Q4 22 WEALTH MANAGEMENT QUARTERLY INVESTMENT LETTER

Good News for People Who Love Bad News

Quick Look

- While there was no Santa Claus rally, markets did post gains in the fourth quarter. U.S. stocks gained 8% while U.S. bonds gained 2%, bucking the trend of three consecutive quarters in which both were negative.
- Balanced portfolios experienced their worst calendar year performance of the post-war era.
- Because of the outsized focus on monetary policy when it comes to markets, both stocks and bonds have begun to react positively to bad macro news on the hopes that the Fed will start pivoting away from restrictive policy.
- The positive investment returns of the past quarter are a reflection, in part, of greater certainty that the Fed's peak funds rate ends up between 5% to 5.25%.
- It seems reasonable to expect that the first half of 2023 brings an end to the current rate hiking cycle.
- The Fed has downgraded their outlook for GDP growth for next year to just 0.5%, as the path to a soft-landing scenario has exceedingly narrowed.
- While the macro environment looks worse to start 2023 than it did 12 months ago, the good news is that markets often lead macro, and there are a number of reasons why investment fortunes may turn for the better.

Contacts

KEVIN P. WHELAN, CFA
President & CEO
kwhelan@opusinc.com

NATHAN A. BISHOP, CFA
Principal & CIO
nbishop@opusinc.com

NATHAN M. BAILEY, CFA, CFP®
Principal & Portfolio Manager
nbailey@opusinc.com

221 East Fourth Street, Suite 2850
Cincinnati, Ohio 45202
P (513) 621-6787

www.opusinc.com

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Opus Capital is an evidenced-based investment advisory firm driven by our overriding mission to help people. We believe the marriage of comprehensive financial planning + statistically proven investment principles creates the clearest roadmap to long-term success.

We are independent and transparent in all aspects of investment management decision making and financial planning. We selectively partner with like-minded individuals and families, endowments, foundations, and 401(k) plans in over 30 states.

Quarterly Investment Letter, Q4 2022

Happy Holidays, Happy New Year, and Good Riddance and Bah Humbug to what was a very Grinchy investing year. Let's start with a laundry list of headlines over the back half of 2022, which reads more like a Festivus-inspired Airing of Grievances:

- Inflation reached a 40-year high.
- The most restrictive Fed policy in 40 years.
- An economy on the doorstep of a recession.
- Leading indicators are negative.
- The Treasury curve reached a 40-year inversion between the 2- and 10-Year rates.
- Manufacturing is contracting according to the ISM Survey.
- M2 money supply growth is poised to contract for the first time in history.
- The lowest consumer sentiment reading in history.
  - Credit spending is surging as pandemic-relief savings are spent down.
- The U.S. savings rate has fallen to the second lowest on record.
- Housing has collapsed; existing home sales are down 30% from last year.
- Earnings forecasts for 2023 are declining.
- The Russia-Ukraine War marches on with no end in sight.
- The worst calendar year for bonds on record since the inception of the Aggregate Bond Index.
- The 9th largest drawdown for stocks since 1950.
- Balanced portfolios experienced their worst calendar year performance of the post-war era.

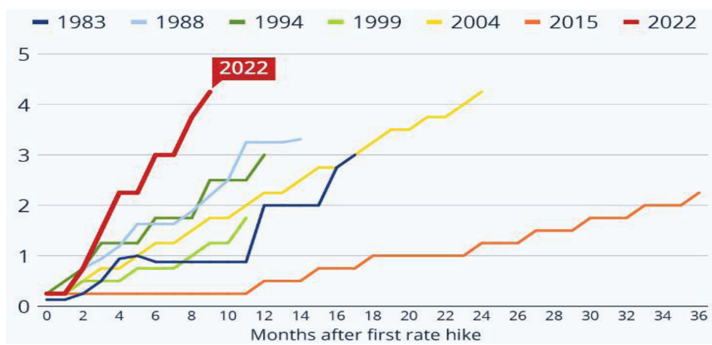
And yet through all this, the Whos still celebrated, as markets rallied in the 4th quarter. U.S. stocks gained 8% while U.S. bonds gained 2%, bucking the trend of three consecutive quarters in which both were negative. Developed international stocks jumped 17%, boosted in part by the falling dollar, which started to weaken this quarter after a five-quarter torrent of dollar strength. The final quarter's positive gains helped to take some of the stink off this year's numbers, slightly improving the classification of investors' 2022 returns from absolutely putrid to mostly malodorous.

Helping matters this quarter is that it appears we have entered the bad news = good news stage of the cycle. The news is bad. That is good! Because of the outsized focus on monetary policy when it comes to markets, bad news is viewed as evidence that the Fed should start pivoting away from restrictive policy. Good news, meanwhile, provides rationale for the Fed's higher-for-longer policy narrative.

It is hard to overstate the importance of Federal Reserve policy when it comes to markets. In Ben Johnson's book *Invest with the Fed*, Johnson found that when the Fed was implementing expansive policy (i.e. lowering the fed funds rate), the S&P 500 annualized return was 15% (dating back to 1966). Conversely, during periods of restrictive monetary policy, the S&P 500 annualized returned was just 6%. Bonds also fare worse during restrictive monetary policy, with annualized returns 2.4% below periods of expansive monetary policy, when adjusted for inflation.

Additionally, it is hard to overstate the extremity of this year's pivot in monetary policy. The Fed's rate change from the zero bound to 4.5% is the largest hike in rates in over 40 years. These rate hikes have occurred just in the last eight months, making it also the fastest rate-hike cycle in over 40 years.

Rate Hikes Over Last 40 Years



Source: Federal Reserve, Statista

This hawkish shift in policy comes off the heels of the most accommodative policy in Fed history, which was their 2020 pandemic response of zero rates and quantitative easing for "however long it takes". Given the magnitude of the Fed's 180-degree change in policy, investment returns for this year, while unpalatable, are certainly understandable.

U.S. EQUITY RETURNS (%)

As of 12/31/2022	Q4 2022	Year 2022	3-Year	5-Year	10-Year
S&P 500	7.6	-18.1	7.7	9.4	12.6
Russell 1000 (Large Cap) Growth	2.2	-29.1	7.8	11.0	14.1
Russell 1000 (Large Cap) Value	12.4	-7.5	6.0	6.7	10.3
Russell 2000	6.2	-20.4	3.1	4.1	9.0
Russell 2000 (Small Cap) Growth	4.1	-26.4	0.7	3.5	9.2
Russell 2000 (Small Cap) Value	8.4	-14.5	4.7	4.1	8.5

Source: Morningstar

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So what does this mean for 2023?

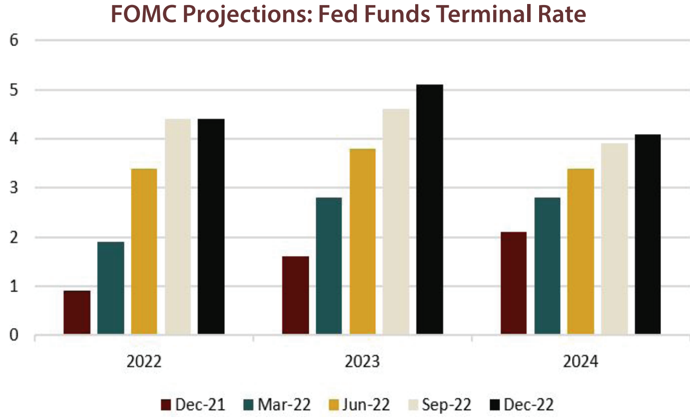
One-year S&P 500 price targets are pretty useless, as are most macro forecasts. Each quarter the Fed provides their own projections for the federal funds rate, inflation, GDP, and unemployment, and they were wildly off the mark from where they were at the end of last year. These projections, however, at least provide some clues as to the Fed's potential endgame on restrictive policy. To quote Howard Marks, "we never know where we're going, but we ought to know where we are."

Fed Funds Rate

One of the major headwinds over the past year has been the helium in the terminal rate (i.e., the maximum fed funds rate in this cycle). Since the end of last year, the Fed's terminal rate projection saw continual upward adjustments above both the market-implied rate and the Fed's own forecasts, escalating from 2% at the start of the year until it breached the 5% barrier in October. The positive investment returns of the past quarter are a reflection, in part, of greater certainty that the Fed's peak rate winds up between 5% to 5.25%. Given that we enter 2023 at a fed funds rate of 4.5%, we are just two to three additional 0.25% hikes away from the peak.

We continue to view the real fed funds rate (fed funds rate less inflation) as the key to finding the terminal rate. The real fed funds rate did not trough until summer, falling below -5.0%. The second half of 2022 has seen marked improvement thanks to the series of aggressive hikes by the Fed, coupled with a peak in core inflation. At present, with core personal consumption at 5.0%, the real fed funds rate is just slightly negative (-0.5%) and is on pace to turn positive by the first quarter of 2023. The Fed has never ended a tightening cycle with the real fed funds rate negative, so while there is still work to go, it seems reasonable to expect that the first half of 2023 brings an end to the current rate hiking cycle.

FOMC Projections: Fed Funds Terminal Rate



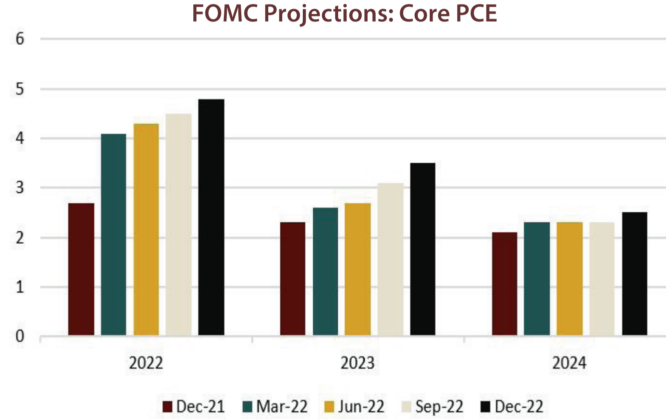
Source: Federal Reserve

We would push back on the notion that once the Fed reaches its terminal rate, it will begin cutting rates immediately. The market-implied fed funds futures for the end of next year has three rate cuts priced in assuming a 5% rate peak; we can imagine the Fed wanting to see the real fed funds rate reach a positive 2%-3% before cutting, which will require inflation falling to their long-run 2% target, again assuming a 5% rate peak.

Inflation

The impetus for the Fed's aggressive hiking policy has, of course, been in response to high inflation, which has proven to be far stronger and more persistent than originally thought. Headline inflation peaked in June and has been descending since. Core inflation has been more stubborn, but is down from its September peak. From fertilizer prices to shipping freight rates to auto prices, all signs are pointing to supply-side constraints alleviating. Evidence of the follow through into the aggregate government reports will take some time, though the last two monthly prints have been promising. Assuming the peak in inflation remains in the rear-view mirror, the focus shifts to how long it will take inflation to decelerate to the Fed's 2% target.

FOMC Projections: Core PCE

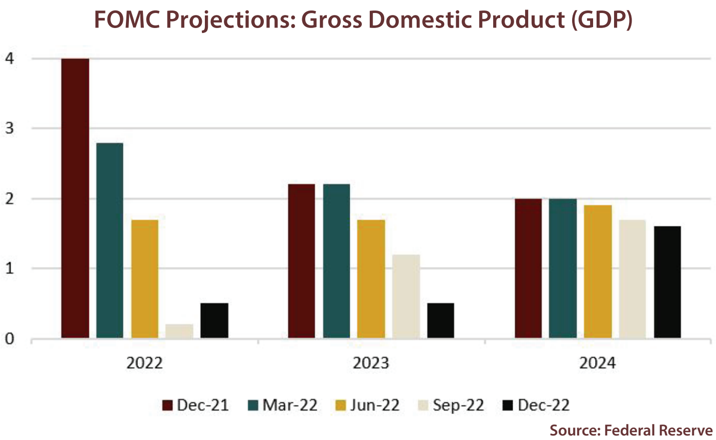


Source: Federal Reserve

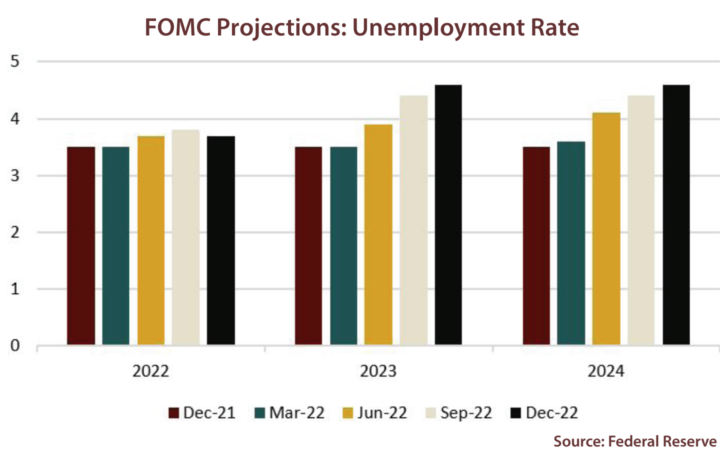
As inflation nears the long-term target, it allows the Fed more flexibility to cut rates. A key lesson from the 1970s is that easing too soon can restoke inflation, so the guess here is that the Fed will want to see a trend of negative or flat monthly core inflation readings before they switch to accommodative policy. Given how wrong the Fed was about the transitory nature of inflation in 2021, they likely will want to make sure they are certain the current inflationary pressures are squashed for good before any change of policy.

Economic Growth

The prospects of economic growth for the coming year are dim; this is not a contrarian opinion, as a recent Bloomberg survey showed 70% of economists are predicting a recession for 2023. Rate hikes stunt economic growth, which is why the majority of tightening cycles end in a recession. All the tried-and-true signs of a pending recession are evident, be it a deeply inverted yield curve, negative annual leading indicators, plunging consumer sentiment, etc. The Fed has downgraded their outlook for GDP growth for next year to just 0.5%, as the path to a soft-landing scenario has exceedingly narrowed.



The strongest part of the economy remains the labor market, which is hovering around a half-century low in unemployment. Historically, job losses are one of the final dominos to fall at the end of an economic cycle. However, this employment cycle is unique because the strength is not driven as much by economic growth, but because the labor force remains below pre-pandemic levels. Job openings and voluntary quits are still near all-time highs, and layoffs near all-time lows. The Fed's projection of a 4.6% unemployment by the end of 2023 equates to 1.5 million job losses in the coming year. Historically, the Fed's projections are notorious for undershooting job losses during recessionary periods, which average around 3 million job losses, but the current skew of this job market leads one to see how job losses could be milder than in past cycles.



Markets

In summary, plenty of bad news – the macro environment looks worse to start 2023 than it did 12 months ago. The good news – markets lead macro, and there are a number of reasons why investment fortunes may turn for the better.

- » With inflation cooling and the terminal rate more certain, markets appear to be transitioning from interest rate concerns to recessionary concerns. This should bode well for bond returns, and perhaps break the positive correlation between stocks and bonds that flummoxed balanced portfolios in 2022.
- » Income is back for safe assets! Cash accounts are paying over 3%, while 90-day T-Bills are yielding over 4%. Investors are no longer required to take risk to yield a reasonable return.
- » Intermediate-term bonds should perform better as rising interest rates become less of a concern. Intermediate-term bonds have outperformed T-bills in the 12-months following the peak fed funds rate in every cycle over the last 50 years.
- » Earnings declines do not necessarily equate to market losses. Per data from Strategas, stocks were up in nine of the eleven calendar years since 1950 in which earnings declined by more than 10%. Markets look forward.
- » While Fed rate cuts may not happen in 2023, the easing cycle is expected to begin by 2024, which is important as stocks look ahead by 12 months.
- » Within equities, we believe tilts toward the value and yield factors should continue to reward investors on a relative basis in a post-low-rate environment, as should the quality factor (i.e. profitable companies without a high debt burden) as capital becomes harder and more costly to access.

As always, short-term market fluctuations are unpredictable. However, the weakness of 2022 has spawned higher expected future returns in most assets classes, particularly fixed income. We appreciate your confidence in our firm's ability to navigate a challenging 2022 and value your partnership. Please contact us to discuss in further detail.

INTERNATIONAL RETURNS (%)

As of 12/31/2022	Q4 2022	Year 2022	3-Year	5-Year	10-Year
Int'l Developed ex US	17.3	-14.5	0.9	1.5	4.7
Emerging Markets	9.7	-20.1	-2.7	-1.4	1.4

Source: Morningstar

FIXED INCOME RETURNS (%)

As of 12/31/2022	Q4 2022	Year 2022	3-Year	5-Year	10-Year
Aggregate Bond	1.9	-13.0	-2.7	0.0	1.1
Muni	3.4	-8.2	-0.8	1.0	1.6
Int'l Bonds	5.4	-13.8	-4.0	-1.8	-0.9
High-Yield	3.9	-10.1	-0.2	1.7	3.2
Short-Term	1.2	-5.2	-0.4	0.9	1.1
90-Day T-Bill	1.1	2.1	0.9	1.3	0.8

Source: Morningstar

Opus CAPITAL MANAGEMENT
Opus Capital Management
221 East Fourth Street, Suite 2850
Cincinnati, OH 45202
(513) 621-6787 • www.opusinc.com