January 2023

QUARTERLY COMMENTARY

Investment companies traditionally start their January communication by first covering the year in review then addressing their outlook for the new year. We believe our clients would be better served by devoting less time to rehashing yesterday's news or focusing on current industry predictions. Why? Over the past 20 or more years, Wall Street annual forecasts miss the mark by 12 percentage points compared to the actual S&P 500 return. More beneficial is gaining an awareness of events that can influence financial markets in the short-term yet not detract from longer-term market results. So we will curtail a discussion of 2022's lengthy headline news:

- crypto-currency (FTX Digital Markets Ltd.) and the unsurprising eventual meltdown of other highly speculative areas
- inflation too stubborn to decline or the Federal Reserve's response by the unprecedented speed of interest rate hikes
- a seldom seen negative year for all three major asset classes (stocks, bonds, and real estate) caused by Fed policy
- ramifications stemming from Russia's invading Ukraine
- global and financial market risks related to China-Taiwan tensions
- COVID and its lingering supply-chain problems
- tech stocks' recent underperformance after years of inflated valuations

The impact of the confluence of so many significant events when forecasting, as well as their exact timing related to financial markets, is beyond the comprehension of market participants. Experience has shown that an investor can be correct on many things yet wrong on only a few and still suffer unfavorable consequences. That is why investment portfolios should be structured in a manner that can result in competitive outcomes when all meaningful circumstances can't be foreseen.

Although predictions too often prove costly to investors, they serve a useful purpose in developing a broader, yet incomplete, understanding of possible developments ahead. 2023's range of economic and market forecasts is wider than almost any time. While some believe a recession is inevitable, today's Wall Street consensus is that there will be a mild recession or weak economic growth related to higher interest rates with stocks modestly positive for the coming year. But longer-term investor success depends on being prepared for other outcomes as well.

Another scenario is that the Fed may be forced to stop interest rate hikes due to political pressure. Although the Fed is determined to raise rates until inflation is reduced to desired levels, inferring higher rates for longer, it has also stated that it is data dependent and therefore reserves the right to change its mind based on circumstances. Research by Jeremy Siegel, Professor at the Wharton School of the University of Pennsylvania, concludes that compelling evidence will materialize that warrants the Fed to lower interest rates sooner than expected. Such an event can lead to double digit positive returns for the stock market according to Professor Siegel.

Two outlier outcomes that some investors will be (and others will not be) adequately prepared for are 1) a deeper and longer recession caused by excessive higher rates, which will likely put further pressure on stocks but eventually help bonds, and 2) the economy remains relatively strong while inflation is no longer a concern and stocks rally suddenly. An investor's particular mix of stocks and bonds will largely determine the results, for better or worse. Whatever the forecast, it is always beneficial to go through the exercise of considering multiple investment and other related consequences.

Investing would be more predictable if the stock market consistently followed the direction of corporate profits. But many factors influence movements in financial markets, especially changes in investor sentiment. Fortunately, stocks have often appreciated even when earnings have declined. According to Birinyi Research, profits since 1970 have declined on a yearly basis 17 times and in 12 of those occurrences, or 70% of the time, the S&P 500 was up in that period. The evidence clearly supports why betting against the stock market, due to an investor's negative outlook, often leads to costly results. It is also beneficial to understand that bonds issued by solvent issuers pay par value or one hundred cents on the dollar at maturity, regardless of price volatility between purchase and maturity dates. This is the primary reason our Company emphasizes high quality and intermediate, not long-term or high credit risk, bonds. Regardless of yearly market movements, bond investors can expect repayment of their total cost at purchase and interest earned in a reasonable timeframe.

Forecasting the timing of major moves in real estate can be equally challenging. Interest rates were already low, so this fact alone cannot qualify as the catalyst for the recent buying frenzy in residential real estate. The sudden change in attitudes by homeowners to upgrade their living conditions in a "stay at home" COVID society created the unpredicted buying craze. Low interest rates made moving homes feasible. We know from the past that higher interest rates lead price movements in the residential rental market, which also impacts housing prices. With interest rates moving rapidly, and likely to continue to do so, predictions hardly warrant serious consideration. More meaningful is that the demand for shelter is far greater than the supply, which is positive long-term for many homeowners.

In summary, investors can have confidence that capital markets work, but do not necessarily work all the time -- 2022 case in point. **Fortunately, investors do not require financial markets to deliver positive results every year to achieve long-term success because rising economies and positive financial markets far surpass in magnitude and duration the negative periods.** Positive stock markets occur 74% over all one-year periods, 87% over all five-year periods, and 97% over all ten-year periods since 1925. Surprisingly, some of the best periods in market history have occurred around crises. Therefore, sound wealth management practices should embrace constructing investment strategies to perform competitively across a broad range of outcomes in order to better meet their clients' objectives.

While looking forward to the new year, we recognize that capital markets do not operate on a calendar basis. The challenges present last year do not disappear on the first day of a new year. Markets anticipate and respond to circumstances. Overcoming obstacles requires a reasonable amount of time. Who doesn't know that inflation has peaked, the Fed is resolute on additional interest rate hikes, and the economy will ultimately weaken? There is far less certainty however, in their effects and the length of time it will take before sustainable economic prosperity and strength in our financial markets resume. Everyone relies upon global financial markets, not just individual persons and corporations around the globe. Federal, state, local, and foreign governments all need capital markets to successfully function. For this reason, we are confident that capital markets will continue to meet the expectations of our clients. My team and I appreciate the opportunity to serve you. We respect all our clients' concerns, embrace their goals, and welcome significant progress in the coming year.