

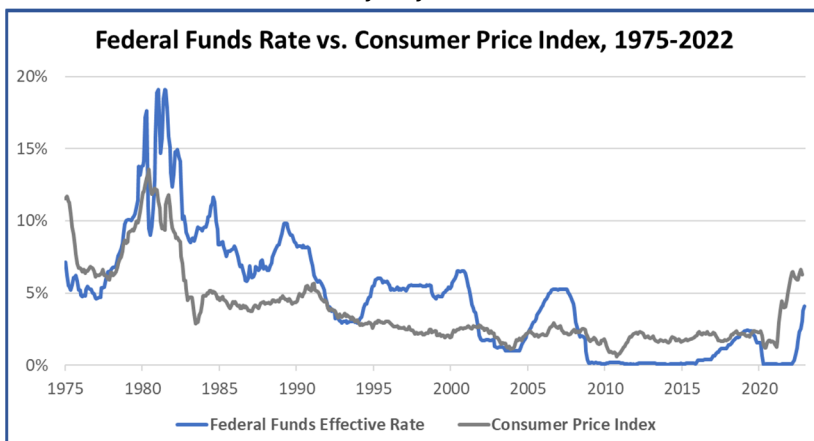
Private Wealth Management 2022 Review...and Outlook

	Dec. 30, 2022	Dec. 31, 2021	% Change
S&P 500® Index	3,839.5	4,778.7	-19.7%
Dow Jones Industrial Average	33,147.3	36,338.3	-8.8%
NASDAQ Composite Index	10,446.5	15,645.0	-33.2%
Russell 2000® Index	4,377.1	5,580.2	-21.6%
VIX Volatility Index	23.1	19.7	+17.3%
Barclays U.S. Aggregate Bond Index	42.7	51.7	-17.4%
10-Year U.S. Treasury Yield	3.83%	1.52%	+152.0%
Baltic Dry Index – Spot (Ocean Cargo Shipping Rate)	1,515	2,217	-31.7%
Gold (\$ per ounce) – NY Spot	1,820	1,828	-0.4%
Oil (\$ per barrel – West Texas intermediate)	78.40	75.33	+4.1%
Bitcoin (\$)	16,500	47,985	-65.6%

Source: FactSet Research Systems, Inc., and the Federal Reserve Bank of St. Louis. Figures represent the overall value of the benchmarks shown.

Putting 2022 in Perspective. 2022 was a rough year for investors. The equity market, as gauged by the S&P 500® Index, fell about 20% last year – the worst year for stocks since the Great Financial Crisis of 2008. Bonds, a usually safe investment, suffered too, as the widely-cited Barclays Aggregate Bond Index dropped by 17% (bond prices fall when rates rise). The proximate cause of the rout in both assets was the same: the decision by the Federal Reserve Bank to fight the highest inflation in 40 years by ending the bank’s multi-year policy of ultra-low interest rates. The federal funds rate – the rate upon which all other borrowing costs are based from car loans to mortgages – jumped from zero at the start of 2022 to 4.50% by year-end. As a result, a portfolio consisting of a typical “60/40 split” between stocks and bonds clocked its worst calendar-year performance in a century, according to RBC Securities. Most seriously wounded were “long duration” investments, which are assets whose values reside mostly in the future – for example, growth stocks with high price/earnings valuations (or no earnings at all) and low- or zero-coupon bonds whose maturities occur far in the future.

Will the Fed Pivot Soon? Many investors have viewed the drop in commodity prices since late-summer as a hopeful sign the Fed will soon stop raising rates, and perhaps even *cut* them in 2023, *i.e.*, “pivot” toward a more dovish rate stance. This seems unlikely to us. First, Fed Chair Jerome Powell has said recently (and forcefully) that the Fed is committed to a rate trajectory that will bring inflation down to the bank’s long-run goal of 2%. We’re a long way from that level. And second, history says “not so fast,” at least based on the Fed’s response to our country’s last bout of serious inflation (1979-1981). Back then, the Fed boosted the funds rate to 20% and kept rates well above the inflation rate *for 10 years* (see the chart on the left). The only stretch of time in which the fed funds rate was below inflation was the last 15 years (2008-2022) when the Fed’s concern was that inflation was *too low* – vastly different from today. Over the past half-century, the fed funds rate has averaged about 85 basis points (0.85%) *above* the consumer price index. So, if the CPI does eventually settle at 2%, we might expect to see federal funds in the range of 2.75-3.00%, with all other interest rates



Source: Federal Reserve Bank of St. Louis data as of December 31, 2022.

spreading higher from there. Over many decades, the spread between U.S. investment-grade corporate bonds (Baa rating) and the fed funds rate averaged 3.8%. So, again, if these historical relationships hold – a big if – we might expect investment grade bonds to yield about 6.5%. The current rate on such bonds is about 5.5%. Although bond interest rates could move higher from here, the greatest part of the adjustment (and damage to bondholders' wealth) might be behind us. We suspect investors will not wait for these historical alignments to fully play out before buying bonds. After all, 75 million yield-hungry Baby Boomers are expected to retire by 2030. And the pension funds that support those retirees will need income, too. Perhaps it's now time to nibble on bonds.

A Silver (and Gold) Lining in the Gloom. The dismal year that just ended was not without its high notes. Not the least was this: for the first time in years, savers could achieve positive returns on their cash or near-cash holdings like demand deposits, CDs, and treasury bills. This coincided with the implosion of many low-quality speculative investments: crypto currencies, meme stocks, NFTs, “blank check” companies, and similar fads. When interest rates were at zero, investors were drawn to such speculations (even borrowing money – at little cost – to fund those bets), because they could earn so little on safe, but unrewarding, assets such as treasury bills. But sharply higher interest rates have reversed the script. Why would one speculate in crypto today (especially after so many scandals in that market) when short-term treasury bills now offer a guaranteed annualized return of 4.5%? We think this is positive for investors on two levels: first, the bloom is off the rose of so many poor-quality investments that had attracted investment capital, and second, the markets' realignment has begun to reward capital invested in issuers with solid records and dependable prospects. And a word on gold: this 5,000-year-old store of value and medium of exchange has enjoyed renewed attention from investors skeptical of “fiat money” but wary of crypto. Since the end of September to present, the metal's price has risen by about 15%. We do not know if this is the start of a trend, but gold's investment promise should not be dismissed.

What About Common Stocks? Common stocks – equities – are the bedrock of most client portfolios. And for good reason: every analysis shows stocks have outperformed other investment assets such as corporate and government bonds, CDs, and treasury bills, at least in the long term. But stocks don't win every year, and 2022 was a losing year for most stocks. The Fed's sharp and abrupt rate jump signals economic slowing, if not recession. But market slumps rarely coincide seamlessly with recessions. Since 1969, the U.S. has experienced eight recessions of varying length and severity. The average interval by which stocks have led the economy was six months, and the average market gain in that lead time was 25%. Put another way, by the time economists declare a recession over, the stock market may have correctly anticipated it – and by a long time. We have not yet seen any signs that stocks have bottomed; however, they *may* remain in a holding pattern in the near-term. There are many “known unknowns” including, among others, the Fed's rate path from here, the war in eastern Europe, U.S.-China tensions, and – more recently – U.S. legislative instability vis-à-vis the federal debt ceiling and budget.

The Search for Leadership. The leadership stocks of recent years – large tech-focused companies – are slumping on their thrones. The “tech-heavy” NASDAQ fell by 33% last year, far more than the value-focused Dow Jones Industrial Average (down 9%). The phrase “creative destruction” describes capitalism's brutal vitality; those on top one day may be displaced by innovation, complacency, and/or political shifts. Of the ten largest companies by market value in 2000, only one remains on that list today. Technology shares are in the bull's eye of upheaval for several reasons: first, innovation, that ultimate driver of “creative destruction,” is their business model. Second, tech companies' sheer growth, influence, and profitability have made them rich targets for competitors and regulators. And, significantly, we believe many technology shares are still expensive compared with their alternatives. The crown might fall from recent champions, but new winners will arise. So where will we find these new champs? We make a critical distinction between “*technology stocks*” and “*technology*.” Technology is a primary source of global productivity and growth. New technology champions might emerge in older fields such as energy, transportation, and health care – or even kindle fresh growth in incumbent technology companies. Identifying the new leaders will be one of our greatest challenges in the year ahead. We are on the case.

Thank you for allowing us to manage your investments. We aim to reward your faith in us with creativity, diligence, and good results.

Sincerely, Palisade Capital Management

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The Dow Jones Industrial Average (The Dow) is a price-weighted measure of 30 U.S. blue-chip companies. The index covers all industries except transportation and utilities.

The NASDAQ Composite Index measures all NASDAQ domestic and international based common type stocks listed on The NASDAQ Stock market.

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The Bloomberg Barclays U.S. Aggregate Bond Index covers the USD-denominated, investment-grade, fixed-rate, taxable bond market of SEC-registered securities.

The Baltic Dry Index (BDI), is issued daily by the London-based Baltic Exchange. The BDI is a composite of the Capesize, Panamax, and Supramax Timecharter Averages. It is reported around the world as a proxy for dry bulk shipping stocks as well as a general shipping market bellwether.

West Texas Intermediate (WTI) is a grade of crude oil used as a benchmark in oil pricing and is the underlying commodity of the New York Mercantile Exchange's oil futures contracts.

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