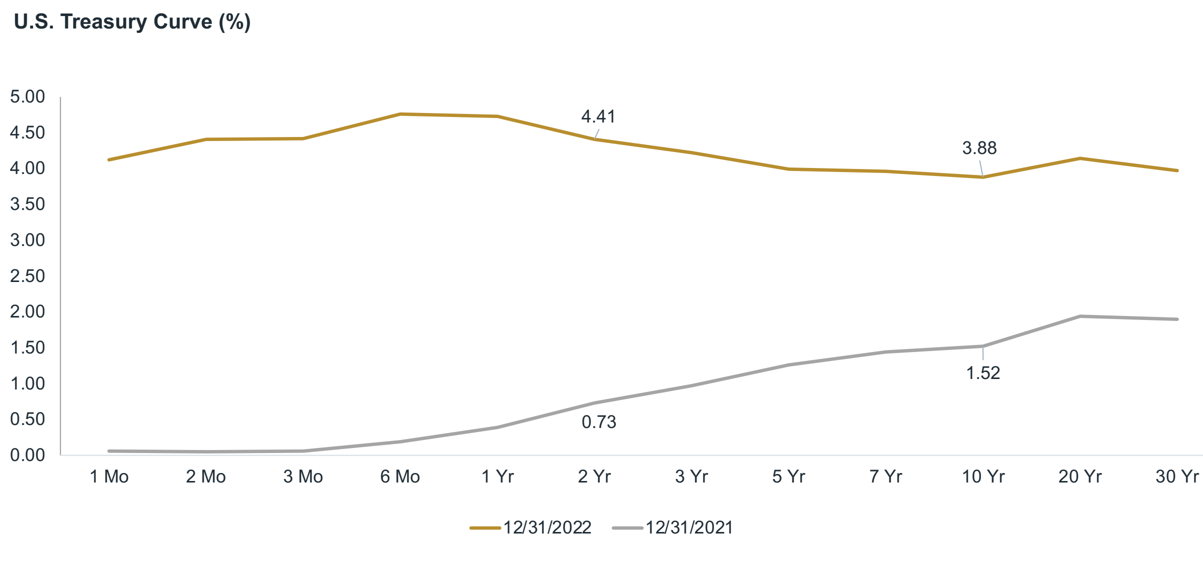
Winter 2023 Market Commentary

Of the many variables that coalesced to wreak havoc on the world in 2022, the one that mattered most to investors was the sharp rise in interest rates or, the cost of capital. When the cost of capital is artificially repressed, as it was for over a decade following the 2008 Great Financial Crisis, unintended consequences are apt to manifest. Negative real yields (after factoring inflation into the calculation) incentivized investors to overlook risk and to steer investment capital toward higher yielding but lower quality investments. In the case of equities, investors plowed money into high growth stocks that promised future returns if cheap financing and strong underlying economic growth prevailed, pushing their stock prices higher. These trends characterized investor behavior over the past decade until early in 2022 when the Federal Reserve acknowledged that the inflation that flared up during the pandemic period was not going to be transitory in duration but persistent and affecting the cost of almost everything consumers buy. In response, the Fed began to tighten monetary policy to slow consumer demand. Throughout 2022, the cost of capital shot upward at the fastest pace experienced in history. The overnight Fed Funds rate jumped from a level of 0% to 4.25-4.50% in just nine months' time.

YIELD CURVE



Source: U.S. Department of the Treasury as of December 31, 2022

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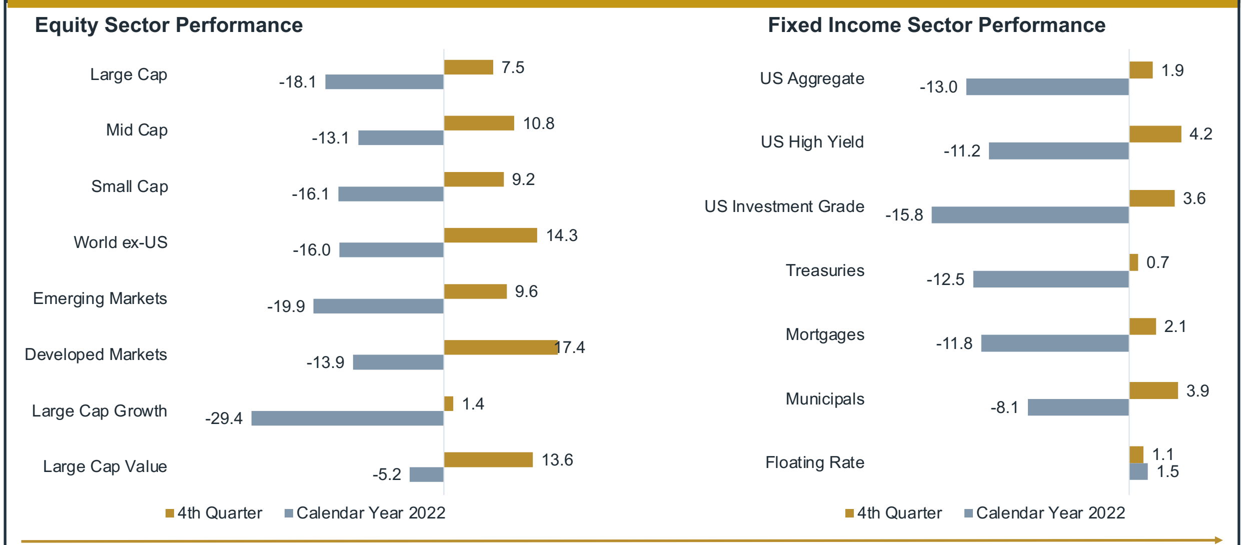
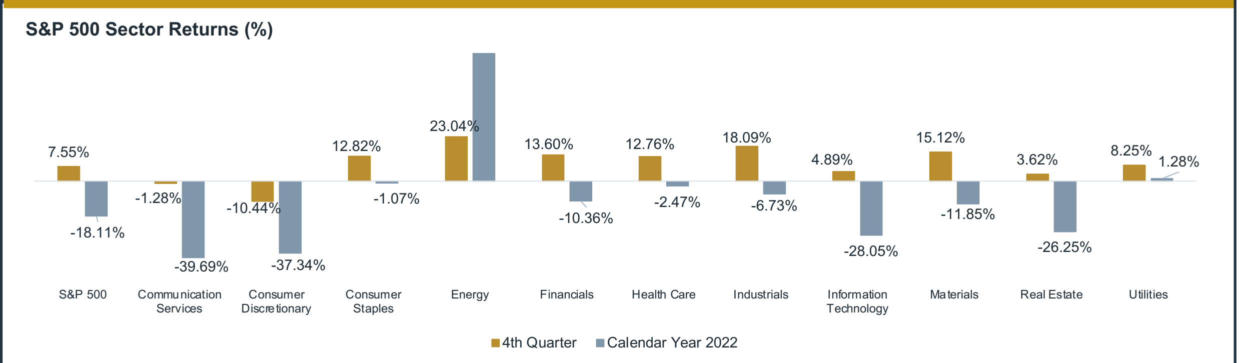
For financial markets, 2022 was a year of economic regime transition with a reset to a new paradigm that features higher interest rates amidst slowing economic growth. This dynamic weighed heavily on almost every investment asset class. Fixed income investments suffered their worst performance EVER as interest rates rose over 400 bp, depressing bond prices. The Bloomberg US Aggregate bond index declined by 13% for the year, hammering even conservatively postured investment portfolios. After three consecutive years of regularly setting new market highs, the benchmark S&P 500 index dropped -19.4% in 2022, marking its worst performance since 2008. Prices for growth stocks in the technology, communications and consumer discretionary sectors that had long flourished in a low cost of capital environment plunged even more. The tech-heavy Nasdaq index fell by 33% and some of its largest constituent growth-oriented stocks were down close to 70% for the year. In contrast, established companies in low-growth sectors with predictable earnings and steady cash flow like consumer staples, utilities and healthcare performed relatively better but were still down for the year.

ASSET CLASS PERFORMANCE



Source: Bloomberg as of December 31, 2022

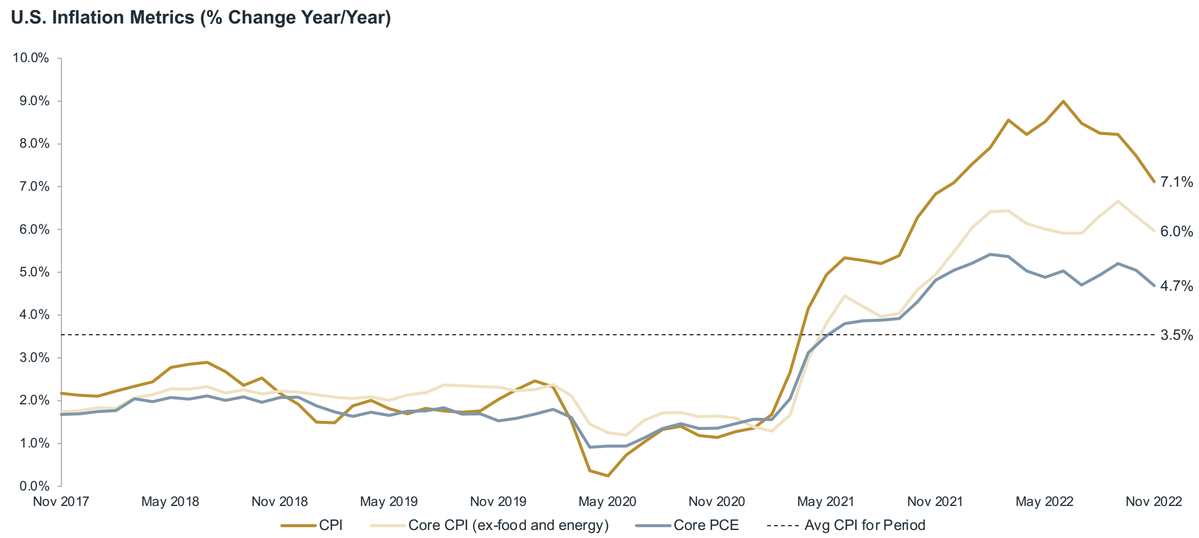
U.S. EQUITY SECTORS



Source: FactSet as of December 31, 2022

We expect that challenges within the investment environment will likely continue into 2023. Depending on the behavior of inflation, the Fed is widely expected to raise rates by another 0.50% in 2023 and then stay at a "terminal" level of 5.25% for the balance of the year until the inflation foe is definitively slayed. A mild recession is expected by a majority of economists and equities may continue to struggle as corporate sales growth and profit margins are revised downward. In the recent past, the Fed eased monetary policy as the economy showed signs of meaningful slowing, leading investors to adopt a "buy the dip" in equities mentality as the return to cheap capital typically buoyed stock prices. In the new market paradigm of 2023, the Fed is expected to largely remain on the sidelines and hold rates steady as it views the battle to reduce inflation as a more important fight to win. Larger "secular" trends such as de-globalization and the restoring of manufacturing, aging populations in the largest developed economies, and heightened geopolitical risk that restricts food and energy resources could keep inflation higher than the Fed's 2% target level as well as dampen global economic growth potential. At some point, a trough in the economic cycle will be reached, at which point a new growth cycle will begin. History suggests that equity bear markets do not bottom when a recession begins, but rather before a recession ends. Since markets are always forward looking and monetary policy tends to be implemented in hindsight, we may see the turnings of a new cycle well before we see a shift in Fed policy. Patience will be an important character attribute for investors to cultivate during this uncertain time.

U.S. INFLATION



Source: U.S. Bureau of Labor Statistics as of December 31, 2022

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One bright spot to highlight: after a decade of suffering through a yield "drought", savers and investors are now able to earn a safe and reasonable yield using fixed income investments. Attractive interest coupons can now be found on even the safest securities and may fully or partially offset any potential future price declines. A more severe recession may negatively impact corporate bond credit spreads, particularly for below investment grade credit issuers and credit defaults may increase. We recommend focusing on high quality US Treasury and Agency securities, insured bank CDs and actively managed bond funds that focus on high quality credit securities. With equity markets likely to remain choppy, bonds may once again fulfill their traditional role as a portfolio stabilizer. High quality stocks in defensive sectors may also be considered. These stocks will not be completely immune to further downside pressure on the equity market but will likely experience much lower price volatility. Many of these stocks pay attractive dividends that can cushion the downside price risk.