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Cadence clips

FOCUSED ON WHAT MATTERS MOST.

2022 Asset Class Returns: Year in Review

By Steve DeBoth

Toward the end of last year's "Year in Review" piece I wrote: "You may be in the camp of investors that sees a year like this year as an opportunity lost as opposed to a sign that we have entered dangerous stock market times." 2021 was one of those years where the US stock market outperformed most other investment categories by enough that it may have been easy for investors to assume there was less risk in the market than there really was at the end of last year.

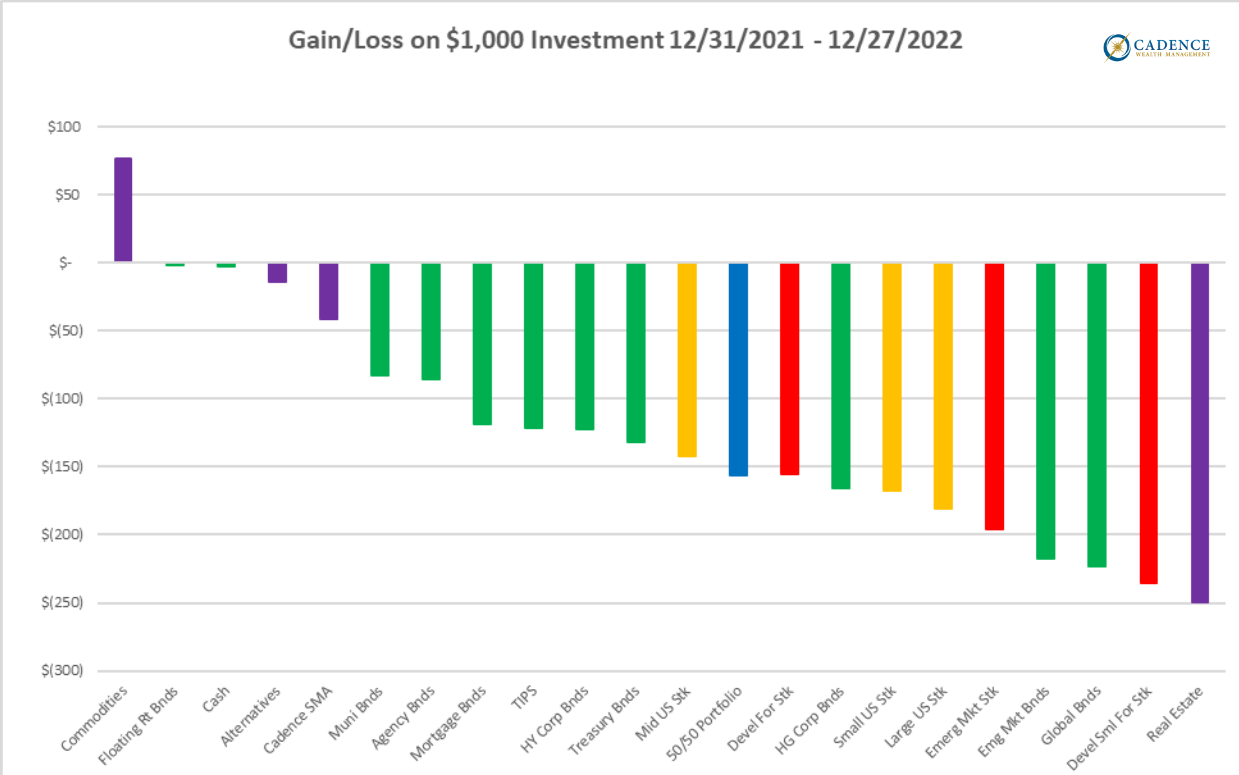
Unfortunately, to many investors' surprise, 2022 came along and proved that, indeed, there is plenty of risk in the financial markets. There were very few other investment categories that were good places to hide this time around, unlike what has been the norm for the past couple decades. To illustrate this, consider three of the most recent stock market downturns and what happened in the bond markets during those times compared to 2022:

Dates:	Returns: S&P 500	Bonds
9/1/00 - 3/11/03	-45%	29%
10/9/07 - 3/9/09	-55%	7%
2/19/20 - 3/20/20	-32%	-4%
12/31/21 - 12/27/22	-18%	-13%

Though corporate and other bond categories may have lost more during these time periods, the average core bond holding held up much, much better in the last two decades during stock market downturns before this year. It's no wonder that 2022 has been a bit of a shock to many investors' systems.

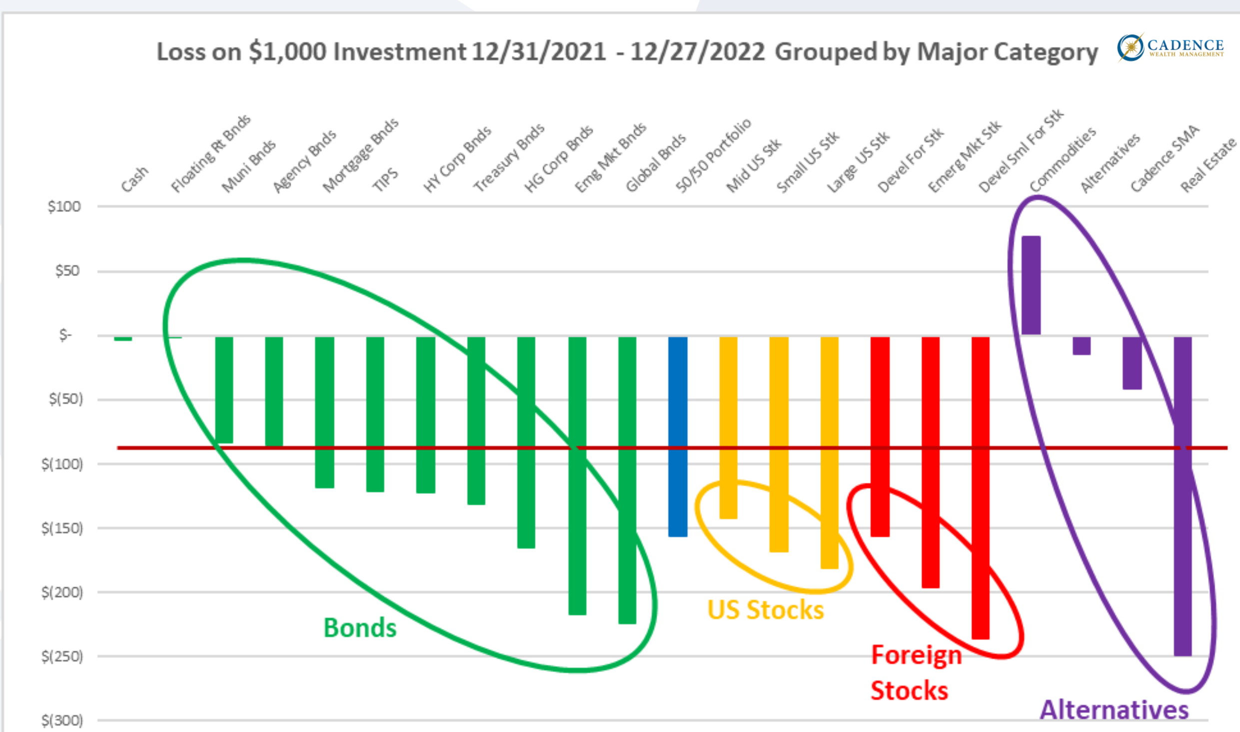
Let's drill down on the various investment categories' performances before we acknowledge some probable causes to this year's pain. The categories we'll look at are broken out in the table on the right, and we'll first look at how all of these categories did, from best to worst. I will include what a 50% stock, 50% bond portfolio would have done in comparison to all of these categories. It is the blue bar on the following page:

US STOCKS (yellow):	BONDS (green):
Large cap stocks	Agency bonds
Mid-cap stocks	Emerging market bonds
Small cap stocks	Floating rate bonds
FOREIGN STOCKS (red):	Global (non-US, non-emerging market) bonds
Emerging market stocks	High grade US corporate bonds
Large cap developed market foreign stocks	High yield US corporate bonds
Small cap developed market foreign stocks	Mortgage bonds
ALTERNATIVES (purple):	Municipal bonds
Cadence separately managed accounts	US treasury bonds
Commodities	US treasury inflation-protected bonds
Real estate	
Global macro, managed futures, everything else	



The 50/50 portfolio is just stocks and bonds, so it does not get the benefit of being exposed to the three alternative categories that outperformed it that would have reduced its losses to some degree, however it also has no exposure to real estate which definitely would have hurt it. Not including the alternative categories, the 50/50 portfolio comes in roughly in the middle of all the returns, which is not a huge surprise given its composition. Still, in a year where large US stocks are down around -18%, you would normally expect a 50/50 portfolio to have performed better than -15.5%.

Let's reorganize this chart and group the sub-categories by their major categories:



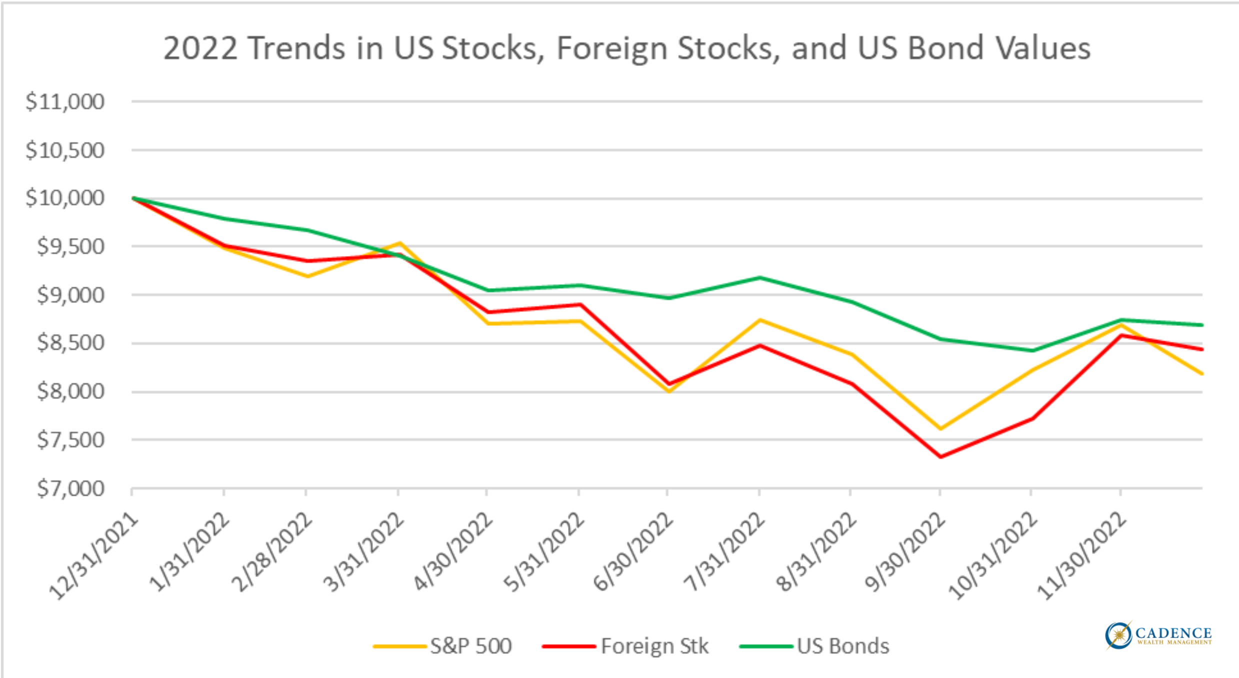
Almost nothing had a good year in 2022. I drew a red line at -10% to show just how many asset classes were down double digits this year. A few of the alternative sub-categories had good relative years, including the Cadence Separately Managed Accounts, with the real star of this year's bad show being commodities, specifically oil. To have a positive return in 2022 by buying and holding something you would have had to concentrate your investments into very few things, like oil, which is actually an incredibly risky strategy. Otherwise, traditional moderate portfolios performed pretty poorly this year as evidenced by the -15.5% return on the 50/50 portfolio here in blue. We Cadence advisors have been utilizing alternative investments, while steering clear of real estate, in preparation for the year both stocks and bonds did poorly, so our client accounts performed a fair bit better than traditional portfolios did. Our energy, precious metal, managed futures, and other alternative investments took some of the sting out of a pretty bad year.

I would not normally include real estate in this analysis as it is not a part of the core nor separately managed portfolios we manage at Cadence. I did so to help illustrate what an unexpected year 2022 was, even in areas that were supposed to be expected. We had been calling for inflation to remain high even in the early days when the Federal Reserve was saying it would be transitory. The conventional wisdom in inflationary times is to own tangible, physical assets and inflation-linked securities that can hold their value, the usual suspects being precious metals, US treasury inflation-protected bonds, oil, and real estate, to name a few. Of those, precious metals did ok, oil did well, but the rest did very, very poorly compared to what would normally be expected of them. How can an investment that is linked to inflation like US treasury inflation-protected bonds, and how can an asset that is very obviously a physical, tangible asset like real estate not do well during runaway inflation?

> ***"With US equity valuations already incredibly stretched, it's a wonder stocks have held up as well as they have to this point."***

It seems like for almost every asset that was supposed to do well during high inflation, there was some important variable that was strong enough in 2022 to ruin the returns. To combat inflation, the Federal Reserve (finally) got serious about raising interest rates. However, because it waited so long to do so and because inflation spiked as high as it did, the Fed raised rates very quickly by historical standards. The speed with which it raised those rates added to a slowing economy to hurt the real estate sector. Likewise, rapidly increasing interest rates hurt the bond market, and did so to such a large degree that it pulled down the one bond asset category, inflation-protected bonds, that was actually supposed to do well in these conditions. Looking beyond interest rate hikes, the multi-decade strength of the US dollar hurt precious metals and investments denominated in foreign currencies, and motivated the Chinese and Japanese governments to sell major US Treasury holdings to prop up their currencies, which further hurt US bond prices. To say it was a perfect storm is probably an exaggeration, but only probably. And this is just scratching the surface on some of the uncommon factors hurting investments in 2022, without even mentioning an economy tipped to enter an official recession soon (though it arguably already has), and the largest military conflict in Europe since World War II which has pulled in countries from around the globe. With US equity valuations already incredibly stretched, it's a wonder stocks have held up as well as they have to this point.

The last chart of this piece shows the performance of US stocks, foreign stocks, and US bonds (mostly government bonds) throughout 2022, each starting from a $10,000 value on January 1st. Despite early spring, mid-summer, and late fall rallies, the trend for all was obviously downward:



2022 was one of those years where a number of chickens came home to roost, and unfortunately found a way to bring their other feathered farmyard friends with them, as most asset categories saw profoundly bad years. Though not unexpected had you been reading our pieces over the last few years, the over-valued stock and bond markets were hurt by a number of variables that were harder to foresee. A war in Europe, multi-decade dollar strength, foreign governments dumping US bonds, and a suddenly aggressive Federal Reserve are just a few of the forces that made 2022 what it was, with every indication many of them will spill into 2023 while our economy continues to weaken. The majority of the pain in the bond market may very well have been felt by now, but the big question for 2023 remains: Will the stock market revisit and surpass the lows it set at the end of the summer?

What Lies Ahead in 2023

By Casey Clarke

This year was a year where effective defense made the difference. To come out of it with positive returns, as nice as that would be, simply wasn't in the cards without a healthy dose of risk and even more luck. To lose much less than others, or more importantly, what popular asset classes lost, was a huge victory. The question now of course is where does this leave us as we head into 2023?

To answer this question, it might be most helpful to think about it within the context of time. In weather, it's pretty well established that forecasting is easier within the next few days than it is two weeks out. The further into the future we go, the more unknown variables come into play. With investing, it tends to be the opposite. What happens to markets over the next few days is anyone's guess, but as we move months and years into the future, there are times where certainty can actually improve. The reason for this is markets tend to work more like the seasons than short-term weather patterns, which is to say they are cyclical. Of course, the consistency of their cycles is nowhere close to that of the seasons, but there is no doubt a certain cadence to them. Once we understand the factors that impact market cycles, we can improve our sense as to what may happen over broader sections of time.

Recession in 2023

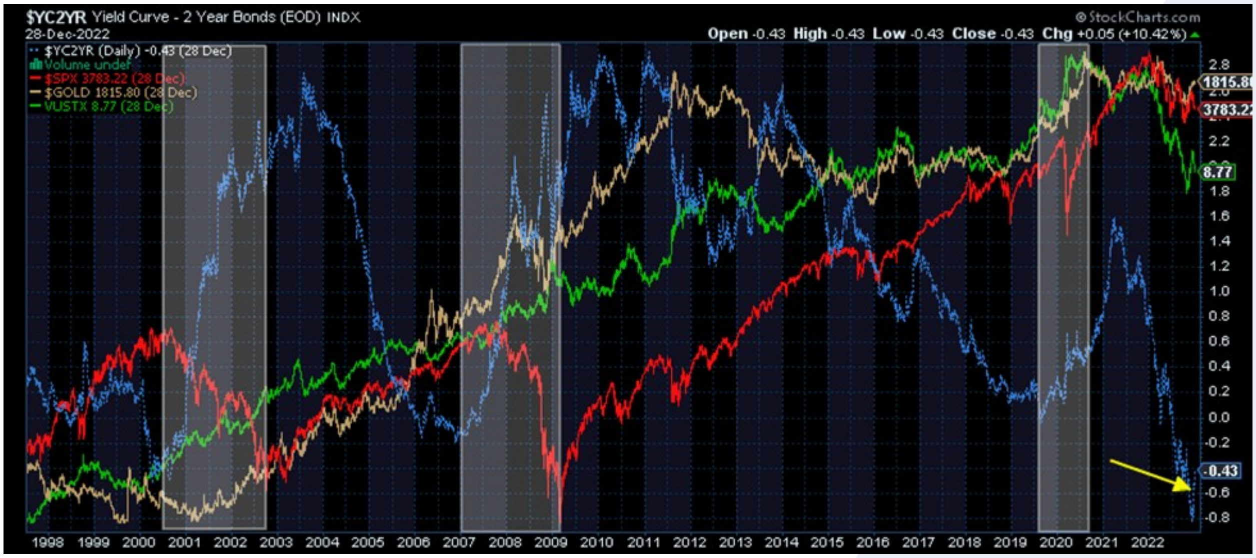
There are no certainties in investing; only probabilities. As we've seen repeatedly over the last handful of years, there's both a first time for everything, and seemingly limitless ability for a few men and women to conduct experiments that attempt, relatively successfully so far, to delay the inevitable. That said, the odds are that we will find ourselves in a recession in the early part of next year (2023). We say this because the current trend in economic growth is lower, the conditions that have caused that trend are still present, and mathematical comparisons going forward will make it hard for growth to reaccelerate. In addition, we are just now starting to see genuine weakness in employment, which of course is always one of the last pieces of the recession puzzle to fit into place. You wouldn't know this by listening to the "official" establishment employment report. It's not until you look at the lesser discussed household survey of employment, along with other data points such as new openings and the average manufacturing work week (hours), that you get a clearer sense as to what's going on. (A reminder to stray from the suggested path if something isn't making intuitive sense). Job cuts are happening and it's likely just getting started. Remember, this is the component some have been saying is required for an official recession to take place. Regardless of whether the definition is met and the label affixed, slowing or shrinking economic growth into the first quarter or two of next year sets the stage for our 3-6 month forecast.

Stocks Further to Fall

Not only do slowing growth and recession create a generally hostile environment for stocks, but the addition of a deeply inverted yield curve makes the potential for hostility even worse. The chart on the following page looks at the spread between the 10-year treasury yield and the 2-year treasury yield (blue) along with the price performance of stocks (red), gold (yellow), and long-term treasury bonds (green). Over the past 25 years, this 10/2 yield curve has inverted, or gone negative, 4 times with the most recent inversion being one of the deepest on record. As for recession indicators, an inverted yield curve tends to be one of the best as it signifies a very unhealthy financial system where long-term interest rates are lower than short-term interest rates. Not only does that indicate that lenders are requiring more interest to make loans (presumably due to a lack of creditworthy borrowers and high demand for loans in general), but it also suggests that economic activity and demand for funds down the road may not be as robust as right now; hence the lower rates on longer-term debt/loans. In addition, banks and financial institutions that make money borrowing short and lending long cannot make money with an inverted yield curve.

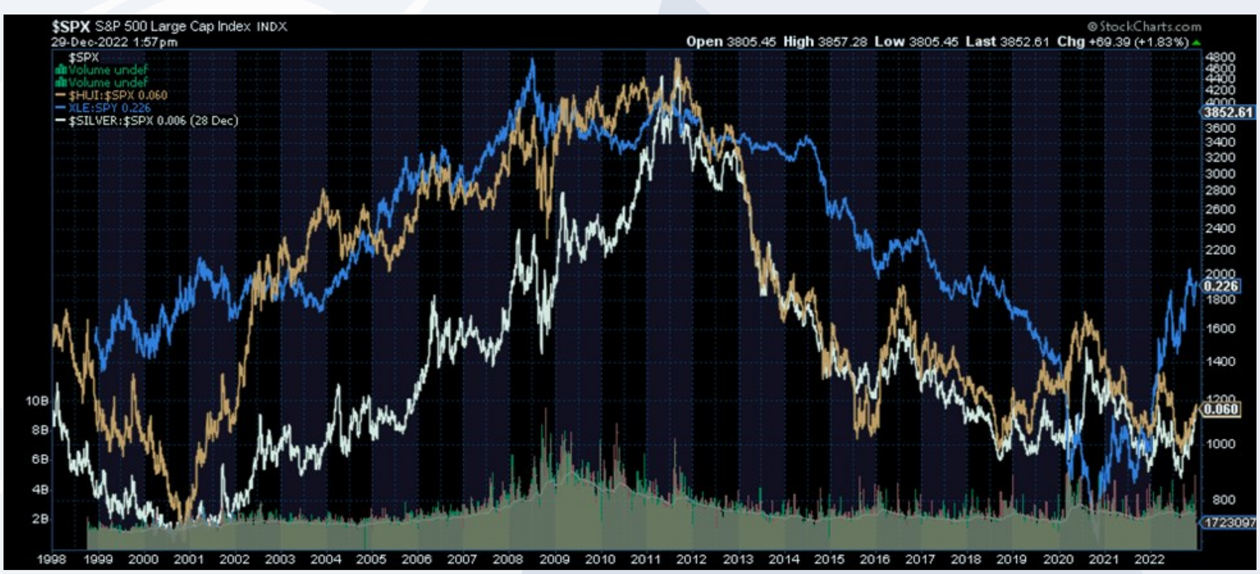
So, to sum all that up, we are sitting near the trough of a deeply inverted yield curve which supports the case for recession. It also suggests that stocks may have a good amount further to fall even after the Fed begins cutting rates and the yield curve begins steepening again. This is a critical point – markets still need to fall (along with inflation coming down a bit) enough to initiate interest rate cuts from Powell and the Fed, and then after that happens, it typically takes more time and additional turmoil before markets bottom. If the last two recessions are any guide, 2020 excluded for its peculiarity, we wouldn't be at all surprised to see another 30-40% downside in the major stock indices next year. Hypothetically speaking, this could take the form of say another 10-20% decline that gets the Fed to cut rates, after which we get another 20-30% or so further decline. This is a conceptual blueprint, not a forecast. There could be a scenario like in 2020 where crisis is averted, or at least delayed for a bit, or we could have a situation where panicky markets move beyond their mean or "average" valuation levels, in which case it could be worse than a 30-40% decline before we hit bottom. Both are possible, but we're planning for what we feel is more probable. It's also important to keep in mind that should we be headed toward a new, much lower bottom for the stock market, 2023 wouldn't have to encapsulate all of it. It could well play out over years. We'll take it one day at a time and react to what comes at us.

The flip side of that ugly stock scenario is the gold and green lines on the chart below. Treasury bonds and gold tend to perform much better in recessions and in the early phases of yield curve steepening. This, along with corresponding asset classes, is the defense that served us so well in 2022. There's no reason to expect it won't continue to serve us well heading into 2023, and with any luck, on an absolute basis rather than a relative one. Again, no certainties, only probabilities.



Energy

Energy-related investments were one of the few shining stars this year and one that contributed positively for our clients. As with anything that goes up a lot however, there is always a subsequent down often correlating some degree in magnitude. Although our longer-term outlook for energy is still positive, given the tremendous move higher in a relatively short period of time along with the fact that we're likely getting into the meat of the economic slowdown, the resulting hit to demand for energy beyond what supply issues could compensate for has us expecting more problems than prizes from the energy patch into the first half of next year. The chart below shows the price of energy stocks relative to the S&P 500 (blue). You can see clearly the level of outperformance over the last two years compared to silver (white) and precious metals miners (gold) which still remain historically cheap relative to stocks.



Time As Our Enemy

Although we'd like to believe that the passage of time brings healing, wisdom, and more predictable portfolio returns, almost anyone further along in age will tell you that at some point time turns from being friend to foe. This reality causes some introspection not only around how one spends their time, but around some of the assumptions we've made along the way. Time typically heals our wounds, unless we're doing something nutritionally, chemically, or physically to disrupt or prevent that healing. It brings wisdom assuming that we're willing to make mistakes, learn from them, and stay open-minded to new information. And the assumption around time being your friend when it comes to buying and holding stocks and bonds we take particular issue with because – A, it's not always true, and B, it sets up unsuspecting investors for financial ruin. Time, it turns out, can be a fickle foe.

We've been discussing for quite some time the fact that Wall Street and its financial heuristics are based on the last 40 years of financial market history which, not-so-coincidentally, also happen to be the best 40 years of financial market history. When one hears something like "buy and hold never fails" or "you're young, it'll bounce back", it's important to remember that those rules are only mostly factually correct when applied over the last 40 years. There absolutely are periods of time where stock investors would have been underwater for uncomfortably long periods of time, whether it's the 25 years from 1929 to 1954 or more than a -60% loss to inflation from 1968 to 1982. There is also Japan from 1990 to present, whose Nikkei stock index is still underwater more than 30 years later. The MSCI World Stock Index ex-US is also currently lower than where it was in 2007. The point is, long periods of time where stocks (and other markets) treat us more as foe than friend are far more common than Wall Street would have modern investors believe. We've been conditioned to look only at the last 40 years and ignore the rest. Any student of history and follower of cycles knows this isn't particularly smart. It's probably also clear to some exactly whose interests it serves most.

All this is to say that 2022 may have been the year that in retrospect will mark the beginning of a long period of mean reversion for U.S. financial markets. With stock valuations still stretched further than any other point in more than 100 years, debt levels at records, zombie corporations infesting the public markets due to bailouts and low interest rates being the norm for too long, and finally, inflation that's indisputably too high for most to handle, the jig may actually, finally, be up. This economic contraction could be the one that gets the pendulum swinging back toward balance and reasonability. For a "mass market" buy and hold investor, this is a scary prospect. For a human being who likes the idea of less wealth inequality and power concentrated amongst the biggest people and corporations, it's a more acceptable outcome, as this is part of how positive change happens. Inefficient zombie corporations failing and large powerful companies being forced to price goods competitively without endless performance-indiscriminate liquidity from capital markets will breathe fresh air into the whole economic system. Cycles. Creative destruction. Rebirth. All of which have been stifled over the last 10 to 20 years and has played a part in bringing the world to the seemingly extreme state it's currently in.

Time is only an investor's enemy if he's invested incorrectly, in the wrong things. As you can see from the chart on the previous page, there are still asset classes that are much cheaper than the traditional ones Wall Street has funneled the masses into over the years. The fact that most investors today all own varying degrees of the same stuff is largely why most asset classes are so expensive today. It's also why at some point, those same asset classes will become much, much cheaper – there's no shortage of future sellers, and in a panic, they all start clumsily running in the same direction. This is why time should be much friendlier to she who is invested in reasonable things. Sadly, as was the case this year, the system perpetuates the thinking that the only option for the bulk of an investor's assets is traditional stocks and bonds. There's a reason why the average 401k retirement date fund, whether mostly stock or mostly bond, is down almost the same amount this year (~-15 to -20%). One must know who to listen to and use their head in determining if the information they're getting sounds reasonable and sensible. My rule for filtering through financial market information and otherwise is to run the source through the following questions; 1) Are there embedded conflicts of interest? 2) Are there profit incentives or financial motivations? And 3) Is there regulatory capture? In other words, are the big financial institutions (or otherwise) better friends with their regulators than the regulators are with you? This goes a long way toward getting one pointed in a trustworthy direction. Our goal at Cadence is to always serve as fiduciary for our clients and to always operate in the world we find ourselves in rather than the one we want. Understanding the reality of the landscape is critical to coming up with an effective plan of action.

In summary, although there's likely to be tremendous volatility in financial markets next year and beyond, there is also tremendous opportunity. The stampede of investors that the traditional Wall Street model, as well as ETF and retirement plan model portfolio proliferation has driven into the major asset classes over the years has left other assets largely neglected. As valuations revert to their mean, which they always do, and the stampede finds the land they inhabit increasingly devoid of nourishing grass, those who had the confidence and foresight to break from the herd and plot their own course might instead find themselves grazing in wide open fields of lush, abundant grass. As with anything else in life, breaking from the herd when it is most important to do so is also when it's the hardest to do so. It takes courage; it's not easy. On behalf of myself and all of the advisors and staff at Cadence, I want to thank all of our clients for the trust they have placed in us and the courage it has taken to allow us to guide them differently in this respect. It paid off thinking and acting differently in 2022, and like I mentioned above, this may just mark the start of a much longer process. We have a plan. Here's to confidently embracing 2023 and all it has to offer. Most important, let's welcome a year rich in good health and happiness.

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