INVESTMENT OUTLOOK

A PEAPACK PRIVATE WEALTH MANAGEMENT PUBLICATION

FOURTH QUARTER 2022: THE SANTA CORRESPONDENCE

...Santa's on his way
He's loaded lots of toys and goodies on his sleigh
-The Christmas Song

If you're reading this, you're (probably) too old to believe in Santa Claus. Still, the King of Gifts is an appealing and powerful figure, and even the most grown-up among us may harbor a desire to share our wish lists with him.

We had the occasion recently to hitch a sleigh ride with jolly St. Nick, and he was kind enough to share with us some private epistolary exchanges he had this holiday season with a few leading luminaries from the economic and financial markets domains.

MARKETS CELEBRATE THE SEASON

Sleigh bells ring, are you listening?
In the lane snow is glistening...
-Winter Wonderland

Before we get to those cards and letters, it's worth noting that after a rugged nine months that was punishing to both stock and bond holders, Santa delivered to investors glistening fourth quarter returns beautifully wrapped with a big red bow.

Asset Class	Index	4th Quarter Results	Full Year Results
US Large Cap Stocks	S&P 500 Total Return	7.6%	-18.1%
US Small-Mid Cap Stocks	Russell 2500	7.4%	-18.4%
International Developed Markets Stocks	MSCI EAFE	17.3%	-14.5%
Emerging Markets Stocks	MSCI EM	9.7%	-20.1%
Real Estate Securities	MSCI US Real Estate	5.2%	-24.5%
Commodities	Bloomberg Commodities Futures	2.2%	16.1%
Bonds	Bloomberg Barclays US Aggregate	1.9%	-13.0%
Cash	FTSE USBIG 1 Month Treasury Bill	0.9%	1.5%

SOURCES: THE WALL STREET JOURNAL, STANDARDANDPOORS.COM., FTSE, MSCI, BLOOMBERG

All asset classes turned in solid results, with overseas markets as the real standouts. US dollar weakness during the period contributed to strong appreciation in international markets. US markets recorded sound mid- to high-single-digit returns. Bonds, too, reversed weakness earlier in the year and generated positive returns.

Still, the robust fourth quarter only modestly diminished losses for the full year, as investors' greed was punished with a lump of coal. Equities generally generated mid- to high-teens negative returns. Real estate was particularly weak, following a remarkable runup in 2021. The only positive returns came from commodities, as oil prices have been elevated since the Russia-Ukraine conflict, and cash.

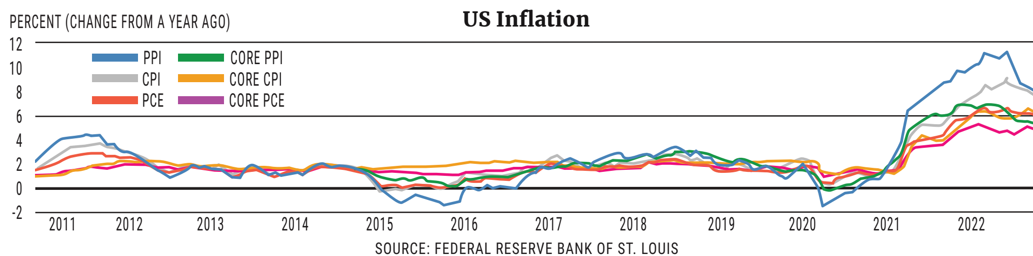
WHAT JEROME REALLY WANTS

And so this is Christmas
And what have we done?
Another year over
And a new one just begun.
-John Lennon

DEAR SANTA—

Mea culpa. I really, really thought inflation was going to be transitory. I misjudged how much fiscal stimulus Congress provided, and just maybe, too, how much my team's zero interest rate monetary policy would juice the economy and spike demand. And I thought supply chains would normalize sooner than they have. So now I've had to jack up interest rates, fast and by a large amount. But it's working, I swear.

Inflation has peaked and is coming down.

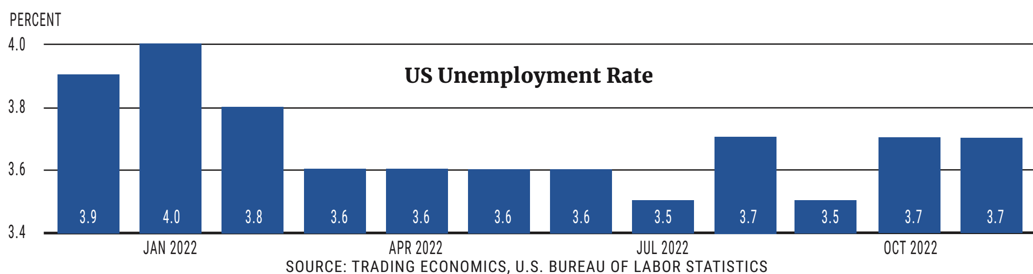


SOURCE: FEDERAL RESERVE BANK OF ST. LOUIS

Core price consumption expenditures (excluding food and gas) were up 4.7% year over year in the last reading, after spending much of the year above 5%, and up only 0.1% month over month. Gasoline prices (I know, I don't control them) recently averaged $3.10 nationally, according to the AAA—the lowest level since June 2021. Prices for goods, excluding food and energy, fell 0.4% in November, after falling 0.2% in October. The docks in the ports of Los Angeles and Long Beach are no longer backed up, as supply chains normalize.

So, I think higher rates are working.

At the same time, I'm in pretty good shape with my other mandate, full employment. The unemployment rate has held under 4% all year, notwithstanding our efforts to rein in inflation.



SOURCE: TRADING ECONOMICS, U.S. BUREAU OF LABOR STATISTICS

But I know the labor market is running too hot for inflation to come down as much and as fast as it needs to. The services sector, sensitive to labor costs, is also exhibiting inflation. I know time will solve this issue, and I'm patient, but the world isn't. So, I have to raise rates a bit more. And then keep them at a restrictive level. Like a constrictor waiting for its prey to stop breathing. And then I can relax rates again.

I'm worried, though, that the price of higher rates will be job losses. I am not as hard-hearted as my long-ago predecessor Paul Volcker, and I don't want to cause anyone to suffer.

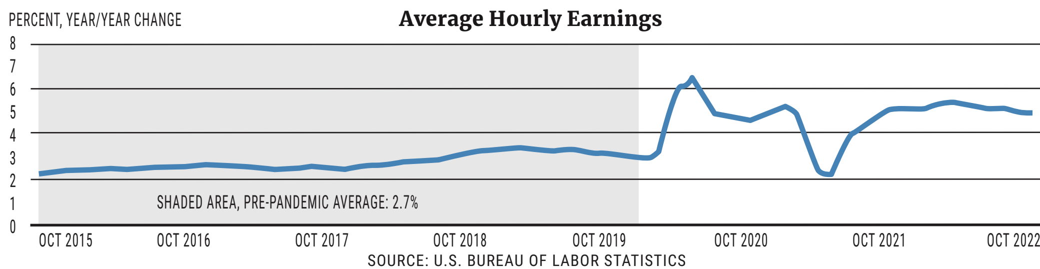
So, there's just one gift I'd like from you, the gift of a soft landing. I'd like to see inflation come down quickly without the economy tumbling into a recession. I hope that's not too much to ask.

Humbly,
Jerome (Jay) Powell

DEAR JAYJAY—

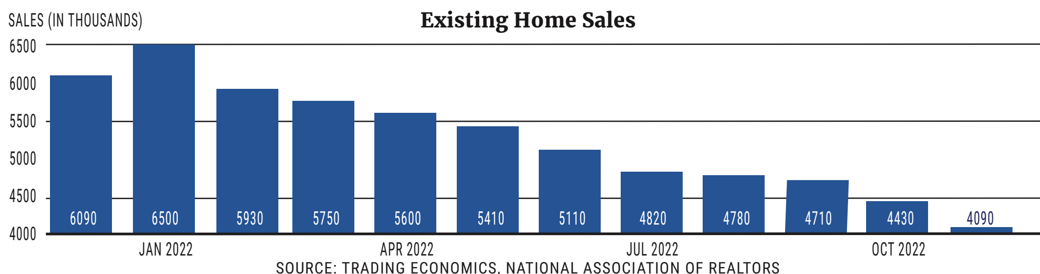
You're a good and well-meaning public servant. And your heart is in the right place. Santa is constitutionally inclined to deliver requested gifts, and while you may have been misguided, you're not on my naughty list.

But the cold hard fact is that you have to break some eggs to make your Western omelet. Yes, you're right, inflation is coming down, but it is still woefully, painfully elevated. Perhaps the stickiest problem is wage inflation.



In the third quarter, total compensation costs rose at a 5.0% annual rate, according to the Bureau of Labor Statistics. Even the elves in the workshop, who have few alternative employment options, are demanding hefty increases in their hourly rates.

Higher rates are effective at slowing economies—just look at housing, which—blinders off—looks like it's already in recession.



Existing home *sales* are in freefall, down for 10 consecutive months and 35% below year-ago levels, according to the National Association of Realtors. Existing median single family home *prices* peaked in June, and have been down for five consecutive months. And in case you thought existing home sales data were outliers, look at homebuilder confidence for new home sales—it has fallen every month this year.

Housing is not the only indicator of a sluggish economy. Semiconductor chip makers, ranging from Qualcomm to Nvidia to Micron to Intel to AMD, are all reporting excess inventories as demand weakens for laptops, cell phones, and other consumer electronics. Shipping rates have tumbled, as consumer appetites for goods have softened and global trade has stalled; the World Container Index, compiled by Drewry Shipping Consultants, is down 77% this year. Full year 2022 auto sales are projected by Cox Automotive to come in 8% lower than in 2021 and 20% lower than the market peak in 2016. And November retail sales fell by 6.5% versus the prior month.

Some say the consumer is in great shape. But the US savings rate is at a near record low 3.1%, suggesting that consumers—particularly at the lower end—are getting squeezed by inflation. This supposition is confirmed by the rapid rise in recent months in credit card debt outstanding.

And there is that classic recession warning, the inverted US yield curve.

Remember, too, my friend, that labor market data are lagging indicators. You're going to have to sacrifice your full employment mandate, in the near term, in order to meet your price stability mandate. Among the many goodies on my sleigh, I'm hard pressed to find a soft landing—though there are some nicely wrapped mystery gifts that might surprise you pleasantly.

What I can bring you is a vial of Dutch courage, to help steel your nerves as naysayers try to sway you from the inflation fight. Your credibility is at stake, so stick to your Summary of Economic Projections. (Remember, you're only offering forward guidance, not a firm commitment.) Go ahead, lift rates once or twice more, and then hold steady till inflation drops below 4%. Who knows? It may happen sooner than you think.

Warmly,
Santa

WARREN'S WISHES

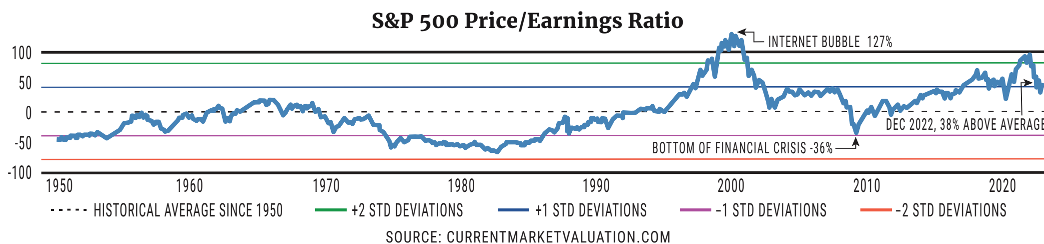
I am a poor boy too
Pa rum pum pum pum
-Little Drummer Boy

DEAR SANTA—

I know it's been a difficult year in financial markets, and I should be grateful. The stock of my company, Berkshire Hathaway, was up 4% this year while the stock market was off 20%.

But as I have written before, in another place, we investors should be greedy when others are fearful. And I've also written that it's only when the tide goes out that you know who has been swimming naked.

I am concerned about climate change, but I'd still like it if you could make the tide go out a little further. I have over $100 billion of cash to invest, and I'm not finding a lot of bargains. While stocks are less expensive than they were at the start of 2022, they still don't strike me as cheap. And I've done the math—they're a standard deviation higher than their long-term average.



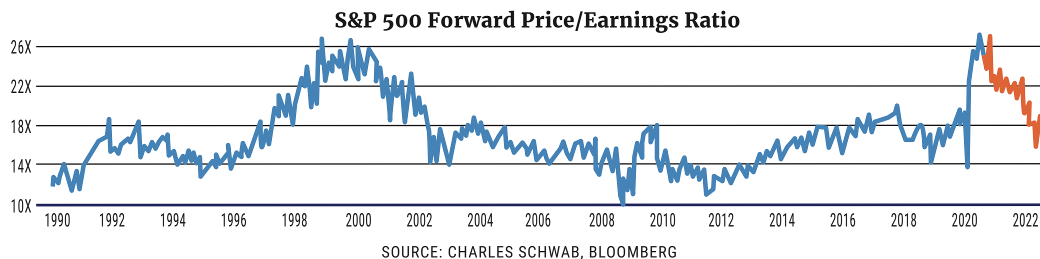
I'd be ever so grateful if you could soften stock prices a bunch more, giving me and fellow investors a stock market loaded with attractive companies at low prices, and allow me to put that cash to work.

Yours sincerely,
Warren Buffett

DEAR MR. BUFFETT—

Allow me to say that you're perhaps a little too old to come sit on Santa's knee. It also strikes me that this isn't the first time this gift has been on your wish list.

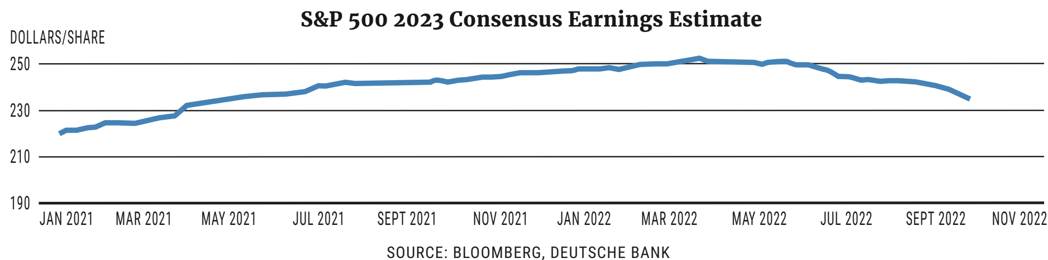
That said, I may be able to bring you some of what you're looking for, though perhaps not as much as you'd like. Your observation is, naturally, astute. Stock prices are cheaper than they were, but they're not cheap.



SOURCE: CHARLES SCHWAB, BLOOMBERG

As you have written, it's usually a mistake to underestimate the adaptability and resilience of American business. Companies have done a great job, generally, adjusting to the current inflationary environment. They've done so by raising prices, thereby largely protecting profit margins.

But price increases, unlike diamonds, aren't forever. They come at the cost of lower volumes, and as the economy slows further, volumes will weaken. In the third quarter, companies in the S&P 500 lifted sales by 11.3%–but, due to rising costs, lifted earnings by a mere 1.6%.



SOURCE: BLOOMBERG, DEUTSCHE BANK

Analysts are estimating that profits for the S&P 500 will advance by a further 5% in 2023, down from earlier estimates of a 10% increase. Still, that doesn't sound like investors expect rising unemployment and a sluggish, if not recessionary, economy.

Analysts are preternaturally disposed to be optimists, but as companies roll out fourth quarter earnings and provide guidance for the new year, it seems likely that current estimates will need to be trimmed. That trimming, in turn, could be depressive for stock prices in the first half of the new year, and that could create the opportunity for the greatest investor of all times, and others, to pounce. Be poised, as the opportunity could prove short-lived.

Yours in sympathy,
Santa

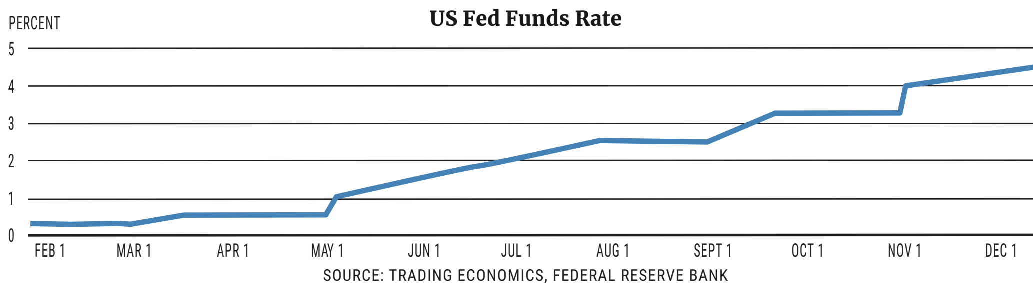
THE (FORMER) BOND KING DREAMS

I have no gift to bring
Pa Rum Pum Pum Pum
That's fit to give our king
Pa Rum Pum Pum Pum
-Little Drummer Boy

DEAR SANTA—

I know that long ago now I lost my status as the bond king, but it's been an uncomfortable place to be, and even deposed kings harbor dreams (along with resentments). Eschewing false modesty, I believe I invented investing in bonds for total return—income plus price appreciation.

But 2022 decimated bond investors seeking total return, with bond indices down anywhere from 5 to 20% depending on credit quality and maturity. The Fed lifted interest rates an astonishing 400 basis points, one of the fastest and most aggressive rate hiking cycles in history.



SOURCE: TRADING ECONOMICS, FEDERAL RESERVE BANK

I care a lot about posterity, and my image. Could you manage, Santa, to find a way to redeem my reputation and grant a gift to bond investors of high total returns on their bond portfolios in 2023?

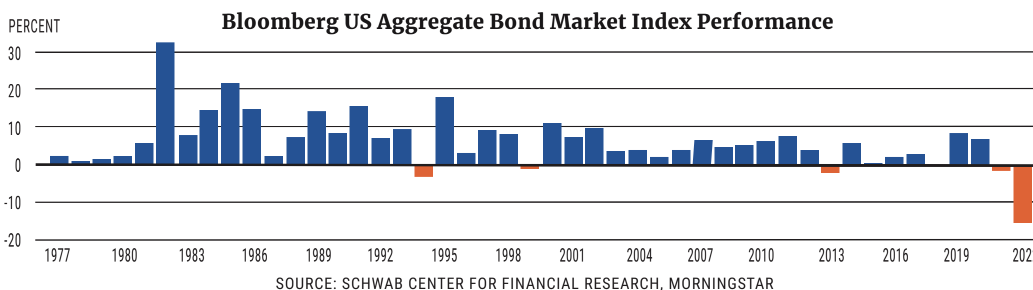
(Forcibly) humbly,

Bill Gross, the once (and future?) bond king

DEAR BILLY BOY—

I know I shouldn't talk, but it would be nice if you cut your hair.

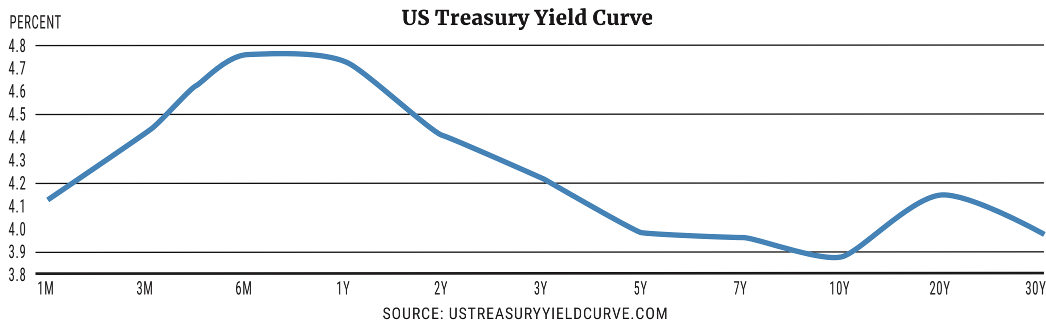
You're right, of course, that 2022 was a devastating year for bond investors, who didn't get the ballast effect of bond price stability in their portfolios, to offset equity price declines. But stock price declines and bond price declines had the same driver: higher interest rates. Because the year began with literally zero percent interest rates, the aggressive monetary policy moves by the FOMC produced the worst bond returns in the history of the most widely recognized benchmark.



SOURCE: SCHWAB CENTER FOR FINANCIAL RESEARCH, MORNINGSTAR

As I check my list, I don't see your name on my nice list, but I am sympathetic to how much bond investors suffered in 2022, so I think I can bring a nice gift to your former followers.

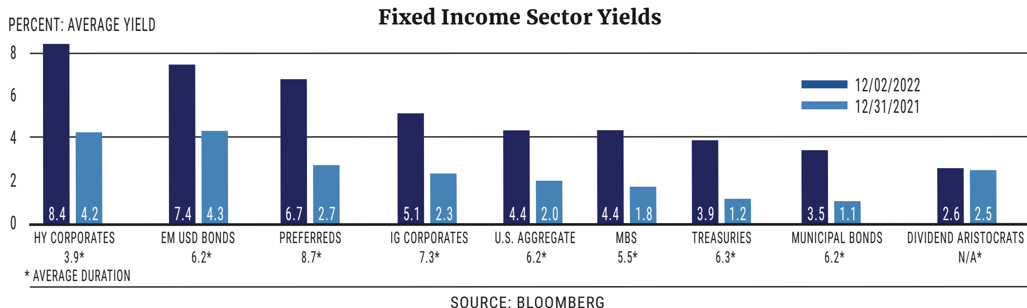
Yields on bonds, in absolute terms, are the highest they've been since before the global financial crisis. Looking at the US Treasury yield curve, the 2-year Note is yielding 4.46%, as of this writing. Compare that to the same instrument at the start of 2022—the yield, then, was 0.73%. In short, there's way more income in fixed income today. This is great news for income-seeking bond investors.



SOURCE: USTREASURYYIELDCURVE.COM

Note, however, that interest rates are lower for longer maturity US government bonds. This reflects investors' expectation that by the end of 2023, the FOMC will not only have stopped raising interest rates but will have started cutting rates. (This implies a recession.) That is a distinct possibility, though by no means a foregone conclusion. If market participants' bet proves correct, it makes sense now to modestly extend duration into intermediate term maturities, to lock in these much-improved yields.

Note, too, that, beyond the safety of Treasurys, yields on credit have also multiplied—they have doubled or more on high yield, US investment grade corporates, preferred stocks, mortgage-backed securities, and municipal bonds, among others.



SOURCE: BLOOMBERG

Given the absolute level of interest rates, it's not necessary to go dumpster diving for yield. Investors will be adequately compensated by owning higher quality instruments—particularly in a decelerating economy.

So, in short, Mr. Gross, bond investors will once again be rewarded for choosing balanced portfolios in which bonds reclaim their role as reliable generators of income and with relative price stability. The year ahead may not offer bondholders dramatic price appreciation unless the outlook for the world economy turns grimmer than is currently visible, but fixed income investors will earn and enjoy their generous bond coupons.

With best personal regards,

Santa (aka the Present King)

POSTCARDS FROM THE EDGE

I really do believe in you
Let's see if you believe in me.
-Eartha Kitt, "Santa Baby"

SANTA DUDE—

A few of us had a really, really tough year. Our reputations really got roughed up. Could you bring us shiny new haloes to rehabilitate our tarnished images?

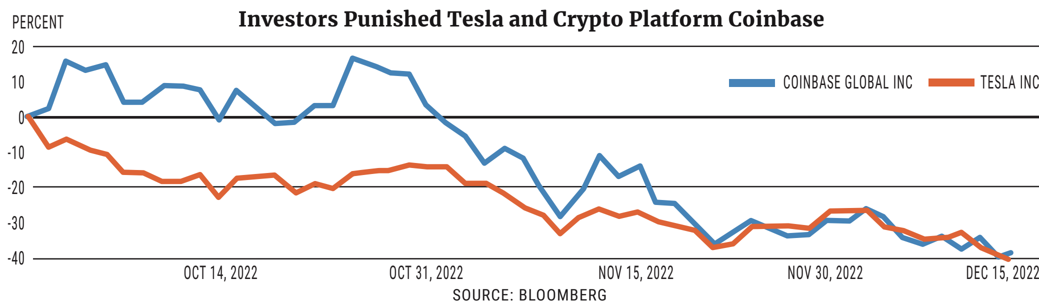
Signed,

Elon Musk
Samuel Bankman-Fried

GENTLEMEN—and I really, really use the term loosely. You are an odd pair, an easily distracted genius and a likely fraudster...but you do have in common a loss of investors' faith in you.

Santa is really better at delivering tangible gifts than at conjuring abstract services. And what you really need is beyond the capabilities of even the finest PR agents. Both your names are on my naughty list, for various reasons, so there's not a lot I can do for you.

But you have served to remind investors of eternal truths. To invest in what you understand. That valuations matter. As do trust and integrity. It's no surprise that assets you've championed plummeted this year. Their valuations became unanchored to any reality, and you didn't help your cause, whether you tweeted contradictory statements or defrauded investors.



So, while it was a difficult market environment in 2022, it did serve to flush out speculative excesses. SPACs, meme stocks, zombie companies all had their comeuppance. The crypto market plummeted from a $3 trillion valuation to less than $1 trillion. Tesla stock lost 65% of its value.

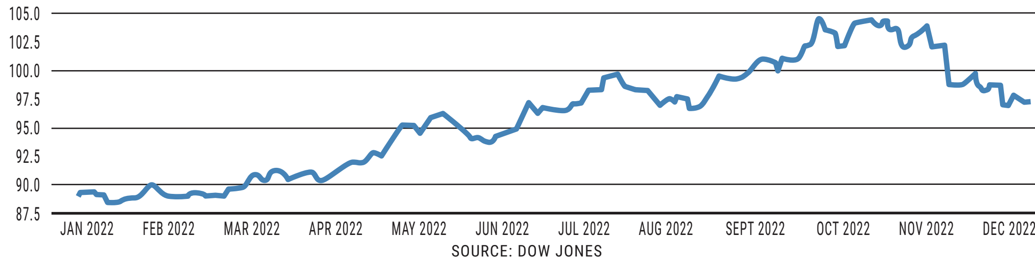
The two of you, dear correspondents, have—unintentionally—given a gift to investors, the gift of a re-focus on fundamentals of sound portfolio construction, integrity, and thoughtful security selection.

2023 is, according to the Chinese zodiac, the year of the rabbit, and it is predicted to be a year of hope. On the domestic front, the presidential election cycle—equity markets have consistently generated strong positive returns in the twelve months following midterm elections—bodes well, even if there's a rough patch to survive in the first half of the year, from an earnings reset. Bonds, as noted, have become more interesting than they've been in 15 years. Internationally, the Eurozone economy has proved to be remarkably resilient in the face of war in eastern Europe and the resultant sky-high natural gas prices—seven times the level in the US! GDP in the

Eurozone grew by 1.7% in the first nine months of the year, versus 0.2% for the US. In Asia, China has begun its shaky departure from its zero-Covid policy, giving investors reason for optimism that it could see a revival of economic growth. And Japan, the last holdout of zero interest rate monetary policy, has begun to permit interest rates to rise in league with the rest of the world.

The remarkable strength of the US dollar for the first three quarters of the year, driven by the FOMC's aggressive interest rate increases, has reversed course since its peak in late September. Given that most commodities are priced in US dollars, an expensive dollar is inflationary for other nations, and increases debt burdens for countries with US dollar-denominated debt.

Wall Street Journal US Dollar Index



SOURCE: DOW JONES

So, a reprieve from a falling US dollar is welcome indeed. Global central banks are starting to catch up with the Fed in lifting interest rates, strengthening their currencies. As the growth outlook improves around the globe, the US dollar should weaken further, turning from a headwind to a tailwind for economies around the world.

Bad actors may spend a long time in the penalty box—or in prison. But after a challenging year, investors deserve some hope, and I am happy to pile it high on my sleigh. It seems not unreasonable to think that, setting volatility aside, investors may have more to cheer next Christmas than this one.

With heartfelt hopes for a more peaceful and prosperous new year, I remain

Yours faithfully,

Santa

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