Springwater
WEALTH MANAGEMENT

# Fourth Quarter 2022 Market Commentary

While it had been expected for months, it was still a shock when Russia invaded Ukraine on February 24. The unprovoked attack, which started the largest ground war in Europe since Work War II, was the defining event of 2022.

The humanitarian toll of the conflict has been a tragedy - with tens of thousands of troops killed on each side, but also an estimated 40,000+ civilians dead as a result of Putin's war.

Ukraine's economy has suffered tremendous economic losses, too. After more than ten months of attacks on its towns, cities and infrastructure, the country's prime minister estimates the damages from the war at over $750 billion.

The impact of the war has not been restricted to Russia and Ukraine. The conflict has upended the global economy. It has become painfully clear how important Russian natural gas is to the Western world - Germany, for example, obtained 60% of its gas from Russia up until just before the war. As European countries sought to find alternatives to Russian energy, supply shortages sent prices spiraling upward. Bloomberg has estimated that higher energy prices due to the war in Ukraine have already cost Europeans over $1 trillion.

## The Economy

American corporations are seeing their profit margins decline, as they struggle to continue raising prices. While declining profit margins are not a positive for investors seeking higher returns, it is a plus for the Federal Reserve as it combats inflation.

Pre-tax profits for companies in the S&P 500 index reached an all-time high in Q2, according to data from the Bureau of Economic Analysis, and they have risen almost 70% since the same period in 2020, driven in part by government stimulus payments designed to boost the spending power of consumers and businesses when Covid-19 devastated the global economy.

However, the estimated net profit margin for the S&P 500 index fell to just 11.6% for Q4, down from 11.9% in Q3, and 12.4% in Q4 2021. Investment analysts have been trimming their earnings forecasts for 2023, and now project a further decline.

Lael Brainard, a high-ranking Federal Reserve official, has said that bringing down "elevated" retail margins - the difference between what retailers pay for an item and what they can sell it for to the end consumer - will help reduce the price pressures that have forced the central bank to boost interest rates.

However, inflation tied to services, such as for dining out, travel, and medical care, remains high, and is likely to keep upward pressure on prices until well into 2023.

In late December, the US Senate and House of Representatives both signed off on a $1.7 trillion omnibus government spending bill. As a result, the federal government remains funded through its fiscal 2023, which ends September 30.

The bill includes $772 billion for domestic spending, and $858 billion for defense. The bill also includes roughly $40 billion in disaster relief for communities recovering from hurricanes, wildfires, drought and other natural disasters; reforms to the Electoral Count Act and a ban on TikTok on federal agencies' devices, among other commitments.

The Senate approved amendments to the House's spending bill that protect nursing mothers, allow the U.S. to transfer proceeds from assets seized from Russian oligarchs to Ukraine, and require employers to provide "reasonable accommodations" for pregnant women in the workplace.

The package also provides an additional $45 billion in emergency assistance for Ukraine, essential support as Russia continues its attacks on Ukraine's energy infrastructure.

The omnibus bill also contains a number of important provisions affecting the way in which Americans plan and save for retirement. We'll send out a summary of these changes - referred to as the Secure 2.0 Act - in the coming days.

## Inflation

The annual inflation rate in the US slowed for a fifth straight month to 7.1% in November of 2022, the lowest since December last year, and below the market's forecast of 7.3%. It follows a reading of 7.7% in October.


Source: [Trading Economics]

Looking forward, the markets remain confident that the Fed will succeed in its efforts to get inflation under control. The bond market is projecting that the average annual inflation rate over the next decade will be below 2.3%.  This figure has remained steady over the past several months.


Source: [Federal Reserve St. Louis]

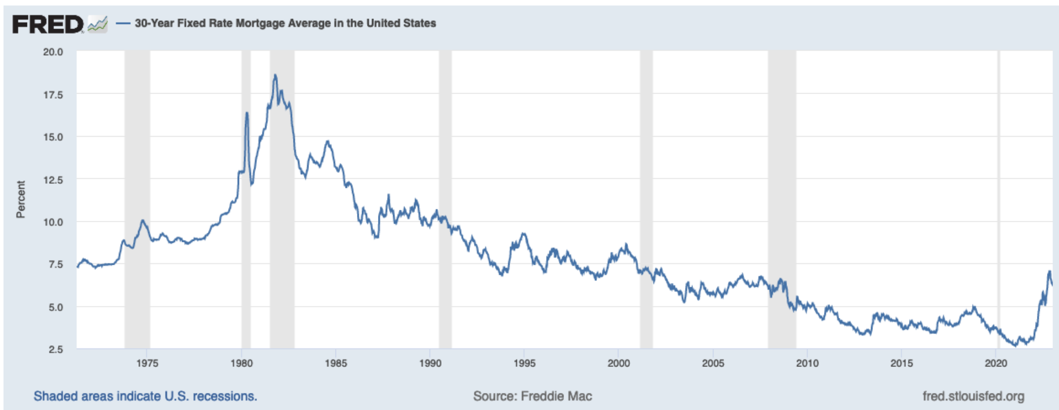
As we have pointed out in our previous writings, the current inflationary environment isn't unique to the US. Developed economies around the world are struggling with the highest inflation rates experienced in many decades. The European Central Bank is combatting an EU-area annual inflation rate above 10%.

The chart below shows the annualized inflation rate in the EU area over the past 12 months:


Source: [Trading Economics]

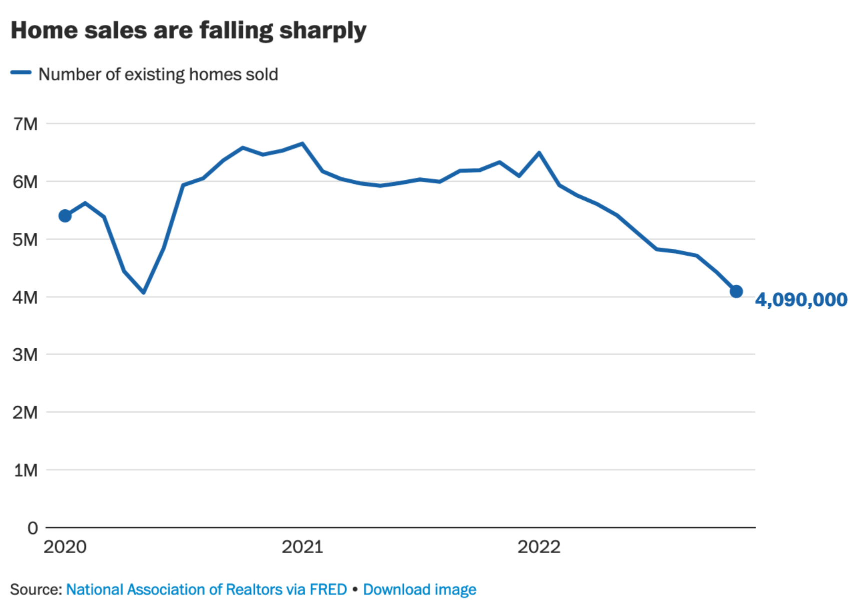
## Mortgage Rates

Mortgage rates have leveled off over the past few weeks, as the housing market has cooled and inflation has trended downward. According to data from the Federal Reserve, the average rate on a 30-year fixed-rate mortgage is about 6.42%, down from the 40-year high of 7% seen this fall.




Source: [Federal Reserve St. Louis]

As mortgage rates have risen, the affordability of homes has declined, leading to a rapid slowdown in home sales:



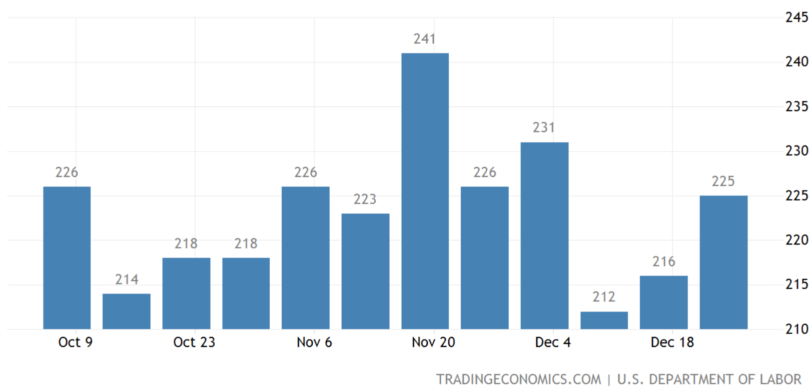

Source: [Washington Post]

## The Labor Market

The number of Americans filing new claims for unemployment benefits rose by 9,000 to 225,000 for the week ended December 24, largely in line with the market's expectations. The four-week moving average, which removes week-to-week- volatility, was basically unchanged at 221,000.

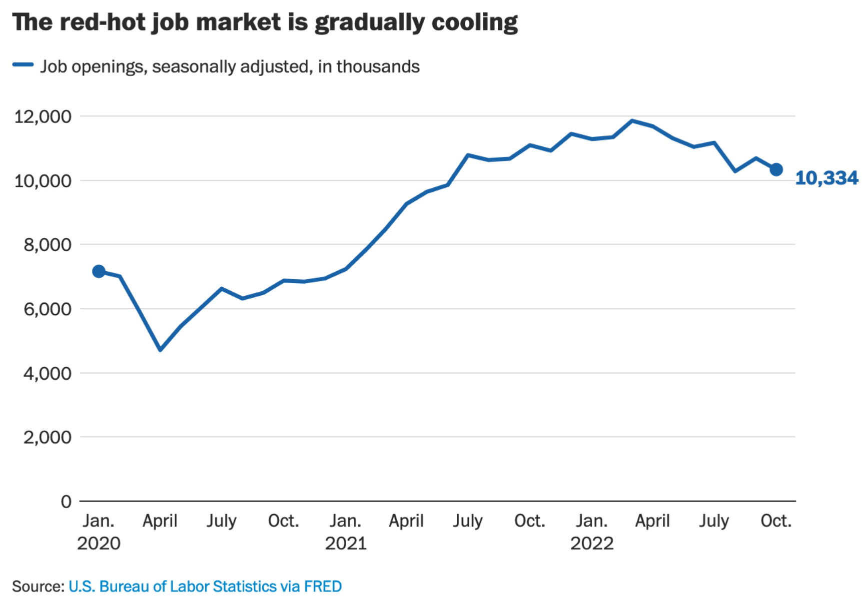
These figures reflect a labor market which remains relatively tight, despite the Fed's aggressive raising of interest rates to fight inflation.

The chart below shows weekly initial jobless claims:




Source: Trading Economics

In line with the slight tick-up in jobless claims, the number of job openings is beginning to decline:




Source: Washington Post

## The Capital Markets

Global stocks and bonds lost more than $30 trillion in value in 2022, as inflation, higher interest rates and the war in Ukraine triggered the largest losses in the financial markets since the Great Recession in 2008.

US Stocks

US stocks ended a dismal year on a sour note, with investor pessimism about the prospects for economic growth and tighter monetary policy worldwide negatively impacting share prices.

Looking back, 2022 marked Wall Street's worst annual performance since 2008. Governments and central banks around the world grappled with stubbornly high inflation arising from years of loose monetary policy and the fallout from Russia's war in Ukraine. The sharp decline in global equities worldwide wiped out nearly 20% of the capitalization of global stocks.

For the fourth quarter, the S&P 500 – a proxy for large US companies – was up 7%, while the tech-heavy Nasdaq was down 1%. For the year, the S&P 500 was down 19.4%, while the Nasdaq was down 32.9%.

The chart below shows the performance of the S&P 500 over the past 12 months:

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Source: [Trading Economics]

The chart below shows the performance of the Nasdaq over the past 12 months:


Source: [Trading Economics]

<u>International Stocks</u>

The Stoxx 600 index – a proxy for large European companies – closed 2022 on a negative note, falling just over 1% on the final trading day. Over the past month, the index is down 4.2%, and over the past year it has fallen 12.9%.

The chart below shows the performance of the Stoxx 600 over the past 12 months:

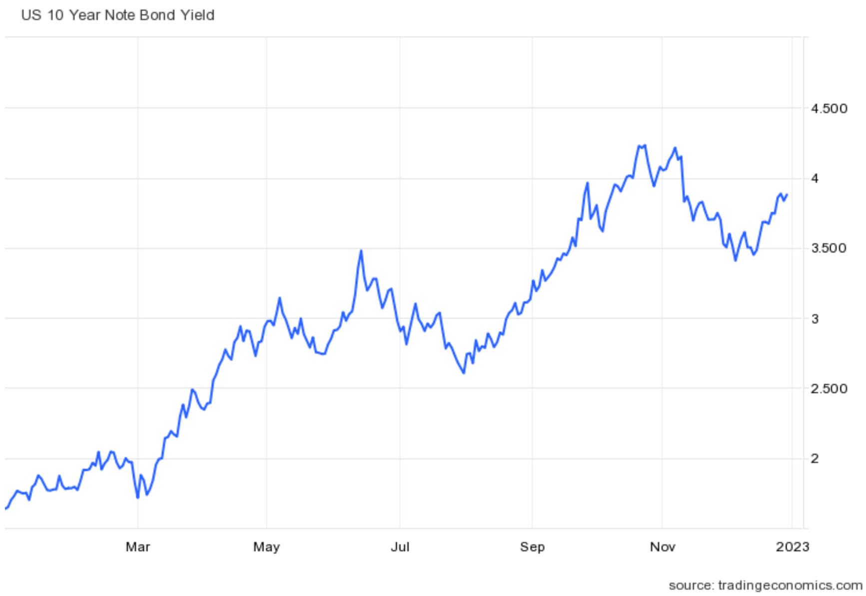

Source: [Trading Economics]

<u>The Bond Market</u>

The benchmark US 10-year Treasury bond declined roughly 16% this year, as the Federal Reserve rapidly raised interest rates. The US central bank hiked its federal funds rate by a cumulative 4.25% this year, the most since 1980, bringing borrowing costs to the highest level in 15 years.

The yield on the 10-year US Treasury bond rose to as high as 4.3% in October, a level not seen since June 2008, before bottoming at around 3.8% in December, as the market's expectations changed from a focus on fighting inflation to slowing growth and the likelihood of a Fed policy pivot.

The chart below shows the performance of the 10-year Treasury over the past 12 months:




Source: [Trading Economics]

Oil

Futures contracts for the benchmark West Texas Intermediate ("WTI") product traded at around $80 per barrel on Friday to close out the year, capping an 8% year-on-year increase.

It was a year marked by tremendous volatility in commodity prices, as supply risks and demand concerns roiled the markets. WTI reached a 14-year high of $130 per barrel in March in response to Russia's unprovoked attack on Ukraine. Prices then gradually fell as the world's major central banks aggressively raised interest rates to tamp down inflation, which triggered fears of a global economic recession.

The chart below shows the performance of the benchmark WTI contract over the past 12 months:


Source: [Trading Economics]

Gasoline

Gasoline futures traded at around $2.30 per gallon on Friday, almost 6% higher than they were at the start of 2022.  Still, gasoline prices are more than 42% below the record $4.10 per gallon reached in June 2022, with the Biden Administration's release of oil from the Strategic Petroleum Reserve, concerns about a recession, and renewed lockdowns in China all driving prices down.

Source: [Trading Economics]

## Benchmark Returns

For comparative purposes, the S&P 500 index (a proxy for large US stocks) fell -19.4% for the twelve months to December 31, but rose 7.1% in the fourth quarter.

The Russell 2000 (a proxy for small US stocks) fell -20.4% for the twelve months to December 31, but rose 6.2% in the fourth quarter.

The Wilshire 5000 index (a proxy for the broad US stock market) fell -19.0% for the twelve months to December 31, but rose 7.1% in the fourth quarter.

The MCSI EAFE index (a proxy for large international stocks) fell -16.8% for the twelve months to December 31, but rose 17.0% in the fourth quarter, as measured in USD.  Because the USD strengthened slightly versus the EUR over the full year, the picture was different when measured in the local currency, with the index falling -11.3% for the 12 months to December 31, but rising 7.4% for the fourth quarter.

Finally, the MSCI Emerging Markets index fell -22.4% for the twelve months to December 31, but rose 9.2% in the fourth quarter.

In the fixed income segment, the Bloomberg Barclays US Aggregate Bond Index returned -13.1% for the twelve months to December 31, as rapidly rising interest rates pushed down bond prices.

## Looking Forward

As we mentioned last quarter, and as we remind ourselves (and you) from time to time, successful investing is not a sprint, but a marathon.

The equity markets tend to go up more than they go down, because investors are generally rewarded for taking risk.  This reward comes in the form of higher expected returns than those that can be earned from safer investments like cash and government bonds.

But… risk also means that these higher expected returns aren't delivered day in, day out, without fail.  Risk means that there will be times when the performance of the stock market is bad, even terrible, and certainly much worse than the small positive return earned on cash.

So, what is an astute, level-headed investor to do, when one of these "bad return" periods arrives?  History shows us that investors are best-served with a strategy of patience, systematic rebalancing, and a long-term focus.  This is not to say that one won't be uncomfortable at the time – after all, we're emotional beings, not robots. Rather, we should endeavor to ensure that our emotions don't influence our investment decision-making.

Springwater's investment philosophy is based on decades of robust, peer-reviewed academic research. One of the principles of that philosophy is that, over time, investors can expect to generate higher returns if they tilt their portfolio's equity allocation toward small stocks (the "size" factor) and value stocks (the "value" factor). The important caveat is that these tilts don't consistently deliver higher returns, day in and day out, just as stocks don't always out-perform bonds and cash.

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For those of you that are not already doing so, we encourage you to follow us on Twitter (at @SpringwaterWM), Facebook (at https://facebook.com/SpringwaterWealth/), and/or Instagram (at springwaterwealth). We're conscious of the "information overload" that everyone faces these days, and by using social media we can share with you our thoughts, observations and ideas in the least intrusive manner possible.

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## Important Disclosure Information