Weekly Market Update

January 3, 2023

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"Kindness is like snow.
It beautifies everything it covers."

~ Kahlil Gibran

Market Watch

Week Ending Dec. 30, 2022

(Source: Briefing.com)

• **DJIA:** *2022 YTD -8.80%*	33,203.90	-56.70
• **NASDAQ:** *2022 YTD -33.10%*	10,497.80	-31,40
• **S&P 500:** *2022 YTD -19.40%*	3,852.36	-5,32
• **Russell 2000:** *2022 YTD -21.60*	1,763.42	0.32
• **10 Year Treasury:**		3.88%

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Dave's Weekly Commentary

Good morning and Happy New Year! Nancy and I took a short trip to Florida to visit friends and bring in the New Year. It was a welcome respite, spent relaxing, boating, watching football, and enjoying great food with a great group of friends. Flying in to RSW, and seeing the destruction from Hurricane Ian from above was saddening and devastating, it will take some time to rebuild. The tremendous amount of work already done in a short time to get basic services running and businesses back up makes me grateful for the resillence and endurance of the human spirit. You've got this Florida!

At the office we are laying plans to review 2022 and while I am tremendously happy with our team and professionally did a very good job navigating the troubled waters of this past year, it is also a good exercise to reflect backward and see if there is anything we could improve upon. We try to do this as an ongoing self-assessing process, but the beginning of the year is always a good time for a review. As part if that review is assessing staffing needs and both maintaining and improving upon service levels, and to that end Michael and I over the past two weeks have been interviewing Wright State Financial Service co-ops. We have had three interviews, and our choice is not going to be easy. If the team agrees, and timing allows, we may try and work in two co-ops this semester instead of one. Stay tuned.

The last week of the year shaped up to be like most of 2022, disappointing for the stock market. The major indices remained under pressure from continued weakness. Mega cap losses accelerated this week on lingering valuation concerns and presumably tax-loss selling activity by participants who bought into the seemingly invincible stocks last year. Some of the mega cap names are not so "mega" any more given the in loss of market value that occurred this year.

The Santa Claus rally period, which encompasses the last five trading days of the year and the first two trading sessions of the new year, has gotten off to an uneven start. It is believed to be a good sign for how the new year will start when this period produces a cumulative gain over that stretch. 2022 was a definite exception to that belief. The 2021 Santa Claus rally produced a net gain of 1.4% for the S&P 500 and yet the S&P 500 declined 5.3% this January and 5.0% in the first quarter. It looked like Santa Claus might come charging to town following Thursday's rally. The S&P 500 closed the session just a whisker below the 3,850 level, where it has remained since mid-December, but then backed off again in Friday's trade. When this year's Santa Claus rally period began, the S&P 500 stood at 3,822.39. The S&P 500 closed Friday's session at 3839.50 after visiting the 3,800 level. It was also a disappointing week in the Treasury market. The 2-yr note yield rose 10 basis points to 4.42% and the 10-yr note yield rose 13 basis points to 3.88%.

Only two of the 11 S&P 500 sectors closed with a gain this week in thin trading conditions. The financial sector rose 0.7% and the energy sector rose 0.6%, aided by a bump in oil prices above $80.00/bbl. The materials and consumer staples sectors were the worst performers with losses of 1.2% and 0.9%, respectively. This week we will see major releases that includes the December ISM Manufacturing Index, the December Employment Situation Report, and the December ISM Non-Manufacturing Index. That about sums of the last week of the year.

2022 Year in Review

Good riddance 2022! We don't want to hang out with you anymore. You were just too much of a downer -- a real party pooper. You brought a lot of baggage with you and it got unpacked in a troubling way. You tossed stocks around like clothes in a teenager's dirty room, leaving them on the floor in a heap and with scant attention to the mess you made... and what a mess you made!

The Nasdaq Composite was down 33.1%, the Russell 2000 was down 21.6%, the S&P 500 was down 19.4%, the S&P 400 was down 14.5%, and the Dow Jones Industrial Average was down 8.8%. Looking beneath the surface, nearly one-third of S&P 500 components saw a decline of at least 25%; and still many other stocks suffered losses of 40%, 50%, or 60%+. The losses were not just reserved for stocks, which saw the S&P 500 hit 4,816 on January 4 and scrape 3,800 on the last trading day of the year. It extended to bonds, too. Some would argue that they were an even bigger mess considering 2022 was the worst year ever for bonds!

So, what happened? Stocks and bonds got hit by rising interest rates. The 2-yr note yield, which started the year at 0.73%, ended the year at 4.42%. The 10-yr note yield, which started the year at 1.51%, ended the year at 3.88%. The crux of the interest rate matter for most, however, was the target range for the fed funds rate. It started the year at 0.00-0.25% and it ended the year at 4.25-4.50%, with a strong hint from the Federal Reserve that it will move higher

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yet in 2023. In brief, the Federal Reserve killed the bull market in 2022, racing to catch up to an inflation rate that it had let run unchecked far too long. Exiting 2022, the annual rate of CPI and core-CPI inflation is 7.1% and 6.0%, respectively. For the PCE Price Index and core-PCE Price Index, it is 5.5% and 4.7%, respectively. The Fed's inflation target is 2.0%.

In Catch-Up Mode The Fed was slow to raise rates because it thought inflation would be "transitory." It wasn't. The Fed also held off on a rate hike in January because of the uncertainty created by Russia's troop buildup on Ukraine's border. That troop buildup turned into an actual invasion in February, the direct effects of which have been devastating for Ukraine. Meanwhile, the indirect effects on energy supplies for Europe and food supplies for the world have created their fair share of damage beyond Ukraine's borders. Russia's act of unprovoked aggression was among the biggest messes of 2022 and it is still a mess as we close out the year.

The latter point notwithstanding, life went on around that mess. The Federal Reserve is no longer reluctant to raise rates in the face of it. The scope and pace of those moves, which were also accompanied by the introduction of quantitative tightening, reflected in our estimation the work of a Fed that knows it waited too long to raise rates to fight inflation and is in catch-up mode. That was a major problem for the stock and bond markets, as well as the housing market, which saw mortgage rates climb from 3.27% at the start of the year to north of 7.00% in October.

Overall, the U.S. economy was fairly resilient in 2022, bouncing back from negative GDP prints in Q1 and Q2, underpinned by a tight labor market. Q3 GDP was up 3.2% at an annual rate and the Atlanta Fed's GDPNow model estimates 3.7% real GDP growth for Q4. The unemployment rate of 3.5% in July matched a 50-year low. It has since risen to 3.7%, which is still below the Fed's longer-run full employment estimate of 4.0%.
Oh, and the Treasury yield curve is inverted, which is often regarded as a harbinger of recession. That inversion has created a troubling dynamic for stocks, because it has raised legitimate concerns about the Fed making a policy mistake and 2023 earnings estimates being too high.

Guidelines 2022 has been a year of multiple compression for stocks. Things began with the S&P 500 trading at 21.5x forward 12-month earnings and it is exiting the year trading at 16.8x forward twelve-month earnings (which are likely to be marked down further). The 10-year historical average is 17.1x, according to FactSet. This compression has been, in part a result of rising interest rates, the concern of a weakening economy hurting earnings prospects, and the killing that in 2021 when interest rates were near rock-bottom levels, providing little competition for stocks.

Politics As 2022 drew to a close, China started rapidly to unfold the mess it made in 2022 with its zero-COVID policy. Remarkably, it did so after some messy-looking public protests by Chinese citizens fed up with the draconian testing and lockdown measures. The initial trade-off has been an explosion of COVID cases in China and overrun medical facilities. This experience could potentially disrupt supply chains in early 2023, but net-net, the distancing from a zero-COVID policy should be a positive for China's economy and the global economy as the year progresses, assuming it doesn't result in contributing to persistently high inflation rates that leave the Fed and other central banks in a tightening mode longer than expected.
Separately, 2022 saw a thickening in the political tension between the U.S. and China over Taiwan, which looms as one of the larger geopolitical risks for the market in 2023.

U.S. politics, meanwhile, produced the $739 billion Inflation Reduction Act, which is a climate and health care bill that passed along party lines. We also got through the midterm elections in November with Democrats winning majority control of the Senate and Republicans winning majority control of the House.They are narrow majorities in both chambers and the divide will make it difficult to pass any additional landmark legislation over the next two years. It also sets up the possibility of more debt ceiling drama in 2023.

Good Bye 2022 There was an ample amount of drama in 2022. The Federal Reserve was often at the center of it all. The Fed invited it by waiting too long to raise interest rates and end its purchases of Treasury and agency mortgage-backed securities. Now, it is assuming the leading role again of being a credible inflation fighter, meaning it is not the market's friend as we exit 2022. The Fed promises to be a main character in 2023, too. Its words and actions will be key to the market's performance along with the trend in earnings estimates. There is talk today that we have hit "peak inflation" and that we are getting close to "peak Fed policy." Maybe so, but the messy story of 2022 was rooted in rampant inflation and a ramp in the Fed's tightening efforts. Source: Briefing.com.

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