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4Q 2022 Commentary

January 10, 2023

EQUITIES

Almost all major equity indices finished the 4th quarter with positive returns as equity markets rallied strongly in October and November before they sold off in December.

Quarterly Returns: As can be seen from the adjoining ***Table 1*** (see below), value outperformed growth in the 4th quarter. The S&P 500 gained 8%, the NASDAQ was down 1%, and developed international stocks[1] performed best, up 17%. Gold rallied 8% while Bitcoin fell 16%. Hedge fund indices were up in the quarter, while private equity, which reports with a lag, posted negative returns.

2022 Returns: The S&P 500 lost 18%, its worst year since 2008. Value significantly outperformed growth. Developed international stocks (down 14%) outperformed the S&P 500 for the first time since 2017. Gold outperformed most asset classes and finished the year roughly flat, while Bitcoin fell 65%. Hedge fund indices were down but less than the S&P 500, with some sector-specific funds posting positive returns. Private equity is likely to have had its first negative year since 2008.

Value outperformed growth in the quarter and the year.

Table 1[2]

4Q 2022	Value	Core	Growth
Large Cap	12.4%	7.6%	2.2%
Mid Cap	10.5%	9.2%	6.9%
Small Cap	8.4%	6.2%	4.1%

2022	Value	Core	Growth
Large Cap	-7.5%	-18.1%	-29.1%
Mid Cap	-12.0%	-17.3%	-26.7%
Small Cap	-14.5%	-20.4%	-26.4%

[1] Developed international = MSCI EAFE Index.

[2] Large cap growth = Russell 1000 Growth Index; Large cap core = S&P 500; Large cap value = Russell 1000 Value Index; Mid cap growth = Russell Mid Cap Growth Index; Mid Cap Core = Russell Mid Cap Index; Mid cap value = Russell Mid Cap Value Index; Small cap growth = Russell 2000 Growth Index; Small cap core = Russell 2000 Index; Small cap growth = Russell 2000 Value Index.

FIXED INCOME

Bonds rallied in the 4th quarter and are still very attractive after historically low 2022 returns.

Short-term rates are higher than long-term rates.

Quarterly Returns: Corporate and municipal bond returns were positive in the quarter. The US Treasury yield curve continued to invert (short-term rates higher than long-term rates) as the Federal Reserve (the Fed) raised the Federal Funds Rate another 1%. Longer-term yields rose slightly, which coincided with acceleration of "quantitative tightening." The Federal Reserve holdings of Treasury Notes and Bonds fell $153 billion.[3]

2022 Returns: Municipal, corporate, and government bonds all posted negative returns. The Bloomberg Aggregate Bond Index had the worst year in its 45-year history, as did many bond funds (which are different from individual bonds purchased by PSG). Performance was driven by sharp increases in yields highlighted in blue in ***Table** 2* below.

Table 2

Maturity*	12/31/21	9/30/22	12/31/22	2022 Yield Change
3 Month	0.05%	3.23%	4.41%	**+4.36%**
2 Year	0.73%	4.20%	4.42%	**+3.69%**
5 Year	1.26%	4.04%	4.00%	**+3.74%**
10 Year	1.51%	3.80%	3.88%	**+2.37%**
30 Year	1.90%	3.76%	3.97%	**+2.07%**

**Source: FactSet*

Yield curve inversions occurred before the 1990, 2001, and 2008 recessions.

The inverted shape of the yield curve is unnatural. Investors typically demand higher compensation to lend money for longer periods of time. Prior inversions occurred because the Fed raised short-term interest rates beyond sustainable levels. Yield curve inversions occurred before the 1990, 2001, and 2008 recessions.

Inflation remains high but is showing signs of slowing. Regular gasoline prices, a critical driver of inflationary pressures, are down 38% from the summer (despite the ongoing war in Ukraine) and are at 18-month lows.[4] Housing prices and rents appear to have peaked. Inflation estimates for both the 4th quarter 2022 (3.6%) and full year 2023 (3.8%) are below the current Fund Funds Rate (4.5%) and 3-month Treasury (4.4%).[5] Investors can potentially earn a "risk-free" return higher than inflation.

ECONOMIC AND MARKET ENVIRONMENTS

Housing Slowdown: The housing market has slowed as higher mortgage rates negatively affected activity and prices. The Pending Home Sale Index is lower than the worst levels seen in 2008–2010. New home starts are down 21% from April's peak.[6] Housing has a material impact on economic growth because of all the goods and services consumed, directly or indirectly, by newly built and purchased homes.

[3] Source: Federal Reserve and PSG; the Fed owned $4.7 trillion of Treasury Notes and Bonds as of 12/28/2022.
[4] Source: Fred.stlouisfed.org.
[5] Source: BLS, FactSet; the Fed Funds rate and 3 month Treasury are closely linked.
[6] Source: FactSet, PSG.

US Leading Economic Index falling to levels seen only when preceding or in recession.

Manufacturing Contraction: The US manufacturing sector is contracting. The 2020–21 COVID reopening caused a surge in demand and resulted in a shortage of many goods. These shortages motivated retailers to raise prices and over-order hot items to ensure adequate inventories. Manufacturers, originally caught off guard, ramped up production to meet demand. As retailers' sales returned to or below "normal," the shortages turned to oversupply. Retailers then ordered fewer goods and rolled back price increases. The manufacturers, which had ramped up operations and supplies to meet the demand surge, then saw their customer demand fall much more sharply than the retailers'. Manufacturers wound up "stuffed" with their suppliers' inventories. Those suppliers saw their orders fall by a larger magnitude. The resulting slowdown can be seen in US manufacturing, US imports, and manufacturing order indices in China. The decline in US manufacturing, coupled with poor equity returns, an inverted yield curve, and decline in housing starts, has resulted in the US Leading Economic Index falling to levels seen only when preceding or in recession.[7]

The job market remains robust.

Job Market Strong: The job market remains robust. The 3.7% unemployment rate remains near all-time lows. Wages were up ~6.5% through November,[8] though wage increases are no longer accelerating. New jobless claims are historically low and continuing claims remain consistent with very low levels of unemployment. Despite millions of job openings, there were still fewer employed Americans at the end of 2022 than at the end of 2019. The labor market tends to be a lagging indicator, but it is difficult to have a recession when the labor market is so tight.

Consumer Spending Growth Continues: Consumer spending, which constitutes ~70% of the US economy, continues to grow. While goods consumption has slowed, spending on services has increased. Services are mostly produced domestically and may help explain the persistent strength of the US labor market. Many Americans appear to have burned through stimulus and savings accumulated during COVID as consumer credit card debt is up $200 billion, or 27%, from the April 2021 low.[9] While that increase may seem alarming, it is still below the pre-2020 growth trajectory and should not be difficult to service in a growing economy with a strong labor market. The decline in gasoline prices noted above is positive for consumers.

Don't fight the Fed.

Equity Market Backdrop: One of Wall Street's axioms is, "Don't fight the Fed." Fighting the Fed in 2022 meant buying growth companies and sectors with high valuations. The largest and most popular growth names had their comeuppance in 2022 as Apple (-28%), Google (-39%), Microsoft (-28%), Tesla (-65%), Meta (formerly Facebook, -64%), Netflix (-51%), and Amazon (-50%) all underperformed the broad market. Consumer Services, Consumer Discretionary, and Technology were the three worst-performing sectors in 2022 after having been the darlings in 2020 and 2021. "Safe" utility, consumer staple, and healthcare stocks were the second, third, and fourth best-performing sectors in 2022.

CONCLUSIONS

Diversification and quality matters.

Stocks: Don't fight the Fed does not mean "sell equities." Instead, it underscores why diversification and quality matters. Dividend-paying, value-oriented managers easily outperformed their high-flying growth counterparts after underperforming the last few years. Quality matters as highly indebted low-quality businesses can no longer count on low

[7] Source: FactSet and PSG; note one month in 1996 was below today's level and did not lead to recession.
[8] Three-month moving average, seasonally adjusted annual rate; source: Atlanta Federal Reserve.
[9] Through 12/28/22; source: The Federal Reserve, FRED.

interest rates. PSG managers own high-quality stocks, and some we have met with believe the market low in September was the bottom, even with the Fed continuing to raise rates. While it is harder for us to get super excited about equities until the Fed stops raising rates, equities still offer compelling returns regardless of entry point over the long haul. We will continue to deploy fresh cash earmarked for equities cautiously, particularly for growth managers.

Individual bond yields are attractive.

Bonds: Individual bond yields are attractive, particularly when compared to recent years. Bonds now provide higher income with relative stability and continue to be an important component of many diversified portfolios. Counterintuitively, the inverted yield curve has often been a signal to buy lower-yielding longer-term bonds rather than the higher-yielding shorter-term bonds. A good return for a long period of time is often better than a very good return for a short period of time. That said, short-term Treasuries yield more than 4% and money market funds more than 3.5%. We recommend clients with large bank balances (usually earning less than 1%) take advantage of the significantly higher yields we can earn.

Opportunities in distressed investments.

Private Investments: Private investments in sector-specific, opportunistic, and other alternative funds performed relatively well in turbulent 2022. Private equity had a weak year as lower equity valuations hurt results. Funds with fresh capital to deploy will now be able to take advantage of lower valuations. Higher interest rates and a less stable economic environment may create opportunities in distressed investments. We have invested in distressed debt funds since 2004. They perform particularly well coming out of slowdowns/recessions and are a good portfolio diversifier.

PSG'S NEWEST ADDITION

We are pleased to announce the addition of Marc Connuck to PSG. Marc recently passed the third CFA exam and will add quantitative rigor to our richly experienced investment committee. He will focus on the investment process and manager due diligence. Welcome, Marc!

DISCLOSURE

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