INVESTMENT COMMENTARY
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Executive Summary

High inflation and tightening financial conditions proved challenging for almost all major asset categories in 2022. The broad equity market sell-off improved valuations, but US stocks may not be adequately discounting the risk of a decline in corporate earnings—although a US recession is widely anticipated by economists. A mild recession within the next 12 months is also our base case assumption, but it's not a certainty given the ongoing strength of the labor market. To combat inflation, the US Federal Reserve (Fed) has pursued one of its most aggressive rate hiking cycles on record. As a result, investment grade fixed income returns were historically weak. Bond yields have returned to levels not seen since 2008, indicating better forward-looking returns. However, the uncertain macroeconomic environment and geopolitical backdrop suggests that volatility across asset classes will remain elevated.

In our view, proper diversification remains as important as ever. Our tactical positioning themes include:

- Maintain a slight underweight position to core/investment grade bonds, but increase exposure given recent weakness and more compelling yields.
- Target an underweight position in US large cap equities while emphasizing high-quality stocks. Remain fully invested in more reasonably priced international developed and emerging markets stocks.
- Continue to target an overweight position in real assets like commodities and natural resource stocks as the investment case remains compelling and the asset class offers powerful diversification benefits.

Asset Category Performance (As of January 31, 2023)	YTD 2023	Full Year 2022	Last 5 Years*	Last 10 Years*
Fixed Income				
Municipal Bonds (Bloomberg 1-10 Year Municipal)	+2.0%	-4.8%	+1.9%	+1.9%
Taxable Bonds (Bloomberg US Aggregate Bond)	+3.1%	-13.0%	+0.9%	+1.4%
High Yield Corporate Bonds (Bloomberg US High Yield)	+3.8%	-11.2%	+3.0%	+4.3%
Equities				
Global Stocks (MSCI All Country World)	+7.2%	-18.4%	+5.5%	+8.2%
US Large Cap Stocks (S&P 500)	+6.3%	-18.1%	+9.5%	+12.7%
US Small Cap Stocks (Russell 2000)	+9.8%	-20.4%	+5.5%	+9.4%
Non-US Developed Markets Stocks (MSCI EAFE)	+8.1%	-14.5%	+2.1%	+5.0%
Emerging Markets Stocks (MSCI Emerging Markets)	+7.9%	-20.1%	-1.5%	+2.1%
Real Assets				
Commodities (Bloomberg Commodity)	-0.5%	+16.1%	+5.9%	-1.6%
Natural Resources (S&P Global Natural Resources)	+7.5%	+10.3%	+7.8%	+5.3%
Energy MLPs (Alerian MLP)	+6.6%	+30.9%	+4.2%	+1.4%
Global REITs (MSCI ACWI REIT)	+9.8%	-25.0%	+5.6%	+6.5%
Flexible/Alternative Strategies				
Directional Hedge (HFRI FOF Strategic)	+2.8%	-11.9%	+2.1%	+3.4%
Less-Directional Hedge (HFRI FOF Conservative)	+0.5%	+0.1%	+3.7%	+3.5%

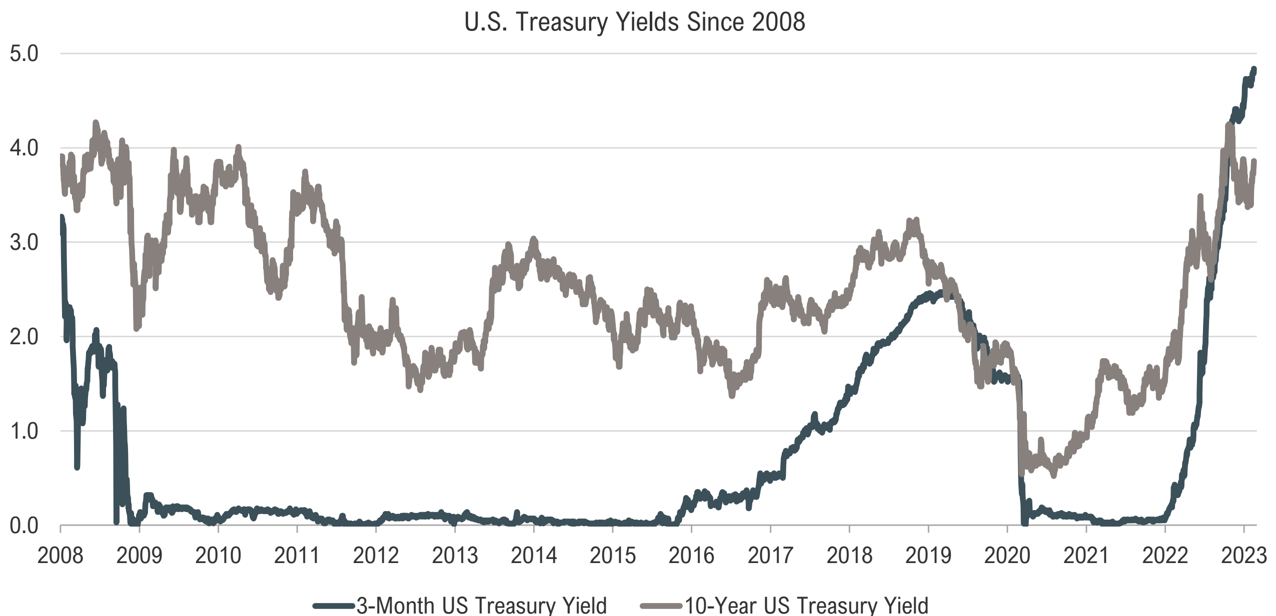
*Note: Data provided by Zephyr Associates. *Indicates annualized return. Past performance is not indicative of future results.*

Market Review

Despite some relief in the fourth quarter, 2022 proved challenging for most asset categories. Financial markets battled several headwinds, including high inflation, hawkish central banks, the Russia-Ukraine war, lockdowns in China, and growing recession fears, resulting in significant volatility and generally weak performance. Both stocks and bonds experienced broad declines while inflation-sensitive assets, like commodities, generated gains. 2022 was only the third year since 1926 that both US stocks and investment grade bonds declined, and the only year that both asset classes lost more than -10%. The broad global equity market's decline of over -18% was the worst calendar year performance since 2008. Underneath the surface, the most speculative investments, like cryptocurrencies, fared the worst. For example, both the price of Bitcoin and Cathie Wood's ARK Innovation ETF, the darling investment vehicle of the pandemic era, fell over -65% during the year.

Within the broader equity market, the sell-off hit growth stocks hardest. Companies with higher growth rates but limited near-term return or cash flows can be viewed as "longer duration" equities and, therefore, more sensitive to higher interest rates. As such, "shorter duration" value stocks exhibited better relative results in 2022. Despite the headwind of a strong US dollar, international developed markets stocks (such as those issued in Europe and Japan) outperformed domestic shares, aided by their value-orientation. In addition, the US equity market is dominated by the more speculative sectors (technology, communication services, and consumer discretionary) that fared the worst. Emerging markets stocks underperformed in 2022 as China sold off and the Russia-Ukraine war wreaked havoc on the surrounding developing countries.

In fixed income markets, core investment-grade bonds suffered their worst calendar year in the history of the Bloomberg US Aggregate Bond Index at -13%, a loss more than 4 times greater than the previous worst calendar year on record, 1994, in which bonds posted a -3% loss.[1] The key driver, of course, was the sharp rise in interest rates. For example, the 10-year Treasury bond yield currently stands at 3.9% after starting 2022 at only 1.5%. In March 2022, the Fed decided that inflation was not transitory and pivoted from its accommodative monetary policy into one of the fastest rate hiking cycles on record. The central bank has raised rates eight times, pushing its target to a range of 4.50% to 4.75%, a 15-year high. The combination of hawkish Fed policy and weakening forward economic indicators has led to an inverted Treasury yield curve—meaning short-term yields are above long-term yields. In fact, the current slope of the Treasury curve is its most inverted posture since the last time the Fed was battling the grips of inflation during the 1970s and early 1980s.[2] Historically, yield curve inversions have been a fairly reliable predictor of economic recessions, though the timing from inversion to onset of recession has been highly variable.



Source: Federal Reserve Bank of St. Louis, Economic Research Division as of February 16, 2023.

Macro Backdrop

As Howard Marks at Oaktree Capital Management has written many times about the economy, "we may never know where we're going, but we had better have a good idea where we are." The unusual backdrop over last few years, including the unprecedented Covid-related disruption and rebound, underscores the difficulty in economic forecasting. Instead of making predictions about the future, we seek to frame the macroeconomic backdrop by considering a range of potential outcomes.

At this stage, a US recession is widely anticipated. According to the Wall Street Journal, more than two-thirds of the economists at 23 large financial institutions that do business directly with the Federal Reserve are betting the US will have a recession in 2023. Two others are predicting a recession in 2024. The main culprit is the Fed, economists said, which has been raising rates for months to try to slow the economy and curb inflation.[3]

Key leading indicators of US economic performance have deteriorated over the past several months, corroborating the early warning signal of an inverted yield curve. For instance, banks have tightened lending standards, and loan demand has weakened to near levels typically associated with recessions. The Conference Board's set of leading economic indicators has fallen for eleven months in a row, reaching levels that have historically preceded recessions.

Cleary, with the near-term risk elevated, a recession represents a reasonable base case scenario—but it's not a certainty. In fact, the economy has been surprisingly resilient thus far. First, the labor market remains quite strong (despite high-profile layoff announcements in technology and finance), enabling consumer income and spending growth. In January, the unemployment rate fell to 3.4%, hitting a level not seen since May 1969. And households still have "excess savings" stemming from the pandemic estimated to be about $1.2 trillion. Business balance sheets are also in good shape with many firms having refinanced their debt at low rates prior to 2022's sharp rise. Though the initial reopening has been bumpy, China's sudden abandonment of its highly restrictive zero-Covid policy and eventual return to stronger growth trends should serve as a tailwind to the global economy, especially for its key trading partners in Europe, Latin America, and Asia.

Given the strength in consumer and corporate balance sheets, it's likely that any potential recession would be somewhat mild—perhaps a more "normal" type of cyclical recession rather than akin to the 2008-2009 financial crisis or the 2000-2002 dotcom bubble burst. Importantly there don't appear to be any major, systemic economic or financial icebergs lurking under the surface (unlike in 2008 with the housing/mortgage derivatives market). However, much of the economic outlook depends on the future path of inflation and monetary policy.

- **Inflation:** Realized inflation rates surged to their highest levels in decades, driven by supply constraints related first to the pandemic and later to the war in Ukraine, along with a stimulus-induced demand surge.[4] Yet, goods inflation has come down considerably as supply chains have become unstuck. Falling housing prices and lower prices on new rental leases also indicate that the sticky "shelter and owners' equivalent rent" component of inflation will also decline.[5] But core services inflation remains elevated, driven largely by the tight labor market's effect on wages. The number of job openings, currently about eleven million, continues to surpass the availability of labor capital, with less than six million unemployed individuals. Until this imbalance approaches a state of equilibrium, the Fed may find it challenging to engineer a soft landing.[6]

- **Monetary Policy:** After more than a decade of excessively easy monetary policy following the 2008 Global Financial Crisis, central banks have completely reversed course. Since the beginning of 2022, at least 28 global central banks have raised interest rates to combat inflation. In addition, the Fed started reducing the size of its balance sheet in June and the European Central Bank expects to follow suit in later this year. According to PIMCO, monetary policy has likely already reached restrictive levels in several major economies, including the US.[7] So the Fed is likely close to the end of this tightening cycle and the pace of rate hikes has slowed—but we're unlikely to see a return to stimulative policies any time soon. In fact, the Fed seems determined to restore its credibility as an inflation fighter.[8] But the prospect of higher interest rates for longer than the market is expecting poses a risk to asset prices.

Market Outlook

There is a silver lining to the weak financial market results in 2022 in the form of improved valuations and, therefore, better long-term return prospects. As Ben Inker at GMO explains, "last year's beat-down across all traditional asset classes has done a huge service to the expected returns of pretty much everything…For the first time in several years, it is possible to now put together a well-diversified portfolio of assets and strategies that are either outright cheap or at least fair value."[9] Of course, the potential for additional downside risk still exists. In fact, the highly uncertain macro environment suggests that volatility across asset classes is likely to remain elevated. And there's no shortage of potential geopolitical events that could rattle financial markets, such as another US debt ceiling showdown later this year. Investing, however, is always about making decisions under a cloud of uncertainty.[10] As we seek resilience across a range of scenarios, proper portfolio diversification is as important as ever.

The broad equity market sell-off caused valuations for all categories of global stocks to decline, while earnings growth continues to slow from the decade-high rates registered during the profit recovery in 2021. The forward price/earnings (P/E) multiple for the S&P 500 Index is now roughly 18.0x, which is below the 5-year average of 18.5x, but above the 10-year average of 17.2x.[11] By comparison, various international developed and emerging markets appear more attractively valued, either trading near or below their 10-year averages. As a result, the valuation disparity between US and international equities is much wider than usual, indicating a favorable long-term backdrop for non-US stocks.

The fact that we (and the consensus of economists) anticipate a recession within the next 12 months doesn't necessarily mean that equities will perform poorly—if current prices have already discounted a recessionary outcome. Historically, corporate earnings have declined by -15% on average during recessions. This would indicate that a mild recession could see a smaller drawdown in the mid-single digits.[12] Indeed, 2023 earnings estimates for the S&P 500 have been coming down for several months now. Analysts expect earnings declines for the first half of 2023, but still predict earnings growth of about +2% for the full year. [13] Therefore, we worry that US equity valuations haven't adequately discounted the likelihood and severity of a potential corporate earnings recession.

The outlook for fixed income investments is certainly different than it has been over the last decade. The era of unconventional monetary policy following the 2008 Global Financial Crisis pushed bond yields to extremely low levels, which made stocks highly attractive by comparison. The acronym TINA became a popular way to describe the environment where "there is no alternative" to equities. Given last year's sharp rise in interest rates, today's environment is different. For example, across the US Treasury bond yield curve, investors can earn a risk-free yield of 3.9% or more. Investment grade corporate bond yields are higher, though they carry some credit risk. This increase in yields for fixed income has created more attractive alternatives for equities. On a comparison of earnings yields to bond yields, stocks no longer look *relatively* cheap.

Portfolio Strategy & Tactical Asset Allocation Views

Within the context of a sound, long-term asset allocation framework, we believe that an active, flexible approach can enhance returns by shifting capital to attractive risk/reward opportunities. Throughout 2022 we opportunistically rebalanced portfolios, seeking to take advantage of market volatility. For example, we trimmed commodities exposure throughout the year on strength, while adding to investment grade bonds and high yield credit on weakness. Our current portfolio positioning themes are summarized below.

- **Maintain a slight underweight position to core/investment grade fixed income, but increase exposure given recent weakness and more compelling yields.** While rising interest rates still pose a risk to high quality bonds, yields have returned to levels not seen since 2008. In addition to better forward-looking return prospects, higher starting yields also improve the potential diversification benefits of investment grade bonds in risk-off scenarios. In our view, high yield corporate credit offers attractive risk/return potential, but we recommend a selective approach to the space, aiming to utilize skilled managers to minimize default risk.

- **Target an underweight position in US large cap equities while emphasizing high-quality stocks. Remain fully invested in more reasonably priced international developed and emerging markets stocks.** Valuations have improved, but US stocks perhaps still reflect an overly optimistic outlook for near-term corporate earnings growth. Thus, we recommend an underweight position, along with a tilt towards higher quality companies (those with strong balance sheets, stable earnings, and high margins). While non-US stocks are also at-risk from a potential recession, we believe a lot of bad news and negative sentiment is already priced into these markets. The headwind of a strong US dollar should reverse itself over the next few years, given the large US federal budget and current account deficits, and a shrinking interest rate gap versus the rest of the world.

- **Continue to target an overweight position in real assets.** The past two years have underscored commodities' diversification benefits. While traditional asset classes can be vulnerable to unexpected increases in inflation, commodities and commodity-producer stocks can offer a potent hedge. We also share PIMCO's view that, over the long-term, a prolonged period of limited supply-side investment along with the secular transition toward renewable energy sources could further support commodities prices, and energy in particular.[14]

- **Maintain exposure to diversifying and credit-oriented alternative strategies.** We continue to believe that certain types of hedge fund strategies are valuable for their diversifying active returns. In our view, the investment case remains compelling given macro uncertainty and anticipated volatility across traditional asset classes. However, we'll continue to reevaluate our positioning in light of higher investment grade bond yields.

- **Where appropriate, continue to develop private equity and private real estate investment programs.** Because of the associated illiquidity and inherent inefficiencies, private assets typically compensate investors with a premium return. We recommend maintaining the planned pace of commitments as new capital deployed during periods of economic disruption often generate significant upside. Of course, private assets are not immune to higher macro and market volatility or higher interest rates.[15]

The table below illustrates our current tactical asset category views.

Asset Category Tactical Views	Strong Underweight	Underweight	Neutral	Overweight	Strong Overweight
Cash					
Cash and Short-Term Bonds				✓	
Fixed Income					
Investment Grade Municipal Bonds		✓			
Investment Grade Taxable Bonds		✓			
Bank Loans and High Yield Credit				✓	
Equities					
US Large Cap Stocks		✓			
US Small Cap Stocks			✓		
Non-US Developed Markets Stocks			✓		
Emerging Markets Stocks			✓		
Real Assets					
Commodities and Natural Resources				✓	
Public Real Estate	✓				
Flexible/Alternative Strategies					
Diversifying Hedge			✓		

Note: Based on research and opinion provided by Greycourt & Co. Tactical views reflect a three-year investment horizon. Suggested asset class weights are used as a starting point in assessing client portfolio weights against strategic targets which typically reflect a ten-year investing horizon.

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[1] *Fund Evaluation Group, "Fourth Quarter 2022 Market Commentary," January 2023.*
[2] *Ibid.*
[3] *Dion Rabouin, Wall Street Journal, "Big Banks Predict Recession, Fed Pivot in 2023," January 2, 2023.*
[4] *Tiffany Wilding and Andrew Balls, PIMCO, "Cyclical Outlook January 2023."*
[5] *Mitch Zacks, Zacks Investment Management, "3 Factors That Could Drive Markets in 2023," January 3, 2023.*
[6] *Fund Evaluation Group, "FEG Research Review Fourth Quarter 2022," January 2023.*
[7] *Tiffany Wilding and Andrew Balls, PIMCO, "Cyclical Outlook: Strained Markets, Strong Bonds," January 2023.*
[8] *Keith Berlin, Fund Evaluation Group, "Interest Rates and The Great Reset," October 24, 2022.*
[9] *Ben Inker, GMO, "2022: The Joy of Missing Out," Fourth Quarter 2022 Letter.*
[10] *James Montier, GMO.*
[11] *John Butters, FactSet, "FactSet Earnings Insight," February 17, 2023.*
[12] *Erin Browne, Geraldine Sundstrom, and Emmanuel Sharef, PIMCO, "Asset Allocation Outlook: Risk-Off, Yield-On," November 2022.*
[13] *John Butters, FactSet, "FactSet Earnings Insight," February 17, 2023.*
[14] *Greg Sharenow, Lewis Hagedorn, and Jennifer Ziehe, PIMCO, "Growing Demand, Tight Supply Support Commodities in 2023."*
[15] *BlackRock, "Weekly Commentary: Seeking Income and Staying Nimble," February 21, 2023.*