Volume 16

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S&P 500 ANNUAL RETURNS LAST 25 YEARS

Year Ending	Total Return
2022	-18.1%
2021	28.7%
2020	18.4%
2019	31.5%
2018	-4.4%
2017	21.8%
2016	12.0%
2015	1.4%
2014	13.7%
2013	32.4%
2012	16.0%
2011	2.1%
2010	15.1%
2009	26.5%
2008	-37.0%
2007	5.5%
2006	15.8%
2005	4.9%
2004	10.9%
2003	28.7%
2002	-22.1%
2001	-11.9%
2000	-9.1%
1999	21.0%
1998	28.6%
Avg. Annualized	7.64%

Table Source: S&P Dow Jones Indices

Expectations Reset

The S&P 500 closed 2022 down 18%, in sharp contrast to some very favorable market returns in prior years. At the close of 2021, the S&P 500 was up an astounding 26% annually, or 100% cumulatively, over the last three calendar years (2019, 2020, and 2021). While these returns were celebrated, they were then followed by more disappointing returns and a reset of expectations. A similar experience occurred in the late 1990's. For the 1997-1999 calendar year period, the S&P 500 was up 27.6% annually, or 107.6% cumulatively. After this period of growth, the market was down 38% from August 2000 to August 2002.

Each market is unique, so certainly this comparison gives no credit to the large differences in fundamentals experienced during each period. The purpose is for investors to remember periods of significant outperformance or underperformance can be followed by periods of underperformance or outperformance. We labeled this "mean reversion" in last year's newsletter.

Heightened volatility was our expectation entering 2022. As it turns out, more than 52% of the days in 2022 produced gains or losses of greater than 1% for the S&P 500 (as of November 17, 2022). Using this as a barometer of risk, it was the second most volatile year since 1950. This increase in volatility provides tactical asset allocation opportunities.

Growth and Value Attributes

Growth	Value
Higher Price Earnings (P/E) Ratio	Lower Price Earnings (P/E) Ratio
Lower Dividend Yield	Higher Dividend Yield
Lower Debt to Free Cash Flow	Higher Debt to Free Cash Flow
Newer and Fewer Products	Mature Product Offering

Growth materially underperformed value style equities in 2022. In the S&P 500 (down 18.1%), growth style stocks were down 29.4% while value stocks were down 5.2%. In addition to mean reversion and other factors, significant interest rate changes drove this style difference.

One factor driving stock valuations is based upon the discounted value of future earnings. Future cash flows typically occur at later stages for growth stocks, while value stocks have more current cash flows. Unexpected and large interest rate changes materially impact how these cash flows are valued. If rates move higher in a short period, any future cash flows are now discounted in present value terms. The 2022 interest rate environment made stocks with future cash flows less attractive during the year. As rates stabilize, the interest rate change impact will become less material in determining the short term direction of a stock price.

Leading vs. Lagging Indicators

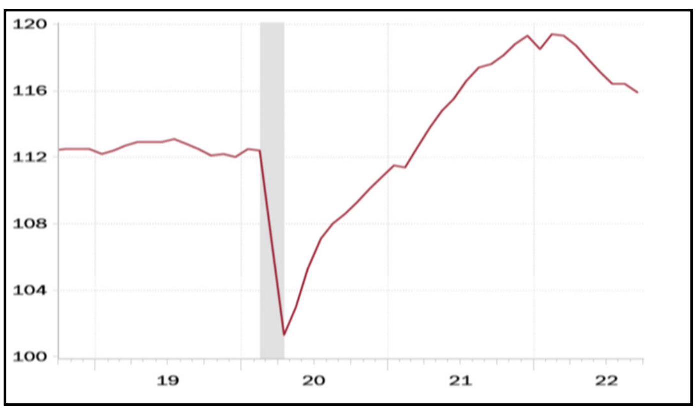
Most economic data can be classified into three categories: leading, coincident, and lagging. As a reference, think about driving a car. Would you drive a car by looking through the front windshield (leading) or by looking through the rear-view mirror (lagging)? As investors, we look to understand lagging and coincident indicators as they are newly released, while letting leading indicators drive our view.

The stock market itself is a leading indicator. It will look to put a probability value on future events that may or may not occur. Opportunities present themselves when the market does not properly value these risks or opportunities. The Conference Board summarizes these components into either the Leading or Lagging Economic Index (LEIs).

Leading Indicators	Lagging Indicators
Yield curve	Inflation or CPI
Interest Rate Spreads	Employment
Building Permits	Unemployment
ISM New Orders	Labor Costs
Jobless Claims	Productivity
Stock Market	Gross Domestic Product or GDP

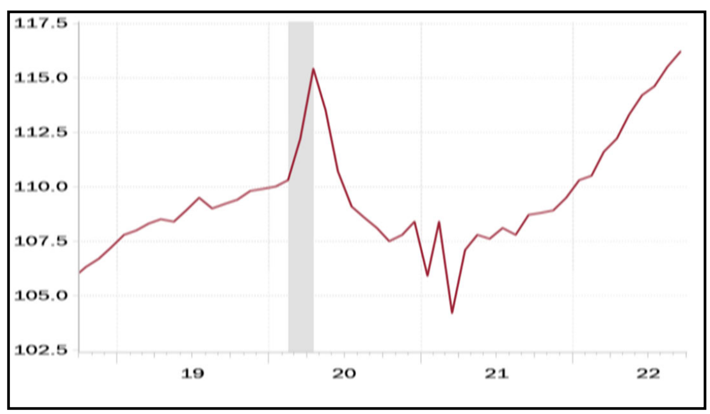
The first chart below highlights Leading Economic Indicators pointing to an expected weakening of the U.S. economy. This weakness is being highlighted during a period when many headlines are still portraying a strong economy. Many of these headlines are actually referencing coincident or lagging indicators as their basis for optimism.

US Conference Board Leading Indicators



Shading indicates recession
Source: Haver Analytics, Rosenberg Research

US Conference Board Lagging Indicators



Shading indicates recession
Source: Haver Analytics, Rosenberg Research

As indicated in the title of the second chart (above right), lagging indicators tell a better picture of what has already happened. Again, these lagging indicators include things such as inflation and employment. These two charts highlight that leading and lagging indicators are painting two different pictures of the U.S. economy. This is normal. The challenge is to interpret the underlying data and determine where the economy might be heading.

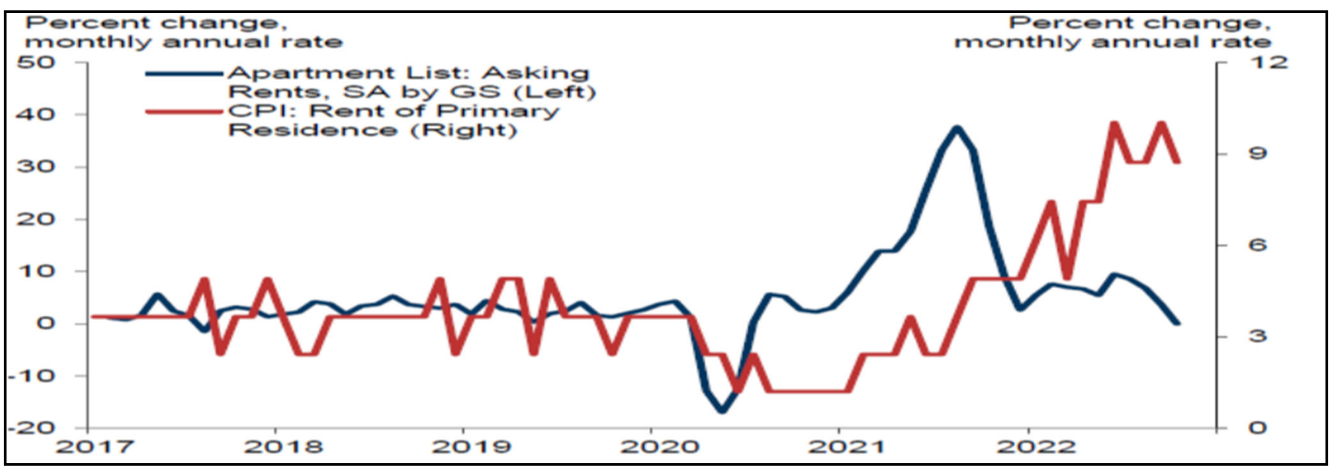
The leading indicators suggest an economy that is weakening. A weaker economy, coupled with the fastest and largest rate hikes in history, historically means the Federal Reserve will not be able to hold rates high for long. This in turn suggests the Fed may end up tightening (or has tightened) too much. When we refer to "tightening", we are referring to the Federal Reserve's attempt to cool the economy by raising interest rates and reducing liquidity. They have conducted this operation all while broadcasting an emphasis on lagging indicators (inflation and employment). A 2023 shift in Fed policy could be the primary catalyst for a positive market turn. The tricky balance is the current Fed does not want an inflationary repeat of the 1970's, when it eased monetary policy (interest rates) too soon.

Despite being a rare occurrence, the Federal Reserve has been able to help guide the economy towards a soft landing on a few occasions. In a soft-landing scenario, bond yields would stay higher for longer, while avoiding economic disruptions. This would be good for savers and reasonable valuation levels. We will likely gain a better sense of success in the first half of 2023. Should a soft landing seem unlikely, corporate profits might decline, causing further unrest in the equity markets.

Both lagging and leading data serve a purpose in evaluating the global economy. When we drive a car, we do not ignore what is happening behind or next to us, but we are more focused on what is ahead!

Declining Inflation—Looking for Price Stability

Inflation may not be as sticky as some would suggest, which would be a positive for equity and bond markets. Both headline and core inflation numbers are down from peak levels (7.1% and 6.0% Nov 2022). Our inflation view would change if wages were growing faster than headline inflation. Real average weekly earnings in the U.S. are currently down 3.4% year-over-year (nominal wage growth - inflation). We would also need to see long-term inflation expectations increase significantly. The bond market still views inflation averaging a little over 2% annually for the next ten years.

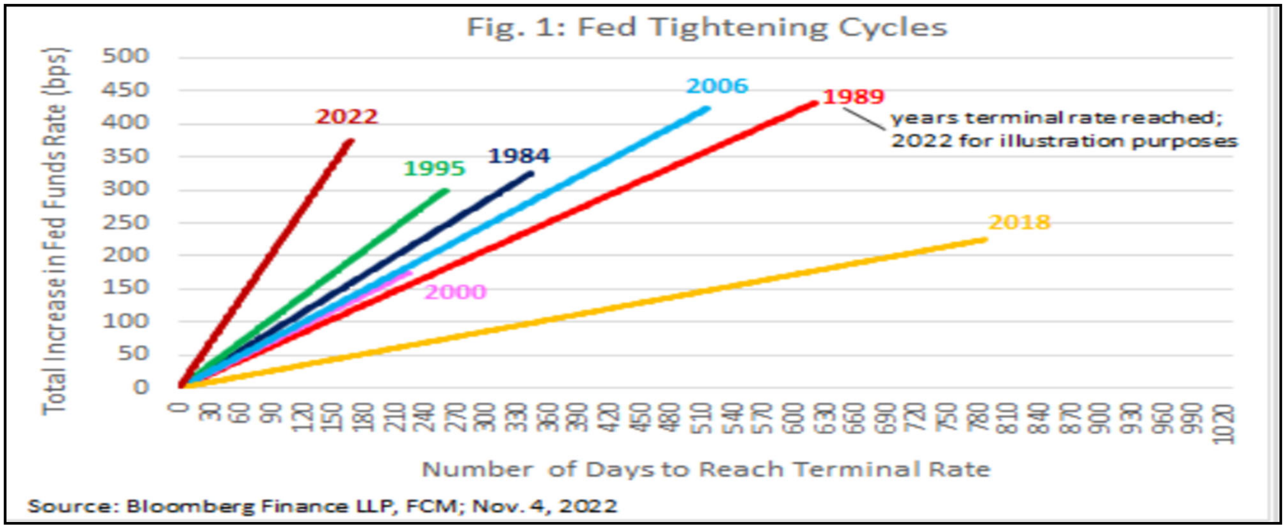


Source: Haver Analytics, Goldman Sachs Global Investment Research

As previously mentioned, inflation itself is a lagging indicator. The chart above compares a leading indicator - Apartment List Asking Rents (blue), to a lagging indicator - CPI Rent of primary residence (red). Leading rental indices (blue) are suggesting a normalization of rental inflation, despite the monthly broadcasted lagging rental index (red) suggesting rental inflation remains stubbornly high. What comes to mind is a saying used in the commodity markets; "Sometimes the cure for high prices is high prices." While this is just a simple generalization, consumers and businesses do eventually adjust to high prices and move down the "value chain".

There are three prevailing scenarios with regards to inflation. The first is for higher-than-average sticky inflation. This could lead to additional rate hikes and cause further market turmoil. This is not our base case scenario. The second is for a soft, feather-style inflation landing. This would mean inflation slowly declining over time with a stabilization of Fed rates (our base case). This second scenario would be a positive for the economy and for the markets. A third view is that inflation is beat and turns into deflation. Since inflation ran too hot in 2022, the probability exists that the Fed may overshoot the 2% target on the downside. We expect this view to gain more headlines in 2023.

Below is a recent history of Fed tightening cycles and the associated duration. The current rate hike cycle is the fastest and shows how nervous the Federal Reserve has been about the direction and magnitude of lagging inflation indicators. This may actually be a signal forecasting a welcome pause or reversal in interest rate policy.



Market View: Attractive Yields & Normal Valuations

Fixed Income

Going into 2022, the fixed income market was not expecting the rate hikes we experienced and had to adjust accordingly. The Federal Reserve executed a rate hike agenda at a pace not seen in decades, which negatively impacted bond prices. Late in the calendar year, a traditional 60% equity/40% bond portfolio was set for its worst performance since 1937—more than 85 years.

Considering this, we have three tactical fixed income views to summarize. First, we have increased our U.S. Treasury allocation as a duration and liquidity tool in our portfolios. Typically, Treasury bonds offer great investment protection in a down stock market. While not the case in most of 2022 due to the unexpected speed of tightening, eventually the downside protection will resurface as rate hikes begin to slow.

Second, we increased the duration of our fixed income portfolios to lock in higher yields for longer. In the second half of the year, yields reached levels ranging from 4% to 6% on high quality bonds. These are very attractive yields relative to what has been available for more than ten years. This is also a defensive position, in the event a recession were to occur or yields were to decline. Our bond portfolio is still classified as intermediate duration as we had a defensive positioning coming into 2022.

Third, we have maintained a material underweight to high yield bonds for a few years, ever since average yields dropped below 5% annually. The limited yield made the risk/return profile unfavorable. While we carry this large underweight into 2023, we are open to adding high yield exposure as average yields are now around 8% for the asset class.

Equity

In down markets, traditionally defensive equity sectors (healthcare, utilities, consumer staples, and energy) tend to perform well—or at least provide stability relative to other sectors. Last year's performance for these sectors was no different.

The sector leader of 2022 was Energy (also a 2021 leader), up 66%. Honorable mention goes to utilities, up less than 2%. While performance in the energy sector the last two years has been remarkable, if an investor were to only buy energy stocks in mid-2008, they would just now be reaching breakeven levels. We mention this to emphasize the importance of diversification. Investors should adjust sector exposures based on valuations and fundamentals, both qualitative and quantitative.

We have two tactical equity views to summarize. First, we remain overweight equities relative to fixed income. In addition, we are overweight U.S. Large Cap stocks relative to international stocks. The global economy carries increased risks and is fragile economically, politically, and structurally, as demonstrated by headlines out of Russia, Ukraine, China, Taiwan, Britain, European Union, etc. Domestic U.S. assets remain more attractive long-term when considering these heightened international risks. Overall, valuation levels for equities are more reasonable due to the 2022 market correction.

Asset Class	Summary of Current Tactical Views
Fixed Income	
Investment Grade	Underweight and favoring high quality and Treasuries. Extended duration.
High Yield	Underweight this lower quality & higher risk asset class. Opportunity may arise to increase high yield position.
Equity	
Large Capitalization	Overweight domestic quality companies and favoring Growth style.
Small & Mid Capitalization	Overweight higher growth sectors.
International	Underweight developed and emerging international markets.

Suitability: Your Investment Strategy

Calendar year returns can be fleeting, but what matters is that your long-term strategy is correct. In the current investment climate, think about these questions to help validate your strategy:

<u>Risk tolerance: Behavior Analysis</u>

- Do you have experience with previous market declines?
- How much of a decline (-10%, -20%, -30% plus) have you experienced?
- What was your investment behavior in previous market downturns?

<u>Investment Tolerance: Investment Needs Analysis</u>

- Are you currently using funds from your portfolio for budget/expense purposes?
- When will you start needing distributions, and how much will the distributions be?

<u>Financial Tolerance: Liquidity Analysis</u>

- What is your liquid net worth vs. your net worth (including real estate business, etc)?
- Have you identified first source, second source, and last source of liquidity?

As you consider these, please feel free to reach out to us for a further discussion.

SECURE Act 2.0[1]

On December 23, Congress passed the $1.7 trillion Consolidated Appropriations Act of 2023 and it was signed into law on December 29. Tucked inside more than 4,000 pages of legislation, you can find SECURE 2.0, which provides a number of changes for retirement plans. Some changes are effective immediately, while others are delayed to future years. Here are some major highlights:

RMD age increase: The age for required minimum distributions (RMDs) is increased to 73 starting in 2023. This age will increase to 75, but not until January 1, 2033. Anyone currently subject to RMDs under the old 70½ or 72 RMD age rules is not impacted and must continue to follow their existing RMD schedule.

QCDs expanded: Starting in 2023, a one-time only, $50,000 qualified charitable distribution (QCD) to a charitable gift annuity, charitable remainder unitrust, or a charitable remainder annuity trust will be allowed. Also, the QCD limit of $100,000 will be indexed for inflation starting in 2024.

IRA catch-up indexed: Individuals who are age 50 or over can make an additional IRA catch-up contribution of $1,000. This amount will be indexed for inflation starting in 2024.

Rollovers from 529 plans to Roth IRAs: Effective in 2024, beneficiaries of 529 college savings accounts are permitted to roll over up to $35,000 aggregate over the course of their lifetime from a 529 account in their name to a Roth IRA. These rollovers are subject to Roth IRA annual contribution limits, and the 529 account must have been open for more than 15 years. This new rule will allow any "leftover" 529 funds to avoid tax or penalty if rolled over.

Higher SIMPLE contributions: Beginning in 2024, higher salary deferrals and additional nonelective contributions to SIMPLE IRAs will be allowed.

No lifetime RMDs for Roth Plans: Unlike Roth IRAs, Roth accounts in workplace plans have been subject to RMDs during the owner's lifetime. Beginning in 2024, this will no longer be the case.

Supercharged plan catch-up contributions: The catch-up amount will increase to $7,500 for those 50 and older. Starting in 2025, individuals who are ages 60, 61, 62, and 63 will be eligible to make larger catch up contributions to their employee-provided retirement plans—up to $11,250.

More "Rothification": The trend toward "Rothification" continues as Congress seeks immediate tax revenue. SEP and SIMPLE plans can allow Roth contributions beginning in 2023. Further, all plan catch-up contributions for age 50-or-over higher income employees must be Roth contributions, starting in 2024. Finally, beginning immediately, plans can allow employer matching contributions to be made on a Roth (after-tax) basis.

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Wrap Up

In down markets, some investors choose to monitor their investments more frequently. Others take the "no look" approach. Each market has its own unique characteristics. Considering this, it is good to remind ourselves that there are three main categories of market downturns:

- Cyclical: mainly related to the economic cycle and rising interest rates—stock market corrections typically drawn out (think of "U" shapes)
- Structural: driven by asset bubbles and excess leverage—typically leads to the deepest decline and very dramatic rallies/declines (think of "W" shapes)
- Event driven: tied to exogenous shocks—typically over quickly (think of 2020 and "V" shapes)

At this stage, this market appears to resemble a cyclical downturn, driven first by inflation, rising interest rates, and finally a weakening economy. Should leading indicators show stability in 2023, the Fed may be able to orchestrate a soft landing.

In last year's newsletter we addressed many elements of inflation. Most of the inflation we are experiencing came from events occurring in 2021 and prior. These past few years produced supply/demand imbalances and significant government intervention and spending. We would reiterate our view that the inflation experience of the last year is not structural (longer-term) inflation but rather cyclical (shorter-term). This view correlates well with a cyclical market correction.

We enter 2023 with a small overweight to equities. Leading economic indicators suggest a weakening economy. High quality bonds are yielding on average 4-5% annually. While these yields are fairly average from a historical perspective, they are more attractive than we have seen in over a decade. The forward price to earnings multiple (a valuation measure) for the S&P 500 is now 16.7, while the 25yr average multiple is 16.8. This suggests a stock market that is cheaper than the last two years and fairly valued considering long term historical averages.

This equity market valuation and normalized yield environment cause us to look forward with cautious optimism.

Happy new stock market year!

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Sources include: Rosenberg Research, Various 2022 Issues. JP Morgan Asset Management, *Guide to the Markets*, December 31, 2022. Goldman Sachs, *Macro Outlook 2023: This Cycle is Different*, November 16, 2022. Goldman Sachs, *2023 Outlook: Bear With It*, November 21, 2022. Fidelity Investments, *Fidelity Capital Markets 2023 Outlook*, November 5, 2022. State Street Global Advisors, *2023 Market Outlook: The Great Balancing Act*, November 17, 2022. Data source providers include Thomson Reuters, S&P Dow Jones, Tamarac, and providers to.