Year-End Newsletter 2022

This year was one of the most challenging years in the market in half a century for the simple reason that both stocks and bonds had bear markets. The challenges we face are partly because we've experienced two large and disruptive global events (Covid & war in Ukraine) in about two years. It was also a noisy year regarding inflation, recession predictions, corporate earnings, domestic and international politics, etc. The 24-hour news cycle also tends to promote overreaction and conceals important facts in a sea of otherwise useless "noise.".

The bond market had incredible turmoil due to rising interest rates to help combat inflation. For context, the 10-year treasury started 2022 at 1.62%; rose to 3.48% in June; dropping to 2.64% in July; rallying to 4.23% in October; dropping again to 3.40% in December. Existing bonds get repriced lower when interest rates rise; therefore, many high credit quality bond funds were down about 15%. For emphasis, this is also the first time in US history that core bonds have lost money over five years. The volatility did create opportunities for exchanging in and out of different duration bond funds (short term versus medium term maturity) to take advantage of some of these swings. But bond trading likely only limited losses and couldn't avoid them. The US was the first major developed market to start raising interest rates. This has caused the dollar to appreciate against other currencies, exports to fall, and imports to get cheaper. GDP may stay depressed as we export less to the rest of the world while the dollar remains strong.

Hedging strategies also had mixed results. Gold did well in the first and last quarters of 2022, but between March 8th and September 26th declined about 20%. Bitcoin also declined about 60% in 2022 and several crypto exchanges went bankrupt.

Stocks faced headwinds and challenges from continued supply chain issues, higher interest rates, labor shortages, the fallout from the conflict in Ukraine, and all the unknowns around these situations. Many economists and analysts predict that we may enter a recession in 2023. The good news is that while we may have a recession, other data suggests it may be brief and mild. The ongoing labor shortage may keep layoffs subdued or at least limited to specific industries. The markets have largely priced in a recession and may not fall much further. The stock market usually rallies before the wider economy fully recovers too. In a typical recession you see large negative returns (like we saw in 2022) in the first half of a recession, which is usually followed by strong returns in the second half of a typical recession. So, while it's natural to be frustrated and tempted to exit the market, the market usually rebounds quickly and dramatically. There are many historical examples of higher returns following peaks in inflation and bad years in the stock market. The stock market has averaged a 21.3% return over the 12 months following peaks in inflation since 1926, according to Blackrock[1].

While US consumers are hurt by higher prices, many other parts of the world are facing shortages for fuel and food and even grimmer circumstances. Higher interest rates could also help retirees and savers if rates remain elevated longer term and may reduce some riskier behaviors in the market and economy. This year reminds us that being a long-term investor doesn't always feel good. So, while we don't have to be happy about the investment returns in 2022, we are still in a better position than much of the world and could be handsomely rewarded for our patience.

Sincerely,

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[1]Blackrock, Student of the Market, October 2022; Performance Following Peaks in Inflation, p 10.