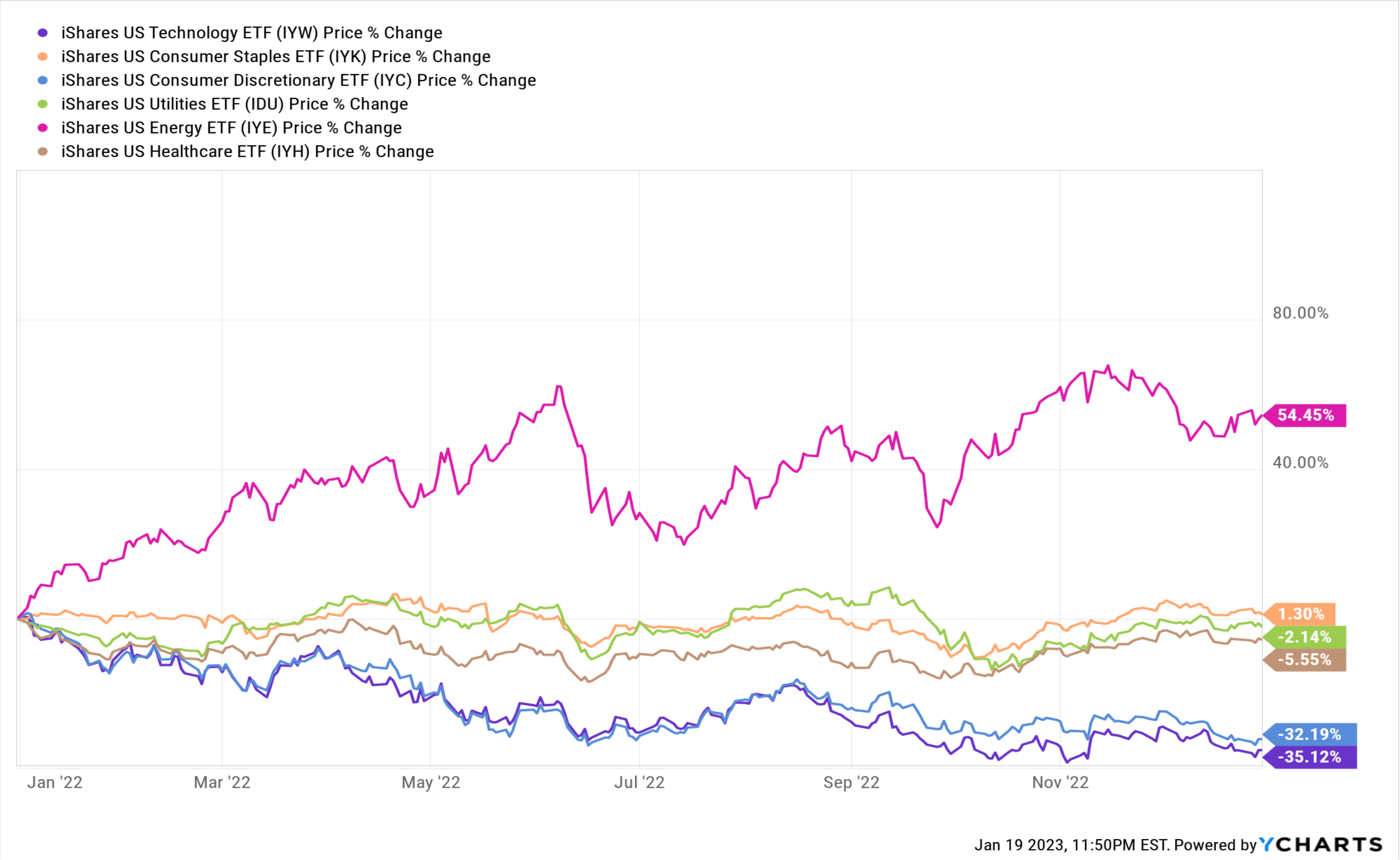
The UK stock market has almost no weighting to technology companies, whereas the US S&P500 has about a 25% weighting and the European market is about 13% technology. As the chart below shows, technology companies did poorly last year.



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As the above chart shows, there was a large disparity between sector returns in 2022, with technology and consumer discretionary down over 30%, more conservative sectors such as utilities, consumer staples, and healthcare, down 1% to 5%, and energy vastly outperforming, up over 50%. After years of out-performance, large technology companies had a terrible year. Apple and Microsoft were down almost 30%, Google (Alphabet) down almost 40%, Amazon down 50%, and Facebook (Meta) and Tesla down about 65%. These six companies make up about 20% of the S&P500 stock index by market capitalization.

Most stock market indices, and therefore the index and ETF funds that reflect those indices, are market-cap-weighted, which means that the largest and most valuable companies in the indices have the greatest influence on the value of the index. Market-cap, or market capitalization, is the shareholder value of the company, it is the share price multiplied by the number of shares outstanding. For example, if a company has 1 million shares outstanding and trades for $20/share, then its market cap is $20,000,000. If the share price of a company in an index increases much faster than the share price of other companies in the index, its market cap grows and its influence on the index grows in proportion. This has been the case for some of the large US technology firms in recent years, and now they have a large influence on a stock market index like the Standard and Poor's 500.

If we weighted each company in the S&P500 index equally instead of by market cap, then index performance would have been much better last year. The chart on the next page shows a comparison between the regular Russell 1000 index (a market-weighted index of the 1000 largest US companies) and its equal-weighted counterpart and between the S&P500 and its equal-weighted counterpart. In both cases, the equal-weighted indices outperformed by about 6% last year.

On the following page we can see a comparison between value and growth and small and large (S&P500) companies. Value stocks finally outperformed growth stocks after 5 years of growth outperformance. So I was a year early in calling for this to happen but now here we are. There was a 10% difference between US value and growth stock returns last year, mostly as a result of underperformance of technology companies. As a result of this, our more growth-oriented strategies did poorly last year but despite the recent downturn in share prices of Apple, Amazon, and Tesla, it seems a good long-term bet to invest in these market-leading companies.

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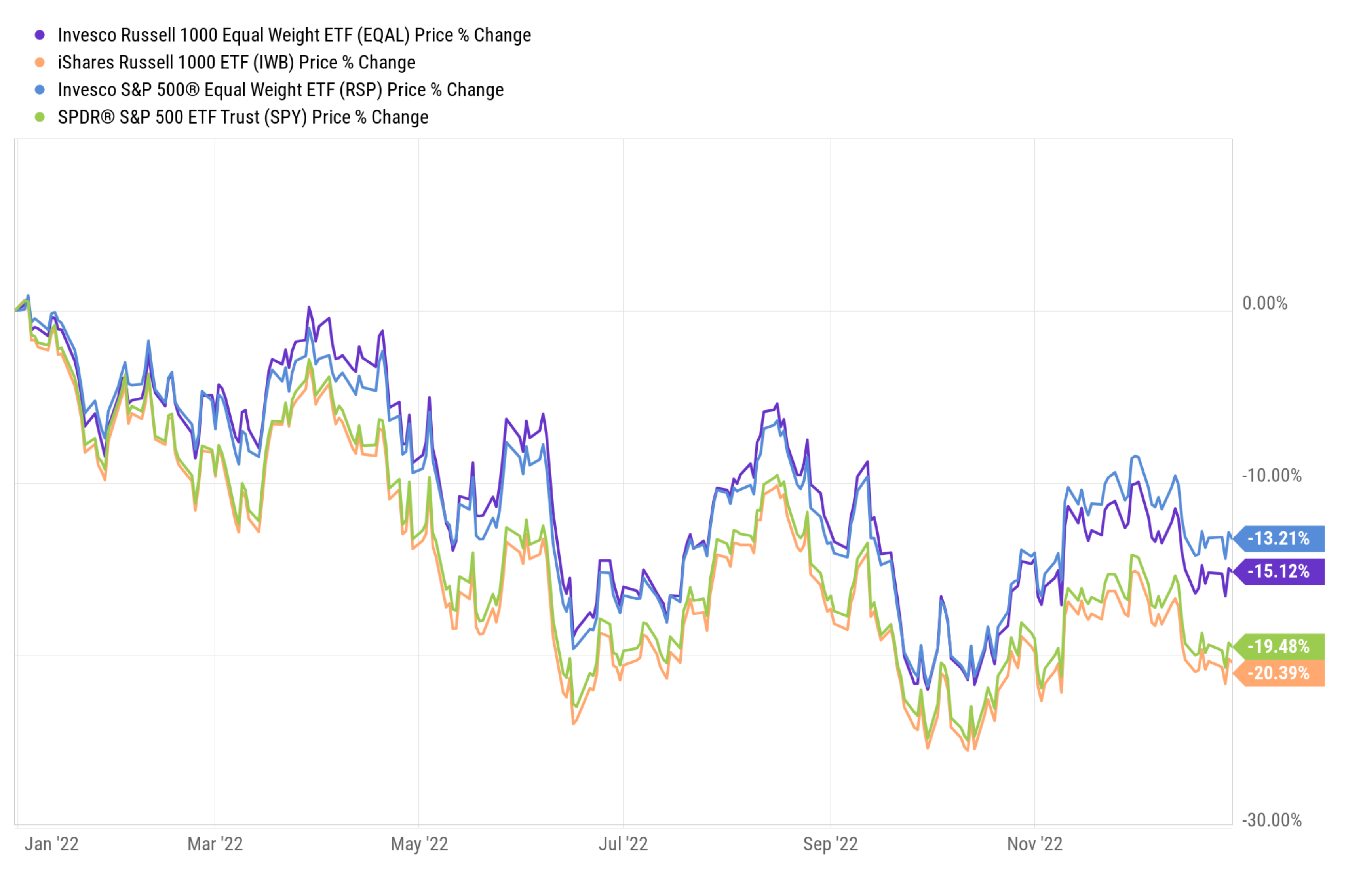

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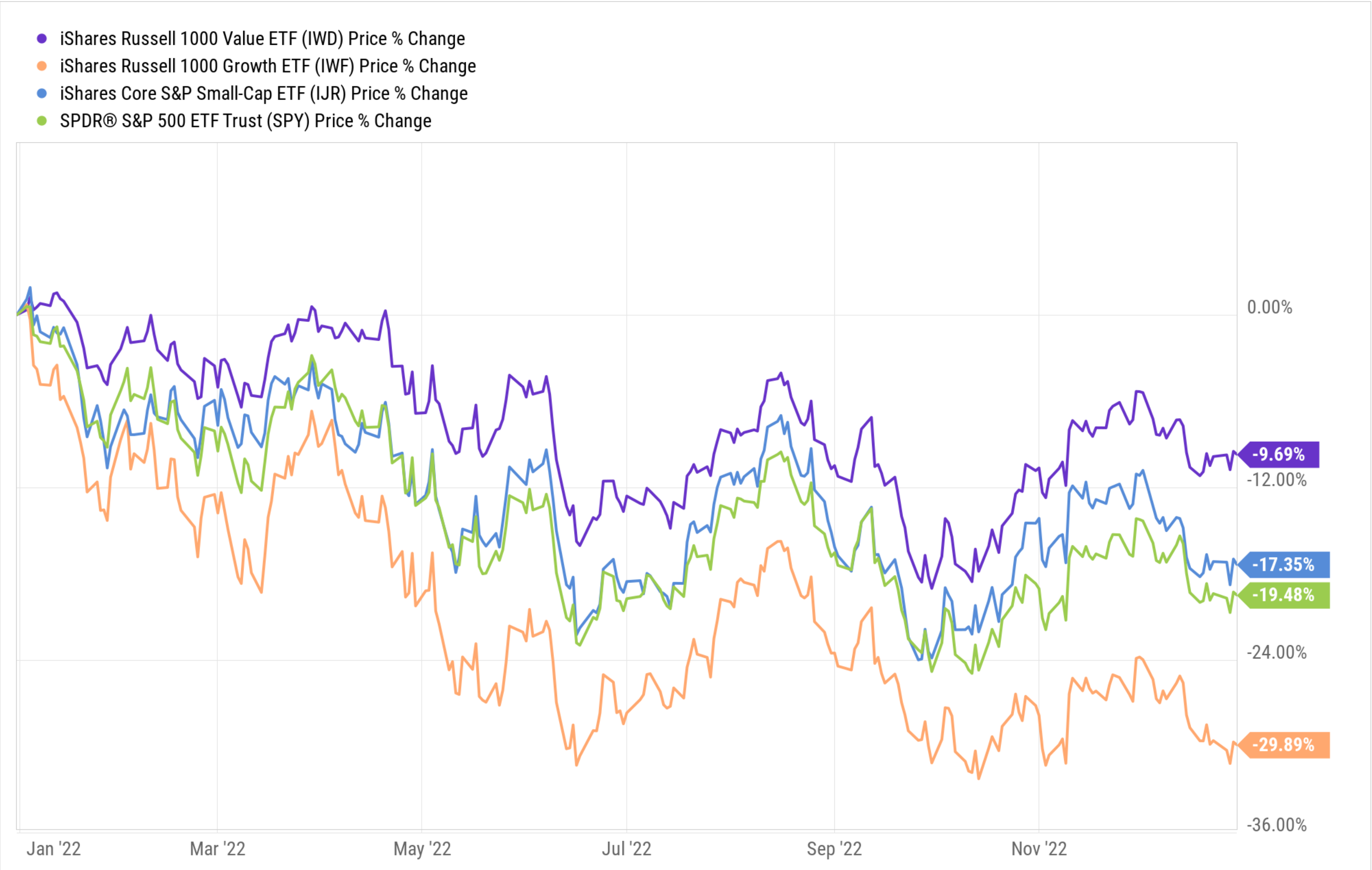

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So what can we expect for 2023? It's an especially interesting question this year because opinions are all over the place. Many so-called experts are calling for a mild recession in the USA, a bigger recession in Europe, and then a mixed bag for the rest of the world. However, projections are not as gloomy as they were just a month or two ago. Europe has been blessed by a relatively warm winter and the energy disaster that many predicted as a result of Russian oil and gas curtailment has, at least so far, not materialized. inflation has been very high but there are indications that perhaps it has peaked, especially in the USA. The IMF has recently raised its projections for global economic performance and China is attempting to open up its economy again after several years of covid shutdown.

I'll go out on a limb and say that I think it is going to be a good year for investments in general. I think stock markets will bounce back but I think non-US markets will outperform US markets. After many years of US market outperformance before 2022, I think we are at a point where non-US markets start to catch up. With China opening up and the recent positive comments made by the Chinese government in support of industry, some of the hard-hit large Chinese companies might have a good year and some of the companies that do much business in China may also do well.

Interest rates will likely increase at a slower rate and possibly stop increasing later in the year, which should be supportive of the bond market and finally perhaps gold will have a good year because there will still be quite a bit of uncertainty amongst investors.

Many US companies still seem overvalued, trading at price/earnings ratios higher than their long-term averages; but this is less so amongst non-US companies and in certain sectors such as healthcare and mining for example, for this reason I would still favor value rather than growth companies in 2023, especially in more conservative accounts.

There are certainly risks out there: The Russia/Ukraine conflict could escalate and, as China re-opens, this could drive oil and gas prices upwards leading to out of control inflation and a larger than expected economic downturn in places that depend on energy imports.

China might also turn out to be a real disaster this year as a result of covid. Some estimates have said that 900 million people in China have been infected and it is difficult to imagine how the Chinese healthcare system will cope. What will this actually mean economically? On the one hand, Chinese industry is re-opening, but on the other hand, it could be severely affected by rampant covid.

Inflation is still a concern, and especially the reaction to inflation in places like the UK where there are many strikes going on at the moment in key industries by workers who feel their salaries are not keeping up with inflation - it is difficult to imagine how the UK could possibly do well economically in the near term.

In the USA there is much talk of recession and much angst over the rate of interest rate increases, but unemployment is at historic lows despite many layoffs in technology recently. Unemployment is also low in Europe. This seems to indicate that any recession should not be too bad - if we see unemployment start to increase, housing prices falling, and retail spending being cut, then we need to get worried about a more ominous recession.

Putting all this together, I am cautiously optimistic for 2023. I think we need to stay away from companies whose share prices trade at historically high multiples of earnings and we should favor non-US markets, which are more reasonably priced. I think diversification will, once again, be beneficial in controlling investment risk and that we will not see the correlation between stock markets and other asset classes that we saw last year. Finally - I'm liking gold.

As always, I invite you to contact me directly should you wish to schedule a call to discuss your personal investments, our strategies, or any other issues with which we might be able to assist.

Tom Zachystal, CFA, CFP©
President
International Asset Management

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