Year-End 2022 Investment Commentary

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Market Recap

An extremely difficult year in the financial markets ended with a thud for U.S. stocks. After a 14% rally in October and November, the S&P 500 Index dropped 5.8% in December to close out the year with an 18.1% loss, its largest annual decline since 2008.

Foreign stock markets held up much better in the fourth quarter. Developed international stocks (MSCI EAFE Index) gained 17.3% -- one of their best quarters ever -- and Emerging Market stocks (MSCI EM Index) were up 9.7 %. For the full year, developed international stocks were down 14.5% in dollar terms (almost four percentage points better than the S&P 500), while EM stocks were down a bit more than the S&P 500 with a 20.1% drop. These annual returns were despite the U.S. dollar (DXY Index) appreciating 8.3% for the year, which reduces dollar-based foreign equity returns one-for-one. In the fourth quarter, however, the dollar dropped 7.7%, providing a tailwind to EM and international equity returns for U.S. investors.

Turning to the fixed-income markets, core investment-grade bonds (Bloomberg U.S. Aggregate Bond Index, aka the "Agg") had a solid fourth quarter, gaining 1.9%. But this was still the worst year for core bonds in at least 95 years, with the Agg dropping 13.0%. The key driver, of course, was the sharp rise in bond yields; the 10-year Treasury yield ended the year at 3.9%, up from just 1.5% a year prior. High-yield bonds (ICE BofA Merrill Lynch U.S. High Yield Index) had a strong fourth quarter, up 4.0%, but were down 11.2% for the year. Floating rate loans (Morningstar LSTA Leveraged Loan index) were the best segment within the bond markets, down less than 1% for the year. Municipal Bonds were down 8% (Morningstar National Muni Bond Category).

Alternative strategies and nontraditional asset classes generally outperformed traditional stock and bond indexes. The standout was trend-following managed futures strategies, which gained roughly 27% (SG Trend Index) for the year. Flexible/nontraditional bond funds (Morningstar Nontraditional Bond category) declined 6.3%, roughly half as much as core bonds.

Portfolio Performance and Key Performance Drivers

For 2022, our tactical active model portfolios had mixed performance relative to their benchmarks, with relative performance strongest in our more defensive portfolios and weakest in the more equity-oriented models.

Positive contributors included our tactical positions in flexible, actively managed bond funds and floating-rate loan funds (which we sold in late September), which declined much less than the core bond index. Our tactical allocation to trend following managed futures funds significantly outperformed core bonds and stocks, and added beneficial portfolio diversification.

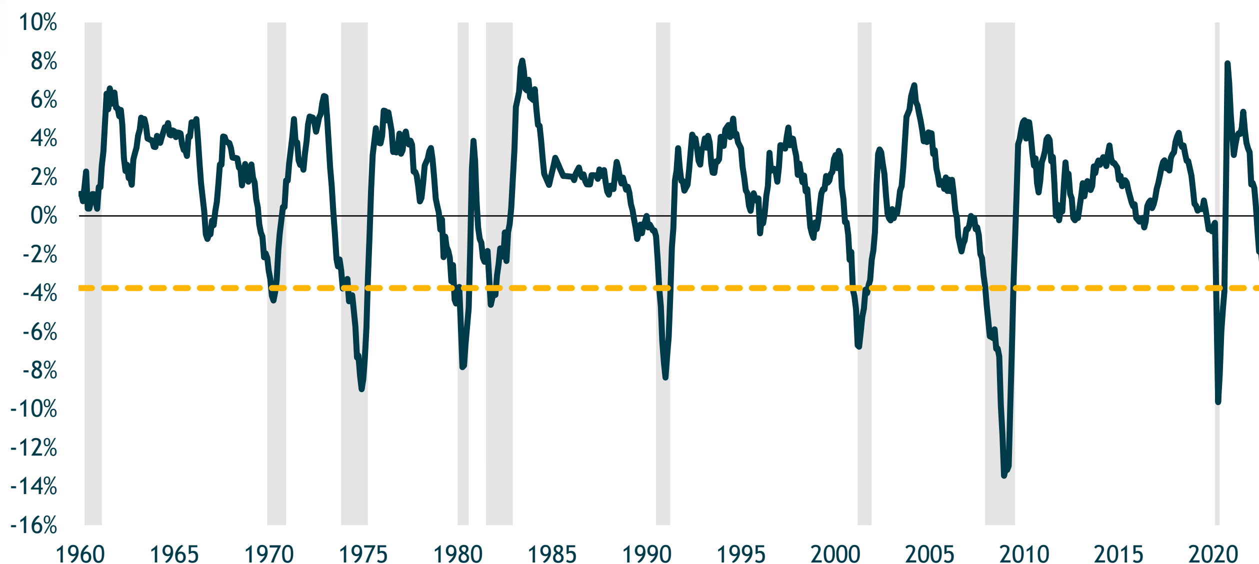
The main detractor versus our benchmarks in our active portfolios was the aggregate underperformance of our U.S. equity and developed international equity managers relative to their respective benchmark indexes. Our tactical overweight to EM equities (via the EM index ETF) was also a slight detractor for the year.

Investment Outlook and Portfolio Positioning

Inflation and monetary policy remain the financial markets' key macro focus. U.S. headline inflation data have improved, suggesting we've seen the peak in inflation for this cycle. Various measures of core inflation (i.e., excluding food and energy) have flattened, but remain at 5% or 6%, far above the Federal Reserve's 2% target. The Fed's message has been clear that it intends to maintain restrictive (tight) monetary policy throughout 2023. Indeed, at its December 14 meeting, the Fed raised the fed funds rate by 0.5% to a target range of 4.25% to 4.50%. It also forecasted 75bps of additional rate hikes in 2023.

Inflation is not just a U.S. problem. Nearly all the other major global central banks (except Japan and China) are also continuing to hike interest rates in their countries. For example, both the European Central Bank (ECB) and the Bank of England hiked their policy rates another 0.5% in December. These synchronized global rate hikes will further depress global aggregate demand and economic growth over the shorter term. It's also typically a headwind for stocks.

On the economic growth front, key leading indicators deteriorated further in the fourth quarter. The Leading Economic Indicator (below), which has a long track record of "calling" recessions, has fallen for nine consecutive months (and likely will again in December). This has never happened without an ensuing recession.



LEI shown is six-month rate of change for the index. Dashed line represents lastest reading. Shaded regions represent NBER-defined recessions. Source: Bloomberg LP. Data as of 8/31/2022.

While we weigh the evidence as leaning strongly towards recession, there are some positives supporting the economy that should mitigate the severity of a U.S. recession if and when it happens. First and foremost, the labor market remains strong, enabling consumer income and spending growth; monthly job growth (nonfarm payrolls) has also remained solid, increasing by 263,000 in November; weekly new unemployment claims (a leading indicator for the labor market) remain low, though they are ticking higher.

Households also still have huge “excess savings” stemming from the pandemic – about $1.5 trillion (down from $2.3 trillion) that can support additional spending even as the Fed tightens. Business balance sheets are also generally in good shape, with many firms having refinanced their debt at low rates prior to this year’s sharp rise. More broadly, there don’t appear to be any major, systemic, economic/financial icebergs lurking under the surface, e.g., unlike in 2007-08 with the housing/mortgage derivatives market.

To the above list of macro positives, we’d add a significant new development in the fourth quarter: the unexpected and sudden abandonment of China’s highly restrictive zero-COVID policy. Zero-COVID has been the key driver of China’s economic slump the past two years. But now the most repressive measures – mandatory testing, quarantines, community lockdowns and travel restrictions – are being revoked. The reopening of China’s economy for domestic consumers should be a catalyst for a growth rebound in 2023.

The bottom line is that a U.S. recession next year is not a certainty. But based on the evidence, we think it is highly likely. On the positive side, it should be milder than the 2007-08 and 2000-01 recessions.

At present, we believe the current price of U.S. Stocks (S&P 500 index) do not adequately discount the likelihood and severity of an economic and corporate earnings recession. This was our view one quarter ago, and since that time the S&P 500 has climbed a few percent while the economic data has worsened. Our analysis of past data on recessions, earnings declines and stock valuations suggest a real possibility of further double-digit declines in the S&P 500 from current levels.

Foreign stock markets and earnings are also at-risk from a U.S. and global recession next year. However, unlike the S&P 500, our five-year base case expected return estimates for developed international and EM stocks are reasonably attractive in absolute terms, ranging from the mid-single digits to the low-double digits, with EM the highest. (See the table below.) These returns are even more attractive relative to U.S. stocks and core bonds.

Between the three regions, we tactically favor EM stocks right now based on their higher expected returns, which are a function of what we expect will be faster sales growth and improving profit margins over the next several years. This comes after more than 10 years of stagnant EM earnings growth. Monetary policy is also likely to start loosening next year across many EMs as inflation comes down, which should be another support for EM equity markets.

Five-Year Expected Returns for Equity

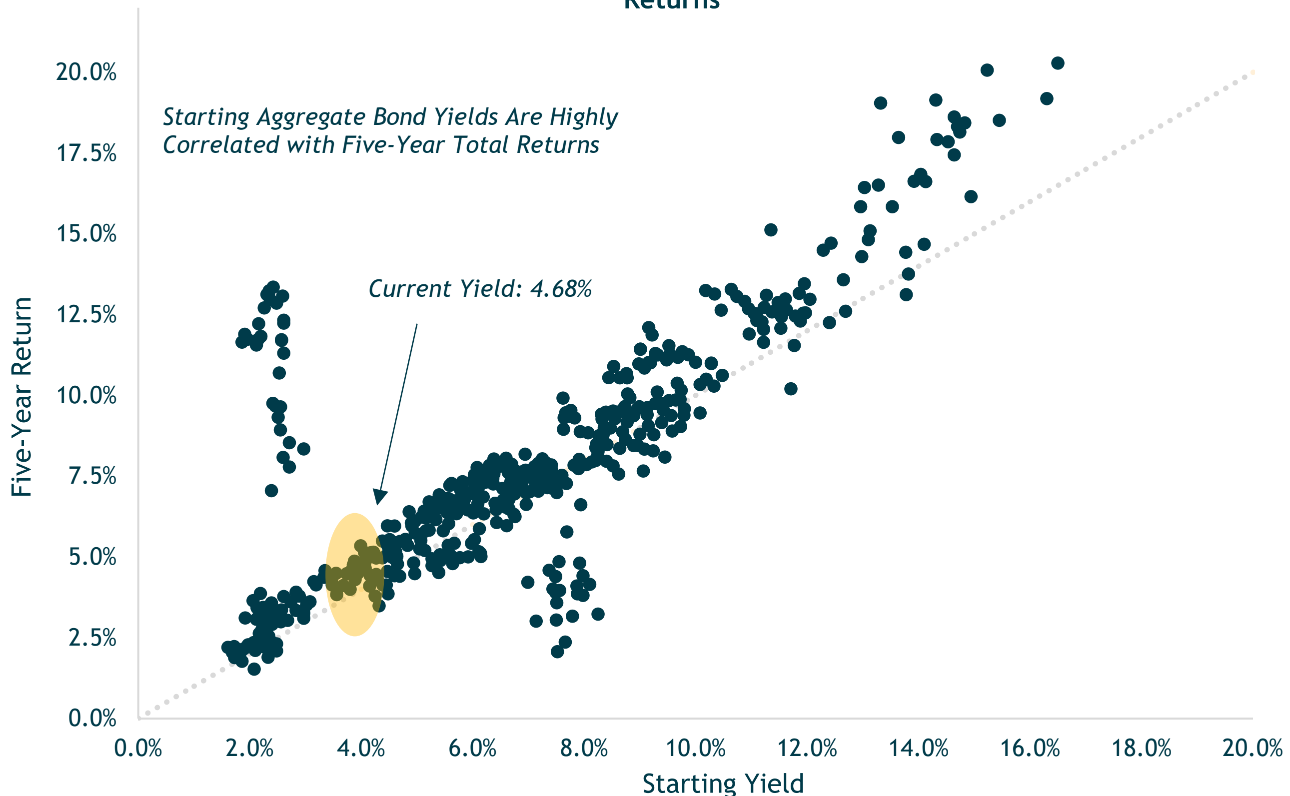
	Current Level	Downside/Bear	Base Case Lower	Base Case Upper	Upside/Bull
US Stocks	3,840 USD	-4.4%	3.1%	9.3%	14.1%
Europe Stocks	1,723 LCL	-3.2%	5.1%	12.4%	19.5%
Emerging-Markets Stocks	57,479 LCL	-1.3%	7.2%	14.0%	21.4%

US Stocks: S&P 500 Index, Europe Stocks: MSCI Europe Index, Emerging-Markets Stocks: MSCI EM. Europe and EM stocks return estimates in local currency—the US dollar will impact returns for dollar-based investors. Return estimates as of 12/31/2022.

Estimated returns are annualized and generated by iMGPFM. This table shows our five-year, annualized asset class return estimates across several broad macroeconomic scenarios we believe are possible. Collectively, the scenarios encompass the range of outcomes we believe are reasonably possible and therefore worth considering in creating our portfolio allocations. We make assumptions for various fundamental and valuation metrics we believe are consistent for each asset class within each macro scenario then incorporate current prices to generate an estimated return. The macroeconomic scenarios and estimated returns can change. When this happens, we will clearly note it and give guidance on new estimates. ***See "Estimated Returns Disclosure" at the end of this commentary for more information on macro scenarios and fundamental/valuation metrics used in the analysis.***

Turning to our outlook for fixed income, given the sharp rise in yields, bonds haven't been this attractive in over a decade. When estimating returns for core bonds (the Agg) over longer periods of time, the starting yield is a good approximation of subsequent returns (see chart below). At year-end, the Agg was yielding 4.7% and our 5-year expected return for core bonds is now in a range of 5% to 5.6%. Moreover, we expect core bonds to deliver a positive return if a recession plays out, providing valuable downside protection while riskier assets such as stocks get hit. Beyond core bonds, there are

other segments of the bond markets, including high-yield and floating rate loans, that offer attractive risk/return potential which we access via our selected active managers.



Data as of 12/31/2022. Source: Bloomberg LP.

Finally, we maintain core positions in trend-following managed futures funds. Managed futures returns have been strongly positive this year as traditional bond and stock funds have plunged. These alternative funds have different return and risk drivers, and we believe will continue to provide tactical and longer-term strategic benefits to our balanced portfolios. They are much less dependent than traditional investments on which type of macro environment (e.g., deflation, stagflation, inflation, or growth) unfolds over the coming years.

Closing Thoughts

As 2022 has reminded investors, we should “expect the unexpected, and expect to be surprised.” This is expressed in our portfolio construction and investment management via balanced risk exposures, diversification and forward-looking analysis that considers a wide range of potential scenarios and outcomes.

We believe 2023 will likely present us with some excellent long-term investment opportunities. Unfortunately, we also expect a recession and the potential for stock market volatility.

While challenging, it is critical for long-term investors to stay the course through these rough periods. The shorter-term discomfort is the price one pays to earn the long-term "equity risk premium" – the additional return from owning riskier assets such as stocks that most investors need to build long-term wealth and achieve their financial objectives.

Outside of the U.S. stock market, we already see attractive medium-term expected returns from international and emerging markets stocks. (With a recession they will likely get more attractive.) A declining dollar, as we expect medium-term, would further fuel non-U.S. equity returns.

Fixed-income assets and high-quality bonds are also now reasonably priced with mid-single digit or better expected returns. Core bonds will also provide valuable portfolio ballast in the event of a 2023 recession. Our investments in alternative strategies and managed futures funds provide further resilience to our portfolios no matter how the next year (and years) play out.

From all of us at iM Global Partner, we wish you and yours a healthy, happy, and prosperous New Year.

—iM Global Partner Investment Team (12/31/22)

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Estimated Returns Disclosure

Scenario Definitions:

Downside*: The economy falls into a deep recession for any of various reasons, such as deleveraging/deflation, unexpected systemic shock, geopolitical conflict, Fed or fiscal policy error, etc. At the end of our five-year tactical horizon, S&P 500 earnings are below their normalized trend and valuation multiples are below-average reflecting investor risk aversion. Inflation, 10-year Treasury nominal and real yields are below the Fed's long-term targets.*

Base*: Consistent with long-term economic and market history, reflecting economic and earnings growth cycles that are interspersed with recessions around an upward sloping normalized growth trendline. Inflation is moderately higher than the Fed's 2% target level (i.e., around 3%) and 10-year Treasury real yields are slightly positive. For equity markets, we bookend our Base Case with Lower-end and Upper-end estimates:*

- *In our Base Lower scenario, we assume nominal economic growth is higher than the average due to moderately higher inflation. We assume some additional profit margin compression and moderately lower valuations compared to the Base Upper scenario.*
- *In our Base Upper scenario, we assume nominal economic growth is higher than average due to both moderately higher inflation and strong real growth. As such, we assume S&P 500 profit margins remain elevated (although below their all-time highs) and valuation multiples are also elevated versus historical averages.*

Upside: This is the "Goldilocks" scenario for stocks. S&P 500 earnings end the period well above their Base Case trendline, driven by both higher sales growth and high profit margins. Valuation multiples are well above average and higher than the Base Upper assumption. Inflation is under control, around or slightly higher than the Fed's 2% long-term target. The fed funds rate is around the Fed's estimate of "neutral," the yield curve is positively sloped, and 10-year Treasury real yields are modestly positive.

What the Table Shows: Our five-year, annualized asset class return estimates under several broad economic scenarios. Collectively, the scenarios we use encompass the range of outcomes we believe are reasonably possible and therefore worth considering in creating our portfolio allocations.

Why We Use Scenarios: Considering how each asset class might react under a consistent set of scenarios allows us to calibrate our return expectations across asset classes. We believe this helps us make better asset allocation decisions.

These Scenarios Can Change: As the overall economic environment changes it will at some point necessitate changes to the scenarios we consider. Therefore, there could be times when we are reassessing scenarios and temporarily suspend providing updates for one or more scenarios. When this happens, we will clearly note it and give guidance on when we expect to complete this process.

Any projections provided regarding the likelihood of various investment outcomes are hypothetical in nature, do not reflect actual investment results and are not guarantees of future results. Investing involves risk, including the potential loss of principal, and investors should be guided accordingly.