

Year-In-Review – Investors are undoubtedly happy to close the books on 2022. While stocks bounced in the fourth quarter, the rally didn't do much to put a dent in the losses for the year. While most sectors closed in the red, the heaviest selling was centered in the speculative darlings of the last couple years. Anything crypto related, SPAC's, profitless IPO's, and a whole host of other acronyms were hit very hard. Furthermore, as the year progressed we started to see the big winners of the last decade start to crack. Within the so-called FAANG index, Meta plunged -64% in 2022, Netflix lost -51%, and Amazon, Apple, and Google lost at least -27%. Together the FAANG stocks shed more than \$3 trillion in value. But it is worth noting that the large-cap value index dipped just -5.4% for the year as investors rotated out of so called 'hopes and dreams' stocks into real companies that generated profits and cash flow.

What made 2022 particularly difficult for many investors was the fact that bond prices fell at the same time stocks slid into a bear market. Stocks are expected to be volatile with periodic down years, but the losses in fixed income are unusual. Normal safe havens like short maturity Treasury bonds lost -3.9% last year, while intermediate-term bonds dipped -15.2%. Both corporate and international bonds were similarly hit hard. Investment grade corporate bonds lost -17.9% while international bonds lost anywhere from -10% to -20% depending on the country and the currency exposure.

The Great Repricing of 2022 – What jumps out at you when you look at asset class performance in 2022 is basically everything repriced lower. Stocks, bonds, real estate, venture capital, precious metals – they all lost ground last year. The same single factor drove all these disparate markets – interest rates. There are a number of ways to show this – the table at the top of the page illustrates the move in the Fed Funds rate and longer-term yields. A more startling example is shown in the chart to the right. This shows the yield on the 10-year Treasury Inflation Protected Security. This so-called real yield was negative at the end of 2021, meaning investors were paying the government when they bought this bond. During 2022

Market Benchmarks			
Market Indices	4 th Qtr	YTD	3-Yr An
S&P 500 Index	+7.5%	-18.2%	+7.5%
Russell 2000	+6.2%	-20.5%	+3.0%
Global Equities	+10.1%	-18.0%	+4.2%
Int'l Index (EAFE)	+17.7%	-14.4%	+0.9%
Emerging Mkts	+8.2%	-17.9%	-1.6%

Other Indicators	12/31/22	9/30/22	12/31/21
Fed Funds Rate	4.25%-4.50%	3.00%-3.25%	0%-0.25%
2-Year Treasury	4.43%	4.25%	0.73%
10-Year Treasury	3.88%	3.80%	1.51%
S&P 500 P/E Ratio*	16.7	15.2	21.2
Crude Oil	\$80.35	\$79.49	\$75.45
Core Inflation	4.7%	4.9%	4.7%

*Forward 12-month operating earnings per S&P

this yield moved substantially higher, and turned positive for the first time since early 2020.

Why is this important? At the end of the day financial assets are priced off three main variables – the cash flow an investment throws off, the vague notion of investor sentiment, and interest rates. All things being equal, when interest rates go up the value of the investment falls. That's why 2022 saw something of a regime change. For the last few years policy rates have been basically stuck at 0% or less, and the inventory of negative yielding bonds totaled roughly \$18tn (see the chart at the top of the next page).

However, this all changed in 2022 as inflation perked up and central banks around the world tightened policy. Virtually every asset class repriced lower as a result, but the most speculative or the longest duration assets were hit the hardest, as we mentioned earlier. When the word duration is used in this context, it can either mean bonds with the longest maturities, or stocks where the expected cash flows are far off into the future. For example, Treasury bonds with maturities beyond twenty years lost -31% of their value in 2022 versus just -4% for two-year bonds. But the same theory applies to the equity market. Growth stocks whose value is tied to possible cash flows far off into the future significantly underperformed value stocks whose current cash flow is typically significant. Again, future cash flows are simply worth less than current cash



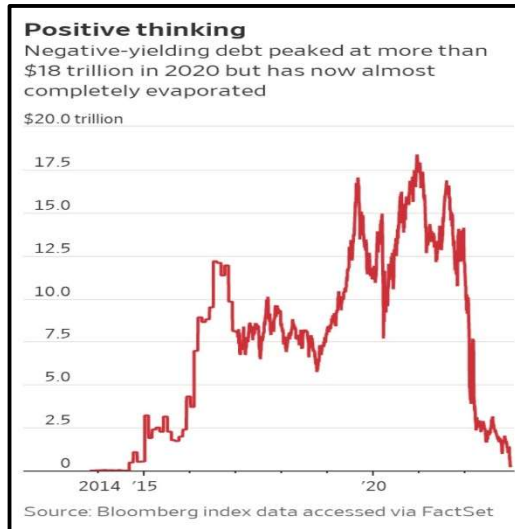
flows in a higher rate environment. This is true whether you are looking at bonds or stocks.

But rising rates and tighter policy also meant the liquidity environment became much less favorable. This is important because easy liquidity had underpinned the values of many speculative assets such as Bitcoin, monkey NFTs (don't ask), or profitless IPOs. Take away free money and the market for such things dried up almost overnight. Bitcoin prices tumbled over -64%, taking down platforms like FTX and BlockFi with it.

All of this is now in the past, though. The question facing investors for 2023 is whether they should extrapolate the great repricing theme into 2023 and beyond, or whether the environment is going to become more nuanced, or even reverse? On this question, first we have to talk about the outlook for inflation.

Divining the Path of Inflation – The fact that inflation spiked after the COVID crisis shouldn't surprise anyone. After all, spend a few trillion in COVID aid, slash rates to zero (or less), boost the money supply by the largest amount in living memory, and throw in some supply disruptions for good measure, and prices should go up. More surprising has been how sticky inflation has been despite the reversal of some of the factors noted above. As late as the beginning of 2022 the Federal Reserve was still talking about transitory inflation, and most economists were on a similar page. However, reality didn't cooperate. As you can see from the chart below, headline inflation peaked at roughly 7% last year, before backing off somewhat in the fourth quarter. But both headline and core inflation are running well above the Fed's 2% target despite a major correction in key components like energy prices and used cars. Where's inflation headed in 2023 and beyond? This is a tough question to answer, but let's look at what we know for sure.

Goods Prices – One component that goes into the inflation stew is simply the prices of the things like food, cars, and refrigerators. The prices for many items shot higher in the post-COVID world due to both supply constraints and the fact that people had excess cash to buy things. Nothing epitomized this more than cars. Supply



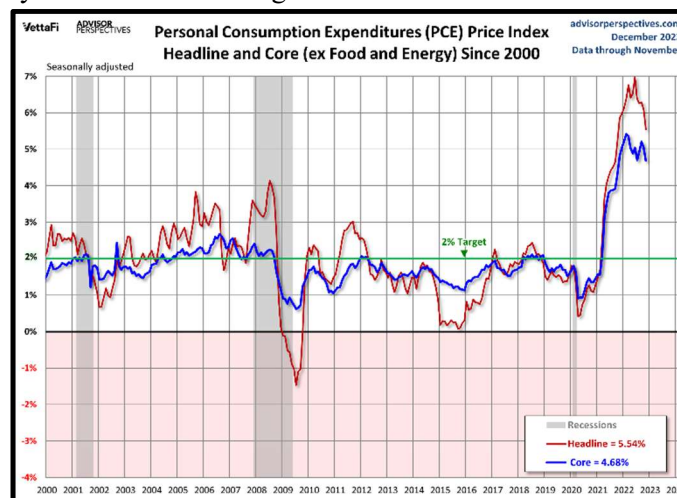
was crunched due to a semiconductor shortage at the same time people were trading cars like penny stocks. The chart at the top of the next page shows that used car prices basically doubled in a short period of time. However, prices are now down -18% from the highs. This is also true in many other areas such as computer equipment and household appliances. We are seeing this in the manufacturing data as well, which is already in recession due to soft demand. Bottom-line: We are unlikely to see broad based increases in goods prices in 2023 = deflationary.

Money Supply – Milton Friedman is renowned for arguing that inflation is an 'always and everywhere monetary phenomenon...' Simply stated, ramp up money supply growth, and as sure as night follows day, inflation will result. Well, that certainly was the case this cycle. As you can see from the chart at the bottom of the next page, money supply growth boomed post COVID – as a matter of fact, it was the biggest boom we've seen outside of war years. But that is yesterday's story. Today the money supply is actually contracting. Bottom-line: Money supply growth is deflationary.

Housing – As strange as it sounds, the price of housing doesn't factor directly into the inflation data. The agency that calculates the data uses rental costs, not home prices. Thus, you can have a situation where housing prices are going gangbusters and inflation isn't impacted because rents are soft. There's also the reverse, which is what we saw last year. The housing market softened in 2022 due to soaring mortgage rates, but rental rates increased due to strong demand. It's not clear how this dynamic will play out in 2023. There's a good chance the housing market remains moribund due to high mortgage rates, but the direction of rental prices will hinge to a large degree on the labor market. As long as unemployment stays low,

expect rental prices to boost inflation. Bottom-line: Neutral to inflationary.

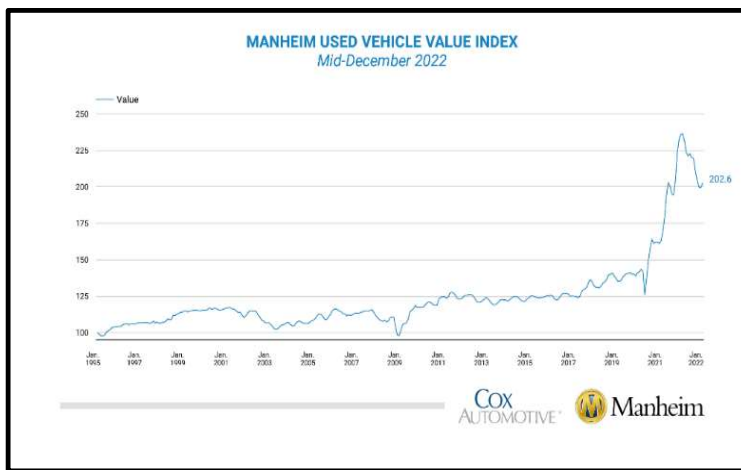
Energy Costs – It goes without saying that energy plays a key role in today's economy. It's hard to think of anything in the modern world that doesn't depend on energy inputs at one point or another. Food needs fertilizer, which in turns needs natural gas. Steel relies on coal. Plastics need oil. And despite our best efforts, oil remains a key input into



transportation costs. So energy costs play a vital role in the direction of inflation. After the Russian invasion last February oil and natural gas prices soared. However, in the second half of last year prices corrected meaningfully, and a warm winter in Europe is putting further pressure on natural gas prices in particular. What does 2023 have in store? No one can claim they really know. From a supply perspective, the market is tight due to a lack of investment in productive capacity. This means prices could spike on the first hint of geopolitical tension. Furthermore, China's reopening from their long-COVID induced lockdown could pressure energy prices higher. But for the time being at least, the lower energy prices of the last few months should pull down inflation. Bottom-line: Short-term deflationary, longer-term ???

Wages - This one is the most ambiguous of all, and it is the one factor that the Fed is laser focused on at the moment. The tightest labor market in the post-war period means wage growth is running hot. Why is this a problem? Remember the wage/price spiral discussion from the 1970s? We are having that same debate again. Does robust wage growth filter through into higher prices (especially for services), which then feeds back into even higher wage growth? Central banks fear that this dynamic can become self-perpetuating and are tightening policy to cool things off, but it's too soon to say if it's working. Bottom-Line: A tight labor market is likely to pressure wages in the first half of 2023 = short-term inflationary.

The Fed is Waiting For The Data to Change – Where does this leave us? There's a good case to be made that the inflationary pressures have peaked. Manufacturing is contracting and supply disruptions have all but faded from memory. Money supply is now contracting for the first time in the post-war period, and if economics teaches us anything, it's that a contracting money supply is ultimately deflationary. But the \$64 trillion question is how quickly does inflation moderate? Central banks have been burned by trying to predict price trends (they will never live down their 'transitory' views).



Based on their comments, it's clear they will keep tightening policy until the facts on the ground change.

What does this mean for Fed policy specifically? Current betting is a quarter-point hike on February 1st followed by another quarter-point hike March 22nd. This should get the fed Funds rate to roughly 5%. Then the question will be twofold: 1) have monthly

jobless claims picked up, or 2) has the inflation data softened significantly? Movement in either (but especially the second point) and the Fed will take a prolonged pause. If nothing has changed then we are likely to see further rate hikes in the spring and summer.

Reasonable People Can and Do Disagree – You can basically boil all the 2023 outlook pieces down into two camps. There's a contingent calling for a recession later in 2023 which coincides with fading price pressures. In the perverse way the markets work, this would probably be good news for stocks and bonds. Weakening growth and rising unemployment would mean the Fed pauses in March of this year and possibly starts cutting rates in the fourth quarter. This is certainly what the bond market is pricing in today. The closely watched yield curve is deeply inverted (short-term rates higher than long-term rates), and this is generally taken as a sign of a coming recession. This scenario would echo the one we experienced in 1973-1975. Back then the stock market bottomed as soon as inflation rolled over and investors started to price in rate cuts. The market totally ignored the recession and decline in earnings back then.

Conversely, there are others arguing that the economy will prove more resilient than most expect. Not only did the economy expand much faster than expected in the second half of 2022 despite rising rates, we will also see another fiscal boost in 2023. The recently passed \$1.7



trillion funding bill increases defense spending by 10% and domestic discretionary spending by 6%. At the same time monthly social security and disability payments to seventy million recipients will rise by 8.7% starting this month. This adds up to a lot of cash. If this scenario proves accurate it would mean more Fed hikes than

are currently priced into the market, and more pain for stocks and bonds in 2023.

Our Economic Outlook – Let’s dust off the crystal ball. We currently think 2023 will be a tale of two halves. In the first half we suspect investors will struggle to get a handle on where the economy and inflation are headed and how central bank policy will adapt. Markets will swoon on every hot CPI report and spike higher on hints of economic weakness (again, markets work in a perverse way). But ultimately, we think the economy softens and price pressures relent. The discussion about a recession is likely to pick up as the housing market stagnates, manufacturing continues to contract, and consumer spending slows. But the good news is that this means policy makers can take a pause. This implies that the markets find a footing in the second half of the year.

Market Implications – Let’s address the bond market first. This time last year a well-diversified fixed income portfolio was yielding less than 2% annually. Today that same portfolio is generating 5% plus. This looks pretty attractive. Furthermore, if the economy does dip into recession later this year, there’s a good chance fixed income investors will see some capital gains over the short-term. Now whether bonds offer good long-term opportunities today depends largely on where inflation normalizes at. If inflation is headed to between 2% and 3%, bond yields look pretty decent on an inflation adjusted basis. But they are far from a fat-pitch if inflation normalizes at 4% plus. It’s going to take time to get a read on the longer-term inflation outlook. Currently we are positioned in relatively short maturity bonds where we can easily get yields over 5% without taking undue risk. But we are looking closely at our bond allocation to adjust strategy in 2023.

As for stocks, we think we see more of the same in the first half of 2023 – continued volatility with dissimilar returns across sectors. The good news is that much of the froth in the market has been taken out. Speculation has dried up and valuations in many areas are now normal to erring on the cheap side. This means any correction should be viewed as a buying opportunity for value-oriented investors. And we think value is key again in 2023. If you look at relative earnings trends, we could very well see meaningful earnings contractions in many of the growthier sectors such as online advertising, alternative energy, cloud computing, etc. Conversely,

many of the value sectors could see modest growth (think energy stocks, healthcare, some financial sectors). This means another year of disparate returns in the market, and we have tilted our portfolios towards value exposures both domestically and internationally.

We are starting to change our minds on international stocks. For the first time in a long time, there’s a chance the overseas markets gain some ground versus U.S. equities. This isn’t so much a valuation story - European and emerging market stocks have been cheap for some time. But for once the earnings outlook for global equities looks better than that for large-cap U.S. stocks. International equities might have fits and starts in the first half as we get a handle on inflation and what China’s reopening means for the global economy, but we think we could see relative outperformance for the full year.

Final Thoughts – To circle back to our original question as to whether investors should extrapolate the great repricing theme into 2023 and beyond? We think this would be a mistake – at least for this year. We think central banks will do what is necessary to cool price inflation, and it is quite possible they have done enough already. It may take a few months for the hard data to support the idea of cooling prices, but ultimately we think the markets will stabilize on signs of durable progress on the inflation front. And this will be more important for investors than worries about recession or earnings contractions. We do worry about longer-term inflation challenges, though, and will write more about this in coming quarters.

What risks could throw things off course? There’s the usual laundry list of geopolitical worries. Maybe the biggest issue is what happens with energy prices. Could Putin weaponize Russian oil production? Could the end of China’s zero-COVID policy spur energy demand? Both would prove problematic given the supply backdrop. Politics in the U.S. is another wildcard. Does the current mayhem in the House translate into a battle over the debt ceiling later this year? You can’t rule anything out in our highly charged political environment. But ultimately, we think there are some decent opportunities in both the stock and bond markets today that should reward investors over the coming quarters, especially if we don’t see a repeat of 2022’s great repricing move in rates.

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