



## ***2022 Market Review & 2023 Outlook***

### **2022 Economic & Market Review/Comments**

Almost all investors will be glad that 2022 is now in the history books. The Russian invasion of Ukraine, 40-year high inflation, the most aggressive Fed interest rate hiking policy seen since the 70s, major China geopolitical tensions, and the doubling of mortgage rates all took their toll on financial markets. US stocks returned -18.3% in 2022 (the worst year since 2008), and the US bond market returned -13.1% (this is by most measures the worst year for the bond market in modern history).

Despite all these headwinds US corporate earnings will likely be flat or down marginally from 2021 to 2022. Corporate earnings on the SP500 will likely end up around \$200 in 2022. A logical question to ask is; if earnings were the essentially the same from 2021 to 2022, why did stocks fall over 20% from the early January 2022 top? The answer is rapidly rising interest rates causing investors to revalue most financial assets significantly downward.

For example, in 2020, when an investor could only earn around 1% on cash/bonds you might be willing to pay 25X – 30X earnings for a quality stock. Currently when asset allocators can earn 4% - 5% with little/no risk, investors should demand higher returns from stocks (therefore lower current valuations). The same stock that was valued at 25X - 30X earnings in 2020, could be only worth 15X - 20X earnings in 2023. This is what happened in 2022 for the vast majority of stocks, where the SP500's valuation came down from an average of around 23X earnings in 2021 to 18X or so currently.

This means some of the 'hard work' might be done for stocks, and from this point forward the valuation and movement of stocks will be more nuanced and will depend on future interest rate levels (it is likely we are nearing the 'top' in rates), earnings growth (likely muted or negative), and future Fed policy. With this backdrop, we are cautious, but think bonds will have a good year and stocks will have a materially better 2023 than 2022.

Select 2023 Asset Class Returns	
Pipeline Companies (TPYP)	+ 16.1%
Diversified Private Credit (NICHX/CELFX)	+ 10.2%
Private Real Estate (TIPWX)	+ 10.1%
Middle Market Lending (CCLFX)	+ 6.5%
Diversified Real Assets (VCRRX)	+ 4.0%
Alternative Lending (LENDX)	+ 2.3%
Private Equity (PIIVX)	+ 1.6%
Insurance Securities (XILSX/SHRMX)	- 0.2%
Municipal Bonds (MUB)	- 7.1%
High Yield Bonds (HYG)	- 11.4%
Foreign Developed Stocks (IEFA)	-15.1%
Intermediate Treasury Bonds (IEF)	- 15.2%
Investment Grade Bonds (LQD)	- 18.0%
US Large Cap Stocks (IVV)	- 18.3%
Emerging Market Stocks (IEMG)	-19.9%
Public Real Estate (IYR)	- 25.5%

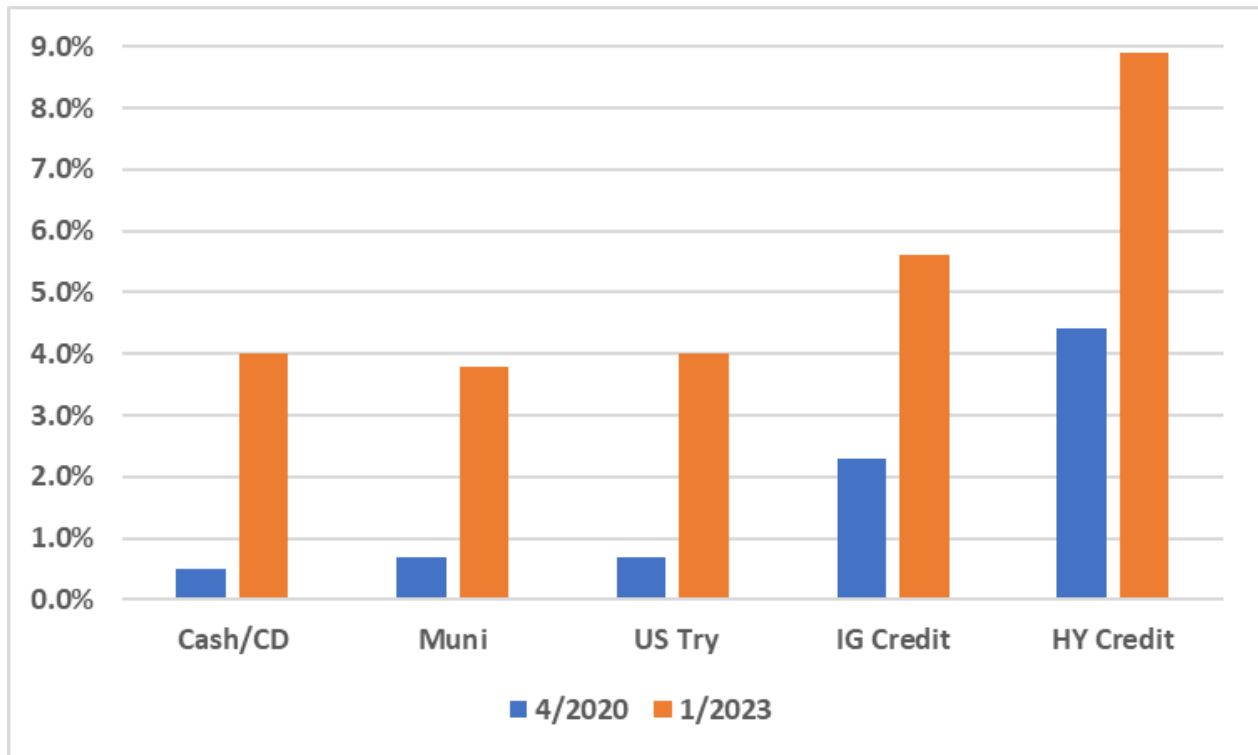
*Yellow shaded rows indicate Traphagen private/alternative investments; blue indicates traditional investment classes.*

Despite the historically poor performance of almost all traditional asset classes last year, our suite of alternative/private investments provided both offense (solid positive returns) and defense (extremely low volatility and no correlation to rising rates/falling stocks). On average our alternative/private suite returned roughly + 6% on a firm wide basis for 2022. This provided the vast majority of our clients a formidable shield from rates, stocks, inflation, and all other headwinds that plagued most investors in 2022.

In fact, 2022's rising rates actually helped the returns for several of the assets within our alternative/private suite. Currently the three private credit funds we hold for clients are yielding around 10%, while the insurance linked securities (combination of rising base rates and historically high insurance premiums) offer 9% -12% yields. Although we did trim some alternative exposure and rotate into high quality bonds to lock in profits, we remain optimistic on these investments over the next several years.

After the extreme rise in rates in 2022, future returns on traditional high-quality bonds are the highest in the past 15 years. This creates an attractive opportunity for many investors; since the great recession cash/high quality bonds yielded 0% to 3%, where now 4.5% to 6% yields are commonplace.

**Below: Current vs. 4/2020 yields on different traditional bonds classes**



Given our robust outlook for most alternative/private assets and the highest rates available on traditional bonds in 15 years we can earn a good return on our ‘lower risk’ investment allocation. When we pair these defensive building blocks with a higher quality/dividend paying stock allocation; a well-defensed portfolio can be constructed with current dividend yields of 3% to 5% along with additional capital gains likely over the longer term regardless of any shorter-term volatility.

Despite significant short-term headwinds and volatility, for the first time since 2009, Traphagen sees good opportunity in select stocks, alternatives, and traditional bonds.

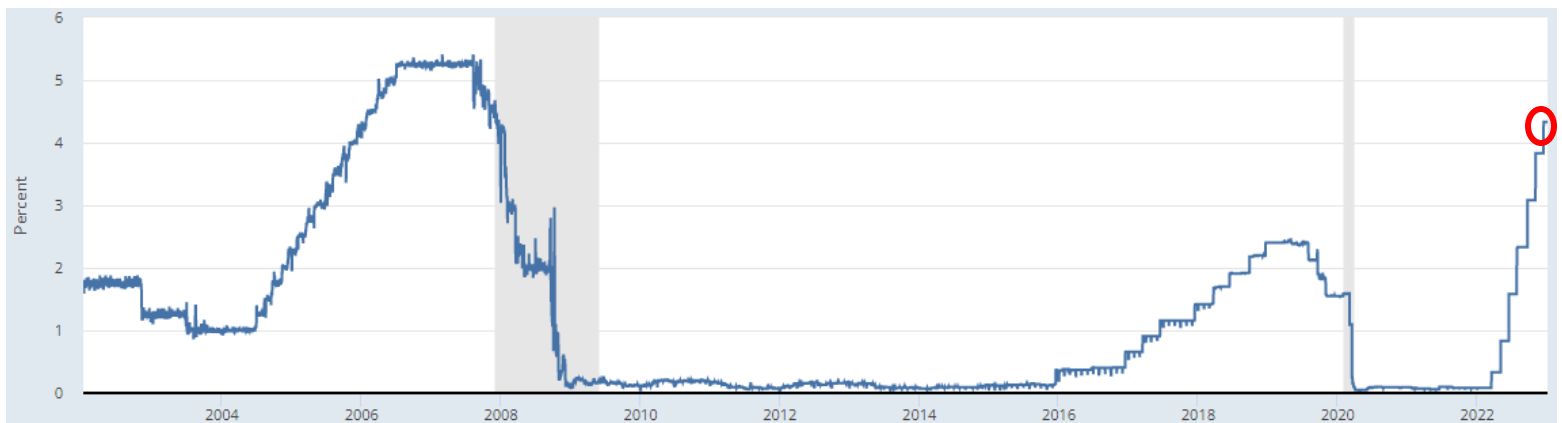
**Below:** Summary of broad inflation/growth scenarios for 2023 and impacts (*I* = inflation, *G* = Growth)

	Stocks	Bonds	Alternatives
High I / High G	Neutral	Negative	Positive
High I / Low G	Negative	Neutral/Negative	Neutral
Low I / High G	Positive	Neutral/Positive	Positive
Low I / Low G	Negative	Positive	Neutral/Negative

Given our belief that inflation will come down significantly during 2023, to between 2% and 4% by mid-year, we are overweighting our investments that benefit in that environment relative to prior years. This is why we significantly increased our allocation to traditional bonds which should benefit in either lower inflation scenario, while trimming alternatives and stocks. We also tilted our stock allocation to more value, quality, and dividend paying companies.

## **Major Issues that impacted the markets & client portfolios in 2022:**

**Historic Rise in Interest Rates:** The FED, along with market forces, caused a rapid rise in interest rates unlike anything we have seen since the 1970s. The 10 Year Treasury closed 2021 at 1.51% and rose to 4.3% by mid-October 2022. In addition, the FED increased short term/cash rates from near 0% on January 1<sup>st</sup> 2022 to the current level of 4.2%. This enormous increase in interest rates impacted mortgages, car loans, home sales, corporate financing, valuations, and almost all financial assets. Interest rate levels and FED policy (which are directly related) in our opinion are the most important factors impacting the economy and financial markets by a wide margin.

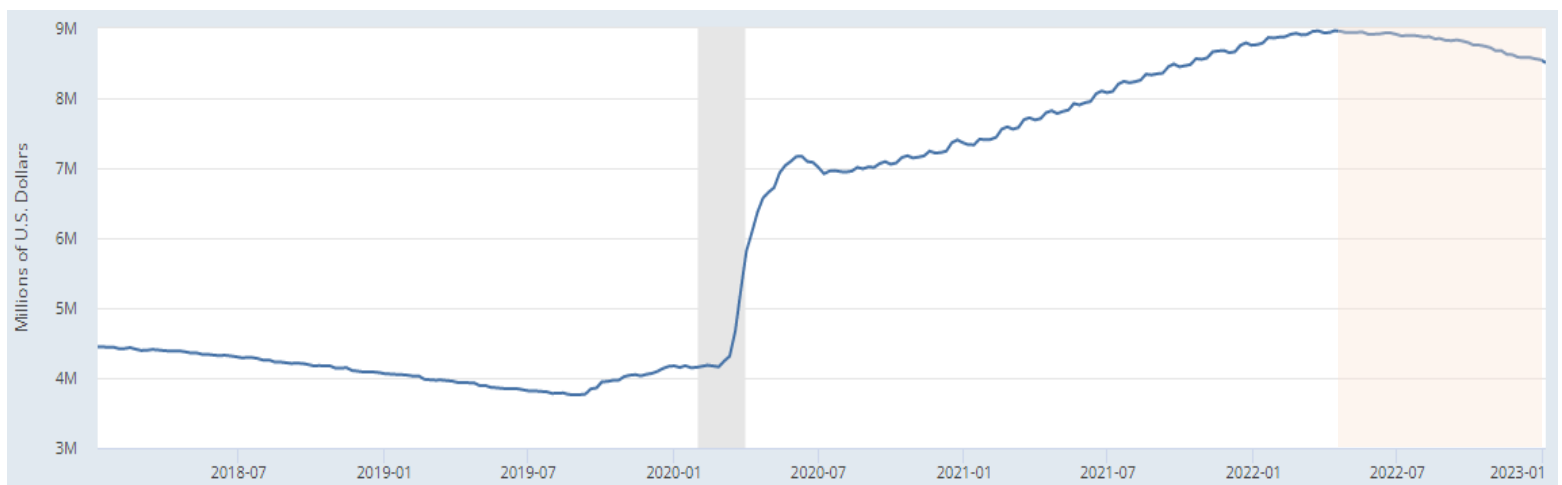


***Above:** Chart of short term/cash interest rates over past 20 years; We are currently at the highest level of short term rates (4.2%) since 2007*

**Highest Inflation Observed Since the early 1980s:** What once was described as ‘transitory’ inflation by the Federal Reserve throughout 2020 and 2021, turned into a major problem for the country and most of the globe in 2022. Inflation topped out at over 8% year over year in mid-2022 with housing, food, energy, goods, and services all having swift upward movements. This was the spark that ignited the Fed’s rate hiking policy. Although inflation remains well above the 2% stated target, Traphagen has high conviction that inflation will be much lower by Q2 or Q3 of this year. We are not sure if we can reach the 2% level this year, but we do think inflation will fall into the 3% to 4% range. For this reason, interest rates should be nearing or in some cases have already reached their highs.

**Reduction of Fed/Government Balance Sheet:** In addition to the Fed hiking rates, they also have been slamming the ‘growth brakes’ by reducing their balance sheet assets. In 2020 the FED was actively buying all types of bonds and assets, providing liquidity into the system and pushing down yields across the economy. This vastly reduced market risk and pushed investors out of cash and bonds. As an accelerant to rising rates in the inflation fight, the FED is now executing the opposite strategy. They are actively selling or letting assets run-off their balance sheet and this has the impact of removing liquidity from the system and slowing growth.

**Below:** 5-year Chart of the Fed ‘balance sheet’. There was a huge increase during COVID but has started to decline in mid-2022 (red shading). There is a high positive correlation between the increase/decrease in size of balance sheet and risk asset performance.



**US Mid-Term Elections:** After the dust settled from the November 2022 mid-term elections we emerged with a split government where democrats control the Presidency and Senate and the republicans have a majority in the House. With this structure in place for at least the next 2 years we see additional major legislation unlikely. Already passed legislation in 2022 will provide some minor tax changes and incentives along with strong support for infrastructure, utilities, and renewable energy. Traphagen continues to have exposure to these areas where we think there is both recession resilience and strong tailwinds/financial support from this legislation.

### Traphagen 2022 Portfolio Comments

2022 were one of the worst years for both bonds and stocks in the last 40 years, however there were pronounced pockets of strength. Many of the asset classes we had significant allocation to for clients (private equity, private credit, insurance securities, infrastructure, oil/gas pipelines, private real estate, healthcare, and some high quality/high free cash flow stock strategies) were near breakeven or up materially on the year.

*Below: List of new/significant added investments made within 2022*

<b>Security &amp; Description</b>	<b>Interest/Div. Yield</b>	<b>Client Return</b>
<b>CELFX:</b> <i>Well Diversified Unique Private Credit</i>	<b>10.2%</b>	<b>+ 6.0%</b>
<b>COWZ:</b> <i>Top 100 cheapest free cash flow yielding US stocks</i>	<b>2.0%</b>	<b>+ 1.0%</b>
<b>IEI/GIGB:</b> <i>High quality Treasury &amp; IG Bonds</i>	<b>5.0%</b>	<b>0.0%</b>
<b>BBH/XBI:</b> <i>Biotech funds</i>	<b>0.5%</b>	<b>- 7.0%</b>
<b>RC:</b> <i>Ready Capital Corp; real estate lending company</i>	<b>12.5%</b>	<b>- 8.0%</b>

The High Free Cash Flow stock strategy (COWZ), biotech funds (BBH/XBI), and Ready Capital (RC) positions were all new securities purchased to take advantage of a slowing/uncertain economy, higher interest rates, and flight to quality/yield. Overall, we were pleased with the relative performance of these securities in aggregate, as on average, the return from the security purchase date to early 2023 was around -2% for 'BBH' holders and – 6% for XBI holders. These returns compare to a roughly – 13% for the overall US stock market in the same time period. Other stock positions that added significant value were our healthcare overweight (FHLC) (outperformed by 16%) and AVUS (value fund) that outperformed by 5%.

Our large cap tech overweight (IGM) was a significant drag in 2022, however since our overweight began in 2018, the cumulative advantage versus the SP500 was around 15% to 20% when we closed out the position late in 2022. In more aggressive portfolios, GINN and crypto were also significant performance drags.

CELFX has been a stellar performer (along with the alternative/private suite overall) in 2022 and for the past 2+ years. We introduced CELFX into most portfolios in mid-2022 and it has returned around 6% since that time. Currently the strategy is yielding just over 10% net of fees and retains the same low volatility and correlation benefits as when we first purchased the security. This fund, in addition to our other private credit funds (LENDX, NICHX, SHRIX) now all yield between 8% and 11%.

In addition to the securities we added, it is also important to note what we trimmed and sold out of the portfolio throughout the year. One of the largest changes we made for most clients towards the end of 2022 was a material trim of several alternative/private

investments which total between 4% and 9% of a portfolio. This came in the form of small trims of LENDX, VCRRX, CCLFX, and a larger trim of TIPWX. We sold 50% of our private real estate exposure in November of last year after a 15% profit in 2022 alone. With the majority of these proceeds we purchased a mixture of Treasury, investment grade, and municipal bonds (depending on client situation).

At the very end of 2022 we trimmed between 2% and 4% out of stocks and again placed that into high quality bonds. These moves are defensive in nature, however with much higher rates now available, these defensive moves are still primed to produce roughly 4% to 5% of cash flow on an annual basis as we hedge recession/slowdown risk. The most recent changes (made in 2023), include the sale of Ready Capital (RC) stock and replacement with more defensive securities and the conversion of 'SHRMX' to 'SHRIX'. This conversion to SHRIX retains the same exact insurance exposure that we had with SHRMX, but Traphagen was able to negotiate with the fund manager to reduce fees by 0.25% per year.

## **2023 Portfolio & Economic Commentary**

Much like in 2022, the most important factor that will impact markets in 2023 is the interplay between inflation, rates, and FED policy. With all the economic data available, our Traphagen recession index (which is at an all-time high), and our internal research over the past several months, our 'base case' scenario for 2023 is rapidly decreasing inflation, muted economic growth (with a recession possible over the next 12 months), and interest rates gradually coming down.

With the above backdrop, in mind below you will find major tenants of our portfolios going forward.

<b>Major 2023 Portfolio Themes</b>
<b>Portfolios are the most defensively positioned in years</b>
<b>Significant allocations to healthcare &amp; utilities</b>
<b>Heavy tilt to high free cash flow/dividend/quality stocks</b>
<b>A reduced, but still significant allocation to alternatives</b>
<b>Material allocation to high quality bonds (4.5% - 5.5% yields)</b>
<b>Private Credit &amp; ILS positions now yield around 10%</b>
<b>Will look for opportunities throughout the year</b>

The current positioning for most clients puts us in a good position to weather any possible storm. With our alternative/private and high-quality bond allocations poised to return 4% or more regardless of any possible recession and the stock position heavily



tilted to more defensive, dividend paying, and value companies, our clients are in a position to play both defense and offense.

If we enter some type of recession, overall portfolio returns could be negative, but with the help of bonds and alternatives likely giving us positive returns, we should be able to greatly outperform the stock market, preserve most portfolio capital, and look to take advantage of much lower stock prices by rotating out of the bonds/alternatives. If we see much lower inflation, muted (but still positive) earnings/economic growth, and get a 'soft landing' all pieces of our portfolio should perform well, and we would expect total returns in the upper single digits or more for most clients.

The economic and market outlook remains cloudy for most of 2023, despite several positive data points including a 3.5% unemployment rate, China reopening after 3 years of lock-down, inflation coming down quickly, most of the FED rate hikes likely behind us, and strong consumer balance sheets. The one factor that could counteract all of these is the delayed impact on companies, individuals, and the overall economy of rates going from near zero to 4.5% - 5.0% in one year.

This type of rapid interest rate increase will have significant (but lagged) impacts all across our economy, and when combined with the FED slowing growth by shrinking their balance sheet, we are cautious and see continued volatility in the stock market.

**Major Issues we will be monitoring throughout 2023:**

<b>2023 Economic/Market/Portfolio Issues to Monitor</b>
<b>FED Fund 'Terminal Rate' (+/- 5.0%) &amp; FED Balance Sheet</b>
<b>Dividend/Value stocks vs. Tech/Growth Stocks</b>
<b>Hurricane Season/Natural Disaster severity</b>
<b>Possible Economic &amp; Corporate Earnings Recession</b>

As we mentioned prior the Traphagen Recession Index (TRI) is currently at an all-time high of 87.1% (which can be interpreted as the chance of recession over the next 12 months). We update this figure monthly and can be viewed at any time via the below link:

<https://tfgllc.com/wealth-management/traphagen-recession-index>

As we discussed prior, we are defensively positioned across all but the most aggressive portfolios as we see headwinds and a possible recession within the next year, but at the same time we are the most optimistic over the intermediate/long term for a diversified portfolio in more than a decade. Since 2009/2010 we have been plagued by 0% to 3%



high quality bond/cash yields, more limited alternative/private investment options, and at times, extremely high valuations for stocks.

In stark contrast to that past 'investment menu' we are now looking at cash/high quality bonds yields between 4% and 5.5%, many private/alternative investments that can produce 5% - 6% or more in total returns, and much cheaper stocks. We believe the seeds of significant investment gains will be planted over the next year or so and are excited and ready to take advantage of that opportunity.

We wish all our clients and their families a very happy new year and offer our continued appreciation for your trust through these tough times in the financial markets.

Best Regards,

**Your Traphagen Investment Team**