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Chartwell Strategies Current Outlook

"Nothing in life is to be feared. It is only to be understood"

-Marie Sklodowska Curie, scientist, 1867 - 1934

Summary

- *Despite a rising interest rate environment, equities experienced a broad rally in the fourth quarter, raising the distinct possibility that a recession has already been discounted. The rally was broad and included banking, energy, housing, industrial and transportation stocks. Consumer Discretionary and Technology sector stocks lagged.*

- *Fixed income markets were also weak due to inflationary pressures which forced the FRB to raise short-term interest rates. In fact, inflation was the main economic concern throughout the year as commodity prices moved sharply higher; for example, oil rose from a pre-COVID price of $60 to $130 per barrel in March..*

- *Inflation on a year-over-year basis, peaked in June 2022 and has been trending lower. However, the Federal Reserve Board remains committed to reducing the inflation rate to its two to three percent target range.*

Background

After a disappointing nine-months, the equity markets rallied in the fourth quarter of 2022. The Dow Jones Industrial Average (DJIA), Standard and Poor's 500 Index (S&P 500) and the Russell 2000 gained 16.0 percent, 7.55 percent, and 6.20 percent, respectively. However, technology stocks, which had been particularly weak throughout the year, were unable to reverse trend in the fourth quarter; reflecting their poor performance, the NASDAQ fell 0.78 percent.

The DJIA was the best performing major index in 2022, falling only 6.86 percent for the twelve-month period. The S&P 500, Russell 2000 and NASDAQ fared far worse losing 18.13 percent, 20.46 percent, and 32.51 percent, respectively for the year. All performance figures are on a total return basis (include dividends).

Fixed income markets were also weak due to inflationary pressures which forced the Federal Reserve Board (FRB) to raise short-term interest rates. In a further attempt to reduce inflation, last spring, the FRB began to reduce the growth of the money supply by shrinking the size of its balance sheet. In fact, inflation was the main economic concern throughout the year as commodity prices moved sharply higher; for example, oil rose from a pre-COVID price of $60 to $130 per barrel in March 2022. While gasoline and food prices are most visible to the consumer, higher prices were pervasive and included clothing, entertainment, food, housing, transportation, and utilities. Furthermore, employers, struggling to find people willing to work, have been forced to raise wages and this process appears to be ongoing.

Figure 1 on the next page illustrates the recent rise in inflation. Prior to the pandemic, the annual inflation rate had been bouncing around the two percent level. When the COVID stricken economy was closed in March 2020, the inflation rate plummeted to near zero. However, as the economy began to recover, prices of commodities began to move higher and was followed by a broad increase in the prices of goods and services. Examination of Figure 1 shows that the annual rate of inflation, year-over-year peaked last June at 9.06 percent, but has now begun to edge lower. At first, the inflationary pressures were presented by Jerome Powell, President of the FRB, and Janet Yellen, Secretary of the Treasury, as "transitory," however, no reasoning was provided for this point of view. In actuality, there has been nothing transitory about the rise in prices and the FRB has now stated that it will continue to use all the tools at its disposal to drive the annual inflation rate closer to their target of two percent.

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Consumer Price Index

2017-2022

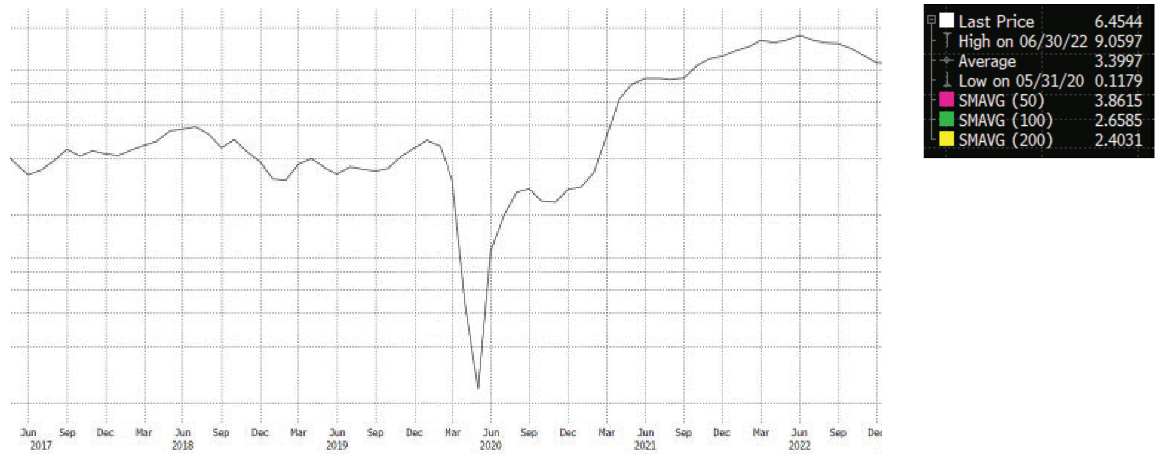

Figure 1. The annual inflation rate has been trending lower since March 2022
Source: BLOOMBERG

The efforts of the FRB have been mitigated by the passage of over seven trillion dollars in legislative bills since the Biden Administration assumed office, which has driven the Nation's debt level to more than thirty trillion dollars. With fiscal policy in conflict with monetary policy, it is difficult for analysts to forecast how long this inflationary period will last and how high interest rates will have to rise to reduce the rate of inflation to an acceptable level. Nevertheless, the FRB's efforts have had a major effect upon the financial markets and the economy this past year. Such effects include equity prices, particularly technology stocks, have fallen as mentioned earlier, bond prices dropped last year more than they have in decades, the residential housing industry has stalled, employee hirings have slowed and layoffs have been announced at many larger corporations. With this background, plus nearly one year of a constant drumbeat from various media sources warning of recession and lower corporate earnings, in our view, an argument can be made that the financial markets have discounted whatever difficulties lie ahead and investors are about to enjoy better times.

One detail that may prove to be important is depicted in Figure 2 below, which shows the rise in the interest rate on the two-year Treasury bond. Over the past year, the interest rate has risen from a little over one percent to a high of 4.799 percent on November 4, 2022, however, despite further rate increases by the FRB, the interest rate on the two-year has drifted lower to 4.202 percent. It is possible that the fixed income markets are signaling the economy is slowing sufficiently for the FRB to avoid forcing the economy into a serious recession, but just a mild slowdown.

Interest Rate on the Two-Year Treasury Bond as of 01.24.23

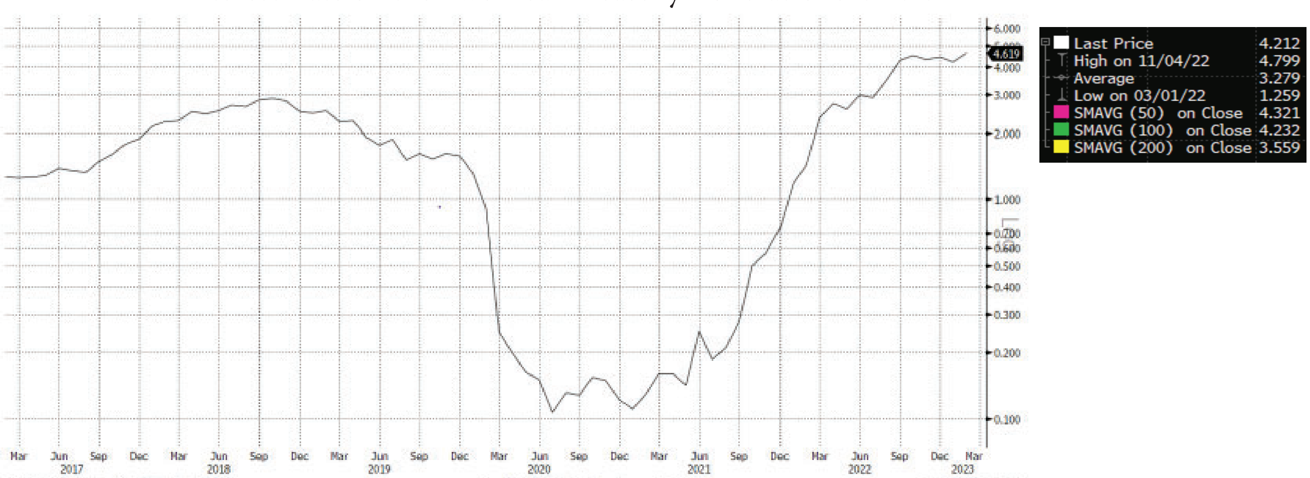

Figure 2. Despite further interest rate hikes, the interest rate on the two-year bond remains below its November 4, 2022 high.
Source: BLOOMBERG

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Past performance is no guarantee of future performance. All investing involves risk of loss. An investor cannot invest directly in an index. The Index returns provided throughout are an example of alternate return potential during the relevant time periods; however, indices may possess different investment attributes that may make comparisons difficult such as volatility, liquidity, market capitalization, and security types. This commentary is for informational purposes only. It is not an offer to buy or sell any security and should not be construed as investment advice. The views in this report were those of the Adviser at the time of writing this report and may not reflect our views on the date this report is first published or anytime thereafter.

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Perhaps more hopeful are Figures 3, 4, and 5, which picture the price action for the S&P 500, NASDAQ, and Russell 2000 over the past eighteen months ending January 24, 2023. Interestingly, none of these indices have recently recorded new lows. After peaking in January of 2022, the S&P 500 appears to have bottomed last October 13th and as of January 2023 is trading 16.8 percent higher. The NASDAQ, the weakest of these indices, also bottomed last October 13th and has since rebounded 15.4 percent as of January 2023 from that low. Lastly, the Russell 2000 bottomed on June 16, 2022, then "tested" that low (but did not penetrate it) on October 13th and has since rallied 16.5 percent as of January 2023. The price behavior exhibited by these indices in the face of poor economic news and countless warnings from Wall Street pundits is impressive to us and suggests that the stock market has already discounted this news and is now looking forward to a period of higher economic growth. If these charts do break down and reach new lows, it will be from some new, exogenous event.

One Year Chart of the Standard and Poor's 500 Index

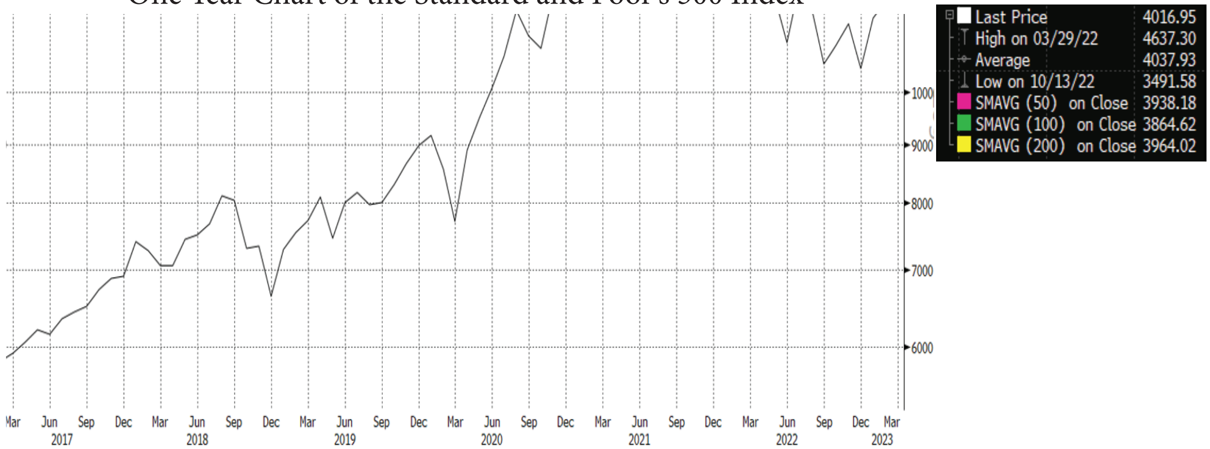

Figure 3. The S&P 500 Index bottomed last October 13th and has risen 15 percent higher as of January 2023
Source: BLOOMBERG

One Year Chart of the NASDAQ Index

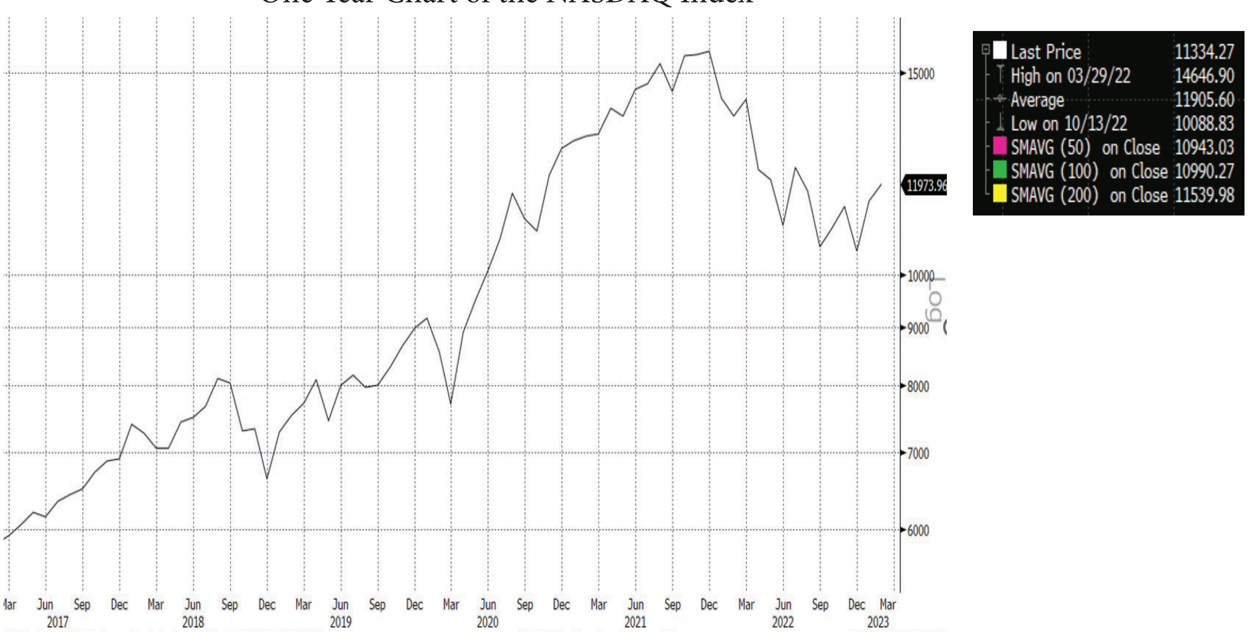

Figure 4. The NASDAQ Index bottomed in October, Tested that bottom in Decmber and as of January 2023 it is moving higher.
Source: BLOOMBERG

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One Year Chart of the Russell 2000

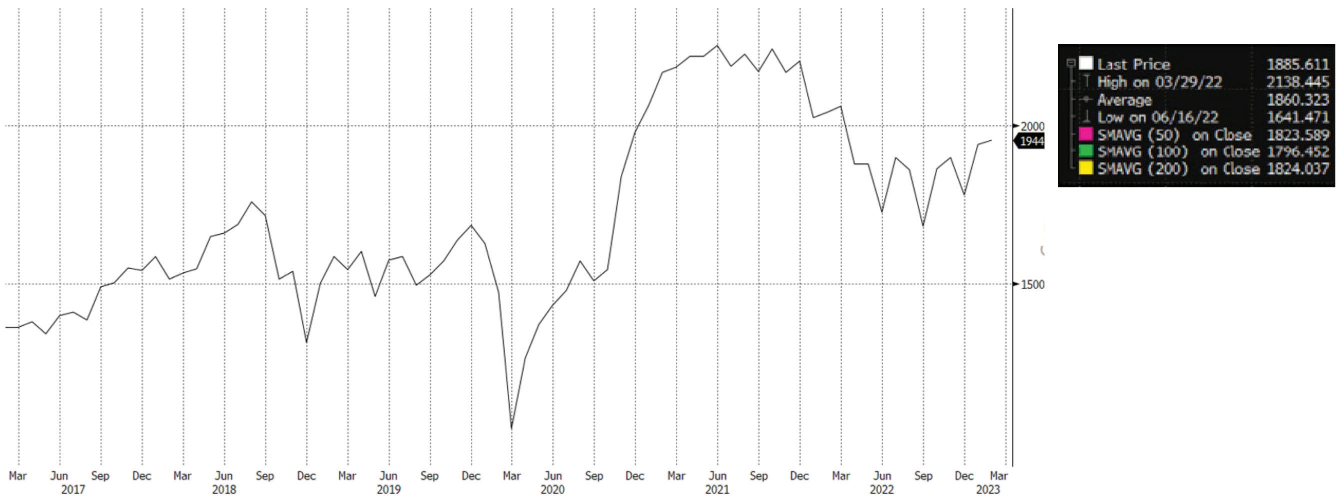

Figure 5. The Russell 2000 bottomed in June 2022, tested that bottom in October and as of January 2023 it is moving higher.
Source: BLOOMBERG

As reflected in the letter, 2022 had shaped up to be a quite different and a little more volatile year than 2021. As we move into 2023, we still have a rising interest rate environment, supply chain issues, while inflation seems to be diminishing. It's uncertain market conditions like these where we believe active investment management can help make a difference. If you wish to receive additional information about the IMAP program please contact Chartwell at (610) 296-1400 or info@chartwellip.com.

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Definitions:

Consumer Price Index: A measure that examines the weighted average of prices of a fixed basket of consumer goods and services (such as food, transportation, shelter, utilities, and medical care), and is widely used as a cost-of-living benchmark.

Dow Jones Industrial Average: The DJIA or "The Dow" is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange (NYSE) and the NASDAQ.

The Nasdaq Composite Index is the market capitalization-weighted index of more than 2,500 common equities listed on the Nasdaq stock exchange.

Russell 2000 Index:
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S&P 500® Index: (registered trademark of The McGraw-Hill Companies, Inc.) is an unmanaged index of 500 common stocks primarily traded on the New York Stock Exchange, weighted by market capitalization. Index performance includes the reinvestment of dividends and capital gains.

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