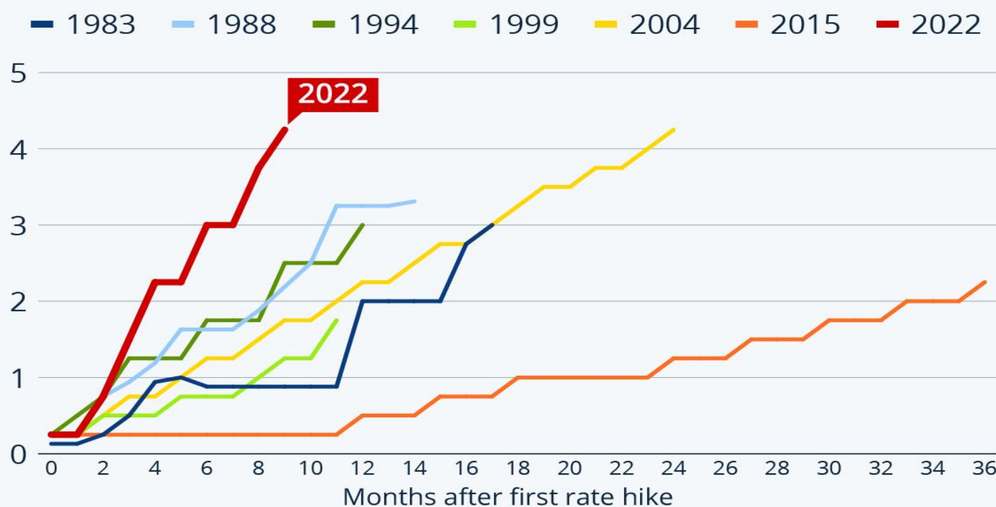
Q4 and Year End 2022 Investor Update

2022 will go down in the history books as marking the end of the free money era. The Federal Reserve reversed their misguided conclusion that rising inflation in the second half of 2021 was "transitory" and did not warrant a monetary response. Fed Chairman Jerome Powell had unilaterally expanded the purview of his department beyond the historical responsibilities of 1) stable prices and 2) full employment. Early in 2022, the Fed saw inflation continue to spike above 9%, a level not seen in over 40 years at which point Mr. Powell refocused on his explicit responsibilities. On March 17th, the Fed Funds rate was increased from 0% to 0.25% (it's actually a range but we'll ignore that unimportant detail). Two months later on May 5th, the Fed commenced with the swiftest tightening cycle in the modern era. In seven months, the Fed Funds rate was raised an additional 400 basis points.

The Fed Is Moving Historically Fast to Tame Inflation

Changes in the federal funds target rate in past tightening cycles (in percentage points)



Source: Federal Reserve

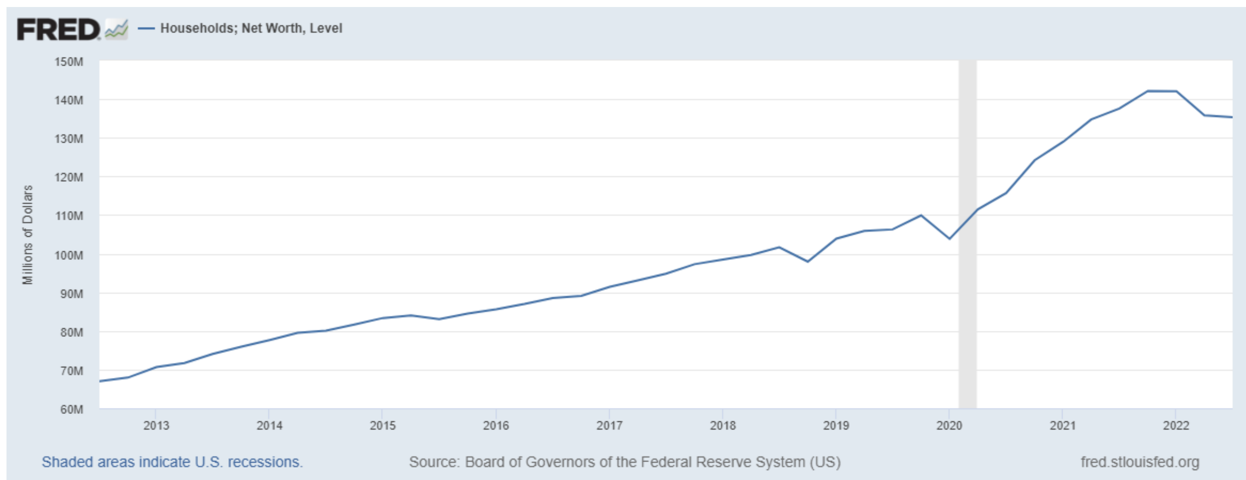
The delay in commencing the rate increases necessitated the unprecedented pace of tightening. As of yearend, headline inflation has slowed from 9+% to the 6+% range. That is a meaningful improvement, but still a long way from the target level of 2.0%. A significant contributor to last year's spike and subsequent decline is based on oil prices. Crude oil peaked above $120/barrel in June and has declined all the way to a low of $71/barrel in December. Core inflation statistics take the volatile food and energy markets out of the equation and that index peaked at 6.6% in September and closed the year with a December (unadjusted) reading of 5.7%.

The Feds slowed the pace of tightening in December to a .50% rate hike. Conventional wisdom is expecting a .25% hike at the next FOMC meeting commencing on January 31st. Chairman Powell has made it exceedingly clear that his Fed will be diligent in their pursuit of stable prices and views the risks of prematurely pivoting away from tighten to be significantly worse than the risks of over tightening. That means the current Fed tightening will be higher and for longer than is currently discounted by investors. With that in mind, we feel even though a .25% hike in Jan/Feb is likely, a .50% hike is very possible. Along the same thinking, the investment markets expect the Fed Funds rate to peak at ~5.1% and begin trending down in the second half of 2023. We feel the peak number will be over 6% and will persist through all of 2023 and into the first half of 2024. Part of this prediction is based on the belief we will not have a recession in the first half of 2023 as is predicted by most. We feel the likelihood of a recession is minimal as long as the U.S. consumer remains strong and freely spending.

Wages and wage growth remain elevated and is one of the key indicators watched by Chair Powell. Additionally, consumers accumulated savings are at record levels. The personal savings rate skyrocketed during the pandemic. Federal relief dollars were abundant, and consumers were confined to their homes and could not engage in many areas of consumptive spending.

Since the retail reopening post-Covid, the consumer has been aggressively spending to the point that savings rates are now below average. Our contention is the consumer will not

meaningfully slow down their spending habits, until the balances they saved during the pandemic return to more normal levels.



Consumer spending accounts for 2/3's of our economy and as long as the consumer is spending freely, a meaningful recession is not likely. Nor is inflation likely to return to the Fed's 2.0% target.

What does this mean for our portfolios? We believe it will be another mixed year for investments. We are expecting increasing short-term interest rates and slightly higher long-term rates which means a further inverted yield curve throughout 2023. Eventually the consumer will begin to run out of savings and start to curtail discretionary spending to the point we will see a recession. Whether that is in 2024 or 2025 we don't know. Under this scenario, value stocks should continue to lead the markets and the relatively expensive growth stocks should continue to underperform. A continuation of the "risk-off" market we saw in 2022. There is currently a narrative growing in popularity that inflation has been tamed and the Fed may have one more .25% rate hike before they stop raising rates and start decreasing rates in Q3 2023. We've seen growth stocks rally off the bottom and higher risk assets showing signs of life. We believe there will be a series of starts and stops in the market but until our fundamental outlook changes, we will remain conservatively positioned in the stock and bond markets. We love companies that are generating earnings and free cash flow and are fairly priced. These stocks performed relatively well in 2022 and we see a continuation of this trend in 2023.

For 2022, our Small Cap composite portfolio lost 14.6% vs the Russell 2000 index that was down 20.4%. Our large Cap portfolio composite lost 11.8% vs the S&P 500 that was down 18.1%. Both numbers are excellent and given our style of investing, these results are exactly what we would expect to see. We don't have a composite for our balanced accounts. These accounts are constructed by combining our respective composites to fit each client's unique personality and unique financial situation. When you consider the Large Cap index was down 18%, Small

cap index was down 20%, and the Aggregate Bond index was down 18%, our balanced portfolios had an excellent year.

Every time new economic data is released, we will analyze the new data and we stand willing and ready to change our position if the data supports a change. Stay tuned as the economic period we experienced over the past three years is truly unprecedented. It's not often that someone who has been in the markets since 1987 and witnessed the 22% one day decline in the Dow on October 19th can say "we've never seen anything like this". The pandemic and our nation's response to it have never been seen before. Novel thinking is required as "doing what we've always done in the past" may not be the prudent course.

We are excited for the opportunities that have been and will be created by these uncertain times. Prudent asset allocation and stock selection has proven once again to be the right way to invest in the long run. We thank you for your business and your trust.