Economic and Market Outlook – Fourth Quarter 2022

Multiple Risks Still Abound

Armed conflict in Europe? Sabre rattling in East Asia? Refugees freezing at borders? Strident political division? Persistent, even if moderating, worldwide inflation? Volatile asset markets? Looming government debt crises? Stubbornly rising greenhouse gas emissions? Bizarre climate patterns? Wintertime Covid resurgence? Check, check, and check. A new year promises the possibility of change, but our longstanding societal divisions, dysfunctions, and hostilities have moved into the new year with us. Double-digit negative returns for global stock and bond markets would have improved valuation, if only earnings and economic conditions were more favorable.

In contrast, we anticipate deteriorating profits, rising unemployment, more volatile asset markets, and recession across the developed world as already tightened monetary policy takes hold. While Central Banks wait for the data to show clear deceleration in inflation, financial restriction raises the overall level of risk. Where exactly those risks will manifest is unknown; past aggressive hiking cycles have led to corporate inability to float new bond issues, liquidity crunches in sovereign bond markets, currency crises, and changes in governments. Aggressive monetary policy is a potent force, but the final effects on economic growth and market returns could be offset by continuing improvements in Covid-related disruptions to labor force participation, lower freight costs, normalized supply chains, and fiscal stimulus focused on jobs and investment that has already been funded such as the Inflation Reduction Act. The contractionary impulse seems clear, but what happens in 2023 depends upon the depth, length, and timing of the expected recession both in Europe and the U.S. A wide range of market outcomes are still possible.

Believe the Fed (Yet Again)

Our commentary last quarter suggested that investors "Believe the Fed" when the Chair and the members of the Federal Reserve Board of Governors assert that they will do "whatever it takes" to tame inflation. Instead, after Core Consumer Price Inflation readings showed signs of moderating in September, investors opted to use their rose-colored glasses to view indicators of both stronger and weaker economic trends as good news, bidding up share prices for Value stocks and for the highly cyclical companies in the Energy, Industrials, Materials, and Financials sectors. Yields on longer-dated Treasuries declined through early December, as investors chose to believe that the Fed's announced intention to slow the pace of rate increases meant that the Fed was reversing course, and would reduce the terminal rate and quickly cut rates thereafter. This despite the Fed minutes, Federal Reserve members' public statements, and the Fed's Dot Plots all indicating the contrary.

We do not believe that the Fed has lowered its terminal rate or decreased the length of time it intends to hold the Funds rate at that higher terminal rate level. As we discussed last quarter, the Fed's increases in the Funds rate this cycle have been breathtakingly aggressive; furthermore, the Fed's rate increases have been accompanied by significant quantitative tightening. The Fed has repeatedly expressed its concern that a too-hasty return to normal will allow inflation to rekindle, and the most recent Dot Plot shows both a 0.5% increase in the terminal rate versus the September plot, and the Fed's intention to keep rates elevated for an extended time. Other Central Banks have also instituted record amounts of monetary restraint, the most significant since 1980.

This synchronized monetary tightening has initiated the predictable chain of events. The U.S. Treasury 10-Year to 2-Year yield curve inverted in early July. The National Association of Home Builders Market Index peaked in September, 2020 and has declined to 2006 levels. The Case-Shiller National Home Price Index peaked in March,

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2022, and housing starts peaked in April, 2022. Another highly predictive indicator, the Institute for Supply Management New Orders, has dropped to the same, contractionary levels as in early 2008. Forward earnings estimates for the S&P 500 peaked in June, 2022. Multiple labor market measures show softening: the number of new jobs created, while still positive, has been trending down since February, 2022; new job openings, while still very elevated relative to the number of job-seekers, have been trending down since March, 2022; and average hourly earnings, while still substantially above pre-pandemic levels, have also been trending down on a year-over-year basis since March, 2022.

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The frequently articulated concern of worldwide Central Banks, including the Fed, with breaking any established embedded inflationary pattern, seems very likely to lengthen the period of monetary restriction, which will lengthen the duration of decreasing employment and make an extended recession ever more likely. Indeed, the Federal Reserve Minutes from December noted that "it would take substantially more evidence of progress to be confident that inflation was on a sustained downward path" and "No participants anticipated that it would be appropriate to begin reducing the federal funds rate target in 2023."[1] While the bond market continues to predict that Fed Fund rates will begin to drop in July, 2023, we disagree. Federal Reserve Chair Jerome Powell has repeatedly referenced the 1979 to 1982 experience, when the Fed believes that it prematurely eased monetary policy after slightly softer inflation readings, only to have to quickly raise rates again when inflation persisted at unacceptably high levels. We expect the interest rate hikes to continue until the Fed is persuaded by several consecutive readings of much softer core inflation, much softer growth in unit labor costs and average hourly earnings, and a substantial rise in unemployment. We also expect that the Fed will be quite reluctant to cut rates until both the employment cost index and the broad personal consumption expenditure deflator measure of inflation are clearly headed back to acceptable levels.

Changes in the 10-Year Treasury yield typically lead the Purchasing Managers Index by 18 months, and the Fed is still raising rates; so the 2% increase in 10-year rates that we have seen since March of 2022 will not begin to have its full effect on economic activity until September of 2023, while current rates will still be constraining the economy in July 2025. We have now entered the time where every aspect of the economy will begin to feel the effects of the prior tightening; it will show up in wage growth, unemployment, falling housing prices, discretionary income, and spending.

Fourth Quarter Performance

After U.S. stock and bond markets both enjoyed a welcome respite in October and November, they resumed their downward march in December. After a two month, 14.14% rally, the S&P 500 returned -5.77% in December. Unlike the third quarter, however, major stock markets managed a gain for the quarter, with the S&P 500 returning 7.56%. After briefly passing the lead to Growth last quarter, Value outperformed Growth, with the Russell 3000 Value Index returning 12.18% while the Russell 3000 Growth Index returned just 2.31%. Nine of the eleven S&P 500 sector indices rose, with only two falling: the Consumer Discretionary sector returned -11.26% and the Communications Services sector returned -1.38%. Other sector returns ranged from 4.74% for Information Technology to 22.74% for the fossil-fuel based Energy sector. However, equity market gains for the quarter were relatively insensitive to either capitalization or geography, with the S&P Small Cap Index gaining 9.19%, the S&P Mid Cap index returning 10.78%, and the MSCI ACWI Net and the MSCI ACWI ex US Net gaining 9.76% and 14.29% respectively. Short-term Treasury yields continued to rise, with the 2-Year Treasury Note increasing by 0.15% to 4.429%; the 10-Year Treasury yield increased just 0.05%, to 3.89% at quarter-end. Investment-grade credit spreads narrowed, resulting in a positive return of 1.54% for the U.S. Government/Credit Intermediate Index, while the Bloomberg Intermediate 1-10 Year Municipal Bond Index gained 3.12%.

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1 Quotations are from: Minutes of the Meeting of December 13-14, 2022, FOMC Minutes December 13-14, 2022 (federalreserve.gov)

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Despite this very positive quarter, 2022 returns were deeply negative for both stocks and bonds. In 2022, the S&P 500 returned -18.11%, the MSCI ACWI Net returned -18.36% and the MSCI ACWI ex US Net returned -15.57%. During the year, estimated forward earnings for the S&P 500 rose by 3.1%, while valuation compression, as measured by price-to-earnings ratios (P/E), reduced S&P 500 returns by 21.9%. The U.S. Aggregate Bond Index returned -13.01% for the year, the worst return for that Index since 1975. The U.S. Government/Credit Intermediate Index returned -8.23% for the year, while the Bloomberg Intermediate 1-10 Year Municipal Bond Index returned -4.84%. This combined loss in both stocks and bonds resulted in the third worst performance for a portfolio of 60% of the S&P 500 and 40% of the U.S. Aggregate Bond Index since 1950.

Valuation and Positioning

The strong fourth-quarter rally brought the S&P 500 forward P/E ratio back to 16.65 times, just below its 25-year average of 16.82 times, and the cyclically adjusted price-to-earnings ratio (CAPE) to 27.96 times, just 0.03 above its 25-year average of 27.93. The earnings yield of the S&P 500 decreased to 6.0% during the quarter, while 10-Year Treasury Inflation-Protected Security yields decreased to 1.58%. This suggests that stocks will return about 4.4% more than bonds over the next year, although the range of possible outcomes is quite high. We continue to favor stocks over bonds as a default position, recognizing that while stocks may have additional risk over the immediate horizon, the earnings growth capacity of stocks should ultimately support their valuation in inflationary environments. However, we also acknowledge that bonds can provide a diversification benefit to portfolio construction after the steep rise in interest rates in 2022 created a more compelling valuation backdrop.

In the near term, declining business confidence and consumer confidence will likely translate into reduced corporate earnings, which may well initiate another down leg for equity markets. While we anticipate a recession and some earnings declines, we expect that the decline in earnings will be fairly modest, in the range of 10% to 15%. Even with the price-to-earnings compression that we have already experienced, we judge that further market downside is possible. In addition, consumer confidence tracks inversely with inflation; as inflation eases, this should support consumer confidence. Consumer confidence, housing starts, and equity market bottoms are all closely associated, so improving consumer confidence may limit the downside. Recovery from bear markets is usually sudden and sharp, so that attempts to time the market are usually unsuccessful. Overall, with distinctions in product type acknowledged, we conclude that we are appropriately positioned for a modestly more risk-off equity market. In either a slowing growth or a recessionary environment, we expect that our focus on quality, lower-leverage, profitable companies with steadier earnings and revenues will be protective.

We continue to avoid positioning for extremes and acknowledge that an environment of high uncertainty means an increased likelihood of rapid rotation, particularly as investors lean heavily on small changes in weekly and monthly data releases. In such an environment, thoughtful analysis of company management, strategies, and prospects assumes added importance. We remain committed to our long-term focus and investment in high-quality and sustainability-centered companies seeking to meet the challenges of this year of recovery and transition, and beyond. In addition, we are seeking out companies that acknowledge the ongoing climate crisis and which are setting their own targets for greenhouse gas reduction.

Where to from here?

In such challenging and difficult times as these, companies will be increasingly distinguished by the quality and integrity of their management, and by management's attention to evolving social and environmental considerations. This is all the more true as we see regulatory frameworks dismantled. The growing environmental, social, and policy challenges facing the world make it increasingly imperative that we, as

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shareholders, engage our companies in creating the transition to a lower-carbon economy and recognizing the human rights and dignity of their workers. We expect companies held within our portfolios to act with integrity and purpose, and to take leading roles in creating alternative mechanisms, through legislation or internal policies, to protect the needs and concerns of their employees, communities, and planet.

About Trillium Asset Management

Trillium Asset Management, LLC (Trillium), with $6.1B in assets under advisement ($4.4B in assets under management and $1.7B in assets under advisement as of 12/31/22), offers investment strategies and services that advance humankind towards a global sustainable economy, a just society, and a better world. For over 40 years, the firm has been at the forefront of ESG thought leadership and draws from decades of experience focused exclusively on responsible investing. Trillium uses a holistic, fully integrated fundamental investment process to uncover compelling long-term investment opportunities. Devoted to aligning stakeholders' values and objectives, Trillium combines impactful investment solutions with active ownership. The firm delivers equity, fixed income, and alternative investments to institutions, intermediaries, high net worth individuals, and other charitable and non-profit organizations with the goal to provide positive impact, long-term value, and 'social dividends.'

Contact Information

ContactUs@trilliuminvest.com

US: +1 (800) 548-5684
UK and Europe: +31 6 3888 5334

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