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CHIEF INVESTMENT OFFICE

Investment Strategy Overview — Executive Summary

2023 Year Ahead: Back To The New Future

December 2022

All data, projections and opinions are as of the date of this report and subject to change.

What does "back to the new future" mean?

The era of quantitative easing and a quick trigger Fed easing policy stance are effectively over. Inflation comes back down to earth exhibiting characteristics more from the 1990s than the 1970s. Corporate fundamentals and valuation matter again with investors looking for earnings stability at a reasonable price. The post-pandemic cycle begins to take shape with a new profit cycle emerging off of better valuations, albeit with less readily available liquidity. This creates a backdrop of "survival of the fittest" in terms of country risk, the "now versus later" prospects for sector and industry group profits, and stable business models at the company level. In other words, the areas most likely to experience upward rerating and positive earnings revisions are the likely outperformers. The new future is most likely defined as high geopolitical risk, less central bank intervention, higher nominal economic growth relative to the post-credit crisis era, a more "normal level of yields," new growth drivers led by automation, healthcare innovation, infrastructure development and climate mitigation, and natural resource and energy security and independence just to name a few; and an overall increase in the importance of portfolio diversification.

We continue to move further into a late economic cycle stage, in our opinion, with an eventual Fed pause sometime in Q1 of 2023. This late cycle stage should also include a material change in the business and market cycle. We expect bonds to outperform stocks until the leading economic indicators stabilize. Once these indicators stabilize and eventually turn higher risk assets begin to follow, in our view. At this point, the baton should shift from bonds to stocks, generally. Lastly, the profit cycle then ultimately bottoms, but, at this point, risk assets, namely Equities, have already discounted this and have turned higher. In order to better assess this 2023 pathway and the intersection between the economy and both the U.S. and global markets, we believe investors should continue to focus on a list of indicators that have historically provided insightful clues in terms of portfolio strategy for the new era.

We expect 2023 to be a foundational year for long-term investors—a year in which the economic cycle bottoms, the market cycle turns, and portfolio diversification, including Alternative Investments (AI) for qualified investors, helps mitigate volatility and allows for participation in a renewed bull market. The list of indicators to consider putting increased focus on include initial unemployment claims, credit spreads, the yield curve (specifically fed funds rate to 10-year Treasury yields), the overall level of the money supply, purchasing managers' indexes (PMIs—U.S. new orders, China, and manufacturing), and export figures from the more cyclical regions like South Korea and Taiwan.

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Christopher Hyzy
Chief Investment Officer

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What developments does the CIO expect to unfold in 2023?

- The Fed pauses as inflation surprises to the downside, and a mild recession begins.
- Long-term rates decline, and Equity valuations stabilize. A full Fed pivot becomes a headline by the end of the year, and a tailwind to Equities.
- Prices of commodities, including oil, rotate between factoring in slower global growth in the first half of 2023 and the potential for economic re-expansion as the year closes, for example, from China reopening, stability in Europe, etc.
- Corporate earnings deteriorate some as margins narrow, but a weaker dollar helps support multinationals, growth for 2024, as does a general rebound in global economic activity.
- China's growth could surprise positively as zero-Covid measures are incrementally relaxed, and procyclical policy is implemented.
- Bonds outperform in the first half and stocks take over in the second half of 2023.
- Opportunities to rebalance portfolios early in 2023 occur in Q1 as financial conditions ease.
- 2023 is expected to be an above-average year for a 60/40 portfolio allocation.
- Alternative Investments for qualified investors follow a similar path through the economic and market cycles. Initially, "diversifying" AI strategies should continue to help provide ballast to portfolios.

We believe the final stages of the post-pandemic reset period hit in Q1 as the Fed pauses, the U.S. dollar weakens, long-term interest rates and inflation turn lower, and earnings estimates are finally adjusted lower. This ends the cyclical bear market, in our view, as investor sentiment, which is close to the poorest on record, begins to look past the reset and into 2024.

What does the CIO expect in the coming few months?

- The biggest surprise for all of 2023 is how sharply inflation falls, with Fixed Income rallying in the early phase of 2023.
- Bonds begin to price in recession.
- The dollar has peaked and experiences subtle weakness.
- Long bond yields have peaked as the two-year yield rises toward equilibrium with fed funds rate.
- A small relief rally in December continues but turns into an exhale in the new year as concerns rise over earnings and recession overall.
- Investor sentiment is just about the poorest on record, so selling pressure is low and vulnerable to positive surprises, helping to balance out the potential for large pullbacks.
- Fed to pause in Q1 as economic data, housing, employment statistics and inflation all point to weakness.
- We favor bonds in the first half of 2023 and stocks in the second half. We still see asset managers investing more in Value than in Growth areas.
- Small-caps could be big leaders of the next decade but need stability early in 2023 to outperform Large-caps consistently.
- International stocks have windows of outperformance as the dollar peaking helps provide support to prices mixed with better valuations.
- A bull market in Equities begins again in 2023 as the cyclical bear market ends.

Index Definitions

Securities indexes assume reinvestment of all distributions and interest payments. Indexes are unmanaged and do not take into account fees or expenses. It is not possible to invest directly in an index. Indexes are all based in U.S. dollars.

Purchasing Managers' Index (PMI)—a measure of the prevailing direction of economic trends in manufacturing. The PMI is based on a monthly survey of supply chain managers across multiple industries, covering both upstream and downstream activity.

Important Disclosures

Opinions and market data are current as of December 14, 2022 unless otherwise specified.

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Alternative investments are intended for qualified investors only. Alternative Investments such as derivatives, hedge funds, private equity funds, and funds of funds can result in higher return potential but also higher loss potential. Changes in economic conditions or other circumstances may adversely affect your investments. Before you invest in alternative investments, you should consider your overall financial situation, how much money you have to invest, your need for liquidity, and your tolerance for risk.

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