Market Review and Outlook

Q4 2022

BRINKER CAPITAL INVESTMENTS
AN ORION COMPANY

Market Performance Review

Global stocks staged a strong, albeit choppy, comeback in the fourth quarter. Long-term interest rates and the U.S. dollar both retreated despite the Federal Reserve raising short-term interest rates twice during the quarter—0.75% in November and then slowing to a 0.50% increase in December. The potential that we have reached near-term peaks in several high-visibility indicators that stressed markets for much of 2022—long-term Treasury yields, the pace of Fed rate hikes, and the U.S. dollar—contributed positively to risk sentiment. Cooling inflation alongside a stubbornly strong job market and modestly positive economic data also raised the probability for an economic "soft landing".

The S&P 500 Index gained 7.6% in the fourth quarter but still closed out the full year down -18.1%--the worst U.S. equity market return since 2008. All sectors were positive in the quarter except for consumer discretionary (-10.2%) and communication services (-1.4%). Energy (+22.8%) and industrials (+19.2%) led the way for the quarter as investors' improved economic outlook prompted a rotation toward more cyclical companies. For the year, energy (+65.7%) and utilities (+1.6%) were the only positive sectors, with communication services (-39.9%) and consumer discretionary (-37.0%) leading the declines. Value stocks continued their strong year relative to growth, with the Russell 3000 Value Index adding +12.2% during the quarter compared to a return of only +2.2% for the Russell 3000 Growth Index. U.S. value stocks finished the year outperforming growth stocks by nearly 22%--the widest annual margin in over two decades. Small cap stocks also rebounded in the quarter. Although the Russell 2000 Index modestly underperformed large cap stocks, the higher-quality S&P SmallCap 600 Index outperformed large caps by roughly 2% for both the quarter and the year.

In overseas markets, stocks (as represented by the MSCI ACWI ex-U.S.) jumped 14% during the quarter with developed markets gaining 17.3% and emerging markets rising by 9.7%. The U.S. dollar had been strong most of the year but fell by roughly -8% in the fourth quarter which helped boost the returns of international assets for U.S. investors. For the full year, developed international markets dropped -14.4% and emerging markets fell -20.1%. Despite these double-digit declines, international stocks managed to outperform U.S. equities for the first year since 2017—and for only the second year in the past decade. Interestingly, after stripping out currency effects, the local market returns of international stocks (both developed and emerging) outpaced domestic stocks by even wider margins for the year. The United Kingdom and other western European countries led the way in developed markets while Latin America broadly displayed relative strength within emerging markets. Conversely, many Asian markets underperformed, particularly China and those countries more closely tied to it.

The widely followed Bloomberg U.S. Aggregate Bond Index returned 1.9% for the fourth quarter, which was the first positive quarter this year for investment grade bonds. In truly historic fashion, the Agg Bond Index closed the year down -13%, its worst calendar year return since its inception nearly 50 years ago in 1976. The 10-Year Treasury yield was 3.87% at quarter-end, just slightly higher than where it ended for the third quarter, but well below the intra-quarter high of 4.24%. Due to the inverted state of the yield curve, the 10-Year Treasury is actually the lowest yield anywhere across the curve, with 6-Month Treasury Bills offering the highest yields at 4.83%. During the fourth quarter, the 10 Year/2 Year yield differential reached -0.9%, the largest inversion of the yield curve in more than 40 years. Although this inversion in the Treasury yield curve has been a fairly reliable signal of recessionary pressures ahead, this message was not relayed to credit markets as credit spreads tightened during the quarter for both investment grade and high yield bonds. Despite declining energy prices, broad commodities rose during the quarter, supported by a "risk on" tone in the market and a falling dollar and led higher by industrial and precious metals.

Approved for general use.

Market Outlook

A range of economic and market-based indicators—inflation, energy prices, long-term bond yields, the U.S. dollar, and the pace of Fed rate hikes to name a few—have recently declined from near-term peaks. Whether the fourth quarter of 2022 is viewed in retrospect as a more durable inflection point for financial markets will be dependent upon the ability of these metrics to continue on their current moderating trajectory. If so, we believe that the economy has a real chance to avoid a meaningful recession. However, we are not ready to sound the "all clear" signal just yet. The global economy has yet to feel the full effects of the Fed's 4.25% in interest rate increases, and because of this lagged impact and economic crosscurrents that make the Fed's imperfect crystal ball even hazier, the potential for a monetary policy mistake remains elevated.

Even if the U.S. economy sidesteps a meaningful recession, we don't anticipate completely smooth sailing for the global economy or financial markets over the next year. Because of the relatively orderly decline in many markets, we have not had a noteworthy capitulation that would clear the decks for a higher conviction buy signal for markets more broadly. Said differently, without suffering through a steep, painful decline like we experienced in 2008-2009 or 2020, we should not expect to share in the exuberance of a sharp rebound. That said, the weakness in global stock and bond markets over the past year has helped to work off many of the excesses spurred by the Fed's easy money policies and the federal government's pandemic-driven largesse. Unwinding these extraordinary measures was never going to be painless, but the U.S. economy is weathering this process better than many feared. The labor market remains strong in aggregate despite high-profile layoffs in technology companies; consumers continue to spend despite recent softening in retail sales data; and corporations have mostly exceeded earnings expectations. These factors (if they persist) may limit the extent of any slowdown in the economy. Beyond this, the recent decline in the U.S. dollar is revealing strength in many overseas markets that hasn't been seen for years. The broad-based outperformance by developed international markets in 2022 is a prime example of this nascent development, with 92% of developed countries delivering local currency returns that outpaced the S&P 500 Index.

As we think about investment positioning in the new year, we are approaching financial markets with a sense of hopeful skepticism (a bit of a different take on cautious optimism). We are skeptical that markets will be able to digest the Fed's rate increases and smoothly adjust to a higher-interest rate environment without some occasional stress and periodic bouts of panic. Consumers, corporations, and investors have become accustomed to easy money policies, and it will take a bit more time to arrive at a stable equilibrium in a regime of higher (or perhaps just normal) interest rates. However, we are hopeful that a more normalized interest rate environment—a world in which there is a greater consideration for the cost of capital when making financial decisions—will reward investment decisions driven more heavily by fundamentals than by FOMO (fear of missing out). We saw the broadening of market leadership beyond large cap technology stocks in 2022; we expect that shift to continue into 2023 and persist for the foreseeable future. In this light, we are heartened by the potential to lean into a wider opportunity set of asset classes with support from a combination of attractive valuations, strong fundamentals, and supportive technicals. Some of these are asset classes that have been left for dead for the better part of a decade, such as international equities—both developed and emerging markets. Others—like small cap stocks, high yield bonds, emerging markets fixed income, and even core U.S. fixed income—are less hated but have still been largely ignored amid the excitement of the "growth decade".

Regardless of the fundamental tailwinds that some asset classes may possess at this point in the cycle, we believe that nearly all asset classes share one commonality—there will be greater return dispersion between winners and losers within each asset class. Furthermore, the winners are not likely to be driven by momentum but by more fundamentally-oriented factors, such as valuation, quality, and profitability. In this world, we believe that active managers will have a greater ability to distinguish the wheat from the chaff … and to actually be rewarded for this exercise. Against this backdrop, we are cautiously optimistic that the environment will be favorable for our active approach to both asset allocation and portfolio implementation decisions. As we tilt our portfolios more heavily toward those asset classes that we believe to have cyclical—if not secular—tailwinds, you should continue to expect that our focus on achieving strong returns will be balanced by our awareness that long-term growth is achieved most successfully by a risk-controlled approach that enables the power of compounding returns to flourish.

Brinker Capital Market Barometer

SHORT-TERM FACTORS (< 6 months)

	CHANGE	NEGATIVE	NEUTRAL	POSITIVE	
Momentum		●			December losses dampened an otherwise strong quarter, positive momentum yet to be sustained
Trend			●		US markets have fallen back below moving averages, but short term averages remain upward sloping
Investor sentiment				●	Survey data is off of extremes, but contrarian view still indicates positive returns going forward
Seasonality				●	Seasonality remains strong through January, though not to the degree that we see in the 4th quarter

INTERMEDIATE-TERM FACTORS (6-36 months)

	CHANGE	NEGATIVE	NEUTRAL	POSITIVE	
Fiscal policy			●		The Omnibus Bill provides fiscal spend, but lack of tax changes increases the burden on corporations
Monetary policy		●			December should have signaled the peak in pace of hikes, but Fed rhetoric remains hawkish into 2023
Inflation		●			Headline inflation has moderated, but y/y numbers remain at elevated levels
Interest rate environment		●			Rates rose in December, but long term rates remain below the highs of 2022; deep inversion persists
Macroeconomic			●		Strong labor market and consumer spending persists, housing showing slowdown from higher rates
Business sentiment		●			Business confidence measures remain subdued as a growth slowdown is expected
Consumer sentiment		●			Consumer sentiment has rebounded over the past few months but remains depressed
Corporate earnings			●		Q4 to solidify earnings growth for 2022, degree of further forward revisions lower bears watching
Credit environment				●	Level of credit spreads at or below long-term averages, defaults remain low, credit conditions modest

LONG-TERM FACTORS (36+ months)

	CHANGE	NEGATIVE	NEUTRAL	POSITIVE	
Valuation			●		U.S. equity valuations near long-term averages; overseas markets below average valuations
Business cycle			●		Q3 GDP showed moderate growth, Q4 expectations show recession fears yet to come to fruition
Demographics			●		Emerging markets possess more favorable trends overall than developed markets

Source: Brinker Capital. Information accurate as of January 6, 2023.

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