Appleton Partners, Inc.

Navigating Turbulent Times

An Abrupt Shift in the Capital Markets

We will refrain from offering a comprehensive year-end market retrospective as the financial media has thoroughly covered that ground, and some may prefer not to revisit the details. Instead, our objective is simply to draw upon 2022's investment experience as a means of reinforcing more personal, timeless planning guidance.

Inflation framed last year's narrative, with a June YoY CPI print of +9.1% representing the highest reading since 1981. Although the latest CPI release moderated to +7.1%, the dragon has hardly been slayed, a reality emphasized by Federal Reserve Chairman Jerome Powell. The latest inflation report was also influenced by statistical base effects and remains far in excess of the Fed's +2% annual target. In response to these pressures, the Fed Funds rate increased more rapidly than ever before in 2022, with four 0.75% hikes followed by a 0.50% December increase. The latest median Fed forecast calls for a peak 5.1% Fed Funds rate, as compared to near zero rates from April 2020 through the first quarter of 2022.

Risk appetite was shaken in response, and volatility characterized the equity markets with 121 trading days producing greater than +/- 1% S&P 500 returns, an anomaly only seen in two prior years. As investors grappled with an abrupt end of extremely loose monetary policy and growing recession concerns, stocks and bonds simultaneously incurred significant losses. In fact, 60/40 balanced strategies suffered their second worst year since 1976.

In today's multi-media world much of the chatter is "inside Wall Street" scorekeeping that is perhaps best disregarded. Our belief in the value of diversified, risk-focused asset allocation has not changed. Clients should also consider that today's more modest equity valuations and higher bond yields suggest a probability of more attractive future returns than might have been expected a year ago when asset values were much higher.

Little Things Make a Difference

Bringing 2022's experience closer to Main Street, we are experiencing a reversal of an interest rate environment that had long punished savers and rewarded borrowers. Sharply higher rates impact many aspects of economic activity, including mortgages (30-year average fixed rates have surged from roughly 3% to 6.60%), consumer finance costs, and business loans. The tide has clearly turned as 2-year Treasury yields have risen from 0.75% to 4.35%, a reality to which we must all adjust.

Sometimes, simple steps can be meaningful, and we suggest starting by making sure bank and investment account income is not an afterthought. Subject to liquidity and other suitability considerations, moving idle cash into income-producing options such as short-term, high quality municipal bonds or US Treasuries makes sense. Investment grade municipals of somewhat greater maturity may also be attractive for those seeking tax-advantaged income, as 10-year AAA rated taxable equivalent yields exceed 4.50% for those in high tax bracket, high tax states despite a recent rally in bond prices.

Conversely, the cost of consumer debt has significantly increased. We encourage clients to also look at the liability side of their balance sheets as debt linked to prevailing interest rates imposes a much greater burden than a year ago. Paying down variable rate debt may be warranted with Fed policy no longer suppressing borrowing costs.

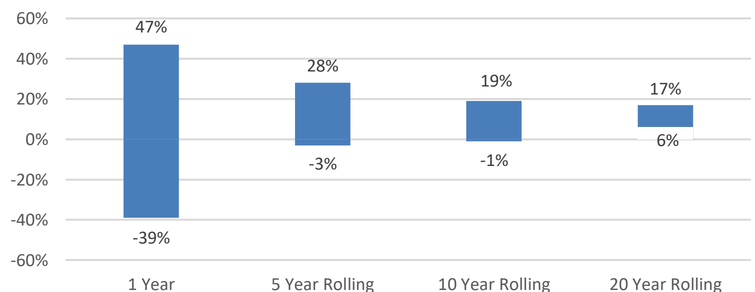
Silver linings are often found amid difficulties, and in private wealth management mining portfolios for tax management purposes can be one of them. November's Review and Outlook discussed the value of selectively realizing losses to reduce net tax liability. Although the 2022 window has passed, tax loss harvesting can still be valuable in 2023 and beyond. We have also long emphasized other tax related financial planning strategies, such as maximizing retirement plan contributions, timing retirement distributions, and strategically implementing charitable giving plans.

Let Fundamentals Chart Your Path

Appleton's wealth management process is built around client specific risk and objective-based planning. Risk is inherently linked to return, and we have no particular ability to predict short-term market movements. Instead, we seek to mitigate risk through timeless disciplines such as personalized asset allocation, portfolio diversification, and avoiding imprudent, speculative forays. Doing so allows time to become your ally, as the likelihood of negative equity market returns diminishes the longer one is invested. This speaks to the value of staying invested unless your circumstances change, while also periodically rebalancing back to asset allocation targets.

The ultimate measure of our success lies in the extent to which we can help individuals and their families achieve their objectives. That is why we think about risk in the context of financial planning goals, not just relative to institutional benchmarks, and try to help clients manage through turbulent times. With the calendar having turned to 2023, we look forward to smoother sailing and wish you and your families a healthy and happy new year.

Time Is An Ally In the Stock Market
High and Low Range of Annualized Total Returns
S&P 500 Shiller Composite 1950 - 2022



Source: JP Morgan Asset Management

MARKET OBSERVATIONS & IMPLICATIONS

Tax-Exempt Investment Grade Municipals

- Q4 started with a continued sell-off with yields reaching their highs for the year at the end of October. The Hawkish tone of the Fed drove the weakness, but a weaker than anticipated CPI report in early November changed the tune and prompted a market rally across the curve.
- Municipals followed USTs, with 10-yr AAA yields trending higher before ending Q4 at 2.63%, 78 bps off October highs. Fed related pressure on the front end created the first municipal curve inversion, as 1-yr AAA yields were about 38 bps higher than yields in the 3 to 8-yr AAA curve.

	9/30/2022	12/31/2022	QTD change
2-yr AAA Muni	3.09%	2.60%	-49 bps
10-yr AAA Muni	3.30%	2.63%	-67 bps
30-yr AAA Muni	3.90%	3.58%	-32 bps

Source: MMD

- Two more Fed Funds hikes above the current 4.25-4.50% range are priced in with moves expected in February and March. We feel increased recession risk will cause the Fed to pause after March and anticipate curve steepening.
- Municipals outperformed in Q4, as the 10-yr AAA Muni/UST ratio fell from 86.2% to a year-end low of 67.8%. These ratios may give investors pause although, as demonstrated in 2021, strong demand and weak issuance can allow markets to sustain below average ratios.
- 2022 saw record net outflows of $121.6B from municipal bond funds, with tax-loss selling likely driving assets into ETFs. Almost 47% of outflows came from long-term funds.
- Credit spreads tightened with A rated municipal spreads of 38 bps falling well below the 10-year average of 49 bps. Demand should drive spreads even tighter in Q1 ’23, and we see value in select A and AA rated issuers. Nonetheless, broad market valuations make caution warranted.
- Q4 issuance dropped 41% vs. 2021 as higher interest rates dampened refunding and increased the cost of new projects. Full year issuance of $384.1B declined by almost $100B vs. 2021.
- Duration drove performance with the 20-year index the top Q4 performer (+5.23%) while the 1-year index lagged (+1.23%). By contrast, higher overall 2022 yields caused longer maturities to underperform.
- In our Intermediate strategy we see value in the 9 to 12-year part of the curve. A flat curve has created opportunities to barbell front end purchases with the longer end of our buying range.

Investment Grade Corporates & Treasuries

- The Fed has warned the financial markets not to underestimate their resolve to bring down inflation, and 2023’s peak Fed Funds forecast now stands at 5.1%, as compared to the current 4.25-4.50% range that followed the December meeting.
- We anticipate two more hikes in 2023, 25 bps and then 25 bps or 50 bps depending on the Fed’s interpretation of economic data. If there are signs of economic easing and subdued inflation the Fed could slow their pace. Consensus is that front end rates will normalize and a flatter yield curve across all maturities may result, a dynamic that would suggests recessionary-like conditions. Our preference for intermediate duration and high-quality credit ought to remain in favor in that scenario.
- Bloomberg Barclays US Corp. IG Index spreads of 130 bps held steady in December after earlier tightening and signs of a less hawkish Fed later in 2023 would be supportive of the credit markets.
- IG Corp new issuance declined 16% in 2022 vs. 2021, and our 2023 expectation is that we will see a similar total issuance number as last year. As rates have moved higher the cost of debt has increased for issuers and other sources of financing are also available. The refinancings of 2020 were almost non-existent last year and Mergers and Acquisitions activity was also much lower, minimizing two very important issuance catalysts of the prior few years. Limited new supply should help keep credit spreads in a narrow range over the next several months, particularly as demand for credit remains strong.

Equities

- Stocks rebounded in Q4, snapping a 3-quarter losing streak, the longest since 2008. Gains were concentrated in October and November, months that saw the S&P 500 rise 14.1% before giving back 5.9% in December.
- Nine of eleven GICS sectors were positive led by cyclicals (Energy, Industrials, and Materials). Growth-oriented Consumer Discretionary and Communication Services were the only negative sectors.
- Early Q4 gains were driven by hopes for a Fed pivot following softer than expected CPI readings. Other signs of “peak inflation” materialized with supply chain pressures easing, used car prices falling, and rents rolling over. However, the Fed reiterated a “higher for longer” rates stance and raised their 2023 Fed Funds forecast to 5.1%, throwing cold water on dovish expectations.
- Recession fears and concern about a monetary policy mistake remain an overhang for risk assets. We are carefully monitoring earnings guidance against market consensus calling for +4-5% EPS growth.
- The bullish narrative emphasizes peak inflation, a resilient consumer buoyed by a relatively strong labor market, and a China reopening. Weak sentiment and more modest valuations after 2022’s declines support the case for stronger forward returns.
- Our portfolios favor dividend payers and defensive sectors as they should fare reasonably well in the face of sustained volatility, as well as maintaining exposure to high quality growth names.

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