2022 Recap and 2023 Market Outlook

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When considering the current outlook, it's a good idea to first take stock of 2022, an unusual year that presented many challenges. Covid continued to amplify these challenges, even as we accelerated our transition to a "post Covid world." Some events were so unexpected, we had to look back in history to find the last time something like this had happened.

The most striking example was Russia's invasion of Ukraine, triggering an equally unexpected strengthening of political alliances. In the U.S., we cheered the legislative progress achieved with the passing of a climate change bill and the CHIPS act, while we lamented with equal measure SCOTUS's reversal in the Dobbs decision, ending women's right to choose what happens with our bodies. Economically, debt levels from Covid policies contributed to inflation rates so high they were reminiscent of the 1970's. We wondered how closely Federal Reserve Chairman Jerome Powell might be rereading Paul Volker's playbook.

These events would be enough for most years, yet those weren't the only themes that shaped our world and markets in 2022. China's zero Covid policies continued to shake the global supply chain and contributed to China's economic slowdown. This and Xi's cozy relationship with Putin accelerated cooperation elsewhere towards the nearshoring of resources and supply chains. Significant political demonstrations, not seen in decades, in China appeared to force an abrupt end to the zero Covid policy in December. However, on top of Russian aggression, Xi's collaboration with Putin and Xi's own stance towards Taiwan have heightened awareness of global political risks and cemented efforts to change the status quo.

Efforts were made to redesign supply chains and examine consumer dependencies in sectors from agriculture to energy. In energy, Putin's weaponization of oil and gas supplies forced Europe to pick up the pace in their green transition. The $60 per barrel price cap on Russian oil may not have been an ideal solution, though it buys much needed time for governments and industry to scramble towards mostly cleaner alternatives. Debate over backsliding and compromises to solve the immediate energy problem are to be expected. Fortunately, after some sharp spikes in March and mid-year, slowing economies and slowing demand have helped to take the edge off fuel price inflation. We are optimistic that most of the efforts to replace Russian energy will eventually be positive for the environment.

Our long list of 2022 events would not be complete without acknowledging how climate change made headlines throughout the year. More intense and more frequent climate events, extreme temperatures, and devastating effects on life everywhere commanded greater media coverage. Despite the evident urgency to combat our climate crisis, a clutch of politicians and state treasurers in the U.S. (several with large fossil fuel ties) took pains to politicize the ESG (Environmental, Social, and Governance) movement and attack sustainable investing as a “woke” social agenda tool of the left. We would remind politicians and investors alike that ESG refers to factors that potentially impact investments, and it is investors’ responsibility to consider those factors that may have a material impact on investments.

Relatedly, this past year we have seen how sensitive food prices can be to both climate change, and geopolitical conflict. Where our food is produced, the distance it is transported, and the availability of critical fertilizer, all factor into pricing. Some of the greatest price increases are in food, second only to energy. We are hopeful that altogether these systemic stresses lead to shifts that improve the resilience of global food production. And with our global population now at 8 billion, we expect the issues of climate adaptation and food security to demand ever greater attention going forward.

Let’s turn to the market impact of all these forces. Most company stock prices began 2022 at what would become their 52-week high. Concern over the slowing economy and the Federal Reserve’s commitment to increasing interest rates immediately cast a shadow, sending benchmarks from a peak in November 2021, down for a first-half bear market performance—not experienced in decades. After marking lows in October, much of the market did lift slightly near year-end, despite a sharp decline in December. Overall the decline for the year was the worst since 2008. The smallest declines could be found in the Dow Jones Industrial Average and international exposures, while the greatest declines were in the tech heavy NASDAQ Composite.

Looking more closely at what was a mostly positive fourth quarter, the market rally in October and November appeared driven in part by hope and optimism that the worst of

Federal Reserve tightening actions might be behind us. After the Fed's sixth consecutive rate increase in November, and the fourth at 0.75%, it seemed increasingly probable that the worst of rate hikes is behind us, with smaller and fewer hikes ahead. And true to expectations, the Fed increased rates by a smaller 0.50% in December with fewer and possibly lower hikes of 0.25% expected in 2023.

Also in October, a positive Gross Domestic Product (GDP) number was reported for the September quarter after negative reports in the first half of 2022. The Consumer Price Index (CPI) report in November was still high, though with a silver lining—it was less than expected and down from the highs reported in recent months.

As we moved into December, the market took on a decidedly grinchy tone, focusing on all the negative data points. While the CPI report on inflation continued to offer hope for moderating and declining inflation, the market focused more on the probability of a recessionary slowdown, both in the U.S. and worldwide. The sobering indicators included the decline of existing home sales, higher mortgage rates, and increasing consumer debt. Additionally, we saw more companies announce layoffs.

One likely catalyst for the early December shift in sentiment was the increase in the yield curve inversion to levels not seen since the early 1980's. Normally short term rates should be lower than long term rates, unless something like a recession, for example, decreases market-wide demand for longer term financing. Because the difference between long term rates (10-year Treasuries) and short term rates (2-year Treasuries), is normally positive, when this relationship flips negative, or inverts, this occurrence signals something is amiss in the pricing and demand for financing. And since yield curve inversions always precede recessions, (though not all yield curve inversions are followed by a recession) the markets in December signaled the increased probability that we face further economic headwinds in 2023.

During the year we adjusted our portfolio holdings to better weather the worsening risk environment. This editing included a shift away from pre-earnings companies and towards innovative companies with more capital on hand, and self-sufficient business models. That said, we would agree with the market's muted optimism and would not be surprised if as we work our way through 2023, we see the markets begin to reflect the light at the end of the tunnel somewhat before our economic indicators are able to reflect a recovery. Nia portfolio companies are positioned to provide products and services that solve the most pressing problems of our times, which we believe improves their resilience in all market environments.