January 2023

Economic Update

Market sentiment changed dramatically during 2022. At the beginning of the year, we were contemplating the potential winding down of the pandemic and celebrating a robust economy with high jobs growth, high wage growth, strong stock market gains and record corporate profits. Inflation had shown some worrying signs, but it was generally thought to be transitory due to supply chain issues that were expected to be resolved within a short time frame.

It didn't take long for that market sentiment to change. The S&P 500 index posted gains on January 3, but that turned out to be the high for the year. Inflation has lasted longer than expected, as it was exacerbated by the Russian invasion of Ukraine that began in February and is still ongoing as of today.

While inflation likely peaked in June, it remains stubbornly high at 7.1% year-over-year as of November per the Bureau of Labor Statistics. The Fed has explicitly targeted 2% as the desired inflation rate over the long run. In a deliberate attempt to curb inflation by slowing down the economy, the Fed consistently raised rates throughout 2022. These raises are not helpful to either stock or bond valuation and both the stock market and the bond market each saw significant losses during the year as a result.

The Fed rate now stands at a range of 4.25 to 4.5%. We are already at the highest Fed rate since before the 2008-2009 financial crisis. Despite that, the Fed expects that there will still be more rate increases to come. Currently, they have stated that their target rate for year-end 2023 is 5.0 to 5.25%.

U.S. Economy

Consumers are already noticing at least some inflation relief. The latest Consumer Sentiment Survey reading conducted by the University of Michigan for December was 59.7. This is a poor reading by historical standards, but it is up from the lows seen in May. While inflation was less of an explicit concern in the most recent survey, 45% of consumers now expect unemployment to rise in the year ahead, which is the largest percentage since the early days of the pandemic in April 2020.

These job loss fears have not yet materialized in the data, however. Per the Bureau of Labor Statistics, the U.S. economy added 263,000 net jobs during October, 256,000 in November and 223,000 in December. The total number of unemployed persons is now 5.7 million and the unemployment rate is 3.5%. Both of those numbers stand exactly where we were pre-pandemic.

Aside from the impact of Fed rate increases, U.S. Stock market losses during the last twelve months can be at least partially explained by a fall in corporate profits during that time. Corporate profits, as measured by S&P operating earnings, declined 4% during 2022. This compares to the 70% increase during 2021.

Depending on who you listen to, we are either in danger of falling into a recession or are already in one. Technically, the National Bureau of Economic Research in in charge of making the call and a recession generally coincides with at least two consecutive negative quarters of growth. Actual annualized U.S.

GDP growth was -1.6% and -0.6% respectively in the first two quarters of 2022. However, U.S. GDP growth subsequently rebounded to 3.2% annualized during the third quarter and could be 3.9% annualized during the fourth quarter per as estimated by the Atlanta Fed.

Regardless, this second-half-of-the-year growth surge will be tough to maintain given the prospect of continued Fed rate increases and potential resulting job losses. In their September update to The OECD Economic Report, the group calls for only 0.5% U.S. GDP growth during 2023.

International Economy

The global economy is in a similar state as the U.S., although Europe and parts of Asia are more directly impacted by Russia's ongoing war against Ukraine.

Central banks throughout the world had generally been slower to respond to inflation as compared to the U.S. Federal Reserve. As a result, the dollar strengthened dramatically against most global currencies for most of the year. However, during the fourth quarter, other central banks started catching up with their own raises and the dollar subsequently weakened.

As of this writing, the Bank of England is at 3.5% and the ECB is at 2%. For comparison, the U.S. Fed is currently at a range of 4.25 to 4.5%. Inflation is particularly a problem in the Eurozone, with consumer prices still up 10.1% year over year in November. While this is down from the 10.6% reading in October, ECB President Christine Lagarde has warned of a possible resurgence in 2023, stating that "there are countries where the prices have not yet passed through fully to the retail level and people have not seen the full impact yet and particularly in energy."

Markets

Developed equity markets rebounded during the fourth quarter, but still finished the year down overall. U.S. large-cap equities, as represented by the S&P 500 Index, gained 7.56% during the quarter, but were down 18.11% in total for the year. Developed international equity markets, as represented by the MSCI EAFE Index, fared a little better. That index was up 17.34% for the quarter and down 14.45% for the year. Real estate had a poor year as well. The Wilshire REIT Index gained 4.05% during the quarter, but finished the year down 26.81%

Bond indexes moved similarly. Longer-term interest rates, which heavily influence bond prices, moderated during the quarter after six months of steady increases. The Barclays U.S. Aggregate Bond Index and the Barclays Global Aggregate Bond Index earned 1.87% and 0.99% respectively during the quarter and lost 13.01% and 11.22% respectively for the year. The Barclays U.S. Inflation-Linked Bond Index posted similar results, gaining 2.04% for the quarter, but losing 11.85% for the year overall.

Emerging markets also posted the same good quarter/poor full year results. The MSCI Emerging Markets Index finished the quarter up 9.70% and the year down 20.09%. Commodities were one of the few asset classes to break the trend. The Dow Jones UBS Commodity Index gained 2.22% for the quarter and finished up 16.09% over the full year.

Through Dec. 31, 2022

% Return	Quarter-to-Date	Year-to-Date	1-Year	3-Year	5-Year
T-Bills	1.03	2.06	2.06	0.82	1.31
Bloomberg US Agg Bond Index	1.87	-13.01	-13.01	-2.71	0.02
Bloomberg Global Agg Bond Index	0.99	-11.22	-11.22	-2.59	0.36
Bloomberg US Infl Linked Bond Index	2.04	-11.85	-11.85	1.21	2.11
S&P 500 Index	7.56	-18.11	-18.11	7.66	9.42
MSCI EAFE Index	17.34	-14.45	-14.45	0.87	1.54
MSCI Emerging Markets Index	9.70	-20.09	-20.09	-2.69	-1.40
Bloomberg Commodity Index	2.22	16.09	16.09	12.65	6.44
Wilshire REIT Index	4.05	-26.81	-26.81	-0.49	3.35

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Outlook

Markets have continued to be volatile over the last few quarters as investors have been trying to successfully guess when the Fed will decide that inflation is finally under control and pivot in a new direction.

Even now, as of this writing, the Fed expects to continue to raise another 75 bps during 2023 while the Fed futures market consensus is that they will stop after roughly 25 bps. Because of this difference in expectations, we expect market volatility to continue for the near future, at least until the Fed finally does pivot because they are convinced that our current bout of inflation has fully been put to rest.

The Federal Reserve System operates under a dual mandate of maximum employment and price stability. Given that they have already signaled that they are willing to accept some employment losses, expect the Fed to continue to primarily focus on price stability, meaning that they will keep taking whatever actions that they feel are needed to fight inflation. Even more so because they were specifically called out by many economists for not recognizing the onset of this inflationary period quickly enough in the first place.

On a positive note, stock market losses during 2022 have resulted in more reasonable stock valuations going into 2023. So, while the current choppiness might continue for the near future, we still believe in the stock market over the long run. As always, we recommend a diversified portfolio containing a reasonable amount of equity exposure for any investor with a long enough time horizon.

Bloomberg US Aggregate Bond Index: The Aggregate Bond Index is a broad-based benchmark that measures the investment grade, dollar-denominated, fixed-rate taxable-bond market, including Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS and CMBS. The Aggregate rolls up into other Bloomberg flagship indices such as the multi-currency Global Aggregate Index and the Universal Index, which includes high-yield and emerging markets debt. The Aggregate Index was created in 1986, with index history backfilled to Jan. 1, 1976.

Bloomberg Global Aggregate Bond Index: The Global Aggregate Index provides a broad-based measure of the global investment grade fixed-rate debt markets. The Global Aggregate Index contains three major components: the Aggregate (USD 300mn), the Pan-European Aggregate (EUR 300mn) and the Asian-Pacific Aggregate Index (JPY 35bn). In addition to securities from these three benchmarks (94.0% of the overall Global Aggregate market value as of Dec. 31, 2010), the Global Aggregate Index includes Global Treasury, Eurodollar (USD 300mn), Euro-Yen (JPY 25bn), Canadian (USD 300mn equivalent) and Investment Grade 144A (USD 300mn) index-eligible securities not already in the three regional aggregate indices. The Global Aggregate Index family includes a wide range of standard and customized sub-indices by liquidity constraint, sector, quality and maturity. A component of the Multiverse Index, the Global Aggregate Index was created in 1999, with index history backfilled to Jan. 1, 1990.

Bloomberg Global Inflation-Linked Index: The Global Inflation-Linked Index (Series-L) includes securities that offer the potential for protection against inflation as their cash flows are linked to an underlying inflation index. All securities included in the index have to be issued by an investment-grade-rated sovereign in its local currency. The list of eligible currencies is the same set of currencies eligible for inclusion in the Global Aggregate Index. The Global Inflation-Linked Index (Series-L) represents a stand-alone multi-currency index exposed to the real yield curve for each relevant currency. As such, the index does not contribute to the Global Aggregate Index. The Global Inflation-Linked Index (Series-L) was created on Oct. 31, 1997.

S&P 500® Index: A market capitalization-weighted index of 500 widely held stocks often used as a proxy for the stock market. It measures the movement of the largest issues. Standard & Poor's chooses the member companies for the 500 based on market size, liquidity and industry group representation. Included are the stocks of industrial, financial, utility and transportation companies. Since mid-1989, this composition has been more flexible and the number of issues in each sector has varied. The returns presented for the S&P 500 are total returns, including the reinvestment of dividends each month.

MSCI EAFE Index: The MSCI EAFE® Index (Europe, Australasia, Far East) is a free float-adjusted market capitalization index that is designed to measure developed-market equity performance, excluding the U.S. and Canada. As of April 2002, the MSCI EAFE Index consisted of the following 21 developed market country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland and the United Kingdom.

MSCI Emerging Markets Index: The MSCI EMF (Emerging Markets Free) Index is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets. As of April 2002, the MSCI EMF Index consisted of the

following 26 emerging-market country indices: Argentina, Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Jordan, Korea, Malaysia, Mexico, Morocco, Pakistan, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, Turkey and Venezuela.

Bloomberg Commodity Index: Bloomberg Commodity Index℠ and Bloomberg Commodity Index Total Return℠ the DJ-UBSCI℠ family includes both the BSCI℠, which is calculated on an excess-return basis, and the BSCITR℠, a total return index based on the BSCI℠. The former reflects the return of underlying commodity futures price movements only, while the latter reflects the return on fully collateralized positions in the underlying commodity futures.

Wilshire US REIT Index: Introduced in 1991, the Wilshire REIT index is intended as a broad measure of the performance of publicly traded real estate equity securities. The index is market-capitalization weighted of publicly traded real estate securities, such as Real Estate Investment Trusts (REIT), Real Estate Operating Companies (REOC) and partnerships. The index is composed of companies whose charters are the equity ownership and operation of commercial real estate.

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