The *Philadelphia* Story

A Quarterly Commentary on the Economy & the Financial Markets January 2023

From: *Philadelphia* Investment Management Group

OVERVIEW

- ***While Inflation Continued to Ease In the Fourth Quarter of Last Year, it Remains Much Higher Than the Fed's Desired Target.*** *Inflation numbers, however, should begin to subside going into the middle of 2023 as interest rate increases continue to slow the economy.*

- ***The Unusual Influence of Business Conditions in the Economy Stemming from the Pandemic Continues to Confuse Economists and Market Strategists Alike in Their Forecasting for 2023.*** *Most were seriously wrong in their forecasts for 2022. Our best guess will be that the rate increases will slow during the course of this year as business conditions begin to return to normalcy.*

- ***In the Past Quarter, the Dollar Began to Lose Some Steam as Investors Bet that U.S. Inflation was Slowing.*** *A weaker dollar will give some relief worldwide as it remains a primary currency for trade and finance. A weak dollar will increase our cost of imports, but it will also help global countries in their cost of imports.*

THE ECONOMY

The economy continues to struggle from the effects of the pandemic on the business climate. The amount of Federal stimulus money ordered by both the Trump and Biden Administrations as a result of the crisis was certainly a lot to blame for the dislocations in the economy. The easy money continues to cause trouble within the jobs market as well as the demand/supply unequalness of business generally. These never-before events of this magnitude were primary causes of the inflation with which we are now saddled.

Inflation is at a 40-year high, forcing the Federal Reserve into an unprecedented series of interest rate increases, cratering the bond market and sending stocks into a bear market that continued into the end of 2022. Since monetary policy acts with a lag, we expect higher interest rates will lead to stagnant economic growth and possibly a recession in the first part of 2023. While, in our opinion, there could be one or two more rate increases in the first half of the year, we think after that, there will be a halt to additional tightening. In fact, considering that we believe economic activity will continue to moderate into the second half of this year, we feel the Fed could reverse course and begin to ease monetary policy.

FINANCIAL MARKETS

EQUITIES

War, severe supply shortages, inflation at its highest level in 40 years, interest rates rising at a speed and by a size that was unprecedented, an historic sell-off in bonds, and at the end of the quarter a collapse of cryptocurrencies, all of this ended a year best forgotten with a look to the future.

The table below tells a very interesting story. The Dow component of 30 stocks, in each of the four quarters of 2022, (except for the third quarter), outperformed the S&P 500 Index. In times of turmoil in domestic and global economies, the very largest and most recognizable domestic companies will outperform the S&P 500, which represents a more broad-based group of businesses. With the Dow down 6.86% for 2022 and the S&P 500 losing 18.11%, the numbers support these observations. We think what we will find, now that it appears the economy's future is becoming clearer, will be a broader base of stock returns reflective of an improving business climate.

	Equity Returns*				
Index	**4th Qtr**	**3rd Qtr**	**2nd Qtr**	**1st Qtr**	**2022**
S&P 500	7.56%	-4.88%	-16.10%	-4.60%	-18.11%
Dow	16.01%	-6.17%	-10.78%	-4.10%	-6.86%
NASDAQ	-1.03%	-4.11%	-22.44%	-9.10%	-33.10%
Russell 2000	6.23%	-2.19%	-17.20%	-7.53%	-20.44%

*Total: price change + reinvested dividends

In addition, within the Russell 2000, high-quality value small cap companies had the highest return, doubling the performance of the growth sector. As investors become more confident in the direction of the economy away from recession, if this were to be, growth will become better received.

Forecasting for 2023, or for any year for that matter, is tricky business, especially now that the New Year is upon us. Strategists use models with a multitude of inputs, analysts focus on reported and expected numbers, and technicians use indicators and charts. Last year was not kind to the majority of these forecasters because, simply put, we have been in uncharted waters from the start of the pandemic through to the end of last year. What we do know, however, is that all of the problems will eventually work themselves out, but it will take time. As we have reported previously, these are times unlike any we have experienced in the past.

Equities should have a better year this year than last. The chart below shows that stock valuations are obviously at more attractive levels than they were at the beginning of 2022. Technology was the third worst performing sector of the S&P 500, losing $4 trillion of market value. Simple reason, it is the most expensive sector of the S&P and thus one to be punished more than others.

S&P 500

Sector	Weight	Returns* 4th Qtr	Returns* 2022
• Energy	5.2%	22.81%	65.72%
• Materials	2.7%	15.05%	-12.27%
• Industrials	8.7%	19.22%	-5.48%
• Cons. Discretionary	9.8%	-10.18%	-37.03%
• Consumer Staples	7.2%	12.72%	-0.62%
• Health Care	15.8%	12.80%	-1.95%
• Financials	11.7%	13.61%	-10.53%
• Info Technology	25.7%	4.74%	-28.19%
• Communication Svcs	7.3%	-1.38%	-39.89%
• Utilities	3.2%	8.64%	1.57%
• Real Estate	2.7%	3.82%	-26.13%

12/31/22
*Price + income
Source: S&P Dow Jones

As evidenced from the above S&P sector analysis, few areas of business were insulated from the rise in interest rates and subsequent slowdown in the business environment. Only Energy had the greatest positive outcome in 2022, and this was more the result of the disruption of supply from the Ukraine-Russia conflict. As to be expected, Health Care and Consumer Staples were areas which, out of necessity, maintained their ground in the highly volatile 2022 market.

In summary, equities are trading at deep discounts but need evidence of a long-term economic rebound and moderating inflation to rally back to fair value.

FIXED INCOME

Bonds experienced their worst annual performance dating back to 1976, as measured by the majority of the fixed income indexes. No part of the market for bonds was spared as rising interest rates across the entire bond yield curve pushed down bond prices. At year end, the yield on the one-year Treasury rose 436 basis points to 4.75%, while the middle of the yield curve rose 254 basis points to 3.80%. In the corporate arena, with concerns about future default expectations, the credit spread widened between the investment grade market versus high-yield non-investment grade credits.

Fixed Income Returns

Index	4th Qtr	2022
Corp/Govt	1.73%	-13.75%
Int. Corp/Govt	1.55%	-8.30%
Long Corp/Govt	2.25%	-26.91%
U.S. Government	0.72%	-12.86%
- Intermediate	1.02%	-7.60%
- Long	-0.38%	-28.15%
Corporate	3.53%	-15.44%
- Intermediate	2.70%	-9.63%
- Long	5.32%	-25.53%
- **Quality**		
- AAA	2.46%	-18.94%
- AA	2.68%	-16.00%
- A	3.11%	-14.69%
- BBB	4.06%	-15.86%
Municipal	4.02%	-9.04%
- Intermediate	2.83%	-4.63%
- Long	4.91%	-12.20%

Source: ICE BofA

The chart above tells the story of the bond market last year. Long-term corporate and government bonds performed the worst as worries set in that inflation would require continued interest rate increases throughout 2023. Only intermediate-term bonds had the least negative returns. The inverted yield curve, with shorter bonds yielding more than longer bonds, offered investors better yield with intermediate maturities, without going too risky with the investment in longer bonds. In other words, fixed income investors felt the most comfortable with intermediate-term bonds, both taxable and tax-free instruments. Municipal bonds suffered, as did corporates, from higher interest rates but also on overall concerns about the financial condition of municipal governments and revenue bond issues.

As we look out over the next few months, the bond markets may encounter some choppy waters. However, as we get further into the New Year, we feel that lengthening duration into longer-dated bonds makes sense, as there is a good chance the Fed will begin cutting the Federal Funds rate in the second half of the year.

****

In conclusion, our policy is to remain well diversified in the equity area and not stray too far away from the S&P sector weights. Within these sectors, we will concentrate on companies whose products are in demand regardless of business conditions. Demand will slow, for sure, but should gain nicely as the economy recovers from the crises.

Our fixed income approach continues to stress high quality in corporate, Treasury and municipal securities with short-to-intermediate maturities. The intermediate maturity range continues to be the most attractive area due to its higher yield versus shorter bonds. While returns further out along the curve can produce higher yields, long bonds tend to be riskier due to their length of time to maturity.

Philadelphia Investment Management Group
105 Clarke Avenue
Pocomoke City, MD 21851