Fourth Quarter Market Review and Comment
January 2023

Updated Market Performance

Returns	4th Quarter 2022	One Year	Annualized 3 Year	Annualized 5 Year	Annualized 10 Year
S&P 500	**7.56%**	**-18.11%**	**7.66%**	**9.42%**	**12.56%**
DJIA	**16.01%**	**-6.86%**	**7.32%**	**8.38%**	**12.30%**

Performance: October reversed September's loses returning 8.10% after dividends. November continued increasing where October left off notching a return of 5.59%. December reversed and continued 2022's downward trend falling -5.76%. This left us with a 4th quarter 2022 total return of 7.56%. This leaves us with a return for 2022 of -18.11%. This is the worst annual return since 2008's return of -38.49%

After the 3rd quarter 2022 posted a loss of -4.88%, the 4th quarter 2022 started off strong in October and November but wavered in December leaving us with a return of 7.56%. The Dow Jones Industrial Average (DJIA) outperformed the SP500, posting 16.01% gain over the same period. For the previous twelve months the SP500 has returned -18.11%, underperforming the DJIA which returned -6.86% over the same period. The annualized three-year returns for the SP500 were 7.66%, the DJIA three-year returns trailed the average increasing 7.32%. Over the last five years the annualized returns are right below historical norms (around 10.50%), with the SP500 returning 9.42% and the DJIA posting 8.38%. The ten-year annualized numbers are running above long-term averages (around 10.50%), with the S&P500 returning 12.56% versus the DJIA which turned in 12.30%.

Breaking down the returns for Q4 2022, we note that there were seven outperforming sectors and 4 underperformers. **The best sectors were Energy (21.68%), Industrials (18.67%), and Materials (14.44%)**. **The underperformers during the quarter were Consumer Discretionary (-10.41%), Communication Services (-1.63%) and Real Estate (2.85%).** The best sectors over the last twelve months were Energy (59.04%), Utilities (-1.44%), and Consumer Staples (-3.17%). Following behind, were Communication Services (-40.42%), Consumer Discretionary (-37.58%), and Information Technology (-28.91%).

Economy: Growth in the economy increased in the second half of this year after negative growth the first half of the year. However, growth is still below average (Historical growth is ~3.00%). Expectations are that this year we will see another deceleration in growth. Inflation is still running hot although it seems to have peaked. The Fed has been aggressively tightening monetary policy to get inflation under control. Normally when the federal reserve tightens monetary policy and raises short term rates, they usually end up hindering growth and causing the economy to go into a recession. Recession risks are currently high. We had a technical recession in the first half of the year which is defined as two negative quarters of GDP. We think a more meaningful recession will occur sometime in 2023 although at the current moment the recession looks to be shallow and short.

The third estimate of 3rd quarter 2022 Gross Domestic Product (GDP) is 3.2% according to the report released at the end of December by the Bureau of Economic Analysis (BEA). The latest estimate suggests that overall economic growth in the 3rd quarter increased 3.8% from the 2nd quarter 2022 third estimate of -.60%. GDP for 2021 came in at 5.7% compared to -3.5% in 2020, 2.2% in 2019, 2.9% in 2018 and 2.2% in 2017. Currently Trading Economics estimate (Forecast of U.S. GDP Growth) has forecasted 2022 Q4 GDP growth at 1.20%. The Federal Reserve Board of Atlanta's GDPNow is forecasting 4th quarter GDP at 3.9%, which is well above the consensus estimate of ~1.20%. By comparison, China says their GDP increased at 3.9% in the 3rd quarter of 2022. Increasing from 2nd quarter 2022 reading of 2.6%. China's 2021 GDP was 8.1%, 2.3% in 2020, 6.1% in 2019, 6.6% in 2018 and 6.8% in 2017. Growth rates for the European Union (EU) and the Euro Area were 2.50% and 2.3% respectively in the 3rd quarter 2022. For 2021, GDP grew 5.3% for the EU and 5.3 for the Euro Area. For 2020, GDP fell -6.1% for the EU and -6.37% for the Euro Area. For 2019, GDP rose 1.5% for the EU and 1.2% for the Euro Area. This is down from the 1.9% growth achieved by the EU and the 1.8% achieved by the Euro Area in 2018. GDP Growth forecasts for the end of the 4th QTR 2022 are 1.50% for the EU and .30% for the Euro Area.

Unemployment is continuing to trend below historical norms (~5.76%). Even with increased layoffs in the headlines, unemployment remains resilient. According to the Bureau of Labor Statistics, November unemployment remained unchanged at 3.7% from October. Unemployment for 2021 came in at 5.36%. Unemployment was 8.11% and 3.67% in 2020 and 2019 respectively. The number of unemployed was essentially unchanged at 6.0 million in November. The labor force participation rate was sparsely changed in November at 62.1%. Notable job gains occurred in leisure and hospitality, health care, and government. Employment declined in retail trade, in transportation, and warehousing.

Inflation increased 7.10% in November continuing to run hot and above the average trend. This is the smallest twelve month increase since December 2021. After averaging 8.33% in the 3rd quarter 2022, inflation as measured by the Consumer Price Index (CPI) increased to an average of 7.40% for October and November. The average rate of inflation for 2021 was 4.70% and was above average by historical standards (~2.47% over last 30 years and 3.23% from 1914-2021). The energy index increased 13.1% for the 12 months ending November, and the food index increased 10.6% over the last year. All these increases were smaller than for the period ending October.

Consumption is an important driver of the economy as it represented 68.2% of 3rd quarter 2022 nominal GDP. The U.S. Census Bureau announced in December that retail sales for November 2022 were down -0.6% from October and were up 6.5% above November 2021. Gasoline stations were up 16.2% from November 2021, while the Food & Beverage industry was up 14.1% over the same period.

Manufacturing economy grew in September. Economic activity in the manufacturing sector contracted for the month of December, with the overall economy contracting for its 2nd consecutive month. This is after 30 straight months of expansion. The Purchasing Managers Index (PMI®) registered 48.4; a decrease of -0.60 from November's reading of 49. Of the five subindices that directly factor into the Manufacturing PMI®, two (Employment and Inventories) were in growth territory, with both gaining a bit of ground. The PMI® registered its lowest level since May 2020, when the index was 43.5. Of the six biggest manufacturing industries, only Petroleum & Coal Products registered moderate growth in December. The Production Index decreased by 3, falling into contraction territory. Supply chain congestion continued to ease, indicated by the Supplier Deliveries Index showing faster deliveries. Only two of the 10 subindices were positive for the period. A reading above 50 indicates that the manufacturing sector is generally expanding; below 50 indicates that it is generally contracting. Based on historical relationships between

PMI and GDP, a PMI of 48.4 corresponds to a -0.1% decrease in real gross domestic profit (GDP) on an annualized basis.

Home prices continued to decrease in September but still have strong year over year gains. However, increasing mortgage rates should increase supply in turn continuing to lower prices. According to the S&P Case-Shiller Home Price Indices home prices in September rose 10.6% over the last 12 months which is down 2.3% from the previous month's 12.9%. Miami, Tampa, and Charlotte had the largest year over year increases with 24.6% for Miami, followed by 23.8% for Tampa, and 17.8% for Charlotte. According to the National Association of Realtors, the year-over-year change in existing home sales was –33.6% in November for Single family homes between $250,000-$500,000. Housing supply continued to remain tight in November with 3.5 months of supply, but we are beginning to see inventories tick up.

Markets: The markets have continued to retreat after hitting an all-time high on the S&P 500 January 3rd, 2022, at 4,796.5. We went from being in a Bull market to being in a Bear market. At this time, the market continues to be driven by hawkish monetary policy, inflation, recession fears, decreasing corporate earnings growth, and Geopolitical risks.

What will move the markets moving forward:

- **Earnings: Earnings growth for the SP500 is expected to decrease -2.8% for the 4th quarter 2022. It will mark the first time the index has reported a decline since 3rd quarter 2020 (-5.7%).** Looking at future quarters, analysts project earnings growth for the 1st QTR 2023 to be 0.7% and 0.3% for the 2nd QTR 2023.
- **Valuations: Valuations came down meaningfully last year.** The current 12-month forward Price to Earnings is 16.7 (21.4 on January 3rd, 2022). The 20 Year average P/E is 15.5, which is 1.2 above our current levels. There is some room for more contraction without meaningful growth. Lower interest rates have historically allowed for higher multiples, which would allow for some P/E expansion or cushion if we don't see growth.
- **Monetary Policy/Interest Rates: Short Term Interest Rates are continuing to increase and are getting close to historical averages. The average effective Fed Funds rate since July 1954 is 4.60%. The average over the last 10 years is 0.69%.** The Federal Reserve raised the federal funds rate by.75% to a range between 4.25%-4.50% in its latest meeting in December and is expected to raise rates by at least .25% in January. The Fed will continue reducing its holdings of Treasury securities, agency debt, and agency mortgage-backed securities, as described in the Plans for Reducing the Size of the Federal Reserve's Balance Sheet. The Committee is strongly committed to returning inflation to its 2 percent objective. The spread between the 2-year and 10-year Treasury yields is -0.61% as short-term rates have risen faster than long-term rates amid expectations for Fed monetary policy tightening. The yield curve is currently inverted (2-year yield is higher than the 10-year yield) and financial conditions are tightening. **Seven of the last Eight recessions have occurred during a rising interest rate environment when short term rates were higher than long term rates (Inverted Yield Curve), which leads to our ongoing concern of the Fed raising rates too fast. It is not if, but when.**
- **Inflation: Inflation has continued to remain elevated, however we are starting to see signs of inflation easing.** The only silver lining is that Social Security will be increasing 8.7% in 2023. Inflation is easing albeit slowly. Currently the Fed has committed to increasing interest rates and decreasing their balance sheet to try to fight inflation. This comes at a time when growth is

slowing. If growth slows too much and inflation stays elevated/high, we may end up with stagflation.

- **Russia-Ukraine Conflict and other Geopolitical risks: The current conflict is weakening the European economy more than the US economy, with some speculation of a recession in some countries (especially Germany).** We are currently feeling the impact through higher oil and commodity prices. At this time, it is hard to determine the total impact this conflict will have on the US. US-China relations remain tense.

Forecast:

We think the biggest threats to the stock market are interest rates continuing to increase accompanied by elevated inflation, the Fed tightening monetary policy, and economic contraction. We think the SP500 will end the Q1 2023 between 3600 and 3700. At this juncture, we venture a guess that stocks will end the year somewhere between 2% and 5% for the year.

For the next six to twelve months, the Federal Funds rate will most likely increase from its current range of 4.25%-4.50% to 5.00-5.25%. **The 10-year Treasury which is currently priced at ~3.79% should remain in a range between 3.60%-3.9% through the end of the 1st quarter.**

As always, we appreciate your continuing confidence in our firm. Please let us know if you have questions.

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