Good afternoon,

And happy new year! Before we begin the annual reading of the tea leaves, it is important to assess the year that just was. In 2022, the S&P 500 declined 19.4% and the Tech-heavy Nasdaq index fell 33.1%. The Dow Jones Industrial Average fared a bit better, dropping 8.8%, while bonds, as measured by the Barclay's Aggregate Index, fell 13%. (At least we didn't have any investments in Bitcoin, which ended the year down 64.2%).

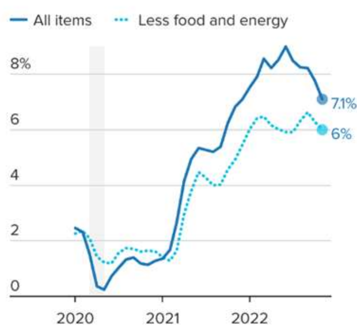
We are starting 2023 with most of the issues that plagued 2022 still with us. Inflation remains high, the Federal Reserve is expected to continue raising overnight interest rates, and corporate earnings are expected to decline from a year ago. Geopolitical unrest continues most notably with the war in Ukraine. And there are concerns over another wave of Covid-19, especially given China's change in policy.

With all the above being said I am expecting a positive outcome in 2023 for both stock and bond returns. Let's look at the issues in greater detail and see why I feel optimism is warranted.

1. **Inflation is peaking**

   While the most recent Consumer Price Index came in at 7.1% for November, inflation has been coming down steadily since June. The CPI measures the price of goods and services today as compared to a year ago. By the end of last year, inflation had already started to climb so this trend should continue. This is important, as inflation is currently the biggest driver of the Federal Reserve's interest-hike campaign.

   To be sure, it may be some time yet before inflation comes back into the Fed's target zone of 2-3%. But should we see signs in the coming months that this is a sustained drop, the market will start to factor in the impact of declining interest rates going forward.



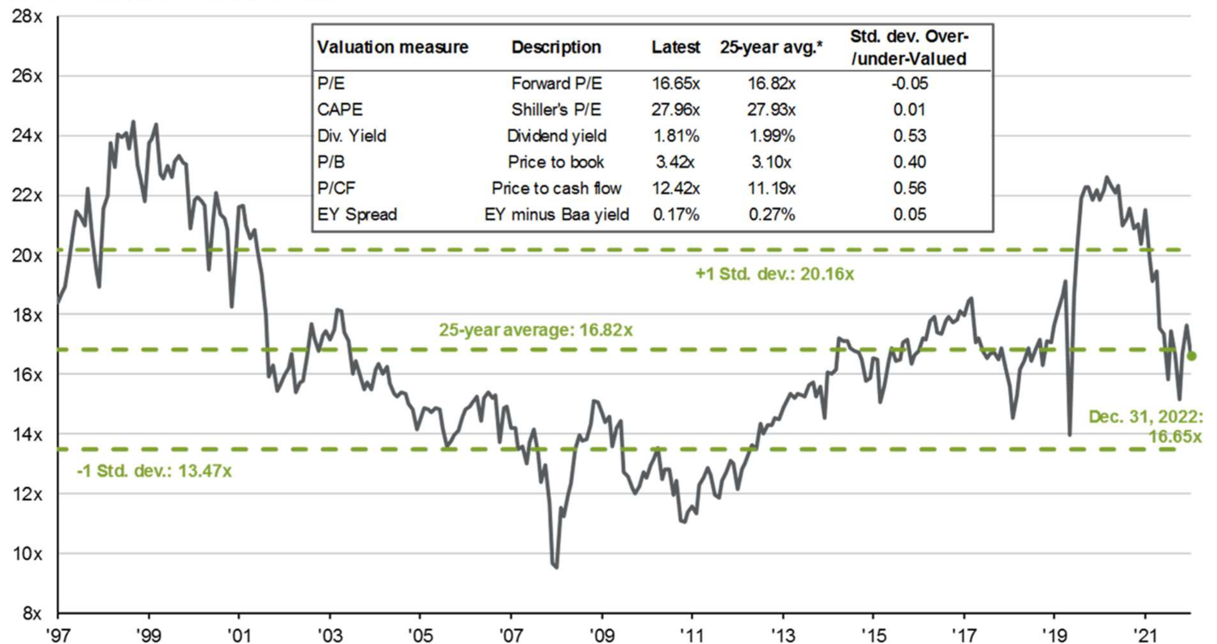
2. **The Fed is near the end of their rate hike cycle**

   The consensus amongst the Federal Open Market Committee is for overnight interest rates to peak at just above 5% in the first part of 2023. That's another 0.5% higher from where they currently stand. However, they are likely going to start declining substantially by 2024.

   Short term bond yields remain higher compared to intermediate and long-term bonds. They are likely to remain elevated for some time yet and we are benefiting from the higher yields.

3. **Earnings expectations are down, but stock prices have declined further than these expectations**

   Earnings on the S&P 500 companies are expected to decline 10% year-over-year in 2023. However, with the index down close to 20%, valuations have become much more attractive. As the chart below shows, at current levels, stocks are slightly under their 25-year average Price-to-Earnings (P/E) ratio.



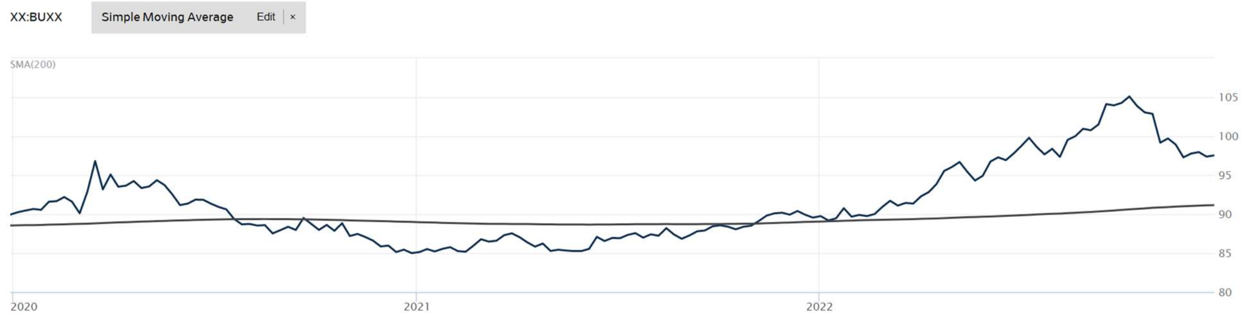
Valuation measure	Description	Latest	25-year avg.*	Std. dev. Over-/under-Valued
P/E	Forward P/E	16.65x	16.82x	-0.05
CAPE	Shiller's P/E	27.96x	27.93x	0.01
Div. Yield	Dividend yield	1.81%	1.99%	0.53
P/B	Price to book	3.42x	3.10x	0.40
P/CF	Price to cash flow	12.42x	11.19x	0.56
EY Spread	EY minus Baa yield	0.17%	0.27%	0.05

Source: JP Morgan

4. **The U.S. dollar is starting to pull back**

The dollar gained 8.4% in 2022 against a basket of foreign currencies. However, as shown in the chart of the dollar index below, it is dropping from its recent highs. This is helping the performance of foreign market stocks. Also, since the companies in the S&P 500 get 40-45% of their earnings from overseas operations, this will also help domestic stock earnings.

WSJ $ Index BUXX.XX



Source: WSJ

Portfolio Summary

We remain in a defensive tilt. However, I am starting to implement some changes in anticipation of a recovery in the stock and bond markets.

1. I am starting to move the maturity of the bond portfolio out to both lock in the higher interest rates as well as position for a price recovery when interest rates start to come back down
2. I am adding preferred stocks to retirement accounts. They are currently yielding 6.1% and will also rise in price when the stock market recovers. I like to think of this as "getting paid to wait."
3. I am adding an index of high dividend companies to the international allocation. The current yield is 7.1%
4. Conditions still favor stable value stocks over high earnings growth companies. But the market will likely start pricing in a recovery before it shows up in the data. With that in mind I am watching the ratio of growth-to-value performance closely.

In summary, while volatility may remain higher than average as we work through the current conditions, it also affords me the opportunity to rebalance portfolios – essentially buying more equities when they are down and thus being in a better position to benefit from the eventual recovery.

As always, please feel free to call or email me directly if you would like to discuss the markets or your investments in greater detail.

Very truly yours,

Jim

Investment advisory services offered through NewEdge Advisors, LLC, a registered investment adviser.