# One For the Record Books

*"We tend to use [the word transitory] to mean that it won't leave a permanent mark in the form of higher inflation,"* – **Jerome Powell (Fed Chairman)**

2022 will go down in history as a landmark year for economics and financial markets, just not the type of year we want to remember. The highest inflation in 40 years, the most aggressive interest rate increases in modern history, and the Russia/Ukraine war were each unique in their own respects and caused extreme volatility in all investment asset classes. This is only the 5th time since 1926 that stocks and bonds have been down in the same year and the first time that both have declined by 10% in a single year.

Stocks ended the year down 18.1% (S&P 500), but at the low were down 25%. After 5 great years of performance, technology stocks lost 32.5% (Nasdaq), with many individual names declining by far larger amounts. Value stocks were down 7.5% (Russell 1000 Value), which feels like a victory in a terrible year. International Stocks did not fare much better with International Developed and Emerging Markets down 14.3% and 20.5% respectively (EFA/EEM).

Perhaps the biggest surprise of the year was the bond market, which is traditionally the "safe money." Bonds ended the year down 13% but were down 17% at the trough. This is the single worst year on record for the Barclays US Aggregate Bond Index. In general, bonds remain in great health and the number of bonds in default is quite low. The losses were simply a result of the massive interest rate increases implemented by the Federal Reserve.

The lone bright spot for investors in 2022 was the strength of many Diversifying Strategies. Most of our private real estate, private credit, and hedge fund strategies had positive years, and many exhibited double-digit returns. It has been our belief that interest rates would increase at some point, and we are thrilled these strategies performed when we needed the diversification the most.

Below we provide a brief recap of 2022 and our views as we move into 2023 and beyond.

## 2022 Recap

On December 15, 2021, the Federal Reserve released their official economic predictions. As shown in the bottom part of the chart, The Fed projected interest rates to be 0.9% at the end of 2022 and forecasted a longer-term average of 2.5%. The world was a good place! A year ago, the Fed dismissed inflation risks, calling it "transitory." It turns out that inflation wasn't transitory as the Ukraine/Russia war began. Fast forward to December of 2022 and the actual Federal funds rate was 4.3%, with a forecast of greater than 5% over time. These rate increases dominated headlines and drove stock and bond performance last year.

| Variable | Median[1] | | | | |
|---|---|---|---|---|---|
| | 2021 | 2022 | 2023 | 2024 | Longer run |
| Change in real GDP | 5.5 | 4.0 | 2.2 | 2.0 | 1.8 |
| September projection | 5.9 | 3.8 | 2.5 | 2.0 | 1.8 |
| Unemployment rate | 4.3 | 3.5 | 3.5 | 3.5 | 4.0 |
| September projection | 4.8 | 3.8 | 3.5 | 3.5 | 4.0 |
| PCE inflation | 5.3 | 2.6 | 2.3 | 2.1 | 2.0 |
| September projection | 4.2 | 2.2 | 2.2 | 2.1 | 2.0 |
| Core PCE inflation[4] | 4.4 | 2.7 | 2.3 | 2.1 | |
| September projection | 3.7 | 2.3 | 2.2 | 2.1 | |
| Memo: Projected appropriate policy path | | | | | |
| Federal funds rate | 0.1 | 0.9 | 1.6 | 2.1 | 2.5 |
| September projection | 0.1 | 0.3 | 1.0 | 1.8 | 2.5 |

Source: FOMC



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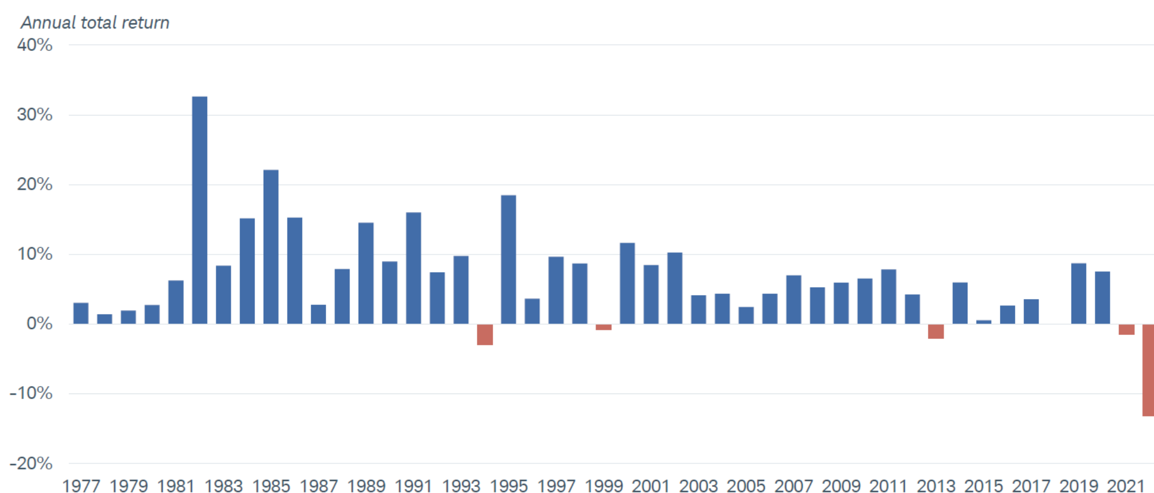
There are thousands of variables that affect the stock market, however, there are only two that ultimately determine prices: corporate **earnings** and the **multiple** investors are willing to put on those earnings. When the final numbers are tallied for 2022, earnings grew slightly over 2021 earnings, which is impressive with all the negativities. However, the multiple that investors were willing to pay for those earnings declined from 21.3x to 17.4x. This is a contraction of nearly 19% and represents most of the drop in the stock market. Just as interest rates drove bonds down, they have also driven down the multiples for stocks. This is why inflation and The Fed dominated the headlines last year. Although politics, the war, and COVID are still important, the market predominantly cared about rates in 2022.

There were a few strategies that performed well in 2022. Private real estate performed quite well, with many funds up by double digits. One of Canal's core investment beliefs is that if investors can tolerate some level of illiquidity, they are better off allocating capital to private real estate markets versus public markets. Last year public REITs (S&P 500 Real Estate) were down over 28%, which demonstrates the problem with public real estate. It is very highly correlated to the overall market in bad times despite having very different characteristics. Inflation can actually be a positive for many real estate asset classes, as debt is locked in at low rates and rents are generally increasing over time. Private Credit investments also performed well. Some of these funds lend money to private companies and some lend money to other sectors such as real estate. At this point of the cycle, the economy is still generally good, and companies are flush with cash, which means there have been very few problems paying their underlying debt. After years of underperformance, many Hedge Funds also had very good years taking advantage of the volatility and dislocations present in the market.

Bonds are relatively simple to value and the following is an even simpler explanation. Bonds are issued at par (typically $100) and mature at par. If the underlying bond shows some financial stress, it can trade at a discount to its par value, but as long as the bond is investment grade it typically trades around it's par value. Interest rates also affect the current value of a bond. If rates increase, new bonds can be issued that pay a

Annual total return for a diversified portfolio of U.S. taxable bonds (1977-2022*)




Source: Schwab Center for Financial Research with data provided by Bloomberg Shown in the chart are annual total returns including price change and income for the Bloomberg US Aggregate Bond Index. Returns include reinvestment of interest. Indices are unmanaged, do not incur fees or expenses, and cannot be invested indirectly. For additional information, please see Schwab.com/Index Definitions. For illustrative purposes only. **Past performance is no guarantee of future results. Diversification strategies do not ensure a profit and do not protect against losses in declining markets. *YTD as of 11/29/2022.**



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higher level of interest, causing existing bonds to decline in value (trade at a discount). Of course, the inverse is also true and if interest rates decrease, bond prices will rise. In 2022, interest rates rose at the fastest pace in modern history, which also caused bonds to have their worst annual performance (*see chart above*). As mentioned earlier, this was devastating for the average diversification strategy and very difficult to navigate as the Fed constantly changed its goal posts throughout the year and is still changing the goal posts.

The real question is where we go from here and how are we thinking about investor portfolios heading into 2023? Below, we discuss our outlook.

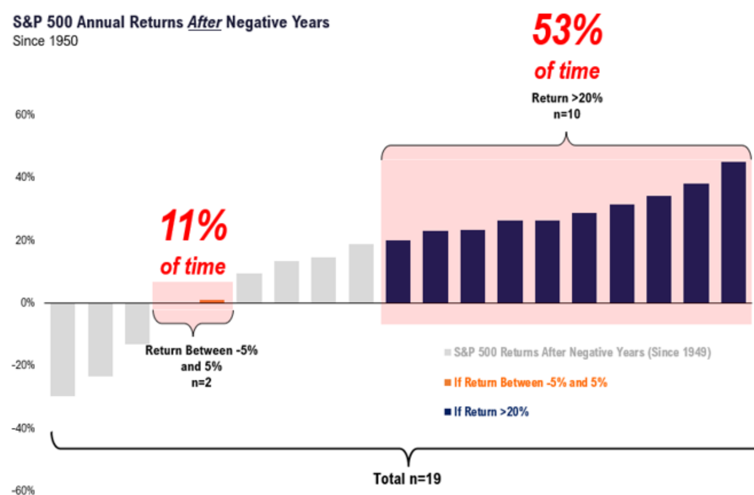
## 2023 Outlook

*"Every economic recovery since World War II has been preceded by a stock market rally. And these rallies often start when conditions are grim."* – **Peter Lynch**

We believe 2023 will most likely see continued volatility, but the headlines driving markets will probably be different. There are many indications that inflation is easing substantially and should be back closer to the 3% range by the end of the year. It appears that the Fed should end its rate increases over the first quarter, but the question becomes: how much damage has been done? It takes months for this level of rate increases to wash through the system and most economists believe a recession is only a matter of when and not if. Thus, recession or no recession will be the key driver of performance this year.

### Stock Outlook

First, let's take a look at history, which does show some signs of hope. Since 1950, there have been 19 negative years in the stock market. In the following year, returns have been positive about 84% of the time, but surprisingly, returns have been over 20% the following year over half the time *(see chart below)*. Despite a very negative outlook from analysts, stocks could potentially surprise to the upside.



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While history is a nice guide, the ultimate outcome will depend on the pending recession. If we are somehow able to avoid the recession, we may have seen the lows for this cycle. During all bear markets without a recession, the average decline is just under 30% and we bottomed on October 12th with a 25% decline. However, a bear market accompanied by a recession typically results in a 40% ultimate decline. Should we see a recession, those two variables we mentioned earlier, earnings and the multiple investors are willing to pay, may have further to fall.

So, with two potential outcomes that have drastically different return impacts, what should stock investors do now with stocks? It is our belief that investors should generally stay the course as we believe we are in the 7th or 8th inning of this decline. However, we can continue with some proven strategies:

- Enhance the quality of our stock holdings as we encounter these large swings. Thinking 3 years into the future versus 3 months in the future will serve investors well.
- Tax loss harvest when there are opportunities. We have been able to capture many losses for taxable accounts without impacting the ultimate outcome of portfolios. These losses will be valuable for years to come.
- Rebalance more frequently – During the last two recessions (Tech Bubble & Global Financial Crisis), there were 5 rallies of 18% or more before the markets found the ultimate bottom. Last years, there were 7 rallies with an average gain of 9%. These large swings present opportunities to adjust risk along the ride.

### Fixed Income Outlook

The outlook for bonds is somewhat similar to that of stocks as there are a few of potential outcomes, but with one large caveat. The caveat is that after such a large increase in rates, there are now a number of places to invest cash and receive safe returns of 4.3%. One such example is United States Treasury Bills. However, patient bond investors will likely see much higher returns as there is a potential reversion to the mean in interest rates. Below are the short-term paths for bonds:

1. **Inflation remains stubborn and the Fed is forced to continue raising rates** – This would mean that bonds have more downside than we saw in October.
2. **Inflation continues its trend to normalize** – This would mean that the Fed stops raising rates and we have seen the bottom for bonds.
3. **Recession becomes certain** – If recession becomes a certainty, the Fed will have to reverse course and begin to lower interest rates. If this were to play out, bonds would go back to their historic norm of being the ultimate diversifier and could see returns in the double digits.

As with stocks, the short term is clear as mud and no one knows what will happen, but the swings in pricing could be large. Last year, the 10-year Treasury Yield peaked at 4.3% in late October and declined to 3.42% in early December, which really helped bonds recovery into year-end. This will be the most important indicator for us in 2023. At current levels, we are somewhat neutral, but if the 10-year were to get into the 4.5%-5% range, that would mean that the first outcome has played out and would probably be an


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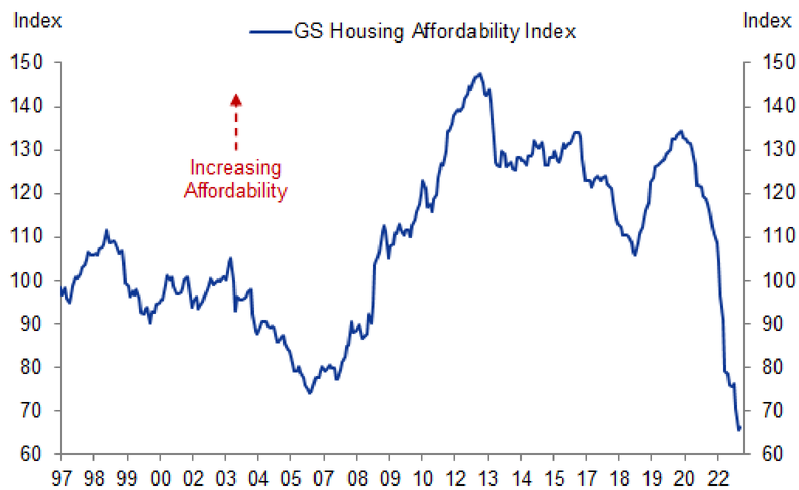
opportunity to more aggressive within our bond allocations. The same holds with the recession outcome, this would also be an opportunity to increase risk within bonds.

**Real Estate Outlook**

There are certain areas of real estate that pose bigger risks to investors, both by geography and by sector. We see the most risk in the areas that were the biggest beneficiaries of COVID, specifically those states which experienced a massive migration and the associated increases in apartment rents and housing prices. Real time rents are falling hard across the country and, in particular, in those areas that experienced the largest increases in rents from 2020-2021.

Home prices are also likely to decline as the affordability of homes has reached an all-time low *(see chart right)*, which is a result of the massive appreciation in home prices and the rise in mortgage rates. The monthly payment for a 30-year mortgage has increased by 50% over the last year leaving many potential homeowners with few options. Although home prices probably need to fall further, there are a couple of big differences today versus the Financial Crisis. First, most homeowners have significant equity in their homes and are not over-leveraged. Second, 99% of all 30-year mortgage are locked in at rates below today's rates and 40% of all mortgages are locked in at rates below 3%.




There is a fear that commercial real estate could be the next shoe to drop. However, similar to home mortgages, most commercial debt has been locked in at very low rates. We are seeing a slow down in the number of transactions being completed as there is a disconnect between buyers and sellers price expectations. Most of the slow down is a result of the increased level of borrowing rates for new buyers and a general fear amongst lenders of a pending recession. At this point in the cycle, we want to stay away from most traditional asset classes like office and high-end apartments and focus on niche asset classes like single family rentals, manufactured housing, small industrial, lab space, warehouses and mini storage. These types of assets tend to have specialized uses and unique demand drivers that have historically held up well during periods of economic uncertainty. It is our view that not all real estate is created equal, and location and sector will be important for the coming quarters.



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## Conclusion

Thank you for taking the time to read this letter. In times of uncertainty, we simply have to work harder and smarter. We will always have periods like these and just like every other bear market in history, we will get through this one. As always, please let us know if you have any questions related to your investments, taxes, or general planning or if there have been any changes to your overall plan or risk tolerance. This is a great time to setup a review meeting.

Sincerely,

Canal Capital Management

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*Canal Capital Management's opinions are subject to change from time to time and do not constitute a recommendation to purchase or sell any security nor engage in any type of investment strategy. The information contained herein has been obtained from sources believed to be reliable and cannot be guaranteed for accuracy.*



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