



WALKER, HIGGINS & ASSOCIATES
WEALTH MANAGEMENT, LLC

Quarterly Market Review and Outlook

2022 Market Re-Cap

2022 was an immensely challenging year for investors. There is not any way to sugarcoat 2022 as it was a tough year for all risk assets. In fact, last year represents the first time in U.S. history that both the U.S. stock and bond markets finished down by double digits in the same calendar year!

Large cap U.S. stocks, as represented by the S&P 500 index, declined by 18% in 2022.ⁱ The tech-heavy NASDAQ dropped almost 33%.ⁱⁱ The story was consistent overseas as large companies in developed foreign countries lost 16%ⁱⁱⁱ and emerging market stocks were down 20%.^{iv} Add it all up and this was the worst year for stocks since the Global Financial Crisis in 2008.

As we have repeatedly stated, rising inflation and interest rates are not good for bonds. Since we had both last year, the U.S. bond aggregate declined 13%!^v To provide a little context, the worst year for the U.S. bond market since 1980 was in 1994, where the bond aggregate lost 2.94%.^{vi} Said plainly, the U.S. bond market just experienced its worst year in over 40 years by four-fold!

Perhaps the only bright spot last year was for cash holders. Since the Fed increased rates dramatically, money market and certificate of deposit rates increased substantially last year. We are seeing money market rates in the 3% range and short-term CD rates top 4%—rates we haven't seen in 15 years.

2023 Outlook & Beyond

Recession Ahead?

There have been countless economists and market “experts” on numerous media platforms calling for a recession in 2023. We agree.

Simply put, the data supports the case for a recession this year. We love this quote— “all models are wrong, but some are useful” (George Box). Virtually every model, and way of looking at where we are economically, points to a recession this year.

Currently, we are suffering from the highest rate of inflation in 40 years, brought on by the reaction to government mandated pandemic closings. Not the closings themselves, but the government's overreaction, in our view, to them. The U.S. government has printed \$5 trillion and counting in money we did not have to provide post pandemic “stimulus”. Not surprisingly, M2 money supply (all the money in circulation in the U.S.) has surged in the last three years. When government printing presses run without restraint, inflation happens. It's not that complicated.

In response to inflation, the Federal Reserve Board increased interest rates seven times last year. Interest rates increased from .25% to 4.25%. The Fed has indicated they will increase rates another 1% this year. Very simply, higher interest rates help reduce inflation, but they also reduce growth in the economy.

As we have said over the years, we follow the movement in interest rates very closely. In particular, we study the relationship between short-term interest rates (3-month yields) versus intermediate-term interest rates (10-year yields). Why? Because a “yield curve inversion” of the three month with the 10 year has been one of the best predictors of recession in modern economic history. As of this writing, the three-month treasury rate is 4.4%—the ten-year rate is 3.69%. Interest rates are currently inverted! Interest rates were inverted at times last year as well. Historically speaking, when this occurs there is a high degree of probability that a significant economic downturn is going to occur at some point over the next 6-18 months. This data point seems to give a strong indication that an “official” recession could happen around mid-2023.

A common question we get is “will this recession be as severe as 2008”? We don’t have a perfect crystal ball, but we believe this one is likely to be relatively mild and short. We see a recession that looks similar to the one in 1990.

Historically, recessions produce high unemployment, often double-digit rates. The recession in 1990 produced unemployment of less than 8%.^{vii} The current rate of unemployment in the U.S. is 3.3% (as of November). We see that ticking up from 3.3%, but we don’t see that approaching 8% even with a recession.

We think corporate earnings will decline over the next six months, but we don’t see it being as severe as in 2008. Also in our favor, the U.S. banking system is in far better shape than in 2008. Finally, while we are not resident real estate experts, we do not see widespread foreclosures occurring if there is not another banking crisis with 2008 level unemployment rates. We would not be surprised to see some home value contraction, but a full-scale collapse like 2008 currently seems a low probability.

Bottom line—we see a recession, but not a severe one.

U.S. Stock Market Thoughts

Despite the U.S. stock market’s poor performance in 2022, we would suggest that there is likely more pain over the next six months or so. If the recession hits mid-year, the stock market will react in a negative way.

The obvious question that everyone would like to know is, when will the stock market go down and where is the bottom? We aren’t fortune tellers, so we don’t know exactly to what level markets fall. However, using history as a guide, we would not be surprised to see the S&P 500 fall 10%-20% from current levels. Brian Westbury at First Trust seems to agree, “fair value for the S&P 500 index would also be about 3,350 if the 10-year yield stays at 3.6% and profits go down 10%, which is what we’d expect to happen in a recession”.^{viii}

The economy and the stock market are intricately linked. But the economy and the stock market are not on the same timeline—the stock market is a leading indicator. With that being the case, we would expect the stock market to decline over the six months before the recession officially begins. Simply put, we think the first six months of this year, in anticipation of the recession, will be tough for U.S. stocks.

A declining stock market is a leading indicator of recession, but it is also a leading indicator of recovery. If we look at unemployment data versus market bottoms across the last three recessions (excluding the COVID recession), we find that the stock market bottomed about 6 to 12 months before peak unemployment hit.^{ix} In other words, assuming the recession is declared mid-year and is indeed mild, we expect the stock market to bottom this summer. Of course, this summer could mean April, or it could mean November—it’s an inexact science at this point for sure.

What is the potential silver lining here? That by mid-year, the stock market bottoms and presents investors with a huge buying opportunity. The last four bull markets following a recession averaged returns of 258% and lasted an average of 81 months!^x

We are short-term cautious but long-term bullish.

U.S. Bond Market Thoughts

We view the bond market in a different light than the stock market in 2023. Whereas caution and prudence should be the primary objective in navigating the stock market, we see opportunities across the bond market and have allocated some money back to this asset class.

First, it appears that interest rate hikes are at a minimum slowing.^{xii} Further, current projections suggest that rate increases will end in the first quarter of 2023.^{xiii} Slowing and, eventually, stable interest rates will take pressure off bond pricing.

Second, bond yields have obviously risen over the last 12 months. Currently, the U.S. Bond Aggregate Index offers yields exceeding 4%.^{xiv} Even if rates do rise some in 2023, a higher yield will absorb some of the price pressure.

Finally, while this is premature to anticipate, it would not be uncommon for the Federal Reserve to cut interest rates once the recession hits. Remember, bond pricing has an inverse relationship to interest rates, so falling interest rates serve as a strong tailwind for bonds.

Account Strategies & Tactics

Given our thoughts above, how do we have accounts positioned and what is our strategy in the coming months?

First of all, very simply, we have accounts allocated in a risk-off position. This means that we have lowered stock allocations and hold a lot of cash in the form of money market assets and short-term certificates of deposit. We are starting to allocate back to traditional bonds. Finally, we are allocating to some hedged products that historically offer protection in volatile markets.

Within the stock market, we see the U.S. as the bright spot (despite what we said above) in the world. We hold almost no international stocks and don't see that changing anytime soon.

Within the U.S. stock market, we have a strong bias to investing in quality and value. Both of these factors historically perform better in periods of economic downturn when compared to growth-oriented strategies. These companies tend to be the bluest of the blue chips, pay solid dividends, and have substantial balance sheets that can withstand a bad economy.

We see opportunities emerging in the bond space. It is our plan to begin an organized process to adjust our bond holdings to remain in alignment with changes to interest rates.

Cash rates are higher than they have been in 15 years. We have put cash to work, in some cases, in short-term CDs at a high of 4.5%. We don't feel bad about holding high levels of cash when we can get those kinds of rates with a guarantee of principal.

Of course, we customize our recommendations to our clients' unique circumstances, goals, and objectives. Recession or not, market decline or not, we remind clients that they should not abandon their long-term goals because of short term turmoil.

Summary

We get a lot of data from many sources and are happy to share some of what we think is credible—

First Trust: “we are comfortable with a forecast of the S&P 500 finishing next year around 3,900 with the Dow Jones Industrials Average at about 33,000”.^{xv}

The Kiplinger Letter: “GDP Growth...0.5% in '23 with recession, 1.1% without”.^{xvi}

Bob Brinker: “Based on our estimated price/earnings ratio of 18 to 20 times forward earnings, the S&P 500 has the potential to reach new highs by late in 2023 or early in 2024”.^{xvii}

Aggregate Prediction of 16 Investment Banks: “Putting it all together, strategists expect a volatile first half to be followed by an easier second half, which could see stocks climb modestly higher. Below is a roundup of 16 of these 2023 forecasts for the S&P 500...the targets range from 3,675 to 4,500”.^{xviii}

As always thank you for your continued trust and the opportunity to serve you and your family! Many of you have blessed us with referrals to friends and family who have benefited from our services. We would like to say thank you and we hope you will continue!

Should you have any questions or would like to review your situation, please do not hesitate to call us.

We hope that 2023 is an excellent year filled with health and happiness!

ⁱ <https://www.slickcharts.com/sp500/returns>

ⁱⁱ <https://www.slickcharts.com/nasdaq100/returns>

ⁱⁱⁱ <https://www.morningstar.com/etfs/xnas/acwx/performance>

^{iv} <https://www.morningstar.com/etfs/arcx/eem/performance>

^v <https://www.morningstar.com/etfs/arcx/agg/performance>

^{vi} <https://www.thebalancemoney.com/stocks-and-bonds-calendar-year-performance-417028>

^{vii} Ibid.

^{viii} First Trust. “Monday Morning Outlook: S&P 3,900-Dow 33,000”. December 12, 2022. www.ftportfolios.com.

^{ix} <https://beta.bls.gov/dataViewer/view/timeseries/LNS14000000>

^x <https://finance.yahoo.com/chart/%5EGSPC#>

^{xi} J.P. Morgan Asset Management. “Q1 2023 Guide to the Markets”. December 31, 2022. Page 16 of 71.

^{xii} <https://www.federalreserve.gov/newsevents/pressreleases/monetary20221214a.htm>

^{xiii} <https://www.cmegroup.com/markets/interest-rates/cme-fedwatch-tool.html?redirect=/trading/interest-rates/countdown-to-fomc.html>

^{xiv} <https://www.spglobal.com/spdji/en/indices/fixed-income/sp-us-aggregate-bond-index/#overview>

^{xv} First Trust. “Monday Morning Outlook: S&P 500 3,900-Dow 33,000”. December 12, 2022. www.ftportfolios.com.

^{xvi} The Kiplinger Washington Editors. “The Kiplinger Letter: Forecasts for Executives and Investors.” Washington, DC. Volume 99, Number 50. December 15, 2022.

^{xvii} Brinker, Bob. “Bob Brinker’s Marketimer.” Volume 38, Number 1. January 2023. www.bobbrinker.com.

^{xviii} First of all, Ro, Sam. “Wall Street’s 2023 Outlook for Stocks”. December 4, 2022. <https://finance.yahoo.com/news/wall-streets-2023-outlook-for-stocks-164955543.html>