

DOLL'S DELIBERATIONS

WEEKLY INVESTMENT COMMENTARY

SUMMARY:

2022 was a year for the history books. After stocks and bonds both declined for each of the first three quarters (not seen in 50 years), the fourth quarter rally was welcome. The rise in interest rates and compression in equity valuations stemmed from the worst inflation in 40 years, even as earnings estimates improved for the first six months of the year. Volatility was high for both stocks and bonds adding to the consternation.

As things currently stand, we will achieve 7.5 correct predictions for 2022, consistent with our long-term average of 7.0-7.5. Here is a brief rundown of the 2022 predictions.

1. U.S. real growth and inflation remain above-trend but decline from 2021 levels.

Real GDP did decline from 2021 levels but was not above trend; conversely, inflation was above trend, but did not decline. Needless to say, nominal growth was significantly above trend and above 2021 levels, but the mix (too little real growth, too much inflation) was problematic. **(1/2 correct)**

2. Inflation falls, but core inflation remains stuck at around 3%.

The notion that core inflation has risen and is stuck is an accurate reflection of the changed environment in the U.S. economy. And, of course, inflation has been falling over the last several months, but has not fallen below year-end 2021 levels. **(1/2 correct)**

3. For the first time since 1958/1959, 10-year Treasuries provide a second year of negative returns.

The rise in Treasury yields (and the fall in bond prices) during 2022 has been breathtaking. On top of last year's fall, the two-year decline in the price of a ten-year Treasury has eclipsed all modern records. Thankfully, bonds have never had three years in a row of negative total return. **(✓ - Correct)**

4. Stocks experience their first 10% correction since the pandemic and fail to make the gains widely expected.

We were in a small minority at the beginning of the year arguing for a down equity year. Of course, we didn't expect the carnage to be as severe as it was. And the first half of the year was the first in history to be down more than 20% while earnings expectations moved higher. **(✓ - Correct)**

5. Cyclical, value, and small stocks outperform defensive, growth, and large stocks.

Cyclicals got clobbered by defensives, value trounced growth and small vs. big remains close. Economic weakness and recession concerns caused defensives to beat cyclicals. Rising interest rates, among other things, allowed value to beat growth. Small stocks remain cheap versus big ones. **(1/2 correct)**

6. Financials and energy outperform utilities and communication services.

Thanks to the energy sector's massive outperformance (best sector in 2022) and communication services underperformance (worst sector in 2022), this prediction is solidly in the money. Financials and utilities both outperformed but have made little difference to the overall results of this prediction. **(✓ - Correct)**

7. International stocks outperform the U.S. for only the second year in the last decade.

This one could come down to a potential photo finish. As of this writing, international stocks are 85 basis points ahead of U.S. stocks year to date. This close is amazing given the strength of the U.S. dollar. (✓ - Correct)

8. Values-based investing continues to gain share.

While information is more anecdotal than ideal to evaluate this prediction, it is clear that the dialogue, education and adoption of values-based investment management is on the upswing. We are witnessing more and more individuals and institutions desiring to line up their portfolios with their values (despite all the ESG "noise"). (✓ - Correct)

9. After a 60+ year low in 2021, federal interest expense as a percentage of revenue begins a long-term move higher.

With interest rates rising as fast as they have in 2022, this prediction has looked as easy as "shooting fish in a barrel". And with debt rising rapidly and interest rates unlikely to fall much, if at all, onerous consequences are likely to be seen as this trend continues. (✓ - Correct)

10. Republicans gain at least 20-25 House seats and barely win the Senate.

Well, this one, according to the polls, looked solid going into election day. Needless to say, we missed the mark on this prediction. The usual mid-term election results of the incumbent party losing ground, especially with disapproval rates so high, did not materialize. (X – incorrect)

IN SUMMARY

Looking ahead to 2023, the big investment question is whether or not the U.S. experiences a recession. We think that call will depend on whether the Fed sticks to its goal of a 2% inflation rate (which will require more tightening and cause a recession with high probability) or acquiesces to a 3-4% rate (in which case a soft landing may be possible). In either event, earnings estimates are too high which probably puts a lid on significant upside to equities.

The next issue of Doll's Deliberations will be released on December 30 at 4PM ET outlining our best efforts for 2023 predictions. In the meantime, we at Crossmark wish all of you a very happy holiday season and best wishes for 2023.

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