The Cobblestone Advisor
Investment Brief
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COBBLESTONE
CAPITAL ADVISORS

The More Things Change

Reversing the trend of the first three quarters of 2022, the S&P 500 delivered strong performance (+7.5%) during the fourth quarter as sentiment improved and investors appeared more willing to take on risk than they were earlier in the year.

It was not just US equities that began staging a recovery during the quarter. International developed and emerging market stocks performed notably well—up a respective +17.3% and +9.7%—partly supported by a weakening US dollar.

Bond markets also delivered positive returns during the period, with the Bloomberg US Aggregate up +1.9%. Within fixed income, riskier segments led the way as higher yield and lower credit quality outperformed higher quality counterparts.

Despite strong fourth quarter performance across most asset classes, the recovery within stocks and bonds only partly offset the declines experienced over each of the prior three quarters. This resulted in 2022 marking one of the worst years for balanced portfolio investors since the Great Depression, second only to 2008 (during the depths of the Global Financial Crisis).

Looking back on 2022 as a whole, there were three key themes that weighed on markets: persistently high inflation, sharply rising interest rates, and US/global recession fears. We expect these issues to remain front and center for investors, and the path of inflation, interest rates, and US/global economic growth to continue driving markets for the foreseeable future.

With respect to interest rates and inflation, Federal Reserve policymakers responded aggressively to elevated inflation throughout 2022 by raising the target range for the Fed funds rate at the quickest pace in history. Although inflation remains elevated, it has softened in recent months, falling from its 9.1% peak in June to 6.5% in December.

Underlying data suggest that inflationary pressures should continue easing in the months ahead. Growth rates in rents and home prices have steadily declined since the first quarter of 2022 (shelter accounts for approximately one-third of the Consumer Price Index). Costs in the supply chain have also either outright declined (e.g., container shipping rates) or are rising at a notably slower pace versus one year ago (e.g., producer prices, which measure the prices of goods as they leave their place of production).

Though it appears as if Fed policymakers are making progress on the inflation front, there remains significant uncertainty regarding the ultimate impact that their aggressive rate hike campaign will have on the US economy. US economic growth—as well as global growth—had already been slowing when the Fed embarked on its tightening cycle in early 2022. In the wake of an already slowing economy and with rate hikes expected to further curtail demand, the balancing act that the Fed has taken on of tightening financial conditions just enough to quash inflation but not push the economy into a recession has become much more challenging. As a result, the path of economic growth from here remains fairly uncertain.

That is not to say that there is clarity ahead regarding the outlook surrounding interest rates and inflation.

(Continued on page 2)

Total Return (%), Ending 12/31/2022				Annualized		
	Qtr	YTD	1 Year	3 Years	5 Years	10 Years
S&P 500 Stock Index	7.5	-18.1	-18.1	7.6	9.4	12.5
Russell 2000 (Small-Cap Stocks)	6.2	-20.5	-20.5	3.1	4.1	9.0
MSCI EAFE (International Stocks)	17.3	-14.5	-14.5	0.9	1.5	4.7
MSCI EM (Emerging Markets)	9.7	-20.1	-20.1	-2.7	-1.4	1.4
Bloomberg US Aggregate Bond Index	1.9	-13.0	-13.0	-2.7	0.0	1.1
Dow Jones US Select REIT	4.8	-26.0	-26.0	-1.4	2.5	5.7
Consumer Price Index (% Chg over Period)	0.0	6.5	6.5	4.9	3.8	2.6

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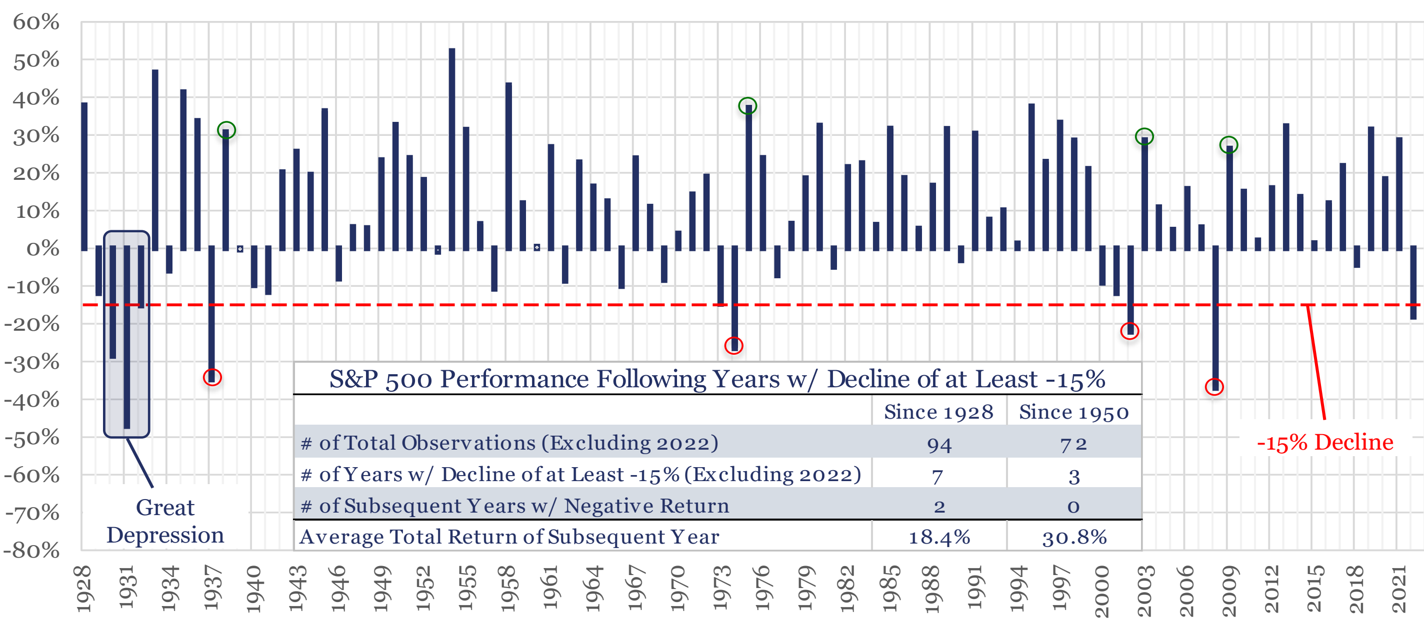
But in addition to the positives we highlighted with regard to inflation appearing to have peaked, most of the Fed's heavy lifting (i.e., aggressive tightening of financial conditions) is likely in the rearview mirror, and interest rate hikes in 2023 should be more gradual.

Taken together, easing inflation pressures and the likelihood of less aggressive rate hikes lowers the probability of materially higher bond yields. And with the 2023 starting yield on the Bloomberg US Aggregate at 4.7%—versus a 2.4% average yield for the index over the last 10 years—the argument for owning bonds is now stronger than it has been in a long time.

A higher starting yield provides greater cushion to protect against total return declines resulting from changes in interest rates and/or defaults. The 4.7% starting yield on the index and 8.5 years until the average maturity suggests expected annual returns of 4% to 5% on average over the next approximately eight years. If we look back to the last time yields were this high, it was 2008 during the depths of the Global Financial Crisis. Bonds went on to deliver a 5.0% annualized total return over the next five years.

The outlook for equities isn't as straightforward. Positively, history does suggest that consecutive years of significant equity market declines are unlikely, having only occurred during the depths of the Great Depression. Outside of the Great Depression, years that experienced a significant decline were followed by years that delivered a significant gain, as shown in the below exhibit.

Nonetheless, it is important to be prepared for a wide range of outcomes until there is further clarity on inflation, interest rates, and the economic outlook. We are cautiously optimistic that clarity on these issues will lead to an improved outlook by the end of 2023. In the meantime, investors should stick to their long-term investment plan and avoid making rash decisions that may lead to suboptimal investment outcomes.



S&P 500 Performance Following Years w/ Decline of at Least -15%

	Since 1928	Since 1950
# of Total Observations (Excluding 2022)	94	72
# of Years w/ Decline of at Least -15% (Excluding 2022)	7	3
# of Subsequent Years w/ Negative Return	2	0
Average Total Return of Subsequent Year	18.4%	30.8%

Source: S&P Dow Jones, Bloomberg.