4th Quarter 2022 Market Commentary

2022 – A Year of Survival

While we hope there were bright spots in 2022 for each of us, overall, it was a tough year for investors. For stocks and bonds, 2022 was a year of survival. The S&P 500 index fell 18.1% for the year, the 3rd worst year for the S&P going back to 1980. Average bond investors did not fare much better, as the U.S. Aggregate Bond Index lost 13.1%. Going back to 1976, this is the worst return for the Aggregate Bond Index and only the 5th negative annual return over that period. The next closest was a -3% loss in 1994.

With 2022 creating so many hurdles, many professional managers struggled as well. According to Bloomberg, there are 865 actively managed stock mutual funds domiciled in the U.S. with at least $1 Billion in assets. On average, those 865 mutual funds lost -19% in 2022. Likewise, a 60/40 mix of the S&P 500 and U.S. Aggregate Bond Index would have returned a loss of about 16.1%

We are pleased to report that all seven of our primary TOPS strategies outperformed the S&P 500 and the average large cap U.S. actively managed mutual fund handily (net of fees). Likewise, our Balanced portfolio strategy composite (with a target equity/bond mix of 57/43) performance (net of fees) outperformed the aforementioned 60/40 index by several percent for the year.

The strong relative performance of the TOPS strategies was driven by a few key elements. The diversification of our equity allocations aided TOPS in outperforming, as large cap growth stocks (a large component of the S&P 500) struggled. For several years, we had highlighted concerns over valuations of large cap growth stocks, and the concerns came to reality in 2022. On the fixed income side, TOPS had the best relative overall outperformance in the 20-year history of our program. Investors in our Balanced strategy, for example, will note their fixed income holdings outperformed the U.S. Aggregate Bond Index by about 6% (gross) for the year. Likewise, for some investors, this significant outperformance has led to bond outperformance through the inception of their account. This outperformance was primarily provided by the risk management strategies TOPS employed to reduce the interest rate risk for our investors. For several years, we have highlighted the high level of interest rate risk and made changes to our strategic allocations to provide, what we feel was, a better risk vs. return position. As this interest rate risk materialized at a meaningful level, our investors benefitted considerably.

TOPS provides long term strategic portfolios for serious investors, focused on optimizing the amount of return we can target for the amount of risk we are taking. We feel TOPS has provided appropriate returns over the two decades of serving our investors. Likewise, we are very pleased we were able to survive 2022 in much better shape than most and to provide meaningful value for our investors.

We often discuss investment markets using the term “cycles.” As the literal meaning would connotate, markets tend to follow certain cycles for various lengths of time. The pervasive cycle of outperformance of large cap growth U.S. stocks, primarily tech stocks, lasted for about a decade. When the tide receded for growth stocks, the exceptionally high valuations revealed risk levels higher than most investors were willing to take. Further, the long cycle of growth outperformance was fueled by abnormally low interest rates and extremely high access to capital. We believe, the next decade may look very different.

As we look out to the next 10 years, we see an environment where the Federal Reserve may be much less accommodative than the last 10 years. The era of the “Fed Put”, the Fed bailing out markets at every slip, seems to be over for now. At least for the next few years, higher interest rates should significantly increase the cost of capital for growth companies. Also, investors will likely ask for more concrete results when the risk-free rate (U.S. Treasury yield) is providing returns over 4%. This may have been a contributor as Tesla saw their stock price fall -65% in 2022, followed by the mighty Apple and Microsoft, at -26.3% and -27.9% respectively. Despite these significant retractions, valuations for large cap growth stocks remain higher than most of the other major asset classes we maintain exposure to.

Given what we know, and the modeling we employ regarding what we do not know for sure, we believe our TOPS strategies are well positioned for the next 10 years. Importantly, we are encouraged by the higher yields available for fixed income holdings and the historically attractive valuations for many of our asset classes, such as small cap, mid cap, international and emerging markets. Additionally, we highlight the continued historically strong valuation of the U.S. Dollar (USD). If the USD were to weaken in 2023 (or throughout the next cycle), it would be a boost to the returns of our international investments.

After discussing Q4 2022 financial market results, we will address three general themes important to TOPS portfolio returns and strategies:

1) It is all about the Fed
2) If we have a 2023 Recession, what will it look like?
3) What’s in store for stocks and bonds in 2023??

Year-To-Date Markets Review

Equity indexes saw positive returns in the fourth quarter. Value stocks (S&P 500 Value) outperformed growth stocks (S&P 500 Growth), returning +13.6% and +1.4%, respectively. Midcap (S&P 400, +10.8%) outperformed both small cap equities (S&P 600, +9.2%) and large cap equities (S&P 500, +7.6%). Developed international (MSCI EAFE) returned +17.3%, outpacing emerging markets (MSCI Emerging Markets), which returned +9.7%. Natural resources (S&P GSSI NA Natural Resources) and real estate (MSCI World Real Estate) were both positive as well in the fourth quarter, up +18.3% and +5.6%, respectively.

Even with a positive fourth quarter, most equity indexes were still negative for the year. The exception is natural resources with the S&P GSSI Natural Resources Index providing +34.1% returns in 2022. Value stocks (S&P 500 Value) returned -5.2% and significantly outperformed growth stocks (S&P 500 Growth), which returned -29.4%. Midcap (S&P 400, -13.1%) outperformed both small cap equities (S&P 600, -16.1% and large cap equities (S&P 500, -18.1%). Developed international (MSCI EAFE) returned -14.5% this year, outpacing emerging markets (MSCI Emerging Markets) which returned -7.0%. Real estate (MSCI World Real Estate) was down -25.1% in 2022.

Like equity returns, we also started to see positive fixed income returns in the fourth quarter. The Barclay's US Aggregate Bond Index had a +1.9% return for the quarter, while the Barclay's US TIPS Index was up +2.0%. Credit (ICE BofA US Corporate Index, +3.5%) outperformed government (ICE BofA US Treasury Index, +0.7%). High yield (Solactive USD High Yield Corporates, +4.2%), investment grade corporates (iBoxx USD Liquid Investment Grade Index, +4.2%), and international bond indexes (Bloomberg Global Aggregate ex-USD, +0.1%) were also positive. The 10-year US Treasury yield increased from 3.83% to 3.88% in the fourth quarter.

For the year, we saw credit (ICE BofA US Corporate Index, -15.4%) underperformed government (ICE BofA US Treasury Index, -12.9%), and shorter duration holdings outperformed longer duration holdings. This was seen in both credit markets, with the Bloomberg US Corporate 1-3 year (-3.3%), and government markets, Bloomberg US Treasury 1-3 Year (-3.8%), where the shorter duration indexes outperformed the previously mentioned full duration indexes. Even with positive fourth quarter returns, high yield (Solactive USD High Yield Corporates, -11.0%), international bond indexes (Bloomberg Global Aggregate ex-USD, -12.7%), and investment grade corporates (iBoxx USD Liquid Investment Grade Index, -17.9%) remained negative for the year. Over the course of 2022, the 10-year US Treasury yield increased from 1.52% to 3.88%.

It is all about the Fed

As we discussed throughout 2022, the Federal Reserve remains in the economic driver's seat. The Fed is carrying out a tightening monetary policy in an effort to cool high levels of inflation. For stock investors, a major fear is a strong labor market may force the Fed to maintain high (and/or increasing) interest rates until they push the economy into recession (directly or indirectly).

As we model this situation, we are consistently asking ourselves, what can go right and what can go wrong? Ultimately, there are many inputs of varying impact which will decide the highest level of the Fed Funds Rate (called the terminal rate) and the amount of time it stays there. Levels of inflation, employment and wage growth will likely be the most impactful inputs.

Just after the end of the year, we got the December jobs numbers. According to the WSJ, "Employers added 223,000 jobs in December, the smallest gain in two years, the Labor Department said Friday. Average hourly earnings were up 4.6% in December from the previous year, the narrowest increase since mid-2021, and down from a March peak of 5.6%." The report could be considered Goldilocks, not too hot and not too cool.

In response to the numbers, BMO reminded us, "the Fed has assumed that a strong labor market would lead to excessive wage growth which, in turn, would lead to inflation pressures." Maybe though, we can thread the needle and have inflation cool even as jobs remain robust. For this to happen, wage growth must remain tame. These numbers, along with recent highly publicized layoffs in the tech arena, are encouraging investors that the Fed may back off a bit in response to the Goldilocks report. However, there are still about 1.8 jobs per each unemployed worker, according to Lazard. Likewise, Labor Force Participation numbers remain at the lowest levels since the 1970s, other than the depths of the pandemic of course. Both facts would typically place upward pressure on wages.

The next Fed policy meeting starts January 31st. Currently, markets are pricing in an equal probability of a 0.25% or 0.50% rate increase at the meeting. Before that meeting, important inflation figures, called the Consumer Price Index (CPI), will be released on January 12th. Fortunately, inputs to the CPI number seem to be trending lower, including gas prices, used car prices, residential rent, goods prices, and retail prices.

As the Fed saga of 2022 enters another year, we continue the search for the soft landing, the opportunity for inflation to subside without a significant recession. The Fed has outlined that their path is going to be data driven and take a while, so patience is necessary. As noted in previous messages, though, we believe stocks will be leading indicators and eventually lead coming out of any economic slowdown.

If we have a 2023 Recession, what will it look like?

The word recession can strike fear for investors. However, recessions do happen, and they are likely a necessary evil in the longer-term success of economies. Economists believe we are more likely than not to have a recession in 2023. In Bloomberg's December survey of economists, the consensus estimate was a 70% chance of recession in 2023, up from 65% in November. The story is much bigger than whether we experience a recession though. The key for markets will be the type of recession we get (if one develops). Will it be short or long? Deep or shallow? Broad or rolling?

A recession which is short, shallow, and rolling looks very different from a recession which is long, deep, and broad. Obviously, there are many different combinations between as well. A recession which is short, shallow, and rolling could have little impact on stocks. Actually, stocks may respond positively, as a mellow recession would potentially be better than what is currently priced into stocks. We do not believe stocks have priced in a long, deep, and broad recession. If a long, deep, and broad recession materializes, we believe this will have a negative short-term impact on stock prices.

It is impossible for anyone to confidently predict whether a recession is coming or not, let alone what that recession will look like. According to our research, we feel there is at least a 50% chance we see a recession in 2023. However, we believe stock prices are already reflecting some recessionary concerns and the likelihood of a long, deep, and broad recession is quite low.

Regardless of whether we experience a recession in 2023, we believe our allocations remain appropriate for our long-term investors. Now that 2023 is starting, stock valuations are already starting to reflect earnings in 2024 and beyond, which look pretty good at this point. Ultimately, earnings are the fuel for stocks. Over the next 12-24 months, we are likely to see analysts making meaningful adjustments to earnings expectations, as the Fed saga plays out and the recession question gets answered. While 2023 may in fact turn out to be another “year of survival”, longer term investors should be rewarded for that risk.

What’s in store for stocks and bonds in 2023?

For quite a long time, we highlighted the relatively high valuations U.S. large cap stocks were recording. As expected, given the concerns of the year, 2022 resulted in “blowing off the froth” on stock valuations. Valuations, which were well above average, fell closer to average for large caps. The story was different for small caps, mid-caps, international and emerging markets though. For these markets, valuations started the decline at lower levels. So, these markets blew off a much smaller amount of froth before they hit averages and are now hovering well below average.

How does this impact 2023? Well, as mentioned earlier, there is no guarantee 2023 will be the end of the current Fed saga. Successful investing typically requires patience, and 2023 may test the patience of all of us. On the other hand, if the Fed is successful in corralling inflation and delivering a soft landing, the expected bounce in securities may be led by some of the markets which currently exhibit more attractive valuations.

Historically, small cap stocks have tended to lead coming out of bear markets, international stocks boast attractive valuations, and there is potential for USD trends to revert. These factors lead us to believe some of these asset classes have a viable opportunity for strong performance when “risk on” shifts into gear. Included in our analysis, and relative focus on diversifier asset classes, is the concern it could be another tough year for tech stocks, and it might be a bold time to bargain shop for vanity brands, such as Tesla, etc. Many of these darlings remain highly valued, even after major pullbacks from astronomic price levels.

In the bond market, we expect to be very involved. At this point, we remain cautious of further interest rate risk and are being rewarded for holding a relatively short duration on our bond portfolio overall. As the interest rate and credit environments evolve, we will continue to put our two decades of experience to work for our investors. If the opportunity presents itself, we would like to return towards our long-term duration target near that of the US Aggregate Bond Index.

TOPS Portfolio Strategies

We cannot say we are sad to see 2022 go. Our 20th year of managing portfolios was one of the toughest we have had. While still paling in comparison to the challenges of the Financial Crisis in 2008, 2022 provided unique trials. That being said, from a relative perspective, 2022 was a very strong year for our portfolios. An accountant's job is not to bring your tax bill to zero; their job is to professionally execute a strategy which provides the best overall result, accounting for risk and return of tax strategies. Our role is similar in many ways; in that vein, we are pleased with what we were able to provide in a year of survival.

Now that we have survived 2022, we live to fight another day. With the confidence of our investors, we will continue to strive to deliver results to the best of our abilities. Beyond our strategic guidance, we will employ tactics for tax efficiency, index investing, sophisticated trading and cost management to help us as well. Thank you to all our investors for your confidence in us throughout the storm of 2022, and your confidence in us leading up to 2022, which provided us the opportunity to fight for you last year.

There is no guarantee that any investment will achieve its objectives, generate positive returns, or avoid losses.

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