

# Looking Back and Looking Ahead

Our theme of “Watching and Waiting” alludes to the way we are currently monitoring economic indicators and company earnings for signs of weakness. We are doing so as we await the eventual full impact of Federal Reserve (Fed) tightening. In the meantime, we are re-examining our thesis around each of our portfolio holdings and reaffirming our conviction levels. To pass our test, each investment must have the potential to demonstrate fundamental improvement in what may be a more difficult economic and competitive environment. Since we find ourselves at the beginning of a new year, let’s take a broad look back at what we have seen transpire over the past 12 months.

**Economy.** At the beginning of 2022, real GDP was estimated to be close to 4%. Currently, expectations indicate that in 2022, real GDP was slightly less than 2% but positive for the year despite two negative quarters. Many are calling for a recession in 2023, which implies very modest or negative GDP growth.

Inflation, the big story of 2022, went from 7% (Consumer Price Index) at the beginning of the year up to over 9% at mid-year. It is now currently believed to be running just below 7%. Most expect inflation to be coming down to some extent in 2023. This will depend somewhat on the level of economic growth (GDP).

Measures of economic health are rolling over for the most part. Examples include LEI (Leading Economic Indicators), ISM Manufacturing, and consumer confidence. The notable exceptions are employment and consumer balance sheets. Unemployment remains strong with 10 million unfilled jobs, and consumer balance sheets are still stronger than they were pre-pandemic. Adding to the mixed economic picture, a number of high profile companies have announced layoffs.

**Interest Rates.** In response to inflationary pressures, the Fed raised its overnight federal funds rate from essentially zero to 4.5%. This was the most dramatic increase in history. More interest rate hikes are expected, but the pace is slowing down. Most expect fed funds to top out around 5% in the first half of 2023.

Longer-term interest rates (10-year Treasury) rose from 1.5% at the beginning of the year to almost 4%. 10-year rates drifted down a bit in the fourth quarter of 2022.

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The yield curve inverted, which is typically a recessionary indicator. Short-term government bond rates (3-month T-Bills) are higher than 10-year interest rates by 50 basis points (1/2 of 1%).

Mortgage rates followed bond interest rates higher with 30-year mortgages topping out at over 7% in 2022. Owners of mortgage-backed bonds suffered losses as housing turnover decreased and prepayments slowed, demonstrating the deleterious effects of negative convexity.

**Other Indicators.** Energy prices were another big story of 2022. Due primarily to the war in Ukraine, at mid-year, gasoline averaged over \$5 per gallon. It is now somewhere around \$3.25. Natural gas prices are down 50% since mid-year.

The U.S. dollar was very strong for most of the year but weakened in the fourth quarter. Reflecting the strength in the currency from a global standpoint, the U.S. was one of the stronger economies and better performing stock markets in 2022.

Bitcoin performed similar to many other speculative assets and proved to be neither a diversifier of risk nor anything resembling a safe place to invest.

While difficult to quantify, there is no doubt that global supply chains and production bottlenecks occurred, slowing economic growth in the process. Measures of global trade softened.

**Corporate Profits.** Amidst a number of economic headwinds, corporate earnings were modestly positive. Expectations predict another year of mundane earnings growth.

Energy profit growth was outsized, and smaller and domestically oriented corporations generally did better from an earnings growth standpoint. The outlook for corporate profits is always uncertain.

**Stock Prices and Valuations.** The S&P 500 Index was down 25% at its low for the year. Recovery in the fourth quarter brought the decline to just under 20% for 2022, the worst year since the financial crisis of 2008. The technology-heavy Nasdaq Index declined 33% as growth stocks came down to earth.

With earnings largely unchanged and stocks down, earnings multiples compressed. Price to earnings ratios for the broad market fell from over 20x at the beginning of 2022 to around

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17x today. As is typical, value stocks are much cheaper than growth.

Value, quality, and dividends did better in the difficult environment of 2022, in keeping with historical relationships during periods of market stress. Small cap stocks were volatile and fell to a greater extent, but, as a category, demonstrated superior earnings growth than large caps.

For more information and perspective, please see our Economic and Market Environment slides on our website.

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