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2022 YEAR IN REVIEW

The year is not over just yet. Next week brings the Federal Reserve's final interest rate decision for 2022, as well as new inflation data. The market impact of this week's dramatic shift in China's Covid policy has yet to play out. But we already know enough to pick out ten stories that have shaped 2022 – the first (mostly) post-pandemic year. We added an eleventh, for good measure. Let us know if you agree.

1. War in Europe

Russia's invasion of Ukraine on February 24th reshaped the world's politics. Its impact on the global economy was also profound, even if less immediately obvious in the US than in Europe. The shock to growth and prices just as the pandemic recovery was underway shifted the trajectory for markets and the economy this year. Fracturing of the post-Cold War ecosystem built on open global trade and investment began before the invasion. But the war delivered a sharp reminder: dependence on potentially unreliable suppliers is risky in today's world. That lesson informed this year's far-reaching US action to tighten export controls on China, with the CHIPS act, and to subsidize domestic production of critical technologies.

The war has divided the world and exacerbated US-China tensions. While few countries openly support Russia, many have been reluctant to oppose it. That group includes Asia's two emerging giants – China and India – and the oil-rich Middle East, as well as other key emerging countries. No doubt Chinese leaders would have preferred the short, successful invasion that Putin likely promised President Xi at the Winter Olympics in January. But national security experts believe that the war has, nevertheless, solidified a China-Russia partnership against US dominance, illustrated by an extraordinarily close relationship between Presidents Xi and Putin. The two have now met bilaterally almost 40 times since Xi's inauguration in 2013.

At the same time, Russia's invasion and subsequent brutality brought US allies closer, with successful US leadership. Wide ranging sanctions, including the seizure of Russian central bank assets, were agreed swiftly. Two traditionally neutral countries – Finland and Sweden – have applied to join NATO. The EU has demonstrated cohesion in confronting the economic and political challenges, including a landmark agreement this month to ban imports of Russian oil. Other allies and partners outside Europe, from Japan to Australia, showed their support for Ukraine and the US posture.

One less remarked upon result of the war: it has brought "hard power" back into focus. The ability of the US – and, to a much lesser extent, its partners – to supply sophisticated weaponry and training has been essential to Ukraine's battlefield successes, as predicted by the Institute for the Study of War, whose maps have become the go-to public source for updates on territorial positions. Russia's outdated equipment, together with poorly trained forces and lack of modern methods of war, have outweighed its huge advantages in numbers and size. The implications for defense and defense-related industries will be substantial and long-lasting.

2. Energy and Food Shocks

For decades, Europe has seen Russia as a potential friend – and critical economic and energy partner. Despite President Putin's 2014 seizure of Crimea and support for breakaway regions in eastern Ukraine, Germany had moved to increase its energy dependence on Russian gas with the Nordstream 2 pipeline. Italy and other EU countries also counted on Russian energy to help power their economies.

The invasion – and consequent sanctions – changed all that, probably for good. The ensuing scramble for energy sent oil and gas prices soaring this summer, hurting Americans at the gas pump and delivering a much greater shock to European industry and households as natural gas prices in Europe started the year at an equivalent of $4.25/mmbtu and climbed all the way to $99/mmbtu in August before falling to its current level of $44.33/mmbtu. In the US gas prices climbed to $5.50/gallon at the peak, nearly double its average price over the last 5 years. And Oil prices have since retracted. Europe managed to refill its gas storage facilities. But energy bills remain a political hot potato in Europe. Agreement among the 27 member nations on how best to shield consumers – and businesses – from the energy shock, while staying within the confines of the single market rules, will be difficult.

A global food price shock quickly followed the energy shock from the war. Higher energy prices drove up the cost of fertilizer, needed to maintain production levels around the world. A more direct hit on food supplies came from a Russian embargo on grain exports from Ukraine – one of the world's major suppliers of wheat, in particular to the Middle East and Africa. Pressures have eased somewhat now, but the World Food Programme estimates that 345 million people face acute food insecurity (more than two and a half times the number in 2019), and 49 million people in 49 countries are teetering on the edge of famine. Add La Niña weather to the mix, and the IMF estimates that food price shock passthroughs could continue for six to 12 months. And the risk of food prices increasing again over the next few quarters, rather than declining, remains high.

3. Inflation Returned – With a Vengeance

After decades of below target inflation, this year saw price increases shoot up on both sides of the Atlantic to levels not seen for decades. Uncertainty about how high inflation might go – and how costly it would be to bring it back down – has been the dominant undercurrent in markets this year. There are some signs that consumer price inflation may have peaked in the US – just shy of double digits. But underlying strength in labor markets (see below) makes central bankers worry. Next week's CPI will be watched carefully.

One puzzle is that while inflation has soared In North America and Europe, the reasons seemed to differ. In Europe, where inflation reached double digits in October and the Bank of England has warned that it could go as high as 11%, supply side factors have taken the blame. This year's energy shock came on top of pandemic-induced supply disruptions. The appropriate policy reaction is complicated, as the hit to real incomes from energy prices depresses demand as well as pushing up prices. The UK, after flirting with a "dash for growth" has now promised fiscal austerity alongside monetary tightening. In Europe, with political pressure to subsidize energy costs probably too strong to resist, fiscal policy may be expansionary, leaving the inflation fight to the central bank.

In the US, the debate about inflation began in 2021. Former Treasury Secretary Lawrence Summers warned about the danger to price stability from the pandemic stimulus, including a huge pandemic-related jump in fiscal spending. Others thought supply factors were dominant, and that inflation would fade as the pandemic disruptions went away.

It was in 2022 that all agreed: inflation was not transitory, it was out of control, and it would not return to pre-pandemic levels without decisive action to tighten monetary policy. All year, investors have followed inflation releases avidly. And for much of the year, those investors have been disappointed. Inflation has persisted.

4. The End of Easy Money and the Bond Market Fallout

Inflation – whatever the cause – led central bankers to execute a U-turn this year. The Fed is expected to raise its policy rate another 50 basis points next week, bringing the total increase this year to 4.25%. This is the sharpest monetary squeeze since 1973, which ties for the most ever in a single year. As RockCreek has said repeatedly, once the Fed realized that inflation was not going to go down easily, it has been determined to push rates up by as much as necessary to bring it decisively back down towards 2%. Equity markets, used to policymaking in a time of low inflation and financial risk, have been reluctant to hear the message. Prices have surged at any hint that the Fed may ease. It will not, until it is clear that inflation is under control.

There is a widespread view that both the Fed and the European Central Bank (ECB) took too long to make the move. Both central banks had put in place new monetary policy regimes since the pandemic began. Eager to learn the lessons from the slow growth and inflation undershooting after the Global Financial Crisis, the central banks had adjusted their reaction functions in ways that effectively slowed the response to inflation overshoots. The debate going into 2023 is whether a pause in rate increases can come before the economy tips into recession.

Few bond investors will look back on 2022 fondly, as the Bloomberg Barclays Agg returned one of its worst years on record, falling over 14% year-to-date. New issuances also plummeted, as rising rates and companies overflowing with cash left few looking to take on any new capital. Banks also took on major losses, as they made several mistakes transitioning out of the age of easy money. High profile deals such as Twitter and Citrix continue to drag on Wall Street's balance sheet, hampering their abilities to allocate to other opportunities.

But the rising rates have raised the hopes of beaten down fixed income investors. As the risk-free rate pushed higher, yield in the IG and HY market followed suit. The Yield to Maturity of the HY Index nearly doubled through the end of Q3, nearly reaching 10%. When investors can collect such a strong consistent return from clipping coupons, it opens up a new avenue to generate returns.

As long as the Fed maintains higher interest rates, cracks in the credit market will continue to form. Inflation has continued to put pressure on cash balances and, at some point, companies will need to issue new debt or take on rescue financing. These opportunities will, for the first time in over a decade, give issuers the upper hand in writing covenants and demanding protections.

RockCreek will continue to watch how the creditor-on-creditor violence continues to spread in the near future. For most of the last decade, companies were able to negotiate loose covenants that leave the current capital stack very susceptible to manipulation. Carvana is a recent example of two major players reaching a truce, but as more defaults begin to happen, the knives will come out.

5. Housing Feels the Pain

The traditional first channel to the real economy from central bank tightening is real estate – the biggest sector that is sensitive to rising rates. The pandemic had a split impact on the sector. Housing – sales and rents – boomed as office workers stayed home and many sought bigger living spaces. Office space languished, particularly in big cities. The bubble in housing and construction – and logistics – kept inflating in early 2022, even as mortgage rates jumped to 15-year highs. We end the year with prices beginning to drop – but still too high for many buyers.

But the gulf between where things currently stand in the housing market and the sentiments surrounding it does denote some worry moving forward into 2023. Despite Fed Chair Jerome Powell recently calling the housing market “very overheated” in November, every single state has seen a year-over-year growth in housing prices, with the median existing-home value growing 6.6% to $254,000.

We are beginning to see cracks though. Price cuts are increasing. The number of listings is rising, with the total number almost back to pre-pandemic levels. The time on market is increasing. In October, there was a 5.9% drop in volume of houses sold. So as we settle into this new economic reality of higher interest rates for longer, a cooling of the white hot housing market may be forthcoming. And that worry already has investors spooked, highlighted by Blackstone fielding numerous redemption requests out of its $69 billion real estate fund.

6. Tech Bubble Deflates

The promise of “low for longer” interest rates coupled with the pandemic lockdown was a boon for tech companies. Extraordinary gains during the two pandemic years – valuations of the US Big Five climbed 115% percent to $9.7 trillion – drove overall US markets to record heights. It couldn’t last. The cloud from anticipated Fed tightening finally burst in January 2022. As interest rates have climbed this year, the tech bubble has deflated. Disappointing earnings data and growing worries about the ad market added to the downward pressure.

During the era of free money, markets rewarded investors who extended the duration of their investments. This was particularly true in technology where Covid lockdowns had a massive impact on peoples' behaviors and online interactions. "Story stock" companies pouring resources into massive trends unfolding over the coming decade, and thus valued in the context of total addressable market, saw their prices skyrocket. Valuation multiples expanded all across growth-oriented stocks; however, a pricing in of higher discount rates naturally reduced the current value of those distant cash flows and prices came back down to earth.

The overall equity market peaked in December 2021, and in 2022, the market has been stuck in its third phase of this bear market – a downward grind for big tech and other long-considered "safe haven" stocks. By the end of a brutal bear market, nearly everything has been thumped. Will 2023 bring about the conditions for a new growth cycle led by higher risk assets? It still feels too early at this point.

7. Crypto Collapse

In 2022, What had historically been considered a burgeoning, idiosyncratic asset class became very highly correlated with traditional financial assets (see Bonds and Tech Bubble above). With its exceptional volatility characteristics intact, it was a painful year for "hodlers" of digital assets. As financial conditions tightened, asset prices tumbled, and it would turn out that crypto is very leveraged to liquidity conditions. Bitcoin now sits 75% below its all-time high from November 2021.

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While they're learning many of these lessons the hard way, crypto natives seem undeterred in their quest to reinvent finance by the arrival of another "crypto winter." They would point to many of the industry's failures (e.g., 3AC, BlockFi, FTX) as reasons to continue the mission of decentralization. There are reasons to be enthusiastic as well, but with a hope that in 2023, investors are more discerning and that valuations more closely track progress in product development rather than hype.

8. Recession Looming, but Corporate Earnings Held Up

Just as the post-pandemic burst of activity was slowing at the turn of this year, growth was hit by the outbreak of war in Europe. Economists rushed to downgrade forecasts, from the International Monetary Fund (IMF) and World Bank to the private sector. In the US, talk of recession became commonplace.

Conflicting numbers from different data series for US growth made it hard to determine what was happening to output. In the end, revised data show that the US economy did shrink for two consecutive quarters in the first half of this year – often seen as a short-hand definition of recession. But as jobs growth remained strong and unemployment low, the body that formally calls peaks and troughs – the National Bureau of Economic Research (NBER) – has not ruled. And it seems that GDP growth returned in the second half of the year. Recession is still on the horizon – but more likely a year from now when the impact of the Fed tightening has gripped the economy more forcefully.

As inflation proved to be much more than "transitory" and the Fed proceeded with its campaign of tightening, a major question was how quickly and to what extent these evolving dynamics would weigh on corporate earnings. Most of the early damage to stock prices was driven by multiple compression as sell side analysts maintained remarkably rosy earnings projections into 2023.

Most economists predicted rising living costs would take a toll on consumer discretionary spending, thus dragging down corporate revenues. Meanwhile, corporations would eventually be unable to pass higher input costs down to consumers, thus squeezing profit margins. While both arguments were true, certain factors, most notably surplus savings from Covid-era stimulus, led to more consumer resilience than many had expected.

While corporate profits have not fallen off a cliff, negative revisions are indeed accelerating as rate hikes work their way through the economy. During the calendar year 2022, S&P 500 earnings are expected to finish up +4.8%, but down -2.1% if one were to exclude energy. Meanwhile, 2023 earnings estimates have been coming down since peaking in mid-April, with the aggregate down -8.7% (-11.6% excluding energy). With inflation not yet under control, expect earnings to grind down further in 2023.

9. A New Hybrid-Jobs Market: Here to Stay?

Persistently strong labor markets have confused the economic picture – and worried central bankers – throughout this year, especially in the US. As the year draws to a close, unemployment is still barely above its pre-pandemic low at 3.7%. Recent increases in earnings and wage costs remain far above the level consistent with 2% inflation. Reported job openings are down only slightly from the record levels reached in the summer, while the numbers looking for work are still well below the level of vacancies.

But – post-pandemic – there have been other important changes in the labor market that may be obscuring the underlying picture. Although employers report a big jump in payrolls this year, and continued labor shortages, households that are regularly surveyed show a smaller increase. The pandemic has left its mark on the way people work and their willingness to work outside the home. Labor force participation remains well below pre-pandemic levels: almost 40% of Americans of working age are not in work or seeking work.

Employers have been hoping for a return to "normal" work all year, as the official word on Covid is that its dangers are passed or passing. But many office workers are pushing to keep a "new normal" of hybrid work, with only a few days in the office – if any – each week. Can this continue, or will the labor market slacken next year and gradually give employers the upper hand?

10. China Leaves Covid Behind?

For most of the year, the big story in emerging markets was the slowdown of growth in China, due to the persistent zero-Covid policy and continued challenges in the property sector, which began the year in the dust of the Evergrande collapse and saw little improvement. The news to end the year is, of course, China's rollout of its re-opening strategy, sooner than expected. While expected, the protests across major cities likely accelerated the relaxation of lockdown measures. The markets have cheered the news, adding to an impressive four week run for Chinese equities.

China's reopening does have some important differences from what we have witnessed in the rest of the world. First, while the COVID inoculation rate is in line with peers, the reluctance to use Western vaccines and relatively ineffective domestic options makes China more vulnerable to Covid. Indeed, there has already been a sharp spike in new cases as winter gets underway.

Second, while Chinese domestic consumers will welcome the newfound freedoms, their wallets are not exactly flush with cash. Unemployment – particularly among the young – is high, and stimulus programs that were rolled out during the pandemic were modest in scope. While large technology platform companies have been encouraged to hire in size, this will take time and wage rates may not be what they were pre-pandemic.

Lastly, it is unclear if the incentive structure for authorities at the provincial and municipal level to maintain infection rates low has indeed been scrapped. In other words, localized restrictions could still be reintroduced in the coming months. These developments will likely put a crimp on the scope of the economic recovery, or at the very least make it messy and uneven. Consequently, RockCreek's local partners, while quite sanguine, have been surgical in their approach to picking individual investments.

11. Postscript

One bright note from Emerging Markets is how Latin America has stealthily outperformed the rest of the world in 2022, defying the odds of imported U.S. inflation, and the fears of many local investors that a sweep of left-wing victories from Peru to Colombia to Brazil would undermine stability. And while some of these fears were confirmed after Peru's leader, Pedro Castillo, was removed from power in December, two days after attempting to dissolve Congress, the region has seemingly passed most of the constitutional democratic tests this year. Next year will test the mettle of Gustavo Petro in Colombia and Luis Inacio "Lula" da Silva in Brazil as they begin the process of implementing their respective wide ranging economic agendas. But for 2022, close to double digit gains seem assured for the region.