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2022 Fourth Quarter Commentary

Now that 2022 has come to an end, we can reflect on what happened and what we may be able to expect in the year ahead. The year started off with a fed funds rate of 0% - .25% and the expectation the Federal Reserve (FED) would raise it to .75% - 1% by year end. Rather, the FED raised the fed funds rate by .25% in March and then proceeded to raise the fed funds rate 4% between May and December, in one of the most aggressive rate hiking cycles in history. This put pressure on most assets as the discount rate soared to levels not seen since before the Global Financial Crisis. 2022 was one of the three worst years for the 60/40 stock/bond portfolio since the Great Depression. The table below summarizes the year with some key data points. Forecasts have the FED raising the fed funds rate by another .5% - .75% in 2023, but likely finishing this hiking cycle by March or May. Historically, the market tends to improve when the FED ends its rate hikes. The question that remains, and the one that markets have been worried about all year, is how much damage higher interest rates and quantitative tightening will have on the economy.

	2022 Performance	High	Low
S&P 500	-19.48%	0.58%	-24.93%
NASDAQ 100	-33.07%	0.96%	-34.62%
Russell 2000	-21.62%	1.29%	-26.32%
Dow Jones	-8.80%	1.25%	-20.92%
MSCI EAFE	-16.57%	1.25%	-29.41%

	2022 Performance	High	Low	
US AGG	-14.98%	0.00%	-17.93%	
60/40 Portfolio	-17.60%	0.37%	-22.53%	
US Dollar	8.51%	19.66%	-0.74%	
CPI (inflation)	8.38%*	9.10%	6.50%	* Average
US 10Y Yield	3.8%*	4.25%	1.52%	*Current

The reason for the FED's aggressive tightening policy was to combat persistently high inflation. Inflation likely peaked in June at 9.1% and has since rolled over with the December report coming in at 6.5%. We have said over the past couple of years that we thought this was a temporary spike in inflation due to COVID and record economic stimulus. We think, in the end, it will prove to be a temporary, though be it longer than expected, spike in inflation that was extended by the war in Ukraine and China's prolonged zero COVID policy. The Consumer Price Index (CPI) Index is made up of energy (8%), food (13.7%), core goods (21.2%), and core services (57.1%). The inflation problem began with a spike in core goods prices due to heightened demand from stimulus checks and faltered supply chains. Supply chains are now mostly back to normal. For example, the price of transporting a 40-foot container from China to the US West Coast has declined from $20,000 in September 2021 to $1,382 today. Next, inflation impacted food and energy prices at the beginning of 2022, largely due to the war in Ukraine. Inflation in these areas began to normalize in the second half of 2022. Then came inflation in core services, over half of which is shelter, or housing. The problem with the shelter metric used in the CPI index is that it lags home price growth by roughly 18 months, so it is now capturing what occurred in 2021. Inflation in core services likely peaked in September and has been rolling over since. Core services makes up 57.1% of the CPI index, so as inflation improves in this area it should have an outsized effect on the overall CPI number. If the current trend in the data persists, it appears as if inflation will be below 4% by summer and will likely end the year somewhere around 3%.

Inflation is on a downward trend, but the question is whether and when it will come down to the FED's 2% target. The COVID pandemic caused massive disruptions in the global economy, however, it will also likely have some longer-term implications. COVID highlighted some of the problems with globalization, as developed countries couldn't source essential goods such as medical supplies and computer chips. This is starting a wave of onshoring, but goods made by the US and its allies tend to cost more than goods made in China and other developing countries. For example, computer chips made in the new Taiwan Semi-Conductor factory in Arizona are estimated to cost 50% more than those made in Taiwan. This comes at a time when we're trying to transition to cleaner renewable energy, which in itself, is inflationary. First, there is the cost to build out wind and solar power but on top of that you must build and maintain backup thermal capacity as well. It is estimated that less than 30% of natural gas capacity can be eliminated from the addition of new solar/wind generation. Electricity usage is also likely to increase as people start electrifying transportation and home heating. Finally, we face a labor shortage in the US which tends to be supportive of wages. All these factors may make it difficult to get inflation below 3%, the unknown is whether the FED will settle for 3% or will they push for tighter policy than they have forecast thus far.

The outlook for the year ahead is uncertain, to say the least. Wall street strategist's end-of-year targets for the S&P 500 range from down 10% to up 20%. Recent data, however, shows the prospect for a so called "soft landing", characterized by lower inflation with a steady economy and steady earnings, are improving. GDP increased 3.2% in the third quarter and forecasts call for fourth quarter GDP to be up about 2%, while the Atlanta FEDs GDPNow estimate for the fourth quarter is near 4%. While tightening monetary policy of the magnitude seen in the past 9 months would typically lead to recession, there is still fiscal stimulus in the financial system counteracting what the FED is trying to achieve. Household excess savings peaked at $2.1 Trillion in 2021 and $900 Billion remains today. This excess savings helped to support consumer spending in 2022. Should the US economy slip into recession in 2023, it will likely be of a rolling nature, where each of the economic variables the National Bureau of Economic Research (NBER) looks at moves either side of zero at different times, rather than all turning negative at once. This should result in a milder recession, but slower growth for longer.

The labor market remains tight with 1.72 job openings for every unemployed person. The December employment report was particularly encouraging as the unemployment rate declined to 3.5%, labor force participation increased, and average hourly earnings were below expectations and revised lower. These are signs that the labor market may be able to cool and wage growth slow without a spike in unemployment, which would be a positive for the economy and inflation. We've all heard of the recent layoffs across corporate America, which may begin to affect the data. Most of these layoffs have been white collar jobs with severance packages, meaning there may be a lag before they show up in the employment data.

Last year was the worst year for the markets since the Global Financial Crisis. However, a few positions in the portfolio did work out well. In the Alternatives asset class, the Private Shares fund was up 1.62% and the Invenomic fund shined, posting a 49.5% gain. Within the Real Estate asset class the Bluerock fund was up 10.14% for the year and the Apollo fund finished flat on the year. Growth stocks and long duration assets were hit particularly hard, while value stocks and assets generating more income/profits in the near term fared better. Our bond portfolio held up better than the US Aggregate Bond Index due to its limited interest rate exposure, however, it still sustained losses.

In conclusion, the outlook for 2023 remains uncertain. Inflation will likely fall sharply in the first half of the year and the odds of a soft landing have improved. Monetary policy is restrictive, and if the FED does what they have indicated they will do, it will remain restrictive throughout the year. Monetary policy works with a long and variable lag so it is unclear what the final outcome will be. Households still have $900 Billion in excess savings which can support spending but will likely run out in the first half of the year. Overall, the macro-outlook has improved in recent months, however, there remains a lot to be uncertain of. The risks for the year are that inflation doesn't come down as expected, or that it doesn't come down to the FEDs 2% target, and the FED is unwilling to settle for 3% inflation resulting in more aggressive policy than currently forecast. There is the risk that the aggressive monetary policy of the past 9 months results in a more severe recession than the market is pricing in. Then, as has been the case so far this century, the biggest risk is likely one that is unknown.

Now for a few company updates. We will be doing a major technology upgrade, which will consolidate most of our software systems into one platform. The systems being consolidated are our portfolio accounting, trading, customer relationship management (CRM), document management, and client portal. We are excited about this upgrade as we hope it will provide a better client experience as well as improve internal efficiencies. If all goes to plan, you should expect to see a change in the first quarterly report. The information provided will be the same, but the format will be different. Later in the year we will be rolling out the new client portal. The feedback we have received from other advisors using this platform is that their clients love the portal, so we hope you will as well. We know change can be difficult and we plan for this to be one major change that will last for many years to come. Additionally, we have had clients effected by layoffs or early retirement programs at Corning Incorporated and other local businesses who have come to us for help navigating the programs or trying to figure out how it may impact their future. If you or anyone you know of has been impacted and is looking for assistance, please let them know we are happy to advise.

Please know we are here to help during this time of uncertainty and are available to answer any questions or concerns you may have.

Take care and be well,

Michael, Michelle Jolie, Nina

The Management Team

Michael, Michelle, Jolie and Nina

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