MARKET REVIEW
FOURTH QUARTER 2022

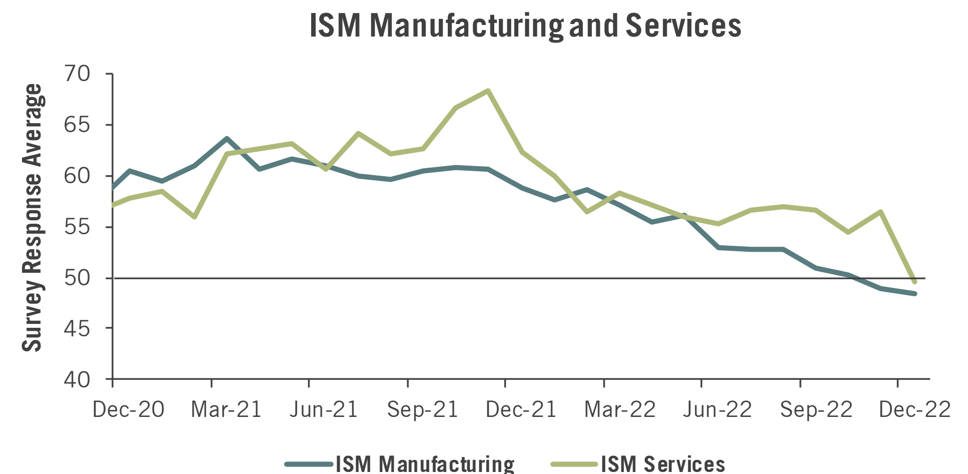
3Q22 GDP GROWTH REBOUNDS...

- The economic engine in the U.S. remains intact for the time being. 3Q GDP growth beat expectations, coming in at 3.2% q/q annualized with the largest positive contribution coming from a narrowing trade deficit. Behind the headline number, however, measures of domestic demand, such as residential investment and consumer spending, were less optimistic.
- 4Q GDP is expected to be approximately 1.0%-2.0% q/q annualized, bringing full-year 2022 growth to ~2.0%. Looking ahead, estimates are for GDP to remain positive through early 2023 before the economy slips into a recession in the back half of the year, resulting in full-year GDP growth that is barely positive.
- The probability of a recession in the next year has increased to 65% according to Bloomberg, supported by a deeply inverted yield curve and slowing economic activity (see below). Discussions about recession will continue into the new year.

Source: Bloomberg

...AMID HEADWINDS FROM HIGHER RATES AND INFLATION

- The labor market remains tight, with another with 263k, 256k, and 223k jobs added in October, November, and December respectively. Notably, job creation has exceeded expectations in just about every month since May. Still, negative real wages, equity markets down ~20% as measured by the S&P 500, and meaningfully higher mortgage rates put pressure on consumers this year.
- Personal savings measured as a percentage of disposable income plummeted in 2022, from 7.5% at the end of 2021 to only 2.4% in November. This marks the lowest savings rate since spring of 2005. After a spike to 1.3% m/m in October, retail sales growth was -0.6% m/m in November. Retail sales ex-autos shows a similar pattern, rising by 1.2% m/m in October before falling -0.2% m/m in November.
- Businesses are not expanding at the same rate that they were previously, with a number of activity measures now in contractionary territory. The ISM Manufacturing PMI dipped to 49.0 in November and 48.4 in December, the first contractionary readings since May 2020. The ISM Services PMI had been a bright spot, measuring 54.4 and 56.5 in October and November before falling to 49.6 in December.



Source: Bloomberg

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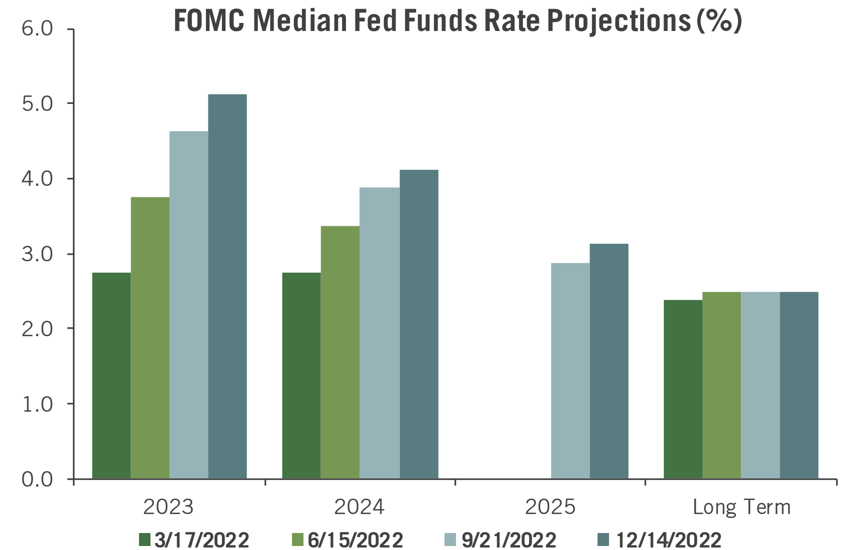
FED REMAINS HAWKISH...

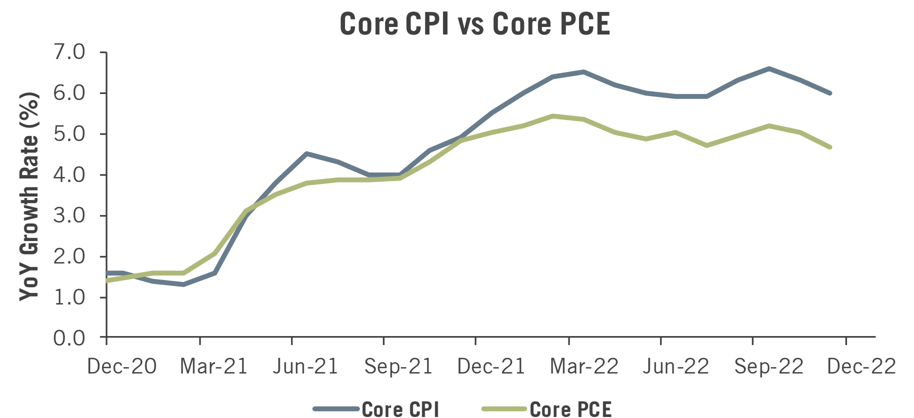
- The Fed increased its policy rate by another 75 bps in November, the fourth such rate increase in as many meetings, before downshifting slightly to a 50 bps increase in December. This brings the total rate increase to 425 bps: the fastest, most aggressive monetary policy tightening in 40 years.
- The Fed's message has consistently been hawkish despite market sentiment that begs for a policy pivot. In post-policy meeting press conferences, Chair Powell has stressed that additional policy tightening will be appropriate in order to achieve the Fed's inflation target. More importantly, Powell suggested that the pace of rate hikes is perhaps less important than the terminal rate and the length of time monetary policy will remain restrictive.
- Furthermore, the recently released December meeting minutes clearly stated that "No participants anticipated that it would be appropriate to begin reducing the federal funds rate target in 2023." However, market pricing indicates another 75 bps of tightening through early 2023 followed by rate cuts in the back half of the year as a result of economic weakness, ending the year closer to 4.50%.



Source: Federal Reserve

...WHILE INFLATION SHOWS SIGNS OF WEAKENING

- There are early signs that inflation is finally heading in the right direction across many key measures. Headline CPI increased by 7.1% y/y and 0.1% m/m in November, down from 8.2% y/y and 0.4% m/m in September, while core CPI increased by 6.0% y/y and 0.2% m/m in November, down from 6.6% y/y and 0.6% m/m at the end of the third quarter.
- Similarly, headline PCE decelerated to 5.5% y/y and 0.1% m/m in November, down 6.3% y/y and 0.3% m/m in September, and core PCE fell to 4.7% y/y and 0.2% m/m from 5.2% y/y and 0.5% m/m for the same time periods.
- Inflation expectations briefly shot higher in October on hopes that a policy pivot was at hand, but retreated in November and December with continued hawkish Fed messaging. 5-year and 10-year breakeven rates ended the year at 2.38% and 2.30% respectively.



Source: Bloomberg

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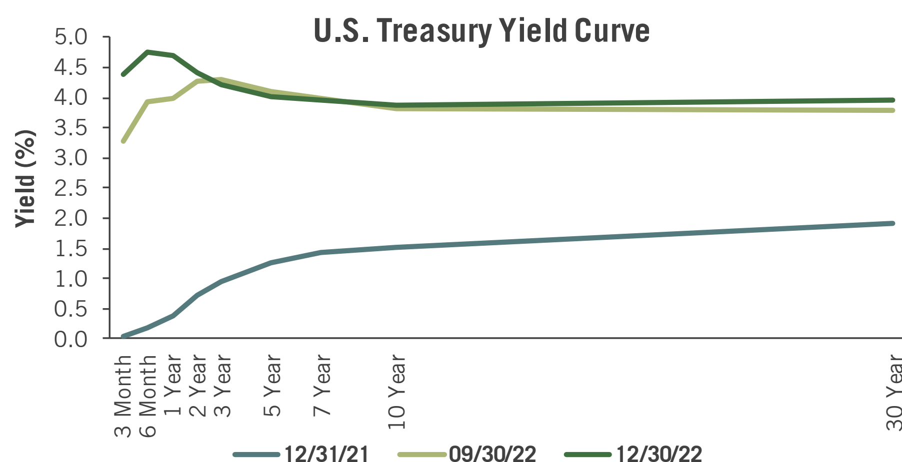
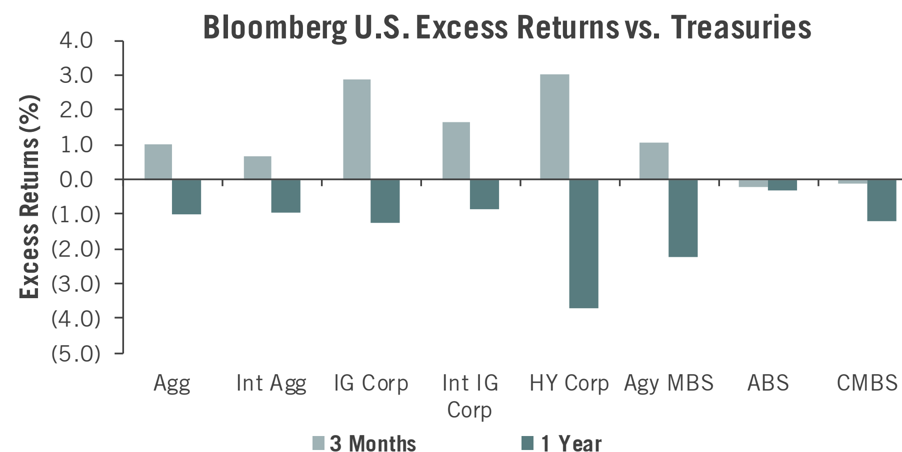
NON-TREASURY SECTORS RECOVER WHILE YIELD CURVE REACHES LARGEST INVERSION IN 40 YEARS



Source: Bloomberg



Source: Bloomberg

- While the curve sold off only slightly during the fourth quarter, 2-year Treasury rates rose 370 bps and 10-year Treasury rates rose 237 bps for the full year. This resulted in 133 bps of curve flattening and the most deeply inverted yield curve in 40 years. In early December, the curve was inverted by 84 bps, the largest inversion since 1981, before ending the year inverted by 55 bps. Reflecting tighter financial conditions and the effects of quantitative tightening, 10-year real yields ended the year a whopping 268 bps higher than at the end of 2021. Considering all of this, it should come as no surprise that fixed income returns were truly dismal in 2022. The annual total return for the Bloomberg U.S. Aggregate Index, -13%, was the worst on record going back to inception in 1976.
- Excess returns were positive for the quarter for most major fixed income spread sectors. Exceptions were ABS and CMBS, which just slightly underperformed like-duration Treasuries. Within IG Corporates, longer bonds outperformed short/intermediate maturities, while BBB issuers outperformed higher quality names.
- Corporates spreads recovered somewhat during the quarter after hitting year-to-date wides in September. For the year, spreads were wider by ~30-50 bps across maturities. Investment grade new issue supply through November was off 2021's pace by ~13% (SIFMA).
- Agency MBS ended the year on a positive note, despite having one of the worst excess return performances on record over the first three-quarters of the year as tighter financial conditions and persistent hawkish Fed messaging weighed heavily on the sector in 2022. Mortgage rates, as measured by the Freddie Mac Weekly Survey rate, ended December at ~6.4%. With financing rates more than double what they were at the beginning of the year, housing activity continues to grind to a halt.
- All things considered, short duration high quality ABS fared relatively well in 2022 despite historic monetary policy tightening. ABS new supply registered $55 billion in the fourth quarter and $277 billion year-to-date, down only 4% vs. 2021 (Citi Research). Over the coming year, some credit deterioration is expected, particularly at the lower end of the spectrum, as the economy cools and unemployment increases.
- CMBS new supply measured a paltry $6.8 billion for 4Q while year-to-date volume was $68 billion, approximately 40% lower than in 2021 (BofA). As with residential housing markets, commercial real estate activity has slowed considerably. With financing rates substantially higher year-to-date and questions surrounding rent growth and valuation, transaction volumes have slowed and some properties with near term maturities may find refinancing existing debt to be a challenge.

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