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2022 | Q4 Market Brief

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I – DOMESTIC MARKETS OVERVIEW

U.S. Equities Mitigate Calendar Year Losses

Markets Recover Over Final Quarter of Year

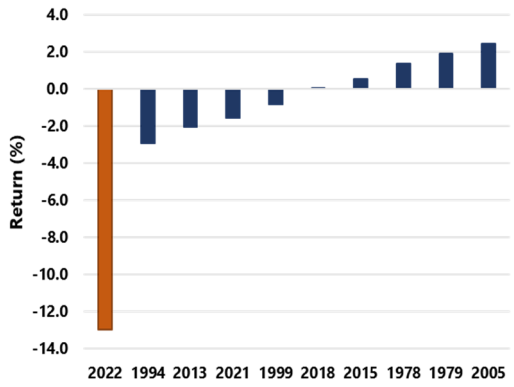
Following a difficult first nine months of the year, equity markets rebounded over the fourth quarter of 2022. Investors weighed the likelihood the U.S. Federal Reserve may begin to slow the pace of interest rate increases as inflation began to cool and as the U.S. economy appears poised to enter into a recession. A resilient labor market and weaker U.S. dollar also buoyed domestic markets (S&P 500 **+7.6%**) (Exhibit A). Most sectors advanced, with value-oriented sectors performing particularly strongly (S&P 500 Energy **+22.8%**; S&P 500 Financials **+13.6%**; S&P 500 Materials **+15.0%**). Traditionally defensive sectors (S&P 500 Consumer Staples **+12.7%**; S&P 500 Healthcare **+12.8%**; S&P 500 Utilities **+8.6%**) also performed well, while higher valuation consumer and communication services companies continued to underperform (S&P 500 Consumer Cyclicals **-12.2%**; S&P 500 Communication Services **-1.4%**). Smaller capitalization companies also advanced over the final quarter of the year (Russell 2000 **+6.2%**), as risk-on sentiment extended across market capitalization. Despite a strong fourth quarter, U.S. equities endured their worst calendar year since the global financial crisis (S&P 500 **-18.1%**), as inflationary concerns and the Russian invasion of Ukraine led to higher volatility across markets.

Exhibit A: Trailing Asset Class Returns (Select Indices; through 12/31/2022) *Source: Morningstar*

Index	3-Month	YTD	12-Month	3-Year	5-Year
Capital Preservation (US 3-Month T-Bill Index)	1.05	2.13	2.13	0.85	1.34
U.S. Fixed Income (Bloomberg US Agg Bond Index)	1.87	(13.01)	(13.01)	(2.71)	0.02
U.S. Large Cap Equity (S&P 500 Index)	7.56	(18.11)	(18.11)	7.66	9.42
U.S. Small Cap Equity (Russell 2000 Index)	6.23	(20.44)	(20.44)	3.10	4.13
International Equity (MSCI ACWI Ex USA Index)	14.28	(16.00)	(16.00)	0.07	0.88
Global Real Estate (FTSE EPRA/NAREIT Developed Index)	6.85	(25.09)	(25.09)	(4.93)	(0.23)

Bond Market Pain Eases Over Final Portion of the Year

Exhibit B: Bond Market Returns *Source: Morningstar*
Ten Worst Calendar Years on Record



As with domestic equity markets, fixed income markets improved over the last three months of 2022. While yields on shorter-maturity bonds increased, muted increases across the intermediate- and longer-dated portion of the Treasury yield curve, coupled with narrowing credit spreads, led to a positive fourth quarter for the aggregate bond market (Bloomberg Barclays U.S. Aggregate Bond Index **+1.9%**). The relief, however, only slightly mitigated what was easily the worst calendar year on record for the Index, whose inception dates back to 1975 (Exhibit B). Cooling inflation, coupled with hopes the Federal Reserve would slow the pace of interest rate increases, underlined an improvement in market conditions. Notwithstanding concerns over a possible domestic recession, high yield bonds outperformed (ICE BofA US High Yield Index **+4.0%**), as did other areas of the credit market, with government-backed securities generally underperforming. A sharp decline in the U.S. dollar along with newfound optimism over an easing of COVID restrictions in China led to a rally in international fixed income markets, particularly those denominated in local currencies.

I – DOMESTIC MARKETS OVERVIEW (Cont.)

Fed Maintains Policy Course

Interest Rate Increases Continue as Labor Market Resiliency Provides Flexibility to Bank

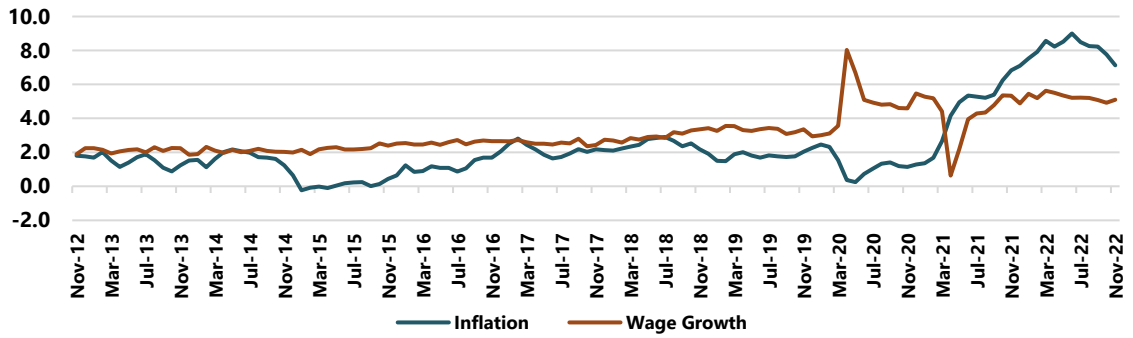
In December, the U.S. Federal Reserve maintained its policy stance and continued to raise interest rates in the face of inflationary conditions. The Fed increased its key Federal Funds Rate to **4.25-4.50%** and provided guidance on policy rates heading into calendar year 2023. The Fed indicated it will continue to proceed with additional rate increases over the next twelve months, as it balances the goal of fighting inflation while seeking to support the overall labor market. Unsurprisingly given the uncertain economic outlook, surveyed officials provided disparate views over longer term rate expectations. Coinciding with the interest rate increases, the central bank continued to reduce the size of its balance sheet over the quarter in accordance with pre-prescribed policy. The December rate increases to end 2022 cap an extraordinary year marked by a velocity and magnitude of rate movement not seen since the 1980s.

Economic Output Rebounds Amidst Strong Labor Market

After two consecutive quarters of negative growth, the U.S. economy grew over the third quarter of 2022, with output advancing an estimated 3.2% on an annualized basis. A strong consumer, narrowing trade deficit, and increases in government spending all contributed to third quarter growth. This more than offset bloated business inventories and warning signs in the U.S. housing market. Notwithstanding the relatively positive report on the domestic economy, most economists and investors continue to believe the U.S. will enter into recession at some point during calendar year 2023 or 2024. As a result, many employers have slowed hiring in recent months or have resorted to reducing headcount.

Underlying recent economic strength is the continued performance of the U.S. labor market. While job growth has decelerated somewhat over the last several months, overall levels of unemployment remain very low (December Unemployment Rate: 3.5%), while broader measures of underemployment (December U-6 Rate: 6.5%) continued to improve. Employment gains have supported consistent wage growth. While wage growth remained stable over the course of the year (5-6% annualized growth), it has continued to trail overall inflation levels. Price increases, however, have begun to moderate somewhat. Prices increased 7.1% year-over-year in November, the smallest increase since December 2021 (Exhibit C). Energy market stabilization, coupled with challenges in the domestic real estate market, have helped cool the overall level of prices. And although consumer sentiment remains relatively weak, consumer angst over inflation has come down over the last couple of months.

Exhibit C: Inflation and Wages (CPI-U and Year-Over-Year Wage Growth) *Source: U.S. Federal Reserve*



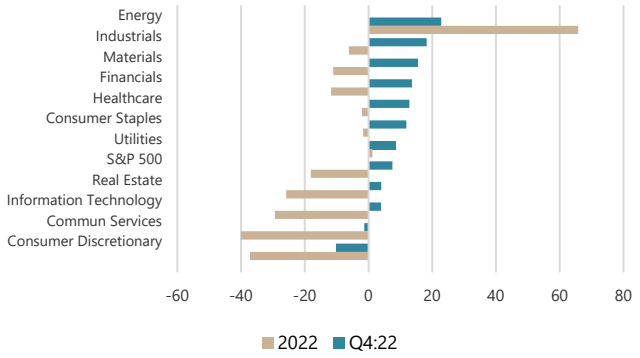
I – DOMESTIC MARKETS OVERVIEW (Cont.)

Market Contributors

Energy Continued to Shine as Equity Markets Rebounded

After declining for three quarters in a row, the S&P 500 Index advanced in the final quarter (**+7.6%**), although it was still down for the year (**-18.1%**). While stocks and bonds typically move in opposite directions, 2022 was the first year both the S&P 500 Index and the Aggregate Bond Index declined. High inflation weighed on stocks and bonds throughout the year. The energy sector was one of the only bright spots, advancing 65.8% in 2022 and 22.8% in the fourth quarter. The gains in the sector were primarily due to sanctions on Russia, one of the largest oil and gas exporters. Sixteen of the twenty top performing companies in the S&P 500 Index in 2022 were in the energy sector. Defensive areas of the market also did well over the quarter and the year due to recession fears. However, positive economic data at the end of the year, aided more economically sensitive sectors.

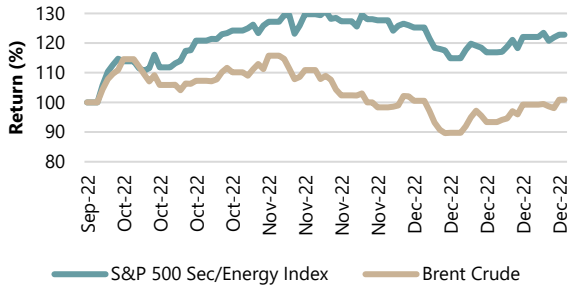
Exhibit D: **S&P 500 Sector Returns Q4 and 2022** *Source: Morningstar*



Unusually, for much of the fourth quarter, the price of oil and the price of energy companies diverged (Exhibit E). Oil prices were negatively impacted early in the quarter by an abnormally mild winter in Europe, the European Union's price cap on Russian oil, and concerns about the Federal Reserve inducing a recession. However, oil prices remained comfortably above the level energy companies needed in order to generate profits, while China's abrupt abandonment of its zero-Covid policy was expected to spur demand in the coming year. China's reopening, and softening inflation data in the United States in November and December, also aided commodities producers, such as copper producer Freeport-McMoRan.

Over the quarter, large industrial companies also did well. Airline manufacturer Boeing was one of the best performing stocks as it received the largest ever wide-body jet order from a U.S. air carrier. Construction equipment manager Caterpillar also performed very well. Its orders have held up, and it has been able to pass on price increases to its customers.

Exhibit E: **Energy Stocks v. Crude Prices** *Source: Morningstar*



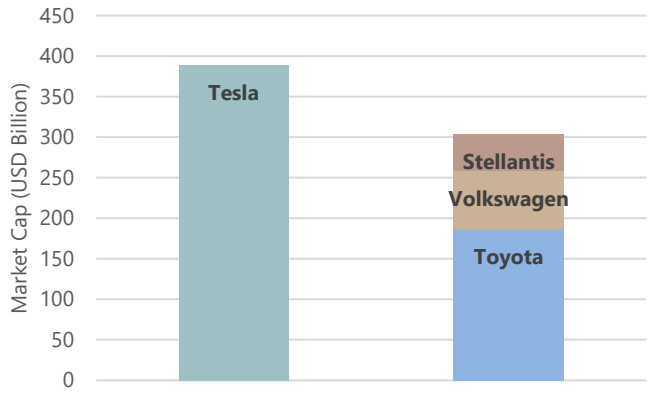
Lower than expected inflation at the end of the year resulted in the yield curve flattening, and fixed income sectors generally advanced. Investors anticipated that lower than expected inflation would lead to fewer rate hikes from the Federal Reserve than previously thought, which negatively impacted the U.S. dollar and aided international bonds in both developed and emerging markets. Robust economic data also benefited more credit sensitive fixed income, such as high yield and investment grade bonds. Long bonds outperformed given the flattening of the yield curve.

I – DOMESTIC MARKETS OVERVIEW (Cont.)

Market Detractors

Growth-Oriented Companies Continue to Underperform

Exhibit F: **Tesla Market Capitalization v. Top Three Carmakers by Revenue 12/31/2022** *Source: Companiesmarketcap.com*



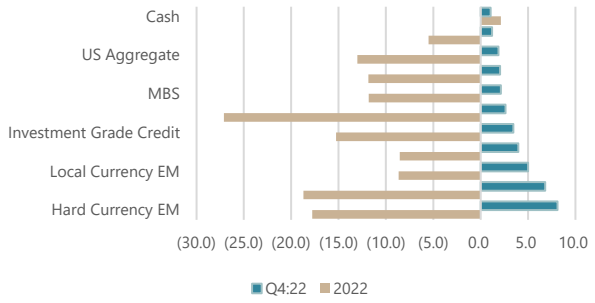
The consumer cyclical and communication services sectors were the worst performing areas of the market for the quarter and the year at large. Previously favored companies like Tesla, Amazon, and Meta continued to underperform as investors soured on growth companies in a world with higher interest rates.

Tesla peaked last year with a market capitalization of over $1.2 trillion, more than almost all other car companies put together, but has subsequently lost 71% of its market value. Investors previously valued the company based on high expectations for future growth, which made the stock vulnerable to rising rates. However, in Q4 the company was penalized for issues common to the car industry, including factory shutdowns and increased competition from rivals. CEO Elon Musk's purchase of Twitter has also been seen as a distraction. Despite the selloff, Tesla's market value is still higher than the next three biggest carmakers by revenue combined (Exhibit F).

Amazon overexpanded during the pandemic and is now suffering from the "goods recession," as consumers shift towards services. The company also reported disappointing financial results over the quarter, including below expected growth in its Web Services business. Unlike Tesla and Amazon, more defensive areas of the consumer cyclical sector, including Starbucks, McDonalds and Yum Brands (parent company of Taco Bell, KFC, and Pizza Hut) all outperformed.

Communication services giants Meta and Alphabet continued to decline as their advertising-dependent business models struggled. Match Group, the company that owns dating services like Tinder, was one of the worst performers over the quarter and the year. The company heavily invested to create a metaverse, which it recently shuttered. The firm's core business has also suffered as fewer singles are signing up for online matchmaking.

Exhibit G: **Fixed Income Returns Q4 & 2022** *Source: Morningstar*



Real estate underperformed as higher interest rates weighed on the heavily leveraged sector. Over the fourth quarter, residential real estate companies fared especially poorly. After years of substantial rent increases, rent growth is expected to slow or reverse as the supply of apartments is set to expand and the industry pushes against the limit of how much renters can pay.

Because rates on the short end of the yield curve increased as the Federal Reserve continued to hike rates, short-term bonds and cash underperformed. Commercial mortgage-backed securities also underperformed as investors expect higher delinquency rates for many property types, such as offices, going forward.

II – INTERNATIONAL MARKETS OVERVIEW

World View

Inflation Optimism Fuels Gains and Sends the U.S. Dollar Tumbling

After declining over the first three quarters of the year, international equities advanced strongly alongside domestic equities during the final quarter of 2022 (Exhibit H; MSCI World Index Q4: 9.8%). We also began to see positive returns in fixed income markets as a degree of clarity emerged regarding future interest rate hikes. In an interesting dynamic, global markets responded to cooling economic data with positivity, despite growing concern that a recessionary environment may take hold in 2023. Mild economic pain is now seen as good news, as it helps to alleviate investor angst over inflation. Signs of inflation easing in the United States and Europe fueled optimism around the world that we may soon turn the tide and dial back the need for further monetary tightening. Central banks continued to walk the tightrope of battling inflation and inducing economic recession, with recent inflection points offering guarded optimism as we move into 2023.

Exhibit H: **Global Equity Returns (%)**
Select Countries and Regions as of Q4 2022. Currency: USD and local.
Source: Morningstar.

Global Equity Returns by Country				
Region/Country	Q4:22		1-Year	
	USD	Local	USD	Local
MSCI Australia	15.7%	9.7%	-5.3%	1.6%
MSCI Canada	7.4%	5.9%	-12.9%	-6.5%
MSCI China	13.5%	12.5%	-21.9%	-20.7%
MSCI France	22.2%	12.2%	-13.3%	-7.7%
MSCI Germany	24.6%	14.3%	-22.3%	-17.3%
MSCI Italy	26.4%	16.0%	-14.4%	-8.8%
MSCI Japan	13.2%	3.2%	-16.6%	-4.5%
MSCI United Kingdom	17.0%	8.6%	-4.8%	7.1%
MSCI USA	7.0%	7.0%	-19.8%	-19.8%
MSCI ACWI Ex USA	14.3%	7.8%	-16.0%	-9.6%
MSCI EAFE	17.3%	8.7%	-14.5%	-7.0%
MSCI EM	9.7%	6.6%	-20.1%	-15.5%
MSCI AC Asia Ex Japan	11.4%	8.2%	-19.7%	-15.4%
MSCI AC Asia Pacific	12.5%	6.7%	-17.2%	-10.4%
MSCI Europe	19.3%	10.4%	-15.1%	-8.5%
MSCI North America	7.0%	6.9%	-19.5%	-19.2%
MSCI World	9.8%	7.5%	-18.1%	-16.0%

International equities easily outperformed domestic equities over the fourth quarter of the year (MSCI ACWI ex USA Index Q4: 14.3%; MSCI USA Index Q4: 7.0%), which also brought trailing one-year returns for international markets ahead of the United States (MSCI ACWI ex USA Index 2022: -16.0%; MSCI USA Index 2022: -19.8%). The Eurozone had a particularly strong quarter (MSCI Europe Q4: 19.3%), led by outperformance from more economically sensitive sectors (energy, financial services, industrials, consumer discretionary). Gains were supported by optimism surrounding an improved inflation situation, with both the European Central Bank and the Federal Reserve slowing the pace of interest rate hikes to 0.50% in December, down from previous hikes of 0.75%. Sentiment faded over the course of December, however, as central banks reaffirmed their commitment to stamp out inflation, causing most equity markets around the world to retreat once again.

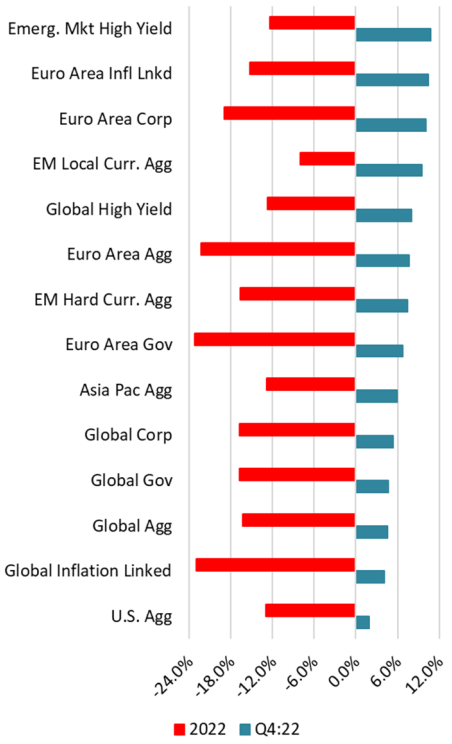
China ended the year on a more positive note (MSCI China Q4: 13.5%) due to an abrupt relaxation of zero-COVID policies. Broad reopening of the Chinese economy spurred financial markets higher in December. The country continues to face challenges with a rapid rise in COVID infections, a slump in manufacturing, and a beleaguered housing sector, but sees strong growth prospects due to three years of pent-up demand. Geopolitical risk remains as the war in Ukraine wears on and China asserts its eventual desire to assimilate Taiwan, by conducting extensive military exercises around the island. Alleviation has come on several fronts, however, in the form of a mild winter in Europe, which has softened energy price pressures, and warming ties between the U.S. and China as President Biden and President Xi Jinping have restored dialog and expressed a desire to improve relations.

II – INTERNATIONAL MARKETS OVERVIEW (cont.)

World View (Cont.)

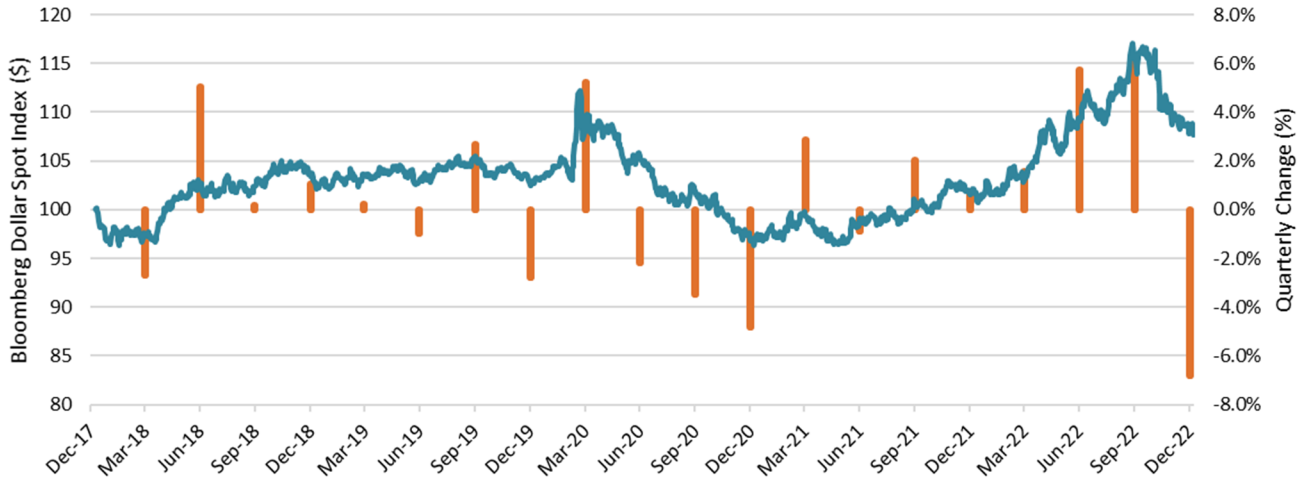
An exceptionally strong United States dollar (USD) served as a detractor to international markets for much of 2022, as a relatively healthy economic backdrop in the United States and aggressive Fed policy resulted in high interest rates and a soaring USD. This trend reversed in Q4:22 as signs of inflation turning over allowed the Fed to slow the pace of rate hikes. The resulting shift in market expectations caused a sharp decline in the USD relative to other G10 currencies. The U.S. Dollar Spot Index declined nearly 7% in Q4:22 (Exhibit J), eroding much of its gains realized earlier in 2022. The currency's sharp decline boosted returns across international markets and hindered returns in domestic markets, causing the U.S. to trail much of the world in Q4:22 (MSCI USA Q4: 7.0%; Bloomberg US Agg Bond Index Q4: 1.9% (Exhibit I)). The tailwind for domestic investors in international markets may continue as the spread in policy rates between the Fed and foreign central banks is expected to narrow in 2023.

Exhibit I: **Global Fixed Income Returns (%)**
Select Regions and Sectors as of Q4 2022 in USD.
Source: Morningstar.



Global fixed income markets saw some respite in Q4:22 due to the shifting inflation story. In a unique year where both equity and fixed income markets moved sharply lower, the prospect of less hawkish monetary policy and a weakening global economic outlook helped fixed income markets advance over the final quarter of the year. Higher yielding bonds benefitted from narrowing credit spreads as improved risk sentiment to start the quarter was met with a more restrictive tone from central banks to end the quarter, which had an outsized impact on government bonds and the short end of the curve. Inflation-linked bonds generally lagged the broader fixed income market due to the changing inflation picture, with the exception of the Euro area, which saw strong positive returns during rate hikes early in the quarter turn slightly negative in December.

Exhibit J: **U.S. Dollar Spot Index Price ($) and Quarter over Quarter Change (%)**
Data as of January 6, 2023. Source: Bloomberg.

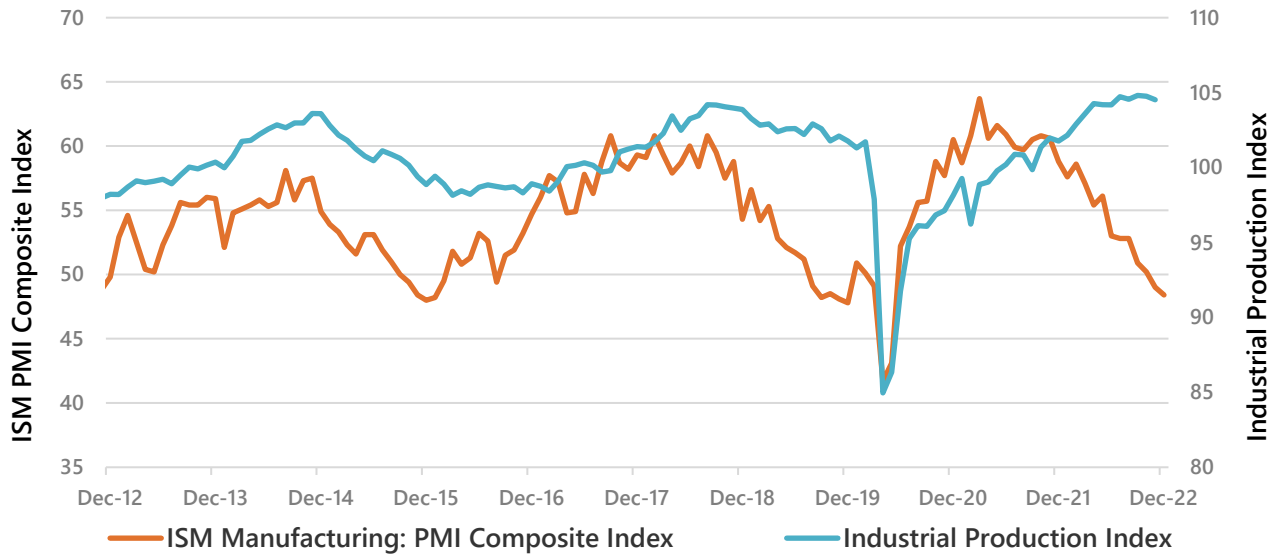


III - LEADING ECONOMIC INDICATORS (Cont.)

Manufacturing and Industrial Output

Exhibit K: **Industrial Production and ISM PMI Indexes**
(Trailing 10-year)

Source: Federal Reserve Bank of St. Louis, Institute for Supply Management,



ISM PMI Composite Index (U.S.) – The Institute for Supply Management (ISM) Purchasing Managers Index (PMI) combines five manufacturing indicators (new orders, production, employment, deliveries, and inventories) to create a composite view of national manufacturing activity. A PMI reading above 50 generally indicates manufacturing expansion.

Industrial Production Index (U.S.) – Calculated by the Federal Reserve, the Industrial Production Index measures real output for all facilities located in United States, including manufacturing, mining, electric utilities, and gas utilities.

Manufacturing Sector Contracts After Twenty-Nine Months of Expansion

The ISM PMI Composite Index showed a decline in manufacturing growth during November and December 2022, ending its twenty-nine consecutive months of expansionary readings spanning the global pandemic recovery. The December Manufacturing PMI reading of 48.4 was the lowest figure reported since May 2020. Slowing growth in the manufacturing sector continued to be partly attributable to softening demand with the New Orders Index falling into its fourth month of contractionary territory. After thirty months of continuous expansion, the Production Index also entered a contractionary period in December as the reading registered three percentage points lower than in November. These factors, combined with growing concern of a global economic slowdown, have led to a steep decline in price growth over the past twelve months. During 2022, the Prices Index started at 76.1, hit its peak of 87.1 in March, then fell to 39.4 in December.

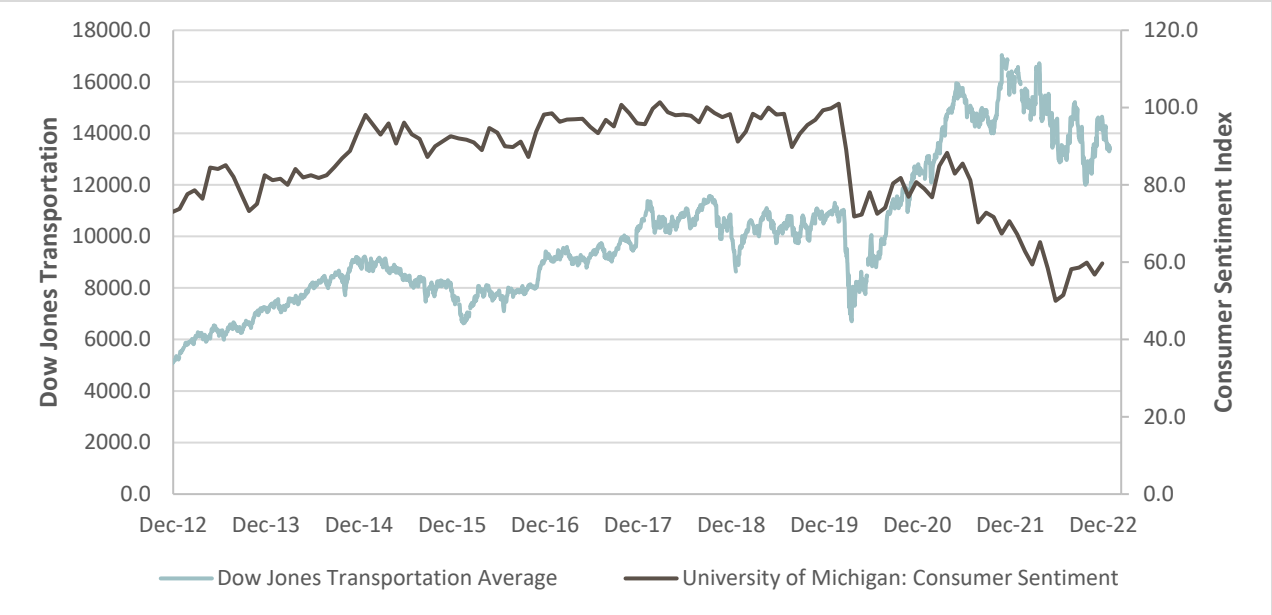
The Industrial Production Index has generally leveled over the year with market groups posting mixed results. Consumer goods, business equipment, construction supplies, and materials declined while the production of consumer energy products, energy materials, and defense and space equipment grew. The decline in consumer goods was primarily related to automotive products, while the production of business equipment was impacted by a decrease in transit and industrial equipment. Overall, the Index grew 2.3% from January to November.

III - LEADING ECONOMIC INDICATORS (Cont.)

Commercial Activity

Exhibit L: **Transportation Index and Consumer Sentiment**
(Trailing 10-year)

Source: Morningstar, Thomson Reuters/University of Michigan



The Dow Jones Transportation Index – The Dow Jones Transportation Index represents the stock price movement of 20 of the nation's largest transportation firms, including trucking, airlines, and railroads. It is commonly used as a forward indicator for future commercial and industrial activity.

Consumer Sentiment Index – Conducted by the Survey Research Center under direction from the University of Michigan, this index reflects the personal and overall economic outlook of respondents. The survey is widely used as a proxy for future consumer spending expectations.

Dow Jones Transportation Index Rebounds, Consumer Sentiment Continues to Rise from Lowest Level Ever

The Dow Jones Transportation Index (DJT) rebounded 11.6% over the fourth quarter after the index dropped 8.4% in the third quarter of 2022. The quarterly gain was driven in part by FedEx, which rebounded 16.7% in Q4 after dropping 21% in the third quarter on missed earnings – causing the entire transportation index to decline. Strong earnings from shipping corporations in the fourth quarter counteracted signs that a weakening global economy, particularly in Europe and Asia, is weighing on the overall transportation industry. While a recession may still be on the horizon, the transportation sector is expected to continue to face headwinds in the near term.

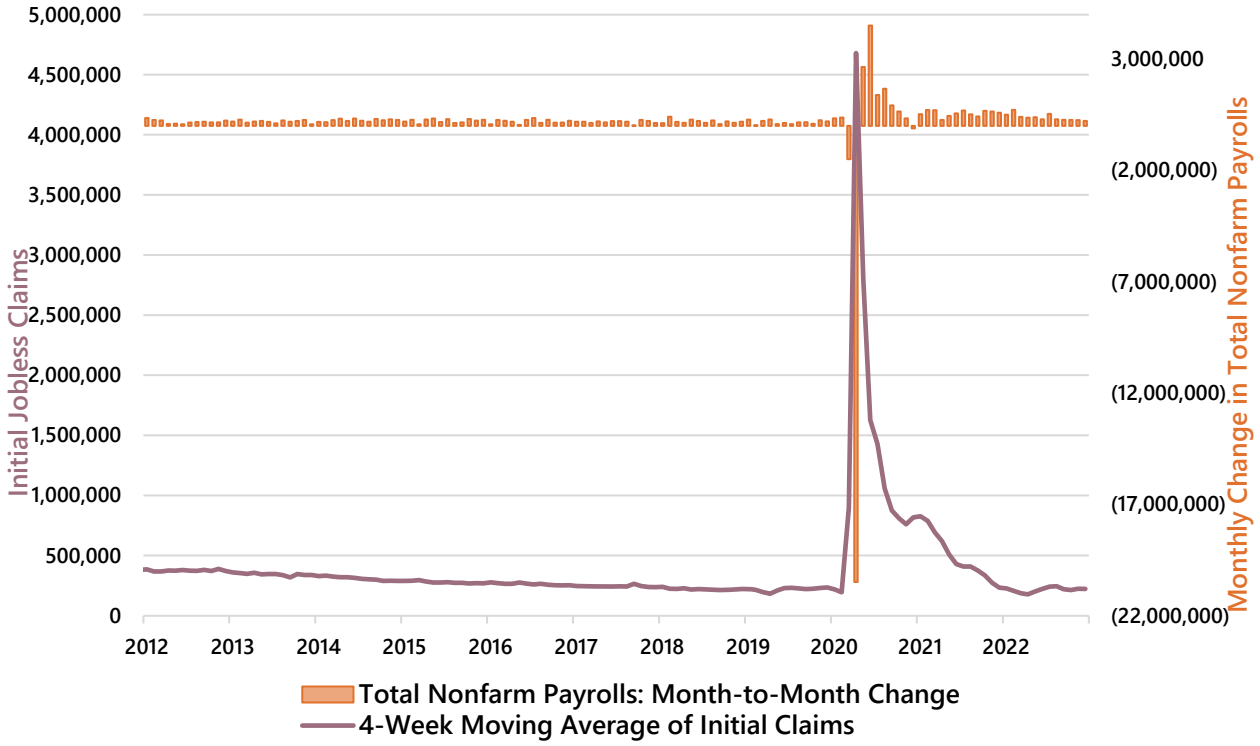
The Consumer Sentiment Index increased to 59.7 in the fourth quarter, increasing from 58.4 in the third quarter. Sentiment rebounded from an all-time low of 50.0 in the second quarter but is still down over the one-year period. Sentiment increased last quarter due to consumer's negative attitudes softening due to easing pressures of inflation. The year-ahead inflation outlook fell from 4.9% annually to 4.4% at the end of the fourth quarter. Sentiment remains low, however, due to consumers exhibiting substantial uncertainty over the future path of prices. Consumers are also continuing to report the least favorable economic prospects in over a decade.

III - LEADING ECONOMIC INDICATORS (Cont.)

Labor Markets

Exhibit M: **Initial Jobless Claims and Total Nonfarm Payroll**
(Monthly, seasonally adjusted, 2012-current)

Source: Federal Reserve Bank of St. Louis, BLS



Total U.S. Nonfarm Payrolls – U.S. Bureau of Labor Statistics statistical measure representing the total number of paid U.S. workers of any business, excluding government employees, private household employees, employees of some nonprofit organizations, and farm employees.

Initial Jobless Claims (4-week moving average) – Initial Jobless Claims readings are issued by the U.S. Department of Labor. This indicator measures the number of unemployed who are filing for initial unemployment benefits. To smooth volatility, a 4-week moving average is utilized.

Labor Market Resilient Despite Slight Deceleration in Job Growth

The U.S. labor market continued to add jobs in each month of Q4, bringing total payroll growth to 4.5 million in 2022. The unemployment rate fell from 3.7% to 3.5% in December, matching pre-pandemic lows. Recent data suggests that although the labor market is continuing to gain jobs, it is doing so at a decelerated rate, which may be a positive signal towards lower inflation.

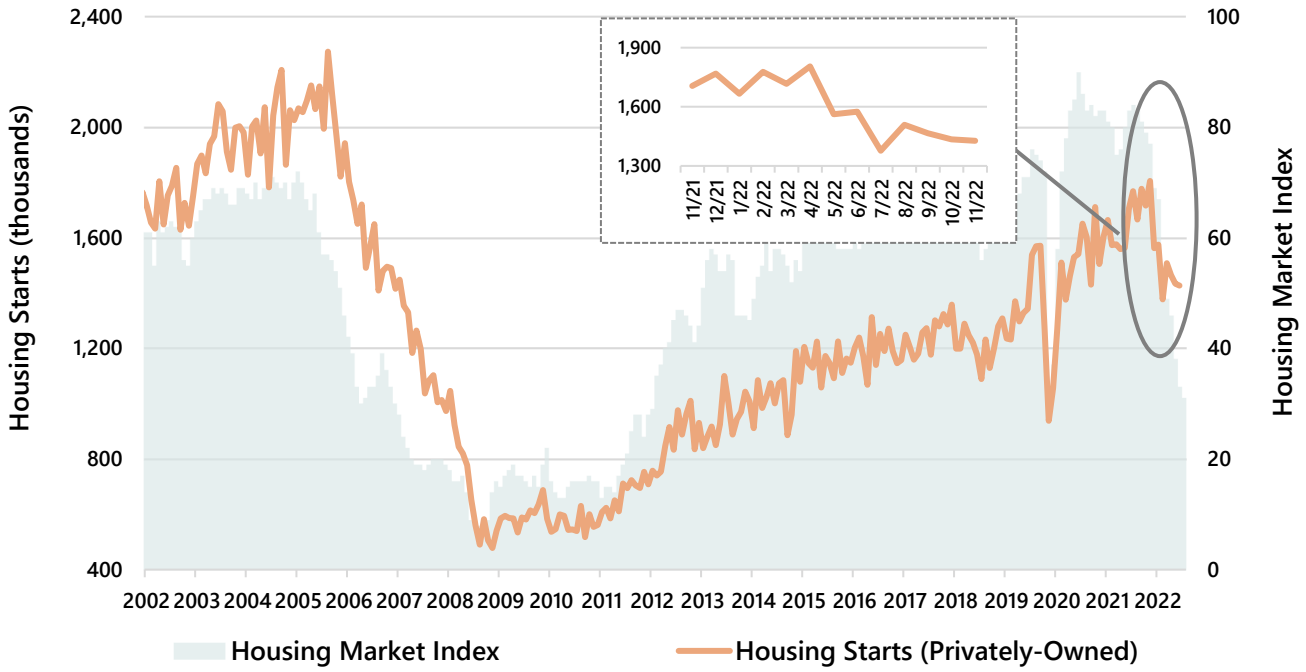
In September, the largest monthly payroll gains were seen in education and health (+78,000), leisure and hospitality (+67,000), and professional and business services (+28,000). The largest monthly decreases in payroll were seen in Professional and Business Services (-6,000) and Information (-5,000). Notably, employment in construction added 28,000 jobs in December. The construction industry's recent labor strength is in line with the declines in recent 30-year fixed mortgage rates, as more home-owners are willing to build due to more favorable financing terms.

III - LEADING ECONOMIC INDICATORS (Cont.)

Housing

Exhibit N: **Housing Starts, Housing Market Index**
(2002 – current)

Source: Federal Reserve Bank of St. Louis, National Association of Home Builders, U.S. Department of Housing and Urban Development



Housing Market Index – Data compiled by National Association of Home Builders (NAHB) based on a monthly survey with a focus on single-family housing. The index is a weighted average of ratings from home builder surveys on market conditions for current and forecasted new home sales. The index ranges from 0 to 100, and a reading of 50 generally indicates positive sentiment in builders.

Demand for New Houses Hurt by Rising Interest Rates

The NAHB Housing Market Index consistently declined throughout 2022, with a reading of 83 in January falling to 31 in December. Home builder sentiment reached the same low as in the beginning of the pandemic, reflecting a significant fall in demand this year. High construction costs and elevated mortgage interest rates largely contributed to the lack of growth. The largest month-over-month decline in 2022 for the Index was 17.9% from June to July. Excluding March and April 2020, the Index has not fallen below 50 since 2014.

Privately-owned housing starts slightly declined from October to November. However, starts decreased more significantly since the beginning of the year- falling from 1,666,000 in January to 1,427,000 in November. The total amount of building permits authorized fell by 10.65% from October to November, which was the largest month-over-month decline in the last twelve months. Since January, starts for single-family homes consistently fell, while multi-family unit construction increased, indicating that privately-owned housing starts have been impacted differently across property type.

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