Wiggin Financial Services Newsletter

4th Quarter - 2022

Dear Client:

Market Recap

A difficult year ended with a thud for U.S. stocks. After a 14% rally in October and November, the S&P 500 Index dropped 5.8% in December to close out the year with an 18.1% loss, its largest annual decline since 2008. Foreign stock markets held up much better in the fourth quarter — developed international stocks (MSCI EAFE Index) gained 17.3% (one of their best quarters ever) and Emerging Market stocks (MSCI EM Index) were up 9.7% — but still saw significant losses for the year. For the full year, developed international stocks were down 14.5% in dollar terms (almost four percentage points better than the S&P 500), while EM stocks were down a bit more than the S&P 500 with a 20.1% drop. These annual returns were despite the U.S. dollar (DXY Index) appreciating 8.3% for the year, which reduces dollar-based foreign equity returns one-for-one. In the fourth quarter, however, the dollar dropped 7.7%, providing a tailwind to EM and international equity returns for U.S. investors.

Turning to the fixed-income markets, core investment-grade bonds (Bloomberg U.S. Aggregate Bond Index, aka the "Agg") had a solid fourth quarter, gaining 1.9%. But this was still the worst year for core bonds in at least **95 years**, with the Agg dropping 13.0%. The key driver, of course, was the sharp rise in bond yields; the 10-year Treasury yield ended the year at 3.9%, up from just 1.5% a year prior. High-yield bonds (ICE BofA Merrill Lynch U.S. High Yield Index) had a strong fourth quarter, up 4.0%, but were down 11.2% for the year. Floating rate loans (Morningstar LSTA Leveraged Loan index) were the best segment within the bond markets, down less than 1% for the year. Municipal bonds were down 8% (Morningstar National Muni Bond Category).

Alternative strategies and nontraditional asset classes generally outperformed traditional stock and bond indexes. The standout was trend-following managed futures strategies, which gained roughly 27% (SG Trend Index) for the year, despite fourth quarter losses which signaled us to move the overweight position to our more normal weighting in ASFYX and PQTIX.

Portfolio Update

For 2022, our tactical active model portfolios had mixed performance relative to their benchmarks, with relative performance strongest in our more defensive portfolios and weakest in the more equity-oriented models.

Positive contributors included our tactical positions in short term treasuries and certain individual equities. Our position in trend-following managed futures funds also significantly outperformed core bonds and stocks, and added beneficial portfolio diversification.

We are currently reviewing and beginning our repositioning in international funds some of which will incorporate emerging markets. In line with our continued position to remain defensive, we will not be investing is strictly emerging market equities at this time.

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Investment Outlook and Portfolio Positioning

Inflation and monetary policy remain the financial markets' key macro focus. U.S. inflation data have improved, suggesting we've seen the peak in inflation for this cycle. But core inflation remains far above **the Federal Reserve's 2% target**, and the Fed's message is that it intends to maintain restrictive (tight) monetary policy throughout 2023. On the economic growth front, key leading indicators deteriorated further in the fourth quarter, which along with tight monetary policy point to a likely recession in the year ahead. On the positive side, it should be milder than the 2007-08 and 2000-01 recessions.

Our portfolios are built using long-term "strategic" allocations that are matched to a client's risk tolerance and goals. Please contact us to go over your particular allocation! So while our investment approach is not based on short-term stock market forecasts, we do assess shorter-term (12-month) downside risk in our portfolio construction and management. And at this time, we continue to believe that the current price of the S&P 500 does not adequately discount the likelihood and severity of a coming earnings recession. This was our view one quarter ago, and since that time the S&P 500 has climbed a few percent while the economic data has worsened.

Analysis of past data on recessions, earnings declines and stock valuations suggest a real possibility of further double-digit declines in the S&P 500 from current levels. Foreign stock markets are also at risk from a U.S. and global recession, but given their cheaper starting valuations, the medium term expected returns are reasonably attractive.

Given the sharp rise in yields, bonds haven't been this attractive in more than a decade. When estimating returns for core investment-grade bonds (the "Agg") over longer periods of time, the starting yield is a good approximation of subsequent returns. At year-end, the Agg was yielding 4.7% and our 5-year expected return for core bonds is now in a range of 5% to 5.6%. Moreover, we expect core bonds to deliver a positive return if a recession plays out, providing valuable downside protection while riskier assets such as stocks get hit. Beyond core bonds, there are other segments of the bond markets, including high-yield and floating rate loans, that offer attractive risk/return potential which we access via our selected active managers.

Finally, we maintain core positions in trend-following managed futures funds. Managed futures returns have been strongly positive this year as traditional bond and stock funds have plunged. These alternative funds have different return and risk drivers, and we believe will continue to provide tactical and longer-term strategic benefits to our balanced portfolios. They are much less dependent than traditional investments on which type of macro environment (e.g., deflation, stagflation, inflation, or growth) unfolds over the coming years.

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Closing Thoughts

As 2022 has reminded investors, we should “expect the unexpected, and expect to be surprised.” This is expressed in our portfolio construction and investment management via balanced risk exposures, diversification and forward-looking analysis that considers a wide range of potential scenarios and outcomes.

We believe 2023 will likely present us with some excellent long-term investment opportunities. Unfortunately, we also expect a recession and the potential for stock market volatility.

While challenging, it is critical for long-term investors to stay the course through these rough periods. The shorter-term discomfort is the price one pays to earn the long-term “equity risk premium” – the additional return from owning riskier assets such as stocks that most investors need to build long-term wealth and achieve their financial objectives.

As always, we thank you for your trust and welcome questions you may have.

Best regards,

Debbie Wiggin

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