Fourth Quarter Update

Dear LMA Clients

Greetings and Happy New Year from LM Advisors. We wish you a healthy, prosperous and successful 2023!

2022 Recap

2022 was a challenging year for equity and fixed income markets, which contended with a confluence of events that negatively impacted financial assets across the board. High-inflation caused by unprecedented stimulus in recent years, the war in Ukraine with significant impact on energy and food markets, and COVID lockdowns in China affecting supply chains, were all major contributors to a highly volatile year.

The major equity and fixed income indexes posted double-digit declines, for the first time in 150 years that this happened in the same year, as investors reassessed asset valuations in light of reduced economic growth expectations and rising rates.

Summary of 2022 major indexes

Equity Market View (As Of 12/31/2022)

Index Name	Level	YTD %
S&P 500	3,839	-19.44%
DJIA	33,147	-8.78%
NASDAQ	10,466	-32.81%
MSCI EAFE	1,943	-16.79%

Fixed Income Market View (As Of 12/31/2022)

Domestic Fixed Income	YTD %
BBGBarc US Aggregate	-13.06%
ICE BofA US Corporates	-15.87%
ICE BofA US High Yield	-11.22%

Global Fixed Income	YTD %
BBGBarcGlobal Aggregate	-16.25%
ICE BofA Global High Yield	-12.71%

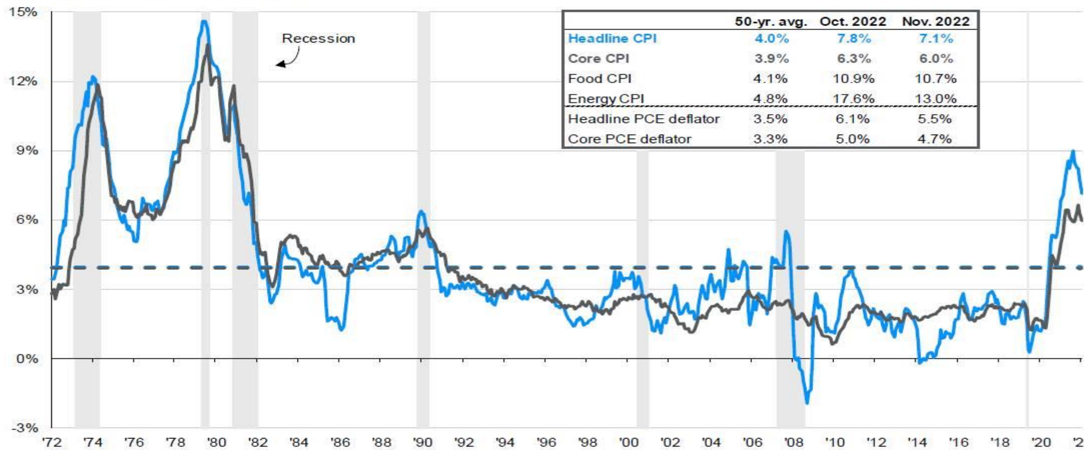
2020 was an unusual year in regards to stock/bond correlation. Generally, when stocks suffer severe declines from unexpected shocks, investors have shifted money out of equities into treasuries in a "flight to safety." In 2022, in the face of rising interest rates, bonds provided no such safe haven. The 10-year Treasury declined 16% as its yield rose from 1.6% to 3.8% over the course of the year. Meanwhile, the S&P 500 stock market index was down 19%.

In this unusual environment, a 60/40 "Balanced Portfolio" therefore did not achieve the moderation in risk and preservation of value that it normally does.

This chart plots the combination of stock/bond returns last year versus the historical observations. It points out the highly unusual circumstance experienced last year.

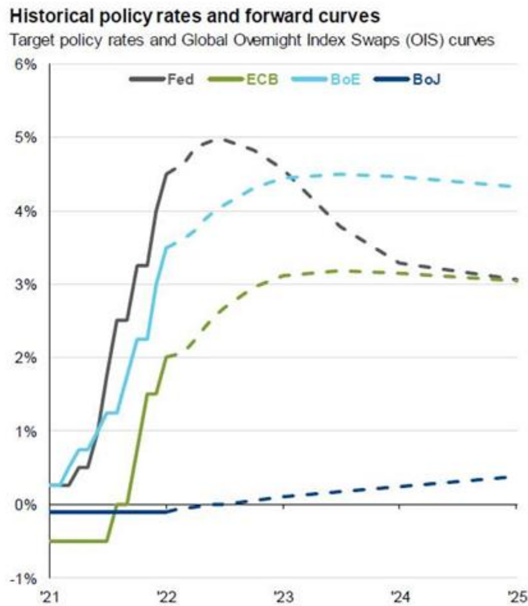
Source: Robert J Shiller; TS Lombard; Financial Times

Beginning in mid-2020, inflation rapidly spiked to levels not seen in decades. It peaked in late 2022 and now shows signs of moderating.



	50-yr. avg.	Oct. 2022	Nov. 2022
Headline CPI	4.0%	7.8%	7.1%
Core CPI	3.9%	6.3%	6.0%
Food CPI	4.1%	10.9%	10.7%
Energy CPI	4.8%	17.6%	13.0%
Headline PCE deflator	3.5%	6.1%	5.5%
Core PCE deflator	3.3%	5.0%	4.7%

To fight inflation, the Fed and central banks around the globe implemented aggressive interest rate hikes at a speed not seen in decades. Central banks use two tools to achieve rate policy objectives. First, they raise the Federal Funds rate (the rate banks charge each other to borrow or lend excess reserves overnight).



Source: J.P. Morgan

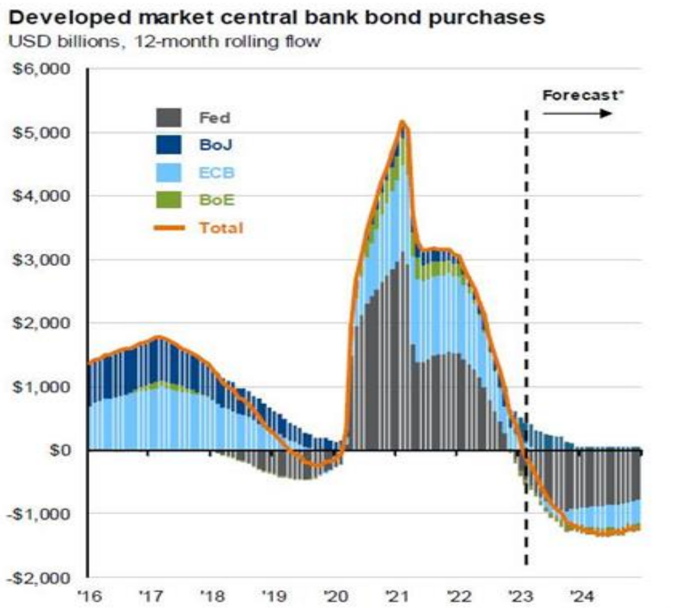
In the current tightening cycle, the Fed has been more aggressive than usual, raising rates from 0-0.25% up to 4.25%-4.50% in a period of only nine months. In previous cycles, the pace of rate hikes was significantly slower.

Time Period	Duration (Months)	Total Change in EFFR (Percentage Points)
Mar 1998 - May 1989	14	3.23
Feb 1994 - Feb 1995	12	2.67
Jun 1999 - May 2000	11	1.51
Jun 2004 - Jun 2006	24	3.96
Dec 2015 - Dec 2018	36	2.03
Mar 2022 - Dec 2022	9	3.90

** We considered a rate hike cycle to be any time period when the Federal Reserve raised rates at two or more consecutive meetings. The 2022 rate hike cycle is ongoing with data as of December 2022.*

Source: Federal Reserve Economic Data, St. Louis Fed
**EFFR is the effective Fed Funds rate which is a weighted average of rates during the period of time*

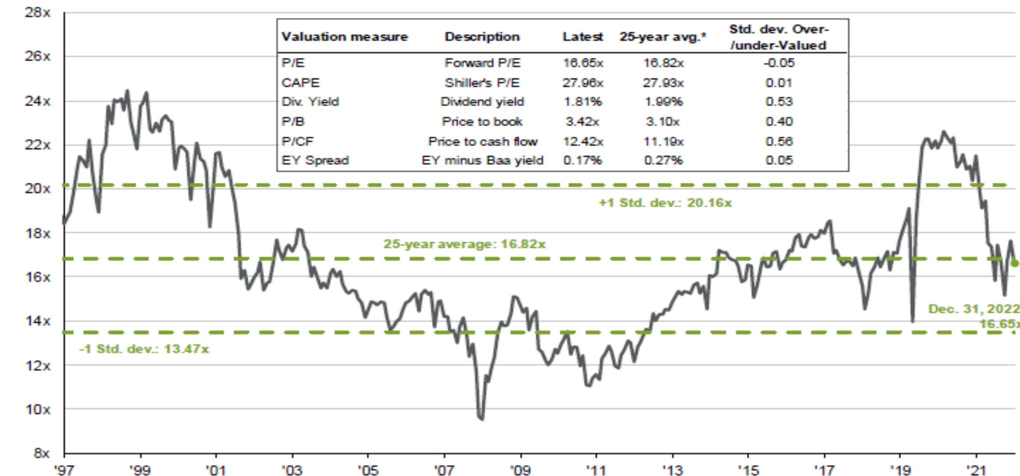
Secondly, the Fed has started an aggressive program to reduce its balance sheet to take out liquidity from the system. The current quantitative tightening ("QT") cycle is a reversal of the quantitative easing ("QE") cycle that occurred in 2020 in response to the Covid lockdowns. The Fed rapidly expanded its balance sheet in response to Covid and is now aggressively reducing it.



Source: J.P. Morgan

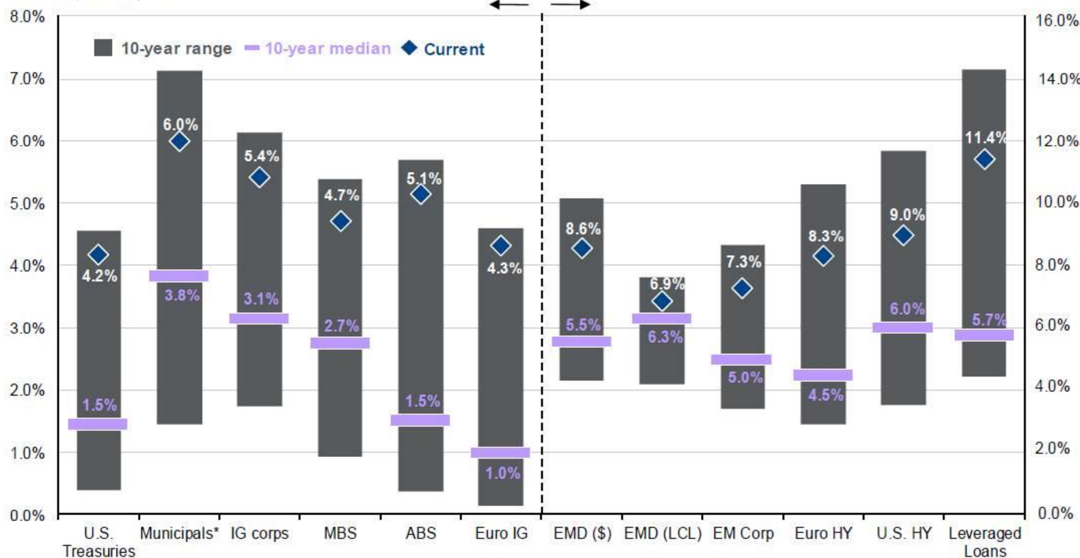
On a positive note, as a consequence of asset prices falling across the board, today's valuations are more reasonable than what they were a year ago.

Forward Price/Earnings ratios more in line with historical levels:



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

Expected returns on different fixed-income sectors are also well above their respective 10 year medians:



Source: Bloomberg, FactSet, J.P. Morgan Credit Research, J.P. Morgan Asset Management. Indices used are Bloomberg except for emerging market debt and leveraged loans: EMD ($): J.P. Morgan EMIGLOBAL Diversified Index; EMD (LCL): J.P. Morgan GBI-EM Global Diversified Index; EM Corp.: J.P. Morgan CEMBI Broad Diversified; Leveraged loans: JPM Leveraged Loan Index; Euro IG: Bloomberg Euro Aggregate Corporate Index; Euro HY: Bloomberg Pan-European High Yield Index. Yield-to-worst is the lowest possible yield that can be received on a bond apart from the company defaulting. All sectors shown are yield-to-worst except for Municipals, which is based on the tax-equivalent yield-to-worst assuming a top-income tax bracket rate of 37% plus a Medicare tax rate of 3.8%.
Guide to the Markets – U.S. Data are as of December 31, 2022.

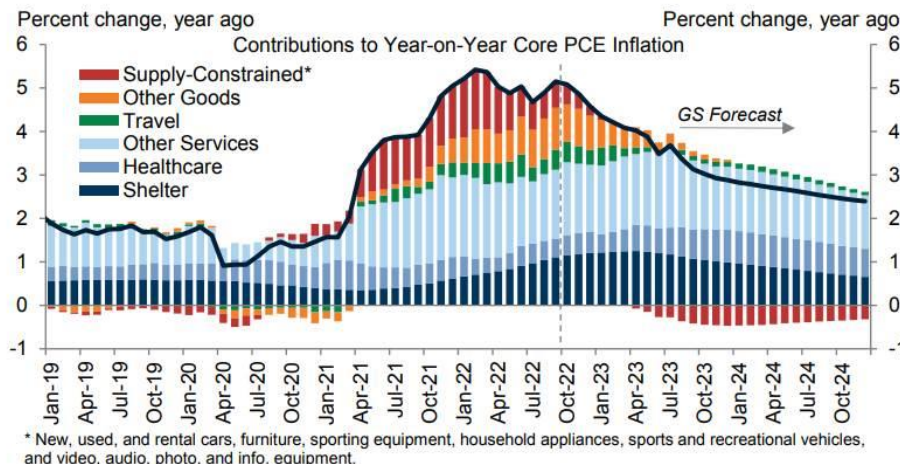
J.P.Morgan
ASSET MANAGEMENT

As the year drew to a close, inflation indicators showed signs of moderating. After rapidly rising through the October, the CPI in November posted a 12-month change of 7.1% following larger increases as high as 9.1% earlier in the year. Looking at the monthly figures, November saw a rise of just 0.1% compared to a 1.3% increase in June.

When the volatile Food and Energy components are stripped out (core inflation), the index declined modestly from a peak of 6.6% in September to 6.0% in November. Supply constrained goods were the largest contributor at the start of the inflation cycle, but as supply constraints eased the drivers of inflation have shifted towards the service-oriented sectors.

As the economy cools in a higher interest rate environment, continued declines in the inflation rate are forecasted.

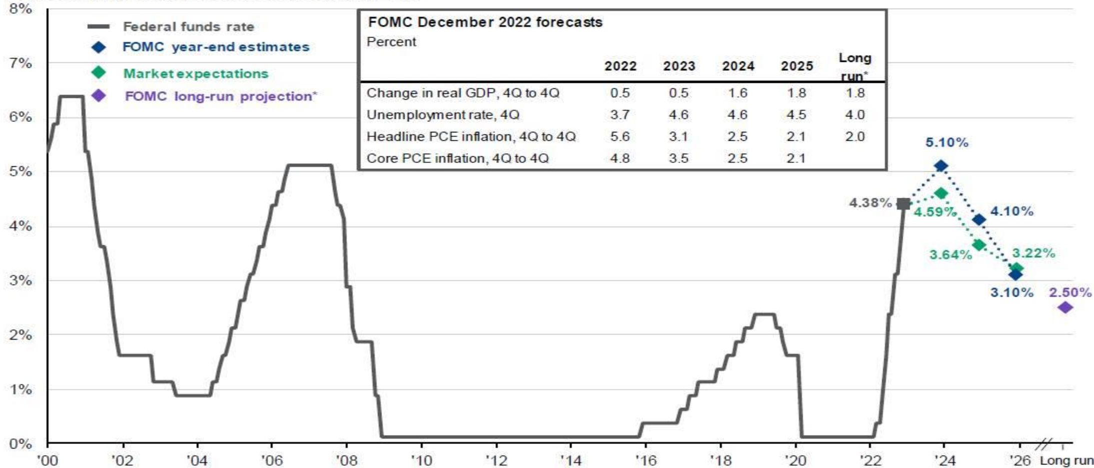
Exhibit 10: Core PCE Inflation Will Likely Decline to 2.9% by End-2023 on Goods Disinflation and Slower Shelter Inflation in H2



Source: Haver Analytics, Goldman Sachs Global Investment Research

2023 Outlook

We believe inflation will continue its trend of moderation and we will likely have a mild recession as the level of interest rates begins to have a more significant impact on the economy. As inflationary pressures ease the Fed should stop its rate hikes in the upcoming months after its latest hike to 4.5% in December. There is a wide range in opinions on how high the Fed will have to go before pausing which could be as low as 4.75% or as high as 6%.



	2022	2023	2024	2025	Long run*
Change in real GDP, 4Q to 4Q	0.5	0.5	1.6	1.8	1.8
Unemployment rate, 4Q	3.7	4.6	4.6	4.5	4.0
Headline PCE inflation, 4Q to 4Q	5.6	3.1	2.5	2.1	2.0
Core PCE inflation, 4Q to 4Q	4.8	3.5	2.5	2.1	

However, the shape of the curve is a warning signal that the economy could be headed into difficult times in the months ahead. As the Fed rate hike cycle gained momentum in 2022 the yield curve first inverted (2-year Treasury note yields rose above that of the 10-year note) in July and has grown steeper. This phenomenon has preceded every recession since the 1960s and signals investor concern of a potential recession.

Most economists assign a higher than 50% probability of a recession in the next twelve months.

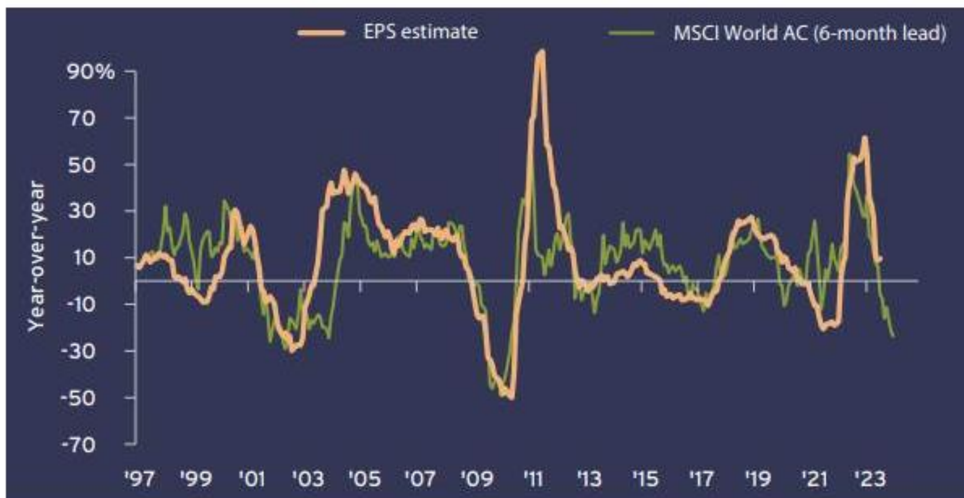
In the case of a recession, the main risk to portfolios will be earnings growth and we believe equities are more vulnerable than fixed income and alternatives. Despite the ~20% decline in the S&P 500 last year, in the event of a recession we would expect earnings to decline which could cause further declines in stock prices.

Certain models are forecasting slower or negative growth in earnings over the next 12 months.

Leading earnings indicators point to S&P 500 earnings decline, Percent

Source: Morgan Stanley US Equity Strategy. October 2022.

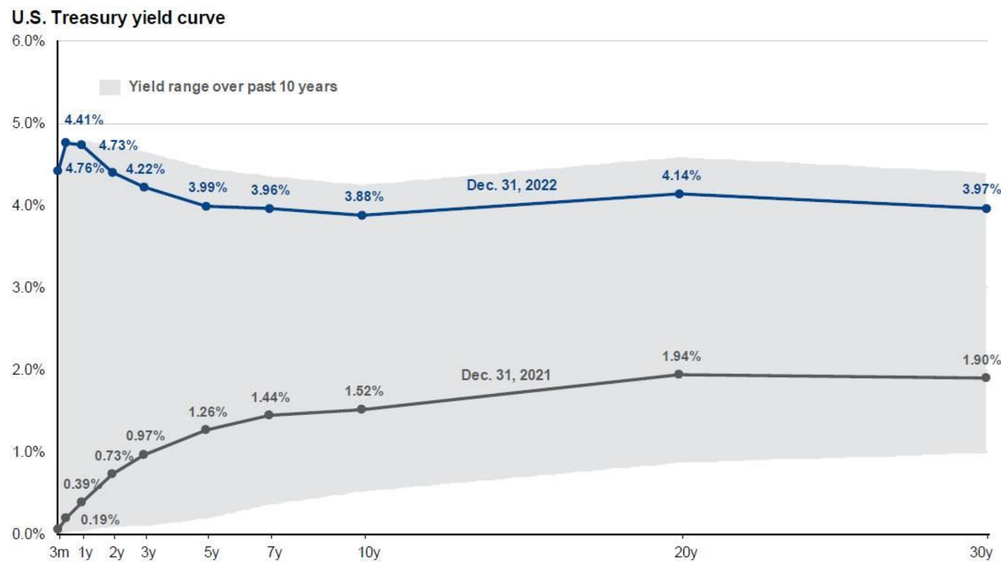
Markets are forward looking and tend to drop <u>before</u> actual earnings declines. In the chart below, we can see the high correlation between stock market levels and earnings estimates with a 6-month lag.



Source: Haver, as of 30 Nov 2022. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary. All forecasts are expressions of opinion, are subject to change without notice, and are not intended to be a guarantee of future events.

On the other hand, bond yields are at the high end of their 10-year average, providing opportunity for fixed-income investors. While before there was not an alternative to equities forcing investors to allocate a higher percent to risky assets, current yields provide a viable alternative.

Yields today (blue line) have increased significantly versus a year ago (gray line):



We will be looking to for opportunities to continue to shift portfolios towards cashflow generating investments such as dividend stocks (for US investors), options with protection, investment grade corporate bonds, municipal bonds and alternative credit. To counter recession risk, we want to be underweight growth and cyclical stocks as well as high yield bonds.

If a recession takes hold, we will have an opportunity to reposition portfolios in areas such as cyclicals and small cap stocks, and high yield bonds at the upper end of the quality spectrum which typically offer superior returns in that phase of the economic cycle.

No doubt 2022 was a challenging year for all of us. We want to reassure everyone our unconditional commitment to provide the best possible advice to our clients keeping their long-term interest at the center of everything we do.

Each portfolio is based on the individual needs to each LMA client. Please contact your financial advisor to discuss in detail the specific implications for your portfolio and if any adjustments are required.

We sincerely thank you for the trust you place in us. We appreciate it and take it with the outmost sense of responsibility.

Sincerely,
LMA Team

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