Dear Valued Client:

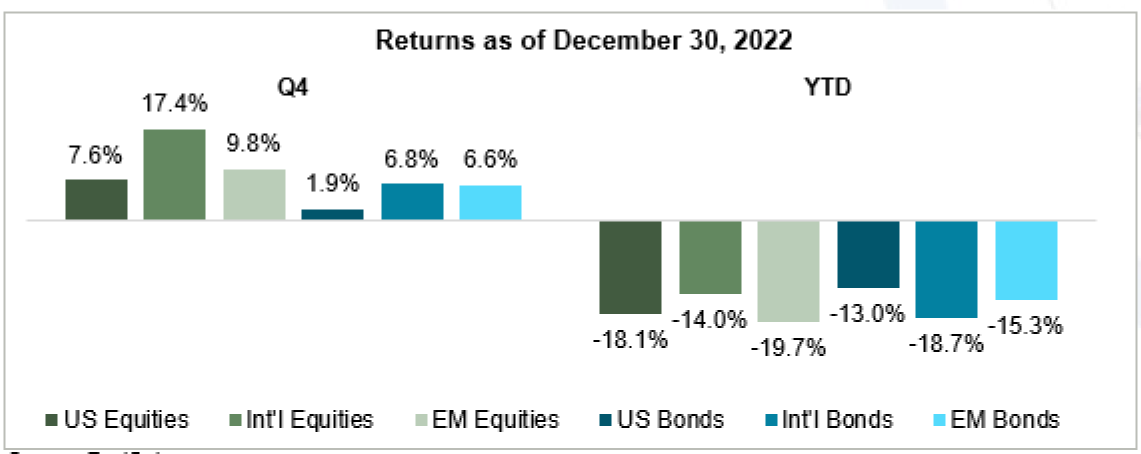
There are many ways to characterize 2022 and not too many of them are good, certainly as it relates to the financial markets. The story throughout was consistent- soaring inflation, hawkish Fed, strong labor market, and liquidity being sucked out of the system leading to a sell-off in both equities and fixed income (more detail below). A Q4 rally helped to take off some of the sting, but 2022 was simply unkind.

We have written many times about the tricky business of predictions. In 2022, most institutions forecast returns in the 8-10% range. Not even close! So, what was missed? A few of the major "unforeseeables" included the Russian invasion of Ukraine, an 18-fold increase in the policy rate in the US, and cratering currencies in Japan, the UK, and Europe. FAANG stocks had a comeuppance and buy the dip became "hold on tight". We collectively waited nervously to catch the most updated inflation report and related "Fed speak" as if we were watching the who shot J.R. reveal on the TV show Dallas. Markets were volatile as the S&P 500 saw many moves of 1% in either direction. Markets are not likely to be surprised by the Fed in 2023 to the same extent and that could mean that fixed income may provide portfolio ballast and reduce overall portfolio volatility. We will not predict.

The Chinese New Year begins on January 22nd. We note that 2023 is the year of the Water Rabbit. The sign of Rabbit is a symbol of longevity, peace, and prosperity in Chinese culture. 2023 is predicted to be a year of hope. In that spirit, we hope that you have a Happy and Healthy New Year!

Fourth Quarter Market Review

2022 was a brutal year for investors, with few places to hide. The war in Ukraine and central banks' fight against inflation led stocks and bonds sharply lower for the year. The fourth quarter bought some relief, but not enough to change the outcome for the year.



Source: FactSet

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Equities around the globe struggled in 2022. Within equities, developed international markets in Europe, Japan, etc. (MSCI EAFE) outperformed the US equity markets in the fourth quarter and the year with a return of 17.4% and -14%, respectively. The outperformance came as the region had a larger exposure to commodity producers and defensive stocks, as well as lower exposure to technology companies. US equities (S&P 500) had their worst year since 2008 and fell 18.1%. Finally, emerging markets (MSCI EM) were the worst performer, with a return of -19.7% for the year led by China, which struggled as Covid lockdowns hurt its economy

Surging oil prices in the first half drove massive gains in the energy sector. The energy sector gained 65.7% for the year, even though oil prices retreated significantly in the second half. In addition, defensive sectors such as utilities, consumer staples, and health care held up better amid the market carnage as investors sought safety. On the other hand, technology-related sectors were the worst performers, thanks to rising interest rates and recession fears.

Value stocks significantly outperformed growth stocks. Growth stocks, often synonymous with next-generation technology companies listed in the Nasdaq index, fell 32.5% as investors demanded certainty in near-term profits amid fear of rising interest rates taking a bite out of uncertain future earnings. On the other hand, value stocks, often considered undervalued, steady, and sometimes even boring dividend payers such as those listed in the Dow index, fared much better and only fell 6.9%.

Bonds had their worst year ever! The Federal Reserve raised the federal funds rate at the fastest pace in history with seven interest rate hikes, bringing the effective rate to a range of 4.25%-4.50% from zero in January. The speed of the interest rate hikes led bond yields significantly higher, driving bond prices to historic lows in 2022. The 2-year Treasury yield rose to 4.3%, up from 0.8% in January, while the ten-year yield rose to 3.8% from 1.5% at the start of the year. US bonds (Bloomberg US Aggregate) fell 13.1%, the worst year since the index's inception in 1976. Long-term bonds (Bloomberg US Treasury Long) with greater sensitivity to interest rates experienced the worst of the damage at -29.3%, while shorter-term bonds (Bloomberg US Treasury Short) offered the only bright spot for bond investors with a gain of 1.0%. Even Treasury Inflation-Protected Securities (TIPS), designed to protect investors in times of high inflation, did not offer refuge against rising interest rates, ending the year with double-digit losses. Finally, high-yield bonds also finished the year down 11.2%, primarily due to a flight to higher quality amid uncertainty.

Commodities gained as oil and natural gas hit highs, while gold was a disappointment. The war in Ukraine amplified inflation concerns sending food and energy prices higher for the year. Broad commodities (Bloomberg Commodity Index) gained 16.1% in 2022. Gold prices fell 0.7% as it struggled to compete with rising bond yields and a stronger dollar and failed to meet expectations as an inflation hedge. Higher interest rates in the US relative to global developed markets led the dollar to rally 9.5% for the year. Finally, US REITs lost 24.9% in 2022 over concerns of rising costs due to higher interest rates.

The classic "60/40" portfolio has only suffered losses larger than 2022's decline once in the last 45 years. With bonds suffering their worst year on record, the classic "60/40 diversified portfolio" comprised of 60% US stocks (S&P 500) and 40% US bonds (Bloomberg US Aggregate) suffered its second-worst year on record. It fell 16.1% going back to the inception of the Bloomberg Aggregate index in 1976. The 60/40's losses in 2022 were only topped by 2008's decline of 20.1%, which were driven entirely by losses in the S&P 500 alone.

Outlook

We have just come through what Kopernick Global terms "A Decade of Economic Craziness and Delusion". In his January 2023 letter to clients, CIO David Iben, CFA, summarizes the last decade as follows: "Any familiarity with economic theory would lead one to the understanding that the suppression of interest rates would, as it always had in the past, lead to an abundance of malinvestments, some dangerous and some outright foolish. Speaking of outright foolish, over the past ten years we have seen:

- Banks accept negative interest rates when loaning money to homebuyers

- Investors pay for the "privilege" of loaning money to distressed countries (including those that they had recently derided as the "PIGS")

- Junk bonds begin to trade at sub-inflation rate yields

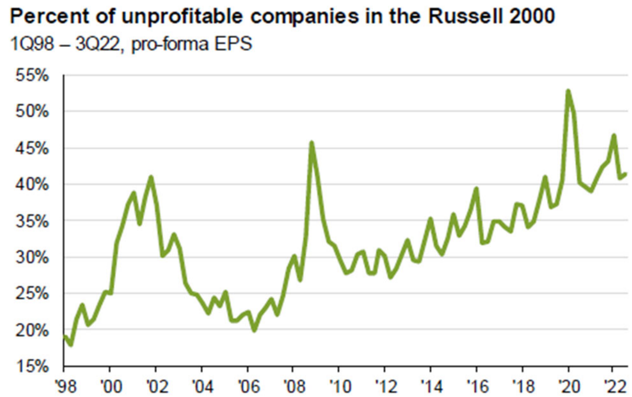
- An index of money-losing tech stocks going parabolic

- Money-losing "venture" companies start to go public—a vast majority completely unprofitable Meme stocks (including bankruptcies) become all the rage

- Non-Fungible Tokens (NFTs), second-tier crypto currencies, Special Purpose Acquisition Companies (SPACs), and other "assets" of dubious value become de rigueur

In summary, mainstream thought began to accept that debt, profit, accounting, valuation, and even research had all stopped being worthy of thought or consideration."

Iben does a nifty job of summarizing the impact of loose monetary policy. Markets were buoyed by easy money culminating in extended valuations that saw growth stocks significantly outperform value stocks. We harken back to the 2000-2002 internet stock collapse to find a similar "growth to value" shuffle that we saw in 2022. The cycle of cheap money began to unwind in early 2022 and take down many of the highfliers noted above. Yet, despite the big price markdowns, the percent of unprofitable companies in the Russell 2000 (small company index) is at around 41% (from 54% in 2020) which is about where it sat in 2002 (see below).



Source: J.P. Morgan Guide to the Markets December 31, 2022

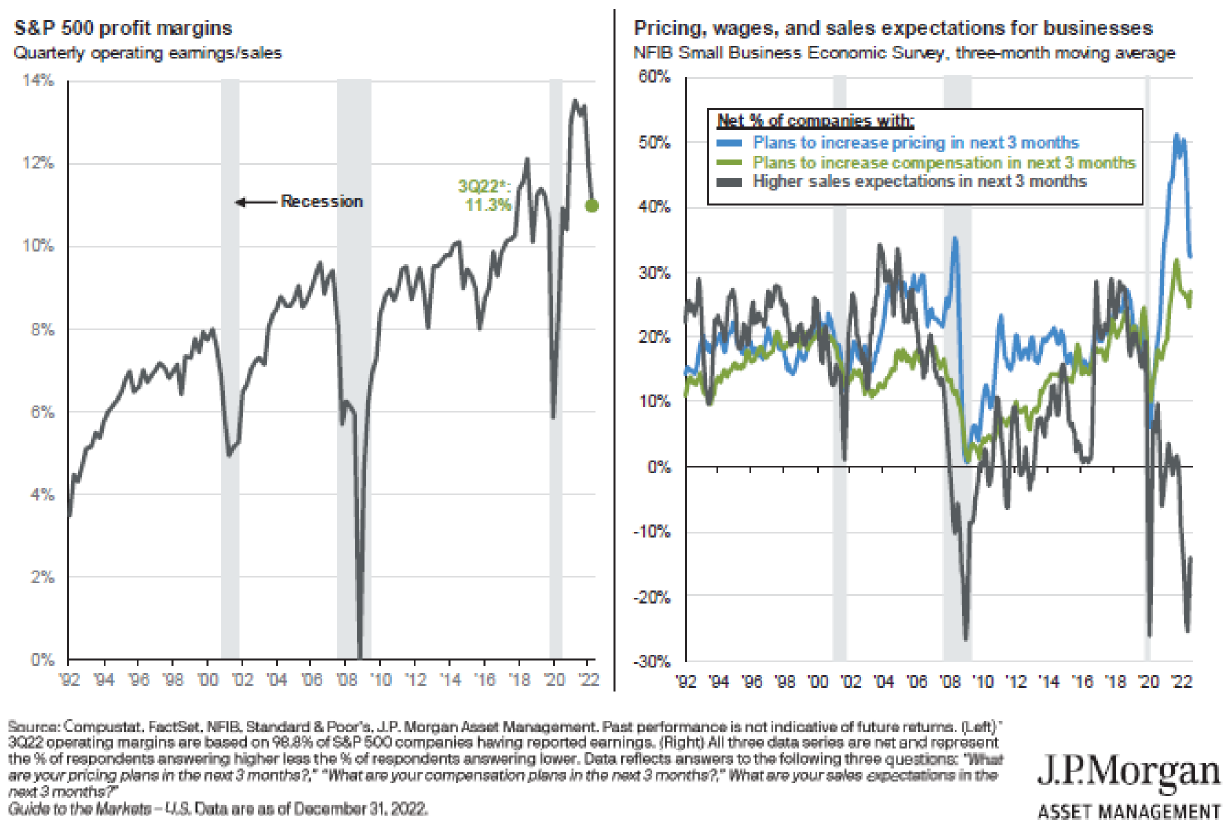
So what happens now? Seems the questions du jour fall into a few headline categories. Will the US and other countries fall into recession and if so, how deep? Will inflation subside and how quickly? Will it be enough to cause the Fed to pause and consider cutting (when?)? Will corporate profits meet current estimates or are projections still too high (implying further earnings markdowns on the way)? There are many others of course, but we will focus on these as they seem to top the list.

The impact of the 2022 rate hikes now permeating our economy should result in slower growth and inflation moderation. The strong labor market has kept recession talk at bay but increased the Fed's resolve. Last week, the unemployment report was greeted favorably with the idea that wage growth was slowing, and that the Fed would take note. It was the first time in many that markets rallied following one of these reports. Unfortunately, markets have been more wrong than right when it comes to predicting Fed action. What was not highlighted last week as much by the media was the drop in the ISM Services report, which screamed stagflation. The overall index came in at 49.6, well below consensus expectations and the first reading in contraction territory since the onset of COVID. The inverted yield curve still suggests recession but Q4 looks like it will be positive "2% plus", corporate balance sheets remain healthy, and debt should still be manageable given the considerable number of homeowners that refinanced when rates were low.

In 2022, monthly balance sheet runoff from the central bank increased to about $100 billion (about $310 per person in the US) per month and there is a high likelihood that this will continue in 2023. Most importantly, the Fed has been clear that they are more concerned about inflation than recession. The Fed has acted forcefully to keep inflation expectations well anchored, and some would say mission accomplished. Now the hard part- keeping restrictive policy even if the economy contracts and unemployment rises. Having had to play catch-up and understanding the mistakes from the past, the Fed is unlikely to be quick to move to a less restrictive posture. If we do get a recession (we see institutions suggesting a 50% probability), it will be the most anticipated in modern history. More importantly, investors expect the economy to falter, corporate profits to decline, and unemployment to jump. Before the economic earnings and job market data hit bottom, markets will have already begun pricing in the next phase of the economic cycle.

While there is never a consensus, the betting line would suggest that inflation will continue to moderate. Some believe inflation will remain very sticky while others believe we may see a sharper fall. Supply chain imbalances have improved but wage growth inflation is tougher to resolve although the Indeed job posting data has started to turn lower. Core goods inflation is coming down and we anticipate housing and owner's equivalent rent will decline later in the year. If inflation does continue to move lower (and we think that will occur) and the Fed pivots, it will make sense for investors to again not fight the Fed.

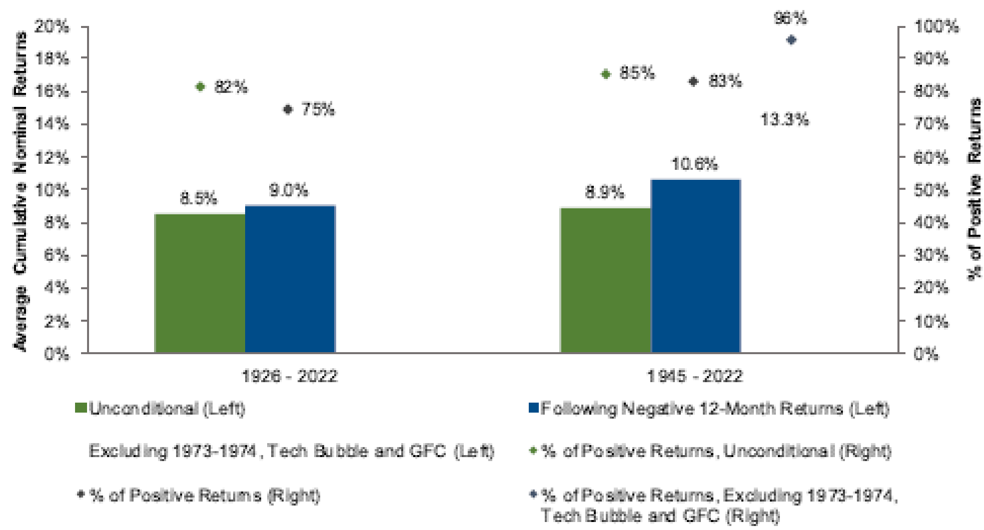
Profit margins are expected to decline, and the charts below put this into context. We think earnings forecasts may be on the higher side (but coming down) but have seen these get adjusted over the course of the year with companies generally beating expectations each quarter. From a valuation standpoint, the S&P 500 forward P/E ratio is now at 16.65 (IBES, FactSet), right at its 25-year average. International stocks are at a discount to US stocks and have been rallying the last few months on a weaker dollar.



It is unusual for markets to post successive years of negative returns. We pointed out in our last letter that over the last 50 years, markets have been positive in the year following the mid-term elections. Below we show a chart of returns after a negative 12 months as we had in 2022. History is certainly on the side of the market, but as pointed out, there are many variables at play as we enter the new year.

Returns After Negative 12-Month Returns

Total Returns for the 50/50 Portfolio Following Negative 12-Month Returns – As of December 2022



Past performance is not indicative of future result, which may vary.
Note: Note: 50/50 portfolio refers to 50% US equity/50% US intermediate bonds. Bonds are represented by US intermediate treasuries and equities by the S&P 500 Index.
Source: Goldman Sachs Global Investment Research, Datastream, Ibbotson

We are more constructive on markets in 2023 but recognize that there are many risks to the downside. We base our opinion on the pain incurred in 2022 that has improved valuations, potentially more normalized fixed income markets offering a reasonable return and ballast, and a Fed that is likely to hit the pause button at some point during the year. We see flash points ahead including a battle over the debt ceiling and continued pressure from higher rates on the already excessive government debt assumed (more on that in the future). The economy is slowing, and a hard landing could mean increased downside pressure on markets.

Our investment committee has opted to add to international allocations, including emerging markets, to bring them more in line with more historical weightings. Valuations overseas are attractive relative to the US, potential for a weaker dollar could serve as a tailwind, and China's economic reopening and policy easing could be bullish for commodity prices and commodity related markets. In the US, we are neutral growth vs value but have a slight overweight to dividend paying stocks. We also maintain a tilt to energy stocks. We have utilized hedged equities with downside protection to smooth the ride and protect portfolios in the event of a 2022 repeat while preserving significant upside potential. Finally, we are incredibly pleased to have access to one of the top long/short funds in the country. The fund plays a prominent role in our portfolios.

Our headwinds/tailwinds summary is below.

Headwinds

- Federal Reserve tightening aggressively
- Inflation (commodity prices) staying high in a decelerating economy
- Labor market still strong- good and bad
- Equity and fixed income valuations remain high on an historical basis despite the recent pullback
- Elevated corporate and government debt levels facing higher interest costs and looming debt ceiling could have meaningful impact on economy and financial markets.
- Geopolitical risks always a factor- unknown what could happen just as the Ukraine war took us by surprise.
- Covid still impacting the world but to a lesser degree.

Tailwinds

- Strong labor market a double-edged sword
- Some signs of economic slowdown could start to show up in the numbers important to the Fed.
- Significant cash on the sidelines- hedge funds are holding a ton of cash and contrarian signals from sentiment readings are growing louder.
- Healthy consumer and corporate balance sheets and continued consumer spending although savings are diminishing.
- Earnings expectations are still positive in 2023.

PRW News

Elliot led a discussion on year-end tax planning for over 350 financial advisors on the Smart Asset platform and spoke with several media outlets on the same topic.

Thank you for your trust and confidence. We look forward to connecting with you over the coming months and wish you all the best in the New Year.

William A. Payne   Richard A. Renwick   Elliot B. Herman

INDEX DEFINITIONS

Asset Class	Index	Definition
China	Bloomberg Commodity	Measures the performance of large and mid-cap shares in China, including: China H shares, B shares, Red chips, P chips, and foreign listings (e.g., ADRs). Index covers about 85% of the China equity universe.
Commodities	Dow Jones Industrial Average	Measures the performance of a broadly diversified exposure to physical commodities via futures contracts.
Dow	Bloomberg Emerging Markets USD Aggregate	The Dow Jones Industrial Average® (The Dow®) is a price-weighted measure of 30 USS blue-chip companies.
Emerging Markets Bonds	MSCI Emerging Markets	Measures the performance of hard-currency emerging markets debt, including fixed and floating-rate USD-denominated debt issued from sovereign, quasi-sovereign, and corporate emerging markets debt.
Emerging Markets (EM) Equity	60% MSCI ACWI, 40% BBG Bloomberg Global Aggregate	Measures the equity market performance of countries considered to represent emerging markets.
Global 60/40 Index Blend		Measures the performance of a blend of global equities and global bond indexes used as a benchmark for balanced portfolios.
Global Equity	MSCI ACWI	Measures large- and mid-cap equity performance of developed and emerging markets. Represents approximately 85% of the global equity investment universe.
Global Bonds	Bloomberg Global Aggregate	Measures the performance of global, investment-grade debt from 24 local currency markets. This benchmark includes treasury, government-related, corporate, and securitized fixed-rate bonds from both developed and emerging markets issuers.
Gold	Bloomberg Sub Gold	Measures the performance of futures contracts on gold and is quoted in USD.
International Bonds	Bloomberg Global Aggregate ex-USD	Measures the performance of investment-grade debt from 24 local currency markets. This multi-currency index includes treasury, government-related, corporate, and securitized fixed-rate bonds from both developed and emerging markets issuers. It excludes bonds issued in USD.
International Developed Equity	MSCI EAFE	Measures the equity performance of countries considered to represent developed markets, excluding the US and Canada.
Nasdaq	Nasdaq Composite	The Nasdaq Composite Index measures all Nasdaq domestic and international-based common-type stocks listed on The Nasdaq Stock Market.
Sector - Consumer Staples	S&P 500 Sector Consumer Staples	Measures the performance of companies involved in the development and production of consumer products, including food and drug retailing, beverages, food products, tobacco, household products, and personal products.
Sector - Energy	S&P 500 Sector Energy	Measures the performance of companies involved in the development and production of crude oil, natural gas and provides drilling and other energy-related services.
Sector - Materials	S&P 500 Sector Materials	Measures the performance of companies involved in industries such as: chemicals, construction materials, containers and packaging, metals and mining, and paper and forest products.
Sector - Technology	S&P 500 Sector Technology	Measures the performance of companies involved in technology hardware, storage and peripherals, software, communications equipment, semiconductors and semiconductor equipment, internet software and services, IT services, electronic equipment, instruments, and components.
TIPS	Treasury Inflation-Protected Securities	Treasury Inflation-Protected Security (TIPS) is a Treasury bond that is indexed to an inflationary gauge to protect investors from the decline in the purchasing power of their money.
US Dollar	US Dollar Index	Measures the value of the US dollar relative to the value of a 'basket' of currencies of the majority of the US's most significant trading partners. Factors the exchange rates of six major world currencies: euro, Japanese yen, Canadian dollar, British pound, Swedish krona, and Swiss franc.
US Bonds	Bloomberg US Aggregate	Measures the performance of USD-denominated, investment-grade, fixed-rate taxable bond market of SEC-registered securities. The index includes Treasury bonds, Government-related Corporate, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS, and CMBS sectors.
US Equities	S&P 500	Measures the performance of 500 leading companies in the US Constituents generally have a market cap above $5 billion and represent approximately 80% of the investable market.

US Long Treasuries	Bloomberg US Treasury Long	Measures the performance of long-term US Treasury bonds, including all publicly issued securities that have a remaining maturity of ten or more years, are: non-convertible, denominated in US dollars, rated investment-grade, fixed-rate, and have $250 or more of outstanding face value.
US Short Treasuries	Bloomberg US Treasury Short	Measures the performance of short-term US Treasury bonds, including all publicly issued securities that have a remaining maturity of between one and three years, are: non-convertible, denominated in US dollars, rated investment-grade, fixed-rate, and have $250 or more of outstanding face value.
US REIT	FTSE NAREIT All Equity REITs	Measures the performance of a comprehensive family of REIT indexes that spans the commercial real estate space across the US economy. The index series provides investors with exposure to all investment and property sectors.
US Growth	S&P 500 Growth	Measures the performance of large-cap growth stocks in the US, which are identified by sales growth, price-to-earnings, and momentum. Constituents generally have a market cap above $5 billion.
US Value	S&P 500 Value	Measures the performance of value stocks in the US, which are identified by sales growth, price-to-earnings, and momentum. Constituents generally have a market cap above $5 billion.
US High Yield	Bloomberg US Corporate High Yield	Measures the performance of USD-denominated, non-investment-grade, fixed-rate taxable corporate bonds. "High-yield" securities have the middle rating from Moody's, Fitch, or S&P of Ba1/BB+/BB+ or below. Index excludes emerging market debt.

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