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QUARTERLY OUTLOOK NEWSLETTER

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NEWSLETTER HIGHLIGHTS

Equities and bonds posted sharp declines in 2022 as the Fed took aggressive steps to combat rising inflationary pressures

- The S&P 500 declined by 19%, its biggest annual loss since 2008
- Bonds posted their largest drop on record, with a 13% decline that extended across all sectors of the fixed income market

The U.S. economy faces a growing set of challenges in the new year

- Although recent data suggest inflation has peaked, lingering pressures will likely require the Fed to maintain its restrictive policy stance into 2023
- Higher living expenses are having an impact on U.S. households, with personal savings rates recently falling to the lowest level in nearly 60 years

We maintain an underweight allocation to equities with a focus on quality across our strategies

- Expectations for slower economic growth are likely to drive further downward earnings revisions in the months ahead
- For the first time in years, equities must compete with bonds for the attention of income-seeking investors

Despite our cautious near-term outlook, it is important to maintain a long-term perspective

- Historical performance data suggest that investors are rewarded for their discipline over the long-term
- After undergoing a sharp price adjustment in 2022, higher bond yields now offer fixed income investors attractive forward returns

The party sponsored by the era of low interest rates came to an abrupt end in 2022, as the risk of runaway inflation drove the Federal Reserve to pursue its most aggressive policy tightening campaign in four decades.

Few areas of the market were spared from the Fed's 180-degree turn in policy. The S&P 500 ended the year 19% lower while bonds shed 13%, marking the first year since 1969 that bonds offered no protection in a declining stock market.

Although investors are unlikely to look back on 2022 with fond memories, the silver lining is that brighter days lie ahead. The past year's adjustment in equity and bond valuations means that investors are entering the new year from a position of strength, and is certainly preferable to the backdrop of early 2022 when bond yields were at record lows and the S&P 500 was coming off a year in which it recorded 70 new all-time highs.

We remain hopeful for a better 2023 but caution that we are not out of the woods just yet. This view is represented by our defensive positioning across portfolios, where we maintain an underweight allocation to equities and a bias towards higher quality sectors of the market.

The coming months will require continuous reassessment of the numerous factors impacting markets. Among a long list of questions facing investors in the new year, we will be closely watching to see how the U.S. economy acclimates to the new interest rate environment. In addition, with inflation still uncomfortably high, investors will be keenly focused on the Fed's efforts to impose additional policy tightening measures in the coming months.

In this quarterly update, we will review the past year's market performance and share how the latest data is informing our outlook for the upcoming year. As always, we will remain disciplined but nimble as we navigate the changing market landscape and encourage clients to remain focused on their long-term portfolio strategy during this period of uncertainty.

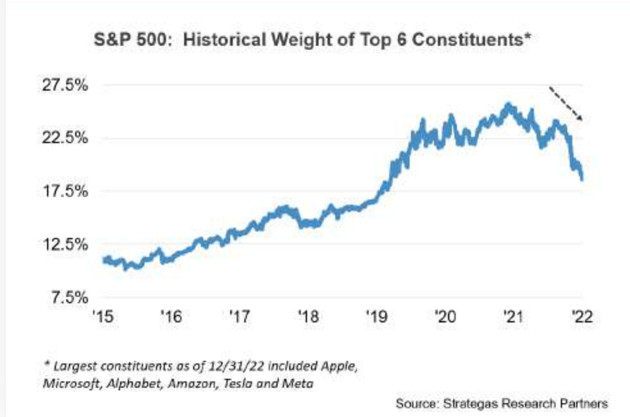
THE YEAR OF THE UNDERDOG

Equity investors experienced a bad case of whiplash in 2022. Following a gain of nearly 30% in the previous year, the S&P 500 dove 19% as persistent inflation and the reality of a more restrictive Fed began to sink in among investors.

In surveying the damage across the stock market, there were a few notable observations. For instance, investors received a fresh reminder about the perils of chasing market performance as big winners from the pandemic such as Peloton, Teladoc and Zoom lost roughly 70% in value.

Perhaps more notably, after years of market dominance (which saw the collective share of Apple, Microsoft, Alphabet, Amazon, Tesla and Meta grow to account for 25% of the S&P 500) shares of Technology and growth-oriented companies relinquished their leadership role to more value-driven sectors of the market.

TECH STOCKS RELINQUISHED THEIR LEADERSHIP POSITION AS GROWTH STOCKS STRUGGLED



In a year when the tech-heavy Nasdaq declined by roughly 33%, counter-cyclical sectors such as Utilities and Consumer Staples outperformed with strong relative returns of -1% and -3%, respectively. Of course, the big winners were energy stocks, where strong earnings growth following years of investor neglect helped propel the sector to a return of almost 60%.

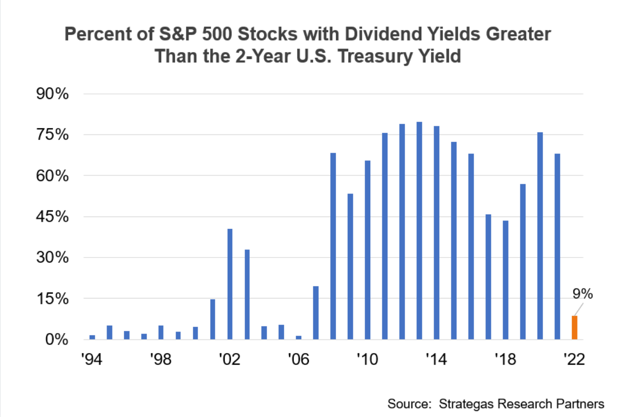
BACK TO THE BASICS

Given the 20% haircut to valuations over the previous year, our outlook for future equity returns is more optimistic than when stocks were trading at all-time highs. However, our view over the near-term is more cautious, and we remain unconvinced that current stock market valuations fully reflect today's challenges.

The average bear market (defined as a 20% decline from a market high) has historically lasted just over one year and seen stocks decline by around 35%. Although the current bear market is approaching the 1-year mark, this episode's drawdown has "only" been 25%, which might suggest to some that we aren't out of the woods just yet.

Of course, past performance is no guarantee, and no two bear markets are the same. Rather than try to predict when and at what level the market will bottom, we prefer to focus on the factors that will drive performance moving forward. Here, it is important to know that the next bull market will likely look and feel different from those that recently preceded it. Therefore, yesterday's investing playbook may no longer apply.

SO LONG "TINA": INCOME-ORIENTED INVESTORS FINALLY HAVE A REASONABLE ALTERNATIVE

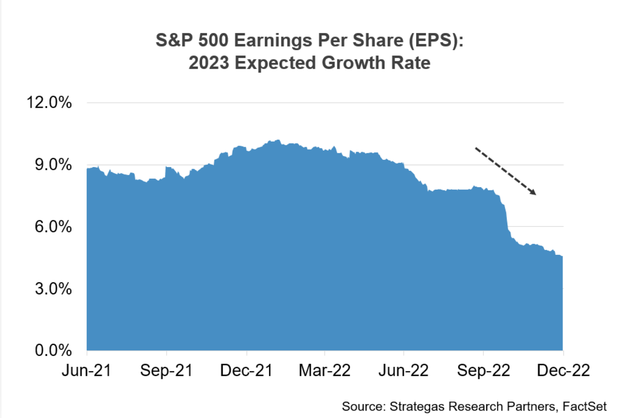


In recent years, investors have been conditioned to expect a "V"-shaped recovery in asset prices as policymakers took drastic measures to support the economy and encourage risk-seeking behavior. Today, with the Federal Reserve focused squarely on battling inflation and no sign of an impending crisis, investors can no longer rely on stimulative policies to come to the market's rescue.

In addition, thanks to the bold actions taken by Fed officials over the last year, bonds now offer the highest yields in years and serve as a reasonable alternative to equities in a diversified portfolio. We all love a catchy acronym, but it is safe to say that "TINA's" (There Is No Alternative) best years are behind her.

Now more than ever, investors will need to rely on market fundamentals to drive price appreciation. In today's environment, we remain focused on the outlook for corporate earnings, and believe that current market expectations do not account for the growing likelihood of an economic slowdown. Although future earnings projections for companies in the S&P 500 have fallen sharply in recent months, expectations for 5% profit growth in 2023 still appear ambitious. In the months ahead, we will look for further downward revisions before upgrading our outlook for stocks.

EXPECTATIONS FOR FUTURE EARNINGS ARE LIKELY TO DECLINE FURTHER

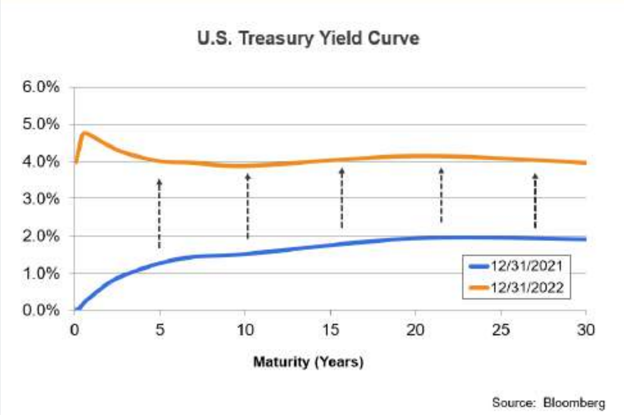


DIVERSIFICATION DISAPPOINTED IN 2022

As fixed income investors are painfully aware, bonds offered no refuge from equity losses as the Fed responded to the highest inflation in 40 years by raising rates at what felt like a breakneck pace. In fact, the Bloomberg U.S. Aggregate Bond index slid 13%, marking the fifth annual decline in its 47-year history and shattering the previous record for worst annual performance (-3%) set in 1994.

There was no place to hide within bonds as the asset class underwent a severe price adjustment that left all sectors and maturities in red territory for the year. In fact, even Treasury Inflation-Protected Securities (TIPS), which are often utilized for their inflation protection features, suffered double-digit losses in 2022.

WHAT A DIFFERENCE A YEAR MAKES:
BONDS YIELDS SPIKED IN 2022



In recent years, one of the more popular trades among investors was to maintain a bias to short-term bonds that offered lower interest rate sensitivity. After all, when rates were at record low levels, there was only one direction for bond yields to move going forward (and it was unlikely we'd follow our foreign counterparts into adopting negative interest-rate policies).

Therefore, what caught most investors off guard this year was not the fact that rates moved higher, but the speed with which yields adjusted. Said another way, the anticipated long-term repricing of bonds was compressed into a period of months rather than years.

FIXED INCOME IS ONCE AGAIN A SUITABLE ALTERNATIVE

There is no sugarcoating the recent weakness across fixed income, and last year's performance has no doubt left many investors wondering if bonds still deserve a place in their portfolio. With inflation likely to moderate going forward and the Fed approaching the end of its tightening cycle, we are hopeful that the worst of the bond market adjustment is now behind us.

It is important to remember why investors own bonds in the first place – for income. Income has historically accounted for more than 90% of bond returns, and with yields now at the highest level in almost 15 years, bonds can finally offer reasonable forward returns.

In addition, unlike in recent years, investors no longer must resort to owning long-term debt or lower quality issues in their quest for a decent yield. In fact, many parts of the investment-grade market now offer yields north of 5%.

FED'S RESOLVE TO BE TESTED IN 2023

After dominating headlines across financial media over the past year, all eyes are likely to remain on the Fed in 2023. Following a cumulative increase of 4.25% in policy rates in 2022 (to the highest level since late 2007), additional policy tightening will likely be needed to restore price stability to the U.S. economy.

Fortunately, recent data suggest that inflationary pressures are beginning to moderate. Since reaching the highest level (9.1%) in more than forty years last summer, prices in November showed a rise of 7.1% over the prior year.

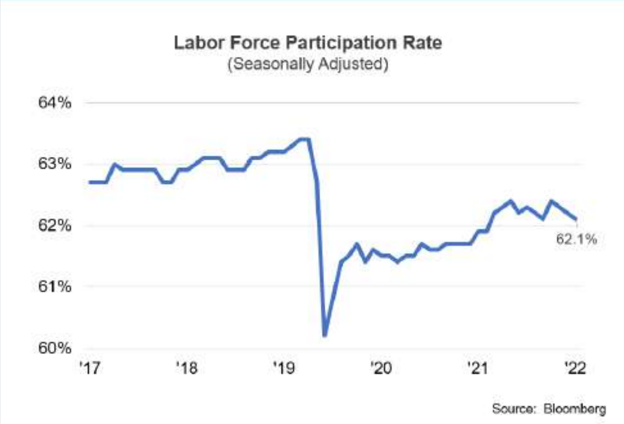
It is encouraging to see that inflation is now trending in the right direction, but 7% annual price growth is still well above the Fed's 2% target and therefore too high for policymakers to declare victory. In addition, Fed officials remain concerned by the tight labor market which is putting upward pressure on wages.

INFLATION HAS LIKELY PEAKED BUT THERE IS PLENTY OF WORK LEFT TO DO

The Fed had hoped that softer economic conditions and higher living costs would bring back workers that retired early or exited the workforce for other reasons during the pandemic. Unfortunately, the November jobs report showed a labor force participation rate of 62.1%, a reduction of 1.3% from the pre-pandemic level.

Fed Chair Jerome Powell recently estimated that roughly 3.5 million people were still missing from the labor force, a condition that has contributed to the 5.1% year-over-year increase in average hourly earnings. Although it is good to see workers earning higher wages, the fear is that companies will share the burden of higher operating costs with their customers and create what is referred to as a "wage-price spiral."

THE ONGOING LABOR SHORTAGE IN THE U.S. IS CONTRIBUTING TO WAGE INFLATION



In the Fed's defense, the central bank has no control over the supply of workers. However, Jay Powell and his colleagues clearly have more work to do as they manage the demand side of the economy in the months to come. Of course, the decision to raise interest rates was easy when inflation was rising and the economy was on solid footing. Policy decisions will likely prove more difficult in the coming year as the delayed impact of last year's aggressive tightening is finally reflected in the data.

RESTRICTIVE POLICIES INCREASE THE RISK OF RECESSION

Despite the impressive resilience shown by the economy in recent months, the impact of a more restrictive policy environment greatly increases the odds of a U.S. recession down the road. Although we believe that the cure is better than the disease, the fact remains that overcoming the highest inflation in four decades will not come cheap.

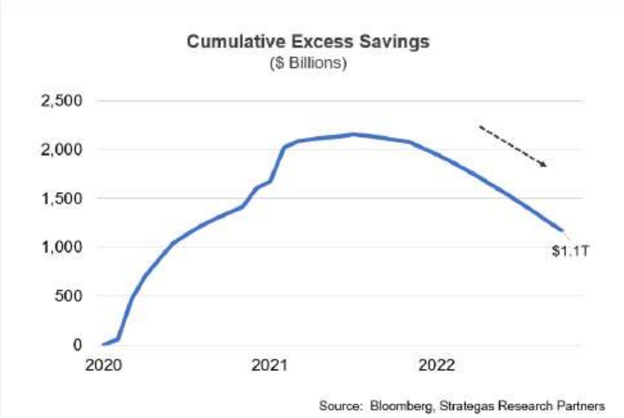
No doubt the first victim of the Fed's policy actions has been the U.S. housing market, where the near doubling of mortgage rates in 2022 simply compounded existing issues around home affordability. In fact, sales of previously owned U.S. homes fell for a 10th straight month in November, the longest streak since 1999.

Of course, after seeing nationwide home prices rise by more than 40% since the beginning of 2020, some might argue a correction was overdue. We expect further weakness from the housing sector in the coming months but are quick to point out that another housing crisis is unlikely thanks to tighter lending standards and the improved credit quality of borrowers in recent years.

Warning signs are also starting to appear among U.S. households, which only a year ago were considered the brightest spot of the economy. Accumulated excess savings levels have declined nearly 50% since late 2021 to $1.1 trillion, while the personal savings rate recently fell to 2.4%, just 0.3% shy of the all-time low set in 2005.

This data suggest that savings are quickly being depleted as households struggle to keep pace with rising living expenses. Meanwhile, the increasing reliance on "buy now, pay later" programs and growing credit card usage provide further evidence that many consumers are under increasing financial stress.

TIGHTER FINANCIAL CONDITIONS ARE PUTTING A DENT IN HOUSEHOLD SAVINGS



It is not just individuals who are feeling the impact of tighter financial conditions. In its most recent survey of CEO confidence, the Conference Board found that 98% of chief executives in the U.S. are preparing to face a recession over the next 12 to 18 months. Although no recession is desirable, it was of some comfort that 85% of respondents said they expect an economic downturn in the U.S. to be brief and shallow with limited global spillover.

STAYING ACTIVE

After their painful experience in 2022 and mindful of the challenges still facing markets in the coming year, many investors are likely looking to 2023 with trepidation. However, it is important to maintain a long-term perspective and remember that investors have historically been rewarded for their discipline.

Of course, being disciplined does not mean sitting on one's hands. Our active approach towards portfolio management was on display over the past year, during which we took a series of steps to reduce risk across client portfolios.

Today, we remain defensively positioned across our strategies, as represented by our below-target allocation to stocks and bias towards higher quality sectors of the equity and fixed income markets. In addition, we continue to utilize uncorrelated assets (i.e., alternative investments) such as commodities that offer the potential for additional diversification.

As always, we will adhere to our investment process and evaluate incoming data to make changes that best position portfolios for the ever-changing environment.

If you have any concerns about your portfolio, we encourage you to review your financial plan with your advisor.

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Managing Director, Portfolio Strategy

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We'd love to help!

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