NORTH STAR
Resource Group

MARKET UPDATE
QUARTER 4, 2022

Stock Markets Quietly Rebound

As headlines surrounding inflation, employment, and Fed action continue to dominate the airwaves, the stock markets quietly rebounded in the fourth quarter of 2022.

The media likes to sell the sizzle of "plunging" or "sky rocketing" key headline numbers to create anxiety, holding the viewership into next segment or next day. No mediocre or uneventful number will keep an audience.

In reality, there are multiple levels and interpretations to each key metric, these can provide a much broader perspective to the state of the economy. Had you been listening to all the media hype, you may have wanted to sell or get out of portions of the market and probably would not have bought in. All the while the stock market quietly posted gains for the fourth quarter.

Economists feel that we're not completely out of the woods and most believe there may be moderate recession hanging over the markets into early 2023. The Fed has continued to signal further rate increases then keeping rates in place until that inflation number comes back to the 2% level. All eyes at this point are going to be watching corporate earnings into 2023, along with the pace of Fed rate hikes.

Much to the surprise of most in the industry, the markets posted positive returns for the fourth quarter:

The US Large Cap Index, the S&P 500, was up for the quarter 7.56% and the small caps of the Russell 2000 index were up 6.23%, but the biggest surprise was the international MSCI EAFE index was up a whopping 17.34%.[1] The fixed income markets and the Barclay's Aggregate Bond Index rose slightly at 1.87%. These are numbers we would be happy to see for a normal full year, although markets are still down for the year. For the year the markets are off -18.11%, -20.44%, -14.45%, and -13.01%,[1] respectfully, for the S&P 500, Russell 2000, MSCI EAFA, and Barclay's Aggregate indexes. In the last 40 years the -18.11% is the third lowest reading for the S&P 500 behind the 2008 Mortgage Crisis and the 2002 Dot Com Bubble.

Inflation as measured by the Headline CPI is at 7.1%, is still above the 4.7% reading in 4Q21[2] and the Fed target of 2%.

However, the trajectory is in the right direction as it is well below the summer high of 9.1%. The 50-year average for inflation is 4%. We have to go back to the late 1970s to find a higher inflation number, so most generations have not experienced or forgot about its effects. Inflation has been very noticeable in food prices, restaurants, hotels, and housing, it has been waning in energy (gas prices) and new and used vehicle prices.

With the realization that inflation was more real than transitory and that it was persistent, the Federal Reserve continued aggressively raising interest rates into the fourth quarter.

The earning of large cap growth stocks came more into focus. An asset class that had been invincible was coming to the realization that the higher interest rates would influence the long- term growth prospects of their corporate earnings. Down almost 30%, large capitalization growth companies and sectors finished the year down the most of all asset classes. Whereas large blue-chip companies with strong balance sheets that reward shareholders with a dividend, finished the year down only -7.5% as the best performing asset class: Large Cap Value.

Small cap and mid cap stocks that were the first affected by Federal Reserve actions have continued to bounce back from their mid-summer lows. Both small cap and mid cap growth stocks are down just over -26% for the year, up from their lows of being down over 30%. On the value side small caps are down -14.5% and mid-caps are down -12% for the year. If you look at the current Price to Earnings ratio, or PE Ratio, to the 20-year average, small caps continue to be cheap to the average, with small cap growth the cheapest. The most expensive is large cap growth at 21.1 times compared to the 20-year average of 18.6.[2]

A PE ratio is calculated by simple dividing the stock price by earnings per share. PE ratios are important, they indicate what the market is willing to pay for growth. The prospect of growth slowing down, or getting cut, will affect earnings, for this reason the market is selling off those companies with most risks. Value stocks continue to be cheap to growth.

Economists continue to focus on the five most relevant metrics during this bear market cycle, inflation, corporate earnings expectations, the labor markets, consumer confidence, and housing markets.

Some of these have shown improvement such as inflation subsiding and labor markets remaining strong. Others, like the housing market and earnings expectations have taken a turn for the worse and are still playing out in the broader economy. Mortgage rates continue to hang around that 7% rate for a 30-year fixed rate mortgage. This is causing a drop in single-family housing starts and an increase in multifamily housing starts, while supply remains low, the national average price of a house rose 9.2%. Fewer and fewer homeowners will qualify for those higher mortgage payments from higher rates and home prices.

Most economist feel a deep, prolonged recession is currently not in the cards given the current state of the economy.

Some even state the bear market low may have been experienced in October. Either way most feel volatility will prevail the beginning of 2023 then ease into a bull market the second half of the year as the Fed stops increasing rates and markets have adjusted.

Sector-wise, Energy was joined by Utilities to be the only sectors that are positive for the year: Energy up 65.7% and Utilities eked out a gain of 1.6%. Even with almost all sectors having a positive fourth quarter, the sectors that have lagged the most for the year were Communication Services, down -39.9%; Consumer Discretionary, down -37%; and Technology, down -28.2%.[1] All three of these are growth sectors where long-term growth concerns and high PE ratios continue to be called into question. Energy, up 22.8%, Industrials, up 19.2% and Materials, up 15% were the best performing sectors for the fourth quarter. Easing supply chains and weakening US dollar can be attributed to the Industrial and Material gains.

It appears that economist Mohamed El-Erain was incorrect in his quote about “the US continues to be the cleanest dirty shirt in the laundry basket” as international markets had an amazing fourth quarter run. During the fourth quarter the widely used international MSCI EAFA index returned an impressive 17.34%[1]. Not only was this an impressive number by itself, it outperformed the US by almost 10% for the quarter, out pacing the US for the year by almost 4%.

A weakening US dollar, opening up of supply chain problems, lowering of energy prices, and increase in industrial production are just some of the main reasons for this developed markets rebound.

One thing that has not contributed is the continued war efforts against Ukraine and the geopolitical overhang associated with it. The US Fed is quite a bit ahead of the rest of the world’s central banks in terms of rising rates to fight the effects of inflation. This will have a weakening effect the strength of the US dollar and affect the foreign currency markets, both positives for international stocks. International PE valuations continue to remain very cheap to the US, a 28% discount, or almost two standard deviations, the dividend yield is 1.6% higher than the US rate.[2] Developed international markets will garner investor attention for the reasons above. If a reduction of the war efforts in Ukraine and associated geo-political risk were to also happen, expectations would be for a strong economic recovery and performance more in line with historical averages. An allocation to international stocks remains an important portion of a client portfolio.

Demographic trends continue to be a very important driver of Emerging Markets economies. The growth of the middle class, notorious for spending, which drives a countries GDP growth, is experiencing exponential growth within many emerging market countries.

Over 95% of the growth between now and 2030 is expected from Asia, Middle East, and Africa. India, China, and Indonesia will account for most of this growth. Of the almost 1.7 billion garnering middle class status during this decade, only 10 million will be expected from North American, while Europe will account for a decrease of 3 million people.[2] After months of COVID lockdowns, protests in China will lead to a quicker than expected opening and potential for increasing growth of GDP. A weakening US dollar could also be a catalyst for increased emerging market activity and growth. Like international, an allocation to emerging markets may finally prove to be a very important portion of a portfolio.

The fixed income markets got a brief reprieve in the fourth quarter as performance increased 1.87%.[1] For the year fixed income benchmark index, Barclays US Aggregate Bond, was down -13%.[1] To better understand the severity of this double-digit bond market loss, we need to understand this is only the third time in the history of the US bond market we are down this much, the last time being in 1931. Inflation data continues to post higher than expected numbers, albeit at a decreasing rate. The Fed has continued to raise interest rates based on strong inflation and employment numbers. The Fed continues to signal they will keep increasing rates and indicated a willingness to keep them at a heighten level until inflation subsides to their 2% target. To further understand the severity of the Fed actions to the yield curve make note of the JPMorgan chart below showing the yield curve from the end of 2021 to inverted yield curve at the end of 2022. Those are significant jumps in yields for that time frame and main reason the bond markets have moved down so much in price.

Yield curve

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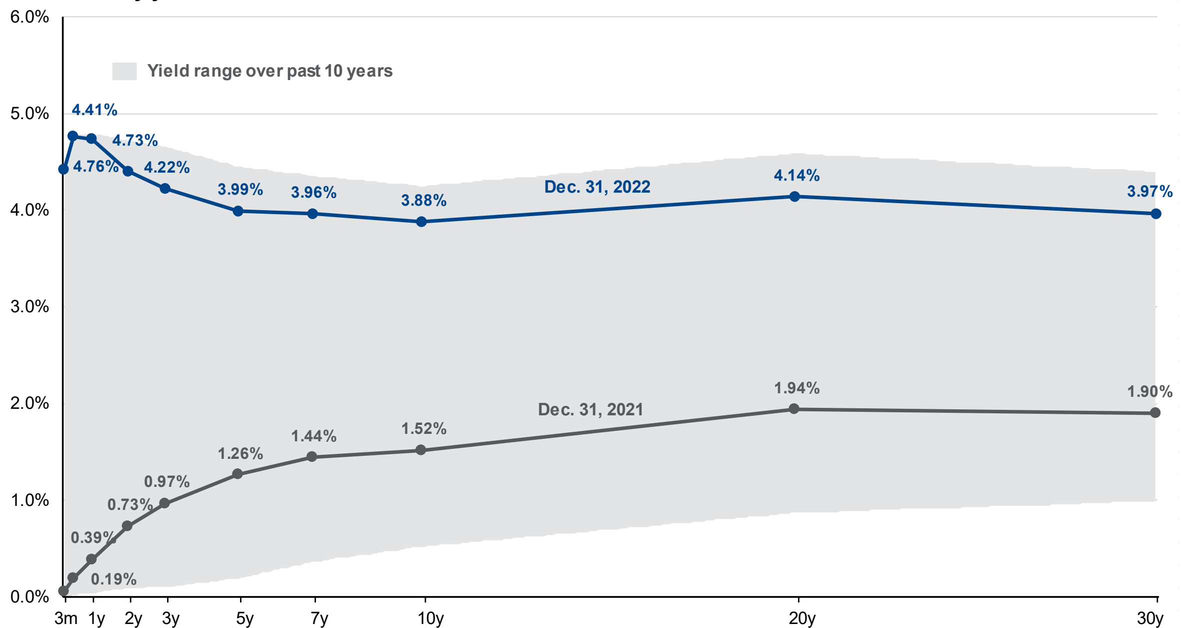
Fixed Income



Source: FactSet, Federal Reserve, J.P. Morgan Asset Management.
Guide to the Markets – U.S. Data are as of December 31, 2022.

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Created Opportunities

The Fed action has created a good opportunity for the fixed income markets going forward. With the exception of high yield, the fixed income markets continue to be relatively cheap compared to the last 20 years. Given the continued inversion of the yield curve, the immediate opportunities are on the short end of yield curve. Short duration bond funds, US Treasury Bills and Notes, and Brokered CDs, all with maturities under two years, currently have very attractive yields. As indicated by the yield curve, even better than maturities of 10 years or more. Most economics and fixed income strategists are recommending a barbell strategy for fixed income. This included buying the short duration bonds for the yield while buying longer duration bonds for the potential price increase if/when the Fed, or markets, decides to pull back on yields. Much like a barbell from the weight room, it creates a scenario where your assets are bookends. Municipal bonds also continue to be attractive for clients in the higher tax brackets. Unlike the taxable yield curve, the taxable equivalent yield curve is not inverted and is actually relatively steep. The opportunity to extend duration and buy longer maturity bonds will present itself as the yield curve returns to its normal shape.

Behavioral Aspect of Investing

We hear over and over again about the importance of staying invested at times like these. Fixed income is the perfect example, as markets are down at levels not seen in well over 50 years, now would be the worst time to sell your fixed income holdings. It may also prove to be a great opportunity to purchase bonds. As with any period, a fully diversified portfolio is the best way to achieve consistent returns and discipline to hold those assets classes that are out of favor.

Markets are cyclical and markets rotate, stay invested!

"The Investors chief problem – and his worst enemy – is likely to be himself. In the end, how much your investments behave is much less important than how you behave." **-Benjamin Graham**

Taking the long-term view at North Star Investment Resource Center, we continue to believe diversified portfolios and disciplined investment strategies continue to provide the best opportunities for those investors seeking growth.

We welcome investment discussions, should you have any questions or concerns, or if there is a change in your investment time horizon or financial circumstances, please feel free to contact us at your convenience.

Written by North Star Investment Resource Center

Average Annual Returns chart on next page

AVERAGE ANNUAL RETURNS FOR PERIODS ENDING 12/31/2022						
INDEX	**3RD Q**	**YTD**	**1 YR**	**3 YRS**	**5 YRS**	**10 YRS**
S&P 500	7.56%	-18.11%	-18.11%	7.66%	9.42%	12.56%
Russell 2000	6.23%	-20.44%	-20.44%	3.10%	4.13%	9.01%
MSCI EAFE (U.S. dollars)	17.34%	-14.45%	-14.45%	0.87%	1.54%	4.67%
Barclays US Aggregate Bond	1.87%	-13.01%	-13.01%	-2.71%	0.02%	1.06%
BENCHMARK COMPOSITES	**3RD Q**	**YTD**	**1 YR**	**3 YRS**	**5 YRS**	**10 YRS**
Aggressive Growth	10.24%	-16.96%	-16.96%	5.31%	6.38%	9.82%
Growth	8.69%	-15.86%	-15.86%	4.05%	5.35%	8.18%
Conservative Growth	7.18%	-14.80%	-14.80%	2.73%	4.36%	6.58%
Income and Growth	5.59%	-13.97%	-13.97%	1.02%	2.99%	4.74%
Income	3.54%	-13.48%	-13.48%	-0.53%	1.86%	3.18%
USD VS LCL	**3RD Q**	**YTD**	**1 YR**	**3 YRS**	**5 YRS**	**10 YRS**
MSCI EAFE NR USD	17.34%	-14.45%	-14.45%	0.87%	1.54%	4.67%
MSCI EAFE NR LCL	8.72%	-7.00%	-7.00%	3.64%	3.81%	7.56%

S&P 500 - The S&P 500 Index is an unmanaged index of 500 stocks that is generally representative of the performance of larger companies in the U.S. Please note an investor cannot invest directly in an index.

Russell 2000 - Russell 2000 Index is an equity index that measures the performance of the 2,000 smallest companies in the Russell 3000 Index, which is made up of 3,000 of the biggest U.S. stocks. Please note an investor cannot invest directly in an index.

MSCI EAFE - The MSCI EAFE Index is the Morgan Stanley Capital International Index and is designed to measure the total return of the developed stock markets of Europe, Australia and the Far East. Investment risks associated with international investing, in addition to other risks, include currency fluctuations, political and economic instability and differences in accounting standards when investing in foreign markets. Please note an investor cannot invest directly in an index.

Barclays US Agg Bond - The Barclays U.S. Aggregate Bond Index is a broad-based bond index comprised of government, corporate, mortgage and asset-backed issues, rated investment grade or higher, and having at least one year to maturity. Please note an investor cannot invest directly in an index.

The Benchmark Composite returns are a weighted average of index data comprised in the following manner. Aggressive Growth is 45% S&P 500, 25% Russell 2000 and 30% MSCI EAFE. Growth is 35% S&P 500, 20% Russell 2000, 25% MSCI EAFE and 20% Barclays US Aggregate Bond. Conservative Growth is 30% S&P 500, 10% Russell 2000, 20% MSCI EAFE and 40% Barclays US Aggregate Bond. Income and Growth is 20% S&P 500, 5% Russell 2000, 15% MSCI EAFE and 60% Barclays US Aggregate Bond. Income is 15% S&P 500, 5% MSCI EAFE and 80% Barclays US Aggregate Bond.

MSCI ACWIxUS - The MSCI ACWI ex US Index is a market capitalization weighted index was designed to provide a broad measure of equity-market performance throughout the world. It is comprised of stocks from 22 of 23 developed countries (excluding the US) and 25 emerging markets. Please note an investor cannot invest directly in an index.

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