Market participants hoping for a year end "Santa Rally" in financial markets were left instead with a lump of coal, a fitting ending for what was the worst year since 2008, in the midst of the Great Financial Crisis. In December, the S&P 500 was down approximately 6.2%, while bond markets also fell, as they did most of the year. 2022 ended up being the fourth worst year for the stock market in the last 80 years. As we have noted in previous letters, there was really no place to hide during an unexpectedly quick Federal Reserve tightening cycle in response to rising inflation, other than commodities and cash, neither of which are sustainable portfolio concentrations over the long run. While clients did not avoid the pain of 2022, we were able to sidestep some of the worst areas of the markets. Long duration bonds, cryptocurrencies, and unprofitable technology stocks, among other asset classes, faced gut wrenching declines, areas in which we have little to no exposure. The core of our investment process is holding very high-quality companies with sustainable business models, and buying them when prices are attractive. This type of strategy will not avoid short term pain, but it tends to hold up better in a "rush to safety," as was the case in 2022.

As we review the year that was, 2022 was a good reminder that the economy is not the stock market, and vice versa. While "Wall Street" and "Main Street" tend to rise in tandem over long stretches of time, in the short run they can diverge significantly. 3rd quarter real GDP growth in the U.S. came in at 3.2%, with the Atlanta Fed GDPNow model estimating 4th quarter real GDP growth at 4.1%. This real growth, on top of high inflation, is faster than any year during the previous decade. Unemployment remains near half-century lows at 3.5%, and job and wage growth have remained strong throughout the year as employers struggle to fill open positions. The continued strong economy has been good news for average workers, but bad news for investors. The momentum of the "Main Street" economy is helping fuel high inflation, which is driving the Fed to raise interest rates, which is weighing heavily on the price of stocks and bonds.

As we enter 2023, the pace of inflation and the health of the labor market will continue to dominate financial headlines, but the biggest economic story may be on the other side of the world. China, after nearly three years of strict COVID lockdowns, is in the midst of reopening, something that the rest of the world started doing 2 years ago. This reopening will have broad ripple effects. The first implication will be related to China's importance within global supply chains. With much of the inflation we have felt over the past 2 years attributed to COVID-related disruptions, the factories of China returning to a normal state of operation should continue to help return global supply chains to their pre-COVID balance, helping reduce inflation. On the flip side, China's reopening may also lead to a rebound in commodity prices. Oil and other commodities, after a sharp rally in 2021 and early 2022, peaked in early summer, and spent the rest of the year declining in price. Many commodity bulls attributed this weakness to China's continued lockdowns, arguing that the demand unleashed by a reopening China will cause prices to continue their ascent. A renewed commodity bull market, especially a rise in the price at the pump, could pose problems for the Federal Reserve's fight to restrain inflation. Finally, China, currently experiencing low inflation and its lowest growth in decades, may be the only major economy in the world to have "easy" monetary and fiscal policies supporting accelerating economic growth, while the U.S., Europe, Japan, and the rest of the developed world continue to see growth slow. Can Chinese growth offset slowdowns in the rest of the world, keeping the global economy in balance? For good or for bad, China will be a place to watch in 2023.

Client activity was elevated during the quarter. One notable activity was additions to positions in international equities. Ever since the financial crisis, both emerging markets and European stocks have underperformed American stocks by significant margins. One of the key drivers of this phenomenon has been the ascendence of technology. The U.S. is home to a majority of the most important and valuable tech firms in the world, and this sector has been the one that has dominated the headlines and equity returns over the last 15 years. In this low growth and low interest rate environment, fast growing and futuristic firms saw their valuations soar, culminating in a COVID era bubble as amateur and professional investors alike threw caution to the wind. As we have exited the COVID era with low unemployment, high inflation, and fast GDP growth, the technology bubble has popped once again, just as it did in the early 2000s, and the market is searching for new leadership. In the post dot-com era, that leadership was seen most acutely abroad, as international stocks far outperformed domestic stocks from 2000 to 2007. While history does not always repeat itself, it often rhymes, and in October we added to broad European and emerging markets positions at prices that were first reached in 2005, over 17 years ago.

We continue to remain cautious within client portfolios. The Federal Reserve is trying to thread the needle of reducing inflation, while also maintaining a strong economy and low unemployment, a so called “soft landing.” In this scenario, we would expect both stocks and bonds to rally from here. We have seen this play out in the first week of trading in 2023, a welcome sign. However, the probabilities of either a deep recession or an economy that remains stronger for longer, forcing further Fed tightening, are both elevated, and both scenarios pose unique risks to stock and bond portfolios. Wall Street analysts currently project 2023 earnings growth of 14% for S&P 500 companies, but many investors remain skeptical. The impact of high interest rates and restrictive Fed policy to cool the labor market may lead to these estimates being revised lower over the course of the year, a headwind to stock prices. The stock market has never made a bear market low before a recession even begins, and it would be historically unique to avoid a recession now given the warning from the inverted yield curve and from many other leading economic indicators.