Holyk Doran
Wealth Management Group

New Year Market Update - January 2023

Good riddance 2022!

2022 was a painful year for investors since both the Bond and the Stock markets had simultaneous sell offs. Naturally we accept uncertain stock market returns every year - as long-term investors we take volatility in stride in exchange for growth - but it was what occurred in the Bond Market - a normally conservative place deemed to be a relatively safe haven that really messed things up.

Stocks:

After the S&P500 returned +31%, +18%, and +29% for each of 2019, 2020, 2021, should we have expected -19% for 2022? There was of course no way of knowing. Interestingly however, if the last four years are averaged together the return still works out to be about 15% per year which is consistent with the 13% long term average. (Note: There are many stock indices that we track but we follow US economic data the closest because as the largest economy with the deepest most liquid markets the US is the trendsetter).

Major world indexes also had negative returns ranging from around -6% (TSX), Dow – 8%, SP500 -19%, the tech heavy Nasdaq down 33.89%, MSCI World -25%, Shanghai -14%, Japan -9, the FTSE 100 (UK) managed a +3% return but that was an exception. Our HDWM Equity Basket – one of the cornerstones in the construction of our model portfolios posted a return of -6.6% relatively good by comparison.

Bonds:

Bonds (and various fixed income instruments) are another vital building block for portfolios. Historically as an asset class they have been a lower yielding but "safer" (less price volatility) relatively conservative asset class that is typically less correlated to stock price movements. That was all blown out of the water in 2022.

When global central banks began their aggressive synchronized interest rate hikes to combat post Covid inflation Bonds got crushed. The benchmark US Government 20-year bond was down 30% in 2022. Interest payments although helpful are paltry in relation to the drop in market values. All liquid fixed income securities regardless of their maturity or credit quality trade off of the benchmark treasury bond rate so the effect was immense.

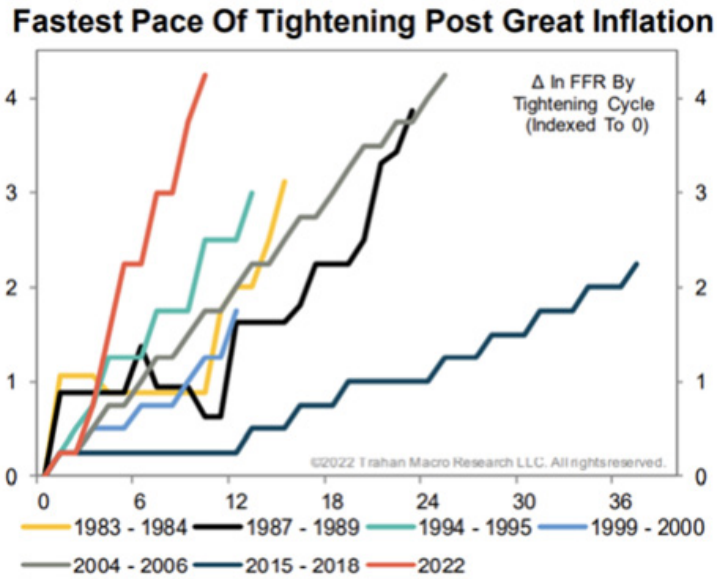
Globally it is estimated that the losses in liquid fixed income instruments by the end of 2022 were in the range of $56 Trillion USD. Ouch. The HDWM Fixed Income Basket is another building block in our model portfolio - it posted a return of -15.9% in 2022. Relatively much better than the benchmark but ugly, nonetheless.

To put this into historical perspective - Over the last 100 years there were only 5 years where US Treasury bonds and the S&P500 both finished negative. 2022 was one of them BUT it is the most extreme case as the bond market was the worst since 1786!

So Why Did This Occur?

During the Covid lockdowns the easy money doled out by governments and financed by borrowing at record low interest rates created an asset price boom. (Think unlimited cash chasing limited investment options.) The lockdowns created distortions in everything but especially so in manufacturing, logistics and the labor markets. This in turn led to severe supply side shortages as post covid demand exploded fueled by a nearly 40% increase in money supply since 2020. When Russia invaded Ukraine energy was in short supply, prices spiked, and this all understandably led to a burst of post covid inflation. When demand exceeds supply then prices go up - inflation.

Consequently, central banks kicked off the most aggressive globally synchronized tightening cycles in in economic history as noted by an over 400% increase in the Fed Funds Rate in the US in a short seven-month period (see chart below).



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This is where the real problems started because every single financial asset is valued against the "risk-free rate". The risk-free rate is often considered to be the yield of US Treasury Bills. Treasury bill yields are most closely associated with the Fed Funds rate. So, when the federal reserve goes through an extremely aggressive interest rate hiking cycle, mostly all asset prices get crushed. They do this to tame inflation.

A little inflation in the range of 0-2% is considered a healthy sign of economic growth but in this case, we had a sudden spiraling inflationary shock in the 8-10% range.

That is not sustainable and must be put down. Rampant inflation is deemed to be the worst of all possible economic outcomes as it devalues currencies and makes life unaffordable for citizens facing ever higher prices with wages that can't possibly keep up. Unfortunately, central banks cannot pull a lever to create supply because the only tool available to them is to raise interest rates and reduce money supply until they crush demand.

That in brief is we had such terrible markets in 2022. BUT....

Now for the good news...

It's easy to get wrapped up in a review of the past year and assume that we're now in a permanently un-investible market. On the contrary – most often a difficult year sets the stage for renewal and rebound and now that valuations and expectations have been adjusted lower much of the risk is now out of the market. Consider a few market statistics:

- In the last 40 years US stocks have turned in a positive performance almost 80% of the time.
- The average annual gain has been 13%
- The S&P 500 has posted 13 down years out of the past 60.
- The years following the down years are up 77% of the time, and the average increase is 13%.

Going forward into 2023, investments have been substantially de-risked due to the market drop last year. For the first time in a decade, bonds carry a reasonable yield. Our fixed income basket now has a yield of >6% and we believe that the interest rates are almost finished. If this forecast holds, there is very limited downside and potentially upside beyond the 6% yield if and when interest rates should drop back again.

For 2023, we also see a stock market that is more likely to generate normal returns. The start of the year may be difficult, as the Fed further raises rates, the economy flirts with recession, and the Russian invasion of Ukraine continues. But we believe that faced with inflation declining to more normal levels and a recessionary environment, the Fed should move to the sidelines sooner than later. This will help equity valuations, which already have come down from high levels. Stocks historically have led the economy out of recession, typically bottoming during the middle of the downturn. Given low unemployment, we don't think an economic recession in 2023 will be particularly long or deep, allowing for an earnings recovery in 2023.

The third asset class in our model portfolio is the HDWM Alternative Asset Pool which we launched in September. We are excited about the opportunities in this space. Alternative assets can provide similar returns to stock and bonds but without all the volatility. More than ever, it is vital to seek out and allocate capital to investments that are not correlated to the traditional stock and bond markets – 2022 is proof of that.

In summary we are cautiously optimistic about 2023 and are working diligently toward providing the best risk adjusted returns possible. Our Investment Committee meets weekly to review existing holdings, interview outside money managers, discuss potential new additions or sales from the portfolio and to assess the ever shifting Geopolitical/ Macroeconomic backdrop to position our client portfolios for success.

Happy New Year!

The Holyk Doran Team

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