JOURNEYING DOWN THE DISINFLATION ROAD

Market Review **FEBRUARY 2023**

In February, stock market volatility rose as interest rates moved higher. Short-term rates continued to advance due to the interest rate policies directed by the Federal Reserve (Fed). In only twelve months, the Fed raised the federal funds rate from practically zero to almost five percent. As most investors know by now, the past increases are significant, especially when considering the speed at which the Fed took action. Further, these new interest rates can raise uncertainty both financially and emotionally.

Short-term interest rates are rising and chasing prices in the economy. Higher short-term rates generally make borrowing in the economy more expensive, from credit cards and new mortgages to corporate debt. Overhead expenses for companies financing labor and material using short-term debt will also increase. Naturally, market conditions during rising interest rate environments can sour economic demand and bring on disinflation as supply responds to weaker demand. Unfortunately, losing aggregate demand to higher short-term rates can slow economic and financial growth.

After January's strong rebound in stocks, investors became more nervous in February, considering the Fed's interest rate hike pause may be farther away than initially anticipated. February's inflation data may have contributed to slowing this market down. Consumer price increases slowed less than expected, and prices tracked in personal consumption expenditures, the Fed's preferred inflation index, accelerated last month. This data rippled through the markets and likely signaled that the Fed's job as a rate hiker and inflation fighter isn't yet complete.

The inflation problem and the interest rate response have produced a negative gap between long-term and short-term yields. As a result, on an annualized basis, long-term yields earn considerably less than short-term yields. This inverted yield curve creates an investing paradox requiring probabilistic weightings of two extremes. On the one hand, if disinflation settles in quickly, short-term rates can move down and find long-term rates. On the other hand, price increases stubbornly stuck above the Fed's inflation target could mean long-term rates rise to meet short-term. In reality, the future yield curve outcome could be a combination of those two extremes, but the path to get there faces uncertainty.

One area of focus regarding the stock market is the future of company earnings. Corporate earnings declined in 2022 compared to 2021. Profits were down due to slower revenue gains and higher input costs. As a result, profit margins narrowed last year, but the stock market declined in advance of the earnings reports, which is common. But the past is now old news, and investors are more interested in what 2023 will bring for earnings. Current forecasts indicate earnings will grow in 2023 as companies cut expenses and expand profit margins. A meaningful year of growth makes a compelling case for investors to demand stocks. However, expectations regarding the future are always subject to change, and investors will never escape the chance that earnings may stall and slow. Regardless, stock prices actively seek to forecast the future of earnings and profit growth rates.

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The Fed is addressing inflation with higher interest rates in the short run, but the long run plan to maintain low inflation and economic vibrancy likely comes from technological gains and a growing working population. Thankfully, capitalism is pushing the limits of science in fields such as genomics, space travel, nuclear fusion, augmented realities, and artificial intelligence. These technologies can lead to discoveries that can improve lives and reduce costs in a variety of ways. Regardless, stock market volatility can rise and fall for many reasons, which can result in uncertainty and behavioral responses by investors. But stocks perform positively more frequently than they do negatively, and long-term stock investors are generally rewarded with appropriate returns relative to the level of risk. We encourage continued communication on each investor's unique time horizon, risk tolerance, liquidity needs, and various other factors, as those characteristics should ultimately dictate the specific investment mix.

Asset Categories	US STOCKS	FOREIGN STOCKS	US BONDS	FOREIGN BONDS	HARD ASSETS	HYBRIDS
Monthly	-2.04%	-3.52%	-1.43%	-2.78%	-6.26%	-1.73%
Year to Date	5.58%	4.36%	1.40%	0.50%	1.89%	4.67%

*DATA USED IS SOURCED FROM MORNINGSTAR®, DATE ENDING FEBRUARY 28, 2023

US STOCKS

US Stocks gave back some of last January's gains in February. Overall performance dipped -2.04% on average, slowing the average year-to-date return to 5.58%. The category average of small-caps finished last month with a -2.56% loss, which lowered the year-to-date return to 7.81%. In addition, the large-cap category average declined by -2.56%, bringing the year-to-date return to 3.24%.

FOREIGN STOCKS

Foreign Stocks slowed in performance in February as a result of the increased volatility. As a result, the year-to-date average finished at 4.36% due to a -3.5% loss in February. Emerging markets experienced losses of -5.62% last month. In two months, emerging markets have returned 2.14%. Developed market equity produced monthly returns of -2.50%, placing year-to-date returns near 5.50%.

US BONDS

US Bonds lessened in value last month as interest rates rose. As a result, broad losses tallied to -1.43% by month-end, causing year-to-date returns to narrow to 1.40%. Intermediate and corporate bond losses experienced larger declines last month relative to other bond market segments. The respective monthly returns finished at -2.23% and -2.96% in the two categories. Last month's performance reduced respective year-to-date returns to 0.38% and 1.03%. Bank loans gained a modest return of 0.44% last month. The loan category stands ahead of the rest, with 3.00% earned this year.

FOREIGN BONDS

Foreign Bonds experienced an average decline of -2.78% in February, cutting the year-to-date returns to 0.50%. Global bonds dropped -3.05% to finish last month. The category has been somewhat flat for investors since the beginning of the year, with returns of -0.02%. In addition, emerging market bonds declined -2.51% last month. Last month's losses narrowed the year-to-date return to 1.03% for emerging markets.

HARD ASSETS

Hard Assets experienced the most market volatility relative to the other asset categories in February due in part to precious metals. Precious metal losses were -12.29% last month, sending the year-to-date return into a deficit of -2.78%. Real Estate also rolled back as monthly returns declined -4.90%. But the real estate category hangs on with 4.23% year-to-date returns. Overall, hard assets broadly declined by -6.26% in February and captured 1.89% since the beginning of the year.

HYBRIDS

Hybrid Assets declined in February, similar to the other asset categories. The category loss is -1.73%, with losses spread almost evenly between preferred stocks and convertible debt. However, the overall year-to-date return of 4.67% is more asymmetrical. Investors have become attracted to preferred stock this year. Its category average has returned 6.78% this year. Convertible debt has not performed as strongly as preferred stock but has still respectably returned 2.57% since the beginning of the year.

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