EMPOWER INVESTMENTS | Thomas Nun, CFA, Portfolio Strategist | Alicia Paul, Investment Analyst

Learning to live with it

2022 could be remembered as the year markets "paid it forward"

Asset class	2022	Asset class	2022	Asset class	2022
U.S. equities		**Non-U.S. equities**		**Commodities and other**	
U.S. large-cap stocks	-18.11%	Foreign (developing markets) stocks	-14.45%	U.S. dollar	7.87%
U.S. mid-cap stocks	-13.06%	Emerging markets stocks	-20.09%	Cash	0.94%
U.S. small-cap stocks	-16.10%	**Fixed income**		Gold	-0.74%
NASDAQ composite	-32.54%	U.S. bonds	-13.01%	Crude oil	27.55%
U.S. large-cap value	-7.54%	U.S. high-yield bonds	-11.27%	Commodities	24.09%
U.S. large-cap growth	-29.14%	U.S. TIPS	-12.13%	U.S. inflation*	6.45%
U.S. REITs	-25.37%	Foreign sovereign bonds	-21.77%		

* U.S. inflation represents the year-over-year change in the Consumer Price Index as of December 31, 2022.

Data: Bloomberg, Morningstar. U.S. large-cap stocks represented by the S&P 500 Index, mid caps by the S&P 400, small caps by the S&P 600, U.S. large-cap value represented by the Russell 1000 Value Index, U.S. large-cap growth by the Russell 1000 Growth Index, and U.S. REITS by MSCI US REIT Index; developed market stocks represented by the MSCI EAFE Index, emerging markets by the MSCI Emerging Markets Index; U.S. bonds represented by Bloomberg Barclays Aggregate Bond Index, U.S. high-yield bonds by S&P U.S. High Yield Corporate Bd Index return, U.S. TIPS by iShares TIPS Bond Index, and foreign sovereign bonds by S&P International Sov Ex-US Bond Index; cash by iShares Barclays Short Treasury Bond Index, gold by S&P GSCI Gold Index, crude oil by S&P GSCI Crude Oil, and commodities by iShares S&P GSCI Commodity Index.

Coming into 2022, the macroeconomic foundation upon which markets rested seemed pretty solid: The U.S. labor market was as strong as it had been in a generation, and economic growth was being powered forward by a strong consumer still flush with COVID-era stimulus and in a mood to spend it. But even while markets continued to climb as 2021 drew to a close, you could feel trouble brewing — inflation was building faster than at any point since the 1980s, and investors understood that it was only a matter of time before the Federal Reserve would have to address it.

And address it they did. After maintaining the federal funds rate at or very near zero throughout much of the pandemic, the Fed began pushing rates higher in March 2022, then continued to do so at each of its next five meetings, something it hadn't done since 2005. More than that, the pace of the tightening was exceptional: The Fed pushed rates up more in 2022 than in any other calendar year since disco was king via a tightening campaign that featured an unprecedented four back-to-back increases of 0.75%. It's fair to say that the Fed hadn't acted that aggressively in recent history until 2022. And it isn't done yet.

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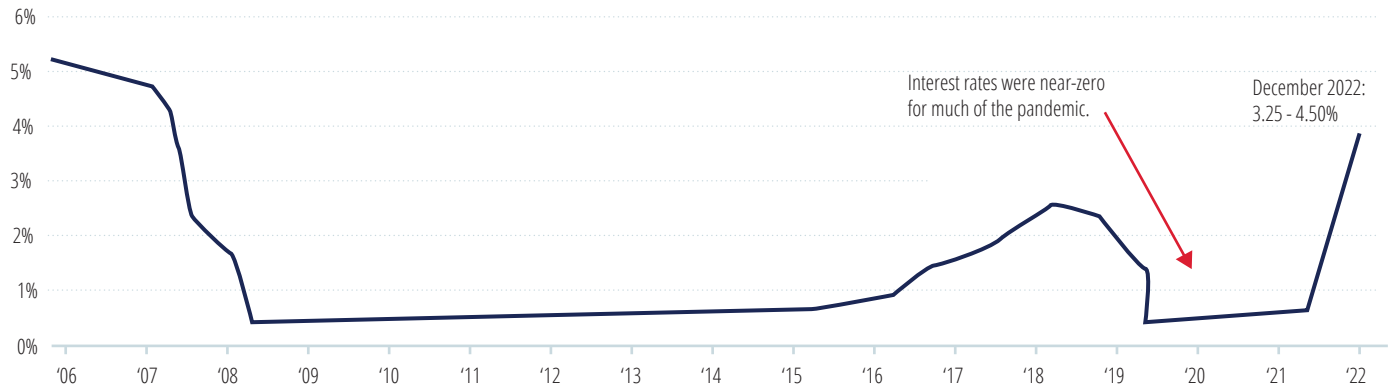
The Fed has continued to raise interest rates

Monthly federal funds target rate



But investors saw such moves coming and began to react even before the Fed opened fire. The peak in equities corresponded almost exactly to the turn of the new year, with the S&P hitting its all-time high just shy of 4,800 on January 3. That also happened to be the very first trading day of 2022, but it was still almost three months before the Fed began its historic rate-ratcheting campaign. It's been mostly downhill for stocks ever since: As of this writing, vast swaths of the market are well below the line that divides "market correction" from outright "bear market," with only brief periods of respite in between.

But for all that, maybe the biggest shock in 2022 was a drop in bonds that closely rivaled the decline in stocks. In some ways, this shouldn't have been too surprising. After all, the environment that pressured stocks in 2022 — rapidly rising interest rates — was precisely the same environment bonds hate most. That's a function of the inverse (and mathematically inevitable) relationship bonds have with interest rates: When rates rise, bond prices fall, and vice versa.

But over longer periods, bonds and stocks tend to behave quite differently, which is why bonds act as powerful diversifiers of equity market risk in the first place. This is due at least in part to the regular income typically produced by bonds, which tends to provide some level of insulation from macroeconomic turmoil. So even if rising rates pressure stocks and bonds simultaneously, the situation often tends to reverse itself fairly quickly when risk aversion takes hold and recessionary fears peak.

Are we in a recession?

Gross domestic product (GDP) notched back-to-back declines in mid-2022, falling 1.6% during the first quarter and 0.6% in the second. That provoked a question: Is the U.S. economy in recession? The answer so far has been no. The final, official word belongs to the Business Cycle Dating Committee of the National Bureau of Economic Research, a group of economists and academics who watch trends in the economy closely for signs that the U.S. has entered a sustained period of decline that is both widespread and lasts more than a few months. We suspect that it's very difficult for the NBER to call the recent soft patch an honest-to-goodness recession with an extremely strong jobs market, low unemployment, and robust consumer spending. However, since the Fed is still aggressively tightening policy, and both consumption and wages have struggled to keep up with inflation, whether or not we will experience a recession in 2023 remains an outstanding question.

Not so in 2022: As of this writing, it looked like core bonds would finish the year with losses almost as steep as those suffered by U.S. large-cap stocks. How unusual is that? The last time U.S. stocks and bonds both finished the same calendar year lower was 1969. Forget disco; you have to go all the way back to Woodstock to find a period that rivals that.

But why is this happening? At the root of all this is the highest rate of inflation in 40 years and the Fed's efforts to control it using the only tool at its disposal: higher interest rates. But rising interest rates work on different segments of the economy in different ways and at far different speeds. Some segments, like housing, tend to respond quickly as the cost of buying a home changes more or less in tandem with rising mortgage rates. By September, the average rate for a 30-year, fixed-rate mortgage surpassed 6% for the first time since 2008 — more than twice as high as last January, when it stood at 2.65%. Meanwhile, the available supply of homes has remained relentlessly tight, keeping prices high and causing affordability to plummet. Little surprise, then, that transaction volumes have collapsed, too.

There are signs that these same types of rate-related stresses are creeping into other areas of the economy as well, particularly as rates have risen beyond the so-called neutral rate and into restrictive territory, where the chilling effects of higher rates move beyond just simply removing COVID-related stimulus from the veins of the economy. But one area of the market that has clearly not reacted as strongly as the Fed would like is labor. The number of open positions in the U.S. reached a record of nearly 12 million in 2021 as the economy struggled to reopen in the wake of the pandemic. That figure has since begun to decline, but there are still well over 1.5 jobs for every available applicant — an extremely unusual circumstance for a ratio that has historically spent nearly all of its time below 1.0. This in turn creates headaches for the Fed because it raises the possibility of a wage-price spiral — a particularly nefarious form of inflation that the Federal Reserve is anxious to avoid at all costs. Little wonder, then, that Jerome Powell and his peers have explicitly targeted a softer jobs market as one of the pre-conditions for ending the Fed's serial rate-rising campaign.

Mid-term elections: Who?!

Given the current backdrop and all the attention being paid to the Fed's efforts to combat inflation, the noise that ordinarily accompanies a mid-term year has been all but drowned out. As expected, it now appears that the GOP has retaken the House of Representatives (although by a far narrower margin than predicted), while a run-off election in Georgia gave control of the Senate to the Democrats by the narrowest of margins. Ultimately it may not even matter much: As the closeness of this year's results suggest, neither party has a clear mandate it can use to run roughshod over economic policy (and therefore markets). While that might make it more difficult to enact fiscal programs if the U.S. economy does indeed enter recession, it also sets up a divided government that markets tend to prefer over a partisan lurch in either direction.

Tragically, another headache for the Fed — and the world in general — has been Vladimir Putin's unprovoked invasion of Ukraine. The human suffering caused by Putin's war cannot and should not be understated, and the economic impacts are also significant. Due to Russia's status as the largest exporter of natural gas and second-largest exporter of crude oil, the invasion triggered a supply shock that reverberated globally and hit Europe particularly hard given the continent's heavy reliance on Russia to meet its energy needs. Moreover, as both Russia and Ukraine are significant producers of grain and other agricultural foodstuffs, the invasion has threatened to make an already fragile global food supply situation even more tenuous. At a minimum, we suspect that Russia's invasion of Ukraine — which now feels like it began a lifetime ago — has made the likelihood of a recession in Europe far higher while at the same time extending the duration and depth of the ongoing inflationary episode for the rest of the world.

Looking ahead to 2023

As we look forward to 2023, there are at least some tentative signs that balance is returning to the U.S. economy. This past October, a better-than-expected CPI report suggested to many that inflation may be in the process of peaking. While we think it's still far too soon for the Fed to declare victory, we, too, were encouraged by the report and would also point to evidence that price pressures are easing inside other high-frequency economic releases as well — most notably within business-focused polls like purchasing managers' indices (PMIs) and similarly designed surveys. Even the labor market — which has grown notorious for its stubborn strength — has shown signs of softening, at least around the margins.

But the key for markets and the economy in 2023 will be whether or not crucial segments of the economy like these — and many others — can soften enough to satisfy the Fed and bring inflation in line without the U.S. falling into full-blown recession mode (as the housing market appears to have already done).

If so, Jerome Powell's Fed will have achieved something rare and precious — a soft landing. But even if not, we see reasons to be hopeful that 2023 may be better than 2022. Yes, it's true that an economic recession is precisely the kind of environment that markets find most challenging. And yes, it's also true that investors sometimes overreact to economic turmoil, temporarily overshooting fair value and sending market valuations lower in the process. That could easily keep markets — particularly stocks — under pressure well into the new year, even if inflation ebbs and the Fed finally begins to slow its roll.

But equally true, at least in our view, is the idea that markets tend to be anticipatory in nature: They often see weakness before it arrives and strength before it returns. If so, 2022 might well be remembered as the year we paid for a substantial portion of whatever weakness awaits us in the coming year.