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QUARTERLY MARKET INSIGHTS – FOURTH QUARTER 2022

To the Clients and Partners of Hilltop Bank Wealth Management:

For most of us, there is a tendency to demarcate our lives in years, regardless of how much sense it makes. You graduate in the fall, but call yourself the Class of (insert long-ago date here). You probably don't have a family member born on New Year's Day, but remember the year you became a parent or grandparent. You recall the year you took that great trip abroad, or the family struggled, or you won that award.

Markets are the same way. We think of 2008 as the year of the Great Financial Crisis, despite the market starting its decline in 2007 and not bottoming out until March of 2009. 2000 was the year the dotcom bubble burst, although the associated recession didn't start until the calendar had turned over. We grade our investments by looking at tables of annual returns, and average them to set long-term expectations.

These twelve-month time frames are mostly arbitrary. Our lives look much the same on January 1st as they did on December 31st. The same market conditions that existed at the close of one year are still around to begin the new. If, however, you actually stuck to your resolutions last year, you and the markets shared the unique trait of a new year bringing with it, a new chapter.

2022 Recap

The S&P 500 set its current, all-time high on the very first trading day of 2022. With plenty of volatility, it ended the year down 18.11%. Of course, not all market sectors performed equally over those twelve months, as value stocks (-0.72%) outperformed growth (-36.70%) for the first time since 2012. That was the largest value outperformance since 2001.

On the bond side, markets had a similar year worth forgetting. Bloomberg's US bond index ended the year down 12.99% in 2022. As with stocks, not all bonds performed equally. Short duration bonds (those with maturities of less than three years) were down 3.69% versus a 29.44% loss in long-term Treasuries.

Despite the market turning in concert with the new year, 2022 was not simply a story of continual downward trajectory - which is why annual results can be misleading. Instead of trying to force 2022 into our annualized framing, it would be more accurately described as a tale of two halves. For equities, the S&P 500 was down 20.6% in the first half, and rebased from that low, gained 0.5% in the second half of the year. For bonds, the benchmark was down 10.93% in the first half, and again rebased to that low, down just 2.31% in the second.

In large part, the outperformance of value stocks and short duration bonds had to do with something we discussed exactly one year ago in this newsletter. The Fed. Over the course of 2022, the Governors of the Federal Reserve voted to raise the Fed Funds rate from zero to 4.25%. In fact, it was the fastest the Fed has raised rates since the early 1980s. The resulting, added cost of financing, has made the longer-term projects that growth stocks rely on for their valuations more expensive, and thus their shares worth less. For bonds, the math is as simple as values moving in the opposite direction of rates, as lower-yielding bonds must trade for less than newer, higher-yielding alternatives. The effect intensifies the further the bond is from maturity.

In the broader economy, 2022 was anything but boring. The headlines included two quarters of negative GDP growth before a rebound in the third quarter, existing home sales that have fallen near the lows of 2010, and crude prices that rose near $120 per barrel before ending the year at $80. We began and ended the year with historically tight labor markets, and inflation peaked at 9.1% in June, and remains well above the long-run target of 2%.

A Look Back at Last Year's "Look Ahead"

Continuing the theme of arbitrary dating, this note marks the anniversary of the very first Quarterly Market Insights I wrote to all of you. Over that time, my goal has been to provide something different than you might get from a broker with offices worldwide, or the kind of financial journalist that seems to get paid based off how outrageous they can make their headline. Namely, I've aimed to write an explanation of global finance we can all comprehend, learn from, and act on. That being said, because I spend a substantial number of hours each year mining those types of publications for anything insightful, I can tell you what you never see, is them revisit what they have previously written for accuracy. So, let's take a look back at last year's newsletter and see if there's anything worth scrapbooking.

First, in last year's "A Look Ahead" we said the one thing we were sure would happen was Fed action. As discussed above, that has certainly come to pass. Second, we doubted that 2022 would see the same level of returns as the previous three years. While directionally correct, that certainly turned out to be an understatement. Next, we also warned about the danger of the Fed overshooting their mark, and eventually sending us into a recession (you may recall this was also the topic of later editions). It remains too early to pass judgment on this prediction, but I continue to expect a recession in 2023. Finally, as for our investment advice in the last year - which could be summarized as "don't try to time the market", "take a long-term perspective", and "don't let the market sentiment infect your reasoning", I continue to stand by it all. (The best advice, with hindsight, would have been to short UK Treasury Bonds and buy credit default swaps against them. I am admittedly not a good source for hot stock tips).

Now, with that track record accounted for, what should we expect in 2023?

A New Look Ahead

After a year like we just had, the obvious question in front of us, is whether things will get better going forward. In the long-term, of course, we know that it will. In the span of twelve months, the uncertainty is much greater.

On the equity side of things, we saw valuations retreat from near dot-com era levels to something closer to the average from '16-pandemic. Investors are now paying a much more reasonable amount for their share of companies' future cash flows. Valuations, meaning the amount paid for a dollar of cash flow purchased, makes up half of the overall pricing equation. The other half of the equation, of course, is the cash flows themselves.

If we are headed for a recession, it is likely that companies from Microsoft to Ford are going to see those cash flows decrease. At this point, the market has more-or-less priced in a mild recession. If the situation becomes more dire, for example if something breaks in the financial system like in 2008, the market will need to account for further lost earnings. In a nutshell, that is the broad downside risk to equity we are considering going into 2023.

For bonds, there is currently a disconnect between what the Fed says it will do, and what the market expects it actually will do. Specifically, the Fed is trying to convince the market it could raise rates higher than expected. The risk to bonds in that scenario is that yields would then take another jump up, and values will fall. The good news, however, is that even the Fed thinks it has done most of tightening it expects to (the current Fed Funds Rate is 4.25%, the market expects the Fed to go to 4.5%, and the Fed expects to go to 5.10%). It appears likely at this juncture, that the Fed will hike rates once or twice more, and then hold steady to see how the economy responds. In the longer term, the better news is that with interest rates off the floor, your bond holdings will have better yields going forward. Currently, the five-year yield on a Treasury is nearing 4%, which hasn't been the case since before the Great Financial Crisis. In addition, and as further evidence of the arbitrary nature of measuring returns by calendar year, it is true that broad bond indices have never had three consecutive calendar years of negative returns (as a reminder, they were -1.1% in 2021).

In sum, plenty of uncertainty remains as we move in to 2023. As investors that can feel troubling, but uncertainty is also the source of future returns. Higher uncertainty today decreases the price we must pay for our investments. As that uncertainty is resolved, the discount disappears and values increase. To illustrate, if someone had told you everything that was to happen in the last 25 years, would you have invested? For reference, that period includes the Asian financial crisis, two Russian defaults, the dotcom bubble and bust, 9/11, the Great Financial Crisis, a global pandemic, and a war in Europe. As it turns out, despite all that, from January 1997 to December 2022 the S&P 500 returned 8.53% annually. That equates to one dollar invested in 1997 being worth $7.74 today. I would never try to predict what might happen in the next 25 years, but it is precisely because of such uncertainty that markets return more than the risk-free rate. It reflects people and companies' ability to adapt and overcome tough times. It's the reason we invest.

On a final note, as those who knew him are aware, Hilltop, the True Companies, and the city of Casper lost one of our great leaders recently in Jack Blomstrom. He was as kind as he was sharp, and our thoughts and prayers go out to his family.

Best,

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