Quarterly Market Update – 4Q, 2022

Market Summary & Outlook

Recap

- **Decelerating Inflation Provided Q4 Bounce –** With the U.S. in late-cycle economic expansion and the rate of inflation set to materially slow, the Fed is closer to the end of its hiking cycle than the beginning. Most asset prices rose in Q4 as interest rates stabilized and U.S. dollar-strength eased.
- **Challenging Market Dynamics, Attractive Valuations –** Persistent inflation in 2022 led to slower economic growth and greater uncertainty for investors. Some of 2022's challenges have now been fully priced into the market, leading to attractive valuations particularly in fixed-income and non-U.S. equities.
- **Widespread Decline Across Asset Classes –** Nearly all asset classes finished 2022 substantially lower than the year prior, posting double digit declines in most cases. A year marked by a four-decade high rate of inflation proved to be a tailwind for the only performing asset class, commodities.
- **Bonds Have Historic Year –** Both large-cap stocks and investment-grade bonds posted double digit losses for the first time since 1926. Paving the way for a historically bad year for bonds as a portfolio diversifier, with large-cap stocks and long-treasury bond indexes losing upwards of -21.65% and -29.26%, respectively.
- **Easing Labor Conditions but Still Tight –** Job openings fell from all-time highs, but many unfilled openings remain as we head into 2023. Several long-term trends may keep the labor market tighter for longer, such as an overall aging U.S. demographic and slower growth in the working-age population.
- **Consumers in Decent Shape but Savings Rates Dropped –** High inflation kept real wage-growth negative, which caused consumers to dip deeper into their savings to make-up for spending shortfalls. Household net-worth reached near all-time highs but declines in asset prices dampened growth.
- **Profit Margins to Be Carefully Watched –** Typical of late-cycle dynamics, rising input costs reduce profit margins and pressure earnings growth. Investors will keep a keen eye in 2023 on corporations' abilities to maintain pricing power and earnings growth, a key story to staving off a longer or deeper growth recession.
- **Inflation Drivers Peak but Remain Persistent –** Supply chain disruptions cleared throughout 2022 and slowed significantly in the 2nd half of the year. However, persistent inflation as a contributor to total inflation remains elevated even after transitory effects have subsided. Unit costs have cooled but tight labor market conditions continue to be a significant contributor to high inflation in the services sector. Investors will watch labor conditions and job openings closely in 2023 for any signs of relief.

ABOUT THE FIRM

Virtus Capital is an independent investment advisory firm serving high net-worth individuals, families, and business owners.

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Performance

Equity Benchmarks	Returns as of 12/31/22 3 Month	YTD
S&P 500 PR	7.08%	-19.44%
DJ Industrial Average PR	15.39%	-8.78%
Nasdaq Composite PR	-1.03%	-33.10%
Russell 2000	6.23%	-20.44%
MSCI AC World Index ex USA Net	14.28%	-16.00%
FTSE Emerging Index	8.52%	-17.23%

Bond/Commodity Benchmarks	Returns as of 12/31/22 3 Month	YTD
Bloomberg US 1-5 Year Treasury	-0.94%	-5.47%
Bloomberg US 5-10 Yr Treasury	-1.18%	-12.58%
Bloomberg US Long Treasury	-0.59%	-29.26%
Bloomberg US 5-10 Yr Corp	3.79%	-13.89%
Bloomberg Municipal Bond	4.10%	-8.53%
Bloomberg Commodity Index TR	2.22%	16.09%

*Data Source: Morningstar and Vanguard Funds

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Discussion

Signs of moderating inflation in Q4 provided some positive momentum for stocks and bonds, as the last quarter of the year saw asset prices regain modest ground. 2022 was a historically challenging year for global financial markets, as 2021's sentiment of "There Is No Alternative" or "TINA", searingly morphed into "PAIN" for investors, or "Possible Alternatives Include Nothing" by the end of Q1, 2022. Commodities were the only major asset category that saw a yearly double-digit gain, but as long-term investors know all too well, you can't put all of your eggs in one basket. Even a significant portfolio overweight to energy and minerals delivered the diversified investor a lack-luster performing year. While asset markets struggled, a strong U.S. dollar stoked the flames with record highs not seen since 2002. A strong U.S. dollar can dampen domestic corporate earnings, especially for those companies that derive a large share of their revenues from overseas, providing yet another market headwind in 2022. Dollar strength did ease in the 2nd half of the year with the DXY cooling from its peak of 114.10 in September to finish the year at 103.52. Still, earnings growth markedly slowed down for almost all major financial sectors, with U.S. Large-Cap Growth stocks bearing the brunt of the downturn, losing over a third of their value.

U.S. based companies are not alone in their earnings growth deceleration, as global markets also continued to cool after a decade-high spike in profits associated with the 2021 reopening and lifting of covid restrictions. Forward earnings-per-share (EPS), which measures a company's profitability for each share outstanding, has been relatively muted across the globe with expectations on a 12-month, forward basis of 0%, 1%, and 5% earnings growth for emerging, developed, and U.S. markets respectively, according to Fidelity's Q4 Institutional Research Report. This broad concensus for slower growth led to risk-off trading in 2022, with the S&P 500 experiencing its largest drop since 2008, losing over 19% to finish the year. However, the concurrent drop in earnings and stock prices has also compressed the valuations of equities, with stock prices generally declining at a faster rate than the decreases in expected earnings. The orderly sell-off in 2022 caused global stocks around the world to fall from their lofty valuations reached in 2021, providing investors with a more attractive average P/E multiple, with all three global market categories (emerging, developed, and domestic) now below their 20-year average on a forward looking 12-month basis. The opportunities then perhaps improve for long-term stock and bond returns, as yields have steadily risen for fixed-income assets in 2022 and foreign equities that are now trading at valuations far below their long run averages. Additionally, as strong-dollar drivers begin to fade, purchasing power parity (PPP) moves towards par value relative to the U.S. dollar, providing an additional tailwind for improving fundamentals in foreign markets. Although 2022 was a rough year for investors, much of the challenging economic data and its associated factors have now been fully priced into most financial assets.

Outlook

Wall Street's consensus forecast is calling for a mild recession in 2023, with Goldman Sachs being the notable outlier. Goldman's Chief U.S. Economist, David Mericle, has baked in a 35% chance of recession in 2023, forecasting only a 1 in 3 chance of a U.S. recession over the next 12 months. Goldman's out-of-consensus view is primarily owed to a disagreement regarding the thought pattern that a recession is necessary to tame inflation, and a belief that the Fed's tightening cycle in 2022 resulted in a front-loaded drop in GDP, with those effects likely to dimmish in 2023. Interestingly, it is seemly becoming more of a challenge for financial professionals, economists, and market participants to agree on a clear definition of "when" we've entered into a full-on economic recession. Absent a formal definition, traditionally, it has been defined as two subsequent quarters of negative GDP growth, which came to fruition in Q1 and Q2 of 2022. An alternative definition has been recently suggested to include a general decrease in economic activity, paired with a drop in payrolls, production, and retail sales. Nevertheless, investors will be closely monitoring economic activity data in 2023 to see if the Fed's interventions, specifically the increase in interest rates, has led to an overtightening effect on key economic growth drivers. Decelerating growth is generally not a positive driver for financial assets, however, historically more defensive market factors such a minimum volatility, or Min Vol factor, can outperform the market on a relative basis during recessionary periods, due to late-cycle dynamics taking hold of the economy and investors potentially favoring lower beta stocks. Inflation sensitive assets such as gold and commodities may still prove to provide a valuable diversifier in 2023, however their sensitivity to growth surprises since 1972 has delivered muted returns comparable to sectors such as Information Technology or Consumer Discretionary. A multi-asset approach to portfolio construction can help hedge against increases in inflation, while providing for upside returns if economic growth overperforms. In the same vein, an overperformance of economic growth above its consensus forecast could also encourage a stable or slightly increasing interest rate environment, improving the value-proposition for fixed-income assets, as yields continue to rise along with interest rates.

On a macro scale of investing, secular trends continue to emphasize deglobalization of trade and growing geopolitical tensions, particularly between the two major global economies – the U.S. and China. This relationship is a complex construct of strategic partnerships and competition. From 1964 to 2006 the ratio of Global Imports/GDP has steadily increased, leading to greater globalization and more favorable international trade policies. By 2006, this ratio began to flatten and is forecasted to drop in the next decade as tensions increase globally due to geopolitical rivalries, tariffs, and supply chain risks. Virtus Capital's investment philosophy continues to focus on a long-term approach to portfolio construction and security selection. Opportunistic and tactical allocations that increase return-profiles are highlighted in our actively managed portfolios. Virtus Capital investors continue to benefit, as seen in 2022, from a diversified risk-adjusted investment style, that aims to deliver greater long-term value through our on-going investment in financial research technologies and our independent advisory model.

Q4, 2022 Quote:

"The stock market is a device to transfer money from the impatient to the patient."

– Warren Buffett

Sources

(1) Benchmark return data - https://personal.vanguard.com/us/funds/tools/benchmarkreturns

(2) Benchmark return data – www.morningstar.com

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(4) Goldman Forecast - https://www.goldmansachs.com/insights/pages/why-the-us-can-avoid-recession-in-2023.html

(5) DXY Data - https://www.marketwatch.com/investing/index/dxy

(6) Fidelity Data - https://institutional.fidelity.com/app/literature/item/9880898.html

(7) U.S. Large-Cap Growth Data - https://www.trackinsight.com/en/index/crsp-us-large-cap-growth-index

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