Market Commentary

Q4 — 2022

DAVIDSON
INVESTMENT ADVISORS

U.S. Equities Market

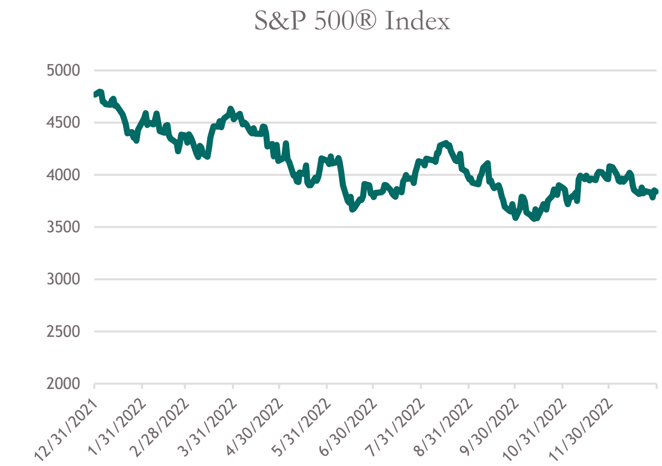
A Very Uncertain New Year

Markets finished the year strongly positive in the fourth quarter, though still down significantly for the year. The S&P 500® Index advanced 7.6% in the quarter, led by positive returns in cyclical stocks within the Energy, Industrials and Materials sectors. Companies in the Consumer Discretionary and Communication Services sectors were in the red as markets became more concerned about consumer spending amid the decline in sentiment and Federal Reserve (Fed) stimulus. The smaller-cap Russell 2000® Index lagged larger companies, but still returned over 6% for the quarter. Growth stocks markedly underperformed their value counterparts by ten percentage points, as highly valued Information Technology and Consumer Discretionary stocks continued to be impacted by higher interest rates.

2022 saw the Fed raise the Federal Funds Rate from 0% to over 4% in the space of 9 months – the steepest and largest Fed reaction in over 40 years. Such a drastic change in the cost of financing changed the dynamics of the market and of investors greatly. As we commented during the year, TINA (There Is No Alternative) gave way to investors now earning over 3% on simple cash assets. Highly-valued stocks, particularly in the Information Technology and Consumer Discretionary sectors, lost a tremendous amount of market capitalization even though earnings of those same companies remained stable or, in some cases, continued to grow. However, with cost of capital significantly above zero, investors and corporations alike are being more discerning as to where and how to invest.

With higher rates comes the higher risk of recession; this has evolved into a debate between bulls and bears as to probability, as well as length. Bullish investors believe the Fed can engineer a "soft landing" due to the strong labor market and a highly resilient U.S. consumer. With inflation slowing, possible future rate cuts could give plenty of fuel for a market rally. Bears, however, have history on their side; the Fed has rarely been exact in its battle against inflationary forces. Those pessimists also point to a slowing industrial economy and a housing market encountering the highest mortgage rates in decades. Even if rates no longer increase, high borrowing costs are hurting investment and big-ticket purchases. Should the labor market follow that weakness, the strongest leg of the U.S. economy could become its strongest headwind. With such a bull-bear tug of war constantly occurring, it is no wonder volatility is increasing.

With slowing growth and the possibility of recession, investors' concerns over corporate profitability are valid. U.S. corporate margins, though impacted by the pandemic, reached new highs as certain travel and entertainment expenses were greatly diminished with pricing power at multi-decade highs. Going forward, high labor and input costs may begin to dent those historically high margins and cause corporate profits to sink. Few are predicting much corporate earnings growth this year, but should margins deteriorate and the U.S. economy slide into a recession, market gains may be difficult to muster.



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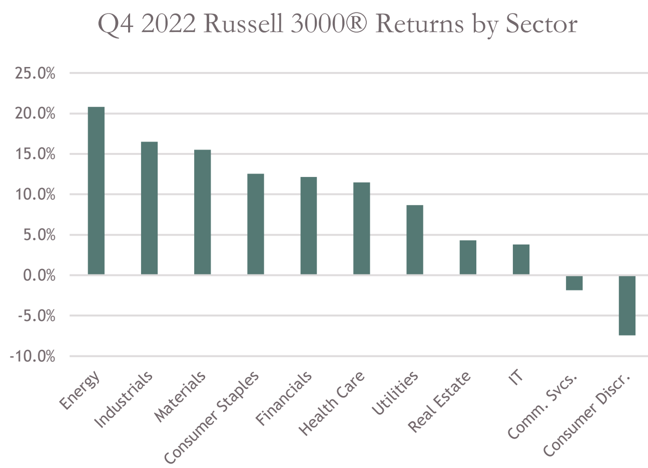

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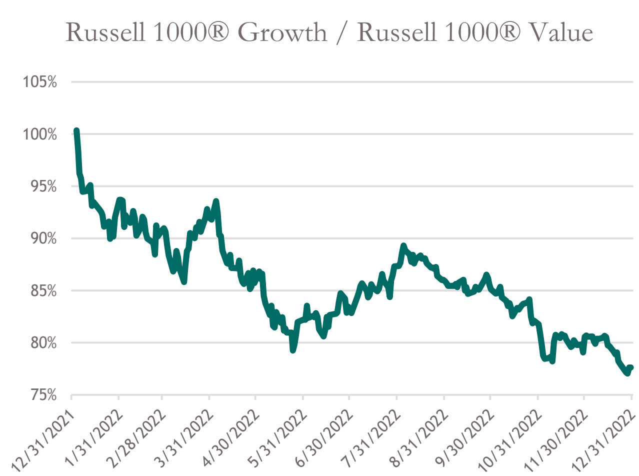

Source: Bloomberg

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Market Commentary

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DAVIDSON INVESTMENT ADVISORS

U.S. Taxable Fixed Income Market

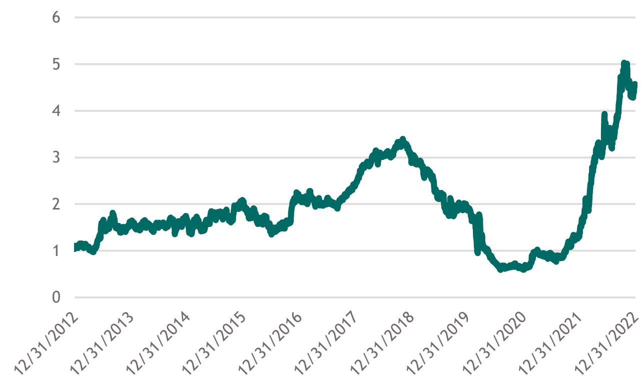
Pause, Pivot, or Panic?

The Bloomberg Intermediate Government/Credit Index gained 1.5% in the fourth quarter of 2022, its only quarterly gain of the year, which brought losses for the year of 2022 to -8.2%. A slowing in the pace of rate hikes from the Federal Reserve (Fed) helped longer Treasury yields come down from their recent peaks and aided spreads during the quarter as well.

For what seems like years now, despite barely being months, there has been much discussion about the impending Fed pause, which would likely be followed by a pivot. Many investors point to the increased likelihood of a recession as the reason for not-too-distant Fed rate cuts. In fact, the median economist surveyed by Bloomberg puts the odds of a recession in the next year at 65%. Another probability of recession based on the Fed's favored near-term forward spread measure sits at roughly that same level. These models say very little about the severity of a recession, and even less about inflation and unemployment (also known as the Fed's "dual mandate"). The lagged reaction by the real economy to Fed policy is why some market participants are calling for a pause in rate hikes relatively soon. It is also why others are calling for a pivot in Fed policy (to lower rates in the latter part of 2023), as evidenced by the Fed Funds futures market recently pricing in a rate cut by the beginning of 2024.

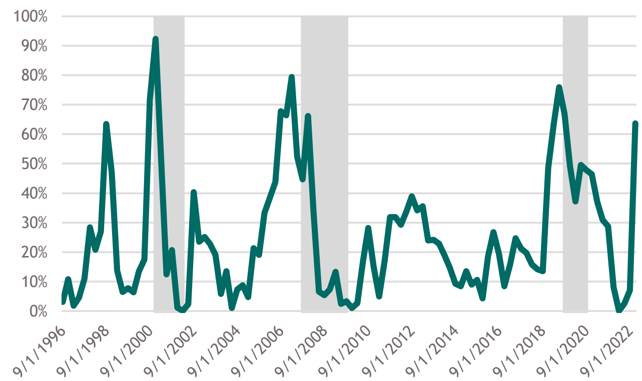
It appears that many investors believe the Fed has already done enough to quell inflation, and by continuing on their current path, they risk allowing price stability to trump full employment in importance, and thus causing undue harm to the economy. However, for the Fed, it is simply not getting bad enough fast enough. If financial conditions remain too "easy" due to the expectation of cuts by the market, then it becomes more likely that the Fed will believe they need to push rates even higher to have their desired effect on inflation. Were this to happen, the likelihood of an orderly Fed pause or pivot would fall, and the chances of a Fed or market panic, accompanied by sharp rate cuts and falling risk appetite, would rise. Patience (something the Fed exercised a great deal of in 2021) from all parties involved would seem the most prudent course of action from here.

Bloomberg Intermediate Gov/Credit Index
Yield to Worst



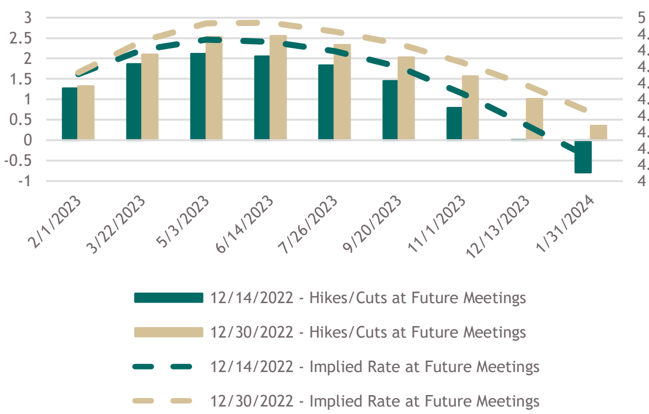
Source: Bloomberg

Near Term Forward Spread Probability of a
Recssion Next Twelve Months



Source: Bloomberg, Davidson Investment Advisors

Fed Funds Futures



Source: Bloomberg

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Market Commentary

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U.S. Municipal Fixed Income Market

Great Expectations, the Fed Version

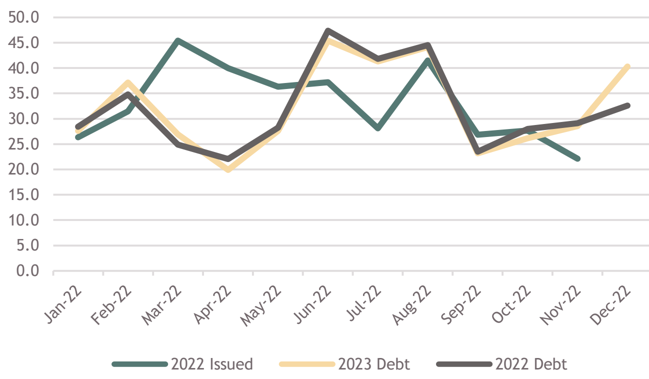
2022 was an exceptionally challenging year for municipal bonds, with the Municipal Market Analytics (MMA) TRR Index reporting its worst annual performance since 1969 and the second lowest return on record. The municipal market dynamics of 2022 were largely a result of the Federal Reserve's (Fed) fight with "transitory" inflation. The result: the quickest rise in the Fed Funds rate since 1979. As of the Fed's December 2022 hike, they raised overall rates twice as fast as during the "conundrum" period, when the Fed increased the federal funds rate 150 basis points from June 2004 to February 2005 while the 10-year Treasury yield remained essentially unchanged.

In many ways, history is repeating itself and we are watching a similar play today. The consensus of the fixed income markets is that the current Fed Funds rate is expected to return to a lower level. As a result, we are seeing longer duration bonds trade at lower yields, with the current municipal yield curve declining approximately 25 basis points over the first 10 years.

In addition, the supply of bonds has been slim, with new issuance dwindling over the last few months. As of January 5, 2023, the 30-day visible supply was only $7.5 billion, compared to $27.5 billion in Bond maturities and interest payments on January 1. This supply imbalance has recently supported a declining yield environment, even with the strong prospect of further Fed rate hikes. The next big wave of maturities peaks later this year in June/July, just as issuance slows for municipalities approaching their June 30 fiscal year-end. Currently, forty-six states use June 30 as their fiscal year end.

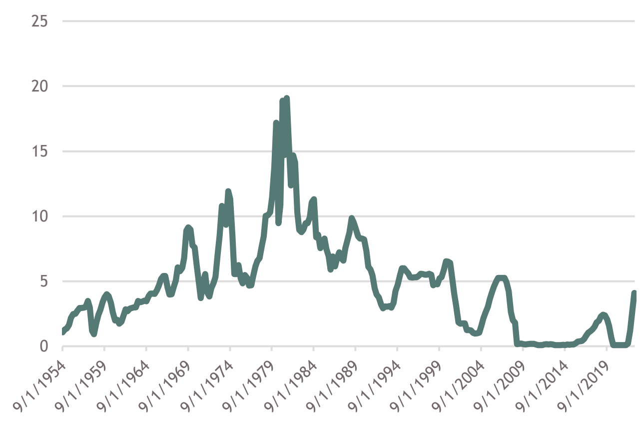
The pace and possible resistance to inflation declines is one of the major factors affecting muni yields this year. Although inflation continues to be stubbornly high, investors are largely betting on an accommodative Fed to reverse recent rate hikes. Interest rate sensitive sectors have slowed, but the overall economy continues to march forward. Therefore, this is a cautious time for many investors. Those betting on declining inflation are extending duration. However, for those that see inflation as more sticky, the recent decline in yields to far below personal consumption expenditures (PCE) levels and the relatively low ratio levels to Treasuries yields have created a reluctance to extend duration. We will continue to add higher-yielding bonds to our portfolios, but we will try to get as much yield as possible without significantly extending duration. Being price sensitive for bond purchases, and carefully bidding bonds, should provide higher returns than passively being a price taker.

2022 Muni Issuance vs 2022 and 2023 Maturities



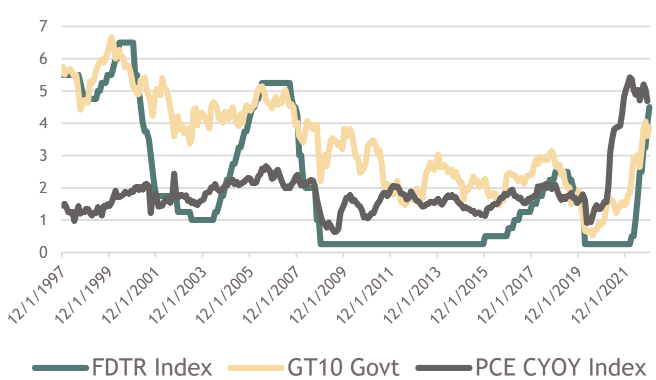
Source: Bloomberg

Fed Funds Rate since 1954



Source: Bloomberg

Fed Funds Rate, 10-Year UST, and PCE Core Y/Y over the past 25 years



Source: Bloomberg

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International Equities Market

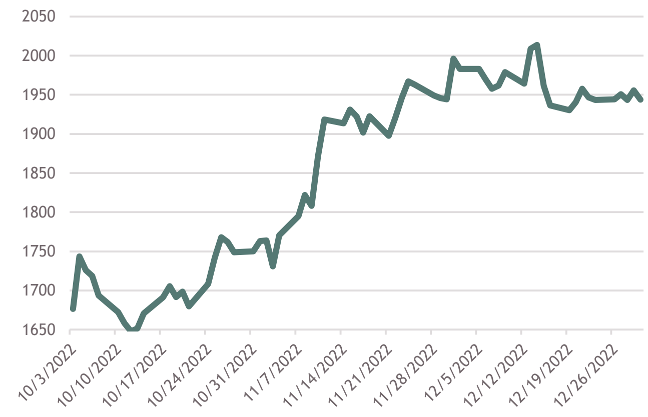
Asia Pivots

International equities recovered during the fourth quarter after three quarters of negative performance – and surprising consensus expectations, international equities outperformed domestic equities for both the quarter and the year. Developed markets, represented by the MSCI EAFE Index, were up 17.3% for the fourth quarter and down -14.5% for the year. Emerging markets finished up 9.7% for the fourth quarter and down -20.1% for the year. The U.S. Dollar followed domestic interest rates over the course of the quarter falling over -6%. Despite this fall, the U.S. Dollar finished the year up over 6%.

The biggest news events for this quarter came from Asia. Japan's central bank surprised investors after announcing it is raising its effective cap on 10-year government bond yields to 50 basis points from 25. Under its Yield Curve Control (YCC) policy, the Bank of Japan has long intervened in the bond market to keep bond yields within its specified target range. The 10-year yield is still pegged at 0% but the wider band relieves market pressure on both the bond and currency markets. More importantly, it restores the central bank's credibility. YCC has proven to be a powerful signaling tool but it was losing its effectiveness as inflation increased over the course of 2022. For now, the Yen has recovered after falling over 20% for the year in October. If inflation pressures decrease, then this change may be all that is needed. Only the passage of time will tell.

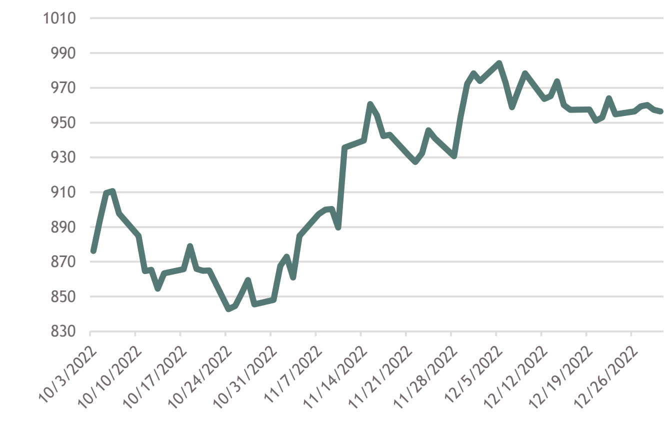
The second major event from Asia came from China. The government announced that it is moving away from its zero-COVID policy after three years of mass testing, lockdowns and centralized quarantines for the infected and their close contacts. After an annual economic conference, Chinese leadership signaled their intention to revive China's weakening economy. There was a distinctive "pro-business" tilt in the messaging. They acknowledged they need to restore consumer and business confidence at home as well as investor confidence from abroad. Specific policies and targets won't be announced until March but the change in tone is positive. One thing is clear, this policy change is bitter sweet for investors. Now, the issue is dealing with the spread of the virus and the associated negative consequences. In addition, a re-opened China, while good for world economic growth, could prolong inflationary pressures and, as a consequence, keep interest rate levels higher for longer. No matter what, the world needs China to return to normal, but that normalization won't be easy and without pain.

MSCI EAFE Index



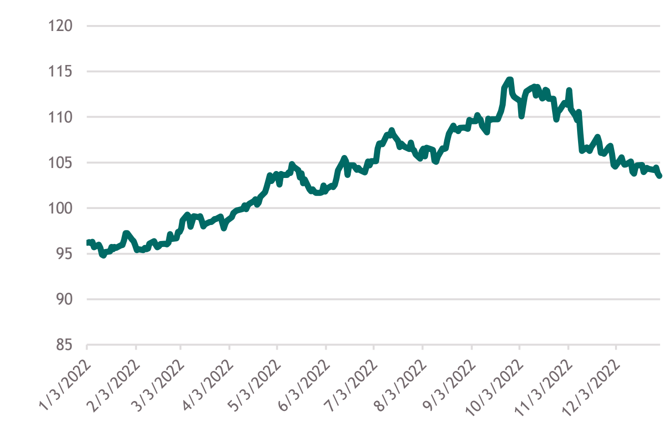
Source: Bloomberg

MSCI Emerging Markets Index



Source: Bloomberg

U.S. Dollar Index Spot



Source: Bloomberg

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The information on indices is presented for illustrative purposes only and is not intended to imply the potential performance of any fund or investment. Index performance assumes the reinvestment of all distributions, but does not assume any transaction costs, taxes, management fees, or other expenses. Indices are not available for direct investment.

The S&P 500® Index is a gauge of large-cap U.S. equities and serves as the foundation for a wide range of investment products. The index includes 500 leading companies and captures approximately 80% coverage of available market capitalization

The Russell 3000® Index measures the performance of the largest 3,000 U.S. companies representing approximately 98% of the investable U.S. equity market. The Russell 3000 Index is constructed to provide a comprehensive, unbiased and stable barometer of the broad market and is completely reconstituted annually to ensure new and growing equities are reflected.

The Russell 2000® Index measures the performance of the small-cap segment of the U.S. equity universe. The Russell 2000 Index is a subset of the Russell 3000 Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership. The Russell 2000 is constructed to provide a comprehensive and unbiased small-cap barometer and is completely reconstituted annually to ensure larger stocks do not distort the performance and characteristics of the true small-cap opportunity set

The Russell 1000® Growth Index measures the performance of the large-cap value segment of the U.S. equity universe. It includes those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values. The Russell 1000 Growth Index is constructed to provide a comprehensive and unbiased barometer for the large-cap value segment. The index is completely reconstituted annually to ensure new and growing equities are included and that the represented companies continue to reflect growth characteristics.

The Russell 1000® Value Index measures the performance of the large-cap value segment of the U.S. equity universe. It includes those Russell 1000 companies with lower price-to-book ratios and lower expected growth values. The Russell 1000 Value Index is constructed to provide a comprehensive and unbiased barometer for the large-cap value segment. The index is completely reconstituted annually to ensure new and growing equities are included and that the represented companies continue to reflect value characteristics

The Bloomberg Intermediate Government/Credit Index measures the performance of U.S. Dollar-denominated U.S. Treasury bonds, government-related bonds (i.e., U.S. and non-U.S. agencies, sovereign, supranational and local authority debt) and investment-grade U.S. corporate bonds that have a remaining maturity of greater than or equal to one year and less than 10 years

The Federal Funds Rate is the interest rate at which depository institutions trade federal funds (balances held at Federal Reserve Banks) with each other overnight.

Personal Consumption Expenditure (PCE) is a measure of inflation that tracks overall price changes for goods and services purchased by consumers; the core index excludes volatile food and energy prices.

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The MSCI Emerging Markets Index is a free-float weighted equity index that captures large and mid-cap representation across Emerging Market countries. The index covers approximately 85% of the free float-adjusted market capitalization in each country.

The MSCI EAFE Index is broadly recognized as the pre-eminent benchmark for U.S. investors to measure international equity performance. It comprises the MSCI country indexes capturing large and mid-cap equities across developed markets in Europe, Australasia and the Far East, excluding the U.S. and Canada. Numerous exchange-traded funds are based on the MSCI EAFE Index, and the Chicago Mercantile Exchange, NYSE Liffe U.S. and the Bclear platform of Liffe are licensed to list futures contracts on this index as well.

The Bloomberg Dollar Spot Index tracks the performance of a basket of 10 leading global currencies versus the U.S. Dollar. It has a dynamically updated composition and represents a diverse set of currencies that are important from trade and liquidity perspectives.

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