

Dear Friend,

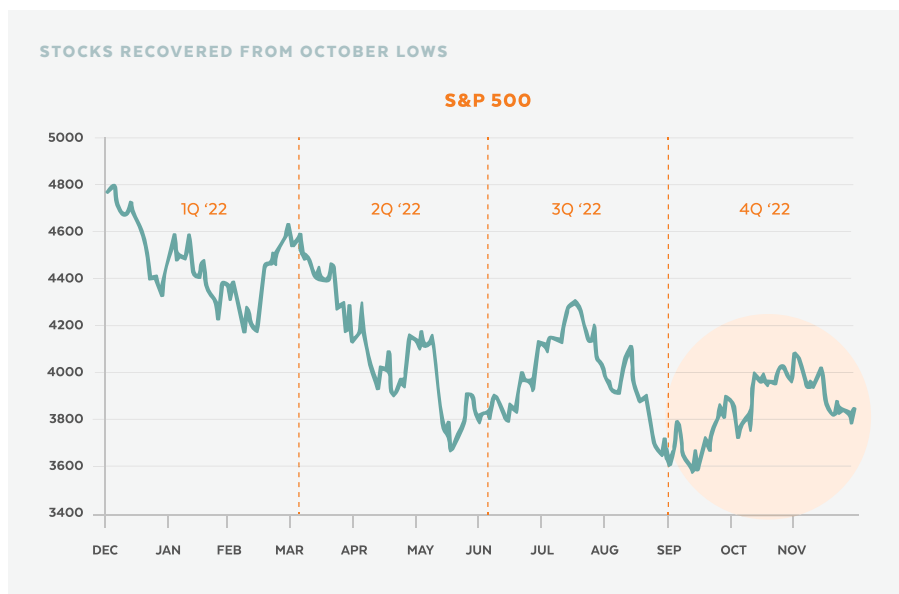
January 12, 2023

2022 was a year beset by challenges, led by the Russia-Ukraine war, global supply chain disruptions, high inflation, rising interest rates across much of the developed world, and pronounced economic weakness in Europe and China. Although the US economy grew at an annual rate of +3.2% in Q3 and is expected to reach +4% growth in Q4, a hawkish Federal Reserve and upward pressure on bond yields led to a significant re-rating of most risk assets. As Strategas Research put it, “the individual investor found few places to hide aside from cash, energy stocks, and a few select commodities.”

Selling pressure was most pronounced in riskier segments of the market, which had previously been the biggest benefactors of the liquidity surge that characterized 2020 and 2021. Cryptocurrencies, SPACs, and high-flying tech stocks were beaten down in 2022, with several high-profile cryptocurrency firms declaring bankruptcy. Growth stocks (-29.1%) lagged value stocks (-7.5%) by a wide margin, while the broad S&P 500 index (-18.1%) fell by about half as much as the tech-heavy Nasdaq (-32.5%).

*“In investing, what is comfortable is rarely profitable.”*

- ROBERT ARNOTT



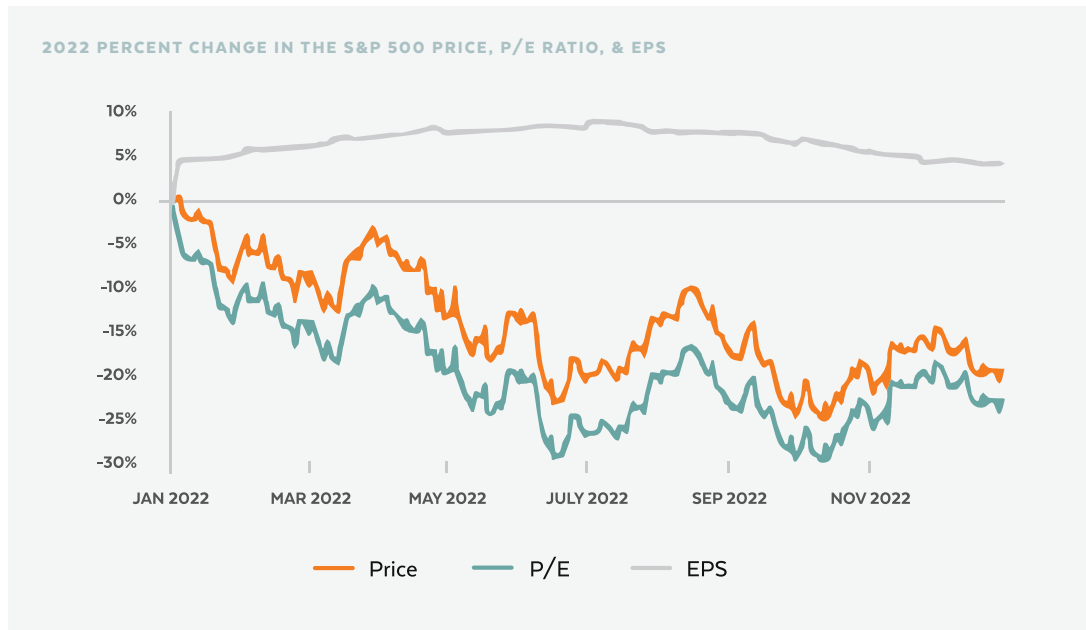
Source: Strategas Research

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Worth noting is that much of the S&P 500's decline in 2022 was driven by multiple contraction (falling P/E ratios), since corporate earnings held up relatively well throughout the year. S&P 500 corporate earnings are expected to have increased by roughly +5% in 2022 (-2% when excluding the Energy sector's contribution), while the index fell by a wider margin. In our view, this could be an indication that some of the expected earnings weakness in 2023 may already be priced into stocks.

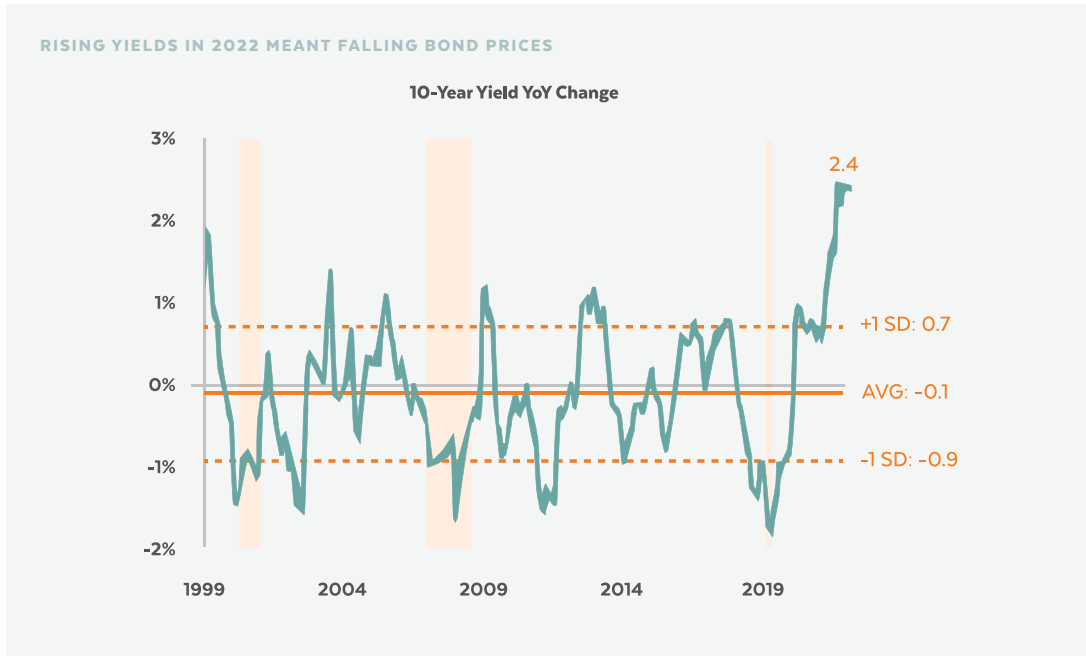


Source: Strategas Research

We also think that in down years it is important to keep perspective, which in this case means recalling the outsized returns stocks had delivered in the years leading up to 2022:

- 2019: +31.5%
- 2020: +18.4%
- 2021: +28.7%
- 2022: -18.1%

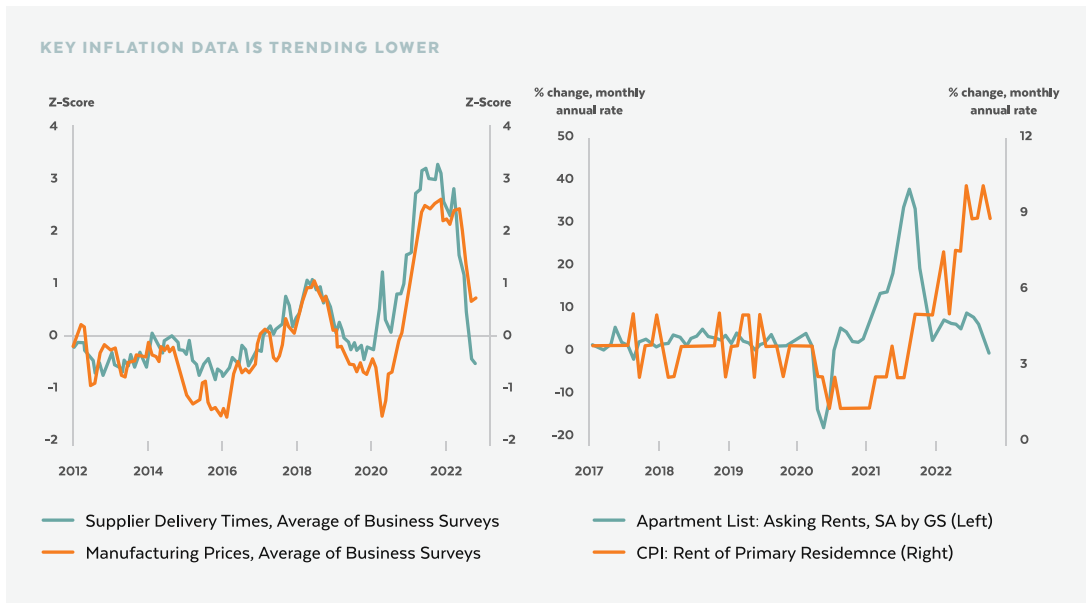
Ever-shifting market and business conditions make downside volatility relatively common in the equity markets. But far less common are across-the-board selloffs in fixed income, which in 2022 saw yields rise as inflation surprised to the upside, and as the Federal Reserve shifted from quantitative easing (QE) to quantitative tightening (QT) while aggressively raising the benchmark fed funds rate from 0.1% to 4.4%. For the year, the yield on the 10-year US Treasury bond more than doubled from 1.6% to 3.88%, high-yield spreads moved from 3.5% to 5.2%, and mortgage rates rose from 3.1% to 6.4%. The US bond market delivered its second year in a row of negative returns, which has not occurred since 1958-1959.



Source: Credit Suisse

Looking ahead to 2023, there is little doubt that key components of inflation will continue to trend in the right direction. In October 2022, we wrote that “inflation pressures are easing and will come down in the coming months,” which they have. Price pressures related to supply chain disruptions have almost entirely faded, giving way to falling costs for semiconductors, used cars, gas, appliances, and a range of other goods that contributed significantly to last summer’s inflation surge. Manufacturing input costs as measured by prices-paid indices have also come down to early 2021 levels (see left-hand side of chart on next page).

Housing is another key component of inflation, making up about 1/6th of the Fed’s preferred personal consumption expenditures (PCE) price index. Existing home sales have fallen -32% over the past 10 months, and home prices have also come down from peak levels. In the rental markets, the supply of new apartments has hit a 40-year high, and more than 500,000 new apartment units are expected to hit the market by the end of 2023 – the highest total since 1986. We’re already starting to see rents falling from peaks in many major cities, but this improvement is yet to show up in headline inflation data since it works on a lag (see right-hand side of chart on next page).



Source: Goldman Sachs

All told, bond markets are projecting the consumer price index (CPI) will fall to 2.6% by the end of 2023, which would arguably put the Fed’s preferred PCE price index very close to its 2% target. This inflation optimism—combined with the belief that overtightening will trigger an economic recession—has many market participants still betting on a “Fed pause” in mid-2023, which may give way to rate cuts in 2024.

To date, the effect of Fed tightening on employment has been modest and relegated mostly to the tech sector. Job openings have come down from a March peak of 12 million to 10.5 million at the end of November, but the number of available jobs still outnumbers unemployed Americans by a factor of almost two. We could see a scenario where the Fed pauses rate hikes if wage pressures, such as average hourly earnings, moderates. Recent data suggests this trend may be underway, but a full Fed pivot to cutting rates will likely require a years’ worth of easing wage pressures and more substantial declines in job openings (i.e., an actual cooling of the labor market).

That being said, we also do not believe rate cuts are needed to usher-in positive returns for the stock and bond markets in the new year. Aggressive monetary tightening to date has already reduced overall inflation, and because rate hikes work on a lag, we see a high likelihood of economic weakness in the first half of 2023—which should also take some pressure off the jobs market. Corporate earnings estimates for coming quarters have already come down considerably in anticipation of this weak patch.

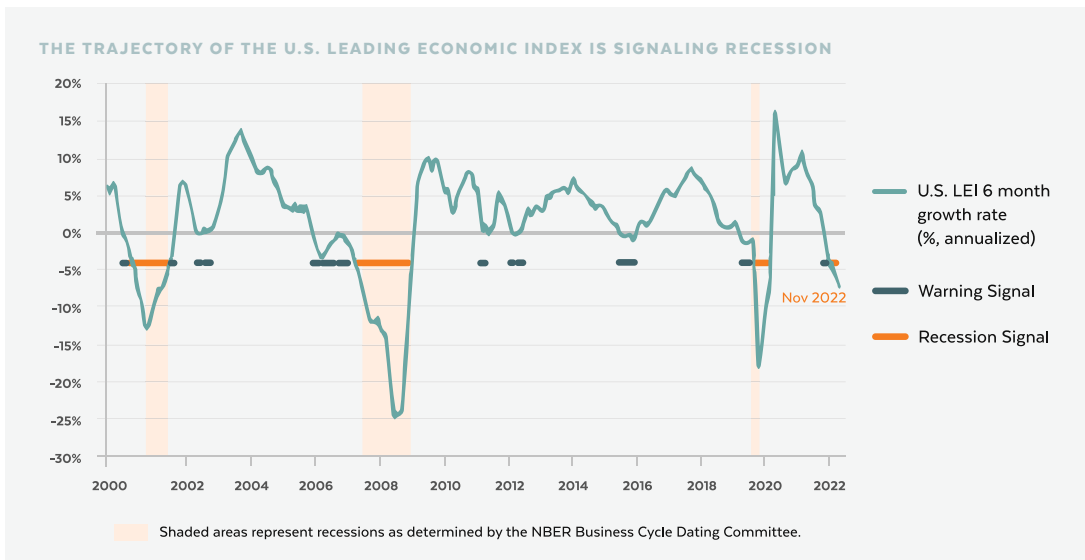
Historically, bear markets and weak economic patches present opportunities for attractive forward returns. As we wrote in last quarter’s letter, bull markets historically have started about 6-9 months before a trough in earnings, and also when economic growth is weak but improving. We think this setup could create fresh opportunities for investors to reposition



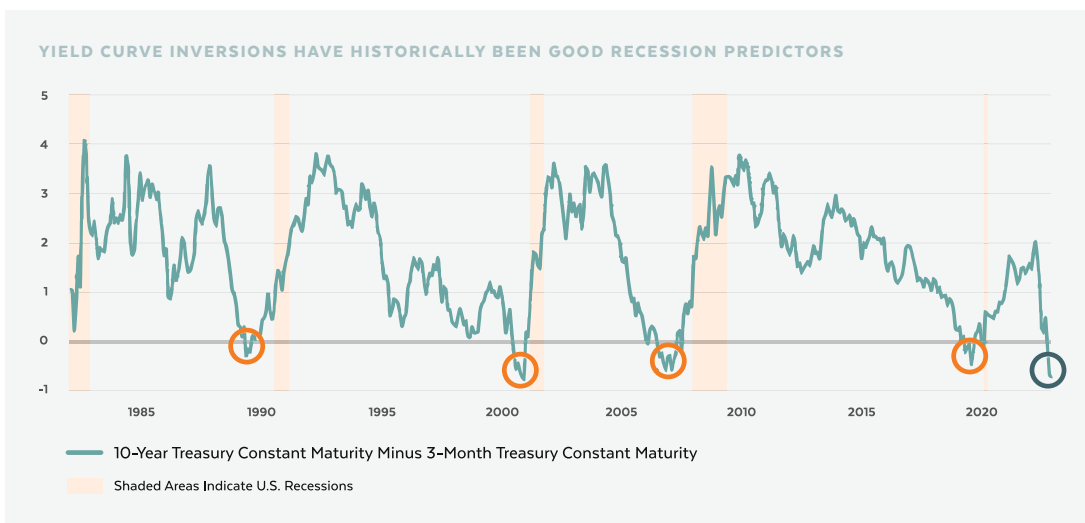
for growth and back into a more pro-risk stance, in anticipation for an economic recovery that may not arrive until late 2023 or early 2024.

### THE POSSIBILITY OF A RECESSION

According to a Wall Street Journal survey of 23 of the US’s largest financial institutions, nearly 80% of their top economists forecast a recession in the new year. As mentioned above, earnings estimates are coming down and S&P 500 profit margins appear to have peaked, which generally implies an economic slowdown is underway or very close. Recession indicators like the 6-month growth rate for the Conference Board’s Leading Economic Index and the 3-month/10-year US Treasury yield curve are also sending strong recession signals:



Source: The Conference Board



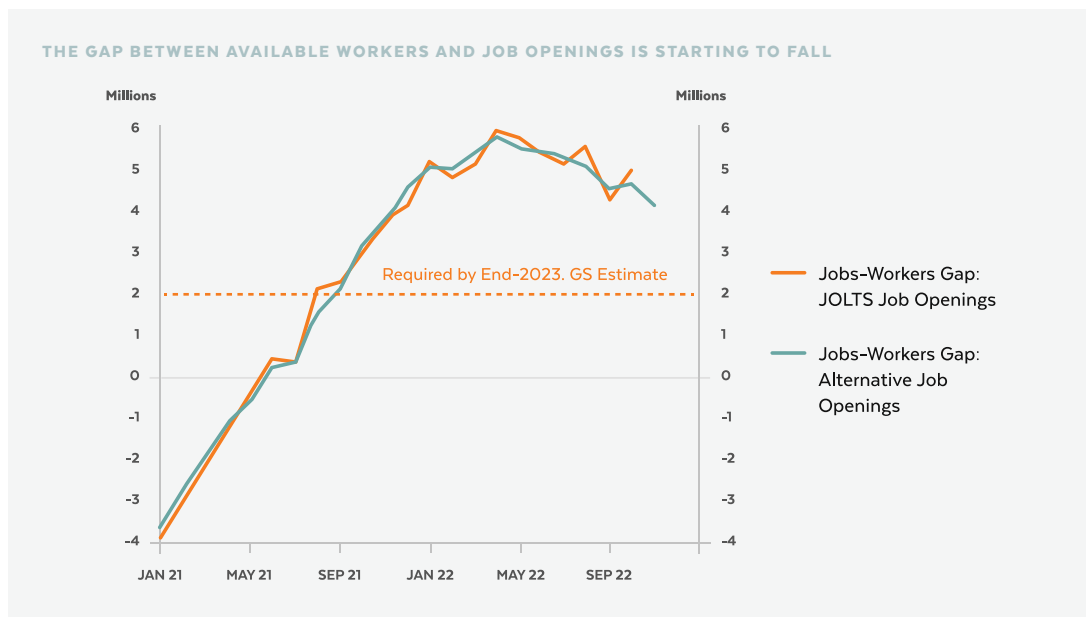
Source: Federal Reserve Bank of St. Louis



Interestingly enough, Goldman Sachs is one of the banks that does not think the US will enter a recession in the next 12 months. While they concede that financial tightening is a severe drag on growth, they also see countervailing forces that could keep the economy resilient in the face of headwinds.

The first is real disposable income, which fell sharply in the first half of 2022 because of fiscal tightening and high inflation. Goldman believes that falling inflation combined with rising wages could push real disposable income up +3% in the new year, which would buttress consumer confidence and lead to increased spending.

Second, Goldman sees a distinct possibility that core inflation can fall without significant job losses, since overheating in the post-pandemic labor market “showed up not in excessive employment but in unprecedented job openings, which are much less painful to unwind.” Goldman thinks the open-jobs-to-available-workers gap only needs to shrink to 2 million (from the current 4 million) to bring wage growth down to a rate compatible with the inflation target.



## CONCLUSION

We expect global economic growth to slow in 2023, with a recession likely in Europe and global corporate profit margins facing significant headwinds for at least the first half of 2023.

We also think the Fed will moderate and eventually end rate hikes in 2023. By the second quarter, the Fed may find that the fed funds rate is higher than the inflation rate, and that wage inflation pressures have cooled. The market may remain choppy in the short-term as



bad news about the economy will likely accompany better news about inflation and interest rates. This mixed environment is a marked improvement from the first half of 2022, however, in which the bond market (and in turn equities) could not catch a break on any economic data at all.

Weaker corporate earnings in the first half of the year seem assured, which may actually present opportunities for investors to position ahead of the earnings recovery. Historically, bull markets have started when the economy is at its weakest and corporate earnings are approaching a trough, both of which are conditions we could see materializing in the coming months.

The wildcard in any forecast, however, is whether inflation surprises to the upside—because of another commodity market shock or any other extraneous factor—which would prompt the Fed to be more aggressive than expected. Our outlook and positioning would likely change considerably in this scenario.

If you have any questions about this review or your portfolio, please do not hesitate to reach out to us. We wish you a very happy start to the new year.

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