ASSET ALLOCATION PLAYBOOK

1Q 2023

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1Q 2023 Asset Allocation Playbook

Serving You and Your Advisor

The Ashton Thomas Asset Allocation Team is comprised of experienced, credentialed investment professionals who work with you and your Wealth Advisor to tailor portfolio solutions that fit the specific needs of your Ideal Financial Life.

MIKE SERIO, CFA®, CAIA®, MBA

Chief Investment Strategist

Mike is focused on ensuring access to high-quality advice for our advisors and their clients. He supports the Asset Allocation and Advanced Planning teams by weighing in on the financial markets and economy, investment due diligence processes, and overall plan development for the firm’s top clients.

CLAUDIU BARBOS

Director of Investments and Trading

Claudiu directs the Asset Allocation Team and supports advisors through monitoring financial markets and economic data, interfacing with third-party money managers, and overseeing trading functions. He also writes commentary on the markets and economy for the firm.

BRANDON CROMER

Portfolio Manager, Assistant Director of Investments and Trading

Brandon helps oversee the day-to-day functions of the trade desk. He also assists the Asset Allocation Team with market and investment analysis, as well as portfolio construction.

KODI THRUSTON

Investment Analyst

Kodi assists the Asset Allocation team with research related to the financial markets, the economy, and the client portfolio holdings. He also supports the firm’s trading functions.

It Is Mostly About Wage Inflation

William McChesney Martin coined the well-worn comment about the Fed being “in the position of the chaperone who has ordered the punch bowl removed just when the party was really warming up.” It sounds cliché at the moment, but it has been over 40 years since a shift in fed policy has been this dramatic.[1] Normally, when inflation runs as hot as it was in 2022, the central bank raises rates on the short end of the yield curve to slow the economy. When done in a timely manner and not to extremes, the economy does not suffer a recession and we can experience the sought-after “soft landing.”

Fourteen years ago, in the middle of the Great Financial Crises (GFC), the grand experiment titled Quantitative Easing (QE) was undertaken to ease rates, not only on the short end of the yield curve, but also for intermediate term debt.[2] In 2008, the fed’s balance sheet was $800 billion. It ballooned to almost $9 trillion at the start of 2022.[3] To put that into perspective, a trillion dollars is a thousand billion dollars! We believe that along with artificially lowering interest rates for 14 years, government spending and transfer payments disguised as tools to reduce inflation have added to the general level of price increases we saw in 2022. As with any buy-now-pay-later transaction, the bill has come due and is being paid in several different ways.

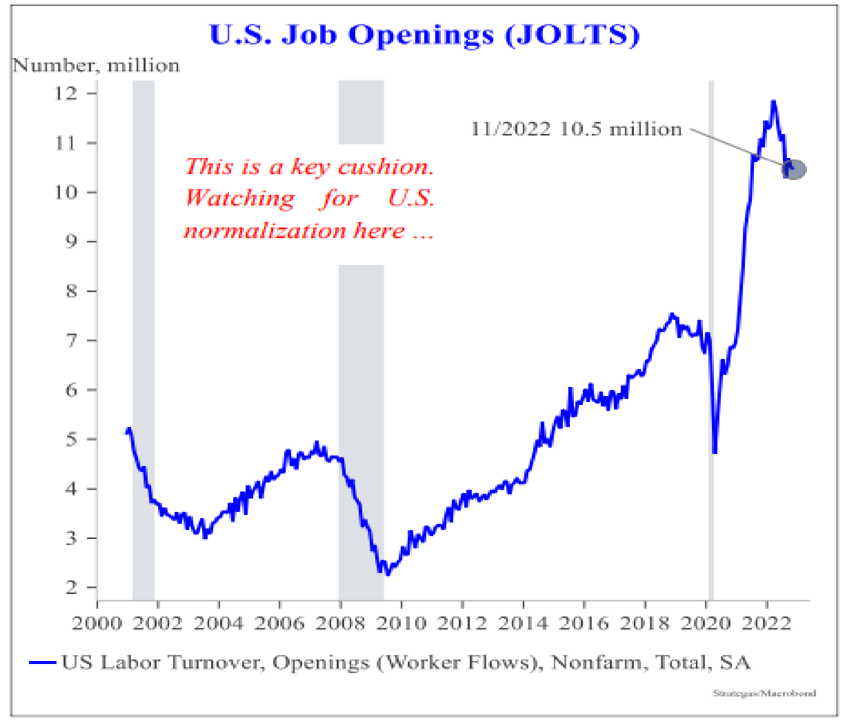
The unwinding of QE comes in the form of Quantitative Tightening which, somewhat logically, works in reverse. The Fed is slowly reducing its balance sheet, rates are rising, and we are seeing the resulting slowdown in economic growth.[3] History tells us that most recessions are, at least in part, a result of mismanaged Fed policy. Per a Bloomberg news article, "Economists say there is a 7-in-10 likelihood that the US economy will sink into a recession" sometime in 2023.[4]

1 https://www.stlouisfed.org/publications/regional-economist/january-2005/volckers-handling-of-the-great-inflation-taught-us-much
2 https://www.thebalancemoney.com/what-is-qe1-3305530
3 https://fred.stlouisfed.org/series/WALCL
4 https://www.bloomberg.com/news/articles/2022-12-20/economists-place-70-chance-for-us-recession-in-2023?leadSource=uverify%20wallhttps://www.cnbc.com/2022/12/23/why-everyone-thinks-a-recession-is-coming-in-2023.html

It Is Mostly About Wage Inflation

So, when does this stop and what could make the Fed reverse course? Even though general inflation levels show signs of falling, inflation is still too high. The good news is that, in most sectors of the economy, inflation is coming down. Housing prices in many areas have fallen due to rising interest rates. Energy, although spiking early in 2022 has moderated. Used cars, furniture, appliances and pharmaceuticals all have seen price increases slow materially, if not fall.[5] However, the Fed's main concern is—and will always be—wage inflation. Once wage inflation is present in the system, it is very difficult to combat.

One of the most popular ways to measure potential wage inflation is what some refer to as the "Jobs Gap". When the number of jobs available significantly exceeds the number of people actively looking for work, the consequence is rising wage growth. The chart to the right reflects the Job Opening and Labor Turnover (JOLTS) index, which measures the "quit rate." In 2022, most people who were actively quitting jobs continued to cite "higher pay" as the number one reason for the move.[6] Until this trend normalizes, we will continue to see a hawkish Federal Reserve Bank.



Source: Strategas (via subscription)

5 https://www.bls.gov/news.release/cpi.nr0.htm
6 https://www.cnbc.com/2022/03/22/great-resignation-continues-as-44percent-of-workers-seek-a-new-job.html

It Is Mostly About Wage Inflation

As higher interest rates are generally detrimental to long-term investing, the key question right now is: "When will this end?" Our forecast is that sometime mid-2023, the Fed will stop raising rates. This seems most likely to occur once the Fed Funds rate lands somewhere around 5% to 5.25%. At that time, further moves will be "data dependent" and will most likely be based on the wage inflation numbers mentioned above. Will the U.S. experience a recession? We put current odds at about 50% in 2023, and slightly higher within the next two years. Since 1907 there have been 14 U.S. recessions as defined by the National Bureau of Economic Research.[7] If history is any guide, there is a 13.83 % average probability of a recession in any one year.[8]

Most recessions do not represent the apocalyptic scenarios the media seems to be focused on promoting. With the number of job openings available, we believe that any negative economic growth experienced in the near term will most likely be shallow and short, extenuating factors notwithstanding. As long as unemployment does not approach levels that affect consumer confidence and, thus, spending (which is the largest component of our economy), we do not foresee a catastrophic economic breakdown in 2023. When the economy weakens, patient investors can be rewarded with buying opportunities that present themselves and can come to fruition in the next period of economic expansion.

7 https://www.thebalancemoney.com/the-history-of-recessions-in-the-united-states-3306011
8 https://ycharts.com/indicators/us_recession_probability

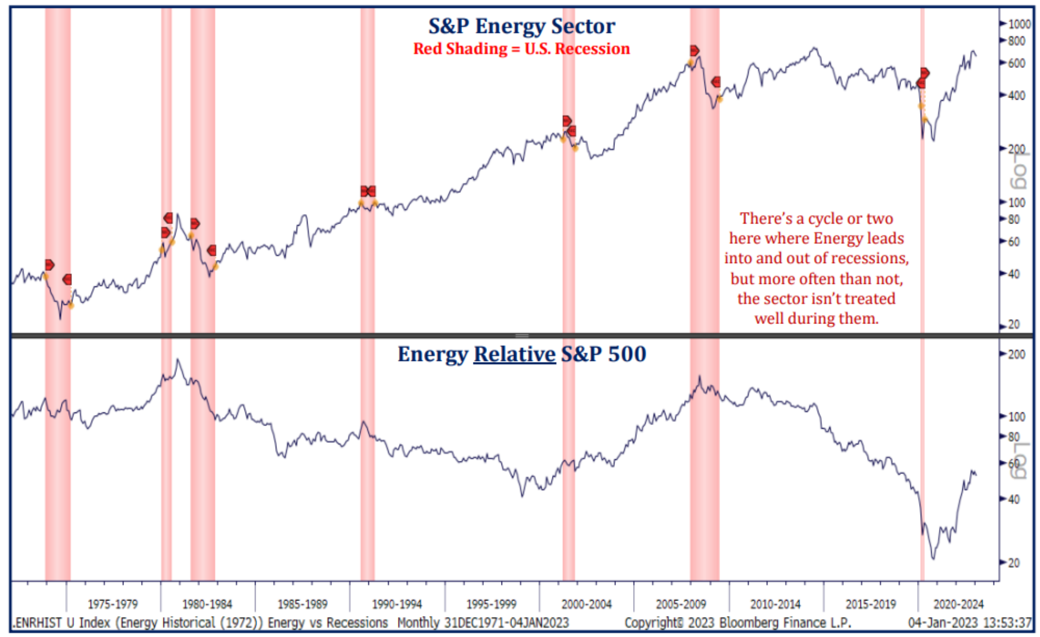
Energy Sector

Over a year ago, Ashton Thomas started looking with interest at the Energy sector for our investment clients. Initially, the environmental, social, and governance (ESG) "discount" made the sector seem inexpensive by all measures. Our belief that there was a 1) lack of supply and a 2) lack of capital going into the exploration and production of electric vehicle materials needed to get to the government's goal of 50% electric vehicle sales by 2030 pointed to potential outperformance of the Energy sector.[1] As with any commodity, prices can be very volatile and give back gains due to a number of possible outcomes. We are looking to take some profits in Energy at some point, but both the technical and fundamental environments are causing us to pause on that action.

The technical views are starting to change. It is rare for a sector to double its weight in the S&P 500 during a two-year time frame, as we have seen with Energy of late. If we are currently in or are about to experience a recession within the next two years, the result for energy prices is not likely to be attractive due to demand destruction, as history has shown (see chart).

However, on a purely technical basis, we continue to hold our positions—for now—and we will be following energy prices closely. Most of the outperformance in Energy occurred earlier in 2022, but the sector may still be attractive moving into 2023.

RECESSIONARY ENVIRONMENT IS A RISK



Source: Strategas (via subscription)

1 https://www.whitehouse.gov/briefing-room/statements-releases/2021/08/05/fact-sheet-president-biden-announces-steps-to-drive-american-leadership-forward-on-clean-cars-and-trucks/

Energy Sector

Even though we are seeing potential changes in the technical aspects of the Energy sector, the fundamentals continue to show positives. We are seeing more companies report expected increases in capital spending for 2023.[2] However, even with capital expenditures possibly moving up versus historical norms, the amount of oil needed to materially bring enough product to market and move prices is still high relative to what can be produced at elevated spending levels. China reopening could also move prices up, as the COVID shutdowns removed a good deal of demand which will be returned to the market by China resuming more normative economic activity.[3]

In spite of both the technical and fundamental environments, we know that investing in anything based on commodity prices can be volatile. The energy idea has worked better than we initially expected, and we will let this run for a while. However, we are never wedded to any one investment idea. When the signals tell us to sell, we will not hesitate to trim or sell out of positions.

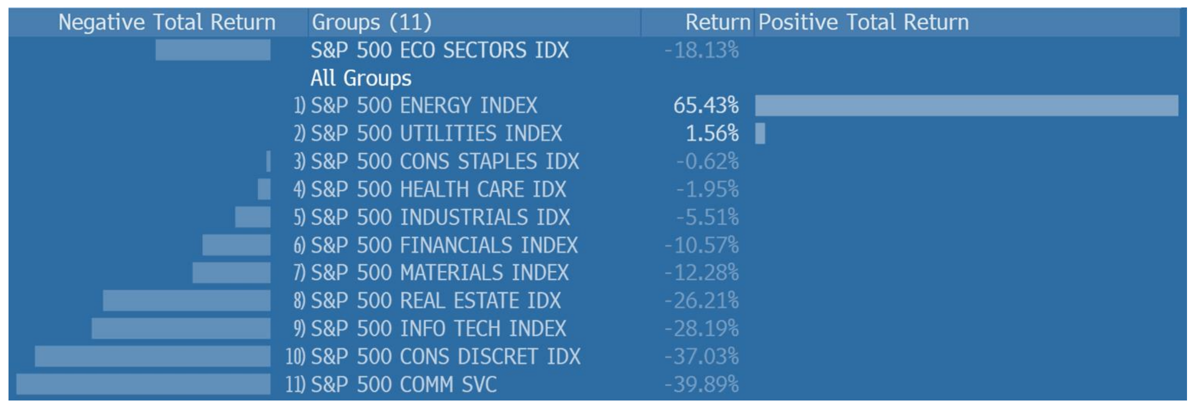
2 https://www.spglobal.com/commodityinsights/en/ci/research-analysis/global-energy-sector-capex-strong-rebound.html; https://jpt.spe.org/exxonmobil-chevron-boost-2023-capital-spending
3 https://www.reuters.com/business/energy/opec-sticks-2022-2023-oil-demand-growth-forecasts-after-downgrades-2022-12-13/

Financial Sector

When Ashton Thomas first introduced the opportunistic idea of the U.S. Financial sector, it was predicated on the forecast of higher interest rates leading to an increase of the spread between what banks pay for capital and the price at which they lend it. Although the relative performance of the idea was positive versus the overall market, the absolute performance was negative, as was every sector in 2022, with the exception of energy and utilities.

Rising rates have helped lending spreads, but the relative performance of banks has been inconsistent. The pace and magnitude of Federal Reserve rate hikes have made financial conditions tighter than markets expected. We believe that if Fed tightening does slow or even stop by mid-2023, the positives of Quantitative Tightening should aid loan revenue and create a more positive banking environment.

Relative performance in 2023 could be impaired by an inverted yield curve, which not only indicates the likelihood of a slower economy, it makes borrowing funds short-term and lending them long-term a bit riskier. Investment banking and the IPO market have come to a relative standstill, weakening the fee revenue of financial institutions.[1] An additional risk is non-financial "financials" taking market share, as we have seen with various kinds of fintech and other global players entering the space.



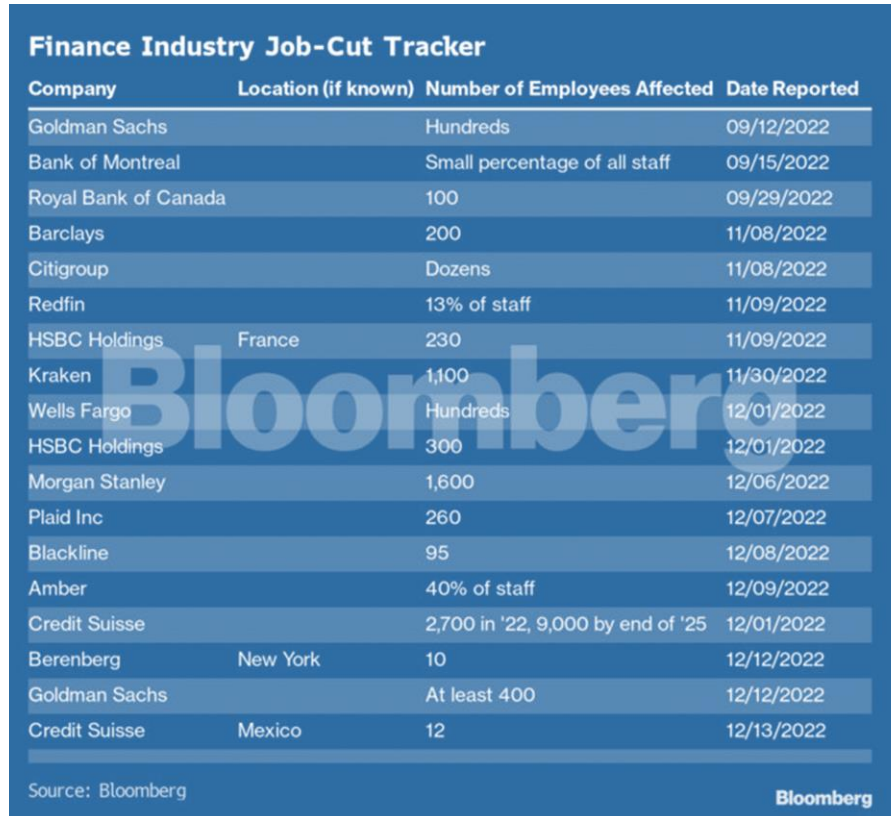
Negative Total Return	Groups (11)	Return	Positive Total Return
	S&P 500 ECO SECTORS IDX	-18.13%	
	All Groups		
	1) S&P 500 ENERGY INDEX	65.43%	
	2) S&P 500 UTILITIES INDEX	1.56%	
	3) S&P 500 CONS STAPLES IDX	-0.62%	
	4) S&P 500 HEALTH CARE IDX	-1.95%	
	5) S&P 500 INDUSTRIALS IDX	-5.51%	
	6) S&P 500 FINANCIALS INDEX	-10.57%	
	7) S&P 500 MATERIALS INDEX	-12.28%	
	8) S&P 500 REAL ESTATE IDX	-26.21%	
	9) S&P 500 INFO TECH INDEX	-28.19%	
	10) S&P 500 CONS DISCRET IDX	-37.03%	
	11) S&P 500 COMM SVC	-39.89%	

Source: Bloomberg, LP (via subscription)

1 https://www.investors.com/news/technology/ipos-in-2022-a-year-to-forget-as-numbers-fall-sharply/#:~:text=It's%20shaping%20up%20to%20be,plunged%2094%25%20to%20%248.6%20billion

Financial Sector

We continue to recommend an overweight in financials, but we are focusing on both lending and fee income growth. At this point, expense management remains paramount for financial firms, and the sector continues to make additional layoffs, a trend witnessed since the waning of the pandemic.[2] Profitability is improving in the sector, but we are watching possible headwinds which would tell us to reverse our opinion.



Finance Industry Job-Cut Tracker

Company	Location (if known)	Number of Employees Affected	Date Reported
Goldman Sachs		Hundreds	09/12/2022
Bank of Montreal		Small percentage of all staff	09/15/2022
Royal Bank of Canada		100	09/29/2022
Barclays		200	11/08/2022
Citigroup		Dozens	11/08/2022
Redfin		13% of staff	11/09/2022
HSBC Holdings	France	230	11/09/2022
Kraken		1,100	11/30/2022
Wells Fargo		Hundreds	12/01/2022
HSBC Holdings		300	12/01/2022
Morgan Stanley		1,600	12/06/2022
Plaid Inc		260	12/07/2022
Blackline		95	12/08/2022
Amber		40% of staff	12/09/2022
Credit Suisse		2,700 in '22, 9,000 by end of '25	12/01/2022
Berenberg	New York	10	12/12/2022
Goldman Sachs		At least 400	12/12/2022
Credit Suisse	Mexico	12	12/13/2022

Source: Bloomberg

Bloomberg

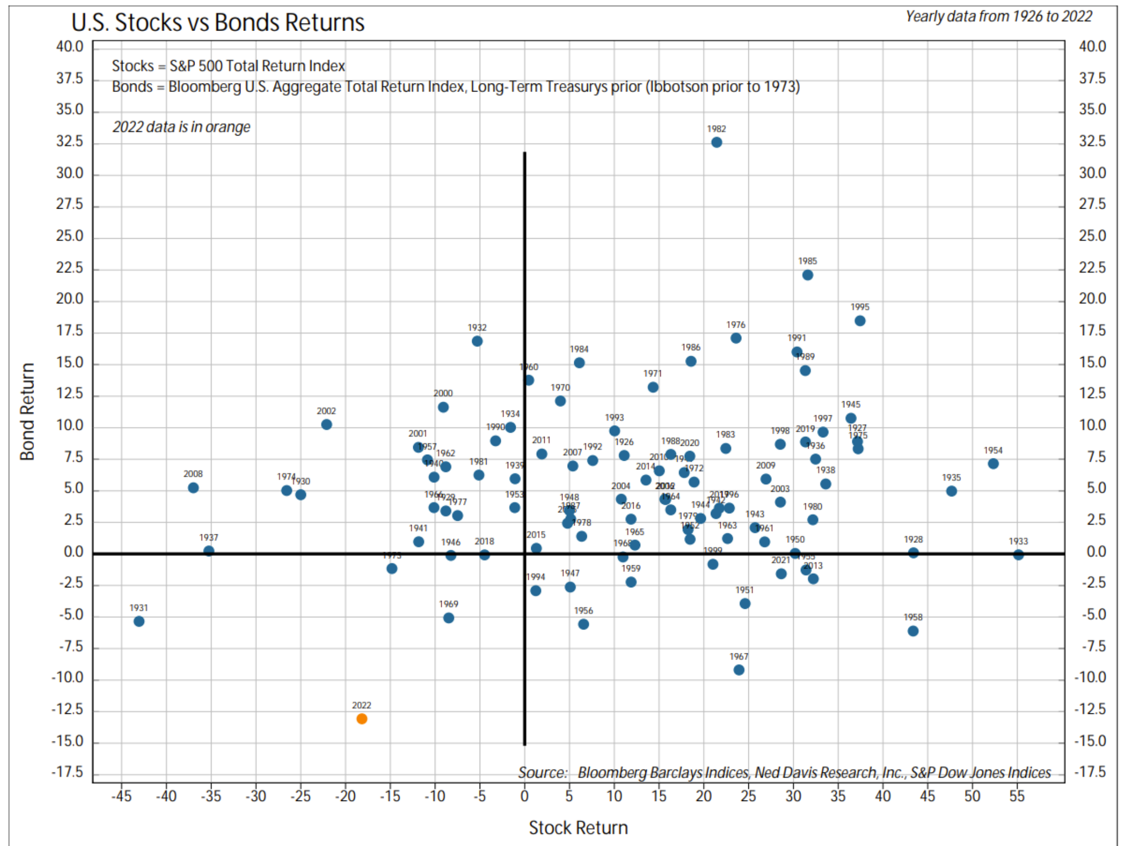
Source: Bloomberg, LP (via subscription)

2 https://www.nbcnews.com/business/corporations/white-collar-layoffs-rising-which-companies-economic-slowdown-rcna59846

Patience Is a Virtue

When seasoned investors look back on 2022, it will be remembered for quite a long time, unfortunately not for positive reasons. Dominating the headlines were the exogenous shock of the Ukraine invasion, the continued effects of the COVID pandemic, and the historical pace and magnitude of Federal Reserve hawkishness.

The S&P 500 fell 18.11% and the bond market, which historically does not move in sync with the stock market and is relied on as a "hedge" to stocks, was down -13.01% as measured by the Bloomberg US Aggregate Bond Total Return Index.[1] It was only the fifth time since 1926 that both stocks and bonds declined in the same year, and the first time they both fell by over 10% (see chart).



BA3

Source: Ned Davis Research (via subscription)

1 https://www.ishares.com/us/products/239458/ishares-core-total-us-bond-market-etf

EQUITIES

Patience Is a Virtue

To further recap 2022 market performance and the Ashton Thomas Strategy during the year we observe that Large Growth stocks severely underperformed Large Value stocks by a margin of -24.63%. We have emphasized value over growth for more than a year, and although the asset class did have a negative return, the weakness in shorter-duration value stocks held up relatively well (see chart to the right).

As for the sector recap, the sector with the largest positive return (by a wide margin) was Energy. As mentioned in the Opportunities section, Energy as a sector was up 65.43% on a total return basis. Our other U.S. equity opportunistic idea, Financials, did not fair quite as well, returning -10.57%. However, it still outperformed the general index by over 8%.

LC Value > LC Growth by most since 2000

Russell Cap-Weighted Total-Return Indices % Gain
12/31/2021 - 12/30/2022

	Value	Blend	Growth
Large	-5.11	-19.77	-29.74
Mid	-12.03	-17.32	-26.72
Small	-14.48	-20.44	-26.36

Source: Russell. Data Total-Return.
Large-cap = Russell Top 200 indices.
Mid-cap = Russell Mid Cap indices.
Small-cap = Russell 2000 indices.
Blend = broad index at all market-cap levels.

Ned Davis Research SBOX_001.RPT

Source: Ned Davis Research (via subscription)

Negative Total Return	Groups (11)	Return	Positive Total Return
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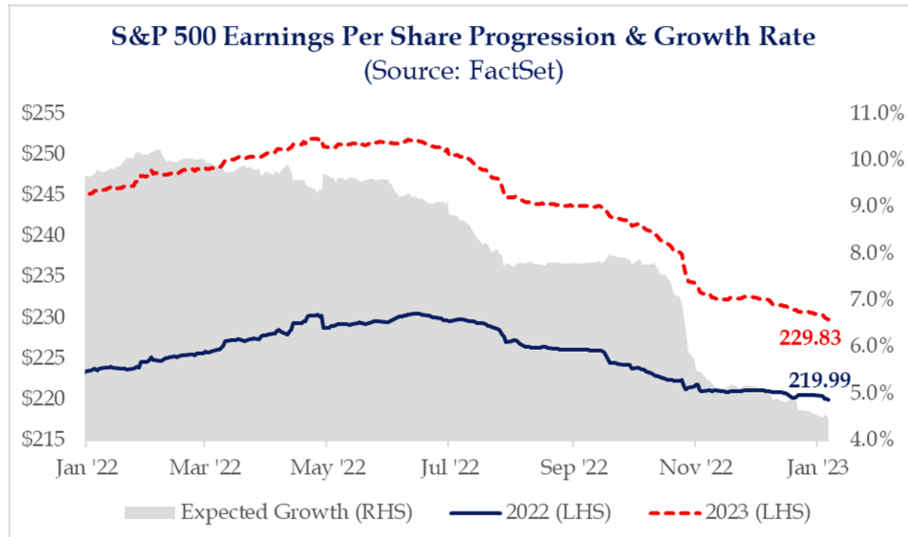
Source: Bloomberg, LP (via subscription)

Patience Is a Virtue

Looking backward can be beneficial, as history sometimes provides guidelines for the future. Investors should look to 2023 and discuss the risks and opportunities present. Two of the most important factors in any investment are cash flow to the investor and interest rates.

As discussed in the Macro comments, interest rates stand to continue rising, probably into mid-2023. Our view is that present market levels have likely factored in the coming increases in interest rates, as least as forecast today.

At this point, we believe the biggest risk for stocks would be sales and earnings weakening. As this chart from Strategas shows, 2023 earnings estimates have been coming down for the last six months. Our view is that consensus earnings estimates are too high, and we should see earnings expectations fall.

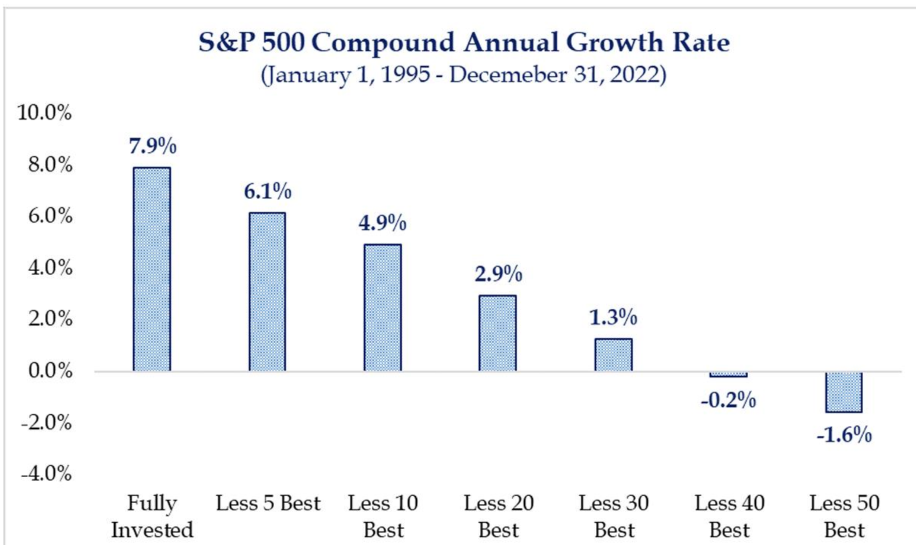


Source: Strategas (via subscription)

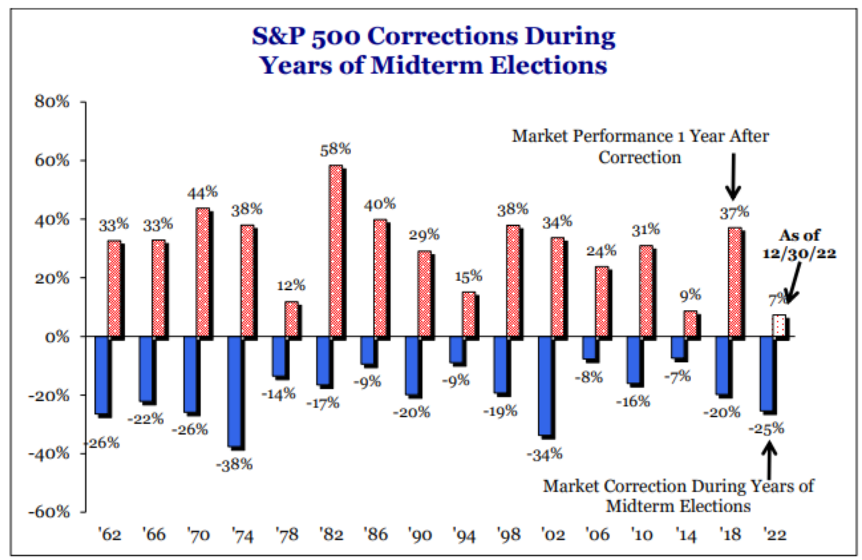
Patience Is a Virtue

Readers of the quarterly Playbook will recognize the chart on the preceding page and the one shown below. The points illustrated in both cannot be stressed enough right now. Many of the questions we have received over the years center around when, if at all, to pull out of the market and if (and when) we think particular risks loom ahead. We continue to counsel clients that the market is more of a "barometer" which seeks to forecast what kind of financial "weather" may be coming, not simply a "thermometer" telling us the current market "temperature." Timing the market is almost impossible, as returns tend to come in a few, short-lived timeframes. This is illustrated by the chart from Strategas below.

At the risk of discussing too many charts, we want to put out one more reason *not* to focus on timing the markets. Dare we say, this chart could even make one optimistic. We are talking about the election cycle. This chart looks at the magnitude of corrections during midterm elections since 1962 and market performance one year after. The conclusion is that, since 1962, every calendar year following a midterm election has been positive. We might conclude that post-election investors anticipate better monetary and fiscal policy in the year following the vote. Of course, there is no guarantee that this will play out, but it does give us food for thought.



Source: Strategas (via subscription)



Source: Strategas (via subscription)

FIXED INCOME

Inversion, Inflation, Correlation, and The Fed

The fourth quarter of 2022 saw some historic activity in the bond market. First, we saw an even deeper inversion in yields, signaling impending Recession. Next, we that saw inflation, as measured by the Consumer Price Index (CPI), remained stubbornly high. Then, we saw fixed income reemerge as a viable source of return, with yields going well above 4% in the short end of the curve. Finally, we saw the Fed continue Quantitative Tightening, raising rates by 50 basis points at their final meeting of 2022. Let us dig in and digest.

U.S. Treasury market

		Change (%)		
Maturity	Yield	Week	Month-to-date	Year-to-date
2-year	4.18	-0.17	-0.13	3.45
5-year	3.63	-0.14	-0.11	2.36
10-year	3.49	-0.09	-0.12	1.98
30-year	3.55	-0.02	-0.19	1.64

Source: Bloomberg L.P., 16 Dec 2022. **Performance data shown represents past performance and does not predict or guarantee future results.**

Municipal market

		Change (%)		
Maturity	Yield to Worst	Week	Month-to-date	Year-to-date
2-year	2.49	0.05	-0.04	2.25
5-year	2.43	-0.04	-0.20	1.84
10-year	2.47	-0.04	-0.24	1.44
30-year	3.42	-0.04	-0.10	1.93

Source: Bloomberg L.P., 16 Dec 2022. **Performance data shown represents past performance and does not predict or guarantee future results.**

Yield ratios

	Ratio (%)
10-year AAA Municipal vs Treasury	71
30-year AAA Municipal vs Treasury	97
High Yield Municipal vs High Yield Corporate	66

Source: Bloomberg L.P., Thompson Reuters, 16 Dec 2022. AAA municipals represented by the MMD scale. The high yield ratio equals the yield-to-worst for the Bloomberg High Yield Municipal Index divided by the yield-to-worst for the Bloomberg High Yield Corporate Index. **Performance data shown represents past performance and does not predict or guarantee future results.**

Characteristics and returns

				Returns (%)		
Index	Yield to Worst (%)	Spread (bps)	Effective Duration (years)	Week	Month-to-date	Year-to-date
Municipal	3.40	–	6.16	0.24	1.07	-7.81
High yield municipal	5.62	241[1]	7.73	0.31	2.07	-11.15
Short duration high yield municipal[2]	5.32	287	4.16	0.17	1.23	-4.67
Taxable municipal	4.88	119[3]	8.37	0.88	2.56	-15.65
U.S. aggregate bond	4.35	50[3]	6.29	0.80	1.70	-11.13
U.S. Treasury	3.86	–	6.32	0.68	1.47	-10.71
U.S. government related	4.48	60[3]	5.37	0.45	1.15	-9.79
U.S. corporate investment grade	5.11	132[3]	7.34	0.55	1.96	-13.73
U.S. mortgage-backed securities	4.33	43[3]	5.65	1.28	1.96	-9.69
U.S. commercial mortgage-backed securities	5.00	121[3]	4.64	0.86	1.35	-9.75
U.S. asset-backed securities	5.03	89[3]	2.92	0.49	1.02	-3.96
Preferred securities	7.17	274[3]	4.99	0.57	0.76	-13.22
High yield 2% issuer capped	8.58	459[3]	3.88	0.03	0.75	-9.96
Senior loans[4]	10.46	648	0.25	0.07	0.15	-1.26
Global emerging markets	7.31	351[3]	6.21	0.47	1.81	-14.46
Global aggregate (unhedged)	3.49	52[3]	6.82	-0.09	1.72	-15.27

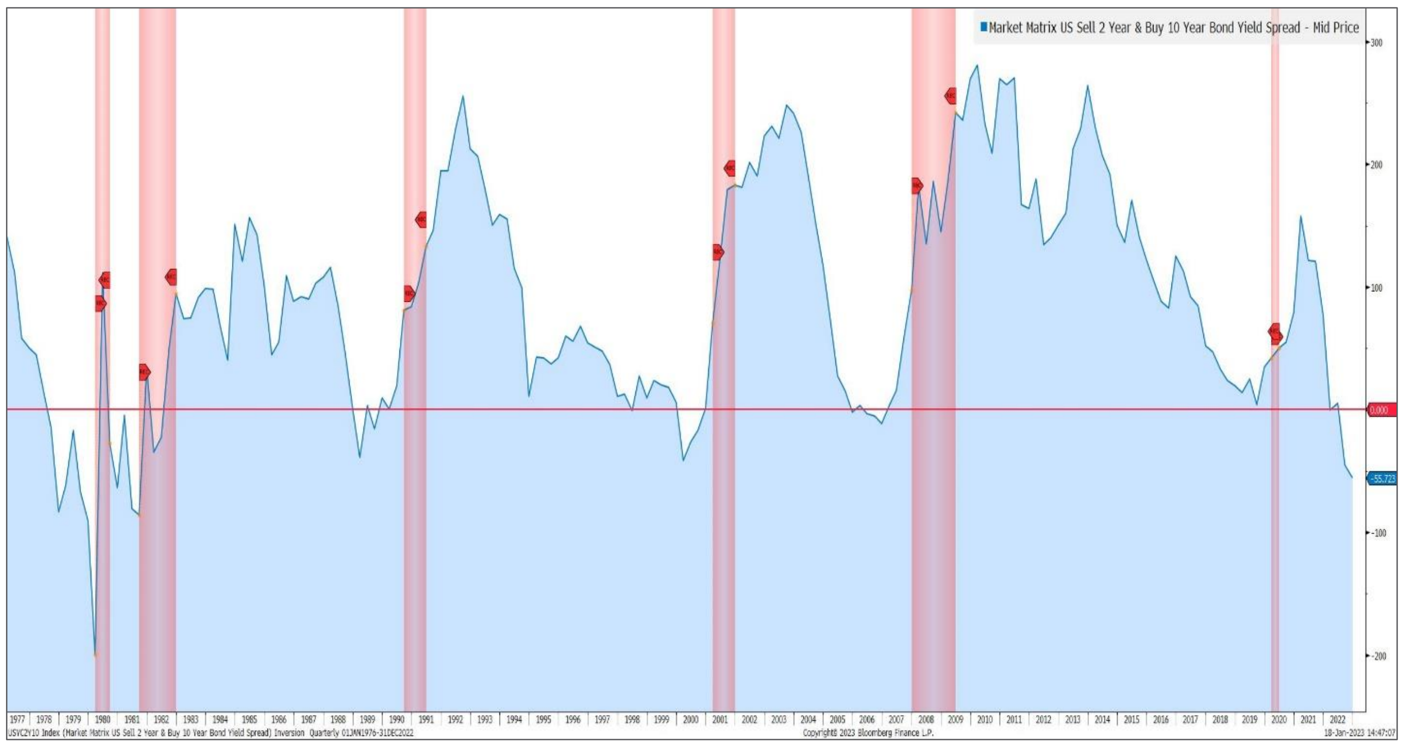
1 Yield difference between the Bloomberg High Yield Municipal Index and the 20-year AAA MMD scale. **2** Data is a subset of the S&P Short Duration Municipal Yield Index that is below investment grade/nonrated. Spread is the yield difference between this subset and the subset rated AAA. **3** Option-adjusted spread to Treasuries. **4** Spread refers to the 3-year discount margin. Duration is estimated based on the frequency of the reset date.

Source: Bloomberg L.P. and Credit Suisse, 16 Dec 2022. **Performance data shown represents past performance and does not predict or guarantee future results.** Unless otherwise noted, the index is Bloomberg. All index returns are shown in U.S. dollars. **Yield to worst** is the lowest potential yield that can be received on a bond without the issuer actually defaulting. **Effective duration** (expressed in years) measures the price sensitivity of a fixed-income investment to a change in interest rates, considering that expected cash flows will fluctuate as interest rates change. Index performance is shown for illustrative purposes only. Index returns include reinvestment of income and do not reflect investment advisory and other fees that would reduce performance in an actual client account.

Inversions

The yield curve inversion steepened sharply during the quarter. The last inversion this severe was in the second half of 2006. The more severe an inversion is, the more likely a recession is to occur.[1] Rates ranging from the 6-month T-Bill to the 7-year Note all inverted to the 10-year Treasury Note. There was more compensation being given to buy 6-month Bills than there was to buy 10-year Notes! The spread (or difference) between the 2-year T-Note and the 10-year T-Note reached as high as 84 basis points, as bond buyers drove up yields on short-term paper in anticipation of further rate hikes.

The inversion of the 20-year Bond to the 30-year Bond continued, as it has for approximately the past year. Again, inversions are the fixed income market signaling that recession is around the corner, whether that be next quarter, next year…or that it may be here already. Although not a perfect gauge, investors who choose to ignore this bellwether often so at their own financial peril.



Source: Bloomberg, LP (via subscription)

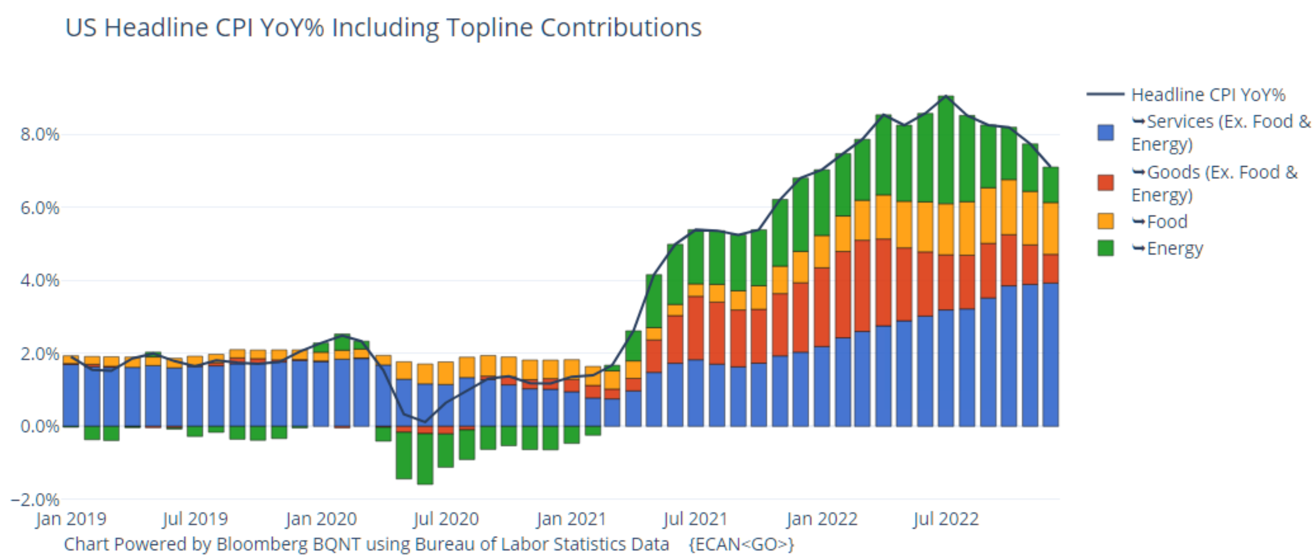
1 https://www.forbes.com/sites/simonmoore/2022/11/18/yield-curve-inversion-deepens-increasing-likelihood-of-2023-recession/?sh=5f0658c834eb

Inflation

As previously mentioned, and discussed in other editions of this Playbook, inflation turned out to not be transitory. Now that the term has been abandoned by everyone at The Fed, the Treasury, and the current White House administration, the focus has shifted to what is really driving inflation and keeping it stubbornly high. The CPI continued to print above 7% year-over-year as of the end of the fourth quarter, and we still believe it will be very hard to bring inflation down to the Fed's target of 2%-3% in the long term. It may even prove difficult in the intermediate term.[2]

Consumers and producers have certainly benefited from lower gas prices, but less-volatile inflation inputs have become much "stickier." Lower prices at the pump in the U.S. were partially due to the White House's policy of draining the Strategic Petroleum Reserve to an approximately 38-year low.[3] That supply must eventually be replenished, and the market and oil producers understand this. Demand in this past quarter has certainly been tamped by China not fully reopening, although there are signs that could happen in early 2023.

When China does reopen from the most recent COVID lockdowns, we expect to see some pent-up demand unleashed, potentially driving commodity prices higher. Add to this, potential escalations in the Russia/Ukraine war, especially due to the current unwillingness of the U.S. to force peace talks with Russia, and this has all the makings of very long winter for Europe and the U.S.

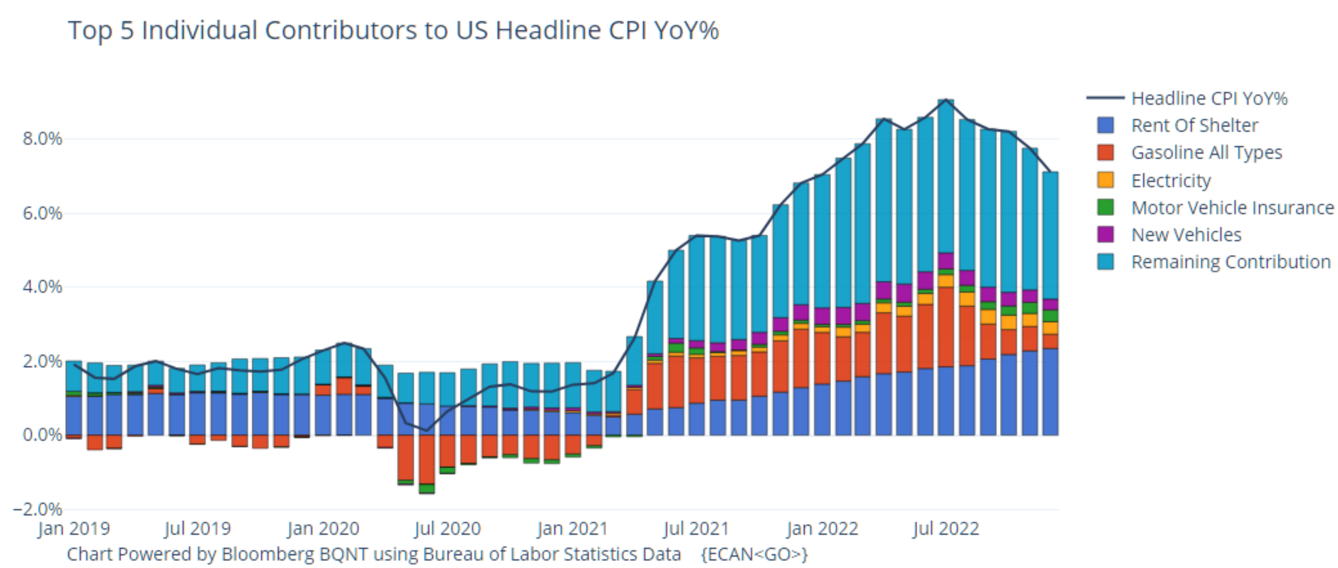


Top 5 Individual Contributors to US Headline CPI YoY%

2 https://www.cnbc.com/2022/01/12/cpi-december-2021-.html
3 https://www.telesurenglish.net/news/US-Strategic-Petroleum-Reserve-Low-at-416.4M-Bbl-20221007-0017.html

Inflation

Services continue to account for a bigger and bigger portion of the CPI. This is troubling for a number of reasons, most notably because this includes things like wages, which remain very sticky to the upside. As of the last reading, wages grew at a rate of 4.6% year-over-year and are proving hard to slow down or decrease, especially when considering that real wages are actually negative (-2.5% to be exact).[4] Employees continue to ask for more compensation and employers have few choices but to meet those demands or risk losing valuable employees, especially since the most recent unemployment rate dipped to 3.5%, from 3.7%.[5] Look for the inflation story, especially the sticky components, to remain a hot topic in 2023, with consumers feeling pricing pain across the board and curtailing discretionary purchases as a result.

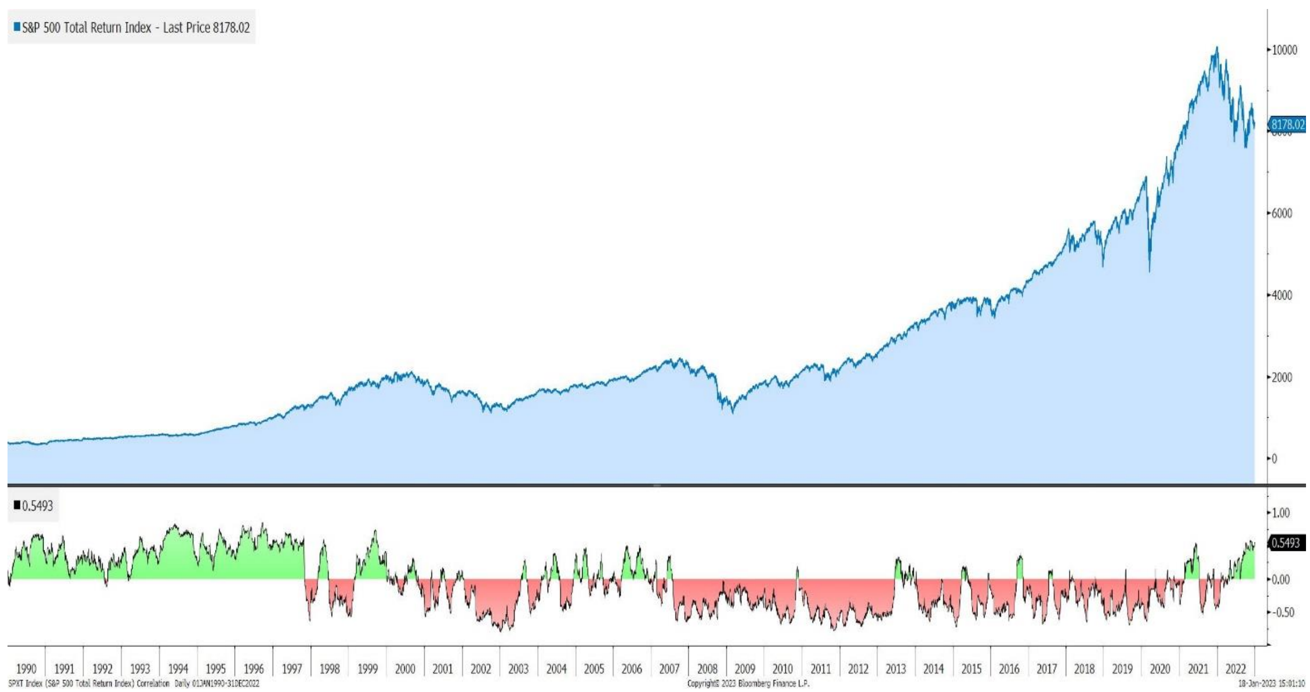


4 https://www.usatoday.com/story/money/economy/2023/01/11/wage-growth-2022-fed-inflation/11024220002/
5 https://www.forbes.com/sites/jonathanponciano/2022/10/07/unemployment-rate-fell-to-35-in-september-as-labor-market-added-263000-jobs/?sh=3d5be9c37fde

Correlation

The strong correlation of the fixed income selloff relative to equities which we saw through the first part of 2022—a correlation of approximately 0.54 to 1—continued through the fourth quarter. Although not unprecedented, this is rare. In fact, the last time it happened was in 2007. This means fixed income has been both a poor diversifier this year and a net contributor to negative portfolio returns. AGG, the iShares Core U.S. Aggregate Bond ETF, finished down 13.01% in 2022.[6] Fixed income traders and investors continued to adjust perceptions and expectations about rising rates in the fourth quarter of 2022. This adjustment meant reconsidering how much interest rates would rise, how quickly, and when the Fed would be done hiking them.

Bond investors, especially those holding long duration, have seen steep declines in value, although some of that loss was erased in the final quarter of the year. Ten-year T-Note yields spiked to as high as 4.21% during the quarter before buyers emerged and drove yields back to a year-end close of approximately 3.88%.[7] This slide in yield and rise in price was a result of access to higher yields not seen since the Great Financial Crisis, so buyers responded by selling equities and taking a yield over 4% from the Treasury. As rates rose, issuance has certainly slowed, especially in the fourth quarter, with many issuers unable or unwilling to issue debt at 5% or more when they could issue 10-year (or more) debt at 2% a year ago.



Source: Bloomberg, LP (via subscription)

6 https://www.ishares.com/us/products/239458/ishares-core-total-us-bond-market-etf
7 https://www.macrotrends.net/2016/10-year-treasury-bond-rate-yield-chart

The Fed

Which leads us back to The Fed, where all fixed income roads eventually lead. The Fed has raised rates and has done so aggressively. They have stated they will continue to do so until inflation is tamed. But some investors are betting the Fed will not raise rates into a recession, as Volker did in 1981.

The Fed has stated and/or shown the following four things which are still applicable in the fourth quarter of 2022 and into the first quarter of 2023:

- The Fed Put is at least suspended, if not dead.[8]
- Housing is too expensive. Mortgage rates are now close to 7% nationwide and housing is in a recession,[9] with some markets showing price decreases on a year-over-year basis.
- The Fed would be comfortable with an Unemployment Rate around 4% to decrease wage pressure. They have stated this clearly.[10]
- Inflation is their primary concern.

We expect at least another 75 basis points of hikes to the Fed Funds rate before the Federal Open Market Committee (FOMC) begins to think about pausing. We anticipate a hike of 50 basis points in February and another of 25 basis points in March. Sadly, this may not be enough, and the Fed may have to continue hiking rates further into 2023. The market currently expects the Fed to reach their terminal rate by about March of 2023. But what if the CPI is still greater than that terminal rate? If that happens, current policy dictates they must keep hiking to fight the inflation fight. Will they have the fortitude to keep doing so, especially since it may mean defaults in the corporate market, higher financing costs for all debt including government debt, and potentially a million workers losing their jobs as they push the Unemployment Rate to 4%? We shall see. The Fed is in a box of its own making and trying to engineer a "soft landing" in a large and complex economy, a possibility looking less likely with each new economic print.

8 https://www.bloomberg.com/news/newsletters/2022-05-18/what-s-happening-in-the-world-economy-the-fed-isn-t-coming-to-rescue-markets
9 https://www.bankrate.com/real-estate/fed-housing-comments/
10 https://apnews.com/article/inflation-business-unemployment-8bbad9288d524bf30b2087d79b71597c

FIXED INCOME

Outlook

We continue to favor a short-duration approach to fixed income for the first quarter of 2023 and possibly beyond. This approach allows investors to tactically take advantage of rates as they rise and as yields adjust. At the moment, there is very little compensation being given for going out past two years in maturity. The recent yields at one year or under continue to be above 4.5%. As the yield curve flattens, we would look to extend duration in anticipation of The Fed either ceasing rate hikes or possibly even lowering them to stimulate the economy out of recession.

We also continue to favor relatively short-term and pre-refunded Municipal bonds, while paying attention to collateral for pre-refunded issues or sources of revenue for traditional general obligation and revenue bonds. We have seen clients access issues with tax equivalent yields north of 4.70% (assuming the highest tax bracket) and should continue to see opportunities for yield pick-up in Munis, although we do see supply becoming an issue and with continued low issuance in the Muni space, relatively speaking.

Lastly, we still favor a short-duration approach to Corporates, paying attention to strength of earnings and cash flow available to meet interest and principal needs. Investment Grade and High-Yield Corporates should be evaluated even more closely to see the impact of inventories and decreased order demand. We favor issuers that can pass along all or most of their increased costs to the consumer. We do not currently recommend foreign or emerging market debt, as we see too many pitfalls from political risk, inflation risk, and increased volatility in those markets. This position could change later in the year as the U.S. dollar softens against other currencies and if the Russia/Ukraine war ends or peace negotiations begin.

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The Standard & Poor's (S&P) 500 Index tracks the performance of 500 widely held, large-capitalization U.S. stocks.

The Bloomberg Barclays U.S. Aggregate Bond Index is a broad-based fixed-income index used by bond traders and the managers of mutual funds and exchange-traded funds (ETFs) as a benchmark to measure their relative performance

The Consumer Price Indexes (CPI) program produces monthly data on changes in the prices paid by urban consumers for a representative basket of goods and services (Source: U.S. Department of Labor).

The 10-year Treasury Note represents debt owed by the United States Treasury to the public. Since the U.S. Government is seen as a risk-free borrower, investors use the 10-year Treasury note as a benchmark for the long-term bond market.

ASSET ALLOCATION PLAYBOOK

1Q 2023

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