ECF Endowment Management First Quarter 2023

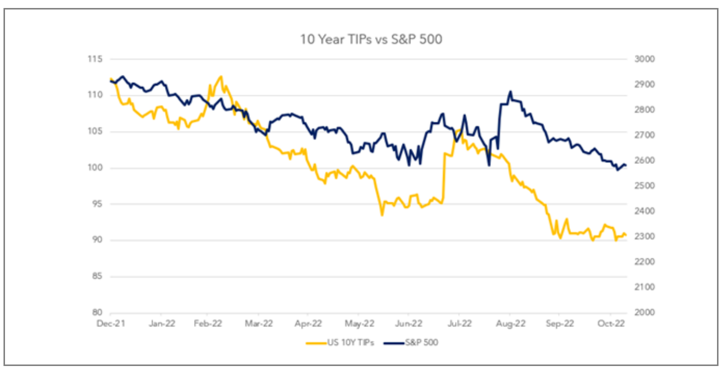
Balancing Inflation and Economic Growth

Has inflation peaked? Will markets ever recover? These are questions that investment committees may be pondering after the fourth worst year for the US equity markets (S&P 500) since 1970. Setting expectations for 2023 can help investment committees plan for the future. To understand the path forward into 2023, rewinding back to review 2022 is essential to provide a longer-term view and better inform your future decisions.

2022: A Pivot Year

After over a decade of consistently low inflation and economic growth, 2022 was the year renewed inflation swamped the markets. Almost anything that could cause inflation did. This perfect storm included supply chain gridlock, worker shortages, housing boom, and even the continuous zero-Covid stance in China. In response, the Federal Reserve used all their tools to keep inflation under control. The Fed began 2022 intending to raise interest rates two to three times during the year. But persistent inflation forced the Fed to pivot to a more rapid rate hike cycle, ultimately raising rates seven times in one year. At the end of 2022, the Fed's policy rate ranged from 4.25% to 4.50%. Yet on February 1, 2023, the Fed raised interest rates for the eighth time this cycle, and policy rates now stand at 4.50% to 4.75%. While the effect on the economy was not immediate, the markets – typically forward-looking – turned sharply downward, reflecting an expected slowdown in both consumer and corporate spending (see Chart 1).

Chart 1: Equities (S&P 500) Downturn Driven by Rising Interest Rates (Dec 2021– Dec 2022)



Source: Morningstar, 2022

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Endowment Tip

During the first few months of the year, many endowment or investment committees welcome new members. Are you creating a culture of welcome and participation? Do you have a training process in place? You will want to explain the long-term goals for the endowment and the basis for current investing and spending decisions. You may also want to debunk the following endowment myths to ensure your new committee is well equipped to oversee the endowment.

Myth 1: Endowments are only for large churches.
FALSE. Churches of any size can start and grow an endowment.

Myth 2: Endowment governance is complex and time consuming.
FALSE. You can set up a small committee for oversight and adopt a simple set of policies for governance.

Myth 3: It's better not to spend from the endowment.
FALSE. An endowment should be set up to enable distributions—that's how it has an impact.

Myth 4: We're stuck with restrictions on use that don't meet our needs today.
FALSE. With a little research and dialogue, you can enable your funds to work better for you.

Myth 5: Parishioners aren't interested in hearing about our endowment.
FALSE. Parishioners are absolutely interested in hearing about your endowment!

This webinar Five Myths of Endowment Management explains these myths in more detail and covers basic principles of endowment management. Please feel free to share it with your committee as part of their training.

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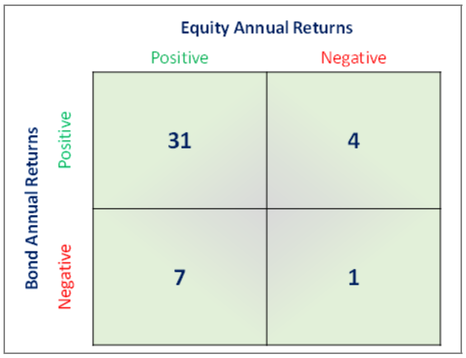
Just How Bad Was 2022?

The US equities market, measured by the S&P 500 index, declined 19.4% in 2022. The US bond market, measured by the Barclays US Aggregate index, declined 13.0%. That is, in the face of rising interest rates, both the equities and bond markets declined, a phenomenon that has not occurred since before 1980. Chart 2 shows the number of years US equities and US bonds were in positive and negative territory since 1980. While there were 31 years when both US equities and US bonds had positive returns, there was only a single year (2022) when both asset classes were negative. Moreover, in 2022, equities and bonds were joined in their negative performance by almost every asset class. International Developed equities declined 14.5%, and Global REITs declined by 25.1%. Even US TIPs saw a downturn of 11.9% for 2022.

Chart 2: US Equities vs Bonds Annual Performance (1980-2022)



Source: Morningstar, 2022

And just how bad was this for investment portfolios? From 1980 through July 2022, the 60/40 portfolio mixture (60% equities and 40% fixed income) delivered an average annual return of 10.8% and positive returns in 35 of 43 years. However, the portfolio experienced down years in 8 of the 43 years, with 2022 being the first negative performance since 2018 and the second worst during the last 43 years (see Chart 3).

Has the Tide Turned in 2023?

We will not likely know if the tide has turned until the end of 2023. With high inflation as the persistent driver of Fed rate hikes, signs of cooling inflation would be positive news indicating that hikes may end sometime this year. Prices may ease a bit with help from both manufacturing and consumers. As supply chains come back online, manufacturing pricing may be in a better place. Yet at the same time, consumers may be spending a bit less. These statistics provide some preliminary insight (see Chart 4):

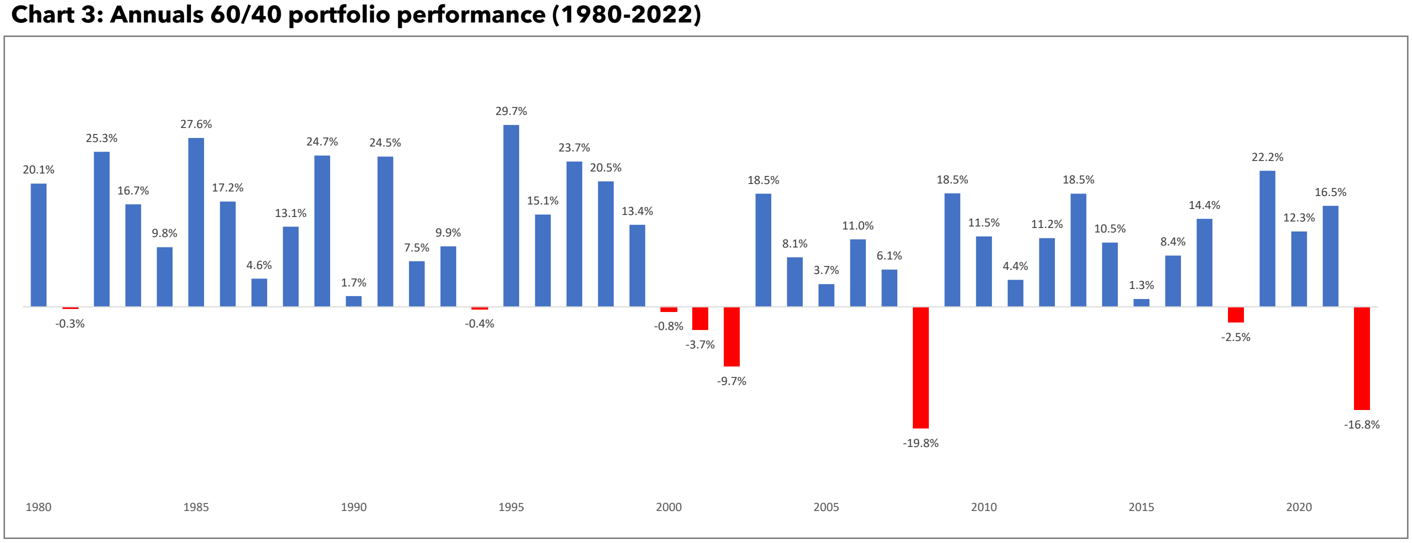
Manufacturing:

- **Manufacturing Backlogs –** In a sign that disrupted manufacturing supply chains are getting back on track, the ISM Manufacturing Backlog Index has seen a decline.
- **Producer Price Index –** The Producer Price Index (PPI), which measures final demand prices across various categories has also been on a decline. As of December 2022, the PPI rose 6.2% (y/y), down considerably from the 11.6% annual increase in March 2022.

Consumers:

- **Housing –** Housing prices spiked during the last 2-3 years. After a year of higher interest rates and higher mortgage rates, housing is now cooling and prices are declining.
- **Consumer Spending –** While supply chains were coming back online, consumers reined in spending during the second half of 2022 in response to higher interest rates. The PCE (Personal Consumption Expenditure) was down

Chart 3: Annuals 60/40 portfolio performance (1980-2022)



Source: Morningstar, 2022

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Chart 5: Equity Markets Pullbacks (S&P 500: 1975, 2003, and 2009)

Year of Market Drop of 15%+	Performance	Performance Following Year	Pullbacks During the Following Year (Performance %)
1974	-26.5%	37.2%	-13.2% -6.6%
2002	-22.1%	28.7%	-28.4% -7.0% -5.5%
2008	-37.0%	26.5%	-13.8% -5.5% -4.0%

Source: Morningstar, Jan 2023

to 5.3% (y/y) in December from a high of 7.0% in June. Although the PCE took a step up in January 2023 to 5.4%, much of the bump up was from a 2% surge in energy prices.

Lens on Economic Growth

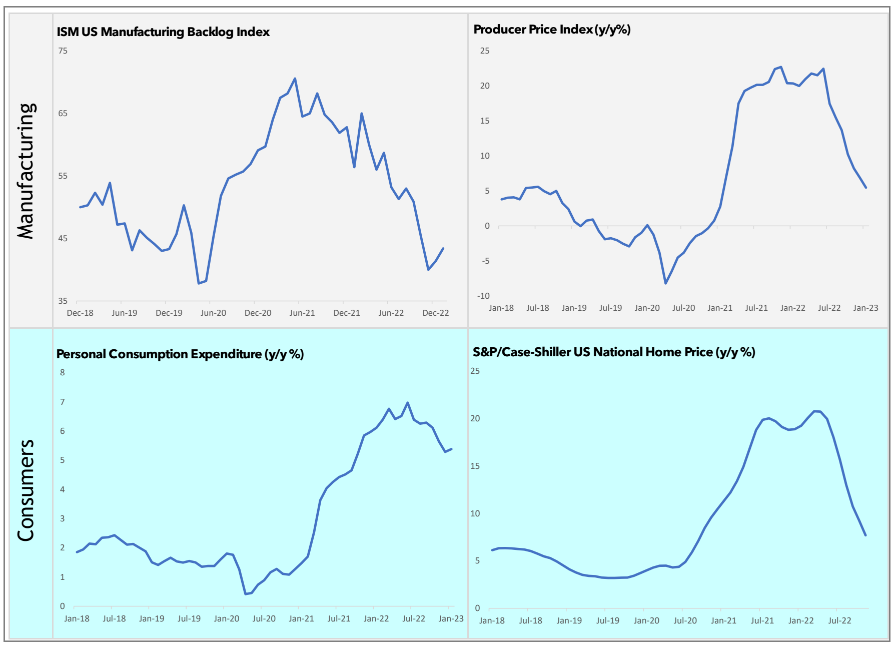
Cooling inflation would be a positive sign, but it could also align with an economic slowdown. Currently the possibility that this slowdown could lead to a recession continues to be a concern. Strong employment persists, giving reason for the Fed to continue rate hikes. In January, nonfarm payrolls increased by 517,000 and the unemployment rate fell to 3.4%, the lowest since 1969. Indeed, current economic growth forecasts from State Street Global Advisors suggest that global growth could be a mere 2.3%, a 30-year low. And in the US, growth could be just 0.4%. Although these are significant slowdowns from where the economy has been the last couple of years, for now growth is still above recessionary levels.

Can Markets Find Some Footing in 2023?

Although the S&P 500 declined significantly in 2022, historically, bad years have been followed by good years. Since 1950, there have been four years (1973, 1974, 2002, 2008) in which the equity market fell more than 15%. In each case, during the following year the market rose an average of 16.5%. If history repeats itself, this will be good news for 2023.

In these recovery years, however, volatility remained high (see Chart 5), and this year may be no different. Uncertainty around US and Global economic growth continues to hang over the outlook for 2023, and a tug-of-war between forecasts could continue to fuel volatility. Investment committees should be ready.

Chart 4: Manufacturing and Consumer Measures (Dec 2018-Jan 2023)



Source: Morningstar, Jan 2023

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Got a Minute?

Your Feedback is Important

In March, ECF's Endowment Management team will begin conducting our annual Feedback Survey. We'd like to hear your opinions to better serve your needs.

Please be on the lookout an invitation to participate in the survey.