2023 QUARTER 1

OUT OF THE BOX

INVESTMENT COMMITTEE UPDATE

Faith | Trust | Excellence | Care

Our Mission is to help people with complex financial needs experience an **EXCEPTIONAL** life.

Our Investment Committee meets each quarter to review the markets and economy. Three voting members review significant market data and hear from current advisors and appropriate support staff. When necessary the Committee adjusts the model portfolios managed by the firm.

Our Quarterly Newsletter represents the Committee's general thoughts behind any adjustments.

KEY TAKEAWAYS

- The US Economy will possibly experience a relatively short and shallow recession because the Federal Reserve (Fed) continues hiking interest rates.
- Economic indicators continue pointing to challenges for financial markets in the months ahead, and may make it more difficult to understand the ultimate direction forward.
- Through fits and starts, China's relaxation of COVID-19 restrictions may prompt a rebound in goods purchased and lead to a cyclical economic uptick.
- Inflation rates will likely decline slowly in 2023 but remain higher than the market anticipates.
- The Fed could slow its tightening cycle and eventually stop hiking rates during 2023, but its policy rate could remain higher for longer than expected.
- Interest rates—Treasury bill and bond yields are likely to remain volatile and trend lower as recession fears linger.

2022 IN REVIEW

Last year presented unique challenges as stocks and bonds posted double-digit losses for the first time in modern history. In fact, the price of almost all asset categories dropped in 2022, which left very few safe places for investors to hide, especially during inflation.

Typically, the bond market posts either a gain or a small loss in the years that equity prices decline. Usually, diversified portfolio managers use this negative correlation to bring stability to the portfolio, but 2022 presented a severe challenge.

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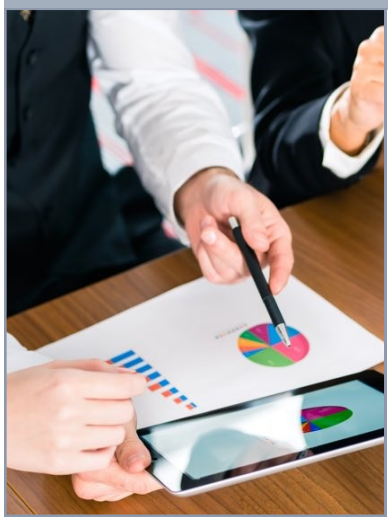
FACTORS CONTRIBUTING TO UGLY 2022

CHALLENGES

Unprecedented Congressional spending and severely limited production of goods were the perfect recipe for record-setting high inflation. This was the first domino in a chain of events that brought 2022 to fruition.

As the Federal Reserve saw inflation rise to 7.48% in January 2022 and peak in June at 9.06%, it began to use monetary tightening to slow the effects of inflation on the economy. Moving the Federal Reserve rate from 0.25% to 4.25% in one year created severe pressure on asset prices and revaluations.

Combine these factors with the painful and ugly geopolitical risks and slowing global growth, and the environment was set for a challenging 2022.



Will a Recession Hit the U.S. Economy?

We believe the chances of the U.S. economy having a recession are moderate. If we do, we think it will be a relatively short, mild recession, most likely to occur in the next six months. Another possible outcome is stagflation. Stagflation is a period of high inflation coupled with little or no economic growth. This avoids the technical term for a recession, as the economy essentially stands still until inflation catches up to where the economy is at. This would mean 2023 likely has a chance of exhibiting ongoing elevated inflation of 3+% and economic growth that remains below long-term trends.

Has the Stock Market Hit Bottom?

The crystal ball remains painfully opaque and foggy as there are cases to be made on both sides and analysts who will argue both positions. The ISM Manufacturing Index, a leading indicator of U.S. manufacturing activity, has decelerated for more than a year and may soon show a contraction in manufacturing output.

More U.S. public sector companies have begun lowering earnings forecasts rather than raising them. Also, a Conference Board survey showed that recession was the biggest concern of corporate chief executives for the U.S. economy (Source 2).

Although the Federal reserve has not stopped raising interest rates, the impact of rate hikes may not be apparent for another six months. These factors would favor the idea that another bottom could be coming; however, stock markets usually begin rebounding aggressively after investors feel comfortable that the Fed is about to stop raising rates or start cutting rates to spur demand. Otherwise, they wait for the employment market to see if it will remain healthy despite plans for continued rate hikes. The last bottom was October 2022, and we could go back there, but the probability that we will rebreak this level seems to be low.

What Is the Outlook for Inflation and Interest Rates?

We believe the Fed will likely boosts its benchmark interest rate to the 5% range before possibly halting rate hikes in the first quarter of 2023 (February and March). Depending on inflation readings and forecasts in the next few months, we think the Fed will likely maintain interest rates at that level, possibly until 2024, when it may start reducing them. (JP Morgan guide to the markets page 34).

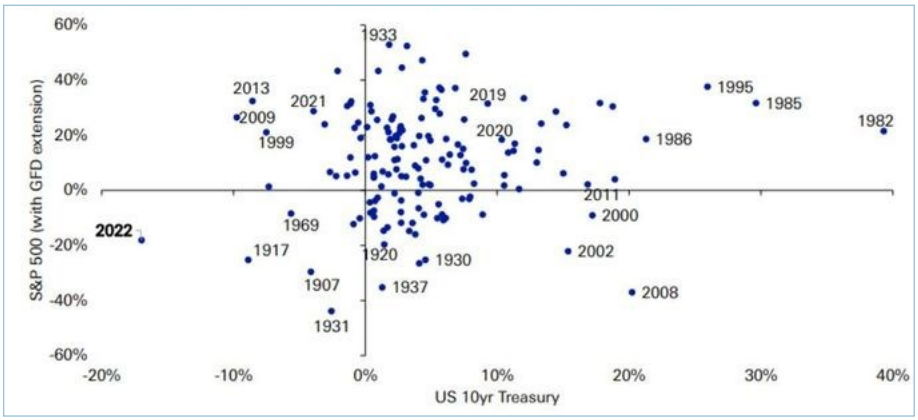
We believe inflation will continue moderating and eventually settle at a higher level (3+%). From January 2010 to December 2020, the average inflation rate was 1.78%. We expect continued inflationary pressure from housing costs, which accounts for a third of the Consumer Price Index, and wages driven higher by the tight labor market.

OUR TEAM

This quarter our team members came together for a service project to pack food at **Feed My Starving Children (**FMSC).

FMSC is dedicated to providing nutritious meals to children worldwide. For more information about this organization, please visit www.fmsc.org.

ANNUAL TOTAL RETURN PERFORMANCE OF THE S&P 500 AND US 10YR TREASURY SINCE 1872



SOURCES

1) **Adinolfi, J.** (2023, January 4). 2022 was the "biggest outlier year" in markets history as stocks and bonds both plunged, Deutsche Bank says. MarketWatch. Retrieved February 22, 2023, from https://www.marketwatch.com/story/2022-was-the-biggest-outlier-year-in-markets-history-as-stocks-and-bonds-both-plunged-deutsche-bank-says-11672859958

2) **CEO Survey: A Recession is the Biggest Worry in 2023.** (2023, January 12). The Conference Board. Retrieved February 22, 2023, from https://www.conference-board.org/topics/c-suite-outlook/press/c-suite-outlook-2023

TOP FACTORS & QUESTIONS FOR 2023

Inflation & Interest Rates

Housing and labor markets will be the two key indicators for us to watch and assess the degree to which the inflation rate may slow in 2023. If inflation can slow, it could provide stopping power for the federal interest rate hikes and rising bond yields.

Fed Tightening

The federal reserve does not have a positive track record regarding raising interest rates. The coveted "soft landing" is when they can settle in at the goldilocks inflation rate that brings balance to the economy. Will 2023 prove to be the year that they can successfully do this? Or will they overcompensate and create unintended consequences?

Jobs

If employers feel a recession is coming, how much are they willing to reduce their workforce? On the other hand, with unemployment rates at 3.4% in January 2023, will this create rising wage pressure as companies compete to fill roles?

China's Economy

After sidelining their economy and manufacturing for over a year due to their zero covid policy, how will a restart impact the world economy? Will it create demand pressure on the world that continues to stoke inflation, or will supply chains loosen up, allowing inflation to finally quell?

SUMMARY

The soft landing scenarios continue to gain traction in the media markets. The consumer economy is picking up strongly, and the financial markets have improved in the last five months. Even the CEO's outlooks are slightly more positive. Still, more promising is that falling energy prices worldwide seems to be having a positive impact on inflation psychology, and higher minimum wages and bigger Social Security payments are now running through many Americans' wallets. Even good savers can now earn almost 5% rates on their savings; just ask us.

But we still believe 2023 uncertainty around these trends will persist well into the year, implying high odds of continued market volatility and a heightened need for significant and quick portfolio modifications. If we are right, labor will be the last component of inflation to cool the cycle. This could cause margins to come under pressure as consumer demand cools but wages remain high. This is why we remain guarded about EPS, where labor costs can rise faster than sales prices.

Taking credit risk seems to make sense currently, and fundamentally; however, small cap and international stocks look appealing as the dollar weakens, but it still is somewhat murky given all the current headlines. Fortunately, the broad-based declines in asset prices in 2022 helped create cheaper valuations of bonds and equities and provide many opportunities in 2023. Historically recessionary periods coincided with high levels of investor pessimism and may end up providing good entry points for new investments.

Yes, 2022 was a year in which we had to act quickly, but the actions we implemented helped protect or portfolios, and now we are ready for the challenges in 2023.

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