STRATIGRAPHIC ASSET MANAGEMENT, INC.

ALAN S. BERNSTEIN

January 10, 2023

To the Clients of Stratigraphic:

Investors in 2022 experienced the worst results since the Financial Crisis of 2008. The S&P 500 Index, our equity benchmark, declined 19.4%. Last year was especially disappointing for fixed income investors who are not accustomed to losing money and trust their bond holdings to cushion equity losses. The Bloomberg U.S. Aggregate Bond Index lost 13.0%. Markets reacted negatively to the Ukrainian conflict, high inflation, steep increases in interest rates, and the global economic slowdown. These factors led to a significant rerating down of equities (lower price/earnings ratios) and a substantial upward adjustment in fixed income yields, causing bond prices to decline.

While negative returns are always unsettling, for long-term investors the losses were tolerable. Even with the poor results last year, 10-year total return of the S&P 500 index was nearly 12% per annum. As a rule of thumb, the total return on common stocks over the very long term has averaged between 8% and 10% per annum. The point is that despite the poor showing in 2022, equity investors have continued to realize returns significantly higher than the long-term average.

The bond market was especially challenged last year as interest rates rose dramatically. The 10-Year Treasury yield increased a whopping 2.5x from 1.510% on December 31, 2021, to 3.875% at the end of 2022. Our strategy in bonds has been to shrink the allocation and to hold more cash. The maturities of our bonds are relatively short, which cushioned the adverse impact of interest rate increases. While the total return on bond portfolios was slightly negative in 2022, compared to the Bloomberg U.S. Aggregate Bond Index, our fixed income holdings substantially outperformed.

In 2023, the market performance of common stocks depends on the resolution of a host of macro uncertainties. The expected continued rise in interest rates tempers our expectations for equity markets in the first half, but for the full year we expect positive returns as investors look to a better 2024. Here is our take on the major issues:

- **Ukraine, Neutral to Positive Outlook**. While there is no evidence to suggest a near term solution is at hand, it is not unreasonable to predict that active fighting could cease in 2023, even if no long-term peace agreement is achieved. The high human and material costs on both sides do not appear sustainable. From the standpoint of investors, what is important is that the Ukrainian conflict has become less impactful on the global economy. Notwithstanding the restrictions on Russian energy exports, global crude and natural gas prices have steadily declined from peak levels at mid-year. Russia and Ukraine are significant exporters of grain and Russia is the largest exporter of fertilizer. While these prices are also off their mid-year highs, they remain elevated and require Russia's consent for Ukraine to export from Black Sea ports. The World Bank recently noted that significant new fertilizer capacity is expected to come online outside Russia over the next two years, restoring capacity and easing prices.[1] Any agreement reached between Russia and Ukraine will be a boon for capital markets and the global economy.

[1] Commodity Markets Outlook, October 2022, World Bank Group, Washington, D.C., page 36.

DOUGLAS ENTRANCE, 804 DOUGLAS ROAD, SUITE 363, CORAL GABLES, FLORIDA 33134
TELEPHONE (305) 447-0300 • WWW.STRATIGRAPHIC.ORG

- **Inflation, Positive Outlook**. The rate of inflation in the next six months is probably the most important determinant of the investment outlook. U.S. inflation peaked in mid-2022 and is currently trending down. How fast the deceleration will be is virtually impossible to project and is a significant risk factor. The Bloomberg consensus of economists who were polled in December holds that the Consumer Price Index and the PCE Price Index (on which the Fed relies) will be at 3% per annum or less in Q4 of 2023. The forecasts from the Federal Reserve estimate inflation rates comfortably under 3% in 2024.[2] Any significant further moderation of inflation will strengthen capital markets.

- **Monetary Policy, Neutral to Moderately Negative**. The Fed Funds target rate rocketed in 2022 from the 0.0% - 0.25% range to its current level of 4.5% – 4.75%. Forecasts from the Fed indicate a peak range of 5.25% – 5.50% around the middle of this year, which implies another hike of 75 basis points.[3] Chairman Powell and the Fed Open Market Committee members who set short term rates are more likely to err by raising interest rates to a higher level than necessary to control inflation, which raises investment risks. While most informed investors should have already taken into account the next leg up in interest rates, hence our “neutral” rating on monetary policy, the possibility that rates may be hiked higher than anticipated (over 5.50%) would have a decidedly negative impact on the market.[4]

- **U.S. Economic Growth, Neutral to Positive**. Notwithstanding the most recent report of the Bureau of Economic Analysis indicating that real GDP grew at 3.2% in the third quarter (which was surprisingly strong), the outlook through next year is for a marked slowing of the economy. Most economists believe that the U.S. economy will experience recession in 2023. However, the economy has been very resilient evidenced by a strong labor market and continued strength in consumer spending. If there is a recession, it will likely be short and moderate. Overall, the U.S. economic outlook seems favorable, especially compared to Europe and Japan.

- **Corporate Profits, Neutral to Negative**. Analyst forecasts for the S&P 500 Index earnings in 2022 and 2023 have been steadily marked down as the economic outlook dimmed. Our best guess is that earnings in 2022 probably declined around 4%. A poll of analysts by Standard & Poor’s forecasts an increase in earnings in 2023 by double digit rates, which seems fanciful. Any growth in corporate earnings will be closer to the trend of mid-to-high single digits, but if there is a recession, no growth is a real possibility. On balance, the corporate earnings outlook near term will be challenging.

- **Market Outlook, Neutral to Positive**. Notwithstanding the uncertainty of corporate profits, the forward price earnings ratio of the market was slightly above its 25-year average of 16.8x, suggesting that the market valuation is reasonable if not cheap. However, any significant downward adjustment in corporate profits in 2023 in the face of higher interest rates could negatively affect the

---

[2] Economic Projections of Federal Reserve Board members and Federal Reserve Bank presidents, December 14, 2022, page 2.
[3] Ibid., “Dot plots” on page 4.
[4] As noted, Fed Chairman Powell will likely push interest rates higher in the first half of 2023. He knows his legacy depends entirely on whether inflation is brought under control. Powell is ever mindful of Paul Volker, who tamed rampant inflation in the U.S. economy in the early 1980s by briefly raising interest rates to 20% (March 31, 1980). No one remembers the recessions and pain Volker caused, but only that he heroically brought inflation under control. The bottom line is that the Fed is likely to overshoot on interest rates, i.e. will raise interest rates to a higher level than necessary to bring down inflation to within a reasonable range of 2% to 3%. No one really knows what peak interest level is required. One leading economist, Larry Summers, believes the Fed should hike short term rates to 6% to bring inflation under control.

> market. The impact will likely be short-lived as investors look to 2024, when the economy and corporate profits are expected to resume growth. Importantly, markets generally advance well before a reduction in the Federal Funds target rate, which seems likely in the second half.

A group of 22 market strategists polled by Bloomberg in December forecast that the market will rise this year around 6.1%; adding to that a dividend yield of about 1.7% results in a 7.8% total return in 2023. While they are likely too optimistic, we expect positive returns. However, it is highly unlikely that the S&P 500 Index will recover near term to its January 2022 high (4797).

Table 2					
S&P 500 Index Levels, Earnings and Price/Earnings					
Current Price Earnings Ratios	2019	2020	2021	2022	2023
S&P 500 Index (at December 31)	3,231	3,756	4,766	3,840	
S&P 500 Index Year-Over-Year Change (Price Appreciation)	28.9%	16.2%	26.9%	-19.4%	
S&P 500 Earnings, 2019, 2020 & 2021 Actual, Standard & Poor's	$157	$122	$208	$200	
S&P 500 Price/Earnings	20.6	29.9	23.6	19.2	
Forward Price Earnings Ratios					
S&P 500 Index (at December 31, 2022)					3,840
S&P 500 Earnings, Estimated, Standard & Poor's (December 30, 2022)					$226
S&P 500 Price/Earnings					17.0
Source: Standard & Poor's, Actual and Estimated S&P 500 Earnings, December 30, 2022; Bloomberg					

Over the long term, we expect common stock returns to be in the mid-single-digit range, which is less than average returns over the last 40 years. This view rests on the belief that global and U.S. economies will experience below trend growth, and profit margins will be pressured by the increased costs of energy, the impact of deglobalization, and higher interest rates. All of these factors will weigh on sales growth and corporate profit margins.

As we noted in our mid-year outlook letter, consumer confidence in the United States has been at historic lows. Although the University of Michigan Consumer Sentiment Index in December recovered from the June bottom (60 vs. 50), the Index remains at around the same level as in the Great Financial Crisis of 2008, which is 30% below the long-term average reading of 85. The current reading indicates that Americans are still discouraged about their prospects. Yet it is hard to understand why. The economy is virtually at full employment. A recession is possible, but it will not be severe. Wages are rising. Inflation is coming under control. Our financial system is sound, and the dollar has rarely been stronger.

The New York-based Eurasian Group, a leading global risk-assessment firm, opened its January 2023 report on the top risks with the following statement:

> We're (mostly) through the pandemic. Russia has no way to win in Ukraine. The European Union is stronger than ever. NATO rediscovered its reason for being. The G7 is strengthening. Renewables are becoming dirt cheap. American hard power remains unrivaled. Midterms in the United States were decidedly normal … and many of the candidates posing the biggest threat to democracy (especially those who would have had authority over elections) lost their races. Meanwhile, Donald Trump is the weakest he has

> been since he became president, with a large number of Republicans preparing to take him on for the GOP nomination.[5]

Recent events in Russia and China bolster the position of the United States on the world stage. Russia is clearly a third-rate power. China has done great harm to its private sector by tamping down its capitalist class, mismanaging COVID, and abusing its debt markets.[6] Given its demographic challenges, the economic growth prospects of China are certainly less than they have been over the past 20 years. Even the risk associated with Taiwan may be les than supposed. A JP Morgan study highlighted that 90% of China's semiconductors are imported of which 70% from Taiwan, which suggests China will not kill the goose that lays their golden egg.[7]

Rumors of the U.S. decline may be exaggerated. John Ikenberry, professor of politics and international affairs at Princeton, recently wrote in Foreign Affairs.

> But in truth, the United States is not foundering. The stark narrative of decline ignores deeper world-historical influences and circumstances that will continue to make the United States the dominant presence and organizer of world politics in the twenty-first century. To be sure, no one knows the future, and no one owns it. The coming world order will be shaped by complex, shifting, and difficult-to-grasp political forces and by choices made by people living in all parts of the world. Nonetheless, the deep sources of American power and influence in the world persist. Indeed, with the rise of the brazen illiberalism of China and Russia, these distinctive traits and capacities have come more clearly into view. [8]

We are moderately optimistic. Maintaining a positive view of the future has consistently paid off in the investment world. Our investment strategy is centered on large-capitalization, established multi-national U.S. companies. This is where we have been invested over the last 10 years to our good fortune and where we will primarily focus our attention in the future.

Stratigraphic Asset Management, Inc.

Under the Investment Advisory Act of 1940, you are entitled to receive a copy of Stratigraphic Asset Management's brochure (Form ADV, Parts II A and B). You may either e-mail us at alan@stratigraphic.com for a copy or go to our web site www.stratigraphic.com where the latest edition is posted and may be downloaded.

[5] Top Risks 2023, Ian Bremmer & Cliff Kupchan, Eurasia Group, January 2023, page 2.
[6] 85% of Chinese property high yield bonds are trading at 20% or less of par value. "2023 Eye on the Market Outlook," Michael Cimbalest, JPMorgan, January 1, 2023, page 8.
[7] Ibid., page 20.
[8] "Why American Power Endures: The U.S.-Led Order Isn't in Decline," G. John Ikenberry, Foreign Affairs, November/December, 2022.