INVESTMENT PERSPECTIVE

Quarterly Report

31 December 2022

U.S. equity markets staged a modest rally in the fourth quarter with the S&P 500 rising 7.6% and the Russell 2000 Value rising 8.4%. International equity markets outperformed U.S. equity markets with the MSCI EAFE rising 17.3%. Despite the rally in the fourth quarter, equity returns remained negative for the year with the S&P 500, Russell 2000 Value, and MSCI EAFE returning -18.1%, -14.5%, and -14.5%, respectively.

The recovery in equity markets was driven by peaking inflationary conditions and the rapid increase in non-U.S. interest rates relative to U.S. interest rates, which triggered a broad-based decline in the U.S. dollar. The 2022 bear market in equities reflects the impact of higher interest rates increasing the cost of capital, and thereby decreasing equity valuations. The next challenge for markets will be digesting declining earnings expectations for 2023. The largest reduction in earnings expectations should occur during the first two quarters of 2023. A second half recovery will be contingent on the interplay between the rapid deceleration in inflation and whether the higher interest rates lead to excessive economic and market weakness.

With the current level of interest rates and expiring monetary and fiscal stimulus, we anticipate that by the third quarter the trajectory of inflation will be on pace to meet the Federal Reserve's inflation target. However, we do anticipate the tighter financial conditions and expiring monetary and fiscal stimulus will lead to an earnings recession and likely an economic recession. Should weakening economic and financial conditions force policy makers to restimulate the economy, we could see inflationary pressures begin to reaccelerate.

The Bloomberg Aggregate Index returned 1.9% for the quarter but finished the year down 13.0%. The ICE BofA 1-10 AAA-A Municipal Index returned 2.9% during the quarter but finished the year down 4.5%. During the quarter, the Federal Reserve raised the Fed Funds rate an additional 125 basis points (75 basis points in November and 50 basis points in December) bringing the target rate to 4.5%. The market is forecasting two additional 25 basis point increases in 2023, implying a 5.0% terminal rate by mid-2023.

Investment grade credit spreads tightened 25 basis points during the quarter ending the year at +121 basis points over Treasury yields. Credit spreads were volatile during the year as the market priced in an economic slowdown and tighter liquidity conditions due to the Fed raising interest rates and shrinking its balance sheet through quantitative tightening. We expect the markets to

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remain volatile in 2023, which should provide opportunities to generate alpha within spread sectors. We reduced our allocation to corporate bonds in 2022 but anticipate adding to corporates in 2023 if spreads widen materially due to a weaker economic backdrop.

While the adjustment to higher interest rates negatively impacted bond returns in 2022, long-term total returns should improve as compared to when Fed Funds rates were at 0%. For instance, the yield-to-maturity (YTM) on the 2-Year Treasury was 0.7% last December versus 4.4% today and the YTM on U.S. investment grade corporate bonds was 2.3% last December versus 5.4% today. As a result, for long term buy-and-hold investors, today's higher yields have presented an opportunity to significantly increase returns across all major sectors of the fixed income market.

Throughout the year, we maintained a shorter average duration relative to the benchmarks across our fixed income strategies to reduce the impact of negative returns from rising interest rates. Now that inflation has likely peaked and with the Fed near the end of its tightening cycle, we are actively increasing duration to take advantage of this more favorable interest rate environment.

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