Marketline December 2022

Stocks:

The last month of the year – while giving us negative broad market returns – did not spoil what was a decent quarter. Too, the quarter's rebound helped take the edge off a poor year for both stocks and bonds. Still the Dow declined 4.2%, the S&P was off almost 6% and the NASDAQ, true to its reputation for volatility both going up and while heading down, dropped 8.7% during the month. Returns were similar overseas, except for Europe, which put in a pretty good showing at only -1.6%. Canada and Mexico were in line with the US.

While the market was up in the last quarter, the Dow been in a slightly upward bound trading range since about June 2022 without much of anyone noticing. The S&P has experienced a gentle downward range largely due to technology stock exposure. Consensus forecasts for the coming year generally center around the idea that the first half of 2023 will also be a trading range – so more of the same – but the last half of the year will be positive. While that's the consensus, other opinions abound, with the most frequent alternative being a bearish outlook. About the only agreement we really see is around the certainty of the recession – which most think will happen. Regarding valuation, sure, technology stocks have fallen dramatically, but they remain expensive, and a check back to 2000-2002 shows that during the second year of that bear market, technology stocks kept falling. On the other hand, the cheaper understory of stocks associated with what investors cynically call the "real economy" have performed relatively well and made a good start to this year. These are companies that make machinery, produce energy, sell materials like steel, and lease real estate – the types of companies that make up the bulwark of our portfolios.

What of the Fed and its activity vis-à-vis stocks? Interest rates are very important, but we have now seen several upward swings in stocks despite rising rates. What's made all the difference is the slack tide out at the long end of the market, where yields have stagnated – trendless for about three months. We notice that loan demand at banks has fallen; without this high-powered money-creating activity in place, the economy is set to decelerate. We think that's the signal the long bond is picking up, along with the abatement of inflation. If long rates can remain near current levels, stocks will have a chance to break free of their trading range – perhaps on the upside.

Bonds:

Last month, yields rose from two years out. The long Treasury travelled toward the top of its recent trading range, closing at 3.96%. The ten year – important for mortgage rates – rose from 3.60% to 3.87%. Mortgage rates are hovering between 6.5% and 7%, causing a significant slowdown in housing activity.

The yield curve remains substantially inverted, with short term interest rates around 4.7%. Unfortunately, an inverted curve has a substantially accurate record predicting a recession. We noted above that the bond market has been in a slightly rising trading range – like stocks – out at the longer end (ten years and more), but it has been affirmatively rising in yield in the short end of the market as the Fed squeezes economic activity to combat inflation. In 2022 this discouraged municipal issuers, made corporate issuers rush to batten down hatches via refinancings or debt retirement, and did nothing to influence Treasury issuance – which must come to market no matter what. On the margin, the aggregate effects of these outcomes were fewer bonds than we saw when yields were lower.

Looking forward, with economic activity clearly slowing, we think it will be difficult for longer term interest rates to rise much from here. Commitments to bonds when the long Treasury rises toward 4% will likely be rewarded. We particularly like investment grade corporate issues at the moment, where yields are still around 4.5% to 5%.

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