Q4 2022

Advisor Group

MARKET VIEW QUARTERLY

Philip Blancato | PRESIDENT AND CEO OF LADENBURG ASSET MANAGEMENT AND CHIEF MARKET STRATEGIST, ADVISOR GROUPP

2022 proved to be a particularly challenging year for investors. The market narrative was shaped by stickier than expected inflation which forced global central banks to raise rates at the quickest pace in history. The tightening led to recessionary fears, causing the S&P 500 Index to decline for three consecutive quarters, the longest quarterly losing streak since 2009 (when the market fell for six consecutive quarters).[3] Similarly, among fixed-income securities, there was no refuge. Interest rates spiked across the yield curve, thereby sinking all investment-grade and high yield bonds alike. As a result, the traditional 60/40 portfolio (60% S&P 500 Index/40% Bloomberg US Aggregate Bond Index) declined the most since 2008, returning -16.07% for 2022.[3] It is rare for stocks and bonds to fall in the same year, as it has happened just four times before this year going back to 1928.[1] Although 2022 was terrible for a diversified mix of stocks and bonds, if we zoom out, the returns leading up to this year show that history favors diversification. In the 3, 5, and 10 years ending in 2021, a 60/40 portfolio of U.S. stocks and bonds was up 63%, 81%, and 184%, respectively.[2] Therefore, we continue to believe that a diversified asset allocation of stocks and bonds can continue to provide solid investment returns in 2023 and beyond.

DOMESTIC EQUITIES

It has been a difficult year for investors with every major equity asset class posting negative returns. The rebound over the past couple of months has provided investors with some relief; we feel this trend can continue and that ultimately the worst is behind us in terms of equity market pain. The S&P 500 was up +7.56% for the fourth quarter but finished 2022 down -18.11%. From an investment style perspective, mature, dividend-paying companies were most in favor for investors during the fourth quarter. As a result, the Russell 1000 Value index returned +12.42%[4] for the fourth quarter versus +2.20%[3] for the Russell 1000 Growth index. Small cap stocks lagged their larger cap peers during the market rally we witnessed during the fourth quarter. Small caps returned +6.23% for the fourth quarter versus +9.18% for mid-caps and +7.24% for large cap equities.[3] We acknowledge that we could continue to see volatility in 2023, however, some positives could cushion the blow of any economic downturn and propel equities to positive performance one again. For one, household and corporate balance sheets are in good shape. Aside from inflation, there are no significant obvious economic imbalances. Similarly, although inflation continues to eat into wages, the equilibrium point is closer now than it has been at any point over the past 20 months. Wage growth came in at 6.4% in November, only slightly below the year-over-year Consumer Price Index (CPI) growth rate of 7.1%.[8] Lastly, we believe that the Federal Reserve (Fed) will end their rate hiking cycle. Historically, over the 12-months following a Fed pause, on average, the S&P 500 Index returns 15%.[4]

INTERNATIONAL EQUITIES

Historically, international stocks outperformed 94% of the time when U.S. stocks returned less than 6%.[5] We saw that exemplified this year with the MSCI EAFE Index, a benchmark of developed foreign country stocks, down -14.45% in the fourth quarter vs. the S&P 500's return of -18.11% over the same time period.[3] The biggest driver of international returns over the fourth quarter was the falling dollar, down -8.30%. As the U.S. dollar falls, developed markets are more attractive to U.S. investors. Furthermore, another tailwind was the rotation into value-oriented stocks as the developed international equity market (mainly Europe and Japan) is much more value-focused than the U.S. market, based on the MSCI EAFE Index and the S&P 500 Index. The MSCI Emerging Markets (EM) Index was down -20.09% for the year 2022 as EM equities made a recovery during the fourth quarter due to the Chinese economy exiting their zero-COVID government rules, after having spent most of 2022 under intense restrictions.[3] Going forward, we believe that the international and emerging market space could experience increased volatility relative to the United States due to the geopolitical risks that are still present after Russia's invasion of Ukraine last February. On top of this, any rotation back into growth and technology stocks in 2023, should result in domestic stock outperformance relative to International and EM stocks. Ultimately, while we currently favor domestic stocks, we do acknowledge that international stocks are significantly cheaper than their U.S. counterparts which may create an attractive entry point if there's an economic recovery in Europe or EM later in the year.

FIXED INCOME

Bond investors will remember 2022 as a year of forced adjustment to a drastically different environment. While the benchmark 10-year U.S. Treasury note yielded just 1.5% at the end of 2021, things changed quickly in 2022. The yield on the 10-year Treasury rose throughout most of 2022, topping 4% in October, a level not reached since April 2010.[6] The 10-year yield ultimately ended 2022 at 3.87%.[9] The importance of the rise in yields is twofold for investors. For one, when yields rise, prices of bonds fall. This negatively impacts bond investments, which can be exemplified by the return of the Bloomberg US Aggregate Bond Index, which returned -13.01% for 2022.[3] This was the worst year for bond investments in history. The Bloomberg US Aggregate Bond Index dates back to 1976 and in those 40+ years of calendar year returns there were only four down years before 2022. The takeaway, investors felt considerable pain in the part of their portfolio that typically provides steady returns with consistent income. Secondarily, the rise in the 10-year yield is significant because it is considered the benchmark for rates on most types of debt. This means higher borrowing costs for consumer loans and mortgages. Multiple factors contributed to bond yields spiking in 2022. Aggressive stimulus measures in 2020 and 2021, rising demand for goods and services, and supply chain disruptions contributed to a surge of inflation. Then, inflation was exacerbated by the Russia-Ukraine war. Higher prices have the potential to hurt consumer demand and drag on economic growth and therefore, the Fed was forced to step up, in attempts to keep inflation under control. As a result, from March through December, the Fed aggressively raised the short-term borrowing rate by 4.00%.[8] Making money more expensive to borrow can temper demand relatively quickly. As buying a house or a car or expanding a business becomes pricier, people pull back from doing those things. With fewer consumers and companies competing for the available supply of goods and services, price gains can moderate. This is what happened during the second half of the year, which one can see by reviewing the change in inflation throughout 2022. After peaking in June at 9.1%, the annual inflation rate as measured by the Consumer Price Index (CPI) slowed for a fifth consecutive month to 7.1% in November.[8] The fastest rate-rise in history seen over the past year brought about a substantial revaluation in bond markets, and over the near term, rates should hover around current levels until inflation pressures abate and central bank policy tightening comes to an end. However, investors can take advantage of this environment, with bonds offering higher yields going forward, stronger overall returns could be ahead.

ALTERNATIVES

During rising inflation, real assets have generally offered more competitive returns because inflation boosts economic activity. Accelerated economic activity pushes commodity prices higher while the demand for goods increases in line with consumption gains and building activity. In an otherwise challenging year for equities and fixed income, real assets across the spectrum benefited from the inflationary environment. As the quarter ended, the West Texas Crude Index (WTI) and Brent prices benefitted from China's reversal of the Covid-Zero policy, lifting the demand outlook in the world's top crude importer. The prospect of a production cut by Russia also supported oil prices. U.S. natural gas prices fell in December to their lowest price since March,[8] on prospects of a warmer-than-expected winter season, suggesting a build-up in the inventories and low usage of the existing fuel during the season. Our expectation is for oil to act differently than most asset classes and maintain price strength supported by improving global demand. Hedged equity strategies designed to capture a portion of total returns of a benchmark at a reduced level of volatility performed in line with expectations during the quarter, providing downside protection while mitigating market risk.

REAL ESTATE

Homebuilder confidence deteriorated for the 12th consecutive month in December, according to the National Association of Home Builders' monthly confidence index. The index's fall of -63% (from 84 a year ago to 31) in December represents a new 12-month record, but not the most significant drop we've seen.[6] That record belongs to the -89% drop from December 2004 to January 2009. Housing Starts for November reported above expectations at 1.43 million, representing an annual decline of -16.4%.[9] Building Permits, which serve as a proxy for future starts, reported significantly below expectations at 1.34 million; versus the market consensus of 1.48 million, a -22.4% decline versus last year.[8] November's early bump in mortgage rates above 7% impaired sales and curtailed home prices, but there are early signs that demand may be creeping back as rates reverse course. Redfin's Homebuyer Demand Index, as well as the number of mortgage applications, have been on the rise, while the number of canceled home-purchase agreements in November fell.[8] However, until a compelling reduction in interest rates materializes, we expect to see continued softening in real estate.

CONCLUSION

A confluence of negative events best characterizes 2022; one of the most aggressive instances of monetary policy tightening on record, two consecutive periods of contracting GDP, soaring inflation, and a war between Russia and Ukraine. Together, these all caused considerable turmoil across equity and fixed income markets. However, as we move into 2023, we see elements in the economic data that could avoid a harsh recession and potentially even achieve a soft landing. The back-to-back lower-than-expected increases in monthly CPI numbers for November and December present a more comforting picture for financial markets.[9] Similarly, the economy expanded in the third quarter, emerging from two negative quarters of growth. Economists expect positive growth numbers will be seen for the fourth quarter as well. The war in Ukraine persists, however supply chain issues stemming from a slower Eurozone recovery and China COVID lockdowns continue to improve, which should continue to have a positive impact on inflation readings going forward. Though inflation has put a slight strain on household budgets, employment has been a relative bright spot in the mixed economic environment. Unemployment remained low at 3.7% for the November reading and job creation continued, albeit at a slower pace than in recent months.8 The main takeaway is that the current level of job openings is almost 11 million, which means there is still 1.7 open jobs per unemployed American.[8] This should allow for much less job losses that come with the average recession. The S&P 500 Index entered bear market territory in 2022. Since 1950, the S&P 500's median return after closing in a bear market is +23.9% one year later. While we wouldn't be surprised by continued volatility, a potential bottoming in the equity markets and peak in yields, should result in a mild grind higher for equity and fixed income markets; a favorable environment for diversified multi-asset portfolios.

Economic Definitions

GDP: Gross domestic product (GDP) measures the final market value of all goods and services produced within a country. It is the most frequently used indicator of economic activity. The GDP by expenditure approach measures total final expenditures (at purchasers' prices), including exports less imports. This concept is adjusted for inflation.

Unemployment Rate: The unemployment rate tracks the number of unemployed persons as a percentage of the labor force (the total number of employed plus unemployed). These figures generally come from a household labor force survey.

CPI (headline and core): Consumer prices (CPI) are a measure of prices paid by consumers for a market basket of consumer goods and services. The yearly (or monthly) growth rates represent the inflation rate.

Housing Starts: Housing (or building) starts track the number of new housing units (or buildings) that have been started during the reference period.

Building Permits: This concept tracks the number of permits that have been issued for new construction, additions to pre-existing structures or major renovations. These statistics are based on the number of construction permits approved

West Texas Intermediate (WTI): West Texas Intermediate (WTI) is crude stream produced in Texas and southern Oklahoma which serves as a reference or "marker" for pricing a number of other crude streams and which is traded in the domestic spot market at Cushing, Oklahoma.

Brent: Brent Crude Oil is a blended crude stream produced in the North Sea region which serves as a reference or "marker" for pricing a number of other crude streams.

Natural Gas: Natural Gas Spot market (natural gas) is a market in which natural gas is bought and sold for immediate or very near-term delivery, usually for a period of 30 days or less. The transaction does not imply a continuing arrangement between the buyer and the seller. A spot market is more likely to develop at a location with numerous pipeline interconnections, thus allowing for a large number of buyers and sellers. The henry hub in southern Louisiana is the best-known spot market for natural gas and is the delivery point for the natural gas futures contract on the New York Mercantile Exchange (NYMEX).

The Federal Reserve System: The central bank of the United States. It performs several general functions to promote the effective operation of the U.S. economy and, more generally, the public interest.

Index Definitions

S&P 500: The S&P 500® is widely regarded as the best single gauge of large-cap U.S. equities and serves as the foundation for a wide range of investment products. The index includes 500 leading companies and captures approximately 80% coverage of available market capitalization.

NASDAQ: The NASDAQ Composite Index is a broad-based capitalization-weighted index of stocks in all three NASDAQ tiers: Global Select, Global Market and Capital Market. The index was developed with a base level of 100 as of February 5, 1971.

Dow Jones Industrial Average: The Dow Jones Industrial Average is a price-weighted average of 30 blue-chip stocks that are generally the leaders in their industry. It has been a widely followed indicator of the stock market since October 1, 1928.

Russell 1000 Value: Russell 1000 Value Index measures the performance of those Russell 1000 companies with lower price-to-book ratios and lower forecasted growth values. The index was developed with a base value of 200 as of August 31, 1992.

Russell 1000 Growth: Russell 1000 Growth Index measures the performance of those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values. The index was developed with a base value of 200 as of August 31, 1992.

Russell Mid-Cap: Russell Midcap Index measures the performance of the 800 smallest companies in the Russell 1000 Index, which represent approximately 25% of the total market capitalization of the Russell 1000 Index.

Russell 2000: The Russell 2000 Index is comprised of the smallest 2000 companies in the Russell 3000 Index, representing approximately 8% of the Russell 3000 total market capitalization. The real-time value is calculated with a base value of 135.00 as of December 31, 1986. The end-of-day value is calculated with a base value of 100.00 as of December 29, 1978.

MSCI EAFE: The MSCI EAFE Index is a free-float weighted equity index. The index was developed with a base value of 100 as of December 31, 1969. The MSCI EAFE region covers DM countries in Europe, Australasia, Israel, and the Far East.

MSCI EM: The MSCI EM (Emerging Markets) Index is a free-float weighted equity index that captures large and mid-cap representation across Emerging Markets (EM) countries. The index covers approximately 85% of the free float-adjusted market capitalization in each country.

Bloomberg Barclays US Agg Bond: The Bloomberg Barclays US Aggregate Bond Index is a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate pass-throughs), ABS and CMBS (agency and non-agency).

Bloomberg Barclays High Yield Corp: The Bloomberg Barclays US Corporate High Yield Bond Index measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below. Bonds from issuers with an emerging markets country of risk, based on Barclays EM country definition, are excluded.

Redfin Housing Demand Index: The Redfin Housing Demand Index is the industry's first and only measure of housing activity prior to purchase. It is based on thousands of Redfin customers requesting home tours and writing offers in 15 major metro areas. The Demand Index is seasonally adjusted, with 100 representing the baseline level of homebuyer demand posted in January 2014. All periods thereafter can be compared to one another in a relative sense.

National Association of Home Builders Confidence Index: The National Association of Home Builders Confidence Index also known as the NAHB/Wells Fargo Housing Market Index (HMI) is based on a monthly survey of NAHB members designed to take the pulse of the single-family housing market. The survey asks respondents to rate market conditions for the sale of new homes at the present time and in the next six months as well as the traffic of prospective buyers of new homes.

DISCLOSURES

1 https://awealthofcommonsense.com/2022/12/9-things-that-surprised-me-in-2022/.

2 https://awealthofcommonsense.com/2022/11/the-markets-cant-save-you-if-you-dont-save/.

3 Data obtained from Morningstar as of 12/31/2022.

4 Apollo Global Management, Inc. Insights.

5 https://www.blackrock.com/us/financial-professionals/literature/investor-education/why-bother-with-international-stocks.pdf.

6 https://www.usbank.com/investing/financial-perspectives/market-news/interest-rates-affect-bonds.html#:~:text=Rising%20bond%20prices%20are%20generally,function%20of%20supply%20and%20demand.

7 https://www.nytimes.com/2022/09/21/business/interest-rates-inflation.html.

8 Data Obtained from Bloomberg as of 12/31/2022.

9 How the S&P 500 Performs After Closing in a Bear Market (WSJ.com).

20 E. Thomas Rd., Suite 2000 • Phoenix, AZ 85012 • 866-481-0379 • **advisorgroup.com**