MARKET OVERVIEW
Fourth Quarter 2022

OPAL WEALTH ADVISORS

Economic Overview

The Federal Reserve's interest rate decisions—past, present, and future—were the primary focus of investors in the fourth quarter. This single phenomenon impacts the trajectory of almost every other financial metric relevant to investment analysis and performance. The Federal Funds rate stood at 3.0%-3.25% at the end of the third quarter. The FOMC raised the benchmark rate by 75 basis points in early November, followed by a 50 basis point increase in December, arriving at the current 4.25%-4.50% range. This represents the highest level the Fed Funds rate has been since December 2007, just before the onset of the global financial crisis, fifteen years ago. Incredibly, the Fed had been holding rates near 0% at the beginning of this year. Although inflation measurements remain at multi-decade highs, the last several months' readings have shown prices are beginning to moderate, suggesting "peak inflation" has likely occurred. These developments, in turn, have sparked speculation of an eventual "Fed Pivot"; that is, a departure from the Fed's aggressive pace of rate hikes to either a slower rate of increases, or even a cessation of rate hikes. Current Fed projections suggest a year-end 2023 rate of 5.125%, meaning two or three 25 basis point rate hikes are likely, and then a long pause before any rate cuts will commence. The Fed Funds forward curve suggests market participants expect rates to top-out near 5.0% in mid-2023 with rates falling to 4.5% by late '23 or early '24. Fed officials have remained steadfast in their commitment to continue combating inflation which remains meaningfully higher than their 2% target. The Fed's hawkishness has fostered a never-ending stream of headlines and sound-bites from Wall Street forecasters regarding the likelihood the Fed will orchestrate a "soft landing": slowing the economy and bringing inflation down while preventing the U.S. from entering a recession. We are not of the opinion that a domestic recession is imminent. Global economic growth has certainly slowed down. Corporate earnings and profit margins are declining (albeit from historically elevated levels) but relatively strong consumer balance sheets and a strong labor market suggest a "muddling through" of the economic headwinds is the most likely near-term situation. A recession may materialize in later 2023 or in 2024 as the lagged and cumulative impact of the Fed's interest rate hikes begin taking their toll on economic progress, but for now we are generally suggesting clients embrace a neutral stance across most risky asset class exposures.

The midterm elections in November resulted in Democrats maintaining control of the Senate while Republicans eked out a slim majority in the House of Representatives. Split control of the federal government—with one party controlling the executive branch and the other party controlling at least one body of Congress—will limit the scope of new legislation. Generally, most corporate executives welcome this result.

China abruptly shifted away from its draconian zero-Covid rules in December, following nationwide protests for a return to normalcy. Economic growth in the region will likely be positively impacted as China reopens; however, many Western companies are rethinking their long-term supply chain logistics and shunning China.

Constructive Observations

- Sentiment is very weak (Q4 earnings may not be as bad as expected).
- Consumer and corporate balance sheets remain healthy.
- China's departure from zero-Covid policy should benefit global growth.
- The case is building for a "soft-landing"; if the economy enters recession it could be a mild one. Current pricing may reflect a mild recession scenario.
- Absolute level of interest rates are still below historical averages (30-year mortgage rate from 1971-2022 averaged 7.76%).

Cautious Observations

- Earnings expectations for 2023 have declined but are likely to drop further.

- Bear market rallies may provide a "head fake" as recession emerges.
- Yield curve inversion suggests a recession in late summer/early fall is possible.
- Consumers will likely exhaust their excess savings by mid-2023.

Macro Overview

Rising interest rates and higher inflation were the hallmarks of the investment environment in 2022. Volatile crosscurrents include persistent inflation, a hawkish Fed, and stubborn geopolitical tensions. Despite declines in both nominal and core CPI and PCE inflation measures over the last several months, we do not think the Fed is close to halting its rate hikes. Their primary focus is on the labor markets and wage inflation and there are few signs of a slowdown in these areas. Unemployment is at 3.5%, a half-century low point, and labor market data still points to a very tight labor market. Inflation should continue to decline, but it is unlikely to reach the Fed's 2% target anytime soon.

Despite dour outlooks from many Wall Street forecasters, the Federal Reserve Bank of Atlanta's GDPNow estimate of real GDP growth for the fourth quarter is now 4.1%. The consensus forecast (drawn from a mix of economists from major investment banks, corporations, consulting firms, and academic institutions) currently ranges from 0% - 2%, with a median forecast of about 1% growth. At least for the time being, recent economic data releases from the Institute for Supply Management, the US Bureau of Labor Statistics, and the US Census Bureau suggest that GDP growth is not flashing recession at the moment.

The Fed's aggressive rate hikes caused the U.S. dollar to strengthen considerably in 2022. The dollar's strength was broad-based, with all major global currencies weakening against the dollar. The dollar tends to be counter-cyclical, and with the threat of a global economic slowdown on the horizon, the dollar was bid up to remarkably high levels this past year. This trend reversed in the fourth quarter. The dollar ended the year down 9.3% from its September 27th peak. As interest rate differentials between the U.S. and other countries declines, the U.S. dollar will likely weaken. The vast majority of our research partners hold this view and we recently downgraded our outlook for the dollar as well.

Markets Overview

Equities

Stock market leadership in 2022 contrasted to that of most of the last decade with value outperforming growth, international stocks outperforming the S&P 500 (for only the 2nd time in 13 years), the equal-weighted S&P 500 outperforming the market cap-weighted proxy and large-cap tech stocks lagging the broad market. U.S. equity indices recovered somewhat in the fourth quarter as investors responded positively to moderating inflation, but still ended the year in substantially negative territory as 2022 marked the worst year since 2008 for the S&P 500 Index.

After back-to-back months of substantial gains in October and November, the market gave some of it back in December. The S&P 500 returned 7.6% this quarter, but still fell 18.1% for the year. Large-cap value stocks rose by almost 14% this quarter and declined just over 5% for the year whereas large-cap growth stocks rose a modest 1% this quarter but fell almost 30% for the year.

Mid-caps and small-caps fared slightly better than large-caps for both the quarter and the year, but displayed similar behavior across the style dimension, with value stocks meaningfully outperforming growth stocks.

Sector performance differentials were extreme for both the quarter and the year. Large-cap energy stocks returned 23% in the fourth quarter and an eye-popping 66% for the year, driven in large measure by supply/demand imbalances associated with the fallout in Europe from Russia's invasion of Ukraine. Large-cap consumer discretionary stocks fell over 10% this quarter and declined 37% on the year.

Over the past two years, policies intended to slow the spread of Covid and to punish Russia for invading Ukraine have resulted in increased nationalism and a slowing of the globalization trends that have persisted for the last thirty years. Nations are reexamining supply chains and trading bloc dynamics, creating greater differentiation among countries. What looks increasingly like a cold-war era proxy war between NATO and Russia is emerging, as well as additional tensions sparked by China's adoption of more assertive nationalistic policies. An extended period of dollar strength has rewarded U.S. investors who focused primarily on dollar-denominated investments. We think it is likely the dollar will begin to weaken on a secular basis which suggests international markets may outperform the domestic U.S. economy in years to come.

International stocks declined almost 15% in 2022 in U.S. dollar terms, but fell less than 7% in local currency terms. International stocks rose more than 17% in the fourth quarter (in dollar terms), dramatically outpacing the S&P 500 return of 7.6%. Emerging market stocks rose almost 10% this quarter, but fell 20% for the year. Many of our research providers have been emphasizing the valuation discrepancies present between U.S. and international stocks suggesting a reversal of leadership may likely favor non-U.S. stocks going forward. The S&P 500 Index has a forward P/E ratio around 17 currently, whereas the MSCI EAFE Index is around 12 and MSCI Emerging Markets is around 11.

Fixed Income

2022 was the worst year on record for bonds. The Bloomberg U.S. Aggregate Bond Index did something it has never done before: it has lost value two years in a row. The index rose 2% in the fourth quarter but declined 13% this year.

The Federal Reserve continues to raise short-term interest rates. After rising throughout the year, 10-year Treasury bond yields peaked in late October. Most bond indices fell by double-digits in 2022. Most Treasury bonds with maturities of less than 20 years rose modestly by about 1% in the fourth quarter. The fourth quarter returns do little to mitigate the full-year pain of declines between 4% (for the shortest 1-3 year maturities) and 30% (for maturities of 20-years+). Intermediate term Treasury bonds with maturities between five and ten years declined between 11% and 15% for the year.

Quantitative tightening, which began in June, will likely continue for some time after the Fed rate increases stop. This shrinking of the Fed's balance sheet by close to $1 trillion will be a drag on bond market liquidity.

Yields on investment grade corporate bonds are at their highest levels since 2009. The average yield-to-worst of the Blomberg U.S. Corporate Bond Index is roughly 5%, down from just over 6% in October. Current yields are not too far below their 20-year highs.

High Yield corporate bonds returned a little over 4% in the fourth quarter but fell over 11% for the year. Bank loans, usually structured as floating rate instruments, did reasonably well this year: up 3% in the fourth quarter and essentially down 1% for the year.

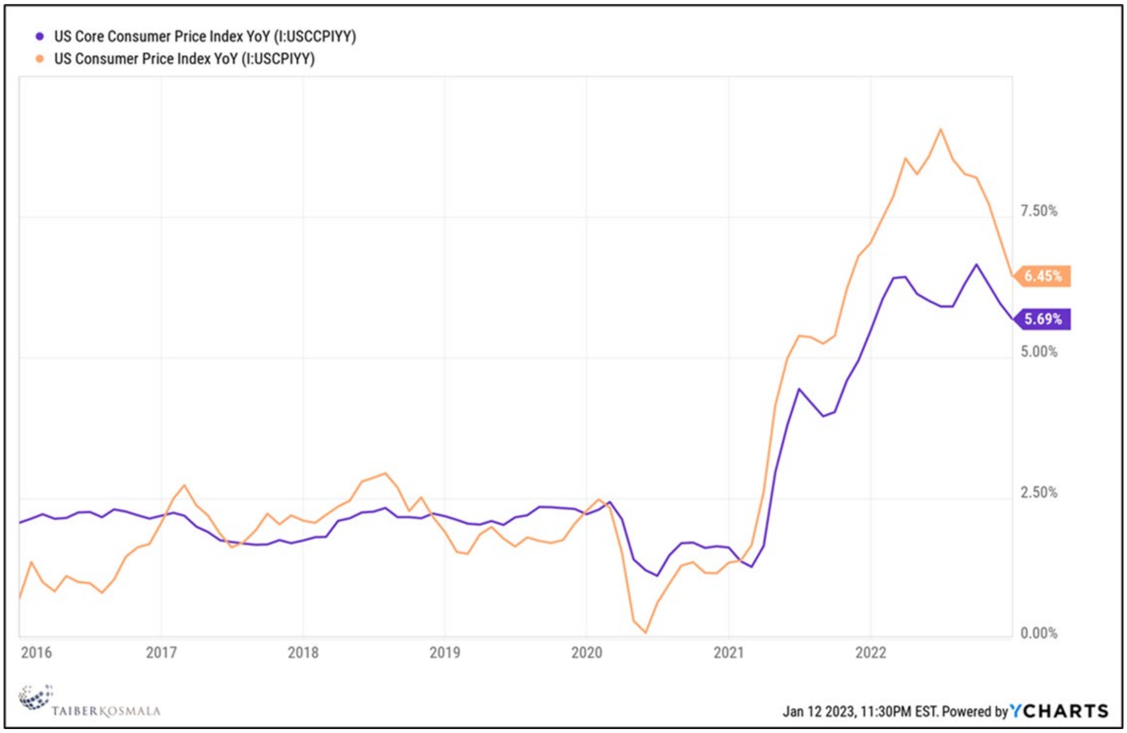
Investment grade bond spreads are roughly 1.4% currently and high-yield spreads are just under 5%, These levels are well below previous peaks over the last 20 years. Generally, bond spreads are usually higher than current levels if a recession is imminent. If economic growth slows, bond spreads should increase but spreads remain relatively low at current levels.

Real Assets

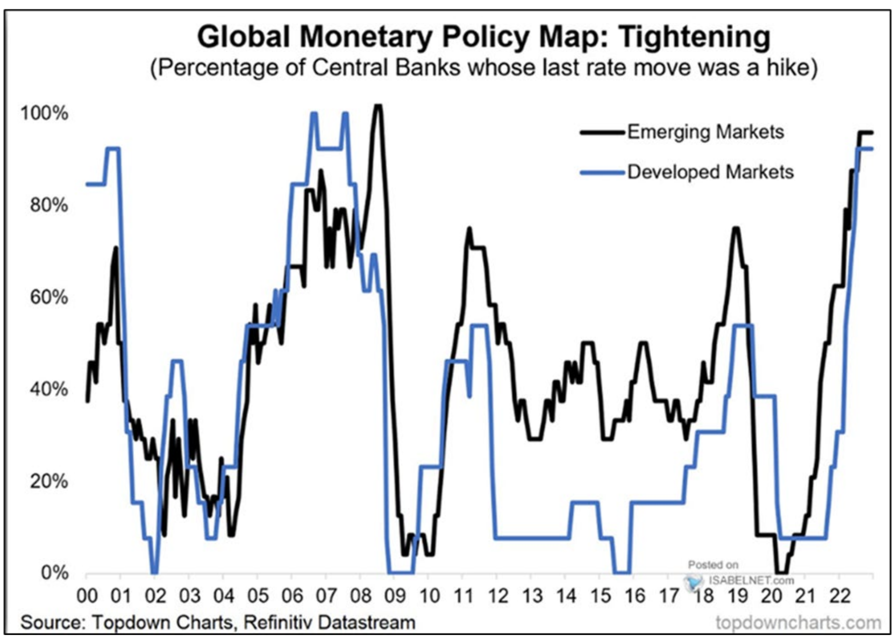
Commodities were the one stand-out asset class in 2022 that generally delivered positive returns. The Bloomberg Commodity index returned 16% for the year and the S&P GSCI index (which is heavily Energy-centric) returned 26%. These summary statistics mask significant volatility that pervaded various sub-sectors at different points throughout the year, primarily driven by the prevailing headlines at the time. The war in Ukraine drove natural gas prices to nose-bleed levels, up almost 87% at the end of the third quarter. As European countries scrambled to replace Russian gas supplies through LNG imports, supply was drawn away from traditional buyers in the Asia-Pacific region. With the onset of a warmer than normal winter in Europe, natural gas prices fell 36% in the fourth quarter.

West Texas crude oil rose 5% in the fourth quarter, up 25% for the year. Agricultural commodities rose slightly more than 2% this quarter, up 16% on the year. Industrial and precious metals rose 16% and 13% respectively, this quarter, but are flat to slightly negative for the year.

Charts of the Quarter

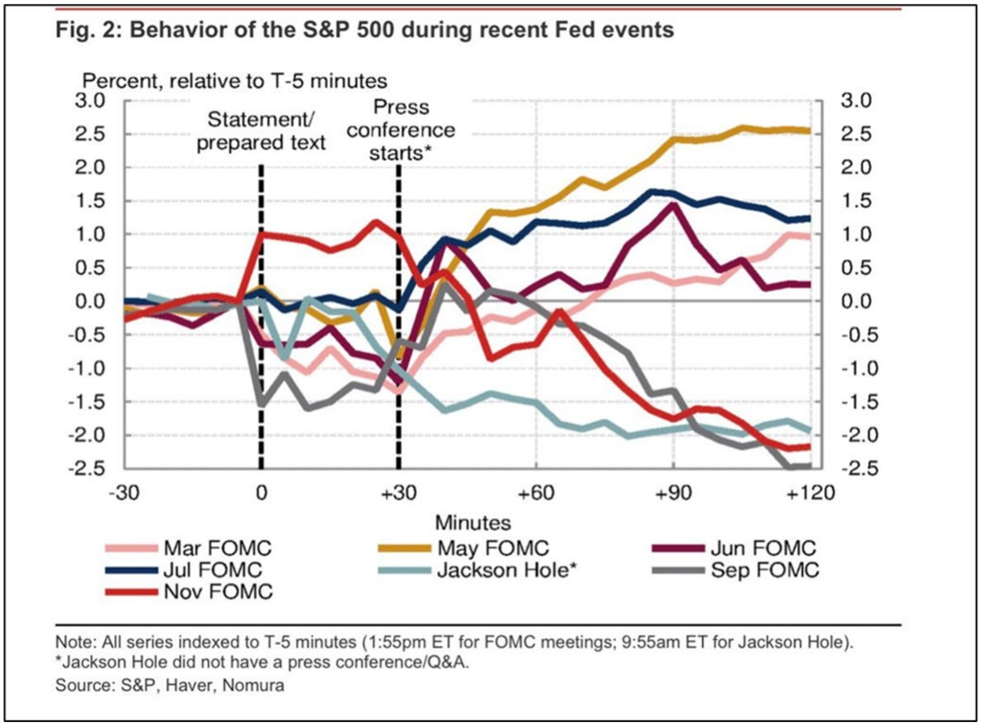


Source: TKA.

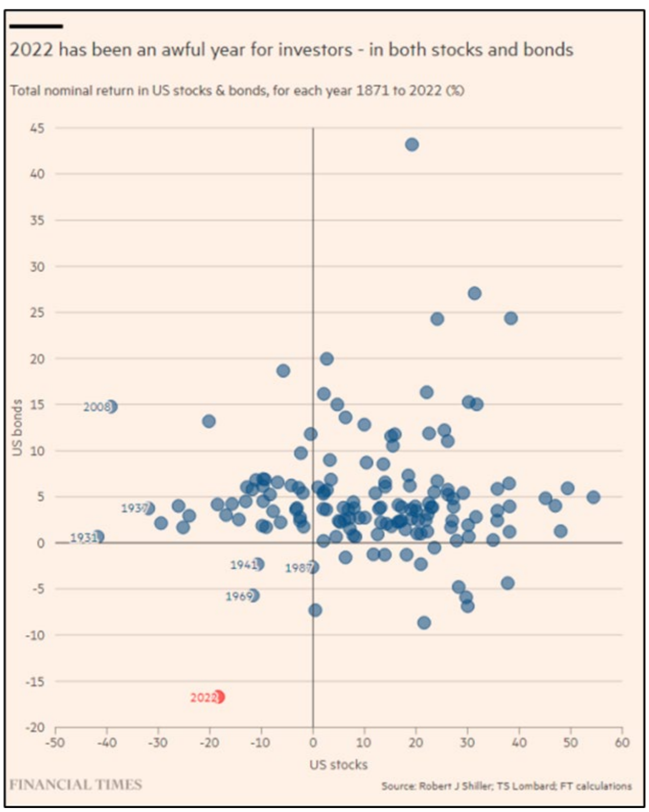


Sources: Topdown Charts, Refinitiv.

Charts of the Quarter



Source: S&P.

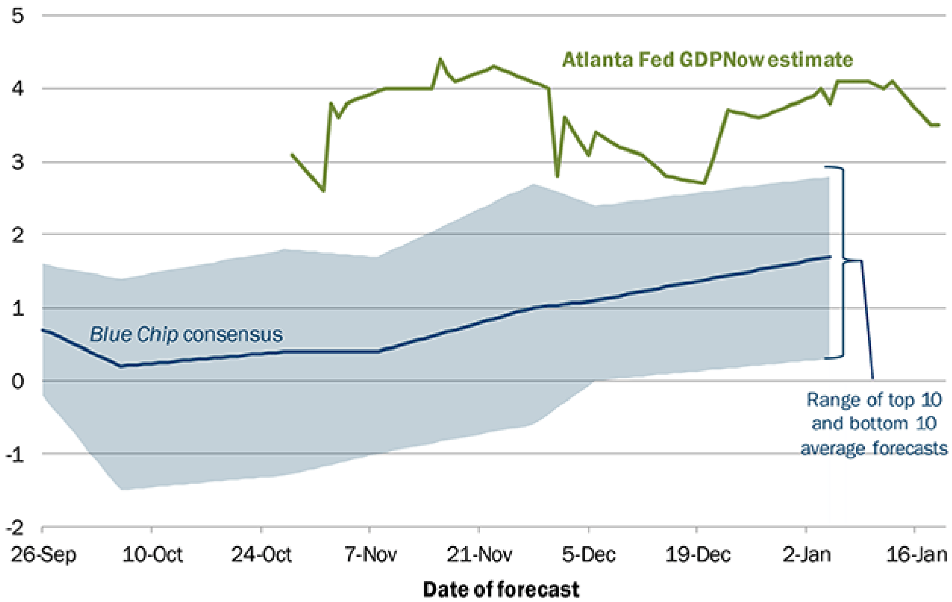


Source: Financial Times.

Charts of the Quarter

Evolution of Atlanta Fed GDPNow real GDP estimate for 2022: Q4

Quarterly percent change (SAAR)



Sources: *Blue Chip Economic Indicators* and *Blue Chip Financial Forecasts*
Note: The top (bottom) 10 average forecast is an average of the highest (lowest) 10 forecasts in the *Blue Chip* survey.

Source: Federal Reserve Bank of Atlanta.

How Long Until the Recession?

When the 3-month to 10-year yield curve inverts for **10 consecutive trading days**

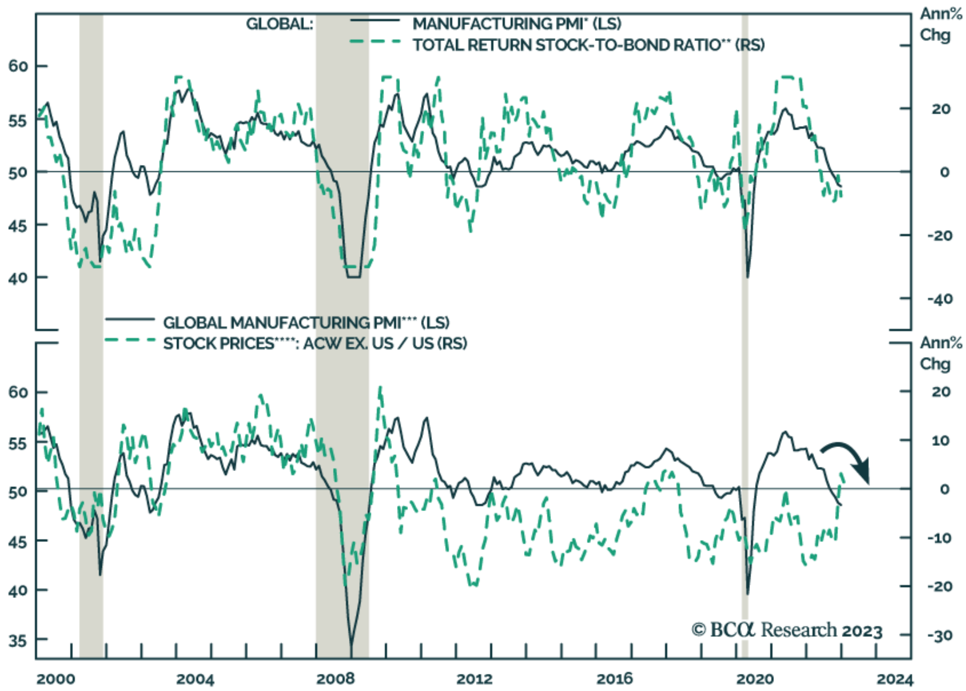
Date of Inversion	Consecutive Trading Days Inverted	Date of Next Recession	Calendar Days to Next Recession
1/10/1969	24	Dec-69	325
6/14/1973	177	Nov-73	140
12/8/1978	91	Jan-80	389
11/7/1980	102	Jul-81	236
6/6/1989	30	Jul-90	390
7/31/2000	135	Mar-01	213
8/1/2006	217	Dec-07	487
6/6/2019	41	Feb-20	268
11/22/2022	***????***	***????***	***????***
Average	**111**		**311**

1/10/1969 = inverted for 24 calendar days, went positive for 33 days, then inverted again for 53 days
6/6/1989 = inverted for 30 calendar days, went postive for 9 days, inverted again for 26 days

6/6/2019 = As of July 31 the inversion has been 41 consecutive trading days.
Positive for 1 day, then inverted again for 67 days (through October 10)

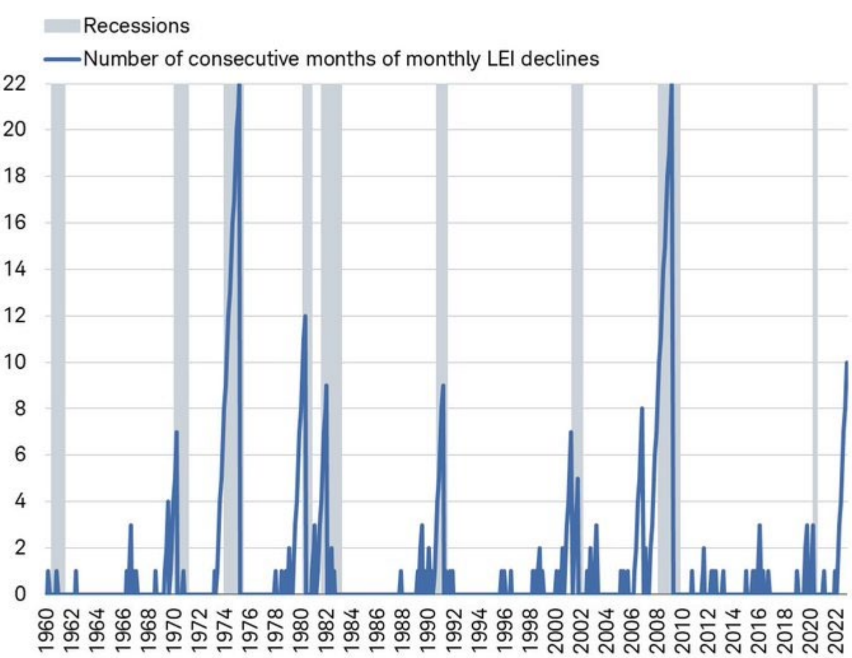
Source: Bianco Research.

Charts of the Quarter



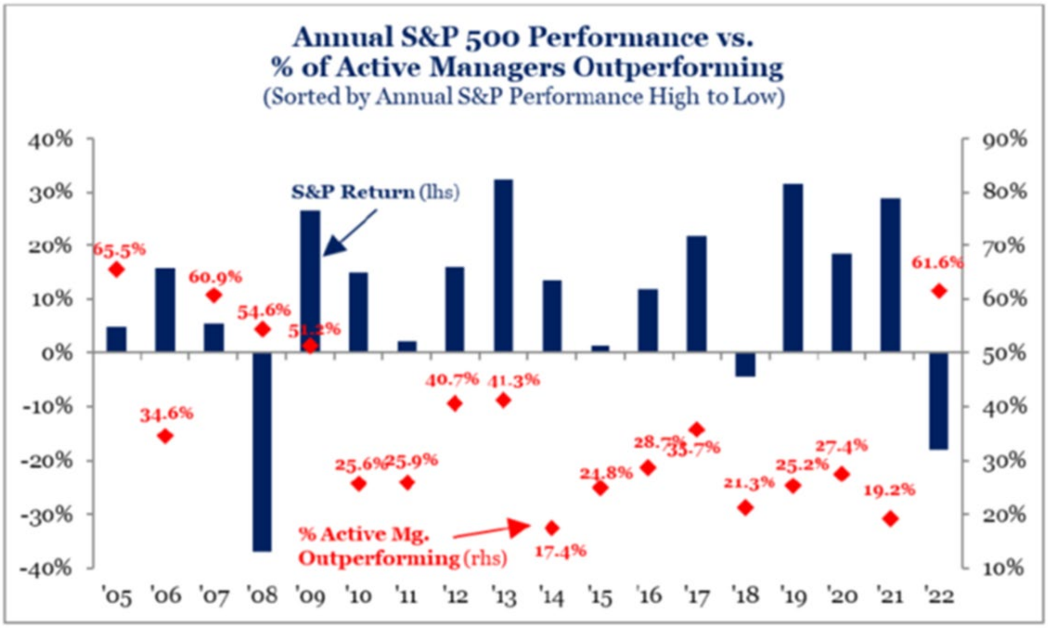
* SOURCE: S&P GLOBAL/MARKIT ECONOMICS LTD. SHOWN TRUNCATED AT 40.
** ANNUAL PERCENT CHANGE IN THE MSCI ACW INDEX TOTAL RETURN MINUS ANNUAL PERCENT CHANGE IN GLOBAL AGGREGATE TREASURY INDEX TOTAL RETURN; SHOWN TRUNCATED AT 30% AND -30%. SOURCE: BLOOMBERG BARCLAYS INDICES, MSCI INC. (SEE COPYRIGHT DECLARATION).
*** SOURCE: S&P GLOBAL/MARKIT ECONOMICS LTD.
**** IN US DOLLARS. SOURCE: MSCI INC (SEE COPYRIGHT DECLARATION).
NOTE: SHADED AREAS DENOTE NBER-DESIGNATED RECESSIONS.

Source: Bank Credit Analyst.



Sources: Charles Schwab, Bloomberg.

Charts of the Quarter



Source: Strategas.

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