

# Investment Update



## 2022 MARKET & ECONOMIC RECAP

Calendar Year 2022 has served investors many slices of humble pie. *It didn't just seem unusual...it was!*

Consider that the Federal Reserve's December 2021 "dot plot" showed expectations of 50-75 bp of rate increases for 2022, only to deliver 425 bp (the most in 40 years). Equity investors saw more days of 2% swings than any year in recent memory and the broad markets saw multiple 10% declines during the year. The broad bond index (AGG) suffered its worst year since the US Civil War.

Whereas 2021 saw equity market push higher despite meaningful headwinds, 2022 struggled for momentum from its earliest days. The year can be reasonably encapsulated in the following:

- Inflation globally rises to the highest levels in decades, including 9.1% in the US
- The US Federal Reserve and global central banks tightened at "warp speed"
- US consumer spending remained resilient, while housing slowed materially with higher rates
- The Russian invasion of Ukraine in February exacerbated already challenged supply chains and much more (including a profound impact on energy prices, initially)
- Mid-term elections failed to deliver the "sweeping mandate" Republicans sought, but did transfer House control to create a divided government
- Near year end, China's Zero Covid policy began showing small signs of easing following protests in some of the country's most populous cities

The Fed's move higher on rates set in motion a repricing of equities that saw many growth-oriented companies tumble 30-50% or more. It wasn't just speculative tech that felt this impact, but mega-cap companies like AMZN

(-50%), MSFT (-28%), TSLA (-65%), NVDA (-50%) and AAPL (-26%) all felt their share of pain. The only sector of the S&P 500 to post gains in 2022 was energy. Among bond classes, short duration protected better than long, but still lost 5.5%. **Most segments lost double-digits.**

Asset classes that historically fare well during inflationary times saw mixed results, while assets that typically benefit from rising rates were equally mixed. Broadly, value outpaced growth and market capitalization offer minimal diversification benefit at the index level. More nuanced strategies (alternatives) largely offered better returns than long-only indices, but only a few posted gains for 2022. A few of this year's "outperformers" are listed below. Not all posted gains, but all provided valuable outperformance relative to their peers and broad markets (many will be touched on further in our "Hiding in Plain Sight" section):

- Covered Call ETFs
- Long Short Equity
- Merger Arbitrage Strategy
- Private Stock Mutual Fund
- Managed Futures and Commodities
- Buffered ETFs

Finally, below is a recap of key market indices for 2022:

- S&P 500: -19.4%
- Russell 2000: -21.6%
- Russell 1000 Growth: -29.8%
- Bloomberg Agg Bond Index: -13%
- TIPS (Treasury Inflation Protected Sec): -11.8%
- DJ Wilshire US REIT Index: -28.4%

# WHAT WE KNOW AND WHAT WE SUSPECT MAY LIE AHEAD...FLIPPING THE CALENDAR TO 2023...

The final 6 weeks of each calendar year sparks volumes of well-articulated, thought-provoking, and compelling cases for why a firm's projections for 2022 are worth consideration. We have read through many of these as part of our continual due diligence process. They serve as a useful point of reference, but not much more than that! We do not believe we can pin our hopes on the projections of any of the best and brightest minds on Wall Street nor leading US Economists. Just because a belief is in-line with the consensus doesn't mean it will materialize.

*We believe investing is a discipline that brings seasons of challenges and seasons of reward.*

What we are not inclined to offer is a 2023 year-end projection for interest rates, the S&P 500, nor the growth rate of the US economy. We do not believe any expert can pinpoint the timing of market inflection points, nor their scale. As a point of reference, below is a chart illustrating the year-end projections for 2022 and 2023 from some of the biggest investment firms in the world, along with a snapshot of the US Federal Reserve's Dot Plots from December of 2021 through its latest meeting. Even those with seemingly immeasurable resources weren't even close!

Firm / Bank	2022 YE Estimate	2023 Projection
<b>2022 Actual</b>	<b>3840</b>	
Bank of America	4600	4000
Bank of Montreal (BMO)	5300	4300
Citibank	4900	3900
Credit Suisse	5200	4050
Deutsche Bank	5250	4500
Goldman Sachs	5100	4000
JP Morgan	5050	4200
Morgan Stanley	4400	3900
Oppenheimer	5330	4400
UBS	4850	3900
Wells Fargo	4715	4300-4500

## FOMC federal funds rate forecasts (median values eoy)

Meeting date	2022	2023	2024
Dec '21	0.9	1.6	2.1
Mar '22	1.9	2.8	2.8
Jun '22	3.4	3.8	3.4
Sep '22	4.4	4.6	3.9
Dec '22	4.4	5.1	4.1

Source: Federal Reserve Board, J.P. Morgan

There have been relatively few investors in the history of the markets who accumulated most of their wealth because of well-timed investment decisions. None of the above is meant to imply that context and historical trends are unimportant, but rather that they should most often drive subtle shifts within a portfolio rather than "in or out." Within that framework, below are our thoughts on some of the specific challenges we face entering the year and how each impacts our viewpoint on positioning and risk management.

**The Fed:** There's no denying that the Fed (and global central banks in general) have been the key drivers of 2022 market behavior. There's also a very low probability that we see activity in 2023 looking like anything akin to that of 2022. The questions remaining front and center are how much further the Fed pushes and what they break along the way. History suggests they will push the US economy into a recession and the consensus is that it would be a mild one. We believe it's worthwhile to note here that the stock market already anticipates much of this. Markets typically look 1-2 quarters ahead to price in the most likely economic outcomes. ***A modest economic downturn would not necessarily derail the stock market.*** Case in point, some of the most notable inflection points in market history (April 1942, March 2009, March 2020) happened at a time of economic challenge and amid tremendous negative market sentiment.

Considering the range of possible consequences of Fed action, we believe owning strategies (both in stocks and

bonds) that focus on companies with strong balance sheets, strong free cash flow, modest debt, and differentiated businesses is key.

**Inflation, the US consumer, and the slow growth economy:** The intended target of Fed policy restriction is the slowing of consumer spending, slowing the US housing market, loosening of the tight labor market, and a reduction of the Fed's own balance sheet. The HOPE and ultimate goal are to tame the inflation that besieged the global economy following global governments' fiscal response to the Covid-19 pandemic. Not only were supply chains disrupted and lives tragically lost, but the influx of unprecedented fiscal stimulus sparked a wave of price acceleration last seen 4 decades ago.

Our view is that inflation is and will continue to moderate to much more palatable levels (think 3-4%, but *not* 2%) in the coming year. We believe that the Fed will likely pause their rate hiking initiatives in the Spring of 2023 and HOPE to maintain a restrictive policy around 5% for 9-12 months. It seems unlikely they will get all aspects of that correct. There's a strong argument that they may have to push meaningfully higher than 5% to tame inflation sooner, while others (like JP Morgan's David Kelly and DoubleLine's Jeffrey Gundlach) believe the Fed is better off accepting a level closer to 3-3.5% inflation in the near term and spare the economic damage further rate hikes could cause.

Given that Fed messaging has gone from "transitory" to the most hawkish in decades, we have minimal confidence that we can predict their steps in the months ahead. Despite multi-decade lows on unemployment, Consumer Confidence sits at historic lows (*which has also been a positive signal for stock performance in the years that follow such low readings*). The housing market has gone from white-hot to frigid (volume, not price).

What we believe matters at portfolio level is a continued underweight to duration and emphasis on active credit management in fixed income. In equities, a heavy emphasis on business and industries that have a history of durability and pricing power should prove helpful. Furthermore, dividends and cash flow from our

investment portfolio will help insulate us from the full brunt of the volatility that likely lies ahead.

**Geopolitics:** Rarely is there a year when geopolitics cannot be disruptive and 2023 certainly figures no different. Both China and Russia served as headwinds to global growth and supply chains in 2022. Huge uncertainties remain in the case of each, but there is a possibility that momentum could swing the other way in the coming quarters. To many investors' surprise, WTI Crude finished 2022 just marginally higher than the \$76.99/barrel where it opened the year. While up ~50% on the year, natural gas closed more than 40% from its August highs.

Any "what could go right" list for 2023 must include both a Russian ceasefire and a modification of China's Zero-Covid policy. A positive turn on either of these could become a source of renewed economic optimism and the unleashing of pent-up global demand. Conversely, such a scenario could also further complicate the task of battling inflation, depending on its timing and speed. These developments would also make a stronger case for the weakening of the incredibly strong US Dollar.

From an investment standpoint, a lot of negativity has been priced into non-US markets. They are historically cheap relative to US peers. While cheap by itself is not an investment thesis, having lower multiples and higher dividends does present an appealing risk/reward dynamic for many non-US domiciled companies. Recognizing this, we have recently made some modest and subtle shifts into global strategies as we enter 2023. It seems likely that this "drip" back into non-US equities continues in the coming months.

**Politics & Taxes:** Gridlock! Despite the surprisingly weak showing by Republicans in the 2022 midterm elections, we have divided government for the next 2 years. Precedent suggests that we will likely see limited fiscal stimulus, no meaningful tax reform, and minimal glacial shifts in reform. Wall Street now knows what to expect and, historically, fares well during periods of gridlock. From a portfolio perspective, there are limited implications in the immediate future, but we remain watchful.

# “HIDING IN PLAIN SIGHT”: MAKING VOLATILITY AN ALLY AS 2023 BEGINS

Throughout this newsletter we have tried to reinforce the ideas of discipline, resilience, quality, and cash flow. For each of these, there are portfolio components we have added to SIGNIFICANTLY in the past year that are specifically designed to help further emphasize these attributes. Rather than the binary nature of a BUY/SELL choice, below we highlight a few of our key tools heading into 2023:

**Covered Call ETFs:** Simply stated, these strategies are designed to offer reduced volatility exposure in the equity portion of a client’s portfolio while also creating a meaningful stream of cash flow. There are 2 basic approaches our managers employ, with one predominantly focused on high cash flow and the other more looking for total return and a 4-5% distribution. We currently use 5 different solutions in this space, each of whom takes a slightly different approach.

While past performance is no guarantee of future results, the strategies each captured more than 2/3 of the equity rally of 2021 and all outpaced the broad markets in 2022 by more than 11%. Heading into a year with immense uncertainty, having a blended 6-9% distribution on a portion of one’s equity exposure figures to be a way to meaningfully manage volatility and potentially positively impact returns.

**Buffered ETFs:** In stark contrast to actively managed covered call ETFs, buffered ETFs are a purely structural and passive tool. The value added by these instruments exclusively stems from their structural insulation against a portion of an index’s loss. For example, a January series 15% buffered ETF would have outpaced the S&P 500 in 2022 by more than 14% (index return offset by the 15% buffer less strategy management fee of 0.75-0.8%). This buffer is “paid for” by capping the upside of the portfolio. In a solidly up year like 2021, such a strategy will fully participate only in the first 10-15% of the market’s returns.

**Quality:** There’s no market where quality isn’t an attractive attribute. As the calendar flips, however, an emphasis on quality seems as important as any year in recent memory. With the prospect of economic slowdowns ahead, owning businesses with proven leadership, solid balance sheets, and differentiated businesses is only logical. Paying an appropriate price for such businesses (not quality at any price!) is the final element of the equation our managers look to get right.

Quality is a feature commonly associated with “blue chip” and value-oriented businesses (i.e. Merck, Coca Cola, J&J, and P&G). In our opinion, quality is even more critical in assessing what one owns in the growth segment of the marketplace (i.e. Amazon, Google, Nvidia, and Tesla). Quality applies across large and small businesses, domestic and overseas (i.e. Siemens, Nestle, AbbVie, and Unilever). It must be assessed dynamically, and adjustments must be made in a timely manner.

**Actively managed Alternative solutions:** Few years on record better illustrate the role of alternatives in a portfolio than 2022. Both equity and fixed income declined across the board, yet several alternative managers posted gains. Among strategies we employ that posted gains in 2022 were long/short equity, managed futures, and merger arbitrage solutions. Collectively these offerings helped dampen drawdowns throughout the year and offered alternatives to traditional fixed income as a way of combatting equity “chaos.”

As we’ve touched on multiple times, we are NOT expecting volatility to subside in 2023. Uncertainty remains high on many fronts, thus having strategies specifically equipped to take advantage of such events can help preserve and grow assets and provide a much less bumpy ride.

## A FEW NOTEWORTHY QUOTES AND OBSERVATIONS...

- Brian Wesbury (First Trust's Chief Economist): “We expect the markets will end next year [2023] largely flat from where we stand today...The economic medicine, while bitter, is part of the price we pay for the policy mistakes made over the past few years.”
  - Brian has been one of the most outspoken, accessible, and accurate economists of the last 2 decades. He isn't afraid to express his opinion, even when it's not consensus.
- Kevin Simpson (Capital Wealth Planning): We expect stocks to remain very volatile throughout the first part of next year—we're fairly valued here. There's a good chance that things will look a whole lot better a year from now, but in the interim, don't try to time the short-term fluctuations.”
  - While not a household name to many, Kevin runs a disciplined covered call strategy that outpaced the market by nearly 17% in 2022. Since the inception of his ETF (DIVO) the strategy has outpaced the index over 1,3, and 5 years and has ranked in the top 20% of his Category every year since 2017!
- Angel Oak (Credit Manager): “Bonds are the new stocks in 2023...we believe the relative value of structured credit stands out across risk assets”
  - One of Wall Street's largest underwriters and managers of structured credit, Angel Oak is a seasoned and key player in the mortgage, credit card, and auto loan marketplace.
- MacKay Shields (Global Bond Manager): We maintain the opportunities in fixed income far exceed the risks of sitting on the sidelines. We fervently believe bonds are back and 2023 will be the ‘Year of the Bond.’”
  - One of Wall Street's most respected “boutique” bond managers across both US and global, taxable and tax-exempt.
- Bank of America: The weighted average coupon of all mortgage loans outstanding in the US today is approximately **3.4%**. Approximately 93% of the MBS universe is paying a fixed rate today (vs. ~67% in 2006). 88% of the mortgage market has an LTV (loan to value) of <80%...in September 2008 over 56% of mortgages had an LTV >80% and 94% of those were at rates >5%.
  - Facts we believe are critical as one differentiates today's housing market from the 2006-2010 era

## 2022 YEAR END CELEBRATION





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