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Hightower Investment Solutions: 2022 Market Recap and 2023 Outlook

The Impact of 425 bps

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2022: The Year of Inflation and the Fed

In response to soaring inflation and low unemployment, the Fed implemented a restrictive policy in 2022, which included a historic pace of rate hikes and shrinking balance sheet.

This marked a significant pivot from the past decade of easy monetary policy, which included the Fed more than doubling its balance sheet during the pandemic.

Inflation data has begun to respond to the Fed's restrictive policy as demand softens amid higher rates.

2022: The Year of Inflation and the Fed

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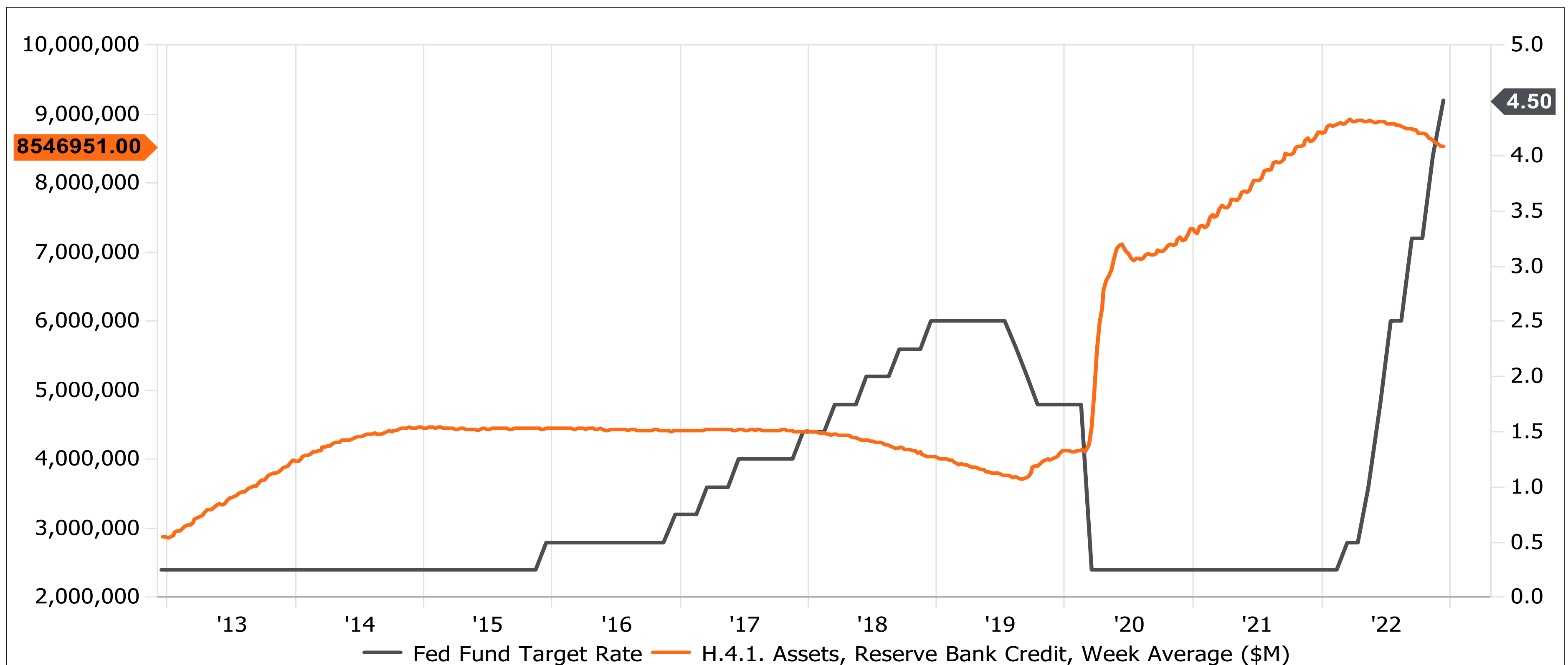
The Fed's actions tend to have a 9-12 month lag as higher rates and lower liquidity in debt markets make their way through the economy. In 2023, the full impact of the Fed's actions will be felt, and we've begun to see leading economic indicators highlight lower costs and softening demand.

The Fed's dual mandate includes price stability and maximum employment. Labor markets remain tight with low unemployment. The Fed has predicted a 5.1% fed funds target rate in 2023, along with a rising unemployment rate and little GDP growth.

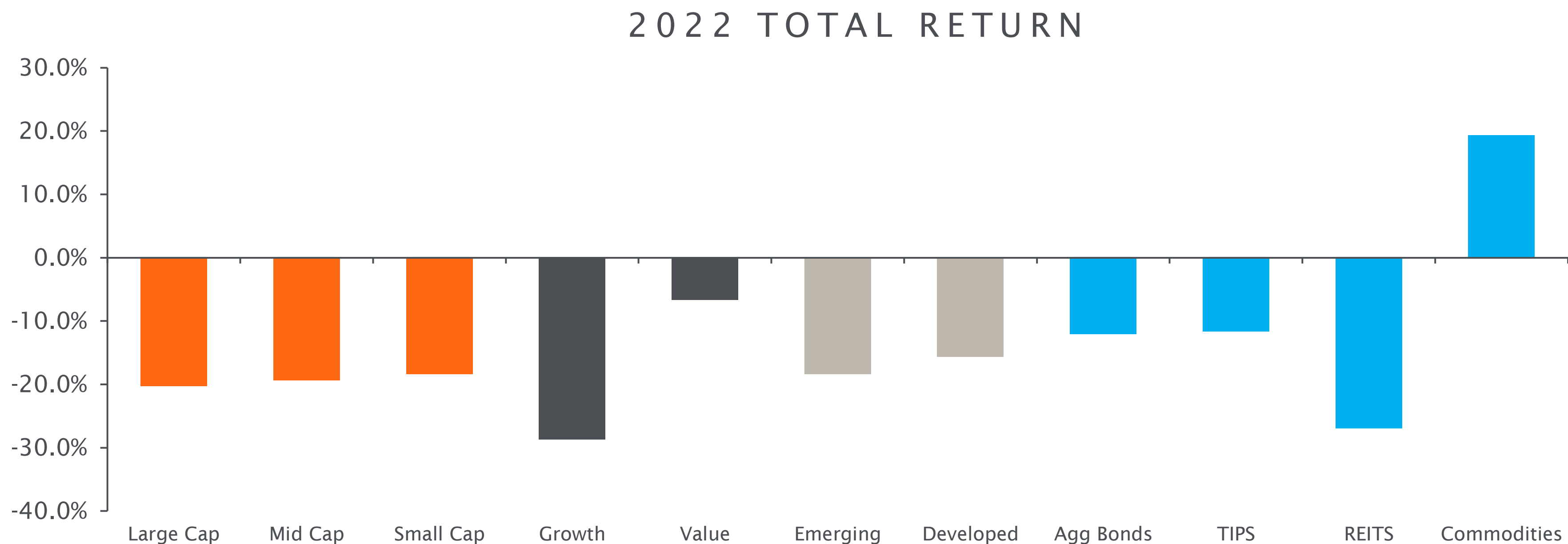
FED TIGHTENING POLICY



Source: FactSet (chart). As of December 20, 2022.

2022 Market Reaction

- Equities and fixed income asset classes both moved lower in 2022. Broad selloff was generated by rising rates and slowing growth from restrictive monetary policy.
- Of the asset class categories that we track below, commodities (+19%) and value stocks (-7%) outperformed. Growth stocks (-29%) and real estate (-27%) were the worst performing asset classes.
- Value equities outperformed growth equities by 22%, while shorter-duration bonds outperformed longer-duration bonds.
- Commodities was the only asset class that was higher in 2022. Commodities' performance was uncorrelated with that of other asset classes, and inflation drove higher prices throughout the first half.



Source: FactSet (chart). As of December 20, 2022.

2023: The Impact of 425 bps

The Fed pivoted its policy in 2022 – tightening monetary policy at a historic pace and restricting economic demand. Over the course of 9 months, the Fed raised rates 425 bps and began shrinking its balance sheet.

Monetary policy has a long and variable lag, as policy works its way through the economy. In 2023, we anticipate the impact of restrictive monetary policy to be felt more broadly.

Higher interest rates will likely ease some labor market tightness and slow economic demand. Meanwhile, better price stability will support lower costs for consumers and businesses alike.

Market Anticipates Rate Cuts, Fed Says There's Still "A Ways To Go"

2022

Markets are a forward-discounting mechanism. The S&P 500 is down (20%) in 2022. A lot of bad news is priced in. Inflation, which was a major concern for most of the year, is falling. While the Fed is expected to remain restrictive, the fed funds target rate is likely near peak. Unemployment remains low, consumer balance sheets are still healthy, and wages are strong.

The United States continues to be a preferred market for investing. There are higher yielding opportunities in fixed income, the U.S. consumer is strong, and a weaker U.S. dollar may help support corporate profits in 2023. The U.S. is investing heavily in supply chain and transportation infrastructure, which will benefit U.S. jobs and industries, while reducing dependency on global suppliers.

2023

"Higher for longer" Fed policy means that rates are not going back to zero. Restrictive policy will continue to support value stocks' outperformance throughout most of 2023. It's possible we see a rate cut late in the year, but we expect restrictive policy, slower growth and loosening labor markets in 2023.

The yield curve is inverted, indicating the Fed will eventually cut rates and a possible recession. We're keeping a close eye on the health of the consumer. If inflation continues to fall, the Fed pauses rate hikes, and there is some recovery in housing markets, we'd feel strongly about the consumer.

Corporate profits will benefit from lower input costs, but margin pressure may still occur from wage inflation and a demand slowdown.

In 2023, we will experience the effects from 425 bps of Fed rate hikes.

Data as of December 20, 2022.

Inflation in Focus

While inflation has retreated from a mid-summer peak, levels remain much too high, and the Fed continues to target a 2% annual inflation rate. Progress on inflation is ongoing, but we anticipate the Fed to execute a restrictive policy throughout most of 2023.

Consumers benefit from lower inflation. Prices have come down for things like gasoline and discretionary goods. Higher wages are another component to inflation that benefits the consumer but creates stickier price increases, particularly across service industries, like hospitality.

Inflation in Focus

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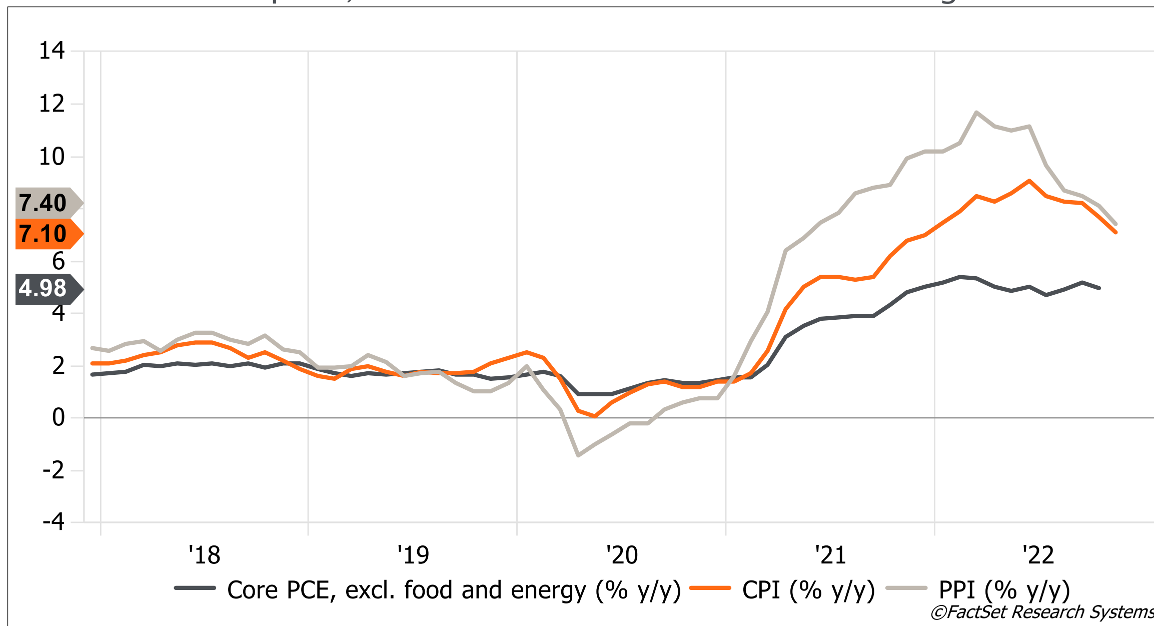
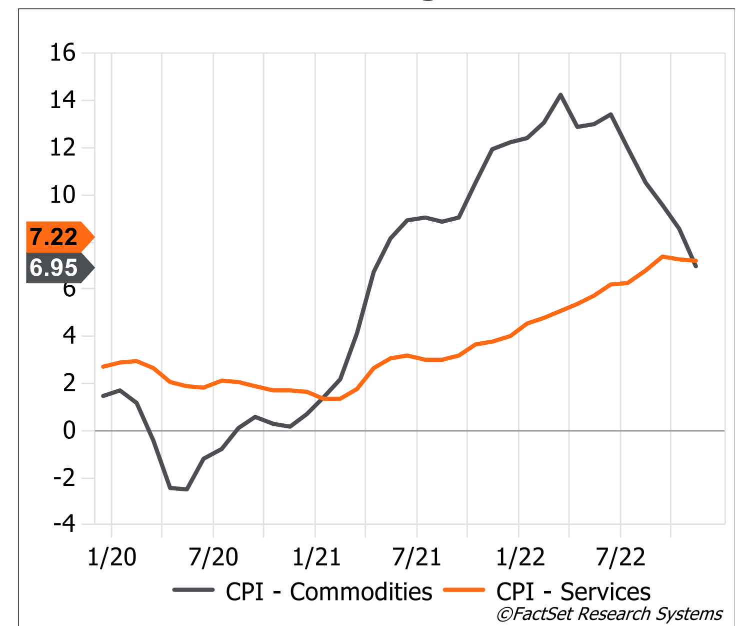
Restrictive monetary policy has had a significant impact on rate-sensitive industries, particularly housing. Higher rates and inflation have also softened demand for certain discretionary goods and have led to consumers "trading down" for certain items (e.g., bargain hunting, choosing store brand vs. preferred brand). Many retailers are managing excess inventories as demand has slowed and supply chains have eased. Discount programs are abundant and, along with lower supply chain costs, have helped to soften goods inflation through the second half of 2022.

Inflation in service industries has continued to remain sticky. Reopening trends, continued hiring and overall resilient demand has stimulated higher prices. Companies are paying higher wages to meet demand and raising prices to support margins. Services represent roughly 80% of the U.S. economy.

Inflation below peak, Core PCE still well-above Fed's 2% target



Goods inflation retreating more than services



Source: FactSet (charts). As of December 20, 2022.

In response to the Fed’s rate hikes, yields have shifted up across the curve. Action in bond markets has largely been duration-driven; security prices are reacting based on their sensitivity toward interest rates.

In addition to higher rates across the curve, the U.S. Treasury curve has become significantly inverted. Curve inversion has historically been correlated with slower economic growth and/or a possible recession.

Rates and Yields Respond

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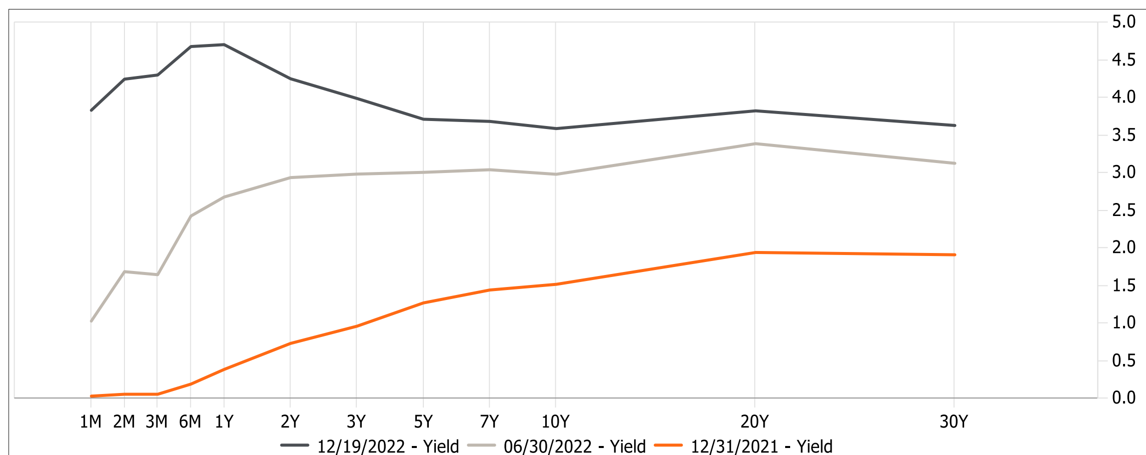
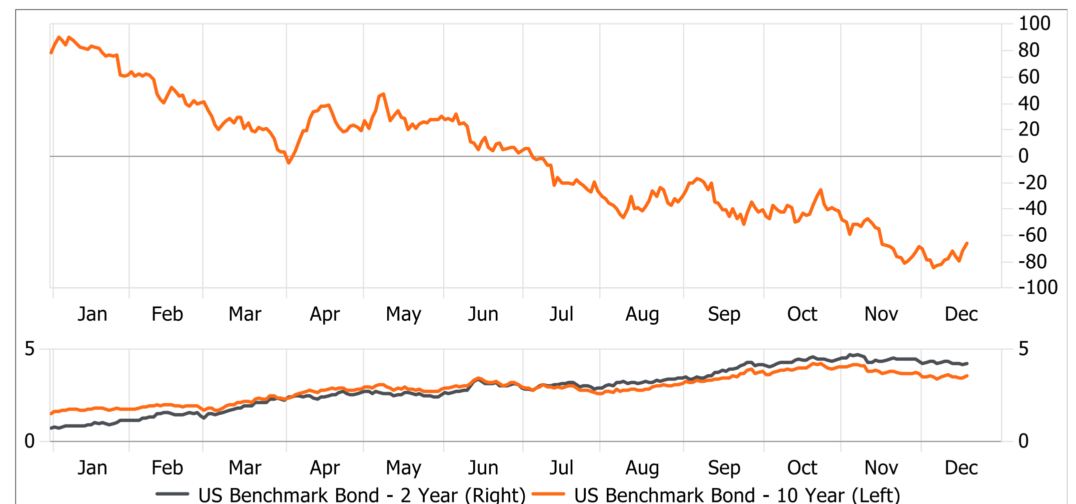
The opportunity in fixed income investing is much greater with positive real rates of return. Return potential is generated from an expectation that we are near a peak fed funds rate. Inflation is moving lower, and credit spreads remain supportive.



Yield Curve Has Steadily Risen Throughout 2022

Curve Is Near Peak Inversion, Indicated by 2/10-year Spread



Source: FactSet (charts). As of December 20, 2022.

Demand Slows, Labor Remains Tight

After mass layoffs during the pandemic, companies have had to rehire. Effects from the pandemic, including early retirements, have created a tight labor market, with a low unemployment rate and higher wages. Labor demand is five million people higher than labor supply. Unemployment tends to lag an economic downturn and could remain tight for most of 2023.

The Fed has sought to slow demand with tighter monetary policy, but excess pandemic savings and higher wages have supported healthy demand and pricing power for certain industries.

Demand Slows, Labor Remains Tight

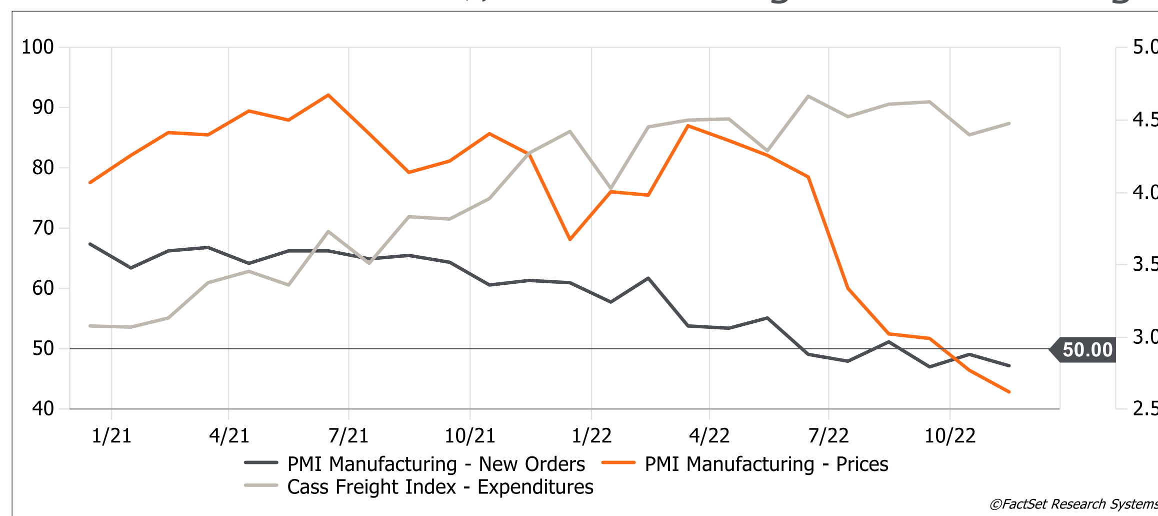
As monetary policy works its way through the economy with a long and variable lag, demand is clearly slowing in certain sectors.

Interest rate sensitive sectors, like housing, have clearly experienced a slowdown. Now, a broader slowdown is occurring – noted by leading indicators like PMI surveys and freight rates.

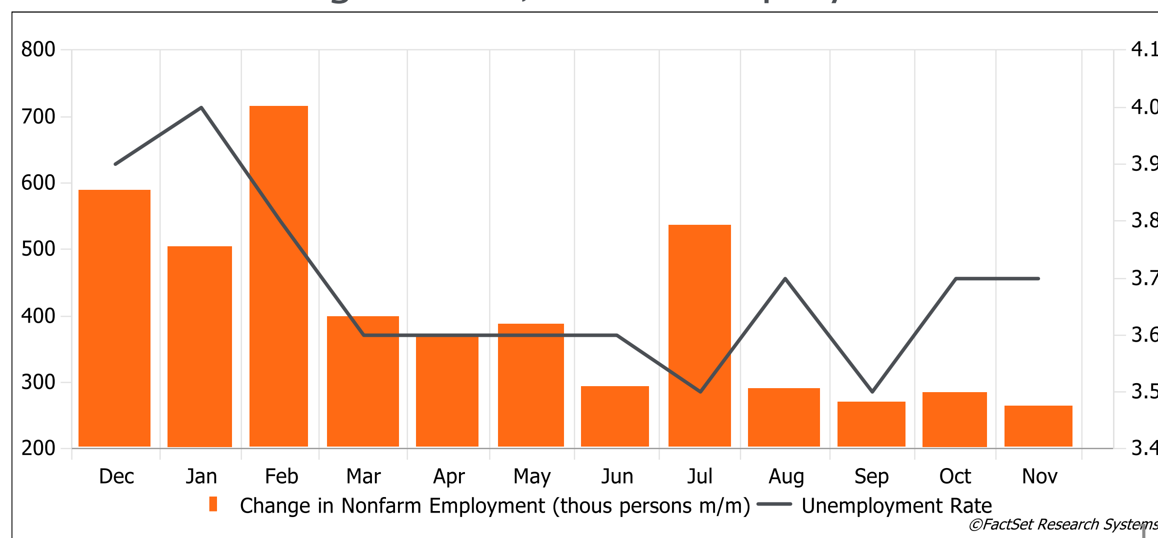
Overall, wages are higher (+7.6% y/y) and hiring growth has slowed. Most industries are near or above pre-pandemic levels of employment.

Some industries, like transportation and warehousing and retail trade, experienced negative hiring growth during the second-half of 2022. Others, like health care and hospitality, continue to experience labor tightness and strong hiring trends.

Manufacturing New Orders and Price Contraction (<50 Indicates Contraction), Elevated Freight Rates Slowing



Slower Hiring Growth, Low Unemployment Rate



Source: FactSet (charts). As of December 20, 2022.

The Health of the Economy: GDP, Earnings and the Consumer

The Fed's latest projection indicates just +0.5% GDP growth and a rising, 4.6% unemployment rate in 2023.

Flat economic growth and higher unemployment would reflect reduced spending and conservative earnings expectations.

The U.S. economy will likely derive support from lower inflationary costs, strong wages and more efficient supply chains.

The Health of the Economy: GDP, Earnings and the Consumer

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The consumer has benefitted from excess savings and higher wages, which have supported resilient demand amid inflationary cost pressures.

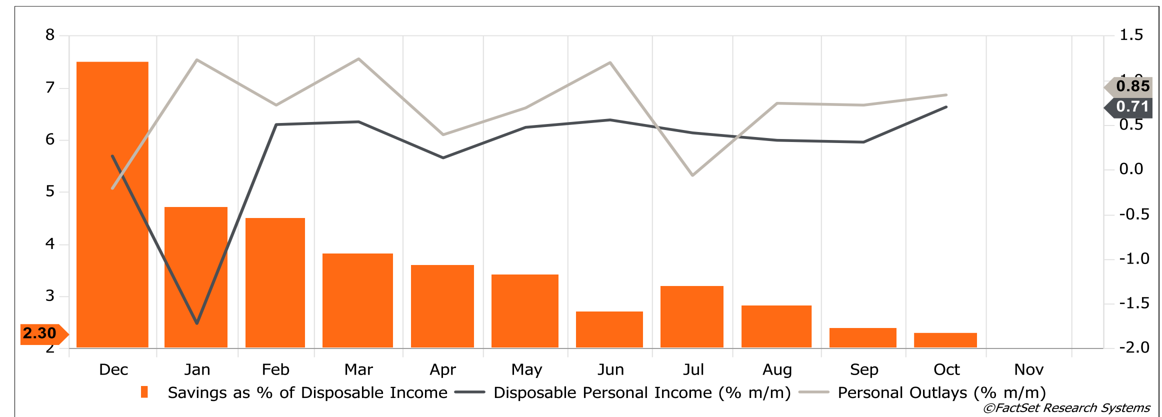
We are paying attention to outstanding credit and delinquency rates, which might indicate deteriorating consumer balance sheets.

Retail sales have softened, while demand strength for services has remained elevated. Demand in 2023 will not be a singular trend – there will be pockets of strength and weakness.

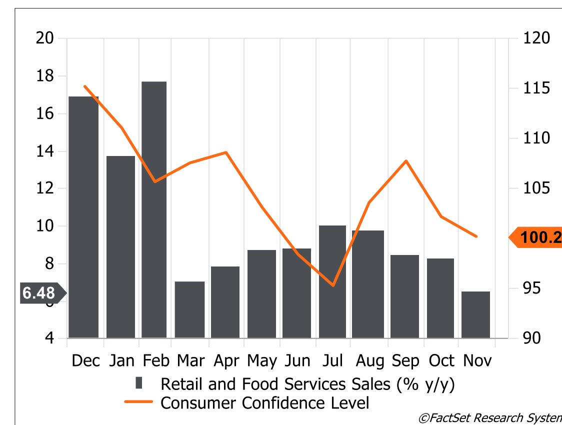
Companies have released conservative guidance and are lowering 2023 expectations. Lower expectations have resulted in markets, as forward-looking mechanisms, pricing in downward earnings revisions.

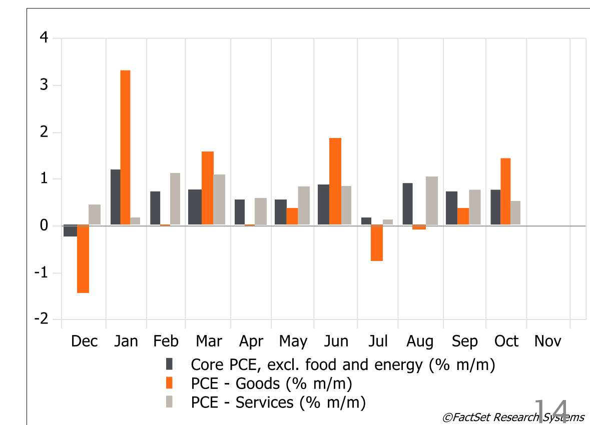
Despite these expectations, lower input costs (e.g., materials, freight, fuel) and more favorable currency rates may support earnings in 2023. A sharper-than-expected drop in inflation due to more efficient supply may also support consumer demand.

Consumer Savings Impacted by Higher Spending, Despite Rising Income



Discretionary Retail Spending Tends to Move with Consumer Confidence. Spending Growth Has Slowed, but Expenditures Across Most Goods and Services Categories Have Continued to Rise Each Month in 2022.



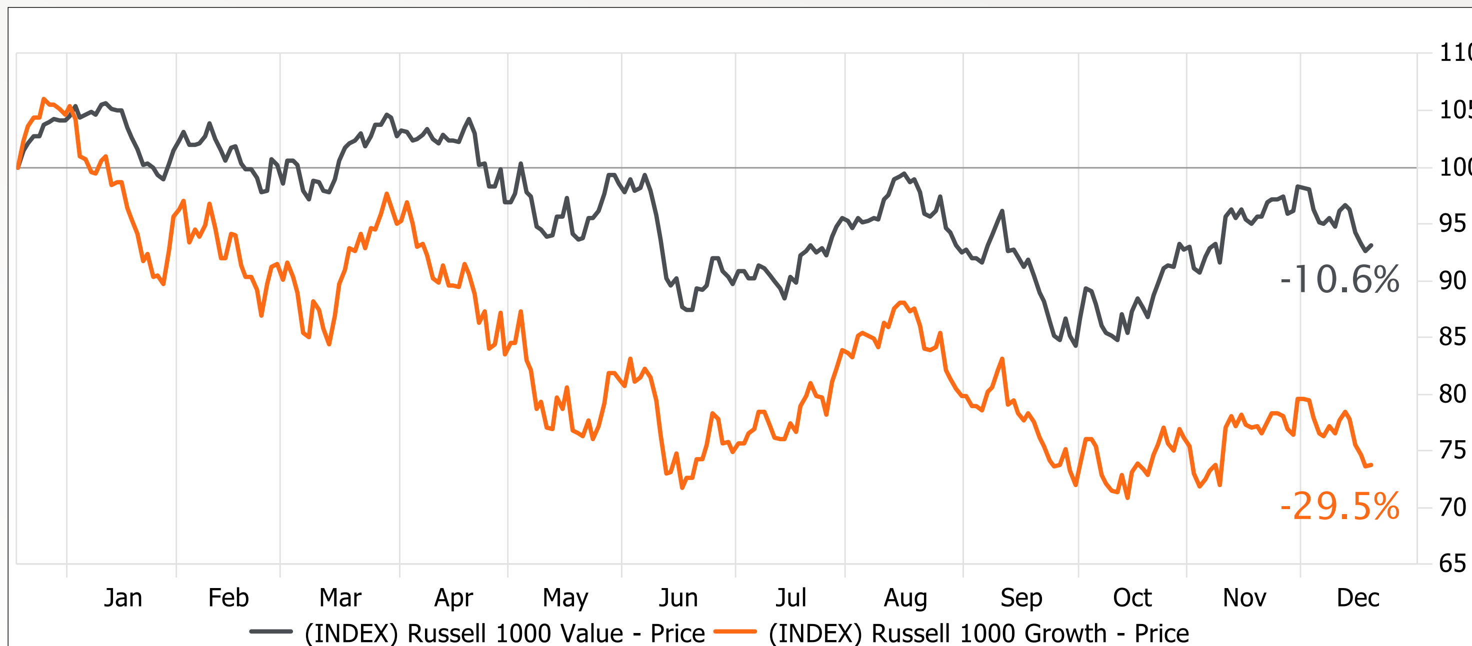


Source: FactSet (charts). As of December 20, 2022.

Value Stocks Outperformed in 2022

Value outperformance driven by...

- Rising rates and restrictive monetary policy have greater impact on longer-duration growth stocks
- Extended growth valuations in 2021
- Energy outperformance
- Slower growth in tech, comm. services – beneficiaries of stay-at-home trends, low-cost funding
- Decline in speculative retail investing



Source: FactSet (chart). As of December 20, 2022.

Six Themes to Watch in 2023

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In a slow economy with restrictive monetary policy, we're seeking investments in companies that benefit from fiscal policy, global shifts and inelastic demand.

U.S. Onshoring Beneficiaries

Fiscal spending support and more efficient supply chains closer to end-markets could generate revenue, job growth for key sectors

1

Global Exposure

Potential China reopening and currency dynamics could favor U.S. companies with foreign revenues

2

Cybersecurity

Mission critical threat that is a rising cost for businesses, growing with digital transformation, and stakeholders span consumers, enterprises and government

3

Pricing Power: Aging Fleets and Technology Innovation

Supply chain disruptions extended demand for machinery, vehicles and innovative technology for gaining efficiencies

4

Stronger-than-Expected Consumer

Healthy balance sheets, strong wages and lower costs could support persistent consumer demand (e.g., discretionary goods, home improvement)

5

Fixed Income

A higher yield curve, lower inflation and near-peak fed funds rate offers opportunity in fixed income markets

6

Key Sectors to Watch in 2023

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Selective and actively managed diversified portfolios should again benefit in 2023. Value may again outperform growth as the old mantra, “Don’t Fight the Fed” should remain true for most of 2023.

Less Value in Defensives

Defensive sectors, including utilities, health care and consumer staples all outperformed in 2022. Given their impressive 2022 relative performance, each of these sectors are also trading at relatively high multiples heading into 2023.

There are opportunities in select names with strong management, key-product and key-market stories.

Selective in Tech, Discretionary

Key themes will continue to generate demand acceleration in select technology and discretionary categories. These sectors, on aggregate, are priced at much lower relative valuations entering 2023. Staying selective in these sectors includes avoiding names with expected (lower) earnings revisions.

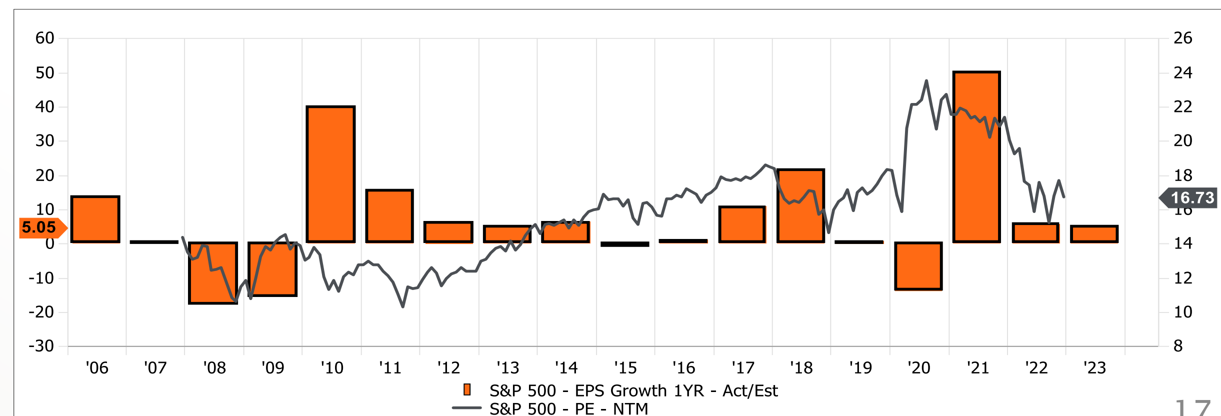
Certain themes we’re following include cybersecurity, artificial intelligence and the cloud. A recovery in digital ad spending will happen eventually.

Pricing Power Across Energy, Materials, Industrials

While the Fed uses their tools to slow demand, supply-side economics continues to create pricing power in key industries. Pricing power and lower input costs combine to produce operating leverage.

Diversified, secular demand for energy resources, equipment, machinery and materials will continue to support a more inelastic demand environment. A potential China recovery will also support demand growth across these sectors.

Throughout 2H22, analysts broadly revised downward their 2023 earnings expectations (+5% EPS in 2023). Revisions are likely extreme, and much could go right for companies, including favorable currency rates, lower debt/input costs, improved supply chains and pockets of persistent demand.



Source: FactSet (chart). As of December 31, 2022.

Thank You

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All returns data and statistics are sourced from FactSet, unless otherwise noted. Returns data as of December 20, 2022.