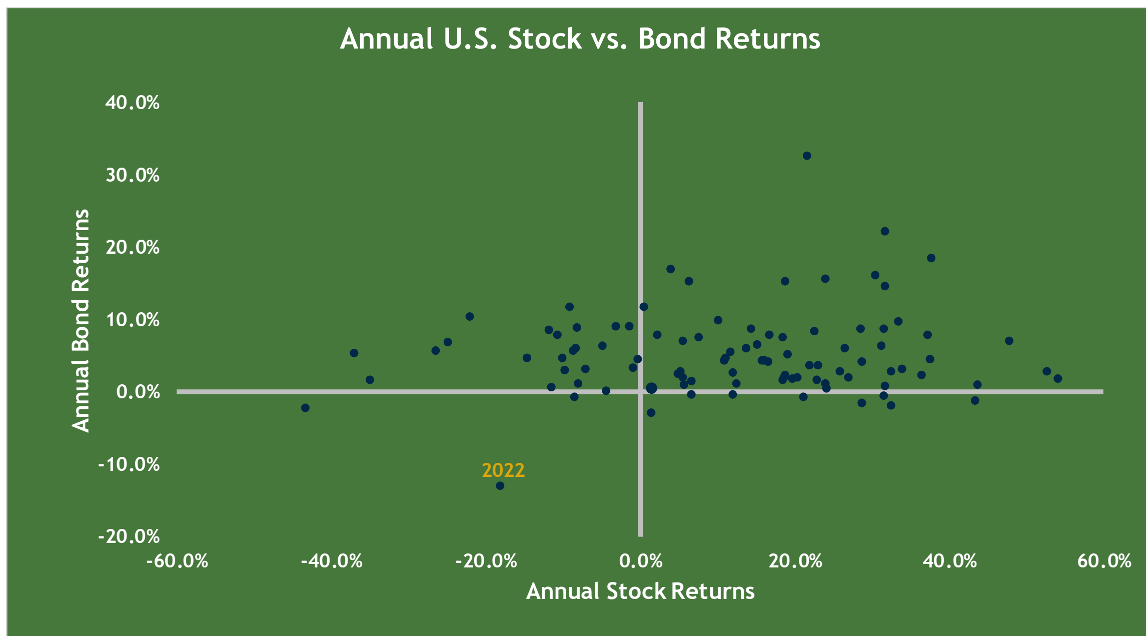
SAGE
FINANCIAL GROUP

2022 REVIEW:

- 2022 was a year that tested investors' resilience, patience, and focus. After three consecutive years of positive returns, markets quickly changed direction in 2022. Several factors drove this shift, including:
    - Inflation, which continued to exceed expectations.
    - The war in Ukraine brought human tragedy and exacerbated inflationary pressures on food and energy prices.
    - A strong multi-year bull market in U.S. stocks left market valuations towards the higher end of their 25-year range.
    - The Federal Reserve's decision to raise interest rates at the fastest pace of monetary policy in the U.S. over the last 40 years.
- 2022 was unprecedented as investors experienced the first calendar year in over 100, in which both stocks and bonds fell by double digits.
    - Bonds were hit particularly hard relative to history. Investment-grade bonds have been down only 11 of the last 96 calendar years. In 2022, they declined by more than 5% for the first time ever.
    - The U.S. equity market was also unkind to investors, as higher interest rates and the anticipation of slower future economic growth beat down global stock prices. U.S. large-cap stocks fell 19.1% for the year in what proved to be a meaningful reset of valuations. U.S. mid- and small-cap stocks declined by 17.3% and 20.4%, respectively.
    - International stocks fell 16.0%, and emerging market stocks declined by 20.1%.
    - The graph below illustrates the annual returns of stocks and bonds, with each blue dot representing a different calendar year.



Source: Sage Financial Group, FactSet, CFA Institute, Morningstar Direct. U.S. Large-Cap Stocks represented by the S&P 500. Returns are total returns and include dividends. U.S. Intermediate Term Bonds represented by the Ibbotson® SBBI® US Intermediate-term (5-Year) Government Bonds Index from December 31, 1925 through December 31, 1975. Represented by the Bloomberg U.S. Aggregate Index from January 1, 1976 to Present. Returns are total returns. Data as of December 31, 2022. Data as of December 31, 2022.

- Sage's approach to portfolio management remained steadfast throughout 2022. Rather than trying to time the markets or overreact to current events, we maintained a disciplined strategy that involved rebalancing (seeking to buy low and sell high) through market fluctuations and diversifying the allocation of investments within portfolios.
- Beginning in early 2021, Sage made several changes to further diversify portfolios in anticipation that traditional asset classes would be challenged.
    - As appropriate, we added numerous nontraditional funds, including alternative bonds, infrastructure, and real estate, in anticipation of an economic slowdown and the possibility of recession.
    - We also reduced clients' exposure to more interest rate-sensitive equity funds where possible.
- While it is important to pay attention to performance and continually consider how it could impact your unique financial picture, we don't let volatility distract us from our investment objectives, time horizon, and client goals. Over the long term, financial returns are driven by economic growth, inflation, and productivity growth (i.e., innovation).

2023 ECONOMIC OUTLOOK:

- Financial markets are forward-thinking. So even though the economic backdrop may remain harsh, we expect investment market conditions to be more stable in 2023.
    - A slowing global economy should create a more favorable environment for financial markets.
        - Equity markets tend to bottom 3-12 months before economic growth hits a trough, and valuation metrics such as price-to-earnings ratios are either close to or below average in many areas of the globe due to price declines.
        - Fixed income returns have more cushion from higher yields. Investment grade bonds now have rates of yield-to-maturity of over 5% for the first time in a decade.
    - However, economic conditions may vary by geographical region in 2023:
        - In the U.S., we believe the economy will continue to grow slowly, likely between 0% to 2% in 2023, which is below the long-term historical average of 3%.
        - In Europe, it appears increasingly likely there will be consecutive quarters of negative economic growth in the first half of 2023.
        - In emerging markets, we expect growth to rebound following the conclusion of central bank hiking policies and normalization of China's COVID policy.
- That being said, we don't know what unforeseen developments may evolve, just as we could not have predicted COVID, Russia's invasion of Ukraine, China-U.S. tensions, etc. Therefore, to guard against the unknown, client portfolios are constructed for many potential scenarios.

2023 KEY ECONOMIC THEMES

We believe three themes are likely to have a meaningful impact on the broader economy and, subsequently, financial markets:

1. **Personal Savings Remain a Tailwind But That May Fade**
    - Households accumulated more than $2 trillion in excess savings from March 2020 through June 2021. Since then, households have drawn down nearly $1.2 trillion to help offset the rising costs of goods and services.
    - Looking ahead, consumers will likely continue spending their excess savings, but the pressures of higher prices are clearly beginning to weigh on them. Thus, if pandemic-era excess savings are depleted before incomes can catch up to higher prices, we may see a more pronounced decrease in spending.
    - Consumer spending comprises 70% of the U.S. economy, and a slowdown would temporarily weaken the economy and assets such as stocks and lower-quality bonds. In contrast, we would expect higher-quality bonds to fare well, along with select alternatives such as infrastructure and multi-strategy funds.
2. **Consumer Spending Behavior Returns to Pre-2020 Trends**
    - E-commerce was a key beneficiary of the shift in consumer behavior throughout 2020. Online retail spending spiked as most states restricted mobility.
    - Over the last decades, consumer spending on services, including travel and dining, increased to 70% of total spending. But in 2020 and much of 2021, these activities were restricted, and consumers splurged instead on goods they could purchase online at home.
    - In our view, a return to the longer-term spending trend favoring services should alleviate pressure on the broader economy and could mean less inflationary pressures, as supply chains are built for the mix of goods and services purchased before the pandemic.
3. **The Fed's Tightening Impacts Jobs**
    - In 2022, the Fed Funds rate changed faster than it had in 30 years.
    - Initially, the labor market demonstrated resiliency. But as we approach a full year of higher interest rates, the shift will likely weigh on jobs.
    - For investors, "bad news is good news."
        - A softening of the labor market, including a rise in unemployment, will signal the Fed that it could end interest rate increases. This shift could benefit global equities.
        - However, if the Fed's measures lead to only a modest rise in unemployment, a future period of rate cuts would increase the value/pricing of high-quality fixed income. All else equal, for bonds with limited or no assumed default risk, as interest rates fall, bond prices rise.

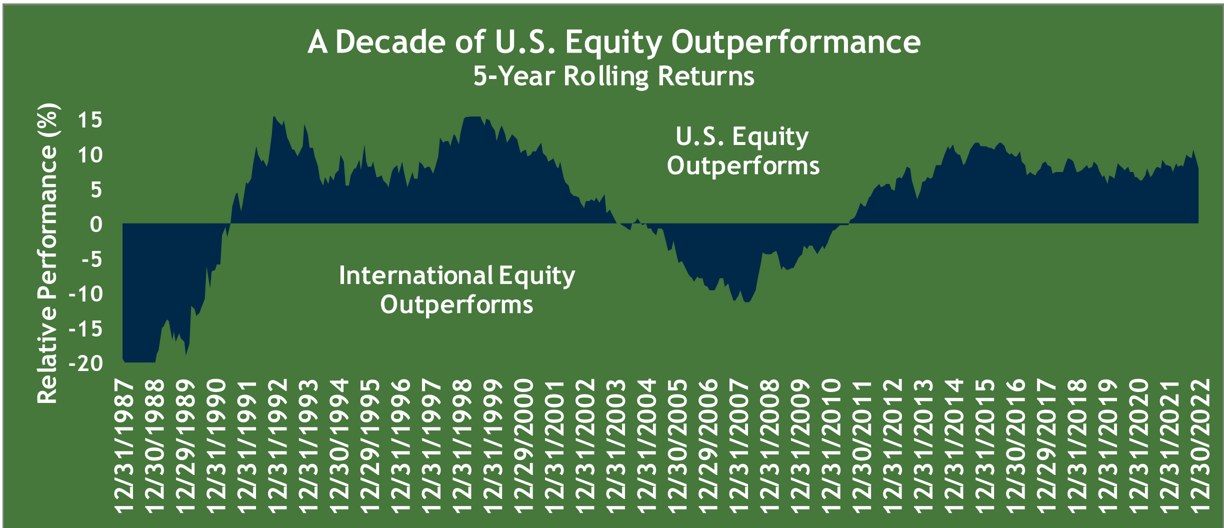
FIXED INCOME MARKET OUTLOOK: Historically, Higher Bond Yields Lead to Higher Returns

- In the Federal Reserve's resolve to fight inflation, it increased interest rates at an unprecedented pace in 2022, resulting in a 4.25% higher fed funds rate than at the beginning of the year.
- A silver lining of this rise is an increase in the potential for better future bond returns heading into 2023.

  - We believe current yield levels provide an attractive starting point for investment-grade bond returns.
  - Over time the fixed interest from bonds can be reinvested at a higher rate, generating more potential income.
- Historically, five-year returns of investment-grade bonds tend to track pretty closely to yield-to-maturity. Currently, investment-grade yields are north of 5% for the first time in a decade.
- In particular, if the Fed does become more accommodative in 2023 to stimulate the economy, we believe it is reasonable to expect mid-single-digit bond returns in the year ahead following a dismal year.
- We continue to believe that the best approach is to hold a mix of bond types to prepare for various outcomes.
  - There is an opportunity to own longer maturity bonds in a diversified fixed income allocation that offers considerable levels of income and potential cushion should equity volatility persist over the year.
  - We are balancing this scenario against the possibility that the Fed continues to increase interest rates for longer than expected due to persistently high inflation.

EQUITY MARKET OUTLOOK: Following a Reset in Valuations

- Overall, we think that equity markets will have no shortage of headwinds in the year ahead, including slowing economic growth and a test of corporate earnings. However, we expect that the forward-looking nature of markets and much more reasonable valuations could help cushion downside volatility in 2023 and boost returns.
- In the year ahead, corporate earnings should drive equity returns. Profitable companies with the ability to generate stable cash flows should weather the potential of an economic downturn.
- Markets anticipate changes in the real economy, typically between 3-12 months ahead of when they appear in economic data. We expect stocks to rally before the economic data turns uniformly positive.
- It has not always been easy to stand by our conviction that shifting capital into a geographically diversified allocation is prudent. Since 2011, U.S. equities have led international equities over any five year period. However, outperformance of U.S. vs. international equities tends to rotate over time (see chart below), and while risks remain, there are some recent positive economic developments to note around the world:
  - In China, a recent policy pivot away from a Zero-COVID approach, along with fiscal support for the embattled property sector, now makes the world's second-largest economy a potentially attractive investment opportunity as it appears poised for a strong recovery in 2023.
  - In Europe, data is holding up better than expected, equity market valuations are below historical averages, and elevated dividend yields offer a favorable entry point, if a recession can be avoided.



Source: Sage Financial Group, FactSet. U.S. Equity represented by the total return of the Russell 3000 Index. International Equity represented by the net return of the MSCI EAFE from 12/31/1982 through 12/29/2000. Thereafter represented by the MSCI AC World ex US Index. Data shown are 5-year rolling returns from 12/31/1982 through 12/30/2022.

As always, we will continue to closely monitor, analyze, and evaluate market, geopolitical, and economic data, consider any implications for investors, and advise you of significant developments that could impact your investments.