Convergence Commentary

December 2022 Market Recap

Quick Hits:

- CPI was cooler than expected again, further solidifying that the Fed's hikes are working
- Stocks declined in December, ending the rally that started off the October lows and marking the end of the worst year for the stock market since 2008
- 2022 was a difficult year but there are reasons to be more optimistic about the market in 2023

Market-Moving Highlights

Congress passed the Secure 2.0 Act, which changed some of the laws regarding RMD age and IRA contributions. The IRA annual contribution limit increases starting on January 1st from $6,000 to $6,500, while the catchup provision for people aged 50 or older increases to $7,500 from $6,500. Starting in 2023, the RMD age will be increased from 72 to 73. If you have questions, please do not hesitate to reach out regarding these changes.

CPI for November increased 0.1% monthly compared to expectations of a 0.3% monthly increase. On an annual basis, CPI increased 7.1%, which was below the expected 7.3% annual rate and the lowest annual increase reported since November of 2021. Meanwhile, Core CPI also decelerated for the second consecutive month at 0.3% month over month, driven primarily by an increase in the housing component. This marks the second consecutive month that CPI has decelerated at a faster pace than expected, which may give the Fed more confidence that inflation is on a downward trajectory. However, there is still a long way to go to get inflation back down to the Fed's target of 2%. Housing was the biggest contributor to CPI in November, accounting for about half of the increase, while energy, used cars, and airline fares all decreased. Food increased 0.5%, due to rising prices for bakery goods and other dry foods like cereal, but other underlying food prices like meat actually declined. After the report was released, markets rose sharply before fading throughout the trading day. For the first time in months, the market ended the day of the CPI report with only modest gains, after experiencing extreme moves to the upside or downside on previous report days throughout 2022. In our view, this is a

signal from the market that investor's primary concern is shifting from high inflation to the implications of the rapid increase of interest rates on the economy.

The day after CPI was released, the Fed met and increased rates by 50 basis points. A 50 basis point increase was the consensus expectation and marked the first time since May that the Fed did not increase by 75 basis points. The primary takeaway from the Fed's meeting was that most of the Federal Open Market Committee (FOMC) now projects the federal funds rate to peak at 5% or more. Continued encouraging inflation data could be a catalyst for the Fed to stop hiking rates, but they have stated they will need to gain more confidence that inflation will continue to fall before pivoting. However, deteriorating economic data could prevent them from reaching their target of a 5% federal funds rate. The Fed will likely continue to maintain their hawkish tone to prevent the market from getting too far ahead of itself regarding a potential Fed pivot. After Powell's press conference, the market fell as it digested the prospects of higher for longer interest rates.

A significant Santa Claus rally failed to materialize as a result of the Fed's continued hawkishness and concern over how the Fed's actions will affect the economy in 2023. As we have covered in previous market commentaries, the market had already experienced a substantial rally off of the October lows and after the midterm elections, so a lack of a rally to end the year is not all that surprising.

Index Performance

Index	1 Month	2022	3 Year	5 Year
S&P 500	(5.76%)	(18.11%)	7.77%	9.42%
Nasdaq Composite	(8.67%)	(32.54%)	6.21%	9.67%
Russell 2000	(6.49%)	(20.44%)	3.19%	5.45%
MSCI ACWI ex US	(1.69%)	(15.57%)	0.42%	1.96%
S&P US Aggregate Bond	(0.45%)	(13.01%)	(2.74%)	0.05%

Stocks were mostly lower in December on the back of Fed hawkishness and more economic concerns. Concerns in the market seemed to have shifted some, from most of 2022 spent being concerned about inflation, rising rates, and the war in Ukraine to more focus on economic growth and the potential of a Fed-induced recession. 2022 was the worst calendar year for markets since 2008. It was also a rare year where stocks and bonds moved in unison to the downside. The S&P 500 was down about 18% in 2022, but if you look at performance of underlying stocks, particularly large cap growth companies, the fact that the market was down only 18% shows the resilience of other parts of the economy that were able to help prevent the index from more downside. Value stocks outperformed growth stocks in 2022 largely as a result of interest rates moving higher. As we have discussed at length, growth stocks struggle in rapidly increasing rate environments because it affects how growth companies are valued by analysts.

While equity performance was disappointing in 2022, especially in terms of year-end performance, the maximum drawdown in 2022 of about 25% was not among the worst annual maximum drawdowns we have seen in recent years. The drawdown in 2022 was only the sixth-largest maximum drawdown since 2000 (JPM). It's also an oddity that the market hit an all-time high on the first day of trading in 2022, making the YTD return look worse than if an all-time high was hit later on in the year. Also, we should note that despite the poor performance in 2022, over a five-year time horizon, the S&P 500 is still returning 9.67% on an annualized basis, which falls near the average annual return of the index dating back to its inception and amounting to a total return of about 58% if you were invested over that five-year period. The market had an excellent run coming out of the early stages of the pandemic and it has become apparent that the market likely got too excited by the ultra-low interest rate environment. Some of the market's performance in 2022 can be attributed to removing some of the excess that was present in certain areas of the market.

Finally, bonds had one of their worst years on record as the Fed raised rates at the fastest pace since the 1980s. Bond prices fall when interest rates rise, so the rapid pace led to bond price depreciation. Because rates were already so low, there was little income to help offset the decline in price. However, this does set up bonds quite nicely moving forward, as there is now the ability to gain yield that has been mostly nonexistent since the Global Financial Crisis. In addition, if rates begin to fall - which could be viewed as likely as the Fed is projected to become less hawkish in 2023 - bonds will likely experience price appreciation that will enhance the price return of the asset class.

S&P 500 Sector Highlights & Commentary

Best Performing Sectors in 2022		Worst Performing Sectors in 2022	
Energy	64.59%	Communication Services	(38.49%)
Utilities	1.77%	Consumer Discretionary	(36.43%)
Consumer Staples	(0.16%)	Technology	(28.08%)

Energy was by far the best-performing sector in 2022 for reasons we have frequently elaborated on in previous market commentaries. The War in Ukraine, lack of global production, inflationary pressures, and supply chain issues were just a few of the driving forces behind the sector's performance. Even as oil and other energy commodity prices have normalized from their highs set over the summer, energy companies have continued to report record profits, propelling stocks in the energy sector upward. The direction of the energy sector from here will likely be driven by what happens in Ukraine, the reopening of the Chinese economy that could further strain supply, and the potential of a global slowdown in economic growth. Given the uncertainties the economy faced and the volatility in the market, relatively strong performance from both utilities and consumer staples does not come as a surprise, given their defensive nature.

With value stocks significantly outperforming growth stocks in 2022, growth sectors like technology, consumer discretionary, and communication services were the biggest losers among the S&P 500 sectors. Communication services and consumer discretionary were both hit hard by some of the biggest companies in their respective sectors, like Facebook and Netflix in communication services and Tesla in consumer discretionary, who were all some of the worst performers in the sectors. All three sectors aggressively rebounded from the COVID-19 era and benefited from low interest rates, which also explains some of their underperformance. The technology sector held up a little better than the other two thanks to better relative performance for its biggest companies like Apple and Microsoft, but still was down almost 30%. Semiconductor companies, which make up a significant portion of the sector, struggled significantly as demand for chips normalized from highs in 2021 and concerns surrounding China, including restrictions on chip sales to China and a

reduction in production capacity due to their zero-COVID policies. According to LPL, the difference between the best and worst-performing sectors were the largest spread since the S&P 500 sector classifications were created in 1990 (LPL), further emphasizing the high volatility the market experienced in 2022.

What to Watch in 2023

Earnings will be reported for the 4th quarter of 2022 starting in early January. As of now, earnings are expected to decline on average, but the extent of the decline, if there is one, will likely impact sentiment on the direction of the economy.

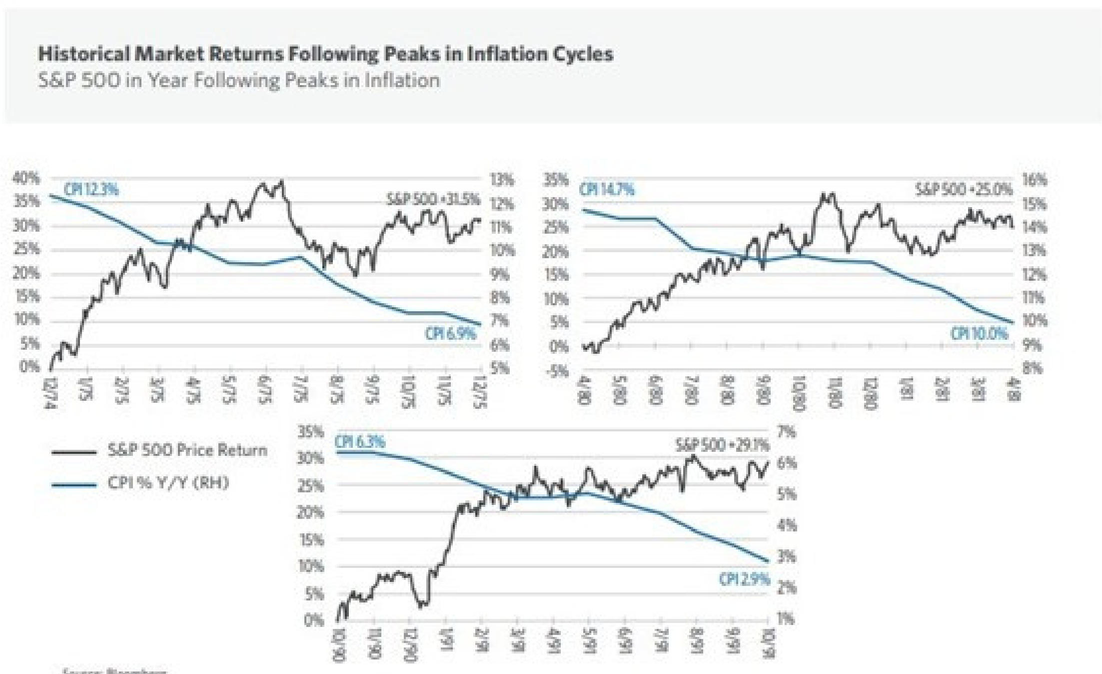
The Fed is likely to stop increasing rates or pivot from their hawkish policy stance altogether at some point in 2023, but the timing of this is still up for debate. It is likely that they will increase rates again at least one more time in February but falling inflation and deteriorating economic conditions could prevent them from continuing rate hikes at as high of a rate in 2023 as they did in 2022. In addition, the market will be watching economic data closely to determine if the Fed over-tightened or if they were able to rein in inflation without leading the economy into a downturn.

The geopolitical strains on the market are likely to continue into 2023, with the War in Ukraine ongoing, China continuing its fight against COVID-19, and tensions between China and the United States all still factors that the market will be watching closely. A resolution regarding any of these 3 would have a strong positive impact on the market.

Market Wrap

There is no doubt that 2022 was a very difficult year for all types of investors. The market faced a number of different headwinds throughout the year, from a significant war to the highest inflation in 40 years and a suddenly ultra-hawkish Fed determined to get inflation back to acceptable levels. All of this and more combined to make navigating financial markets more challenging than it has been in years, but one thing we know by looking back at history is that the stock market has historically always bounced back from difficult times. The chart below shows that the stock market has declined in consecutive years just three times since 1950. Therefore, history tells us that it is more likely than not that the market will be positive in 2023, although there are still significant headwinds and the path to a positive year will likely include continued volatility.

The market also tends to perform well in a deflationary environment. As we have touched on all year, inflation causes serious problems for the economy. Input goods for businesses become more expensive, company earnings become harder to project, and consumer sentiment declines when the cost of everyday goods become more expensive. These issues stemming from inflation, among others, cause the Fed to raise rates which then affects the valuation of stocks. All of these issues combine to impair market performance when inflation is rising. However, when inflation starts to decline, and it appears that it has, the stock market does quite well. In the chart below from Transamerica Capital, we can see that the S&P 500 has bounced back by more than 25% in the year following the peak of inflation during other high inflationary environments in the past.



Finally, the consensus economic forecast for 2023 is a mild recession, which could already be priced into the market at this time. While it is important to acknowledge the possibility of this occurring, we do not believe it is a foregone conclusion that the economy will experience a downturn. While economic growth certainly will slow, that does not necessarily mean a recession will happen, as there are a number of factors that go into determining if the economy has entered a recession. Also, a consensus forecast is not always right and when it comes to trying to predict what will happen both in the economy and in financial markets, consensus can be often wrong. It does not take much research to identify recent times when the consensus was wrong. In late 2021, inflation was transitory, the Fed was not going to need to raise rates significantly, and the S&P 500 was going to break 5,000 for the first time, according to consensus. Those predictions all turned out to be quite wrong looking back one year later, mainly due to the unforeseen events that took place throughout the year. The uncertainty that faces the economy and financial markets as we move into 2023 is significant, but that does not necessarily mean the economy is going to deteriorate. It simply means there is still a lot to sort out regarding the current environment. Times like this often present the best opportunity to invest because once these uncertainties dissipate, the forward-looking market is often already back on its way up.

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Sources

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Since 1950, a down year was only followed by another down year three times: in 1973, 2000, and 2001. (LPL 2023 Outlook)
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Your Investment and Research Team

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Travis Cook, CFP®, CMFC®
CEO, Financial Advisor

Tyler Hoffmann, MBA
Vice President, Financial Advisor

Dr. John Stansfield, CFA
Director of Investments

Logan Clark
Assistant Investment Research Analyst

3919 S Providence Rd, Columbia, MO 65203
573.818.2264
www.convergence-financial.com

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