Q4 2022 Commentary

January 2023

"Success is no accident. It is hard work, perseverance, learning, studying, sacrifice, and most of all, love of what you are doing"
Pelè

Q4 Market Recap

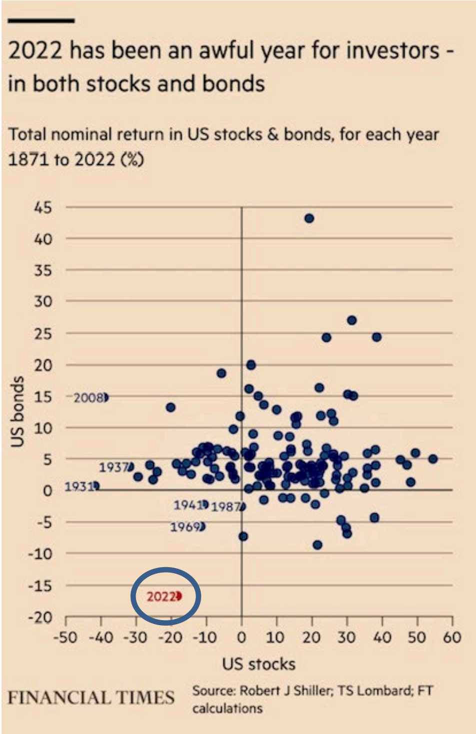
Stocks and bonds rebounded in the quarter but ended the year on a sour note. Decelerating global growth outweighed inflation concerns as investors became increasingly anxious about an economic slowdown. The U.S. Dollar peaked relative to foreign currencies early in the quarter adding a tailwind for international stocks over domestic stocks. Value significantly outperformed growth as large technology stocks continued their fall from grace. Nearly all of last year's market performance was driven by a decline in valuation multiples rather than a substantial decline in operating earnings. Put another way, the economy and corporate earnings grew last year, but fears of a future recession sent share prices lower.

An end in sight for future rate hikes helped bonds bounce off their 2022 lows, but investment grade bonds still delivered one of the worst annual returns in modern history. Junk bonds outperformed investment grade bonds and municipals outperformed taxable bonds. For high tax bracket investors, municipal bonds continue to offer a significant tax equivalent yield advantage over investment grade bonds. Energy commodities, notably crude oil and natural gas have largely retraced back to prices seen before Russia's invasion of Ukraine.

Asset Class	Benchmark	December	Q4 2022	2022
U.S. Large Cap Stocks	S&P 500 TR USD	-5.8	7.6	-18.1
U.S. Small & Micro Cap	Russell 2000 TR USD	-6.5	6.2	-20.4
Intl Dev Stocks	MSCI EAFE NR USD	0.1	17.3	-14.5
Emerging Mkt Stocks	MSCI EM NR USD	-1.4	9.7	-20.1
Global Stocks	MSCI ACWI NR USD	-3.9	9.8	-18.4
U.S. Municipal Bonds	Bloomberg Municipal TR USD	0.3	4.1	-8.5
U.S. Taxable Bonds	Bloomberg US Agg Bond TR USD	-0.5	1.9	-13.0
U.S. High Yield Bonds	Bloomberg US Corp High Yield TR USD	-0.6	4.2	-11.2
Intl Dev Bonds	S&P International Sov Ex-US Bond TR USD	0.2	7.0	-21.8
U.S. REITs	MSCI US REIT NR USD	-5.3	4.9	-25.4
Broad Commodity Futures	Bloomberg Commodity TR USD	-2.5	2.2	16.1
Energy Partnerships	Alerian MLP TR USD	-4.7	10.1	30.9
Gold	DJ Commodity Gold TR USD	4.1	9.5	-0.7

Data from Morningstar as of 12/31/2022

Central bankers are now faced with the challenge of taming inflation without inflicting significant collateral damage to the economy caused by higher interest rates. Inflation readings continue to come down yet remain elevated primarily due to 'sticky' components like rent, household furnishings, and services sectors. Last year stands out as a prominent outlier for public U.S. stock and bond returns relative to the past 150 years (see chart to the right). We've seen deeper and longer drawdowns for stocks, but we haven't seen a year where stocks and bonds both lost more than 10% for a full calendar year. Fortunately, yields are higher and valuations lower entering 2023 making the markets more accurately priced for risks ahead.



The 118th United States Congress started this month with mixed party leadership between the House (Republicans) and Senate (Democrats). Gridlock in Washington has historically provided a tailwind for stocks as investors anticipate more moderate legislation.

Private Assets in Diversified Portfolios

Many private asset strategies such as diversified private equity, direct real estate, and direct lending delivered strong returns in 2022 even as public markets faltered. This was due to myriad reasons unique to each asset class, but largely driven by positive fundamentals and operating results from underlying assets. Private assets are primarily valued based on operating metrics rather than investor sentiment which we see in public markets. Liquid alternatives such as managed futures and equity long/short strategies provided additional diversification benefit to traditional stock and bond portfolios. Owning these types of assets helped many of our clients mitigate losses in 2022.

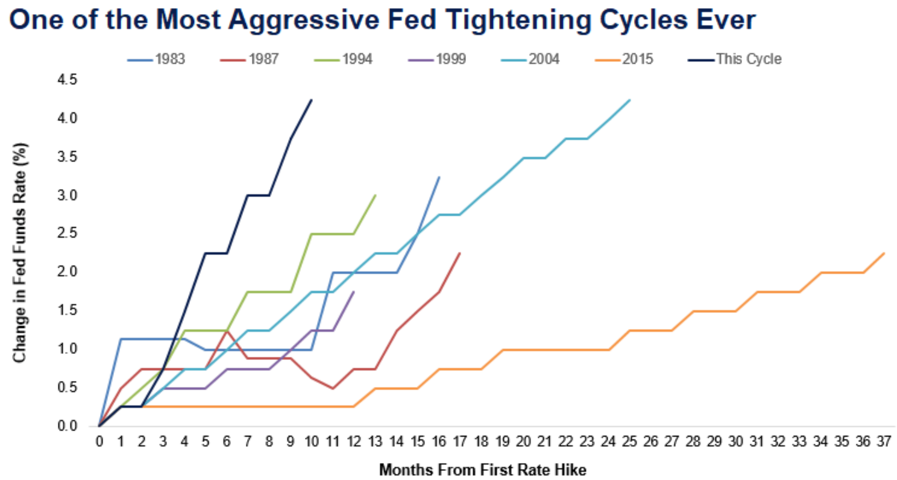
Private asset strategies have experienced tremendous growth over the past decade. Investment vehicles such as closed-end interval funds and nontraded REITs have attracted many dollars by making these asset classes more accessible to all types of investors. Both investment vehicles are regulated, much like a mutual fund, but do not have the same private asset ownership limitations.

These asset classes (real estate, private equity, and private debt) remain liquid and continue to see strong global investor interest. Valuations for these investments will change based on the business cycle as all investments do. We believe private market assets have the potential to diversify risk and return for suitable investors by reducing reliance on more volatile public investments for long-term growth.

Pause not Pivot

The Federal Reserve continued hiking interest rates in the quarter with a half percentage point Fed Funds rate increase at last month's FOMC meeting. Putting 2022 in perspective, this was one of the fastest rate hike cycles in recent memory. Fortunately, we may be close to the end. The Fed's updated forecast now calls for the Fed Funds rate to be in a range of 5.00% - 5.25%, from 4.25%-4.5% currently, later this year.[1] Market expectations are consistent with this forecast, although some investors are anticipating rate cuts as soon as

[1] The Federal Reserve, retrieved from https://www.federalreserve.gov/monetarypolicy/files/fomcprojtabl20221214.pdf, January 3, 2023.



Source: LPL Research, Bloomberg, 12/15/22
All indexes are unmanaged and cannot be invested into directly. Past performance is no guarantee of future results.

this fall.[2] In published research, the Fed suggests monetary policy affects economic activity and inflation with up to a two-year lag. Accordingly, the Fed may pause on interest rate changes for longer than market participants anticipate as FOMC members observe how the U.S. economy responds to higher interest rates.

Recession or correction?

Interest rate spreads are frequently used as recession indicators for a variety of reasons. They are readily observable and have accurately flashed a warning signal in advance of the previous six recessions. Economists will compile other leading economic indicators along with lagging economic indicators to inform their outlook for the business cycle. Today's challenge is these signals are mixed. Bullish leading indicators include the worker quit rate and U.S. consumer spending levels. Historically high quit rates imply that workers have confidence in their ability to find another job and are generally optimistic about future economic growth. The latest spending data on U.S. consumers from November suggest that consumers continue to spend, despite inflation reducing their purchasing power.

Focusing on lagging economic indicators, we see negative trends emerging in manufacturing, consumer sentiment levels, and residential building permits. Meanwhile, we continue to see strength in labor demand, real GDP growth, and corporate profits.

Unsurprisingly, there is a large dispersion between various recession probability models. The Conference Board's model points to a 96% chance of a

	Indicator	Latest Data	Date	Recession Signal?
Leading Economic Indicators	Interest Rate Spreads (2Y - 10Y Trsy Yield)	-0.63%	January-23	Yes
	Stock Market Performance (S&P 500)	-18.1% YTD	December-22	Tbd
	Quit Rate	2.7%	November - 22	**No**
	U.S. Consumer Spending (MoM)	0.1%	November-22	**No**
Lagging Economic Indicators	Manufacturing PMI	48.4	December-22	Trending yes
	Services PMI	49.6	December-22	Trending yes
	Global PMI	48.2	December-22	Trending yes
	Unemployment Rate (U3)	3.7%	November-22	**No**
	Inflation (CPI)	.1% (MoM) / 7.1% (YoY)	November-22	Yes
	Index of Consumer Sentiment	56.8	November-22	Yes
	Real GDP Growth (Quarter over Quarter)	3.2%	September-22	**No**
	Corporate Earnings Growth (S&P 500 - Annual)	5.1%	September-22	**No**
	Housing Prices (YoY)	9.2%	October-22	Trending yes
	Residential Building Permits (National - YoY)	-2.0%	November-22	Trending yes

Sources (in descending order): CNBC, Morningstar Advisor Workstation, U.S. Bureau of Labor Statistics (BLS), U.S. Bureau of Economic Analysis (BEA), Institute for Supply Management, IHS Markit and JP Morgan Chase, BLS, BLS, University of Michigan, BEA, Factset (Q4 2022 data is an estimate), S&P Case-Shiller U.S. National Home Price Index, U.S. Census Bureau

[2] 30-Day Fed Funds Futures. CME FedWatch Tool, retrieved from https://www.cmegroup.com/markets/interest-rates/cme-fedwatch-tool.html, January 3, 2023.

recession in the next twelve months[3] while others such as the Smoothed U.S. Probability Indicator[4] and the Real-time Sahm Rule Recession Indicator[5] are hardly registering the possibility of a recession. What's an investor to make of this conflicting information? For starters it is an excellent reminder to stay diversified and avoid aggressive market-timing moves. Some of the stock market's best days can occur late in an economic cycle or immediately following a market bottom. Second, equities typically lead economic cycles by six to seven months on the way down and on the way back up. Stocks can bottom before a recession is officially declared. More importantly, what are the implications for stock and bond markets? Are recession risks reflected in current market prices or have expectations become detached from what's on the horizon? If the global economy does enter a recession, it will arguably be one of the most thoroughly anticipated recessions in history which has provided ample time for market prices to adjust.

Updating Capital Market Assumptions

While 2022 was a year many investors may wish to forget, the confluence of rising interest rates and falling stock prices has left expected returns for many asset classes more attractive relative to the start of the year. Expected returns are calculated in a variety of ways, but the process generally begins with a risk-free rate (such as a short-term U.S. Treasury) and then various forms of risk premiums are added. Two large financial institutions, Blackrock and JP Morgan, have published 2023 capital market assumptions with both listing improving expected returns across nearly all asset classes. The outlook for investment grade bonds improved considerably (up to 4.2% from 1.6% for Blackrock and 4.6% from 3.4% for JP Morgan). Expectation for stock returns also improved both in the U.S. and overseas. Note these are long-term forecasts (10+ years). We monitor capital market assumptions to aid asset allocation decisions and long-range financial planning analysis. We do not expect the numbers will be exact, rather we are more interested in the directional change year-over-year.

Parting Thoughts

Last year was a good reminder that financial markets and the global economy remain unpredicable. Staying diversified across multiple asset classes and focusing on your personal risk tolerance has served our clients well. We have and always will focus on being good stewards of your hard earned capital.

Our team is here to help you navigate these challenging times. Thank you for your continued trust.

Sincerely,
The Private Capital Management Team

[3] The Conference Board. U.S. Probability Model, data from August 2022, retrieved from https://www.conference-board.org/, January 5, 2023.

[4] Chauvet, Marcelle and Piger, Jeremy Max, Smoothed U.S. Recession Probabilities [RECPROUSM156N], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/RECPROUSM156N, January 5, 2023.

5 Sahm, Claudia, Real-time Sahm Rule Recession Indicator [SAHMREALTIME], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/SAHMREALTIME, January 3, 2023.