



# Money Like Water

Q4, 2022

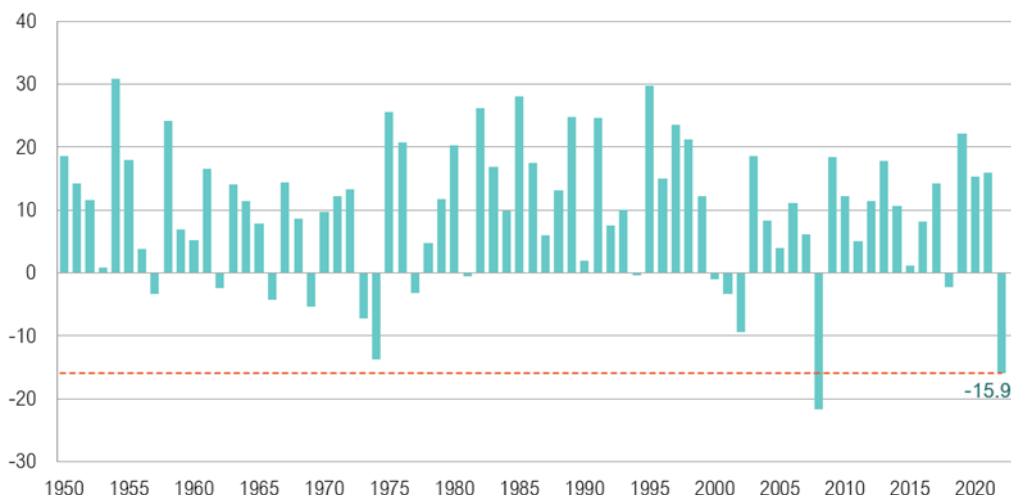
- As inflation showed signs of slowing in the fourth quarter, both stocks and bonds recovered some of their losses from previous quarters, and most assets ended the quarter with positive returns.
- Despite a relatively good final quarter, 2022 was one of the worst years in history for markets, including stocks and bonds shedding more than \$30 trillion globally and the worst 60/40 portfolio returns since the Global Financial Crisis in 2008.
- Although inflation has started to subside, economic activity has also, and whichever one slows faster will likely determine the severity of a recession, if one occurs.
- The interplay between policymakers and their decisions on fiscal and monetary liquidity has the potential to heavily influence inflation, economic activity, and market performance in 2023.

## Overview

This past year was certainly one to remember, characterized by a four-decade-high inflation rate, rapidly tightening monetary policy, and geopolitical uncertainty. As the Federal Reserve's efforts to curb inflation showed signs of success in the fourth quarter, both stocks and bonds managed to recover some of their losses from previous quarters. U.S. large cap stocks ended the quarter up 7.6%, and bonds ended up 1.9%. Despite this, it was still one of the worst years for markets since 2008, and stocks and bonds shed more than \$30 trillion globally.<sup>1</sup> The S&P 500 ended the year down 18.1%, and the Bloomberg U.S. Aggregate Bond Index ended the year down 13%—its worst year since its inception in 1976.<sup>2</sup> A traditional 60% stock and 40% bond portfolio had its second-worst year since 1950.

### 2022 Was One of the Worst Years in History for a 60/40 Portfolio

60% S&P 500/40% Bloomberg U.S. Aggregate Bond Annual Total Returns (%), 1950-Present



Source: Bloomberg

*It was one of the worst years for markets since 2008, and stocks and bonds shed more than \$30 trillion globally*

***If economic growth slows faster than inflation, a recession may be the most likely outcome***

Energy was the top-performing S&P 500 sector for 2022, returning 65.7%. The only other sector that produced positive returns for 2022 was the utility sector, ending the year up 1.6%. The communication services sector led the downside, declining 39.9% over the year. The 105.6% performance gap between energy and communications was the widest performance differential between any two S&P 500 sectors since 1991. The second-widest differential between sectors was in 2000 when utilities outperformed information technology by 98%.

Inflation, the intense focus of 2022, has seemingly peaked. After hitting a high of 9.1% in June 2022, it ended the year with a December reading of 6.5%.<sup>3</sup> Slowing, but still-too-high, inflation ushers in the next phase of this cycle and poses a key question for investors. Will tighter monetary policy dampen the economy so much that it enters a recession, or not? The answer will depend on the relative speed in the decline of growth relative to inflation. Should inflation decrease more quickly than economic activity, the U.S. could experience a soft landing (i.e., no recession)—which would be a positive for risky assets. If, however, economic growth slows faster than inflation, then a recession ensues. As it stands, a recession may be the most likely outcome unfortunately. The Treasury yield curve, as measured by the 2-year minus the 10-year Treasury yield, has been inverted since July.<sup>4</sup> This inversion has correctly anticipated the past half dozen recessions, going back to the early 1980s.<sup>5</sup> Even the Fed's staff noted in the November Federal Open Market Committee (FOMC) meeting that "the possibility that the economy would enter a recession sometime over the next year as almost as likely as the baseline".<sup>6</sup>

### **Money Like Water**

The interplay between monetary and fiscal policy will be another key factor in 2023, and it could significantly complicate the Fed's efforts to further rein in inflation. Both monetary and fiscal policymakers are focused on what's best for consumers, but this could lead to counteracting policies. For its part, the Federal Reserve is tightening monetary policy through interest rate hikes and shrinking its balance sheet to remove liquidity from the financial system. The intent is to weaken the labor market and bridle demand in order to get inflation back to its 2% mandate.

***"...we are strongly committed to bringing inflation back down to our 2 percent goal"***

*"I would like to underscore for the American people that we understand the hardship that high inflation is causing and that we are strongly committed to bringing inflation back down to our 2 percent goal." – Jerome Powell, Chairman of the Federal Open Market Committee (December 14<sup>th</sup>, 2022, FOMC Press Conference)<sup>7</sup>*

On the other hand, politicians will likely be compelled to add fiscal stimulus (i.e., liquidity) to the economy and pressure the Fed to ease interest rate hikes if consumers' financial situation continues to erode and a recession ensues.

*"For working Americans who already feel the crush of inflation, job losses will make it much worse. We can't risk the livelihoods of millions of Americans who can't afford it. I ask that you don't forget your responsibility to promote maximum employment and that the decisions you make at the next FOMC meeting reflect your commitment to the dual mandate." – Sherrod Brown, Chairman U.S. Senate Committee on Banking, Housing & Urban Affairs (October 25<sup>th</sup>, 2022, Open Letter to Jerome Powell)<sup>8</sup>*

Because the U.S. labor market staged a remarkable recovery from its pandemic downturn and remained robust throughout last year, the Fed's tightening strategy still has work to

***Wage growth remains well below the rate of inflation, eroding the purchasing power of consumers***

do. Throughout 2022, unemployment levels remained near all-time lows, ending 2022 at 3.7%.<sup>9</sup> Both initial and ongoing jobless claims ended the year lower than where they started in 2022.<sup>10</sup> The ratio of job openings to unemployed people has remained near all-time highs at 1.7x.<sup>11</sup> Given the tight labor market, nominal wages remain elevated, growing at a pace well above sustainable levels and contributing to elevated inflation. As the Fed continues to try and clamp down on demand, the unemployment rate should start to increase. According to economist Bill Dudley, “This will require a persistent string of payroll gains of less than 100,000 per month and a rise in the unemployment rate to at least 4.5% from the current 3.7%”.<sup>12</sup> In a nod in the right direction, the nonfarm payrolls report for December showed a meaningful cooling of wage growth, and the year-over-year measure fell from 5.0% to 4.6%.<sup>13</sup> While this is a positive from the Fed’s inflation-fighting point of view, wage growth remains well below the rate of inflation, eroding the purchasing power of consumers.

Despite a tough backdrop for real (inflation-adjusted) wages, consumers continued spending throughout 2022. Real personal consumption expenditures in 2022 consistently showed year-over-year growth of 2%, right in line with the average growth rate from 2010 to 2019.<sup>14</sup> But this spending has come at a cost. The personal savings rate is currently 2.4%—its lowest level since 2005.<sup>15</sup> In addition, total consumer credit increased by more than \$300 billion—a record—to \$4.7 trillion.<sup>16</sup> Household debt service payments as a percentage of disposable income have climbed to 9.7%.<sup>17</sup> Should economic activity slow further, the labor market starts to dive, and consumer finances worsen, politicians will likely look to pump more cash to consumers via fiscal support, just as they have in the past three recessions. Such measures would counteract the Fed’s efforts to reduce demand.

Historically, the U.S. government has responded to recessions by providing stimulus predominantly in the form of tax cuts and stimulus checks. In 2001, the U.S. government responded to the recession by implementing the Economic Growth and Tax Relief Reconciliation Act of 2001, which led to \$1.35 trillion in tax relief.<sup>18</sup>



***The U.S. government pumped at least \$4 trillion into the economy with the onset of the COVID-19 pandemic***

In a similar response to the 2008 Global Financial Crisis, the U.S. government implemented the Economic Stimulus Act of 2008. The act provided stimulus checks of up to \$600 for individual taxpayers and tax cuts that provided \$1.7 trillion in relief throughout 2008.<sup>19</sup> With the onset of the global COVID-19 pandemic in March 2020, the U.S. government pumped a total of at least \$4 trillion in economic relief into the economy, distributing a series of stimulus checks—free money—totaling \$3,200 to residents between April 2020 and March 2021.<sup>20</sup>

Stimulus checks directly affected consumer spending, as evidenced by the rise and subsequent fall in retail sales in the months following the checks' issuance. For example, retail sales jumped 5.0% in January 2021 after the second round of stimulus checks at the end of December 2020, but then slipped down 1.9% in February 2021.<sup>21</sup> Nineteen states also issued their own stimulus checks, and these similarly affected retail sales.<sup>22</sup> California sent up to \$1,050 in October, which totaled \$4.1 billion in payments to residents.<sup>23</sup> Were it a country, California would be the world's fifth-largest economy, and the effect of its stimulus appeared to show up in national retail sales.<sup>24</sup> In October, U.S. retail sales were up 1.3% on a month-over-month basis, the second-largest increase in 2022. In the next month, November 2022, however, retail sales hit their lowest point for the year, down 0.8%.<sup>21</sup> The government has also bolstered consumers via Cost-of-Living Adjustments (COLA) for Social Security, which will increase by 8.7% in 2023, topping the 2022 adjustment of 5.9%—which at that time was the highest adjustment since 1982.<sup>25</sup> If 2022 patterns repeat, these cash infusions could boost short-term spending at the cost of longer-term inflation.

***During the 2022 fiscal year, the federal government made \$475 billion in net interest payments***

Should the federal government continue to spend money like water to rescue the consumer and the economy in 2023, it will be doing so from a substantially weakened financial position, which makes any decision a very delicate one. As of the start of the fourth quarter of 2022, the U.S. debt-to-GDP ratio was over 120%.<sup>26</sup> For context, in 2013, the U.S. debt-to-GDP ratio surpassed the 100% mark when both debt and GDP were approximately \$16.7 trillion.<sup>27</sup> Furthermore, as interest rates have risen, the cost to finance the growing debt of the U.S. has risen too. During the 2022 fiscal year, the federal government made \$475 billion in net interest payments, up from \$352 billion the prior year.<sup>27</sup> The estimated annual interest cost now represents 35% of current federal tax receipts.<sup>27</sup>

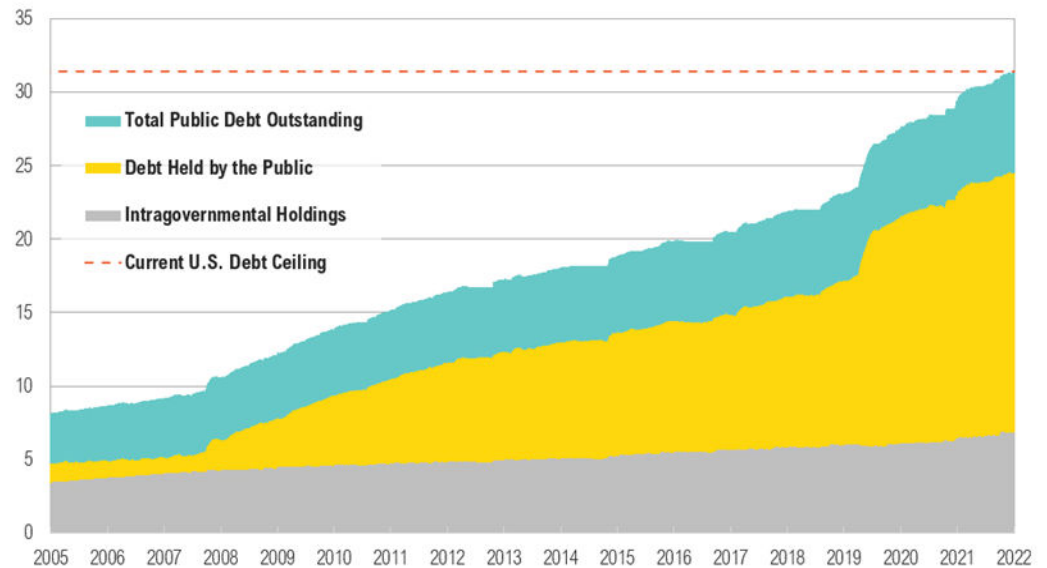
There is a recent precedent for concern around excessive fiscal spending. In early October, an economic package announcement by the U.K. government led to widespread market turmoil and the ultimate explosion of U.K. government bond yields. The economic package included the country's largest tax cut plan since the 1970s, costing the government more than \$169 billion (£150 billion).<sup>28</sup> Consequently, the British bond market imploded, causing significant losses to U.K. pension plans amongst others and ultimately forcing the Bank of England to intervene.<sup>29</sup> In the weeks following the turmoil, Liz Truss resigned, serving the shortest term ever by a British prime minister.<sup>30</sup> Hopefully, lessons can be learned from the recent mistakes of other politicians.

Complicating fiscal spending decisions in 2023 is the fact that the debt ceiling (or debt limit) was hit in November at \$31.4 trillion.<sup>31</sup> The debt ceiling is the total amount of money that the U.S. government is authorized to borrow to be able to meet its existing legal obligations, such as Social Security, Medicare, military salaries, interest payments on the national debt, and tax refunds.<sup>32</sup> The debt ceiling was created in 1917 to make financing World War I easier.<sup>33</sup> Until 1952, the debt ceiling was routinely raised without any

problems. When the debt ceiling is raised, it lets government borrow more to cover the gap between spending and taxes already approved by Congress. Since 1960, Congress has raised the debt ceiling 78 times—49 times under Republican presidents and 29 times under Democratic presidents.<sup>32</sup>

### The U.S. Government Has Effectively Hit its Debt Ceiling

U.S. Debt (\$ trillion), 12/31/2005 - 12/31/2022



Source: U.S. Treasury

**Once the debt ceiling has been reached, the U.S. Treasury can use a variety of “extraordinary” accounting processes to lower debt levels and avoid running out of cash and risking a technical default on its debt**

Once the debt ceiling has been reached, the U.S. Treasury can use a variety of “extraordinary” accounting processes to lower debt levels and avoid running out of cash and risking a technical default on its debt. These extraordinary measures include prematurely redeeming Treasury bonds held in federal employee retirement savings accounts; halting contributions to certain government pension funds; and borrowing from cash reserves set aside to manage possible exchange rate fluctuations.<sup>32</sup> On December 23, Congress passed a nearly \$1.7 trillion spending bill to fund the federal government through September 2023 but failed to address this key issue.<sup>34</sup> While the political negotiations and ultimate resolution in previous debt ceiling increases never were considered material risks, the current situation has the potential to lead to market volatility.

**When the debt ceiling is resolved, it will create a tsunami of bond issuance that may drain significant liquidity from the system**

The debt ceiling debate has already greatly affected liquidity in the U.S. In October, the U.S. Treasury announced that it expected to borrow \$550 billion in the fourth quarter, assuming an end-of-year cash balance of \$700 billion.<sup>35</sup> However, given that the debt ceiling was reached earlier in the quarter, issuance came in well below expectations at \$373 billion, including paying down debt by \$3 billion in December.<sup>35</sup> To fund the shortfall, the U.S. Treasury had to take down its cash balance by nearly \$200 billion to \$447 billion—well below the year-end goal of \$700 billion.<sup>35</sup> This lack of debt issuance, paydown of debt, and drawdown of cash acts as a source of liquidity to markets. For the first quarter, the U.S. Treasury estimated that it would need to borrow \$578 billion, assuming an end-of-March 2023 cash balance of \$500 billion. In lieu of issuing debt, the U.S. Treasury continues to spend its cash, down another \$100 billion to start 2023.<sup>35</sup> When the debt ceiling is resolved, it will create a tsunami of bond issuance that may drain significant liquidity from the system.



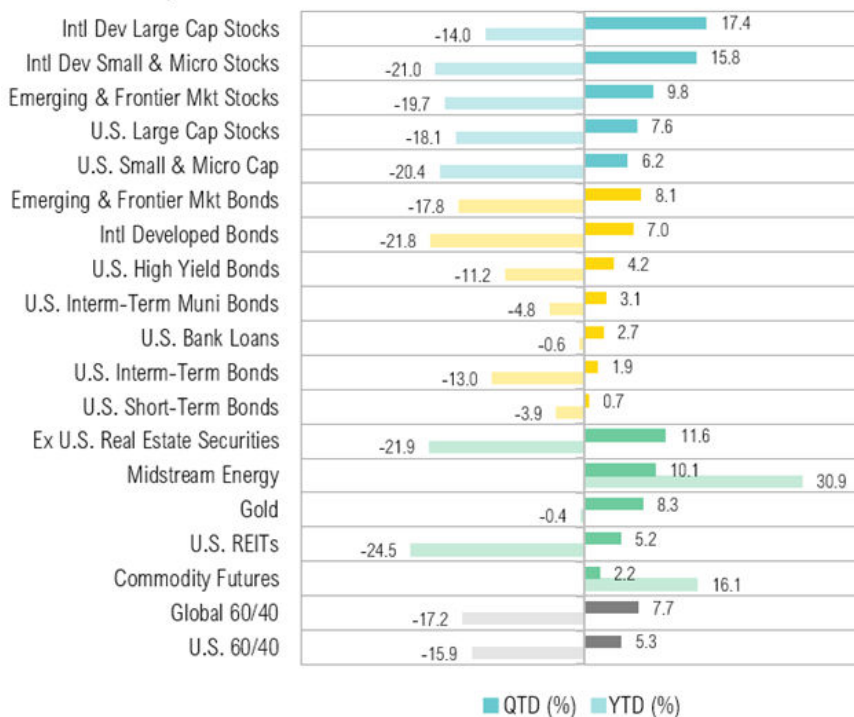
## Markets

Asset classes rebounded in the last quarter of 2022. International developed market stocks were the top performers over the quarter. International large cap stocks ended up 17.4%, and international small cap stocks ended up 15.8%. The Russell 1000 Value Index significantly outperformed the Russell 1000 Growth Index, returning 12.4% and 2.2% over the fourth quarter, respectively. The S&P 500 ended the quarter up 7.6%. In a year in which only three asset classes ended with positive returns, the top performer was midstream energy, which generated a one-year return of 30.9%. The worst-performing asset class of 2022 was U.S. REITs, ending the year down 24.5%.

For the fourth quarter of 2022, the estimated earnings decline for the S&P 500 is -4.1%.<sup>36</sup> Given ongoing concerns about the rising probability of a recession and uncertain economic conditions, analysts lowered earnings per share (EPS) estimates for S&P 500 companies more than usual in the fourth quarter.<sup>36</sup> Earnings estimates for the 2023 calendar year were also lowered, declining by 4.4% throughout the fourth quarter of 2022.<sup>36</sup> Expectations are now for \$225 per share, which would represent 4.7% growth relative to 2022 should estimates be met.<sup>37</sup>

Both U.S. and international fixed income ended the fourth quarter with positive returns. Despite international developed market bonds being one of the best performers out of fixed income in the last quarter of 2022, they were the worst performer for the year, ending down 21.8%. Across the board, it was a tough year overall for fixed income. The best-returning asset classes for the year were midstream energy and commodity futures, ending 2022 up 30.9% and 16.1%, respectively.

### Q4 2022 Key Market Total Returns



Source: Bloomberg

**The best-returning asset classes for the year were midstream energy and commodity futures, ending 2022 up 30.9% and 16.1%, respectively.**

In October, the Bank of Japan conducted emergency bond-buying operations in continued efforts to maintain control over yield spreads.<sup>38</sup> The Bank of Japan is the largest holder of Japanese government bonds, holding 51.4% as of December 20.<sup>39</sup>

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Coupled with this, the Bank of Japan's efforts to maintain ultra-low interest rates and yield curve control have often resulted in the Japanese bond market not trading for days on end. For example, Japanese 10-year government bonds did not trade for five consecutive days from October 7 to October 13 this year.<sup>40</sup> Japanese equities ended the quarter up 3.3%, while Japanese government bonds ended the fourth quarter down 1.9%.

On December 3, members of the G7 formally placed a price cap of \$60 per barrel of Russian oil.<sup>41</sup> The price cap applies to petroleum oils, crude oil, and any oils that originate in or are exported from Russia.<sup>42</sup> The price cap, which came into effect on December 5, aims to reduce Russia's revenues earned from oil exports and curb its ability to finance its invasion of Ukraine.<sup>41</sup> Since Russia invaded Ukraine in February 2022, energy prices have pushed significantly upward. Energy prices surged 60% in 2022, adding to the rising cost of living, particularly in Europe.<sup>43</sup>

### Looking Forward

From our perspective, the interplay between fiscal policymakers, the Federal Reserve, and market participants will determine the trajectory for markets in 2023. As we have seen recently in the U.K., markets have become hypersensitive to increasingly heavy-handed policy decisions. With an inverted Treasury yield curve strongly suggesting a U.S. economic recession, policy decisions become even more critical to determining the magnitude and duration of the economic slowdown and how markets respond to it.

Consistent with last year, we are taking a patient stance, holding all views with an “open hand,” so to speak. Incoming economic data and the policy developments they help shape are fluid and highly uncertain. By implication, fixed views as to where markets will end 2023 are somewhere between silly and hazardous. While we wait for clarity on these topics, we can earn 4% to 5%—returns last experienced more than 15 years ago—on short-term government bonds. We are balancing elevated levels of portfolio liquidity with a diversified portfolio of assets that emphasizes quality and cash flow as much as we believe is prudent.

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Asset class performance was measured using the following benchmarks: U.S. Large Cap Stocks: S&P 500 TR Index; U.S. Small & Micro Cap: Russell 2000 TR Index; Intl Dev Large Cap Stocks: MSCI EAFE GR Index; Emerging & Frontier Market Stocks: MSCI Emerging Markets GR Index; U.S. Intermediate-Term Muni Bonds: Bloomberg Barclays 1-10 (1-12 Yr) Muni Bond TR Index; U.S. Intermediate-Term Bonds: Bloomberg Barclays U.S. Aggregate Bond TR Index; U.S. High Yield Bonds: Bloomberg Barclays U.S. Corporate High Yield TR Index; U.S. Bank Loans: S&P/LSTA U.S. Leveraged Loan Index; Intl Developed Bonds: Bloomberg Barclays Global Aggregate ex-U.S. Index; Emerging & Frontier Market Bonds: JPMorgan EMBI Global Diversified TR Index; U.S. REITs: MSCI U.S. REIT GR Index, Ex U.S. Real Estate Securities: S&P Global Ex-U.S. Property TR Index; Commodity Futures: Bloomberg Commodity TR Index; Midstream Energy: Alerian MLP TR Index; Gold: LBMA Gold Price, U.S. 60/40: 60% S&P 500 TR Index; 40% Bloomberg Barclays U.S. Aggregate Bond TR Index; Global 60/40: 60% MSCI ACWI GR Index; 40% Bloomberg Barclays Global Aggregate Bond TR Index.

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