Q4 2022 Market Update

THE QUARTER IN BRIEF

2022 turned out to be another very difficult year. Widespread vaccination and less lethal strains of COVID-19 led to lower fatality rates, allowing most pandemic-weary populations around the world to move back toward normal activity. However, supply chain disruptions, the lingering effect of fiscal stimulus and Russia's invasion of Ukraine caused inflation to surge to its highest level in 40 years. The Federal Reserve (Fed), like other central banks, tightened aggressively, triggering sharp sell-offs in both fixed income and equity markets. Mid-term elections resulted in a divided government, suggesting little prospect of structural reform to address long-term problems or provide fiscal support should the economy falter. And even as inflation pressures ease at the end of 2022, recession is widely predicted for 2023.

Name	3 Month	1 Year	3 Year	5 Year
S&P 500 Total Return	**9.46%**	-12.74%	27.71%	56.80%
S&P GSCI Commodity Total Return	**-4.85%**	18.88%	37.53%	32.79%
Russell 2000 Total Return	**9.62%**	-11.35%	17.34%	26.51%
Russell 1000 Value Total Return	**13.45%**	-4.49%	23.91%	39.57%
Russell 1000 Growth Total Return	**5.34%**	-21.41%	26.35%	67.25%
MSCI World Ex USA Total Return	**25.00%**	-8.85%	12.55%	15.93%
MSCI Emerging Markets Total Return	**21.16%**	-15.71%	-2.27%	-1.94%
Dow Jones US Real Estate Index Total Return	**15.09%**	-15.88%	4.47%	36.99%
Bloomberg US Treasury	**3.97%**	-9.36%	-5.94%	2.47%
Bloomberg US Aggregate	**5.76%**	-9.44%	-5.76%	3.38%
Bloomberg Municipal Bond	**5.59%**	-5.54%	-0.78%	9.37%

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For investors, however, it is important to look beyond the cycle. While a 2023 recession is quite possible, it should be a mild one if it occurs. More importantly, with inflation continuing to fade and fiscal policy likely on hold, the Fed is likely to end its tightening cycle early in the new year and inflation could begin to ease before the end of 2023. A slower-growing economy will likely temper wage demands, helping stabilize corporate margins after a difficult 2023. By 2024, the U.S. economy may well be back on a path that looks much like that of the late 2010s – slow growth, low inflation, moderate interest rates and strong corporate margins. While this may not represent an exciting prospect for the average American worker or consumer, it is an environment that could be very positive for financial markets.

DOMESTIC MARKETS

2022 was a year characterized by extreme capital market volatility. Uncertainty around inflation that led interest rates to rise sharply, undermining equity market valuations that had been sitting well above long-term averages. Looking ahead to 2023, we are faced with three questions: What is the outlook for earnings? Do valuations have further to fall? And when will volatility decline?

The outlook for earnings will depend on economic growth; if a recession can be avoided, we would expect earnings to be roughly flat relative to 2022 levels. However, if the U.S. economy falls into recession, history suggests earnings could decline by as much as 15%–20%. With inflation only gradually decelerating, rising prices will continue to offset higher costs in certain industries, leaving margins as the key driver of earnings. While margins will continue to decline, they should settle around 10%, rather than falling to the long-term average.

If earnings are expected to be flat to down, how much will investors be willing to pay for these earnings? Although the S&P 500 forward P/E ratio now sits near its long-run average, valuations will decline further if a recession begins to materialize. However, it is not clear that valuations need to retreat to levels seen during prior recessions, as the combination of a mild recession and the higher quality nature of companies suggests markets could find support at higher valuations than in the past. Furthermore, as slower expected growth leads bond yields to decline, equity valuations should find additional support.

Although the outlook for risk assets is improving, plenty of questions remain unanswered. We have seen peak inflation, peak Fed hawkishness and (hopefully) peak geopolitical tensions, but these issues have not gone away and will remain as a source of volatility. However, if we do experience a mild recession this year, markets will begin to look to the coming cycle well in advance of the economic data improving. In fact, since 1960, the S&P 500 has bottomed an average of 6 months before the unemployment rate has peaked. However, until we have further clarity, we will focus on companies with pricing power and consistent cash flows that are trading at reasonable valuations.

LOOKING FORWARD

Looking forward to 2023, investors will continue to face a difficult and confusing environment, including the lingering impacts of COVID-19, the war in Ukraine and fears of fading inflation transitioning to concerns about recession. However, long-term investors should try to look beyond short-term challenges and uncertainties and recognize that better valuations at the end of 2022 should present opportunities going forward. The unifying theme, then, for 2023 is that while uncertainty remains, there is more upside potential than downside risk in global capital markets.

CoreSat Model Update

Core Allocation

Continue to focus on quality companies both domestic and foreign as inflation peaks but recession odds tick higher.

For domestic equities, United States value continues to trade at a discount and strong operating leverage within certain value sectors should support earnings growth. A modification to our domestic equity allocation was made to include a strategy that invests in the S&P 500 after-hours market. The after-hours market has shown to provide differentiated positive returns with less volatility and risk. Overall, we remain overweight value and high-quality growth.

Outside of the U.S., foreign markets struggled in 2022, however more recently they have outperformed US domestic equities. Moving into 2023, we are cautious about international allocations, but recognize that an overvalued dollar and inexpensive valuations should be tailwinds for these markets. As such we have increased our international equity exposure with a focus on shareholder value for both foreign developed and emerging markets. We have also added exposure to China.

Across asset classes, diversification has been challenging, with positive stock/bond correlations through 2022. While falling inflation should reverse this trend, we still want to own alternatives for additional diversification benefits, in addition to the enhanced income and return potential that these assets can provide.

The fixed income allocation has been adjusted to reduce duration, but also take advantage of the sweet spot with regards to yields.

Commodity allocation has shifted from broad diversified index exposure to focus on metals, which typically perform well in the current economic environment, and with the increase in spending for infrastructure.

Satellite Allocation - Tactical

The satellite allocation continues to focus on volatility reduction, and performance diversification by stacking returns outside traditional equities and fixed income. This can be executed with static allocations to various asset classes outside of equities and bonds, or by using tactical trend following strategies that can invest in a variety of asset classes both long and short, using a rules-based systematic approach. We prefer using tactical strategies due to their all-weather go-anywhere approach, which typically produce better risk adjusted returns over time. Based on the current economic environment, we have adjusted the tactical allocation by replacing a fund strategy with another that is better suited to the current environment. We have also added a hedge fund tracking ETF that will essentially replicate broad hedge fund exposures across asset classes and strategies. The goal of these adaptive allocation strategies is to provide differentiated return streams, stacking returns from non-correlated markets and strategies with the goal of providing better risk adjusted returns. The combination of core and satellite allocations are designed to provide a robust approach that diversifies across geographic regions, asset classes, and investment styles.

Drew Corradetti, CMT
Chief Investment Officer

CITATIONS: Morningstar, JP Morgan Asset Management, YCharts, Bloomberg

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3250 Hillcrest Park Drive, Suite 102
Medford, Oregon 97504

Direct: (541) 902-7272
Fax: (541) 779-1916

www.oregonpacificwealth.com
team@oregonpacificwealth.com