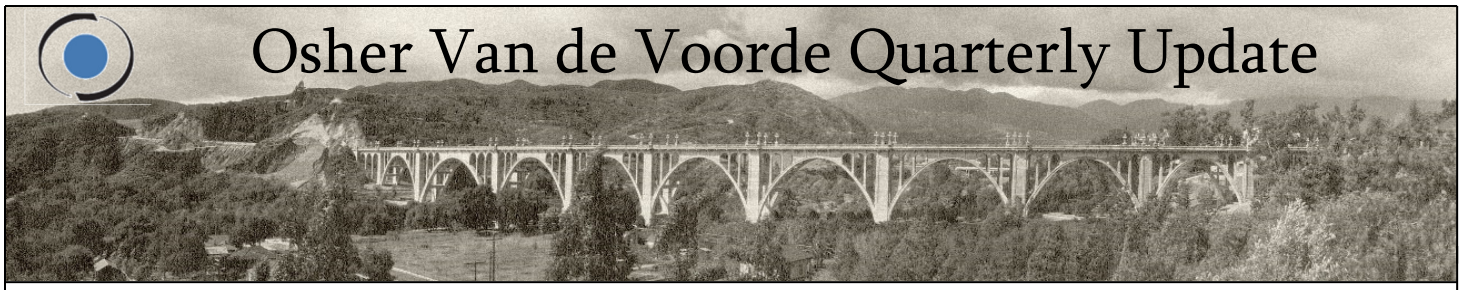


Outlook 2023

January 2023

What a difference one year makes. While we accurately predicted the potential for heightened volatility in 2022 due to shifting policy at the Federal Reserve and rising geopolitical tension in Russia and China, we did not foresee the rapid pace at which the Fed would ultimately hike interest rates, nor did we anticipate a full-blown war in Ukraine that would leave the world the closest to global conflict since WWII.

Also, while we did suggest that the Fed may have to hike rates more aggressively than anticipated, we were not sufficiently convicted in that possibility and placed too much trust in the Fed's own (woefully inaccurate) forecasts. Instead of three rate increases in 2022, Fed Chair Powell persistently hiked rates at seven consecutive meetings at a magnitude not seen since the Paul Volcker Fed. The combination of surprising Fed hawkishness, a brutal war in Ukraine and ongoing supply chain disruptions due to China's zero-COVID policy proved too much for the market to bear and trumped an otherwise strong economy. Indeed, the S&P 500, Dow Jones Industrial Average and NASDAQ Composite declined by -19.44%, -8.78% and -33.10% respectively in 2022. Even the benchmark U.S. Treasury Bond declined by 15% in 2022, marking the worst year ever for bond investors and the third worst year ever for a 60/40 balanced portfolio.

As we embark on a new year, the question remains as to how much further the Fed will raise interest rates and whether recession is the inevitable price to win the battle against inflation. The Fed Funds rate now stands at a 15-year-high range between 4.25% to 4.5% and the Fed presently forecasts that the benchmark rate will reach a peak of 5% to 5.25% in the first half of this year. Since the Fed has already tapered its pace of rate increases from 75 to 50 basis points and has telegraphed its intention to maintain the terminal rate for the remainder of the year, it would only take two to three more 25 to 50 basis point hikes before the Fed's hypothetical pause. Importantly, while markets are pricing in the potential for a rate cut "pivot" to follow the Fed's pause in the current year, the Fed only sees a reduction in the Fed Funds rate back to 4.1% by the end of 2024 and 3.1% by the end of 2025. In other words, the Fed is telling us that rates will stay higher for longer than the market currently expects.

To be sure, there are definitive signs that inflation is cooling dramatically from its recent peak. In November, the annualized consumer price index (CPI) grew at a slower-than-expected 7.1%, down from 7.7% in October and the 9.1% peak in June. On a month-over-month basis, CPI rose just 0.1% in November, a pace that would bring annualized inflation down to 4.1% in March and below 3% by May. It is well recognized, even by the Fed, that there is a lag before the full impact of rising interest rates permeates the economy. Rather than take a victory lap, Fed rhetoric has remained decidedly hawkish.

Evidence of the Fed's success against rising inflation is more apparent when one considers the disproportionate impact from shelter which accounts for one-third of the CPI calculation. Rents are now rising at a 10% annual rate in a lagged response to the dramatic increase in housing prices during the previous year. Rents are used to compute costs not only for renters but also for homeowners, and the November CPI indicated that shelter costs for homeowners rose by 8%. With 70% of outstanding mortgages fixed for 30 years and 20% of mortgages fixed between 10 and 20 years, shelter costs have not increased at all for most homeowners. Further, most of these fixed-rate mortgages are locked in at historically low rates. Excluding shelter, CPI *declined* by 0.2% in November and has risen by only 1.3% over the last three months.

Despite supply constraints due to the ongoing war in Ukraine, energy and other commodity prices have rolled over. Roiled by rocketing mortgage rates, the housing market is at a standstill. Retail sales have slowed, and consumers are taking on unwanted credit card debt. Surplus savings built up during the pandemic are winding down. Manufacturing activity has contracted for two consecutive months. Mostly from losses in the stock market, U.S. households lost nearly $7 trillion of wealth in 2022 and these losses could grow markedly should housing prices contract meaningfully. It seems like only a matter of time before the resilient U.S. consumer relents and services activity recedes.

Indeed, persistent strength in the labor market is buoying the economy and market participants are laser focused on each monthly jobs report. In today's bizarro world where good news is bad news, continued strength in the labor market implies potential for additional rate hikes and growing propensity for Fed policy error. The Fed is hellbent on inflation and won't reverse course until they are convinced that falling inflation is "sustained." This will require a softening labor market and subsequent slowdown in prices for services. Mega-cap technology firms Alphabet, Apple, Meta and Microsoft (who hired aggressively during the pandemic to meet unprecedented demand for all things digital) have all recently announced hiring freezes or staff reduction measures. At press time, cloud software and Dow Jones component Salesforce announced a 10% reduction in employee headcount, while Amazon announced 18,000 new layoffs. Cracks in the labor market are emerging, offering further evidence that recession may be a fait accompli.

The argument that recession is necessary to bring inflation under control only makes sense if one believes that the pain of today's inflation is worse than the pain of higher unemployment to come. While it is certainly true that *real* wages have suffered due to rising inflation, *real* wages will fall even faster as nominal wage growth declines under the weight of rising unemployment. While we don't believe the Fed wishes to wreck the economy in the name of taming inflation, our estimation is that the Fed will be hard-pressed to pull off any semblance of a soft landing should rates move much higher than the terminal 5.25% rate currently anticipated. There is too much evidence that rate increases already in the rearview mirror are having their desired effect, not to mention the lag effect still to come.

With bond prices stabilizing and the yield on the ten-year Treasury down to 3.73% from a recent high of 4.25%, the collective wisdom of the bond market is at odds with Fed rhetoric. It is very possible that we have already observed the peak in long-term yields, even if short-term rates climb a bit further. If interest rates have indeed peaked and the Fed is closer to a pivot than Chair Powell is telling us, the stock market is poised for worthwhile returns in the year ahead. If the Fed decides to plow further ahead and move the Fed Funds rate closer to 6%, we expect the market to retest the recent lows. As the lag effect of rising interest rates filters through to corporate earnings, guidance for the balance of 2023 will be critical. It is possible that markets retest recent lows should guidance prove soft, even if the Fed maintains the status quo. Earnings may be the last shoe to drop.

The S&P 500 currently trades at just under 17x 2023 earnings and 15x forward earnings for 2024. Whether these valuations prove reasonable will be determined by Fed policy and the extent of the Fed-induced economic decline. While consensus expectations for the market to test recent lows during the first half of the year followed by a sharp rebound in the second half is an easy narrative to follow, rarely does such a widely held view come to fruition. Indeed, lopsided bearishness stirs the contrarian in us.

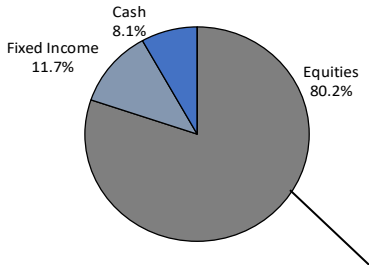
While we admit that it will be difficult for our crystal ball to become clear until we have greater clarity on the Fed's ultimate terminal rate for Fed Funds, we do expect volatility to persist and a 10% trading range for the S&P 500 between 3400 and 4200. It is important to remember that markets always bottom before the economy or at least concurrent with the trough in economic activity. If the Fed pauses in relatively short order and the expected recession is shallow, it is possible that markets have already bottomed. An even more aggressive Fed will usher in economic damage not presently priced in by the market and we would expect new lows. Should the S&P 500 move much lower than 3400, we would become decidedly more bullish. For now, we are somewhat neutral going into 2023 and will be paying close attention to coming Fed meetings and economic data.

Your portfolio is built on a foundation of best-of-breed businesses with Fort Knox balance sheets, dominant brands, pricing power and consistent records of earnings and dividend growth. Further, our equally weighted approach to building portfolios is serving clients well as the impact of dramatic declines in the mega-caps weighs on the cap-weighted major indices. Finally, bonds are priced more attractively and even money market cash offers a cozy 4%+ yield. While there may be additional downside risk for the stock market in the short-term, your portfolio is well-positioned to deliver worthwhile total return over the long-term.

Investment Strategy Summary

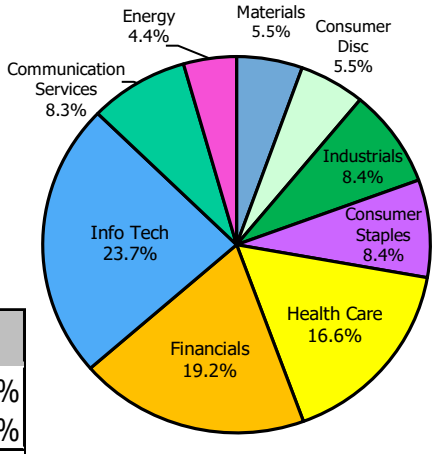
As of December 31, 2022

Firmwide Asset Allocation



OVIM Equity Composition	
International Core	7.6%
U.S. Core	92.4%

Equity Sector Allocation

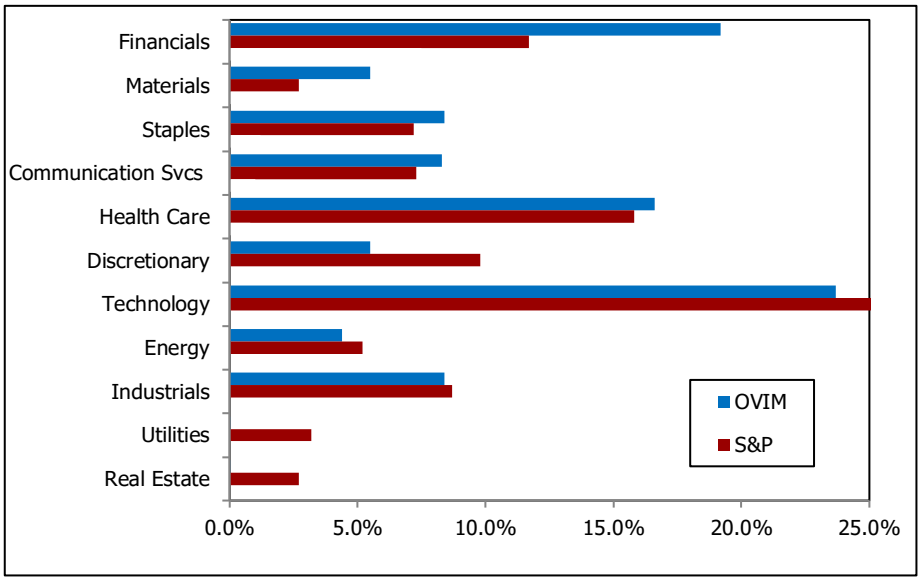


Top Core Global Equity Holdings

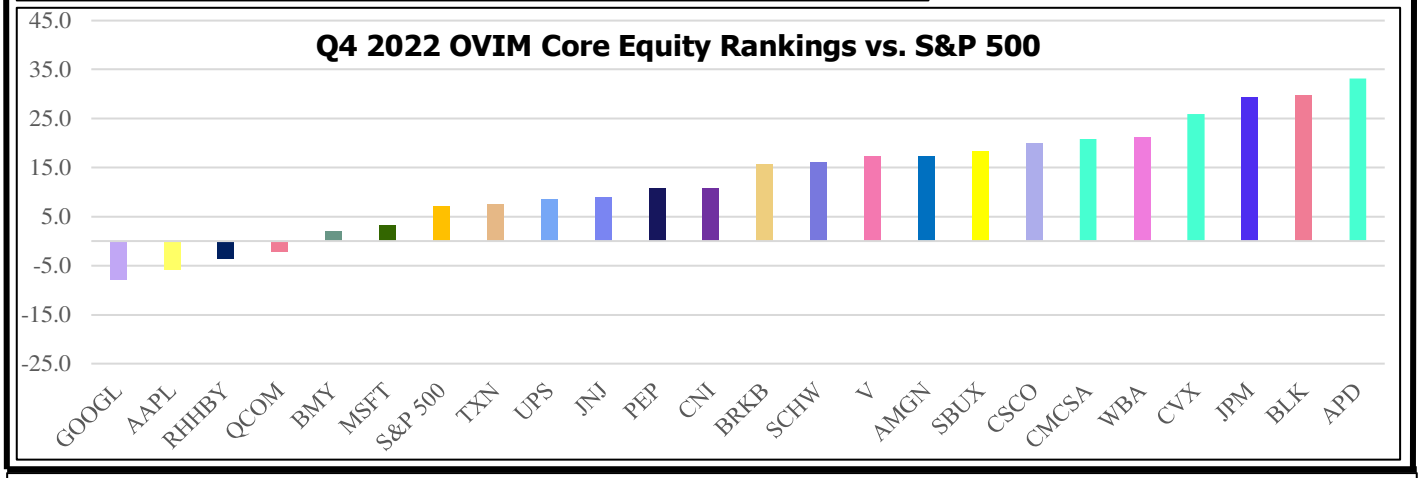
Air Pros Chems Inc.	APD
JPMorgan Chase & Co.	JPM
BlackRock Inc.	BLK
Starbucks Corp.	SBUX
Charles Schwab Corp.	SCHW
PepsiCo Inc.	PEP
Visa Inc.	V
Amgen Inc.	AMGN
Berkshire Hathaway Inc. Cl. B	BRKB
Chevron Corp.	CVX
United Parcel Service Inc.	UPS
Bristol-Myers Squibb Co.	BMY
Comcast Corp.	CMCSA
Alphabet Inc. Class A	GOOGL
Johnson & Johnson	JNJ
Canadian National Railway Co.	CNI
Cisco Systems Inc.	CSCO
Texas Instruments Inc.	TXN
Qualcomm Inc.	QCOM
Walgreens Boots Alliance Inc.	WBA
Roche Holding AG ADR	RHHBY
Microsoft Corp.	MSFT
Apple Inc.	AAPL

Sector Weightings Relative to S&P 500

Ranked by Largest Overweight



Q4 2022 OVIM Core Equity Rankings vs. S&P 500



This presentation is solely for informational purposes. Data is pulled from sources believed to be reliable, but not independently verified. Past performance is no guarantee of future returns. Investing involves risk and possible loss of principal capital. No advice may be rendered by Osher Van de Voorde Investment Management unless a client service agreement is in place. Please contact us at your earliest convenience with any questions regarding the content of this presentation and how it may be the right strategy for you. This data is representative of all equity securities held across Osher Van de Voorde's client accounts, however portfolios are tailored to meet specific client objectives and actual client holdings will vary.

The S&P 500 Index or the Standard & Poor's 500 Index is a market-capitalization-weighted index of the 500 largest U.S. publicly traded companies. The S&P 500 is a float-weighted index, meaning company market capitalizations are adjusted by the number of shares available for public trading. Note: Investors cannot invest directly in an index. These unmanaged indices do not reflect management fees and transaction costs that are associated with most investments.

Intrafamily Loans

The recent rise in interest rates has made it exceedingly more difficult for would-be homeowners to afford and qualify for a new loan. As a result, many families are considering intrafamily loans to help children or grandchildren complete a desired home purchase. To be considered a legitimate loan and not a gift subject to gift tax reporting, possible gift tax, and reduction of the lender's lifetime gift and estate tax exemption, qualified intrafamily loans must adhere to certain IRS guidelines.

To qualify as a loan and not a gift, intrafamily loan terms must include a market rate of interest at least equal to the Applicable Federal Rate (AFR), the rate published monthly by the IRS for federal income tax purposes. The AFR is based on the term of the loan and is the minimum rate of interest to be charged to avoid the adverse consequences of the loan being considered a gift. While interest rates have risen dramatically in 2022, the AFR may still be lower than interest rates available through banks or other commercial lenders. In addition, the AFR may be fixed for the term of the loan preventing interest costs from escalating in a rising-rate environment.

The December 2022 AFR for a long-term loan paid monthly is 4.25%, compared to 6.65% for an average 30-year fixed conventional mortgage. For comparison, the monthly principal and interest payment on a 30-year fixed $500,000 conventional mortgage at the AFR rate of 4.25% would be $2,460 and the total interest paid over the life of the loan would be $385,492. This compares to a monthly principal and interest payment on a 30-year fixed $500,000 conventional mortgage at the market interest rate of 6.65% of $3,210 and total interest paid over the life of the loan of $655,537.

Advantages of an intrafamily loan include flexible lending terms, no limitations on how the loan proceeds may be used, interest rates that are generally lower than commercially available rates, avoidance of traditional loan underwriting, avoidance of loan origination and transaction fees, and the ability to keep interest and principal payments in the family. While buying a home seems to be the biggest catalyst for clients considering an intrafamily loan, the borrower may use loan proceeds for other purposes, including paying down high-interest debt, starting a business, or investing the proceeds to achieve potential investment returns that may exceed the interest charged on the loan.

Flexible lending terms may be structured based on the borrower's specific needs and may include terms such as interest-only payments with a balloon payment due at a future date. While the loan will not reduce the lender's gross estate, an intrafamily loan that is invested for returns that exceed the interest rate charged on the loan effectively transfers growth on wealth (the growth of loan proceeds invested exceeding the interest rate paid on loaned funds) to the second-generation borrower without using the lender's lifetime gift and estate tax exemption or possibly resulting in gift taxes for the lender. An intrafamily loan allows a parent or grandparent the ability to help their children achieve their goals without making an outright gift and requiring the responsibility to make timely loan payments.

Disadvantages include paying ordinary income tax rates on interest income received by the lender, no reduction of the lender's estate as the loan principal remains part of the lender's estate, the potential for a loan default to trigger gift tax for the lender, and the borrower not building credit history required to obtain other commercial loans. In addition, intrafamily loans have the potential to affect certain family dynamics such as the relationship between parent and child or between siblings. Lending to only one sibling may be seen as unfair while a potential default may cause family tension. It is recommended that the lender specifies in the promissory note how the loan would be treated upon the lender's death, whether the loan would be forgiven or if the borrower's inheritance would be reduced.

For loans exceeding the annual gift tax exclusion, it is recommended that a signed promissory note be completed and notarized between the parent or grandparent lender and the child borrower to summarize loan terms including the loan amount, interest rate, payment amount, payment frequency, and fixed maturity date. In addition, the borrower must have a reasonable ability to repay the loan. The formal agreement is important for the lender to support taxable interest income reported on their tax return and to avoid reclassification of the loan as a gift.

The parent or grandparent lender may use their annual gift tax exclusion ($17,000 per recipient in 2023) to forgive mortgage payments each year without gift tax consequences. However, for loans exceeding a certain threshold, payments not made by the borrower and forgiven by the lender may be required to be reported as taxable interest income by the lender.

Interest payments made by the borrower may be deductible as an itemized mortgage interest expense if the loan is properly recorded as a lien against the property and secured by a qualified residence. Interest paid by the borrower is not deductible if the loan is an unsecured home loan, used to pay down high-interest debt, or used to pay personal expenses.

We recommend meeting with an experienced, licensed CPA or attorney before establishing and implementing an intrafamily loan to address the implications for estate, gift, and income tax including the tax consequences of possible loan default, debt forgiveness, and the borrower's ability to deduct interest expense.

DeLynn Russell and James Van de Voorde

Sources: IRS, Fidelity, Schwab, Forbes, kitces.com, RBC Wealth Management, Mortgage News Daily

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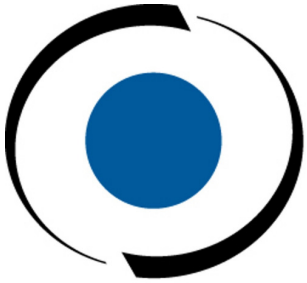

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2023 IRS Tax Inflation Adjustments

Reflecting today's higher cost of living, the IRS has implemented substantial inflation adjustments for 2023. Some taxpayers may see their taxes drop due to the adjustments for many 2023 tax provisions including income-tax brackets, long-term capital gains tax, standard deductions, the annual exclusion for gifts, the exclusion for estate and gift taxes, and the maximum elective deferral to retirement plans and IRAs.

Key Facts for 2023 and the 2023 marginal tax brackets for ordinary income and capital gains are illustrated below:

Key Facts for 2023

- The top marginal tax rate remains 37% for individual filers with income above $578,125 and joint filers with income above $693,750.
- The standard deduction for joint filers increased to $27,700 in 2023 from $25,900 in 2022, while the standard deduction for single filers increased to $13,850 in 2023 from $12,950 in 2022.
- The annual gift tax exclusion is increased to $17,000 in 2023, up from $16,000 in 2022.
- The estates of decedents who die during 2023 have a basic exclusion amount of $12,920,000 in 2023, an increase from $12,060,000 for decedents who died in 2022.
- IRA and ROTH IRA Contribution Limits: $6,500 plus another $1,000 for individuals over 50
- 401(k) Contribution Limits: $22,500 in 2023, up from $20,500 in 2022
- SEP IRA Contribution Limits: 25% of compensation or maximum of $66,000 in 2023
- Long-Term Federal Capital Gains Rate: 20% on taxable income over $492,300 for single taxpayers and taxable income over $553,850 for joint filers
- Long-Term Federal Capital Gains Rate: 15% on taxable income between $44,625 and $492,300 for single taxpayers and taxable income between $89,250 and $553,850 for joint filers
- 3.8% Net Investment Income Tax on investment income, dividends, and capital gains for single taxpayers with AGI greater than $200,000 and married taxpayers with AGI greater than $250,000
- Health Savings Account: $3,850 contribution limit for self-only coverage in 2023, up from $3,650 in 2022, $7,750 contribution limit for family coverage, up from $7,300 in 2022, $1,000 Catch-up for taxpayers over 55

Marginal tax brackets for 2023 tax year

Marginal rate	Individual income	Married couples filing jointly
10%	$11,000 or less	$22,000 or less
12%	$11,000 to $44,725	$22,001 to $89,450
22%	$44,726 to $95,375	$89,451 to $190,750
24%	$95,376 to $182,100	$190,751 to $364,200
32%	$182,101 to $231,250	$364,201 to $462,500
35%	$231,251 to $578,125	$462,501 to $693,750
37%	$578,126 or more	$693,751 or more

Capital gains tax rates for 2023

Long-term capital gains rate	Taxable income
Single filers	
0%	$0 to $44,625
15%	$44,626 to $492,300
20%	$492,301 or higher
Married filing jointly	
0%	$0 to $89,250
15%	$89,251 to $553,850
20%	$553,851 or higher

Sources: IRS, Kiplinger, Schwab, Tax Policy Center