ZWJ INVESTMENT COUNSEL

MARKET OUTLOOK

First Quarter 2023

The primary drivers of the investment markets in 2022 were macroeconomic in nature: the direction of inflation rates and interest rates drove market performance more than microeconomic factors like corporate margins. In simple terms, the cost of money exploded, as short-term rates moved from zero to four percent. Longer term rates followed suit, especially mortgage rates, which went from under 3 percent to almost 7 percent. These moves in lending rates were related to changes in the prices of goods and services, and this inflation began to look less transitory and more entrenched.

Interest rates and inflation could go even higher in 2023, but we believe the driver of markets will be the resetting of earnings forecasts. Company by company, Wall Street analysts will be updating their estimates to account for an environment of higher inflation and higher interest rates. Our view is that Wall Street continues to be too optimistic about earnings for 2023. Analysts will begin to revise their earnings models, first accounting for lower operating profit margins, and then accounting for the slowdown in economic activity that tends to follow rapid increases in costs of goods and services as well as the cost of money. Every well-known market strategist seems to be forecasting a recessionary period starting in 2023, and we do not disagree. There is a great variety of opinion on the depth and length of the recession, but that one is coming is clearly a consensus view.

When the cost of money is not zero, the price one pays for an investment suddenly matters. In 2022, valuation began to matter. Valuation has always been a significant component of our research process, so the equity names we owned did relatively better than the broader market and significantly better than the popular Big Tech names. Likewise, our bond portfolios did relatively better because we have for some time had average maturities much shorter than the leading bond indices. 2022 was a rare year in that both the major equity indices and the major bond indices had sharply negative results, so relatively better returns did not equate to absolute gains. We acknowledge that experience does not feel like a "win" to clients, but sometimes navigating stormy seas is a "lose less" game. We did that very well in 2022.

The revaluation of 2022 hit some parts of the market very hard. Cryptocurrencies and their related stocks declined in some cases to zero. Not understanding how a cryptocurrency could be any more substantial than a fiat currency, we shied away from adding them to client accounts as we could not establish a valuation. It turned out there was not much value there in the end, and some of the major characters in that industry are facing legal charges of fraud and theft. The cryptos were not the only high-flyers to suffer dramatic price declines. High tech companies like Tesla and Amazon gave back a great deal of their accumulated gains as valuation came to matter even to successful operating companies.

2022 was a year in which an investor could decide to sell all or part of a position and wait before reinvesting the proceeds, for rising short-term interest rates meant money market funds offered a competitive compensation for cash on the sidelines. After a decade of "buy-the-dip" indoctrination, many investors could not sit on the sidelines, but we were happy to buy the "dollar fund" and wait for a better entry point.

2023 could be a year of transition, in which inflation and interest rates continue to exert a dampening effect on the equity and bond markets, and recessionary factors weigh on economic performance. That means we may not yet have seen the bottom of the market, nor the peak of inflation and interest rates. The sort of stocks that held up well in a defensive strategy will likely not be the winners when it is time to hit the gas. It will likely be the case that we must continue to be active investors, trimming those stocks that have run up even if the companies are still great. We will likely have to be tactical traders, waiting for good days to initiate or add to positions in out-of-favor stocks, and the money

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market funds are a solid intermediate holding during those waiting periods.

We would like to extend maturities in our bond portfolios as long rates may be near a peak. Fixed income markets are sometimes not as liquid as equity markets, so this extension may be gradual, as we replace maturing positions with longer-dated ones. In our balanced accounts, the bonds are a safety device as much as they are a return device, and prudence demands we balance those considerations as we contemplate bond portfolio moves.

Since we invest in individual companies, we make our buying and selling decisions on individual stocks and bonds. On the equity side, each stock has a price and valuation level that means either the company is in serious trouble or the stock is simply a great bargain. Our internal analysts are charged with helping us all know the difference, and we are all trying to be more aggressive in taking action when the price of a stock is at either extreme. Thus, our clients may see some selling of traditional value-style stocks that did so well last year as we take our gains, and they may see some buying of out-of-favor (former) growth-style stocks that have declined to those great bargain levels. That is the essence of active management, and we are active managers of both stocks and bonds.

Rising above the level of individual securities, we are revisiting asset allocations with our clients. Bonds make sense these days, so they should be a consideration if perhaps five years ago there were not. Communication with our clients is central to our firm, and we recommit every year to continuing a high-level conversation with every client who will hear us.

2022 reminded investors that markets and economies are dynamic, so those who fight complacence will be rewarded. We think 2023 will be no less dynamic, and we will continue to review client accounts regularly, develop and maintain positive channels of communication with our clients, and evaluate what we own and what might be added. Our team is committed to helping clients navigate all markets, both smooth or choppy, and we will take great care in 2023 to continue that no matter what market or economic environment we encounter.

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Unrelated to markets, 2022 also brought an end to the great investment career of our partner and friend, John Shepard. John brought great wisdom, great stability, and great leadership to our firm for twenty years, and we will miss his wonderful smile and warm personality. We wish him a happy and long retirement.

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